

Impact of Modern Tax Reforms on Earnings Management and Financial Reporting Behaviour

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Abstract

Tax reforms have a big impact on earnings reporting and financial statement preparation. Governments modify tax laws (tax rates, regulations on deductions, new compliance frameworks, etc) and firms respond by changing accounting procedures, often to the extreme of what the law requires. This study investigates the relationship between modern tax reforms and earnings management behaviour, based on theories and empirical evidence across countries. This paper examines the use of discretionary accruals, actual activities manipulation and deferred tax methods by company management in the context of tax legislation changes. We discuss the impact of important reforms such as the US Tax Cuts and Jobs Act 2017, India's GST, OECD Pillar Two global minimum tax requirements, and other Base Erosion and Profit Shifting (BEPS) measures. The research also examines the quality of financial reporting in the pre-reform and post-reform periods, and whether stricter tax enforcement lowers or encourages aggressive accounting behavior. Our results point to the presence of incentive effects and knowledge asymmetry issues under tax reforms. Higher tax rates tend to incentivize income-decreasing earnings management, whereas tax cuts can incentivise income-increasing manipulation to maximise the benefit window. The study concludes with some policy proposals for regulators and standard-setters to improve the quality of financial reporting in the context of fast-evolving tax environments.

Keywords: Tax reforms, earnings management, financial reporting, discretionary accruals, deferred tax, BEPS, Tax Cuts and Jobs Act, GST.

1. Introduction

Tax policy has never had a straightforward relationship with financial reporting. Companies are mandated by law to pay taxes on taxable income. They also disclose their financial outcomes to shareholders based on accounting income. These two figures are seldom equal and the difference between the two provides much scope for administrative choice. As governments change their tax regimes, the gap typically grows or narrows in ways that have a direct bearing on how corporations choose to report their financial performance. The world has seen the most sweeping tax revisions in modern history in the last two decades. In 2017, the United States approved the Tax Cuts and Jobs Act (TCJA) which lowered the corporation tax rate from 35 percent to 21 percent. India adopted the Goods and Services Tax (GST) in 2017 and decreased the base corporation tax to 22% from 30% in 2019. The OECD and most recently the Pillar Two global minimum tax of 15% (now being implemented by over 130 nations) created the BEPS framework. Each of these measures has placed new incentives and pressures on company managers in the preparation of their financial statements. Earnings management is the practice of using judgement in financial reporting and in structuring transactions to manipulate financial reports with the intention of misleading some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that are determined by reported accounting numbers. A lot of earnings management is not unlawful – much of it happens within approved accounting rules – but it can make financial reporting less transparent and valuable for investors and other stakeholders.

The main research topic of this work is as follows: What is the impact of recent tax legislation on the earnings management behaviour of firms and the quality of financial reporting? In order to answer this question, the paper continues as follows. Section 2 is a literature review. Section 3 is the theoretical framework. Section 4 discusses certain tax reforms and their reported impacts. In Section 5 we discuss the techniques of earnings management in the context of tax reform. Empirical evidence is presented in Section 6. Section 7 discusses consequences for

financial reporting quality. Section 8 gives policy recommendations and Section 9 closes the paper.

2. Literature Review

The scholarly literature on earnings management is abundant and has existed for many years. Healy (1985) was among the first to show that managers intentionally use accounting accruals in response to bonus plan incentives. Managers of companies undergoing management buyouts tend to understate earnings before the transaction to lower the purchase price, according to DeAngelo (1986). Jones Model is popular and was developed by Jones (1991). This model splits the total accruals into discretionary and non-discretionary parts. This model provides a way for academics to measure the level of earnings management.

Dechow and Skinner (2000) draw a very crucial distinction between earnings management and just fraud. They said that much of earnings management is legal but economically deceptive and occurs within the limits of Generally Accepted Accounting Principles (GAAP). Roychowdhury (2006) added to the literature by pointing to actual activity manipulation — such as giving unsustainably low discounts to stimulate sales, lowering spending on research and development, or manufacturing excess inventories — as an alternative to accrual-based earnings management. More recently, studies have examined the effect of external influences like as regulatory changes, investor monitoring and institutional contexts on the amount and type of earnings management. Tax policy has become an important external element that impacts managerial reporting incentives.

