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Book-Tax Income Conformity and Earnings Quality:
EGX-Based Evidence

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ABSTRACT

This article aims to investigate the incremental value of book-tax differences (BTD) for the future earnings post the Egyptian revolution crisis and also examine the changes in BTD information under earnings discretionary overestimation versus underestimation by Egyptian stock exchange (EGX) listed firms. The findings show a negative incremental BTD value for the one-year ahead earnings performance. This finding is more pronounced for large BTD regardless of its sign (positive/ negative). However, large BTD negative implications are more evident in firms managing earning upward. The findings advocate that BTD are more likely to be driven by earnings manipulation incentives than tax management incentives. The findings suggest a regulatory disclosure policy of a reconciliation of book and taxable incomes to help improve investors' understanding of the BTD potential sources.

KEYWORDS

Accruals, BTD, Cash Flow, Discretionary Overestimation, Discretionary Underestimation, Earrings, Egypt, Revolution Crisis

INTRODUCTION

Academic researchers and policy activists have used the difference between accounting income and estimated taxable income, commonly referred to as the book-tax difference (BTD) as a proxy of the unobservable level of corporate income tax planning. In drawing any policy implications from observed BTDs. Book-tax differences (BTDs) refer to the gap between the pre-tax income reported in a company's published financial statements (book income) and the taxable income reported to the tax authorities. Recent phenomenon is the increased scrutiny of the level of corporate income tax paid by companies. Companies have often attracted adverse attention because of a perceived

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discrepancy between the level of accounting profits reported and the associated levels of taxable income and consequentially, the level of corporate income tax payable (Abdul Wahab and Holland, 2015).

Companies are required to calculate two measures of income on an annual basis. One measure is determined by financial reporting regulations to give accounting or book income while the second uses tax law to produce a figure of taxable income. The degree to which the resulting levels of income correspond depends on the extent of conformity between the two measures (Hanlon, 2005). Any difference between the two levels is commonly referred to as the book-tax difference (BTD). The conflicting objectives of accounting and tax rules lead to divergent requirements in income reporting, which generate mechanical book-tax differences (Tang & Firth, 2011). The emergence of several bankruptcies cases (Enron, Worldcom, etc.) questioned the quality of accounting information and weaken the investor confidence of its use for sound capital decisions. As a result, researchers and several practitioners in accounting recalled the importance of a qualitative appreciation of financial reporting earnings. Since then, more transparency concerning the differences between book income and taxable income (i.e., book-tax differences) has been required (Hanlon, 2005).

Some prior literature focused on the sources of the BTD differences as possible determinants (Desai & Dharmapala, 2009a; 2009b; Frank et al. 2009; Raedy, 2009; Tang & Firth, 2011; Wilson, 2009; Philips et al. 2003). Also, a stream of literature studies investigated whether book-tax differences are bound to either earnings management (e.g., Abdul Wahab & Holland, 2015; Jackson, 2015; Philips et al. 2003) or tax management behaviors (e.g., Frank et al. 2009; Tang & Firth, 2012; Wilson, 2009); or tax and earnings management mutual effects (e.g., Ayers et al., 2009; Blaylock et al., 2012; Raedy, 2009; Tang & Firth, 2011). However most of the BTD related literature is conducted in developed countries context; very rare research investigated the BTD in developing economies context like Egypt.

Egypt is a developing country with an emerging capital market that needs to raise its capital, attract foreign investment and promote the confidence of the existing as well as potential stakeholders. A critical factor for achieving these objectives is the transparency and fairness of corporate disclosures. In Egypt, a high conformity exists between accounting regulation and tax regulation. Although, they serve very different purposes, determining current year tax liability on the one hand, and providing a particular informational input to investors on the other hand. The determination of taxable income relies on the book income; while conducting some adjustments (i.e., reinstatements and deductions); and ideally there are differences between the two measures. The high-confirming Egyptian accounting system and Egyptian tax law give rise to discretionary book-tax differences. In 2011, the EGX witnessed unique market crash (the Egyptian revolution crisis) with adverse shocks that triggered a sudden loss of investor confidence in the EGX market. In such crisis period, managers may be motivated to opportunistically manipulate earnings using discretionary accruals choices to cover poor firm performance and pay less tax as well. In light of these institutional characteristics, exploring the BTD information value would be so crucial.

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