# eJournal of Tax Research

Volume 14, Number 1 July 2016

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Atax
UNSW

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

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

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## 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.




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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

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

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 shifting by 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

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

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