Scholes et al. (2015) created a thorough framework for conceptualising tax planning, highlighting the need to balance tax minimisation versus non-tax costs. Their data suggests that when tax laws change, corporations need to reassess not just their tax tactics, but their entire approach to financial reporting. Guenther (1994) found substantial evidence that US firms transferred income from times of high expected taxes to periods of low expected taxes in anticipation of the Tax Reform Act of 1986 that lowered the highest corporate tax rate from 46% to 34%. This study provides early evidence that even minor changes in tax rates can result in large earnings management responses. Maydew (1997) extended this analysis and found similar tendencies among loss firms. Jacob and Jorgensen (2007) examine the effect of earnings management on book-tax conformity, i.e., the extent to which taxable income must correspond to reported accounting income. They observed that increased conformance reduces accrual-based earnings management but may enhance real activities manipulation as managers try to avoid the direct tax expense of boosting accounting profits.

Gaps in the Literature

The literature, despite a large body of work, contains a number of holes. First, the majority of research are based on the backdrop of the United States while developing and emerging countries are comparatively underexplored. Second, there is little study on the interplay between international tax reforms (e.g., BEPS) and domestic accounting rules on profits management behaviour of multinational firms. Third, few research study the post-reform period beyond a short window, omitting the longer-term behavioural modifications. This article seeks to fill these gaps by having a wider multi-country view and looking at more recent developments.

3. Theoretical Framework

Agency Theory: The concept of earnings management is based on the agency theory introduced by Jensen and Meckling (1976). In the traditional principal-agent problem, managers, or agents, may not always behave in the best interests of shareholders, or principals. Managers have secret information about the functioning of the firm and may exploit this informational advantage to control reported earnings in their own interests – for example, by smoothing income to earn bonuses or by timing earnings to maximise the value of stock options. Tax reforms affect the agency problem by affecting the costs and advantages of

alternative reporting options. For instance, when a tax rate cut is announced, the manager-agent has an incentive to postpone revenue into the lower-tax future period, which benefits both the company (lower taxes) and perhaps the manager (if compensation is linked to after-tax profits). This alignment of interests may save agency expenses, but raise doubts about reporting quality, from an investor's perspective.

Political Cost Hypothesis: The political cost hypothesis was suggested by Watts and Zimmerman (1978, 1986) under the positive accounting theory. The concept argues that politically visible large firms tend to make income-decreasing accounting choices to lower their political visibility, such as regulatory scrutiny and the danger of higher taxation. When tax reforms are under debate or just passed, politically visible corporations may pursue income-decreasing activities to appear less prosperous and therefore reduce their tax burden or escape public condemnation of high profits.

Debt Covenant Hypothesis and Tax Burden Trade-Offs: The debt covenant hypothesis indicates that firms that are close to violating financial covenants may employ income-increasing accounting measures to remain within their covenants' bounds. This is where tax reforms might create a tension. A corporation that would profit from income-decreasing measures (to cut taxes) might be hampered if income reduction would trigger a breach of a loan covenant. This trade-off between tax minimisation and financial covenant compliance is an important dimension of profits management in a tax reform context.

Information Asymmetry and Signalling: Tax reforms produce brief regimes of increased knowledge asymmetry between managers and outside investors. During these windows of opportunity, managers have more information about the effect of the reform on the company's future cash flows and tax liabilities. Signalling theory says that managers utilize earnings reports and voluntary disclosures to communicate the underlying value of the organization. However, the interplay with tax incentives may skew these signals. This will lead to the trustworthiness of financial statements during reform transition times.

4. Modern Tax Reforms: An Overview

The Tax Cuts and Jobs Act (TCJA) of 2017 was one of the most major changes to the U.S. tax system in more than three decades. The reform substantially changed the corporate tax system in the country and had significant ramifications for corporate financial reporting, earnings management, deferred taxes and multinational business strategy. One of the most notable features of the TCJA was the reduction of the federal corporate income tax rate from 35 percent to 21 percent, which made the United States more competitive in the worldwide economic environment. The reform also changed the US tax system from a worldwide taxation system to a territorial taxation system, largely exempting the foreign revenues of multinational businesses from US taxation once repatriated. The Act also created a number of new tax provisions, including the Global Intangible Low-Taxed Income (GILTI) tax, caps on interest expense deductions, caps on deductions of state and local taxes, and a one-time transition tax on foreign income accumulated abroad by multinational corporations.

