eJournal of Tax Research

Volume 14, Number 1 July 2016

CONTENTS

4 Country-by-courtry reporting: An assessment of its objective and scope
Monique Longhorn, Mia Rahim and Kerrie Sadiq

Atax
UNSW

eJournal of Tax Research (2016) vol. 14, no. 1, pp. 96-118

.

Book-tax conformity: The review of recent research and its implication for the IFRS adoption in Europe

David Procházka and Jan Molin[1]

Abstract

As the goal of corporate taxation contradicts substantially the accounting principles of true and fair view, distinct measures of income are used in corporate and tax accounting. This dichotomy may facilitate an opportunistic behaviour of executives to manage earnings upwards in financial reporting and taxable profits downwards simultaneously. Aligning both measures may restrict the misbehaviour of management, however at cost of losing informativeness of accounting information. The deliberations on the level of book-tax conformity are complicated by international capital mobility, which facilitate the cross-border profit shifting. Finally, the worldwide adoption of IFRS challenges the governments to decide, whether to allow IFRS to be a tax base for corporate taxation. The growing number of opportunities to relocate profits to more favourable jurisdiction constitutes risks, but also opportunities, for governments struggling to retain control over taxation. The decision may influence both the regulatory frameworks and the business practices of companies. The paper analyses the advantages and disadvantages of low/high book-tax conformity. Our analysis rests on the review of respective literature and it is complemented by the classification of real corporate and tax accounting systems of the EU countries after the IFRS adoption. The classification can be employed in research studies, when the control for different aspect of de jure book-tax conformity is needed.

Keywords

Book-tax conformity; IFRS adoption; accounting choices; tax avoidance; reporting incentives

Acknowledgement

The paper is supported by the Czech Science Foundation under the research project Assumptions for Introduction of the IFRS as an Alternative Tax Base in a Small Open Economy: Evaluation of Its Impact on Competitiveness (No P403/12/1901); the support is gratefully acknowledged.

Cd1 0 0 1 286.97 124.94 Tm( )]TJET0 C0 0 125 TJis 217.13 252.77 Tm(a)4(7 Tm(a)4(7 Tm(a)4(7 T6(a)4890 Tc( )]TJETBT1 0 0 1 . aBT1 0 0 1 177.74 252.77 Tm 0

1. INTRODUCTION

Under model of

Both studies, although, do not contain any satisfactory empirical evidence, whether double-opportunistic behaviour of firms is really a phenomenon expanding over the economy. Some supportive arguments on dichotomy of accounting and tax profits are shown by

quality, as each system assists to completely different purposes. Ali and Hwang (2000) document that value relevance of accounting earnings diminishes with increasing BTC. The loss of earnings informativeness to the capital markets under tight BTC using the explanatory value of earnings of US companies is documented by Hanlon and Shevlin (2005), Hanlon, Laplante and Shevlin (2005), and Hanlon, Maydew and Shevlin (2008). Atwood, Drake and Myers (2010) apply an alternative approach and different dataset, but with the same conclusions. Based on worldwide data, they confirm that persistence of current earnings declines with increasing BTC. In addition, the association of current earnings and future cash flows is moving oppositely to the development of BTC. Temporary book-tax differences may then serve as a useful signal of earnings persistence (Hanlon 2005; Blaylock, Shevlin and Wilson 2012). Finally, Blaylock, Gaertner and Shevlin (2015) uncover that companies located in countries with higher BTC exhibit higher rather than lower levels of earnings management. The study contains evidence on 34 countries, thus challenges strikingly the arguments of BTC proponents appealing for the higher dependence between accounting and taxation measure of profit.

Besides the negative impact of high BTC on the informativeness and quality of accounting earnings, the research has also identified that a proposed closer link between accounting and taxation does not work and it does not enhance accounting quality of earnings. According to the study of Guenther and Danquing Young (2000), accounting earnings in the UK and the US are more tightly related to real economic activity than accounting earnings in France and Germany, despite latter two countries incline to a higher level of BTC. Lang, Lins and Maffett (2012) detect that earnings management is lower for firms domiciled in the countries with a weaker link between tax and financial reporting. The findings of these studies deteriorate the arguments for linking accounting income with taxable one. Real data indicates that higher BTC results in lower earnings persistence and lower dependency between current earnings and expected cash flows and provides thus additional arguments in favour of the independency of accounting and taxation.

