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Book Review

Luca Menicacci, *Book-Tax Conformity in the IFRS era. Evidence from Italian Listed Companies*

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The issue of whether a jurisdiction should increase the required conformity between reported earnings (following GAAPs) and taxable income has been debated for years (Braydlock et al., 2015). Proponents argue that book-tax conformity (hereafter BTC) reduces managerial opportunism over financial reporting and minimize the firm's compliance costs. BTC opponents argue that conformity implies a significant loss of useful financial information, as the information required by users of financial reports and by tax authorities significantly differs. Also, they argue that the reduction in compliance costs would not be as large as one can expect. Most of prior research has been devoted to the costs and benefits of high/low conformity (Hanlon & Heitzman, 2010), with researchers exploiting changes in regulation or cross-national differences to investigate the topic. As expected, the most important outcomes of BTC are related to accounting quality and tax avoidance. As this book clearly outlines, US based research converges on the notion that greater BTC implies lower quality earnings, i.e. less discretional and/or less informative earnings for financial reporting users. In non-US settings, the empirical findings are mixed due to cross-Country institutional differences, related to e.g. the law system, the law and tax enforcement, the corporate culture, characteristics of the financial markets.

Within this stream of research, the book by Luca Menicacci offers a timely, brilliant, and well-written contribution. It investigates the underexplored effect of switches from a regulatory setting in which reported GAAP income and taxable income are determined separately (i.e. "two-book" system"), to a setting in which reported GAAP income and taxable income are strictly interrelated (i.e. "one book system" or similar to a one book system).

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To this purpose, Italy is selected as a suitable setting for several valid reasons. After the adoption of IAS/IFRS by EU, Italy still adopted in 2006 and 2007 the "two-book" approach, requiring IFRS firms to restate IFRS financial statements into local Italian GAAP, to apply tax adjustments and then calculate the taxable income. Italy subsequently switched from a two-book system to a one-book system in 2008 and the IFRS income began being used to determine the taxable income under the "enhanced derivation" principle. This setting allows exploring the effect of both strong and weak BTC on the accounting quality of the Italian public companies.

The book is divided into four Chapters, with the latter dedicated to the concluding remarks. The first paragraph of the first Chapter is effective in demonstrating that BTC is not a mere academic debate topic, rather is at the center of corporate taxation policymaking since at least two decades. Indeed, the trade-off between earnings informativeness and risks of managerial opportunism, on the one side, and reduction of compliance costs, on the other side, animated the political debate in the US in the mid 2000s. Recently this debate re-surfaced, this time more related to the political sensitivity of taxation on corporate income. The debate over BTC also has a long history in Europe, where it crossed the path with the IFRS adoption in mid 2000s and overall, with the process of accounting and taxation harmonization in Europe in the last two decades. The first Chapter next discusses the effect of the European Directive on IFRS and accounting on taxation, with a specific focus on Italy. After outlining the evolution of corporate taxation in Italy, the chapter explains that initially the Italian government selected tax neutrality of IFRS, forcing IFRS adopting firms to restate their accounts under the Italian GAAP and calculate the taxable income. This two-book system was adopted given the uncertainty surrounding the adoption of IFRS and the concerns about the use of different accounting rules to determine the taxable income, which could have produced inequalities for taxes paid at similar levels of earnings. The legislator switched to a one book system from 2008 on, to reduce the compliance costs for IFRS adopters and started introducing changes to Italian GAAP users toward a one book approach, under an enhanced derivation principle. The Chapter ends framing the book-tax links in the Italian setting, using the matrix by Lamb et al. (1998) and Nobes and Schwencke (2006).