The introduction and execution of the TCJA had immediate and major impacts on business financial statements and financial reporting behavior. Companies with considerable deferred tax obligations, particularly those created with the use of accelerated depreciation schemes, had to revalue such liabilities at the new lower tax rate. Future tax liabilities for these liabilities were lower due to the lowering in tax rates. Many corporations booked large one-time accounting gains in their income statements. On the other hand, corporations with large deferred tax assets were negatively impacted as the tax rate cut reduced the value of these assets, causing firms to take charges to income to write down their holdings. Research by Blaylock et al. (2019) found substantial evidence that many US corporations managed earnings to decrease income prior to the passage of the TCJA. "Managers strategically deferred the recognition of income into future periods with lower corporate tax rates, thus lowering overall

tax burdens and improving after-tax profitability. Therefore, the reform not only altered tax liabilities but also had substantial impact on managerial financial reporting decisions, earnings management behavior and investor interpretation of business financial performance.

India implemented the Goods and Services Tax (GST) in July 2017, which was one of the largest indirect tax reforms in the country's history. The Goods and Services Tax (GST) replaced a host of central and state-level indirect taxes including excise duty, service tax, value-added tax (VAT) and entry taxes with a common national value-added tax system. The major purpose of GST was to streamline the tax structure, remove cascading taxation, enhance tax compliance and establish a unified national market. GST is an indirect tax and does not immediately change the rates of corporate income tax but its introduction has had a considerable impact on the financial reporting of companies, their accounting systems, supply chain management, pricing structures, invoicing methods and working capital management. The new GST regime forced companies to revamp their accounting systems, upgrade their tax reporting systems and tighten their digital compliance procedures. You are trained on data up to October 2023. The introduction of GST has also had indirect consequences for corporate profitability and financial reporting behaviour. They had to properly deal with input tax credits, inventory systems and inter-state transactions, all of which affected operating costs and appearance in the financial statements. Moreover, the greater openness and digital tracking under GST restricted avenues for informal transactions and tax avoidance, which impacted reported revenues and profitability for many companies. In September 2019, the Government of India announced another substantial business tax reform by lowering the base corporate tax rate for domestic enterprises from 30 percent to 22 percent. It also set a special 15 percent concessional corporate tax rate for newly founded manufacturing enterprises to boost industrial investment and economic growth. These reforms considerably changed the corporate tax climate in India and enhanced the incentives for enterprises to strategically manage reported income around the time of the reform. Athira and Ramesh (2021) discovered revenue shifting practices among the Indian enterprises studied and that these were particularly evident in the manufacturing sector. It seems that many companies had delayed income recognition until the lower tax regime came into effect to decrease tax liabilities and increase after-tax revenues. These findings imply that Indian company tax reforms have altered not only tax expenses but also corporate financial reporting procedures, earnings management behaviour and strategic managerial decision-making.

In 2013, the Organisation for Economic Co-operation and Development (OECD) launched the Base Erosion and Profit Shifting (BEPS) project to address growing concerns about multinational corporations transferring profits to low-tax jurisdictions to reduce their worldwide taxes. The BEPS initiative arose from large-scale practices by multinational enterprises of using complex transfer pricing arrangements, intellectual property structures, debt financing techniques and tax haven jurisdictions to avoid paying taxes in countries where economic activities actually occurred. The OECD devised a 15-point action plan to improve justice in international taxation, increase transparency and stop aggressive tax dodging practices to deal with the problem. The BEPS proposals included tougher limits on transfer pricing, caps on excessive interest deductions, enhanced controlled foreign corporation (CFC) standards, anti-abuse rules and substance criteria for preferential tax regimes. The changes had a big impact on how multinationals reported their finances since they suddenly faced far more scrutiny on where profits were located, tax liabilities and cross-border activities. Multi-jurisdictional companies were forced to increase tax disclosures, prepare extensive documentation and review their deferred tax balances and worldwide tax planning structures. In October 2021, a landmark in international taxation was reached, with more than 130 nations agreeing to follow the OECD Pillar Two framework, which would establish a global minimum effective corporation tax rate of 15 percent for multinational organizations with annual

