I investigate the role of book-tax differences in indicating the persistence of earnings, accruals, and cash flows for one-period-ahead earnings. I also examine whether the level of book-tax differences influences investors' assessments of future earnings persistence. I find that firm-years with large book-tax differences have earnings that are less persistent than firm-years with small book-tax differences. Further, the evidence is consistent with investors interpreting large positive book-tax differences (book income greater than taxable income) as a “red flag” and reducing their expectation of future earnings persistence for these firm-years. I then investigate potential sources of the lower persistence for firm-years with large book-tax differences. I find that special items contribute in part to the results but that firm-years with large book-tax differences continue to have lower persistence in earnings after controlling for the effect of the special items.
Finally, we show that industry-wide cash flows is the most persistent component of earnings while firm-specific accruals is the least persistent, suggesting that economic fundamentals and accounting constructs are jointly informative about firms’ future earnings. The market predictably misprices these components, however, significantly underweighting the persistence of industry-wide cash flows and overweighting the persistence of firm-specific accruals. Book-tax-conformity-earnings-persistence-and-the-association-between-earnings-and-future-cash-flows_2010_Journal-of-Accounting-and-Economics.pdf. Uploaded by. Zhang Peilin. Book-tax conformity Book-tax differences Usefulness of earnings Earnings persistence Future cash flows. 1. Introduction. abstract. We suggest that firms operating in countries with lower required book-tax conformity will report greater book-tax differences, resulting in more unexplained cross-sectional variation in current tax expense. Thus, we infer the degree of required book-tax conformity in a country from the amount of observed variation in current tax expense that cannot be explained by the variation in pre-tax earnings, income from foreign operations, and dividends. Accrual and cash-basis methods recognize revenue and expenses at different times. Here are the advantages and disadvantages of each method. Cash basis accounting is easier, but accrual accounting portrays a more accurate portrait of a company's health by including accounts payable and accounts receivable. The accrual method is the most commonly used method, especially by publicly-traded companies as it smooths out earnings over time. Accrual Accounting Method. Revenue is accounted for when it is earned. Typically, revenue is recorded before any money changes hands. Unlike the cash method, the accrual method records revenue when a product or service is delivered to a customer with the expectation that money will be paid in the Calls for eliminating differences between accounting earnings and taxable income in the US have been debated extensively. Proponents of increased book-tax conformity argue that tax compliance will increase and earnings quality will improve. Opponents argue that earnings quality will decline. We examine whether the level of required book-tax conformity affects earnings persistence and the association between earnings and future cash flows. We develop a comprehensive book-tax conformity measure and find that earnings have lower persistence and a lower association with future cash flows when... Book-tax conformity Book-tax differences Usefulness of earnings Earnings persistence Future cash flows. year. 2010.