Thesis: A Comprehensive Study: The Information Content of Large Book Tax Differences on Earnings Persistence & Firm Characteristics

Bertram Essay: The Black Swan Pandemic & The Board of Directors: A Shift in Priorities

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Introduction:

Earnings management is the use of accounting techniques to produce financial statements that present an overly positive view of a company's business activities and financial position. Many accounting rules and principles require that a company's management make judgments in following these principles. Earnings management takes advantage of how accounting rules are applied and creates financial statements that inflate or "smooth" earnings. One way to manage earnings is to report high income on the financial statement and low tax income on the tax forms. For example, I show that firms which invest heavily in fixed capital expensive assets, CAPEX in accounting technical terms, report larger incomes to their shareholders compared to when they report to the tax authorities. Contrarily companies with high research and development expenditure record small earnings on their financial accounting statements, strangely when it comes to filing their tax income the numbers are higher than that. This means there is a difference between book income and tax income, which I name book tax difference abbreviated with BTD in my thesis. So I study the question why large positive and large negative book-tax differences are associated with lower earnings persistence. I look at other aspe3cts of this relation as well, for example I ask can the combination of being in large BTD and having low earnings quality be evidence of firms getting in financial trouble in the future. Or I ask why capital intensive and R&D intensive firms associated with lower corporate earnings quality in the large positive and large negative BTD groups respectively show growth or earnings fraud.

Earnings Management & Corporate Governance

The board of directors can play both a direct and indirect role in minimizing manipulative activity and controlling accountant's actions not to misreport and inflate the numbers. Directly by the selection of reputable, trust worthy managers and directly supervising and oversighting the activities and financial reports. Indirectly through putting in place auditors, hiring management consulting experts etc. The management may try to keep the real numbers and the true nature of the firm hidden from the board of directors. In the absence of a strong and organized governing team, the management can potentially take advantage of this weakness and not act in the best interest of shareholders. For example they may commit tax fraud, move stock prices and report false income. Based on the research showing shareholder-manager relationship it is the responsibility of the board of directors to protect and oversee the interests of shareholders. Knowing this in advance, the board should design can take action to prevent this action, for example it can write and sign contracts that disincentivize accountants from reporting false financial and tax numbers. Regarding the relevance of my Bertram study to corporate governance research, it is most relevant to Canadian directors especially in the context of the 2020 COVID-19 crisis. In this study I ask what the impact of the COVID-19 crisis is on the corporate governance practices of firms in Canada's oil & gas industry, and then I discuss the impact of COVID-19, and examine how corporate governance practices have been affected and conclude with recommendations of policies to be adapted by firms in principle to cope with pandemics of this magnitude. Therefore, the focus of my study is the shift in the agenda and priorities of the Board of Directors' based on their fiduciary responsibilities to the financial stakeholders of the firm, the shift from a shareholder-focused board to a senior-debt-focused board, and how Boards of Directors of Albertan energy companies such as CNRL, Suncor and Husky handled the shift from a shareholder focus to a senior debtholder one. A prominent example is the change we observed in Suncor's financial strategy. Suncor announced a $1.5 Billion cut in capital spending for their 2020 annual budget in order to preserve cash. On April 8th, Suncor Energy raised $1 billion in new debt by issuing 10-year bonds, primarily to pay down currently existing and maturing debt. On May 5th, the company made a statement declaring a 55% slash in cash dividend payments. It lowered production and planned to lower its utilization rates in 2020 by almost 10%. All the actions taken by Suncor represented actions to preserve liquidity, limit cash leakage and preserve valuable long-term assets.

Major Findings & Contribution:

My dissertation findings provide tools to plan ahead for future unwanted outcomes. My BTD variables when combined and interacted with the low earnings persistence numbers can act like the canary in the coal mine, signaling corporate scandals, bankruptcy, tax or earnings fraud, before things get out of control and becomes too late.

First, I introduce alternative sources that explain how earnings persistence relates to earnings management. Second, I find what accounting variables in the balance sheet create abnormally large gap between financial earnings and tax income. Third, I explore the conditions under which discretionary accruals act as a strong indicator of change in persistence. As a complementary study the explanatory power of large BTDs is examined in bankruptcy prediction models. The thesis study is unique in that it is the first to comprehensively investigate the large negative aspect of BTDs, and to explain previous findings on large negative BTD sample. Beside earnings, the cash flow component results inform us of the real effects of strategic investment uncertainty and risk. Impacting the operations of a firm, large fixed investments can destabilize operating, financing and investing cash flows.

My major contribution to both the academic world and business world is to identify the major drivers of these differences between book and tax income, especially for the large negative BTDs. Capital and R&D expenditure are only two of the main accounting items creating large BTDs, and my work recognizes the further need for expansion into more complete disclosure of the book-tax differences. Future researchers can identify and look further into these matters, which I believe in return can assist not only investors but also board directors to do a better job in managing the company affairs.