THE CHOICE OF ACCOUNTING STANDARDS UNDER COMPETING TAX AND EXTERNAL REPORTING PREFERENCES: EVIDENCE FROM INTANGIBLE ASSET REPORTING IN SMALL PRIVATE FIRMS

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OVERVIEW

What?

We investigate small private firm reporting choices in
1) a disclosed reporting preference setting
2) with tax-accounting links.

Why?

- Implications for the development of the national and international reporting frameworks, such as IFRS for SMEs
- Implications for evaluating financial and tax reporting alignment

How?

2014 Swedish accounting regulation change when all Swedish private firms had to explicitly choose between K2 and K3 reporting standards.

WHAT DO (SMALL*) PRIVATE FIRMS WANT FROM THEIR REPORTING?

Private firms are tax oriented

Private firms aim to inform their external stakeholders

Overall external reporting orientation?

Specifics on the reporting preferences?

Interplay between **financial and tax reporting** preferences?

Earnings management / quality measures as proxy for tax orientation (e.g. Burgstahler et al. (2006))

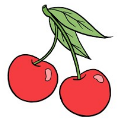
Investigations of **specific accounting choices** in the context of changing tax regulation (e.g. Kosi & Valentincic, 2013)

Voluntary IFRS adoption for **consolidated accounts** (Bassemir, 2018; Bassemir & Novotny-Farkas, 2018)

GAAP reporting choices for **consolidated accounts** (Lisowsky & Minnis, 2020)

THE SETTING – SWEDISH REPORTING OVERHAUL IN 2014

	Reporting regulation pre-2014	Reporting regulation 2014 and onwards
Small legal entities	**ÅRL (SAAA)** **RR (SFASC)** **BFN (SASB)** Some flexibility present: 1. Areas with little guidance beyond ÅRL 2. Competing guidance from RR and BFN 3. Areas with only RR guidance but leeway from BFN to deviate	**Explicit** choice between K2 (rules-based; tax oriented) and K3 for legal entities (basis: IFRS for SMEs (2009))
Medium & large legal entities		**Mandatory** adoption of K3 for legal entities (based on IFRS for SMEs (2009))
Privately held groups		**Mandatory** adoption of K3 for groups (based on IFRS for SMEs (2009))
Groups with listed parent companies (shares or bonds)	IFRS	IFRS



SIZE THRESHOLDS

	Micro firms	Small firms
Asset size	<EUR 2 million	<EUR 4 million
Revenue size	<EUR 2 million	<EUR 8 million
Number of employees	<10	<50

Medium & large firms

Our main sample: 4,130 independent legal entities making an accounting standard choice

PRINCIPLES OF THE ALTERNATIVE STANDARDS

In 2014, small* private firms had to choose between these two financial reporting standards:

K2	K3
Simpler, aligned with tax reporting	More complex, more emphasis on high-quality accounting for capital providers
Rules-based; less discretion in some respects	Principles-based (**IFRS-for-SMEs**); more reporting options available to companies
Less disclosure	More disclosure
Less administrative costs	More administrative costs

FINANCIAL VS TAX REPORTING CHOICE

Choice considers costs and benefits:

- K3 better* reflects economic performance → External reporting oriented
- Costs to prepare and disclosure costs
- Tax-linked areas affect the timing of tax

Topic	K2	K3	Accounting-Tax-linked?	Tension
IGIAs / R&D	No capitalization	Choice between expense model and capitalization model for development costs	Yes	Better* reporting under K3, but preparation costs and tax timing
PP&E	Tax rules can be applied in some areas; no revaluation	Revaluation permitted; components approach for subsequent costs; useful life applies, sophisticated impairment test.	No, there are generally specific tax rules	Better* reporting under K3, but higher admin costs


K2 i praktiken
PwC:s handbok vid
tillämpning av K2
pwc
K3 i praktiken
PwC:s handbok vid
tillämpning av K3
Tredje reviderade och utökade upplagan
pwc
Studentlitteratur

1. REPORTING STANDARD CHOICES

14 %

of the small independent legal entities chose K3

2. DETERMINANTS OF THE STANDARD CHOICE – ARCHIVAL EVIDENCE

Areas with tax-accounting link
- Internally generated intangible assets reported in 2013

Expected choice: K3

Areas without tax-accounting link
- PP&E intensity in 2013

Expected choice: K3

Overall tax orientation
- Tax burden (tax/sales)
- Discretionary allocations to a profit periodization reserve (Pre-tax profit-reducing)

Expected choice: K2

External orientation
- Bank debt
- Trade credit

- External CEO
- Board size
- Big 4 auditor

Expected choice: K3

2. DETERMINANTS OF THE STANDARD CHOICE – ARCHIVAL EVIDENCE

Panel A: Choice Models

	(1) $K3_{ft+1}$	(2) $K3_{ft+1}$
$IGIA_{ft}$	2.2699***	2.5598***
	(0.3926)	(0.4415)
$HIGH\_TAX_{ft}$	-0.4840***	-0.4899***
	(0.1386)	(0.1451)
$PROFIT\_RESERVE_{ft}$	-0.2718*	-0.2559*
	(0.1476)	(0.1510)
$IGIA_{ft}$ * $HIGH\_TAX_{ft}$		0.1138
		(1.2410)
$IGIA_{ft}$ * $PROFIT\_RESERVE_{ft}$		-0.7990
		(0.7742)
$BOARDSIZE_{ft}$	0.0853**	0.0850**
	(0.0376)	(0.0375)
EXT_CEO_{ft}	1.3016***	1.3063***
	(0.1042)	(0.1070)
$BIG4_{ft}$	0.6443***	0.6448***
	(0.1358)	(0.1354)
PPE_TA_{ft}	-0.4754	-0.4585
	(0.3363)	(0.3333)
LEV_{ft}	0.3404	0.3277
	(0.4950)	(0.4925)
$TRADE_{ft}$	-0.7896	-0.7191
	(1.7409)	(1.7206)
	(0.0826)	(0.0839)

