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Author(s)	Mulligan, Emer; Oates, Lynne
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Tax and Performance Measurement: An Inside Story

ABSTRACT

Against the background of increasing regulation and spotlight on the tax position of MNEs, this study explores the relationship between tax and performance measurement. The paper is informed by a series of in-depth semi-structured interviews conducted in 2006 with 26 senior tax executives from 15 Silicon Valley based companies. We also draw on documentary evidence including the relevant 10K reports and take an interpretive approach to the analysis. Many of the performance measures referred to in prior literature were employed in the companies. There was no evidence to suggest the profit center performance measurement model is being adopted by MNEs for their tax departments. Two distinct aspects particularly exercised the interviewees i.e. the effective tax rate (ETR) and post-tax versus pre-tax performance measurement. Many interviewees did not perceive the ETR as being an appropriate measure of performance, yet they recognized its importance internally and externally. Many companies worked on the basis that there is an 'acceptable range' of ETRs which won't give rise to any unwanted questions. Most interviewees shared the view that a post-tax basis of measuring performance of business units might only serve to increase tax risks, preferring instead for the in-house tax executives to remain the exclusive tax knowledge experts. This study contributes to the diversification of tax research within accounting by demonstrating how qualitative work can provide unique insights. It enhances our understanding of how performance measurement of tax might influence the tax planning behavior of in-house tax executives and cautions against exclusive reliance on the ETR as a measure of the effect of tax planning.

Keywords: Performance measurement, effective tax rate (ETR), post-tax performance measurement, pre-tax performance measurement, multinational enterprises (MNEs), profit center

INTRODUCTION

The tax field is unquestionably complex, particularly in the context of multinational enterprises (MNEs). It includes a regulatory aspect in which the relationship between regulated and regulator has been described, for example, as a ‘dance’ (Braithwaite, 2009, 35; see also Gracia & Oats, 2012, 306) and a ‘game’ (Picciotto, 2007). It includes a professional aspect; highly skilled and professionally qualified actors within both regulator and regulatee organisations work to create and maintain the field doxa, whilst engaged in the struggle for dominance. Our understanding of many aspects of the tax field is circumscribed, however, by a lack of information. Relying on publicly available data, as is the case with much tax research within accounting, requires assumptions to be made and proxies to be found which lead to caveats about the reliability of conclusions reached. In this paper an alternative methodology is used, in particular semi structured interviews with senior tax executives in US MNEs. We thereby contribute to the diversification of tax research within accounting by demonstrating how qualitative work can provide unique insights and make a contribution to tax policy debates (Clemons & Shevlin, 2015).

This paper is concerned with one particular dimension of the tax world of MNEs at a particular point in time; 2006, in the wake of the Enron scandals but before the advent on the global financial crisis. Specifically, we explore three different, but curiously overlapping aspects of the relationship between tax and performance measurement. The first is the measurement of the performance of the tax department within a large multinational organisation. The second is the use of tax as a measure of organisational performance presented to external stakeholders. The third is the extent to which tax is recognised in the measurement of performance in other parts of the organisation.

A wide range of performance measures were employed in the companies examined (ranging from timely and accurate compliance to reacting to the unexpected such as an Internal Revenue Service (IRS) audit), and some interviewees put a greater emphasis on qualitative as opposed to quantitative measures. The Chief Financial Officer (CFO) emerged as a key evaluator of the performance of tax executives. However there was no consensus on the degree of formality around the performance management process. Two distinct aspects relating to performance measurement particularly exercised the interviewees i.e. the effective tax rate (ETR) and post-tax versus pre-tax performance measurement of business units. Many interviewees did not perceive the ETR as being an appropriate measure of performance, yet they were very aware of it, and needed to be able to understand and explain to internal (the Board, CFO etc.) and external (market analysts) interested parties, its make-up and why it differs from their competitors’ rates. The latter demonstrated clearly the importance of relativities over absolutes in this context. Only one company among those in the study subscribed to and employed a post-tax measurement of performance to business units. Most interviewees shared the view that a post-tax basis might only serve to increase tax risks, preferring instead for the in-house tax executives to remain the exclusive tax knowledge experts within their organisation, and be rewarded on that basis.

ETR as an externally presented measure of organisational performance serves several diverse purposes. Predicting the ETR for the market (the Street), and the subsequent reaction by the investment community was a recurring theme in the discussions with interviewees on ETRs, as well as reputation risks flowing from adverse media attention. It appears that when a company sets a target ETR, it was monitored and changed typically on a quarterly basis,

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and fluctuations from the rate given to the market were generally perceived as not good news, which ultimately can impact on share price.

An intriguing aspect of this study is the differences between the approaches of the organisations examined in terms of the extent of monitoring of the tax function in terms of formal performance measurement. Another is the gap between theory and practice in relation to the use of tax as an external measure of organisational performance. By examining both of these simultaneously, we are able to shed light on to an aspect of organisational life, the functions and functioning of the tax department that has previously received very little attention in the literature.

This paper proceeds as follows. The next section provides some background on the changing regulatory landscape within which US MNEs operate and the role of in-house tax executives, which is being carried out under an increased level of scrutiny. This is followed by an outline of the methodology used in the study. The findings are then presented and discussed in line with the key themes, which emerged throughout the interviews. The paper then concludes, summarizing key findings and insights on tax and performance measurement.

BACKGROUND

This study is based on interviews conducted in 2006, subsequent to the Enron scandal and pre-dating the financial crisis. The post-Enron environment presents a new risk terrain for the companies involved in the study, in which new regulations with concomitantly onerous penalties have been introduced; most obviously the Sarbanes Oxley 2002 (SOX) reporting requirements as they apply to tax. Donald T Nicholaisen, Chief Accountant of the US Securities and Exchange Commission (SEC) observed in 2004 that “[t]he accounting and reporting of income taxes has received increased scrutiny by investors, analysts, Congress and others. Your auditor will be asking for more information, and you may have noticed an increased level of scrutiny from the SEC staff. That spotlight is likely to continue. Welcome to the new world.” (cited in Mulligan & Oats, 2009). As a result of SOX, quarterly reserve setting had become burdensome and subject to auditor scrutiny, who in turn is scrutinised by the Public Company Accounting Oversight Board (PCAOB). This development was described by one interviewee in the following terms: “We do what the people who measure them [the auditors] count and that oversight body can put them out of business, so they do what that body tells them to do.” (see also Deloitte, 2006). Another significant change in the US tax landscape, introduced in 2003, is a regulatory requirement to disclose participation in tax ‘shelters’, essentially abusive tax avoidance schemes.

