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# **THE RELATIONSHIP BETWEEN INCOME TAXES AND MARKET RETURNS**

by

**Chelsea Hepworth**

**Thesis submitted in partial fulfillment  
of the requirements for the degree**

of

**DEPARTMENTAL HONORS**

in

**Accounting  
in the Department of Accounting**

**Approved:**

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**Summer 2016**

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## **Abstract**

This paper investigates the relationship between book to tax differences and market returns. Prior research has been conducted that shows the ability of book to tax differences to predict future earnings, and this study expands that research to see if book to tax differences have predictive value in terms of actual market returns. This study uses a sample of firms from the Compustat database and runs a regression using book to tax differences and company returns as compared to the market. Results show that book to tax differences do have some predictive value which could potentially allow an investor to “beat the market”; however, further analysis of the data shows that this strategy could be fairly risky for an investor to actually implement.

## **Acknowledgements**

Many thanks to my project advisor, Dr. Richard Price, for his mentorship, as well as to Dr. Shannon Peterson and Dr. John Ferguson for all of their help and encouragement.

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Thanks to my parents for all of their love and support throughout my college career.

## Introduction

Millions of dollars are invested in the stock market each year, all by investors hoping to “beat the market” and make a profit on their investment. Both academic scholars and business professionals have long debated whether or not beating the market is possible: Some say that the market fully reflects all information, making it impossible for someone to beat it without taking on incredible risk, and others saying that the market does not fully understand all information, leaving small openings for investors to take advantage and earn a high return. In the groundbreaking paper “*Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?*”, Richard G. Sloan makes a strong case for those who are against the market efficiency theory as he demonstrates his idea that the market does not fully understand using cash and accrual components of earnings. This paper expands Sloan’s experiment to incorporate book to tax differences.

Book to tax differences arise from differences in financial accounting rules and tax accounting rules. They can be permanent, such as differences resulting from fines and penalties, or temporary, such as differences resulting from depreciation methods. Unlike permanent differences which never reverse, temporary differences reverse over time, allowing companies to use these differences to their advantage by altering the timing of payment of taxes. In general, companies try to take advantage of temporary differences that allow them to prolong their payment of tax, allowing them to keep as much cash as possible in the present time. Taking advantage of these differences can be a significant tool for a company to manage cash flows and future earnings, which begs the question of if these differences can be a significant tool for investors to use in trading. Although book to tax differences have become a more common research topic in recent years, they have not yet been fully tested in the context of market returns.

This paper provides evidence on market efficiency related to book to tax differences by testing the relationship between book to tax differences and market returns for a sample of firms.

### **Prior Research**

As noted above, the Sloan paper (1996) investigates if stock prices fully reflect the weight of the cash and accrual components of cash flows and serves as the basis for this research. Sloan finds that stock prices act as if investors “fixate” on the earnings number as a whole, failing to fully understand that earnings contain both cash and accrual components and should be evaluated further to determine the health and earnings potential of a company. By providing strong evidence that it was possible to beat the market, Sloan opened the door for a wave of research testing other market-beating theories. For example, Frankel and Lee (1998) found that the V/P ratio (a measure of a firm’s fundamental values ( $V$ ) compared to price ( $P$ )), was a good predictor of long-term returns. Piotroski (2000) similarly used the book-to-market ratio to predict returns. Doyle, Lundholm, and Soliman (2003) found that firms who excluded more items from their non-GAAP measurement of earnings tended to have lower future cash flows, which also resulted in lower market returns. In 2006, the same authors found that stock prices tended to drop in the years following a positive earnings surprise. These are only a few of many papers which provide evidence surrounding the idea that the market can be beaten through a variety of strategies. This paper builds upon this prior research by looking to provide an additional approach for investing in the stock market.

