

# **Disentangling the effects of changes in book-tax conformity related to mandatory IFRS adoption on earnings quality**

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# **Disentangling the effects of changes in book-tax conformity related to mandatory IFRS adoption on earnings quality**

## **ABSTRACT**

Using variation in book-tax conformity across EU countries, we provide new evidence on whether mandatory IFRS adoption leads to increases in earnings quality. Specifically, we examine if the relation between earnings quality and IFRS adoption differs among firms in countries with and without a concurrent change in book-tax conformity. We offer three main results. First, for countries adopting IFRS without a concurrent change in book-tax conformity, we find decreases in earnings persistence and cash flow predictability following IFRS adoption. Second, for countries experiencing decreases in book-tax conformity concurrent with IFRS adoption, we find increases in earnings persistence and cash flow predictability. Finally, we find no significant difference in the level of earnings quality in the post-IFRS period across firms in the two sets of countries. Our findings highlight the importance of considering concurrent changes in book-tax conformity when examining the costs and benefits of a change in financial reporting regulations.

**Keywords:** Book-Tax Conformity; IFRS; Earnings Quality; Regulation

**JEL Codes:** F23; G18; H25; M41

## 1. Introduction

The mandatory adoption of International Financial Reporting Standards (IFRS) in the European Union (E.U.) spurred an extensive literature on the costs and benefits of adoption (e.g. Armstrong et al., 2010; Byard et al., 2011; Tan et al., 2011; Kim et al., 2012; Neel, 2017). However, recent research calls into question previous results and suggests that other contemporaneous changes may explain these previously identified costs and benefits of mandatory IFRS adoption (e.g., Isidro et al., 2020). In this paper, we analyze an additional contemporaneous change not yet considered in the literature: book-tax conformity. While the E.U. required all companies listed in regulated markets to adopt IFRS for fiscal years beginning on or after January 1, 2005 (European Parliament, 2002), each country could separately choose if and how IFRS adoption would affect the starting point for calculating taxable income. We use this cross-country variation to further disentangle the effects of mandatory IFRS adoption into two groups: those stemming from mandatory IFRS adoption and those stemming from the concurrent changes in book-tax conformity driven by separating financial and tax accounting.

In this paper, we use variation in book-tax conformity across E.U. countries to examine whether mandatory IFRS adoption leads to an increase in earnings quality. More specifically, we examine if the relation between earnings quality and IFRS adoption differs among firms in countries with and without a concurrent change in book-tax conformity. We focus on two specific groups of countries to test our research question. We first identify countries whose financial and tax accounting are independent of each other in both the pre- and post-IFRS periods (*Independent*) and argue that firms in these countries did not experience a change in book-tax conformity with IFRS adoption. We include this group to examine the direct effect of IFRS adoption on earnings quality. Our second group of countries use the same starting point for both financial and tax

reporting pre-IFRS (Local GAAP) and shift to using IFRS for financial reporting while continuing to use Local GAAP for tax reporting in the post-IFRS period. These countries have decoupled their tax reporting from their financial reporting in the post-IFRS period (*Decoupled*).<sup>1</sup> We identify any incremental changes in earnings quality in the *Decoupled* sample as compared to the *Independent* sample as the concurrent effect of IFRS adoption on earnings quality through changes in book-tax conformity.

This topic is of interest not only to researchers, but also to regulators. Prior literature on the effect of IFRS on earnings quality is mixed (e.g. Atwood et al., 2011; Yip and Young, 2012). However, many country-level and institutional changes occurred at the same time as IFRS adoption, making it difficult to disentangle these effects (e.g. Christensen et al., 2013; Isidro et al., 2020). To our knowledge, our paper is the first to examine the effect that concurrent changes in book-tax conformity have on the relation between IFRS and earnings quality.

Our findings should be of interest to regulators for several reasons. First, the stated goal of mandatory IFRS adoption is to increase transparency and comparability of financial statements and ensure an efficient capital market (European Parliament, 2002). By identifying a subsample of countries that did not experience a change in book-tax conformity upon IFRS adoption and controlling for previously documented country-level characteristics, we provide more direct evidence on the effects of IFRS adoption on earnings quality that is independent from the effects of *decoupling* tax from financial reporting.

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<sup>1</sup> Blaylock et al. (2015) show that Atwood et al.'s (2010) continuous metric for book-tax conformity didn't change between pre- and post-IFRS periods. Blaylock et al. (2015, p. 166) recognize that their results were 'surprising', making it clear that "whether moving from Local GAAP to IFRS increases or decreases book-tax conformity also depends on how conformed Local GAAP was to the tax rules before and after the change." We, therefore, fill this gap by considering tax and financial reporting pre- and post-IFRS adoption across countries within the E.U. In addition, a potential explanation for the absence of differences in the continuous metric between pre- and post-IFRS periods would be the use of a 'ranked' variable. If the mean of a 'ranked' variable is always 0.5, then one would not find any difference when comparing two different periods.