For all companies, but in particular MNEs, tax is a significant cost that requires careful management and control. Such management and control is not only in the sense of the amount of tax payable, but also managing the external scrutiny that arises under the regulatory regime. Tax management is a highly specialised area of practice, and in the case of MNEs, is carried out by highly skilled specialists with either accountancy or legal qualifications, most usually the former. When the organisation’s business crosses international borders, tax management becomes even more complex and requires careful coordination of specialised teams in different geographical locations.

MNEs, to varying degrees, create teams of in-house specialists responsible for tax aspects of the organisation’s operations. This will include mundane activities such as the computation of tax liabilities, discharging filing and payment obligations and managing the relationship with the tax authority. It may also include more creative tax planning activities

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which entail careful consideration of the opportunities provided in the tax law to structure transactions and activities so as to achieve a favourable tax outcome. A favourable tax outcome in this context should not be construed as the lowest possible tax; a common misnomer perpetuated by the popular press and tax activists. A contemporaneous survey by Deloitte (2006) revealed that a majority of respondents were concerned about the in-house tax department's ability to perform tax planning activities and avoid tax related errors in financial statements. The in-house tax team will most likely also be responsible for interacting with other parts of the organisation. Armstrong, Blouin and Larcker (2012), for example, characterise the role of the tax director as including responsibility for compliance, an advisory role to the firm's senior executives on tax minimisation opportunities and 'actively pursuing tax planning opportunities by generating investment opportunities where the net present value of the project derives solely from tax benefits' (p.392). In addition we have argued elsewhere that such in-house tax specialists work largely in the shadows of their organisations, but are also engaged in institutional work, helping to shape the institutional environment within which they operate (Mulligan & Oats, 2015).

Traditionally, the activities of in-house tax departments have been considered to be back room operations. The changing tax landscape referred to above, however, signalled an important shift in tax practice; bringing the tax aspects of organisational life to the fore and exposing in-house tax specialists to unprecedented levels of scrutiny, both within organisations and by actors external to the organisation, not only in the US but also elsewhere (see for example HMRC (2006). In much the same way that corporate managers "exercise discretion as to how rules are enacted" (Cooper & Robson, p.427), in-house tax executives are engaged in acts of interpretation; of the rules themselves and also, importantly, presentations of compliance with those rules. In-house tax executives develop mastery of field specific language through acquisition of knowledge and skill and awareness of current and emerging practices (Gracia & Oats 2012, p.310). By looking 'inside' organizations and questioning how the tax function operates in practice, new insights can be obtained about the effectiveness of the regulatory environment.

METHODOLOGY

This paper is informed by a series of face to face interviews conducted with 26 tax executives¹ from 15 Silicon Valley IT companies, conducted in 2006 by one of the authors as part of a wider collective case study (Stake, 2000; Rogers & Oats, 2012). Ahrens and Chapman (2006) suggest that interviews can be used with different methodologies "*depending on the notion of reality they are supposed to explore*" (p.4), and we use them here in line with a constructivist notion of a social reality (Berger & Luckmann, 1966) of tax planning in MNEs. The interviews provided us with a source of rich data that enabled us to work towards understanding the social reality of the world in which MNEs' tax executives operate. The interviews were in-depth and semi-structured (see Oats, 2012) giving us some flexibility and spontaneity and allowing the interviewees "a degree of freedom to explain their thoughts" (Horton, Macve & Struyven, 2004, p.340). The focus on one industry facilitated more in-depth interviews since both the geographical and sector commonality between respondents leads to them facing similar business and planning issues which have to be managed from a tax perspective (Mulligan & Oats, 2015).

¹ Not all interviewees were male, however in the interests of protecting anonymity, all will be referred to as 'he'.

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This study focused on MNEs in the information technology sector. The headquarters of all our sample companies were located in the Silicon Valley area of California.² These US MNEs operate in many jurisdictions throughout the world and accordingly had many and varied tax issues to address on a worldwide basis. Silicon Valley provided a geographically concentrated relevant sample of companies which facilitated an efficient scheduling of interviews.³ Choosing these MNEs was a deliberate attempt to seek out companies and individuals engaged in the subject being studied; i.e. “purposive sampling” (Miles & Huberman, 1994, p.27). US MNEs invest heavily in tax planning activities (Scholes et al., 2014), which incorporate engagement with the external environment, and there is good evidence to suggest this investment is economically worthwhile: Mills, Erickson and Maydew (1998), examining the tax related expenditures of 365 large US corporations, estimate that (on average) they save \$4 for every \$1 they spend on tax planning. Focusing on one industry (IT in this study) facilitates more in-depth interviews: companies operating in the same industry frequently face similar business and planning issues which have to be managed from a tax perspective, so this limited focus provides insights into the commonalities (or otherwise) of how performance of the tax executives in these companies is measured, and the associated implications.

The interviewees were all highly qualified tax executives, many of whom headed up the in-house tax departments. Job titles held by the tax executives in our study were ‘Senior Director of Taxes’, ‘VP Tax and Trade’, ‘VP Tax’, ‘VP Tax, Licensing and Customs’, ‘International Tax Director’, ‘Director, US International Tax and Audits’, and ‘Senior VP Taxation’. Use of the designation Vice President Tax, regardless of the exact nature of their activities or real powers, indicates that the company takes tax matters seriously.

