

'Street' ERTs are more useful in predicting companies' future tax outcomes, study finds

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Before considering a company as a potential investment, smart investors will analyze a company's financial statements and look at its taxes and other expenses alongside net income.

New research from the University of Notre Dame sheds light on the

most effective methods to predict future tax outcomes, which simplifies the decision-making process for investors.

Effective tax rates (ETRs) are, in effect, a company's tax expense divided by pretax income as reported on its financial statements. 'Street' ETRs are created when, for one reason or another, analysts adjust the ETR reported under generally accepted accounting principles (GAAP). GAAP is the set of rules that companies follow when creating their financial statements—to provide consistency and comparability of financial information between different companies as well as the same company over time.

If analysts notice an unusual or infrequent item included in the financial statements, they might adjust the GAAP ETR to remove the item, resulting in a street ETR. For example, if the GAAP ETR includes a large settlement with the IRS, an analyst might remove that item because it is unusual and does not reflect the current performance of the company.

"Street vs. GAAP: Which Effective Tax Rate Is More Informative?" is forthcoming in *Contemporary Accounting Research* from Erik Beardsley, assistant professor of accountancy at Notre Dame's Mendoza College of Business, along with Michael Mayberry at University of Florida and Sean McGuire at Texas A&M University.

The study finds that street ETRs provided by analysts do a better job of predicting future tax outcomes than the ETR included in [financial reports](#) prepared using GAAP. The study also finds that the market responds to street tax information more than GAAP tax information, suggesting investors find street tax expense more relevant for their decisions.

"Taxes are a significant component of earnings, but the extent to which

analysts understand and use tax information is not clear," Beardsley said. "We find that they make adjustments to tax information in such a way that improves the informative nature of GAAP ETRs."

The team first examined 2,221 analyst reports to determine the types of adjustments analysts make to create a street ETR. They found about one-third of street ETRs included a tax-specific adjustment, but surprisingly, more than 90 percent included the tax effects of pre-tax adjustments.

Next, the researchers pulled data for 14,627 firm-years from 2003 to 2016 to assess the relative ability of street and GAAP ETRs to predict future tax outcomes. They found street ETRs performed better at predicting future tax outcomes.

"Street earnings metrics such as street ETRs are becoming more and more common, but regulators like the SEC are concerned that non-GAAP metrics can be misleading to readers of financial statements," Beardsley said. "Our study should be informative to regulators and users of [financial statements](#) because it provides evidence that street ETRs are useful."

More information: Erik Beardsley et al. Street vs. GAAP: Which Effective Tax Rate Is More Informative?, *SSRN Electronic Journal* (2020). [DOI: 10.2139/ssrn.3555795](https://doi.org/10.2139/ssrn.3555795)

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