In addition to the research done involving market strategies, much research has been conducted in relation to corporate income taxes. Ayers et al. (2009) conducted a study providing evidence that the association between taxable income and market returns is a function of the level of noise in taxable income, adding to the research regarding a correlation between taxable

income and market returns. In 2010, Ayers et al. examined whether changes in book to tax differences have any correlation with credit ratings. They found that large positive book to tax differences are associated with lower credit ratings, showing that credit analysts may realize that these differences are a sign of reduced earnings persistence. Lev and Nissim (2004) found that book to tax income helps to explain earnings growth and stock returns when using the earnings-to-price ratio as an indicator of returns. This paper shows that book to tax differences can be a valuable indicator of performance. Weber (2009) built upon Lev and Nissim's research to determine whether or not equity investors and sell-side financial analysts fully understand how book to tax differences inform earnings. Hanlon (2005) investigated whether large book to tax differences affect the persistence and pricing of earnings, accruals, and cash flows, as well as if these differences affect investors' views of a company's earnings ability. She found that large book to tax differences result in lower future earnings and that investors reduce their future earnings expectations, showing that investors understand the relationship between book to tax differences and earnings. Blaylock et al. (2012) built upon Hanlon's research by investigating what causes the relationship between book to tax differences and earnings. They suggested that because book to tax differences can come from many sources, not all book to tax differences should be treated equally when considering whether these differences will result in lower future earnings. They found that firms with large positive book to tax differences from earnings management had lower future earnings than firms with large positive book to tax differences resulting from either tax avoidance or characteristics of the firm itself. In 2012, Graham et al. wrote a paper giving a comprehensive review of income taxes and offering up ideas for research. This paper addressed the association between book to tax differences and earnings characteristics and suggested that association as a good potential area for further research. Noga and Schnader

(2013) used book to tax differences as a predictor of bankruptcy, and they found a correlation between abnormal changes in book to tax differences and future bankruptcy, once again showing that book to tax differences are a good indicator of the potential performance of a company.

This paper builds upon prior research that book to tax differences can serve as an indicator of financial well-being by examining the relationship between book to tax differences and actual market returns.

## **Hypothesis**

Similar to previous research conducted, this paper investigates whether the market truly acts as a representation of a company's standing by examining whether the stock price is fully reflective of book to tax differences within financial statements. A negative stock reaction would be expected for large fluctuations in book to tax differences, and a positive stock reaction would be expected for small fluctuations in book to tax differences. This type of relationship would show the inefficiency within the market. This experiment is structured to determine if changes in book to tax differences can explain stock price changes from year to year. The hypothesis will be proven if the book to tax differences can explain a significant enough portion of the change in market value.

## **Research Design**

The sample is composed of firms included in the Compustat database with financial statements released from 2000 to 2015. It does not take into consideration firms with assets less than 1 billion as well as firms that did not have a stock price, indicating that they are not publicly traded. These conditions allowed the study to be conducted with only large companies that were publicly traded. This supplied 50,231 observations. Table 1 displays the number of observations per year, categorized by the fiscal year ended.

Table 1

Year	Number of Observations
1999	220
2000	2,753
2001	2,694
2002	2,730
2003	2,882
2004	3,012
2005	3,121
2006	3,232
2007	3,289
2008	3,181
2009	3,174
2010	3,237
2011	3,274
2012	3,350
2013	3,467
2014	3,623
2015	<u>2,992</u>
Total	50,231

To test the relationship between book to tax differences and market returns, this paper runs a regression to see if a change in book to tax differences from year  $t$  to year  $t + 1$  explains the change in returns as compared to the market from year  $t$  to year  $t + 1$ . To calculate the change in book to tax differences, I followed the methodology used in Noga and Schnader (2013), which builds upon the methodology used in Ayers et al (2009):

$$BTD_t = (\text{Book Income}_t - \text{Taxable Income}_t) / \text{Average Total Assets}_t$$

$$\text{Book Income}_t = \text{Pre-Tax Net Income}_t - \text{Minority Interest}_t$$

$$\text{Taxable Income}_t = [(\text{Federal Tax Expense}_t + \text{Foreign Tax Expense}_t) / \text{Top U.S. Statutory Rate}] - \text{Change in Tax Loss Carryforward}$$

Each of the variables used to calculate book to tax differences were obtained through the Compustat database with the exception of the top U.S. statutory rate, for which the 2016 rate of 35 percent was used.

