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.

This content is only available as a PDF.

American Accounting Association
2005

You do not currently have access to this content.
We show how tax bases are defined, describe one-book and two-book accounting systems and further discuss advantages and disadvantages of the existing accounting systems. Moreover, we show how different types of corporate tax systems work and provide examples how countries apply the corporate tax systems discussed. Further, we discuss avoidance mechanism of triple taxation. After explaining the legal framework for corporations, we present a Standard Model for corporations taking taxes into account. In particular, we discuss the cases of financing the initial investment by retained earnings or n... Hanlon, M.: The persistence and pricing of earnings, accruals, and cash flows when firms have large book-tax differences. 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