The 26 interviewees were all part of arguably the ‘elite’ set of tax executives in SV: many headed up their organizations’ tax functions, and the others were all in senior management positions reporting directly to the head of tax. There were also a small number of interviews carried out with large tax advisors with experience of advising large MNEs in the IT sector. All interviews were recorded and written up immediately afterwards, noting the tone of the interview, overall impression formed, and any other significant observations.⁴ The interview transcripts, post-interview notes and email correspondence from interviewees before and after the interview amounted to a significant amount of data for analysis. QSR NVivo was used to assist data management and data interrogation and analysis (Mulligan, Cunningham, & Gawley, 2016), and it also provided a form of ‘audit trail’ (Bringer, Halley & Johnson, 2006). We also draw on documentary evidence including the relevant 10K reports and other corporate documentation and take an interpretive approach to the analysis (Oats, 2012).

MEASURING THE PERFORMANCE OF THE TAX FUNCTION

The size of MNEs in-house tax departments (in terms of staff and other resources) varied, as did their relative importance, and the extent to which they are integrated or embedded in

² Although one company has a Cayman Islands-based tax structure.

³ See Suchman and Cahill (1996) also for a qualitative study focussing on Silicon Valley area.

⁴ For example, some individuals were keen to distinguish his/her company from others in Silicon Valley using phrases like: ‘we are different’, ‘maybe other companies don’t do it this way’, ‘SOX may have changed things for other companies, but not for us’.

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those organizations. While their size depended on both internal and external factors, size and complexity of the company and the amount of resources a company is willing to put into the tax function, and the increasing demands on tax departments arising from the changing regulatory environment, were recurring issues referred to by our interviewees.

The constitution of in-house tax departments was found to be dynamic, and tax team membership fluctuated over time. In the US, there tends to be considerable movement of tax professionals between in-house roles and positions in public accounting firms (at this level, generally Big 4 companies) or the revenue authority (IRS) (Borkowski, 2005). There was evidence of MNEs taking a strategic attitude towards recruiting ex IRS officials and ex partners from accounting and law practices, with the latter in particular being well positioned to manage external impressions of the companies. (Mulligan & Oats, 2015)

Whatever a company's overall approach to performance measurement, tax is, as noted by TE 19⁵, 'a difficult one to measure'. Many companies formally set objectives and goals, often on a quarterly basis. The performance measurement of the tax personnel then tends to revolve around the extent to which and the effectiveness with which these objectives are met (Ernst & Young, 2006). Other companies don't formally set out goals and objectives for the purposes of performance measurement. According to TE 23 this lack of formality was due to company size and tax budgets. He identified the need to have larger departments and budgets to address this area by way of formalised goals and objectives.

Typical goals/objectives of performance being measured included (although definitely not agreed upon nor used within all of the companies involved):⁶

- timely and accurate compliance with the tax rules and regulations;
- tax personnel's ability to interact with its internal customers (ie other departments within the organisation) to provide timely and accurate advice;
- responsiveness to management's questions, issues and concerns relating to the tax aspects of organisational life;
- staying within budget guidelines;
- staying ahead on issues;
- 'keeping us out of trouble' with Tax Authorities around the world, reaching settlements with them (extremely important for Company 7);⁷
- impact on the 'bottom line', dollars saved;
- successful and efficient completion of specific projects;
- presenting tax planning opportunities;
- tax risk minimisation;
- reacting to the unexpected (for example an IRS audit);
- maintaining/reaching a specific ETR, and the cash tax rate.

These measures are a mix of qualitative and quantitative measures, many of which are self explanatory, and their importance and usefulness were agreed upon by many of the interviewees. Such measures are not therefore discussed further⁸.

⁵ 'TE' denotes Tax Executive

⁶ Some of these align with the economic environmental factors referred to by Ashton and Roberts (2011)

⁷ Company 7 had recently succeeded in reaching a favourable agreement with the Internal Revenue Service (IRS).

⁸ Specifically in the context of tax risk minimization, it might be expected to see some reference to FIN48 reserves, but these interviews took place pre FIN48. As pointed out by Blouin (2014) some researchers use the

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In light of the published report on the role of professional firms in the US tax shelter industry (US Senate, 2005), one potentially controversial issue at the time was the question of whether the tax department is considered within the organization to be a cost center or a profit center. Some strong philosophical views were expressed by interviewees in this regard. One interviewee, TE5 said ‘I would have a problem with going into a tax department that was viewed as a profit center. Now that makes me nervous and I have made that comment, I have some colleagues that worked in places like that, most of them are in jail now’. Most of the interviewees described the department as service center, service provider or in one case a ‘support center..... we don’t design anything, we don’t build anything and we don’t sell anything so we’re not a profit center’ (TE 24). Some interviewees were unsure how to approach this question; one saying it was more of a service provider, liking to think of themselves as ‘consultants to the other groups within the company advising them on the tax aspects’ of transactions etc’ (TE 22). In some contrast, Robinson, Sikes and Weaver (2010) referred to some firms moving to using the profit center performance measurement model for their tax departments in the 1990s and they examined this choice further.⁹ They suggest that firms are more likely to adopt profit center models when the firm is large, diverse and has tax-planning opportunities that can affect a number of business units. Notably, this paper drew on survey data from 1999 and as outlined earlier the tax landscape had changed considerably since then, which might explain the absence of the profit center approach to measuring the performance of tax departments by 2006.

Importantly TE 15 expressed a very strong view that ‘no-one in the tax department should be directly rewarded, a link created between the benefit they produce and their own compensation’ (for example, decreasing ETR or saving a certain amount of tax dollars). He suggested this gets ‘some tax departments into trouble’. Such performance measurement techniques do, in his view encourage aberrant behavior and may result in taking unwise tax risks. Interestingly, his argument continued that the tax personnel who engage in such behavior might well have left the company by the time any ramifications are felt¹⁰. He jokingly added ‘I should have gone about 14 years ago because you shouldn’t stay or get audited right’. This is a very serious point which exposes a very shortsighted perspective which some tax personnel may take towards tax planning. Arguably it should encourage tax authorities towards a shorter rather a longer audit cycle.

