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The Persistence and Pricing of Earnings, Accruals, and Cash Flows When Firms Have Large Book-Tax Differences

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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.

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