I examine the relation between book-tax differences (BTDs) and earnings growth. Because financial accounting rules afford managers more flexibility and discretion in reporting than tax accounting rules, prior studies suggest that large differences between book and taxable income indicate lower quality (or less persistent) earnings. Lev and Nissim and Hanlon provide evidence that BTDs contain information about future firm performance, but the nature of the causality in this relation is not clear. While BTDs could proxy for earnings quality, they may also reveal underlying economic events or management’s private information about future performance or simply predict future reversals in effective tax rates. I divide total BTDs into their measurable components: temporary (deferred taxes) and non-temporary (permanent differences and tax accruals), and test their relation with the components of net income changes: pretax earnings changes and tax expense changes. I hypothesize that the non-temporary component of BTDs is negatively related to future changes in tax expense, whereas the temporary component of BTDs is negatively related to changes in future pretax earnings. I also examine the maintained hypothesis that the lower earnings growth for large BTD firms is due to earnings management. I use various proxies from prior literature to identify firms potentially managing earnings and test whether the presence or absence of suspected earnings management activity alters the relation between BTDs and earnings changes. My results provide compelling evidence that permanent BTDs are related only to future changes in tax expense, and temporary BTDs are related to changes in pretax earnings. These results are robust to multiple sensitivity analyses, including a replication of the sample and methodology of Lev and Nissim. The results also hold in the case of firms not suspected of earnings management. Overall, my study suggests that it is only the temporary component of BTDs that is related to future firm performance, with non-temporary differences being related to future tax expense changes, and that these results are primarily due to underlying economic factors, not earnings management.
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