TE 15 managed the tax department’s performance measurement process by producing a very summarised and ‘very cryptic’ list of its achievements delivered annually to the CFO

FIN48 reserve as a proxy for tax risk/aggressiveness of a firm. In further research currently being undertaken by the authors of this paper, involving interviews with tax executives in MNEs, the impact of FIN48 on performance measurement of the tax function and the related area of tax risk management is being examined. Under FIN48, publicly traded firms are required to disclose their unrecognized tax benefits which represent an income tax provision for future tax contingencies.

⁹ They drew on a survey of over 200 CFOs of Fortune 1000 companies focussing on the survey question that asks whether whether the tax department in their respective firms is measured as a profit or cost center. They specifically examined the link between four constructs and the performance measurement choice of the firms, namely, firm decentralization, the degree of coordination between the tax department and operating divisions within the firm, firm growth and tax-planning opportunities, and the importance of financial tax management to the firm. This paper also refers to a body of research linking compensation and aggressive tax reporting.

¹⁰See Blouin (2014) for an interesting and thought provoking discussion on the challenge of defining and measuring tax risk and tax aggressiveness.

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either orally or is handwritten on a piece of paper. This was then sent onto ‘the Boss’.¹¹ This was done before bonuses or pay rises are decided on every year. When questioned about this somewhat mysterious process with apparent inattention to metrics, the sensitivity of this with respect to the IRS was evident: ‘I don’t really want it to fall into the IRS’ or anyone’s hands’. When asked about the nature of the achievements that might be listed, no specifics were given, but he said there are qualitative and quantitative ones and ‘a lot of it has to do with is there a feeling that the tax department is in control of what’s going on’. Interestingly, TE 10 also emphasised the qualitative nature of performance measurement: ‘we don’t use metrics for this stuff’.

Somewhat at the other end of the spectrum in terms of process, TE 24 was very proud of the company’s very formal performance measurement system in place for the previous 5 years whereby all tax personnel have personal goals and objectives set up in such a way that there’s a very clear alignment within the company of everybody’s objectives and how their performance will be measured so that

‘it aligns directly to what the company is trying to accomplish and it’s gotten to be pretty, I think a pretty good system as it’s been perfected.’

A key factor he identified was how well tax supports the business, namely ‘business partnering’. Tax personnel in this company, rather exceptionally, were rated by their internal customers (e.g. operations group, VP logistics) through a survey on performance against expectations and requirements. This interviewee (VP Tax) had frequent one on one meetings with tax personnel to ensure everybody was clear on the objectives and to monitor how all of these objectives are being met. Interestingly, this company did not look to the ETR for performance measurement as its overall tax structure was Cayman Islands based which in itself results in a very low ETR (see below). It was particularly important, therefore, for this VP to look to other measures of performance.

In relation to very specific tax planning strategies TE 2 referred to the measure of success as ‘is it sustained on audit’, and are the tax benefits effectively kept intact? The term ‘audit’ is used in a comprehensive sense here incorporating internal audit, external audit, auditor’s auditors and IRS audit. Rather amazingly, TE 18 admitted there was no formal performance measurement of the tax function, which he attributed to the way the business is organised and its net operating loss (NOL) position.

There was general support for Douglas and Ellingsworth’s (1996) view that the CFO is the primary internal evaluator of tax, with the one notable exception noted above where all of the internal customers (from business units to logistics) were involved in such evaluation. Most of the performance measures referred to in the literature (Porter, 1999; Douglas & Ellingsworth, 1996) were mentioned by many of the interviewees, although not all of them were being utilised by any one company. A number of interviewees did emphasise qualitative rather than quantitative measures, and although performance measurement was recognised as an important, albeit difficult function there was no consensus on the degree of formality around the performance measurement process. In the next section we focus on one particular, and somewhat controversial metric, the effective tax rate.

¹¹ ‘the Boss’ was the CEO and was named in the interview.

EFFECTIVE TAX RATE

All of the interviewees in this study talked at some length about the ETR as a measure of performance of the tax function. ETR can be calculated in several ways and so it was necessary to clarify and assess the degree of consensus as to how a company's ETR is calculated and reported. Scholes et al. (2014) provide two possible definitions of ETR as follows:

1. tax currently payable and deferred tax expense/net income before tax (which they posit is popular for external reporting purposes)
2. taxes paid currently/net income before tax (which is popular with the 'tax reformer' e.g. citizens for tax justice)

Having reviewed the most recently filed 10ks of all of the companies involved in the study, the ETR is computed as the provision for income taxes/income before tax provision, which is in line with the first definition above. This is therefore the definition based on reporting requirements (GAAP)¹² and was also confirmed to me by some of the interviewees.¹³ Blouin (2014) in her discussion on tax risk and tax aggressiveness also noted that 'research has shown that public corporations are primarily concerned with their GAAP ETR' (p.880).

Importantly however, TE 14 referred to another ETR that the investors and analysts are interested in also; a 'pro-forma' ETR which is based on the core business activities only and does not include the impact of items such as acquisitions, disposals, write-off of goodwill etc. Similarly TE 19 referred to being measured on a non-GAAP rate which is calculated based on 'our normal operations'. The process of how that is managed, monitored and communicated is very important as opposed to the actual rate itself.

While being aware of the existence in some cases of the alternative operations only based definition referred to above, the following discussion is based on the first Scholes et al. (2014) definition of ETR above which is based on US GAAP. Table 1 sets out the 2004 ETRs for the companies calculated using this definition, based on the information contained in their 10k returns.¹⁴ While companies 3 and 13 stood out for their relatively low ETRs, having an ETR in the high 20s/low to mid 30s would appear to be 'normal'.

Table 1. Sample Companies Effective Tax Rates

Company	ETR % 2004 year end
C1	28
C2	26.10
C3	8.10
C4	30
C5	16.7
C6	27.8

¹² In the U.S. GAAP denotes generally accepted accounting principles i.e. accounting rules used to prepare, present, and report financial statements for a wide variety of entities, including publicly-traded and privately-held companies, non-profit organisations, and governments.