The findings of all previous studies support an idea that a high level of BTC has an adverse effect on accounting quality defined in terms of earnings management, timely loss recognition, and value relevance of accounting amounts (Beaver 1998; Barth, Beaver and Landsman 2001; (Barth, Landsman and Lang 2008). However, there are two recent studies showing an opposite picture. Tang (2015) investigates financial statements of companies from 32 countries and finds out that high BTC is associated with less earnings management and lower tax avoidance. Moreover, an increasing BTC curtails earnings management more in code-law countries, but does not result in significant differences between developed and developing capital markets. Finally, the IFRS adoption has not affected the association. The main weakness of this study is the sample, which employs consolidated financial statements of analysed companies. In majority of code-law countries, corporate income tax is levied on a separate legal body, and the tax calculation must

substantially extend or contract the base, which is subject to taxation. The impact on tax revenues then depends on the type of earnings management behaviour. Besides the general evidence in the previous section, additional stream of research methods may be applied for the evaluation of the phenomena of IFRS adoption. Methodologically, the introduction of new accounting principles for determination of taxable profit is equivalent to the changes in other tax-relevant variables.

The impact of IFRS adoption on tax collection may be estimated by the findings of

calculated under impairment testing (IAS 36) or disposing assets (IFRS 5). In some instances, market-based fair values are not available and have to be estimated. The estimate based on projected discounted cash flow can be both necessary and sufficient to inform users of financial statements, but it may lack sufficient objectivity to become subject to taxation. The principle of neutrality would be then violated, if estimated unrealised gains included in the financial reporting measure of earnings were taxed. There are also some concerns about deterioration of the effectiveness of tax supervision under IFRS model (Barbe, Didelot and

- are required to prepare their individual financial statements in conformity with local GAAP; or
- are allowed to opt between IFRS and local GAAP.

The third level of classification of corporate and tax accounting systems refers to the link between separate financial statements and tax fillings, as far as the calculation of taxable profits concerns. Depending on whether accounting income from statutory accounts is relevant for the determination of tax base or not, the systems may be sorted out into two extreme groups:

- systems with zero book-tax conformity (ie absolute independence of accounting and taxy

Figure 1 captures the classification of mutual relationship of corporate and tax accounting regimes in the European Union after the IFRS adoption. The classification follows the principles outlined above; each country is assign to respective group with reference to (a) the analysis of legal acts regulating financial reporting and taxation in given country;[7] (b) studies of EY (2014), PwC (2014a), PwC (2014b) and review of jurisdiction profiles by (IASB 2014). Contrary to the model of Watrin, Ebert and Thomsen

government; only dividends are taxable on distribution. Other countries follow a more common approach, under which accounting profit is somehow adjusted for tax purposes. Financial standards used in separate financial statements can then decisively determine the tax base. The largest group contains 11 countries, which mandate listed companies to prepare not only consolidated, but also separate financial statements in compliance with IFRS. Majority of them allow calculating tax profit based on statutory income, which results in application of IFRS for taxation, too see *Scenario A2*. The number of adjustments differs within the group; the association between accounting and tax profit may thus vary significantly. For example, Danish firms may expect that their accounting income will be (almost) equal to their tax profit. On the other hand, a high number of adjustments required eg by Croatian tax rules may loosen the linkage. Despite allowing IFRS to be tax base, the resulting tax obligation could be effectively independent on the figure reported in IFRS income statement in countries with high number of adjustments.[10] The Czech Republic is the only country not permitting IFRS for taxation, despite listed companies must prepare both consolidated and individual statements according to IFRS. For income tax purposes, Czech listed companies have to firstly transform their statutory accounting income (based on IFRS) to accounting income based on Czech GAAP; consequently Czech GAAP income is adjusted (for relatively high number of instances) to taxable profit.