I calculated the difference in returns from year to year by taking the annual change in closing price for the sample of firms and comparing that to the average annual change in index level for the SPDR S&P 500 ETF as reported on Yahoo Finance. Because the SPDR fund is

composed of 500 companies from the S&P, I would expect it to fairly represent the market return as a whole as compared to the companies used in the sample. The difference in the company returns and the market returns is what was used in the regression, as this number will tell how well the companies perform in relation to the market.

To prepare for the regression, it was necessary to delete the first observation for each company since the experiment needs lagged values for some items. This resulted in a final observation number of 45,416.

### **Initial Results**

As shown in Appendix A, the regression returned a beta of 21.41, meaning that for a 1 percent move in book to tax differences, the company return would move 21.26 percent. The R-Square on the regression is .009, which means that .9 percent of returns are explained by book to tax differences. Although this may appear to be rather low, it does not take much for someone to be able to capitalize on small efficiencies in the market; therefore, the hypothesis that book to tax differences explain market returns would be accepted. The t-statistic of the regression is 20.77, so one would be confident that the results of the regression are correct, and there is some correlation between book to tax differences and stock prices.

### **Outliers**

One potential issue with the initial results is that the data was not adjusted to account for outliers. Outliers can greatly skew the results of a regression, so I sorted the data from smallest to largest based on the book to tax differences and then deleted the top 1 percent and bottom 1 percent of the observations, leaving 44,507 observations. After running the regression again with the adjusted data, I found that the relationship between book to tax differences and market returns was even less substantial. As shown in Appendix B, the R-square lowered to .0005,

showing even less explanation of market returns. The t-statistic lowered to 4.68, meaning that one would be less confident with the results of this regression as compared to the results of the first, but it is still a high enough t-statistic to be fairly confident that the results are correct and the hypothesis would be more likely to be rejected. Thus it appears that the outliers were actually skewing the data to make the results more significant than they actually should have been.

### Controlling for Additional Variables

Another potential issue with the initial results is that the first regressions only tested one variable: book to tax differences. To further test for a possible significant relationship between book to tax differences and market returns, I added net income as another variable to see if the results would change. As shown in Appendix C, the R-square result and the book to tax differences result hardly changed from the last regression to this one. The coefficient on the net income variable is  $3.79E-05$ , which is rather insignificant. The t-statistic on the net income variable is also low, meaning that one would not be confident in the results from that variable; however, this regression overall does not prove much of a relationship between book to tax differences and market returns as compared to the prior regression.

### Deciles

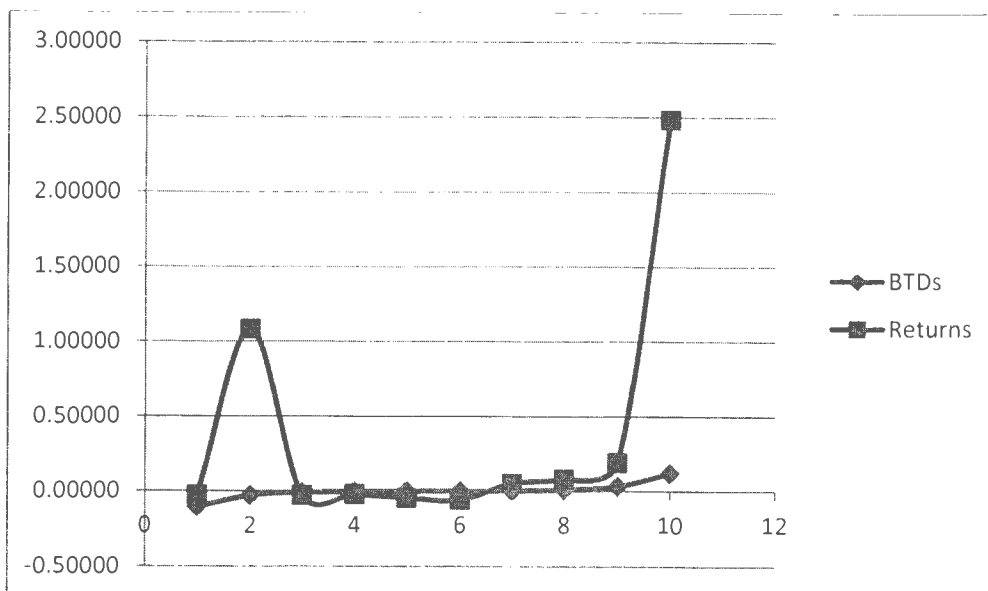
Another way to analyze the data is to sort it into deciles.<sup>1</sup> As illustrated in the graphs below, as the change in book to tax differences from Decile 1 to Decile 10 rises, the change in returns as compared to the market slowly rises (with the exception of an increase in Decile 2) and then sharply