¹³ Not all interviewees were asked to confirm their agreement of the definition, however.

¹⁴ These rates refer to each company's 2004 year end which was not the same in each case.

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C7	32
C8	Tax benefit
C9	32
C10	36
C11	31.6
C12	18.8
C13	13.6
C14	35
C15	Tax benefit

Quite mixed views and opposing philosophies emerged in relation to ETR being used for performance measurement purposes. In Company 1 for instance ETR did not feature for performance measurement purposes at all. Some of the debate with respect to the ETR in a measurement context revolved around meeting (or not as the case may be) the forecasted ETR.¹⁵ As pointed out by TE 19 when the ETR comes in above or below the forecasted rate, there will be ‘a communication between you and management to make sure that they understand what the drivers are in that and what may change it’. TE 3 spoke in terms of having an acceptable ETR range (27-35%) and staying within that range means ‘nothing horrible is going to happen’. This means there are no negative repercussions for the tax function. Getting the CFO etc, to understand that fluctuations outside of this range is mostly out of the tax function’s control relates to the continuing need for education internally about tax.

The forecasted or target ETR appeared to be set in some cases by people outside of the tax function, for example the CFO and company President at Company 3 set the target ETR. Its tax director did not understand how it is decided upon and claims it may even be ‘arbitrary’ but was still ‘my measure’ and he appeared to be quite content with this situation as he was at the time meeting this objective ‘comfortably’. Of course his view may well have been different if he wasn’t meeting this particular objective comfortably. He did understand why tax directors might have a problem with being measured in this way as it can put ‘pressure on you to perhaps do things that you might not normally do. It does incline you to be more aggressive’ (TE 5). This provides some important insight perhaps into what drives and determines the tax risk profile within an organisation. Similarly TE 22 spoke of the CFO and the head of tax setting the objective ETR, he himself, being quite removed from and unsure of the process.

Company 5’s tax group as a whole was measured primarily on the company’s ETR so everything the tax group does was assessed in terms of its impact on the US GAAP ETR. More than 50% of what the Senior VP for taxes in this company was measured on was the ETR. One of the interviewees at this company contrasted this with his previous employer (another one of the companies in this study) that believed the ETR does not impact on stock price and that it should not take on high tax risks (presumably with the intention of reducing the ETR) as well as its existing high technology and market risks. Clearly there is a link here with the overall corporate risk profile (Lavermicocca, 2011).

TE 8 was adamant on the appropriateness of ETR as a measure of performance, content that he could personally influence it. This was in striking contrast with TE 14 who

¹⁵ In accordance with US GAAP, an ETR is forecasted for the year, but each quarter this is re-evaluated, which if it changes the tax provision must be re-evaluated.

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‘would never sign up for a job where bonuses were conditioned upon a certain effective tax rate or a certain amount of tax savings’. He saw these as being out of his control, ‘based on law and...much more a function of statutory tax rates than of planning’, and he suggested that it is only management that had not worked with tax before that tried to tie the success of tax with ‘the amount of money that does not have to be paid to the government’. He argued that you would want to be measured by something else when new tax reliefs are introduced, which your company simply cannot avail of. This view aligns with traditional agency theory which, as pointed out by Armstrong et al. (2012, p.393) ‘suggests that compensation should be based on performance measures that are controllable by the agent’.¹⁶ Interestingly the second individual interviewed from this company who had responsibility in the EMEA¹⁷ tax compliance domain said the Director of Tax was ‘probably monitored on the overall rate and why it is what it is and what we need to do to change it’. TE 24 said he felt sorry for ‘poor tax directors getting screwed’, being measured on the ETR, only a small portion of which they could control. He said the ETR is an inadequate and inappropriate measure of performance as it is accounting based. He further suggested that there are legitimate accounting alternatives available for transactions which facilitate changing or creating different ETRs on the same set of circumstances so, quite infuriated, he said ‘what kind of measure is that?’ Clearly ‘creative accounting’ techniques can be employed to deliver the required ETR to the market. Interestingly and somewhat surprisingly based on the findings of this study, Armstrong et al. (2012) observe a correlation between tax directors’ compensation and the GAAP ETR.¹⁸ They posit therefore that the GAAP ETR is ‘a more informative measure of the tax director’s actions and, accordingly, it is allocated more weight in the incentive compensation contract’ (p.392).

One interviewee who would not want to be measured by the ETR suggested:

‘it’s the business that controls your effective tax rate really...been going all over the place but that’s as a result of the business side.’ (TE 18)

Another, while believing the ETR is very important was emphatic that in his organisation ‘there is no pressure or goal to arrive at a desired rate’. They strive towards an ‘optimal’ rate

‘within the organisation and operation that we have and so there is no pressure to be entering into activities that don’t coincide with our normal business operations.’ (TE 23)

For companies with significant non-operating losses (NOLs), the ETR did not feature for performance measurement purposes. However it was not clear how the performance of the tax function was measured in these companies. In one case it seemed that because the ETR was not appropriate, there was no need to measure the performance at all which is somewhat surprising.

¹⁶ See Chyz and White (2014), Armstrong et al. (2015) and others for substantial research on the topic of agency conflicts/problems and tax avoidance.

¹⁷ Europe Middle East and Africa

¹⁸ This study used a proprietary data set that includes detailed compensation information for many executives, including the members of the tax department, for large U.S. firms, which facilitated the identification of the attributes of the compensation plan that are unique to tax directors, as opposed to the general compensation policy of the firm.

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There was some evidence to suggest a link between the ETR and resources for the tax function, with it sometimes being used as a ‘sword’ to defend against inadequate resourcing: ‘if we can’t spend money on X, Y and Z the effective tax rate is going to go up two points.’ (TE 3)

‘if tax rate is going down and ...the company sees objective results I think he’s [Sr VP Tax] getting resources and will be able to continue to get resources in this environment.’ (TE 17)

For TE 20 an important aspect of managing the ETR is it shows

‘that a company is putting some resource, some emphasis on effective tax planning, to minimise what could be a pretty significant cost to the company.’