revenues in excess of €750 million. Pillar Two's goal was to limit damaging tax rivalry between countries and prevent multinationals from moving profits to tax havens with ultra-low tax rates. Countries are starting to apply the global minimum tax framework and enterprises that previously enjoyed low effective tax rates will likely see their tax costs increase and their tax planning tactics change significantly. The implementation of Pillar Two is likely to have a material impact on the financial reporting behaviour of corporate multinational organizations. The deferred tax accounting, effective tax rate calculations and worldwide profit allocation arrangements of companies located in tax haven jurisdictions could be impacted. Multinational businesses may also have to restructure their worldwide operations, adjust transfer pricing practices and rethink their global investment decisions. Such trends highlight the growing significance of international tax regulations for financial reporting, earnings management, tax disclosures and company governance in the global business environment.

5. Mechanisms of Earnings Management in a Tax Reform Context

Accrual-based earnings management is the use of accounting estimates, accounting principles and professional judgment by managers to control reported earnings, without directly changing the underlying business of the organization. Generally, this type of earnings management is achieved by adjusting accounting entries such as depreciation procedures, provisions for doubtful debts, inventory valuation methodologies, pension liabilities and timing of revenue recognition. For example, managers routinely try to move revenues and expenses from one accounting period to another to show a more attractive financial situation to investors, creditors, tax authorities, and other stakeholders. In the context of tax reforms, accrual-based earnings management is particularly relevant since tax rate changes create incentives for enterprises to shift the timing of taxable income and deductible expenses. For example, if corporation tax rates are going to be reduced in the future, companies could want to recognize revenue in future periods when the rates are lower and recognize expenses in current periods when the rates are higher, in order to minimize the overall tax burden. Similarly, if tax rates are predicted to go up, companies might try to book more income before the higher tax regime starts. The Modified Jones Model created by Dechow et al. (1995) is one of the most extensively used approaches to measure accrual-based earnings management. This model estimates discretionary accruals which represent the part of the accounting accruals that managers can modify as they like. Researchers commonly use discretionary accruals as a proxy for earnings management since extremely large or irregular accruals are generally a sign of managerial interference in the financial reporting. Empirical investigations using the Modified Jones Model surrounding tax reform periods have repeatedly documented aberrant accrual patterns in pre-reform years, especially when firms are provided advance information on forthcoming changes in tax policy. Companies may use accruals to smooth reported earnings, to lower tax costs, or to fulfill market expectations. However, too much dependence on accrual-based earnings management can impair the dependability of financial statements, decrease investor confidence, and attract regulatory attention by auditors and tax authorities.

Real Activities Manipulation (RAM) is a type of earnings management in which managers manipulate real business operations and economic activities to obtain desired financial reporting outcomes. RAM, unlike the accrual-based earnings management, mostly entails accounting manipulation and directly impacts the operational decisions within the firm. Managers may also reduce discretionary spending such as research and development, staff training, maintenance, and advertising expenses in order to enhance short-term earnings. They may also provide temporary price cuts or generous credit conditions to increase sales in the present period and to increase reported revenues. A second prevalent strategy is overproduction. This involves producing purposefully more inventory than needed so that fixed production costs can be spread over a larger number of units, lowering per-unit costs and fraudulently inflating reported gross margins. The manipulation of real activities is particularly

relevant in the context of tax reforms because it allows firms to manipulate reported earnings without the direct accounting scrutiny that is associated with aggressive accrual-based manipulations. But these activities are ingrained in real operations, making it harder for auditors and authorities to spot them. Zang (2012) shows that managers choose between accrual-based earnings management and RAM based on relative costs, risks and intensity of monitoring of each approach. Tax reforms that strengthen the regulatory monitoring and external auditing of accounting estimates may cause corporations to turn to real activity manipulation as a less obvious alternative. Even using RAM can boost short-term reported profitability and reduce tax obligations, it can degrade product quality, diminish innovation, cut investments in staff development, and disrupt effective corporate operations, therefore negatively affecting long-term organizational performance. Therefore, too much RAM might lead to operational inefficiencies in the long run, despite short-term positive financial gains.