Class B contains seven states, which have not allowed the usage of IFRS in statutory accounts of listed companies. Separate financial statements have to be prepared in accordance with local GAAP. The starting point for tax fillings is statutory income, which is modified according to tax principles. In these countries, IFRS adoption has not any material impact on traditional relationship of corporate and tax accounting, and BTC has remained (almost[11]) the same.[12] Finally, Group C is made up by ten countries (including the Netherlands) passing the Article 5 (a) option on companies. Listed companies may decide whether they will maintain their statutory accounts according to local GAAP or whether they switch to IFRS completely for both sets of statements. This company-wide variability in financial reporting has to be addressed also in the tax area. Six states permit the use of IFRS in tax filling, although with relatively significant extent of adjustments. The Netherlands has an independent tax system and three countries do not tied-up tax profit with statutory accounting income automatically. Latvia and Portugal oblige the companies, if reporting under IFRS regime, to calculate additionally the income according to local GAAP, which is then adapted for tax fillings.[13] Finally yet importantly, Slovak policy-makers permit listed companies applying IFRS in statutory accounts to calculate income tax either according to the IFRS or Slovak GAAP rules. For both cases, many adjustments have

---

[10] The divergence between both profits may be magnified by the existence of special tax rules for listed companies and other entities reporting under IFRS, as in case of Romania.

[11] There two exceptions resulting from the local GAAP reforms. Germany underwent quite substantial

to be made in tax returns. In addition, specific provisions are applicable in the first fiscal period, for which IFRS-based taxation was selected. A complex set of tax requirements should ensure that tax expense payable would be the same regardless which type of financial reporting[14] and tax regime[15] will be adopted.[16]

Inspired by concerns about inappropriateness of IFRS based taxation, the researchers attempt to evaluate possible effects, which may be elicited by switching to this system of taxation. Eberhartinger and Klostermann (2007) survey confidential tax data of Austrian companies to evaluate the potential impact of IFRS on discounted tax burden under different scenarios of taxation rules. Taking into account relatively a huge BTC in Austria, they did not find any material effect on tax expense surprisingly. In two scenarios, some tax advantages for companies are identified; the last scenario exhibits only immaterial tax disadvantages. Although IFRS are perceived to be less conservative and thus tend to premature recognition of profits, the assumption that IFRS-based taxation would be higher than local GAAP taxation was not confirmed.[17] Another country

enterprise over a ten-year period; tax burden is expressed as the difference between the pre-tax value and the post-tax value of the enterprise at the end of simulation period (Spengel and Oestreicher 2012). The model can control for all relevant tax rules and it contains fundamental tax and accounting data for 27 EU Member States plus the USA and Switzerland. Jacobs et al (2005), Oestreicher and Spengel (2007), Haverals (2007) use the ETA to test their hypotheses related to induced changes in tax calculation after potential shift to IFRS. Because of the same model and underlying data, they derived at similar results across both countries and industries. On average, the IFRS based tax burden is higher compared to the tax expense calculated with reference to local GAAP. The discrepancies in depreciation and in measurement of inventory (finished and work-in-progress) are recognised as the main factors of a potential higher tax burden. A rather different methodological approach, but with the same results, was adopted by Kager, Schanz and Niemann (2011) and Kager and Niemann (2013). Reconstructing tax balance sheets of Austrian, German and Dutch companies, they estimate that the introduction of IFRS would boost the tax burden. The main sources of increase are intangible assets and provisions; inventories, accounts receivable and accounts payable do not have any material impact on variation in taxation.

Finally, De Simone (2013) investigates the actual impact of IFRS adoption on income tax-motivated profit shifting by multinational entities, which are allowed/required to apply IFRS in their separate financial statements. Using data on the EU separate financial statements and ownership over 2001 to 2010, a significant 16.2 per cent tax-motivated change in reported pre-tax profits was identified following the IFRS adoption by multinational entities, relative to no material change in opportunistic tax behaviour of non-adopters. This is the first study, which empirically challenges the prevailing arguments and empirical evidence against the book-tax conformity analysed in Chapter 2. It demonstrates that the introduction of IFRS has alleviated the tax discipline. Using data from separate financial statements, De Simone (2013) overcomes the methodological shortcomings of Tang (2015) and supplements the results of Watrin, Ebert and Thomsen (2014).[19] The

4. CONCLUSION

The uncertainty of future economic development results in absence of unequivocal definition of income. Consequently, decision-specific measures of income are required as solutions of distinct economic problems call for differentiated characteristics of a performance. The main goal of financial reporting is to provide users of financial statements with information useful in their decision-making, which covers various kinds

regime. This may be risk, but also opportunities for small open economies, which struggle to retain control over taxation.