One interviewee, TE 19, interestingly spoke of the possibility of doing some ‘one time things’ that would lower its ETR towards its competitor’s rate, but he and his company were against a one-time hit because ‘its too painful to have to go back’. Equally going too low is ‘very hard to sustain’ and at some stage is likely to ‘pop back up again’ with possible negative consequences. Instead his strategy was clearly to stick with a more consistent ETR performance over time. Notwithstanding the above, this company was cognisant of competitors’ ETRs. When they looked at tax planning ideas they addressed the short and long term impact on the rate, what other companies are doing, the investment community reaction and finally talked it through with the executives. This process provided them with a balanced perspective on managing the ETR.

ETR AS AN EXTERNAL MEASURE OF CORPORATE PERFORMANCE

Predicting the ETR for the market (the Street), and the subsequent reaction by the investment community/market/street was a recurring theme in the discussion on ETRs. As referred to by a number of interviewees, when a company sets a target ETR, it is monitored and changed typically on a quarterly basis, and fluctuations from the rate given to the Street were generally perceived as not good news, which ultimately can impact on share price. TE 3 referred to his company being criticised when the rate fluctuates as the analysts have built what turns out to be an incorrect ETR into their business models. Arguably the Street’s attention to companies’ ETR is a source of coercive isomorphism (DiMaggio & Powell, 1991b). As noted by TE 21, the ETR

‘is something that the investor relations side of things focus on big time...we know that the investor relations people and the Wall Street guys look at it so we have to look at it.’

The importance for these companies of having an ETR that does not fluctuate significantly and is competitive with peer groups companies was also highlighted by Advisor 3. This ‘importance’ however attached to ETR on the Street did not always filter through to the companies in terms of internal performance measurement as observed above. TE 11 suggested that the ETR is ‘a lot more important I think to Wall Street’ than to [his company], although the CFO does need to understand and be able to talk to the analysts about it. TE 1 stated:

‘if for whatever reason, for legitimate reasons, the rate is higher than our peer companies...that would be ok, as long as there was a good explanation for why.’

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This interviewee was more concerned however with explaining to the CFO rather than the Street. Another, TE 15, described his mechanism for dealing with and managing market reaction. He said there are so many ‘flying points’ i.e. factors which may influence the ETR, that he was only prepared to say to the Market what its ETR will not exceed. He was not prepared to say what it actually will be.

Despite many interviewees’ reservations about the appropriateness and validity of the ETR as a measure of performance, comparison of a company’s ETR with its peer companies certainly happened, and seemed to matter considerably to the tax executives, the CFOs, and the investment community.¹⁹ TE 8 for example, presented at least yearly to the Board concerning the ETR, specifically comparing and explaining the company’s ETR vis a vis its competitors. He did emphasise however that this did not present a pressure which would make them more tax aggressive. Instead he might ‘work on resources differently, prioritise things differently’. Clearly, the Board are interested in the company’s ETR (this interest could be driven by many things), which filters through to performance measurement in the tax group. He sums up the importance of the ETR as follows:

‘I think it’s a competitive advantage to [my company] to have a lower tax rate than [a named competitor company] and I work on it.’ (TE 8)

TE 12 monitored its competitors and saw this as a ‘key measure’. This interviewee raised specific concerns about not being able to match a competitor’s ETR which was based on ‘an extremely aggressive tax structure...we can only hope that the IRS goes after them from now on’. Importantly, however as observed by Blouin (2014) a low ETR does not in itself infer a company is tax aggressive.

One really interesting aspect of performance measurement with respect to how a company is doing vis a vis its competitors concerns the idea of absolutes versus relativities. TE 26 (an Irish based in-house tax executive) suggested that having a very low ETR vis a vis your competitors may in fact pose a question mark in terms of tax risks, with the obvious possible negative impact on the market. He explained that a relatively low ETR

‘attracts a lot of attention and the Board, the CFO may not necessarily see it as a positive to be sort of six points ahead of your competition...beating the market rate by extra points is not perceived to be a critical factor’.

His US based colleague’s view (who probably has greater visibility) was a little different however who said they try to be ‘at or below’ their competitors ETR as they would see this as a competitive advantage.

TE 15 spoke of the rather lengthy and detailed presentation he previously used to do to the Audit Committee (of the Board) explaining the differences between his company’s and its competitors’ ETRs. Part of this analysis involved trying to ‘glean’ what they could from the competitors’ financial statements. This was not done any more as it was considered to be ‘meaningless’. They discovered that even a company listed as a competitor (he named an example) has such a different business model, that they are not really comparable in any meaningful way. He believed the Street does not care about these differences. He did caveat this however by adding ‘unless we were sitting there with a 40% effective tax rate or something’.

¹⁹ The investment community’s interest clearly goes beyond this comparative context however.

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His colleague in the interview did point out however another factor i.e. the ‘CFO network’. When these CFOs talk to each other they become very aware of why other companies’ ETRs may be lower than theirs, (e.g. it may be some structural differences) and they often come back to the VP for Tax querying why their company can’t, for example, restructure to match or beat the competitors ETR so ‘there is some level of comparison’ with competitors taking place. The over-riding important point here does appear to be having an awareness of why your rate is different to your competitors and to be able to explain this satisfactorily to the CFO. TE 23 spoke of the need to ‘explain to the CFO or in some cases the CEO the differences between the character of our competitors and ourselves’. The latter may be particularly relevant in the context of the companies operating in the Silicon Valley area whose businesses and business models could vary significantly across a wide range of technologies.

While TE 2 claimed not to benchmark himself against competitors and claimed no external influences exist at all in terms of performance measurement of tax, his boss (TE 1) did allude to the fact that he contacted a small number of companies in Silicon Valley on an informal basis ‘keeping an eye on what other companies are doing’ and in that way these other companies have an influence on decisions and ultimately therefore performance and performance measurement.