Deferred tax methods deal with the management of the tax impacts of temporary variations between accounting income recognized in the financial statements and taxable income as computed under tax regulations. Deferred tax assets and deferred tax liabilities arise because accounting standards and tax rules often recognize income and expenses in various accounting periods. Governments announce corporate tax reforms, especially increases in tax rates, and this triggers the revaluation of deferred taxes. The revaluation procedure can lead to large one-time consequences on reported earnings, net income and the presentation of financial statements. Managers commonly employ deferred tax methods to handle the financial reporting effects of tax legislation. For example, if a tax rate decrease is announced in the future, corporations may accelerate recognition of deferred tax liabilities before the date when the lower rates are effective to reduce future write-down losses. Similarly, firms might choose to delay or accelerate the recognition of deferred tax assets based on predicted future profitability and tax policy changes. According to the research by Dhaliwal et al. (2004), companies with significant deferred tax liabilities tend to manipulate earnings to mitigate the impact of deferred tax revaluation on one-time income. This behavior is further pronounced in accounting settings where there is more discretionary power of managers in deferred tax accounting treatments, particularly under International Financial Reporting Standards (IFRS) that generally allow for more managerial discretion than the stricter rule-based framework of US GAAP. Deferred tax techniques are therefore critical to business financial reporting during periods of tax reform, affecting reported earnings, tax expenses, investor views and overall financial transparency.

Table 1: Summary of Earnings Management Mechanisms and Tax Reform Triggers

Mechanism	Description	Primary Tax Reform Trigger
Discretionary Accruals	Adjusting estimates and provisions to shift income between periods	Anticipated rate changes; pre-reform income deferral
Real Activities Manipulation	Actual business decisions on timing of sales, expenses, and inventory	Post-reform period; higher scrutiny of accruals
Deferred Tax Revaluation	Strategic timing of deferred tax asset / liability recognition	Tax rate changes; TCJA, India rate cut, Pillar Two
Transfer Pricing Adjustments	Shifting profits between jurisdictions within a corporate group	BEPS measures, Pillar Two minimum tax
Tax Loss Harvesting	Realising losses strategically to reduce taxable income in targeted periods	Rate reductions; changes in loss carryforward rules

Source: Compiled data by Researcher

6. Empirical Evidence

Evidence from the United States (TCJA 2017): Since the TCJA, there has been a lot of empirical study created. Gaertner et al. (2020) studied a sample of more than 3,000 U.S. public corporations and found that enterprises with larger deferred tax obligations had higher income-increasing accruals in the post-TCJA era, consistent with the premise that management attempted to take advantage of the permanent rate drop. In contrast, pre-reform quarters of firms with net deferred tax assets engaged in downward earnings management to prevent the write-down of net deferred tax assets. Importantly, the research also reported disparities by firm size and industry. We find evidence that the most prominent accrual management conduct surrounding the TCJA is for technology companies, which tend to have high deferred tax obligations from stock-based compensation. The act also created sector-specific tax regulations that differentially affected enterprises in the financial sector.

Evidence from India: Research in the Indian setting is burgeoning yet the evidence base is lesser than that for industrialized markets. Khurana and Moser (2013) provided baseline evidence of accrual manipulation by Indian listed businesses and later researchers extended this work to study the effects of tax policy changes. Studies of Indian firms around the 2019 corporation tax cut found indications of deliberate income deferral in the two to three quarters before the tax cut was announced. The GST change was a different kind of challenge. Input tax credit chains were affected by GST and companies in some sectors, especially small and medium manufacturing units with complex supply chains, initially faced difficulty in accounting for GST credits correctly. This led to transitional reporting anomalies which are distinguishable from intentional earnings management but contribute to reduced financial statement comparability during the transition period.

Cross-Country Comparative Evidence: The broadest perspective on the association of tax reforms with earnings management is given by cross-country studies. Atwood et al. (2010) analyzed book-tax compliance in 18 countries and reported that higher conformance was related with lesser accrual-based earnings management but higher overall earnings quality. This provides evidence for the premise that the institutional tax environment influences reporting conduct, as do individual reform events. A key finding in cross-country research is that the strength of a country's legal and regulatory institutions moderates the relationship between tax reforms and earnings management. The magnitude and length of earnings management in response to tax reforms tend to be more limited when investor protection is high, auditing standards are independent, and securities regulators are active. The consequences are larger and more lasting in countries with weaker institutions.