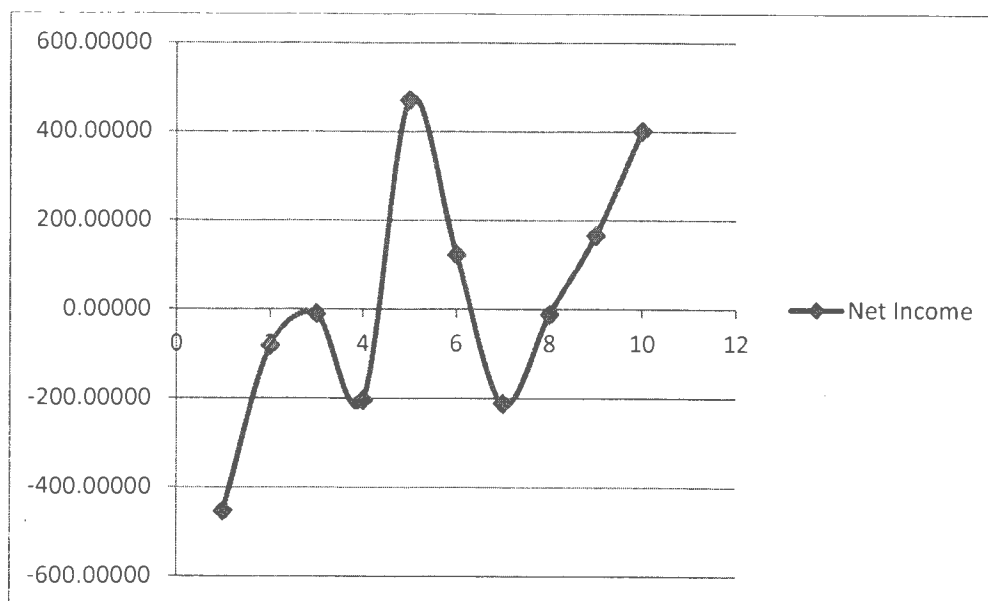
	BTDs	Returns	T-Stat	Net Income
Decile 1	-0.10495	-0.02711	-1.04128	-453.78559
Decile 2	-0.03007	1.08311	0.97972	-82.03648
Decile 3	-0.01150	-0.02993	-4.74597	-10.25349
Decile 4	-0.00281	-0.02189	-2.41788	-204.05735
Decile 5	-0.00004	-0.04557	-15.27261	470.30622
Decile 6	0.00000	-0.05920	-20.21037	121.94749
Decile 7	0.00242	0.05143	7.46615	-212.27495
Decile 8	0.01141	0.08101	5.57264	-11.70781
Decile 9	0.03230	0.18937	3.31843	166.21909
Decile 10	0.11839	2.48323	2.96293	401.09549

increases in Decile 10. Net income on average rises overall but is varied from decile to decile.

<sup>1</sup> Analysis based on data after adjusting for outliers

One can see from the data that the firms with the lowest and highest returns tend to have the most extreme book to tax differences and net incomes, showing that the relationship between book to tax differences and returns is not linear. This analysis would suggest that it could be beneficial for an investor to go short in stocks with the lowest book to tax differences, as these firms tend to perform much worse than the market, and to go long in stocks with the highest book to tax differences, as these firms tend to perform better than the market. The deciles overall, however, are so varied that a trading strategy such as this would likely be fairly risky, so the average investor would be unlikely to implement this type of strategy.





## Weaknesses

Because some assumptions had to be made in order to conduct this study, there are several potential weaknesses involved. The first is the estimation of taxable income. Taxable income itself is not a number that is publicly reported, so it is a necessary assumption. This number was estimated by adding the federal and foreign tax expense, dividing that by a 35 percent tax rate, and taking into consideration any change in tax loss carryforward. Since the assumed 35 percent rate is not necessarily the tax rate that each of the companies in the sample was taxed at, that leaves some room for potential error.