Although at the time of this study, media and civil society attention was much more muted, market analysts nonetheless exerted meso level influences on MNEs’ tax practice through their evaluations of firm performance, which influence Boards’ perceptions about tax, and also puts pressure on CFOs - as well as issuing commentaries which impact MNEs’ share prices. They are particularly interested in companies’ ETRs - what rates they should use for their modeling purposes and why, and why such rates might differ from the rates of their competitors. A CFO having to deal with analysts’ questions about their company’s ETR, is an example of engaging with the organizational field level - the questions push tax onto their agenda. (Mulligan & Oats, 2015)

POST VERSUS PRE-TAX PERFORMANCE MEASUREMENT

The preceding section considered the measurement of the performance of the tax function within MNEs and considered the use of ETR for this purpose. ETR was also considered as a measure of organisational performance used by external actors such as the Street. In this section we consider the final strand of our exploration of the relationship between tax and performance measurement: the difficult question of whether performance measurement within an organisation should be on a pre-tax or post-tax basis.

In this study, all companies in the sample except one measured the performance of the business units and the non-tax personnel leading these units (typically VPs for different operations) on a pre-tax basis. Very strong views were held by the interviewees on this topic. Most interviewees shared the same philosophy and were clearly not in favour of ever having tax being treated as a business expense of the business units.

In the one company where the post-tax basis applied, the bonuses of the VPs of the different businesses depended in part on how much taxes his/her group pays so ‘he cares a whole lot about taxes’ (TE 8). TE 9 (with the same company) acknowledged the counter argument to measuring on a post tax basis but explained why it can work:

‘the businesses can get too aggressive and...unconstrained...a business could do all

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sorts of less than fully kosher things from a tax accounting view...it can be controlled and I think you have to have a strong respected central tax group that sets the rules.’

TE 8 admitted this is politically a difficult area and most tax directors’ attitude would be:

‘My gosh the businesses will run crazy with this stuff and they do. They will do anything now to save taxes and they do and you have to control them and you have to educate them.’

In terms of who drives this performance measurement approach, it goes firmly back to the CFO in 1984/85 who introduced it because he said ‘the only way you are going to get these people to manufacture stuff in Puerto Rico and Singapore is if we put it in their performance’.²⁰

Only one other interviewee (TE 2) indicated that he would like to see a post-tax basis of performance measurement because he was really big on ‘accountability’ and thinks ‘it would be good to include tax as a cost of their business.’ This view was not shared however by his tax colleague who believes the business units ‘are pulling tax in now as it is’ (TE 1). Two other companies could see some merit in it but only in certain situations, but even then said it would be difficult to apply in an equitable fashion. TE 14 spoke of the difficulties with trying to assess on a post-tax basis referring to the fact that some countries (e.g. Ireland) have a significantly lower corporation tax rate than others (e.g. Italy) so these would have to be compensated differently.²¹

The predominant finding was that companies employ a pre-tax basis of performance measurement on business units and almost all interviewees philosophically agree with this approach. TE 11 said: ‘I don’t want the businesses worrying about the tax rates and making decisions’. His colleague (TE 10) agreed:

‘Absolutely do not want ever to be measured on an after tax basis...people should be looking at the business side of things and let the tax department worry about tax’.

Specifically in relation to transfer pricing it could potentially result in tax executives constantly ‘fighting with your operations...they all want to optimize their own P & L as opposed to what’s the correct thing’ (TE 10). This company was very strong on this viewpoint which was really interesting as what were by far the two largest companies in the study held completely oppositional stances philosophically and in practice on this matter, suggesting limits to isomorphism in this regard. TE 18 was also keen to retain control over the tax expertise and focus:

‘I don’t think that the business should really concern themselves with something that they have zero control over. That’s my job to come in there and try and control that...sometimes what happens is what could be good for one group might be bad for another group and you’d have to have all these different battles all over the place.’

TE 19’s concern about moving to a post-tax basis was ‘you start to get people focused more on the process than on what they really should be doing which is the core business’. TE 23 found the idea of post-tax basis as quite ‘worrisome’ and thinks it would put a pressure on business managers that he would not be comfortable about. He referred to the fact that many of the local operations were headed up by sales people and

‘the character of those people is to be aggressive and to want to achieve goals that

²⁰ Manufacturing in these countries typically leads to lower tax payable by the manufacturing groups.

²¹ Standard Irish corporate tax rate on trading income is 12.5% compared to 33% in Italy.

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they've established, or goals in most cases that they haven't established, somebody else has established for them and you know I would not want to see them under that pressure and therefore be susceptible to overly aggressive tax strategies.'

The company which engaged in the post-tax basis, was aware that it is part of a minority of companies in Silicon Valley. Its approach, however, was well embedded i.e. 'institutionalized' (Powell & DiMaggio, 1991) as it was introduced by a very powerful internal actor over 20 years ago. The philosophy and practice within this company would most likely not change without a change at CFO level to somebody with an opposing philosophy signifying the role of powerful actors or 'elites' in the institutionalisation process, who are themselves through their exercise of power 'sources of heterogeneity' in the tax institutional environment (Powell, 1991). However, the chances of this company employing somebody with an opposing view on performance measurement were, at the time, very slim. A post-tax approach to performance measurement can be viewed as a 'cultural rule' (Edelman & Suchman, 1997) within this company which explains some of its rules and organising logics (DiMaggio & Powell, 1991a) with respect to tax. Interestingly this company was perceived as a 'leader' with respect to other tax based activities, yet it was not followed by other Silicon Valley companies with respect to post-tax performance measurement. Another very large company in the Silicon Valley facing many of the same tax planning opportunities and challenges did not share the post-tax measurement philosophy, which again could be explained by an internal cultural perspective created and sustained by some powerful internal actor(s) in the tax domain.

Whilst there was some limited evidence to support the idea that managers (non-tax) managers being assessed on a post-tax basis leading to more tax aggressive planning (Phillips, 2003), as pointed out by Armstrong et al. (2012, p.394) taken as a whole, 'prior literature provides limited evidence that managerial incentives influence tax planning choices'.