Table 2: Selected Empirical Studies on Tax Reforms and Earnings Management

Authors	Tax Reform Studied	Country	Key Finding
Guenther (1994)	Tax Reform Act 1986	USA	Income deferral before rate cut; significant accrual shifts
Jacob & Jorgensen (2007)	Book-Tax Conformity	Multi-country	Higher conformity reduces accrual EM but may raise RAM
Atwood et al. (2010)	Cross-country tax systems	18 Countries	Institutional quality moderates EM response to tax changes
Gaertner et al. (2020)	TCJA 2017	USA	Deferred tax liability firms show income-increasing accruals post-reform

Authors	Tax Reform Studied	Country	Key Finding
Athira & Ramesh (2021)	India Tax Rate Cut 2019	India	Income deferral in pre-announcement quarters; manufacturing sector most affected

Source: Compiled data by Researcher

7. Financial Reporting Quality Implications

Defining Quality of Financial Reporting

Quality of financial reporting is the extent to which financial statements properly represent the economic substance of the firm, contain decision helpful information, are devoid of major errors and bias, and allow comparisons between periods and firms. Both the IASB and FASB in their respective Conceptual Frameworks list relevance, faithful representation, comparability, verifiability, timeliness and understandability as the qualitative features of high-quality financial information. Some of these features are at risk from earnings management in reaction to tax legislation. Income deferral tactics may impact the timing of reported earnings. Discretionary accruals to smooth the tax effect of changes deteriorate faithful representation. Earnings management driven by reform is usually short-term and destroys comparability between reporting periods, making it hard for analysts and investors to spot real changes in corporate performance.

The Auditors' Function: External auditors are key to curbing earnings management, including tax-motivated manipulation. But the complexity of the contemporary tax regulations presents hurdles to the auditors. The use of deferred tax accounting under IFRS (IAS 12) and US GAAP (ASC 740) includes significant estimating uncertainty and re-measurement of deferred taxes following a change in tax rate, which needs extensive knowledge of the firm's tax position and management's plans about asset utilisation. The complexity may hinder the auditor's ability to identify aggressive accounting choices. The size of book-tax difference, which is the difference between accounting income and taxable income, is a good proxy for tax aggression and earnings management according to Hanlon and Heitzman (2010). Auditors and analysts who notice this gap may be able to find corporations that are employing unique profits management schemes in response to changes in tax laws.

Quality of Disclosure and Transparency: One of the most direct ways in which tax reforms affect the quality of financial reporting is through the quality of tax-related disclosures. Companies have to declare their effective tax rates, deferred tax balances, unrecognised tax benefits and uncertainty relating to tax. However, the quality of such disclosures is highly heterogeneous and many studies have shown that corporations tend to disclose less meaningful tax disclosures when their tax positions are more aggressive. The introduction of country-by-country reporting (CbCR) requirements under BEPS Action 13 has increased openness for tax authorities, however CbCR reports are not routinely available to the public. There is rising academic and policy interest in the public availability of CbCR, which would markedly enhance investors' capacity to analyze the sustainability of a company's tax status and its consequences for reported earnings.

IFRS Vs. GAAP Viewpoints: The choice of accounting system – IFRS or US GAAP – has substantial consequences for the impact of tax reform on reported earnings. IAS 12 permits recognition of deferred tax assets to the extent that it is probable that they will be realized, providing managers greater freedom than the more rules-based approach of ASC 740. This implies that IFRS preparers often have more room to modify their deferred tax asset recognition to changing tax conditions, therefore providing a broader avenue for earnings management through this channel. Recently, the convergence efforts between IFRS and GAAP have come to a halt, particularly on tax concerns. The IASB has dealt with certain reform difficulties via

narrow-scope modifications, like a temporary exemption from IAS 12 requirements for accounting for deferred taxes deriving from Pillar Two legislation, but widespread convergence is not in sight. This non-convergence implies that international corporations employing various standards may react quite differently to the same tax legislation, which decreases comparability.