The previous findings highlight the need to examine, whether

Gavana, Giovanna, Gabriele Guggiola and Anna Marenzi, Aligning Taxation and International Financial Reporting Standards: Evidence from Italian Listed Companies (2015) 1 *Politica Economica – Journal of Economic Policy* 77 96.

Gjesdal, Froystein, Accounting for Stewardship (1981) 19(1) *Journal of Accounting Research* 208 31.

Gordon, Roger H, Taxation of Investment and Savings in a World Economy (1986) 76(5) *The American Economic Review* 1086 1102.

Gordon, Roger H, Can Capital Income Taxes Survive in Open Economies? (1992) 47(3) *The Journal of Finance* 1159 80.

Gordon, Roger H, and Jeffrey K MacKie-Mason, Why Is There Corporate Taxation in a Small Open Economy? The Role of Transfer Pricing and Income Shifting in Martin S Feldstein, James R Hines and R Glenn Hubbard (eds), *The Effects of Taxation on Multinational Corporations*, (University of Chicago Press, 1995) 67 94.

Guenther, David A, Earnings Management in Response to Corporate Tax Rate Changes: Evidence from the 1986 Tax Reform Act (1994) 69(1) *The Accounting Review* 230 43.

Guenther, David A, and David A Danquing Young, The Association between Financial Accounting Measure and Real Economic Activity: A Multinational Study (2000) 29(1) *Journal of Accounting and Economics* 53 72Guenther, David A, Edward L Maydew, and Sarah E Nutter, Financial Reporting, Tax Costs, and Book-Tax Conformity (1997) 23(3) *Journal of Accounting and Economics* 225 48.

Hanlon, Michelle, The Persistence and Pricing of Earnings, Accruals, and Cash Flows When Firms Have Large Book Tax Differences (2005) 80(1) *The Accounting Review* 137 66.

Hanlon, Michelle, Stacie Kelley Laplante and Terry Shevlin, Evidence for the Possible Information Loss of Conforming Book Income and Taxable Income (2005) 48(2) *Journal of Law and Economics* 407 42.

Hanlon, Michelle, Edward L Maydew and Terry Shevlin, An Unintended Consequence of Book-Tax Conformity: A Loss of Earnings Informativeness (2008) 46(2 3) *Journal of Accounting and Economics* 294 311.

Hanlon, Michelle, and Terry Shevlin, Book-Tax Conformity for Corporate Income: An Introduction to the Issues (2005) 19(1) *Tax Policy and the Economy* 101 34.

Haverals, Jacqueline, IAS/IFRS in Belgium: Quantitative Analysis of the Impact on the Tax Burden of Companies (2007) 16(1) *Journal of International Accounting, Auditing and Taxation* 69 89.

Hayek, Friedrich August, The Use of Knowledge in Society (1945) 35(4) *The American Economic Review* 519 30.

Hayn, Carla, The Information Content of Losses (1995) 20(2) *Journal of Accounting and Economics* 125 53.

Hicks, John Richard, *Value and Capital: An Inquiry Into Some Fundamental Principles of Economic Theory* (Clarendon Press, 1946).

Hoffmann, Sebastian, and Henning Zülch, Lobbying on Accounting Standard Setting in the Parliamentary Environment of Germany (2014) 25(8) *Critical Perspectives on Accounting* 709 23.

Holthausen, Robert W, Accounting Method Choice: Opportunistic Behavior, Efficient Contracting, and Information Perspectives (1990) 12(1 3) *Journal of Accounting and Economics* 207 18.

IFRS Foundation and IASB, *Jurisdiction Profiles* (2014) The Website of the IFRS Foundation and the IASB <http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx>.

Jacobs, Otto H, Christoph Spengel, Thorsten Stetter and Carsten Wendt, EU Company Taxati3n2 Tm[ )]TJETBT/F

Oestreicher,

Zeff, Stephen A, The Evolution of the IASC into the IASB, and the Challenges It Faces (2012) 87(3) *The Accounting Review* 807 37.