Another assumption in the study is the use of the SPDR S&P 500 ETF as the market return. There are other index funds which do take into consideration the entire market, but these funds include stocks with a large market capitalization and stocks with small to mid-capitalization. Because the sample used in this study was limited to larger firms (those with assets over 1 billion), I assumed that the SPDR S&P 500 ETF would be a more appropriate market return than a fund which includes the entire market since the SPDR S&P 500 ETF includes only large firms.

The Compustat data itself poses another potential for weakness, as its administrators use many assumptions to categorize the data and put it into a form that researchers can use. Financial statements for companies are all different, so the categories that Compustat uses may not be a perfect fit for every company and may result in numbers that do not accurately represent the number that was meant to be used for the sample. In order to be sure that the data used in the sample was correct, one would have to look through the financial statements for each observation in the sample and manually compute the needed information. This would be a tedious and almost impossible task that would be unlikely to produce any material differences from the Compustat data, but it could potentially uncover a weakness in the data used.

## **Conclusion**

Although past research has been able to find relationships between certain factors and market returns, this paper finds that such a relationship between book to tax differences and market returns is fairly small. It was somewhat significant in the first regression, but the results became even less significant as I adjusted the data for outliers and net income. Unlike the accrual anomaly discovered by Sloan, the market appears to be fairly efficient when it comes to book to tax differences. This is not extremely surprising since so much research has been conducted that proves a relationship between book to tax differences and earnings persistence and potential. Investors and analysts aware of this relationship would make decisions based on that information, causing the book to tax differences to be reflected in the stock price itself of a company.

As an area of potential research, one could perform additional regressions that control for even more variables, as this may potentially change the results. One could also investigate into why the firms with extreme returns also tend to have more extreme book to tax differences, as

this may help better uncover how book to tax differences could be used as a market trading strategy.

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## Appendix A

### SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.097011081
R Square	0.00941115
Adjusted R Square	0.009389337
Standard Error	38.55540981
Observations	45416

### ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	641371.5006	641371.5006	431.4584816	2.17649E-95
Residual	45414	67508802.29	1486.519626		
Total	45415	68150173.79			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.730422152	0.180938841	4.036845542	5.42635E-05	0.375779089	1.085065215	0.375779089	1.085065215
BTDs	21.41255155	1.030858167	20.7715787	2.17649E-95	19.39205282	23.43305028	19.39205282	23.43305028

## Appendix B

### SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.02219162
R Square	0.000492468
Adjusted R Square	0.00047001
Standard Error	29.29743037
Observations	44507

### ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	18821.7414	18821.7414	21.9280867	2.83895E-06
Residual	44505	38200396.17	858.3394263		
Total	44506	38219217.91			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	0.353842874	0.138917455	2.547144811	0.01086417	0.081562261	0.62612349
BTDs	10.95042239	2.338462992	4.682743506	2.8389E-06	6.366994495	15.5338503

## Appendix C

### SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.022358772
R Square	0.000499915
Adjusted R Square	0.000454997
Standard Error	29.29765038
Observations	44507

### ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	2	19106.34839	9553.174195	11.1296655	1.47115E-05
Residual	44504	38200111.56	858.352318		
Total	44506	38219217.91			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Low</i>
Intercept	0.353332205	0.138921329	2.543397823	0.01098137	0.081043999	0.62562041	0.0
Net Income	3.7957E-05	6.59176E-05	0.575824306	0.56473685	-9.12427E-05	0.00016716	-9
BTDs	10.82302463	2.348923216	4.607653649	4.0837E-06	6.219094509	15.4269547	6.2

## **Author Bio**

Chelsea Hepworth grew up on a small farm in Rupert, Idaho. Upon graduation from high school in 2012, she came to Utah State where she majored in both accounting and economics. During her time as an Aggie, Chelsea was a member of the USU Honors Program, Huntsman Scholar Program, Beta Alpha Psi, Institute of Management Accountants, Society for the Advancement of Ethical Leadership, and the Women in Business Association. Through involvement in these organizations, she has had the opportunity to travel the world, make lifelong friends, mentor younger students, participate in service projects, and develop as a person. She has thoroughly enjoyed being an Aggie!