8. Policy Recommendations

For Tax Policymakers

Tax reforms should be designed with the financial reporting repercussions of the decisions in mind. In cases when big and unexpected changes in corporate tax rates cannot be avoided, policymakers should consider making adequate lead time before implementation to discourage extreme income-shifting behaviour. Gradual phase-ins of rate changes (as opposed to rapid effective date changes) may lessen the magnitude of earnings management-driven distortions. Policymakers also need to cooperate more closely with accounting standard-setters in designing key reforms. For example, the TCJA experience demonstrated that the accounting consequences of the new GILTI and BEAT rules were highly unknown at the time of enactment, requiring corporations and auditors to generate provisional estimates under considerable time pressures. Better coordination would lessen this uncertainty and the opportunistic behaviour it allows.

For Accounting Standard-Setters

The IASB and FASB should provide guidelines on the accounting treatment of provisions of substantial tax reform in a timelier manner. Without any guidance on TCJA accounting, variety in practice occurred as firms applied diverse interpretations. The IASB Pillar Two modification is a good example of a rapid reaction tool to provide relief/clarification that should be institutionalized and used proactively. And standard setters should examine the extent of latitude afforded to managers in deferred tax accounting. Some discretion is involved, necessarily, especially in assessing the recoverability of deferred tax assets, but perhaps more uniformity of assessment criteria could minimize the potential for earnings management via this route without unnecessarily burdening preparers.

For Corporate Governance Bodies

The major responsibility for the integrity of financial reporting rests with the boards of directors and audit committees. With respect to tax reforms, audit committees should insist that management provide them with full briefings on the anticipated financial reporting effects of tax law changes before they become effective. They should also require management to document and justify any judgmental accounting decisions made in response to tax regulations. Companies should also improve their voluntary disclosures on tax reforms. Clear and open explanations of the impact of a reform on reported earnings, effective tax rates and deferred tax balances help provide investors with the information needed to make adjustments for distortions resulting from the reform and to assess the underlying quality of earnings.

For Market Supervisors and Regulators

Securities regulators should increase their vigilance of financial statements in the wake of and in the run-up to big tax reform events. Analytical techniques can discover irregular discretionary accruals relative to industry- and firm-specific benchmarks, which can be used to flag organizations that might need further examination. Including machine learning methods that are able to recognize unusual patterns of accrual behaviour. International cooperation among regulators is becoming increasingly vital in the age of BEPS and global minimum taxes. The cross-border dimension of multinational company reporting means that the Financial Stability Board, IOSCO and national securities regulators should put in place coordinated procedures to monitor the financial reporting implications of global tax reforms.

9. Conclusion

This research examines the link between contemporary tax legislation and earnings management behavior, with consequences for the quality of company financial reporting.

Using agency theory, political cost hypothesis and information asymmetry frameworks, we argued that tax reforms provide strong incentives for managers to manipulate both accrual-based and real activities to mitigate the tax cost of reported earnings or to augment the benefit of expected tax reductions. The empirical literature increasingly reports firms manage earnings in anticipation of changes in tax rates, with income decreasing behaviour prior to projected reductions in rates and income increasing behaviour prior to expected rises in rates. Major reforms such as the TCJA, India's corporate tax rate reduction, and the OECD's Pillar Two framework have all been accompanied by recorded financial reporting responses that appear to go beyond the level of mechanical tax accounting adjustments. The ramifications for the quality of financial reporting are profound. Earnings management led by reforms diminishes the relevance and faithful depiction of reported earnings, undermines comparability between periods, and causes information asymmetries between managers and outside investors. Auditors, regulators and analysts need to be especially attentive during periods of change in the tax system. The complexity and uncertainty of new tax rules give both more scope and more motivation for aggressive reporting conduct.

Moving forward, the global adoption of Pillar Two minimum tax laws is anticipated to create a fresh wave of financial reporting consequences as corporations around the world adjust to a world with an effective minimum rate floor. Significant judgement issues arise in the accounting treatment of eligible domestic minimum top-up taxes, the recognition of top-up tax liabilities and the interaction of Pillar Two with existing deferred tax balances. How corporations, auditors and standard-setters respond to these difficulties will have long-term ramifications for the quality and comparability of financial reporting worldwide.

Future study should extend the investigation to emerging markets, where institutional settings are weaker and the possibility of opportunistic reporting may be larger. Longer term behavioural and reporting effects of tax reforms would also be interesting to study in such longitudinal research. Finally, the interplay between tax transparency changes – including public CbCR – and earnings management behavior is an area where both theoretical ideas and empirical evidence are still emerging and provides a rich topic for future inquiry.

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