2.DETERMINANTS OF THE STANDARD CHOICE – ROLE OF IGIAS AND TAX

Table 3 Panel B: Predicted Probabilities of Adopting K3

IGIA * Tax preference	P($K3_{ft+1}$)	P($K3_{ft+1}$)
IGIA=0, no tax preference	15.6%	15.6%
IGIA=0, strong tax preference	10.0%	10.0%
IGIA=1, no tax preference	48.4%	54.0%
IGIA=1, strong tax preference	34.6%	28.5%

3. DETERMINANTS OF THE K3 CHOICE: SURVEY EVIDENCE

Panel A: Survey sample construction		
	Number of represented firms	Number of individuals serving as CEO / chairperson
All voluntary K3 adopters, active and independent 2013-2015	725 firms	684 individuals
Identified correspondence address for the CEO or chairperson of the voluntary K3 adopters	604 firms	584 individuals
Survey response received	226 firms	219 individuals (37.5%)
Survey response used	209 firms	202 individuals (34.6%)

3. DETERMINANTS OF THE K3 CHOICE: SURVEY EVIDENCE

Initiators of the K3 adoption choice (N=202; multiple possible)		
Auditors	63%	
Accountants	27%	
Firm owners	17%	
Other	6%	
Banks	**1%**	→ Consistent with archival results
Not identified	10%	

Identified drivers of the K3 choice (N=202; multiple possible)		
Long-term planning considerations	**36,6%**	→ Expect to grow; plan for sale
IGIA reporting	**12,9%**	→ Future orientation:68% do not report IGIAs
Deferred tax accounting	**10,4%**	→ Reporting transparency demands
Components approach	**9,4%**	
Lease accounting	4,5%	
Administrative costs	3,0%	
Other	12,9%	
Do not remember	39,1%	

4. ECONOMIC DEVELOPMENTS

- **Debt financing:** no difference between K2 and K3 adopters
- **Cost of debt:** no difference between K2 and K3 adopters
- **Trade credit:** no difference between K2 and K3 adopters
- **M&A involvement** (becoming part of a group within 3 years)

M&A activity, archival sample				
$IGIA_{f,2013}$		K2	VOL_K3	Total
	0	12.3%	11.6%	12.2%
	1	-	**23.3%**	23.3%
Total		12.3%	12.3%	12.3%

M&A activity, survey sample			
Driver	0	1	Total
Long-term planning considerations	10.4%	**26.5%**	16.1%
IGIA reporting	16.5%	13.0%	16.1%
Deferred tax accounting	16.1%	15.8%	16.1%
Components approach	14.9%	**26.3%**	16.1%
Lease accounting	15.8%	**22.2%**	16.1%

SUMMARY OF MAIN RESULTS

- **14 %** of small independent firms adopt K3
- **Key drivers of the K3 choice**: IGIA reporting, long-term considerations, tax accounting, tax orientation (tax burden)
  - External financing providers **not** identified as drivers of this choice
- **No divergence** between K2 and K3 adopters in external credit outcomes…
- … but some evidence that accounting presentation choice caters to **equity transaction parties**

ADDITIONAL ANALYSIS AND ROBUSTNESS CHECKS

Test	Result
Analysis of foregone income tax reduction due to IGIA capitalization in 2015	0.7% of sales or about 70% of total tax burden
Extent of R&D capitalization in small subsidiaries, i.e. weaker tax-accounting links	3.4% of small subsidiaries report IGIAs; 2.8 higher frequency than small independent firms.
Additional distance-to-threshold controls	Similar results
Comparisons between mandatory and voluntary K3 adopters	Voluntary K3 adopters more likely to report IGIAs and have lower tax burden
Analysis of K3 choice across the continuum of the tax burden	Nonlinear; tax considerations most pronounced in the top quartile of the tax burden
Expanding IGIA measure to better capture R&D activity	Stronger evidence for tax considerations in IGIA reporting decisions, and K3 choice
IGIA capitalization as loss avoidance technique	Some evidence for loss avoidance behavior

SUMMARY

- ✓ We directly observe competing tax and external reporting incentives shaping private firms’ financial reporting choice
- ✓ IGIA reporting is a strong driver of the reporting choice for private firms
- ✓ Firms are willing to incur extra tax burden to be able to report IGIAs
- ✓ The true level of IGIA reporting is likely suppressed by tax links
- ✓ **We exploit a clean setting allowing us to directly observe the accounting-tax trade-off, contributing to the insights on:**
  - Private firm reporting choices and voluntary reporting incentives
  - Regulation of accounting for intangibles
  - As well as to regulation of private firm accounting rules

SAMPLE

Sample Selection Procedure	Sample Attrition	Firm observations
Legal entities in 2014		**431,180**
Less state-owned companies	-1,895	429,285
Less subsidiaries	-138,413	290,872
Less inactive companies	-34,389	256,483
Less firms that do not provide financial information for 2013 to 2015	-31,831	224,652
Less micro firms (2 out of 3: less than 10 employees and assets or revenues less than SEK 2 million)	-217,510	7,142
Firms with identified reporting standard in 2014	**-1,413**	**5,729**
Less mandatory K3 adopters	-291	5,438
Less missing required financial data		4,130
Final sample voluntary K3 and K2 firms		**4,130**