Chapter 2 reviews the literature on BTC in accounting research. The Author first reconstruct the theoretical background of this stream of research: the Scholes-Wolfson framework and the agency theory. The Scholes-Wolfson theoretical paradigm sets the postulates of effective tax planning. Tax planning is effective when it properly considers some key elements: all the parties involved in the transactions; all the explicit and implicit taxes; all the costs of the tax planning process. The agency theory is the primary theoretical framework for accounting and finance studies and, as such, it is the primary references for studies on tax avoidance, within which BTC studies can be located. From an agency perspective, the tax authority is an external monitoring device reducing the agency conflicts between principal and agents (Type I), as well as among principals (Type II). The book discusses the work by Desai et al. (2007), analyzing the agency perspective on taxation as a three parties' relationship: shareholders, managers, and tax authority. Some key implications of the perspective are that: (1) tax minimization (i.e., tax avoidance) is not always in the best interest of shareholders, as it can signal managerial wealth extraction, financial reporting opacity and increases compliance and reputational risks; (2) tax authority act as external monitoring device depends on the way in which tax rules are designed and enforced. Relate to the latter point, BTC undoubtfully plays a role.

Chapter 2 draws a map of cost and benefits of BTC in a fully conformed system (McClelland & Mills, 2007). Among the most important benefits, there are the reduction of cross-firm difference in the effective tax rates and the reduction of compliance costs, i.e., keeping a one book system in which rules determining GAAP earnings and taxable income are aligned. Overall, a one book system should theoretically provide an adverse incentive to manager earnings and to tax avoidance, combining the effects of two monitoring external devices: auditors and tax authorities. However, such system is not exempt from relevant costs. Managers aiming at avoiding taxes could use earnings management to minimize the taxable income, reducing earnings informativeness. Even if the aim of managers would be increasing earnings informativeness, for example increasing earnings, this behavior would be constrained by tax concerns. This mean that a one book system would inevitably reduce the usefulness of financial reporting, whatever the purpose of the managers (signaling or garbling to use the words by Tucker & Zarowin, 2006).

Chapter 2 also discusses more into-depth the interaction between tax avoidance and earnings management, reviewing the literature on conforming and non-conforming tax avoidance. Conforming tax avoidance can be referred to as tax-induced earnings management and directly examines the abovementioned interaction. The literature review proposed summarizes the evidence on the impact pf BTC on accounting quality and tax avoidance.

In the US context, prior research converges on the notion that higher BTC leads to lower quality earnings, largely due to managerial discretion applied in the calculation of the taxable income via GAAP measurements. In the international setting, the findings are mixed or even contrasting. For example, Blaylock et al (2015) examines public firms from 35 Countries from the 1994 to 2007 and find that BTC increases earnings management. Tang (2015) examines public firms from a similar number for Countries in a similar period and find the opposite. The contrasting results may be due to different proxies for BTC and for earnings management. Hence, the effect of BTC on accounting quality and on tax avoidance strategies likely needs to be contextualized in the specific regulatory setting.

Chapter 3 includes an empirical research on the Italian setting. It selects a sample of 114 Italian firms, mandatory IFRS adopters, listed on the Milan Stock Exchange in the period 2006-2010, not consolidated by other firms. BTC is measured using permanent and temporary book-tax differences. Accounting quality is measured using earnings persistence and other earnings management measures: correlation between current earnings and future cash flows, and abnormal working capital accruals. The findings show that an increase in BTC reduces earnings persistence. Further tests show no evidence of weaker association between current earnings and future cash flows after the increase in BTC in 2008. Also, there is no evidence of downward earnings management (proxied by abnormal pre-tax working capital accruals) after the switch from a two to a one book system. The findings further confirm that results of prior literature cannot be generalized in every setting, and that the linkage between BTC and accounting quality deserves further research.

Overall, the volume provides food for thoughts to the reader. Menicacci provides a comprehensive and clearly written analysis of BTC literature and on the relationship between BTC and accounting quality. The empirical research on the Italian setting brings fresh knowledge on the change from two book to one book systems and underlines how the introduction of IFRS and the switch to a one book system increases managerial discretion, leading to lower quality financial reporting. Such insights are of interest to academics, especially in the European Union setting, where the interaction between tax avoidance and earnings management is less explored. It has policy implications for policy makers, auditors, and stakeholders, as it contributes to the debate on the "Minimum Book-Tax" for multinational companies and on a Common Corporate Tax Base in the European Union.

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