Chelsea chose to continue her education with a Master of Accounting also at Utah State. Upon graduation, she will begin working full-time at Tanner, LLC, in Salt Lake City, where she will be a tax associate.

## Reflective Writing

During a financial statement analysis class I once took, I learned about different trading strategies and about how one could develop a strategy and test it for potential use in the stock market. Time in the class did not allow us to actually implement what we learned, so I thought I had to settle for only learning the theory behind it or doing it in my free time once I was not so busy with school. Later, as I was considering what project I could complete for my capstone, the trading strategy idea came to mind. I had recently completed a tax internship, so I decided that I would try to see if income taxes could be used at all to predict market returns since taxes are something that I have always been interested in. Although choosing an idea for projects is generally something that I have difficulty with, it was surprisingly one of the easier aspects of my capstone.

One of the most difficult parts of my capstone experience was collecting the data and figuring out how to analyze it. I had to get a lot of help from my mentor for this part of the project! It was crazy to me how I had never realized how much data had been available right at my fingertips throughout much of my time at Utah State. Once I had downloaded all the data I needed, the even more difficult part was figuring out how to manipulate the data to do what I wanted. My capstone involved regressions, which added an interesting statistical aspect to my project. I used Excel to complete the regressions, and with the amount of data that I was using, that was a difficulty in and of itself. There are specific software packages that are developed to do what I was doing much more easily, but Excel was what I had access to, so I had to make it work. It was an extremely tedious process to figure out how to correctly sort the data and input the correct formulas that would work in all situations (whether numbers were positive or negative). After initially completing the analysis, I sent the document to my mentor for review,

upon which he pointed out several areas in which I had made small mistakes. From this process, I learned how important it is to be careful with data and how much easier you can make things for yourself if you are not afraid to ask questions. One of the greatest triumphs of my project was when I finally got confirmation from my mentor that he thought I had correctly completed the manipulation of the data in Excel. It was such a great feeling to have such a difficult part of project over and to finally be able to work on the written analysis portion and know that the numbers were not going to change again.

Another personal challenge of my project was learning how to interpret statistical findings. This was something that I have never been particularly great at but have always been interested in. I loved that my project incorporated something that I was uncomfortable with because it helped me grow and really develop skills that I did not have before. I read a lot of articles, watched a lot of YouTube videos, and consulted often with my mentor so that I could complete the statistical analysis portion of my capstone. Although it was difficult, I really enjoyed it.

The biggest advice I can give to someone just starting their project is to find a great mentor. You want someone who is knowledgeable in the area you are studying but also who you know is available and always willing to help even if you know he or she has a lot going on. A great mentor can make a huge difference in how well the project goes. My mentor was amazing, and I know my project ended up way better than it otherwise would have because he was so helpful. In addition to choosing a great mentor, I would advise students to choose a project that they actually need a mentor for, meaning choose a project that involves something that is difficult and forces personal growth. I could easily have chosen a simple project that involved something I already knew a lot about, but that would have provided me with a much less

enriching experience. Another piece of advice is to start early. This is obvious, but it is important. Time can be one of the most limiting factors to a great project if you let it become one, so start your project early so this is something that you do not have to worry about.

When I start my full-time job as a tax accountant, much of the work that I did on my capstone will not directly help me at all, but many of the principles that I learned will definitely help me throughout my entire career. I learned to think more critically, deal with data more carefully, and not be afraid to ask questions. Furthermore, I have often considered potentially becoming a professor for accounting, so getting more experience with research was very valuable to me because I learned that I actually enjoy doing research. As I was completing my project, I found that I would have my research on my mind all the time. When I would walk from class to class, I would be thinking of how I could solve the issue I was having with the data in Excel or what certain results meant. This entire process helped me realize that becoming a professor was actually a realistic option for me since it was something I think I would enjoy. Overall, this project really did provide me with a great capstone experience for my undergraduate education, and although I am extremely glad that I have finally completed it, I really enjoyed the process. Thanks to the Honors program for providing me with this great opportunity to learn and grow!

Word Count: 1,005