These findings support the contemporaneous KPMG (2005) observation that pre-tax performance measurement still predominates. The tax executives for the most part were keen to retain a sense of power through being the exclusive tax knowledge experts in the business. Despite not being terribly close to the business, and not always understanding the business, they feel they are best positioned to address the tax implications of the business activities both in terms of expertise and character. It appears something of a contradiction to demand of the business units to consider tax (through early consultation with the tax executives) in their strategic business decision making yet not reward them for doing so through for example a post-tax performance measurement system.

DISCUSSION AND CONCLUSION

This paper demonstrates the value of qualitative research as a means of diversifying and enriching tax research within accounting. Interviewing tax professionals allowed us to examine tax in its practical operation, going behind the scenes and thereby adding to our understanding of how tax work is performed within organisations. Although the landscape has changed significantly since this study was conducted, in particular as a result of the global financial crisis and subsequent attempts to tighten up regulation, the empirical data presented here provides rich insights into a neglected aspect of tax practice: the inside story of how tax is practiced within organizations.

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Many of the performance measures referred to in the literature were employed in the companies (ranging from timely and accurate compliance to reacting to the unexpected such as an IRS audit), and some interviewees put a greater emphasis on qualitative as opposed to quantitative measures. In contrast to earlier research there was no evidence to suggest the profit center performance measurement model was being adopted by MNEs for their tax departments, which might well be due to the changing international tax and regulatory landscape. The CFO emerged as a key evaluator of the performance of tax executives. However there was no consensus on the degree of formality around the performance measurement process. Two distinct aspects particularly exercised the interviewees i.e. the effective tax rate and post-tax versus pre-tax performance measurement. Many interviewees did not perceive the ETR as being an appropriate measure of performance, yet they were very aware of it, and needed to be able to understand and explain to internal (the Board, CFO etc.) and external (market analysts) interested parties, its make-up and why it differed from their competitors' rates. The latter demonstrated clearly the importance of relativities over absolutes in this context. Only one company subscribed to and employed a post-tax measurement of performance to business units. Most interviewees shared the view that a post-tax basis might only serve to increase tax risks, preferring instead for the in-house tax executives to remain the exclusive tax knowledge experts within their organisation, and be rewarded on that basis.

There was certainly a great awareness of the ETR among all of the interviewees in this study. However there was no consensus regarding the extent to which it was used in practice to measure the performance of tax executives, with only one company's tax executives being very content about being measured based on the ETR. The philosophical position of a number of the interviewees was very clear i.e. the ETR is an inappropriate measure of performance as it is not totally within the control of the tax executives, and may encourage aggressive tax planning if it were used to measure performance. ETR moves due to other factors such as business activity, new tax laws etc. In any event as suggested by Slemrod (2005) a relatively very low ETR may in the eyes of the 'savvy investors...result from a more aggressive stance that pushes the limits of what is legal' (p.95), but in itself it may not at all be a reliable indicator of tax aggressiveness (Blouin, 2014). This is not to suggest, however, that all investors are the same and there may well be a 'clientele' very happy to invest in a company with a very low ETR, notwithstanding the degree of tax aggressiveness that might imply. Educating the CFO, the CEO etc, as to why the ETR has fluctuated appeared to be paramount in securing legitimacy and credibility internally. Nonetheless, the Street, a source of coercive isomorphism (DiMaggio & Powell, 199b) attached great importance to a company's ETR, and therefore managing it and explaining it was very important. The Street therefore is an important constituent in the organisational field level and the analysts are important actors at this level. So whether tax executives like it or not they must pay attention to the ETR purely because this important organisational field member does so, in a way that could impact ultimately on shareholder wealth. The latter is a concern, taking account of the fact that the findings do not really support the validity of the ETR as a measure of performance and it clearly seems to be subject to manipulation through creative accounting or flexible accounting standards (Bauman & Shaw, 2005). We welcome the work of Armstrong et al. (2012) on the correlation between tax directors' compensation and the GAAP ETR, but our work suggests there are many other measures of performance used in practice, so further work could seek to establish a correlation (if any) between such measures and the compensation of tax managers.

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Most interviewees were quite exercised with his/her company's ETR relative to competitor companies' ETR. While some interviewees believe a lower ETR is a competitive advantage, a relatively low ETR could also signal aggressive tax planning with possible negative consequences. The need for tax executives to be able to explain the basis of the difference between companies' ETRs to CFOs, the Street and arguably tax executives/CFOs in the competitor companies appeared to be very important and necessary and a mechanism towards achieving legitimacy (Scott, 2008), often revolving around different business models. Such an explanation or understanding cannot be obtained through an examination of a company's published financial statements. It would appear the case for legitimacy is stronger than economic efficiency with respect to the ETR, itself a possible measure of economic efficiency. Identifying and recognising the influence of external constituents like competitor companies and the Street enhance our understanding of 'the relationship between organizational structures and the wider social environment in which organizations are situated' (Hussain & Hoque, 2002: p.164). Strategically many companies work on the basis that there is an 'acceptable range' of ETRs which won't give rise to any unwanted analysts' questions, or get unwanted attention from their peer group companies, thereby securing external legitimacy (Scott, 2008) which is arguably important for their personal survival within the Silicon Valley tax arena.

Contrary to Karayan and Swenson's (2007) suggestion, comparing a company's ETR to the standard US corporation tax rate of 35% did not feature as important in the interviews. These findings do question the validity of the ETR as a measure of the effect of tax planning, yet it has been used by many researchers for that purpose (Zimmerman, 1983; Mills, Erickson & Maydew, 1998; Rego, 2003). It should clearly continue to be used therefore with great caution as suggested by Phillips (2003).

This paper is based on research conducted prior to the financial crisis and in the wake of Enron and Worldcom scandals. It provides valuable insights into the differences and similarities between companies in a particular industry in a particular geographical location at a particular point in time. There is considerable scope for more studies in this vein, in the everchanging international tax landscape, the outcomes of which should be of interest to researchers in the area of performance measurement and regulators and tax policy makers alike.

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