Discussion of
"The effect of corporate taxation on loss provisioning of property-casualty insurers: Evidence from the adoption of SSAP 101"

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A quick summary

Changes in financial reporting affect firms' tax behaviour

- *Setting:* Adoption of SSAP 101 by PC insurers reduces their tax-deductible loss provisions
- *Results:*
  - Lower loss provisions among *private insurers*, especially those with tax incentive: 1) facing greater IRS monitoring, 2) using in-house actuary to certify loss reserves, and 3) with a higher marginal tax rate
  - After adoption, loss provisions and earnings more persistent

Overall impression

- Important research question
- Interesting setting
- Carefully designed empirical tests
  - Diff-in-diff: private vs. public insurance firms
  - Linkage to firms' tax incentive
- Potential implications for standard setters and regulators
  - Financial reporting vs tax

Comments and suggestions

- Tension
- Hypothesis
- Alternative explanations
- Earnings persistence results

FIN 48 vs. SSAP 101

	FIN 48	SSAP 101
Effective Year	2007	2012
Audience	All public firms	All insurance firms (public and private)
Standards	GAAP	Statutory Accounting Principles (SAP)
Major content	In determining income tax loss contingency amount, 1) use "more likely than not" criteria 2) assume tax authority has full knowledge of all relevant information	
Impacts	Significantly reduced judgement and discretion in recognition and measurement of tax contingencies	

FIN 48 vs. SSAP 101 (cont'd)

- Public insurance firms (complying with FIN 48) is an ideal control group for the adoption effect of SSAP 101
  - Unlikely to be affected by SSAP 101, given the similar content between FIN 48 and SSAP 101

FIN 48 vs. SSAP 101 (cont'd)

- Prior studies already document the effect of FIN 48 adoption on public firms' behaviour
  - Gupta et al. (2014): public firms report higher tax expense and tax payments after the adoption of FIN 48
  - Less earnings management using tax reserve after FIN 48; see review by Blouin and Robinson (2014)
- Natural extension of FIN 48 literature:
  - Private firms face lower capital-market incentive (less incentive to avoid losses, Beaver et al. 2003) and therefore higher tax incentive (higher tax-deductible expenses) compared to public firms

To add some tension…

- One could argue that FIN 48 also has a disclosure component
  - FIN 48 adoption substantially increased information about tax uncertainty available in firms' financial statements (Robinson and Schmidt, 2013)
  - For public firms, higher transparency may deter tax avoidance behaviour
- While for SSAP 101, only recognition and measurement are relevant for private firms

Hypothesis

- Like FIN 48, SSAP 101 directly affects the recognition and measurement of tax reserve, or income tax uncertainty
  - "*Tax uncertainty arises because taxpayers are unsure whether tax authority will assess an additional tax payment upon audit of their income tax returns. The potential for these future tax payments (i.e., tax contingencies) implies that the tax liability on the originally filed tax return may be too low (e.g., because too little income was reported, too many deductions were reported, or the character of income reported or credit taken is inappropriate)*." – Blouin and Robinson (2014)
  - This liability is called tax reserve
- It is unclear how SSAP 101 would affect other tax-deductible items, i.e. loss provisions

Hypothesis (cont'd)

- The authors argue "*the increased uniformity and documentation for tax contingencies under SSAP 101 will likely provide the IRS with more information about insurers' tax positions*"
  - 1986 Tax Reform Act (TRA) lessened the degree to which taxes are affected by reserve manipulation: it requires insurers to report the present value of future claim costs on their tax returns.
  - Can SSAP 101 provide additional information beyond TRA? Some examples of such disclosure would be helpful
  - Any anecdotal evidence suggesting higher IRS scrutiny/audit after SSAP 101?

Alternative Explanations

- Does higher loss reserve really suggest more tax avoidance?
  - The authors nicely address this by linking to firms' ex-ante tax incentives
- Could there by other incentives for lower loss reserve after SSAP 101?
  - Insurers with weak financial health more likely to understate loss reserve to avoid regulatory intervention (Petroni, 1992; Grace and Leverty, 2012)
  - Could SSAP 101 increase insurance regulator's (not IRS) scrutiny?

Alternative Explanations

- Could private insurers substitute loss reserve with other tax-deductible expenses to save tax after SSAP 101?
  – Suggestion: direct analysis on the effect of SSAP 101 on private insurers' effective tax rate or total tax expenses

Results on earnings persistence

- The authors argue "*a loss reserve estimate that better reflects the true underlying economics of the insurer*" predicts more persistent earnings
  - Higher earnings persistence after SSAP 101
- Beaver et al. (2003) find that private PC insurers also use loss reserve to smooth earnings
- If SSAP 101 restricts managerial discretion, shouldn't we expect lower earnings smoothness and persistence after the adoption?

Conclusion

- Enjoyed reading the paper
- Learned a lot about tax and PC insurance industry
- Thank you!