Second, there is an ongoing policy debate in the U.S. related to book-tax conformity. Proponents of book-tax conformity argue that increasing book-tax conformity will lead to more truthful financial reporting by discouraging overstating financial income and understating taxable income (e.g., Desai, 2005; Whitaker, 2005; Desai and Dharmapala, 2009a). President Obama’s framework for business tax reform suggests reducing “accounting gimmicks” by reducing the gap between book and taxable income (Treasury, 2012). Recently, President Biden’s campaign proposals included a minimum tax on book income of large corporations to target gaps between financial and taxable income (Tax Foundation, 2021). However, prior literature examining changes in book-tax conformity brought on by the *Tax Reform Act of 1986* or variation in book-tax conformity across countries largely finds a negative association between earnings informativeness and book-tax conformity (e.g., Hanlon et al., 2008; Atwood et al., 2010; Blaylock et al., 2015). Our setting allows us to inform the policy debate by examining the consequences of a decrease in book-tax conformity stemming from a change in financial reporting, and not a change in tax reporting.

Third, the European Commission proposed a Common Consolidated Corporate Tax Base (CCCTB) in the E.U. in 2011 that introduces one set of rules for cross-border companies to use when calculating their taxable income. These efforts were relaunched in October 2016.<sup>2</sup> More recently, the Organization for Economic Co-operation and Development (OECD), as part of its Base Erosion and Profit Shifting (BEPS) framework, released details surrounding its proposed Pillar Two Blueprint, which imposes a minimum tax based largely on financial reporting numbers (OECD, 2019; PwC, 2020). Our results shed light on the use of Local GAAP for tax reporting, but inferences from our findings can be drawn when considering IFRS for tax reporting and potential

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<sup>2</sup> Information about the CCCTB initiative is available at: <https://data.consilium.europa.eu/doc/document/ST-13024-2018-INIT/en/pdf> (Accessed: 08 February 2021).

consequences on earnings quality stemming from recoupling financial and tax reporting. Thus, our findings should be informative to the European Commission and OECD as they work to establish a new corporate tax base.

We regress future earnings (future operating cash flows) on earnings in year  $t$ , the interaction of earnings in year  $t$  and  $POST_t$ , a binary variable equal to one post-IFRS and zero pre-IFRS, and control variables for time-varying and time-invariant characteristics. We run our regressions separately on the *Independent* and *Decoupled* groups and test for differences in the estimated coefficients. By doing so, we identify the extent to which earnings quality changed following adoption of IFRS within the *Decoupled* and *Independent* group of countries and disentangle the IFRS direct effect on earnings quality from the changes in earnings quality attributable to changes in book-tax conformity. In subsequent analysis, we also control for the level of book-tax conformity prior to IFRS adoption for our decoupled firms, allowing us to examine if the effects of decoupling are more pronounced for firms in countries with higher book-tax conformity pre-IFRS. Lastly, we provide additional analyses for earnings management measures.

We offer three main results. First, we find evidence of decreased earnings persistence and cash flow predictability following IFRS adoption for countries in the *Independent* group. Second, we find increases in earnings persistence and cash flow predictability following IFRS adoption for the subset of firms in countries that decoupled their financial and tax reporting (*Decoupled* group). Third, we find evidence, after comparing both groups, that the increase in earnings quality is related to the change in book-tax conformity and that the positive effects of decoupling yield similar levels of earnings quality across countries in the post-IFRS period. Overall, these results support the growing literature considering the joint effects of a change in accounting standards (IFRS) and other time-varying and time-invariant characteristics. Our findings suggest that IFRS

adoption has an indirect positive effect on earnings quality through changes in book-tax conformity. Finally, while we find that firms in both groups of countries decrease earnings management post-IFRS adoption, we do not find that decreases in book-tax conformity incrementally contribute to this decrease.

Our study provides several contributions. First, we use cross-country variation in IFRS adoption practices to identify a sample of countries where we can directly test the effects of IFRS adoption on earnings quality without the effects relating to book-tax conformity. By doing so, we contribute to the overall literature examining the costs and benefits of adoption (e.g., Armstrong et al., 2010; Byard et al., 2011; Tan et al., 2011; Kim et al., 2012; Neel, 2017). We find that the change in accounting standards brought negative effects on earnings persistence and cash flow predictability. Second, we identify decreasing book-tax conformity resulting from decoupling as a significant and economically relevant explanation for the positive effects on earnings quality. We, therefore, contribute to the literature by explaining *why* there was an increase in earnings quality after IFRS adoption for a group of E.U. countries, even after controlling for other time-varying and time-invariant institutional factors (Christensen et al., 2013; Isidro et al., 2020).

Third, we complement the previous literature (Guenther et al., 1997; Hanlon et al., 2008) that finds negative effects of tax-induced increases in book-tax conformity by showing that decoupling financial from tax reporting yields benefits for financial reporting quality, even without changing the tax code. Finally, results indicate that allowing financial reporting choices without any direct tax effect allows managers to better communicate private information, thus contributing to the debate about conformity between book and tax (e.g., Desai, 2005; Desai and Dharmapala, 2009a; Hanlon et al., 2008; Atwood et al., 2010).

## **2. Background and hypothesis development**

In this paper, we attempt to further disentangle the indirect effects of changes in book-tax conformity upon IFRS adoption on earnings quality. In this section, we first begin by discussing prior literature examining the costs and benefits of IFRS adoption. Next, we discuss policy debates and related literature on the relation between book-tax conformity and earnings quality. Finally, we discuss our three hypotheses examining the effect of IFRS adoption and concurrent changes in book-tax conformity on earnings quality.

### *2.1. IFRS adoption and earnings quality*

Prior literature examining costs and benefits of IFRS adoption generally finds mixed evidence on IFRS adoption and improvements in the information environment. Supporting benefits from IFRS adoption, Byard et al. (2011) find improvements in analysts' information environments, while Tan et al. (2011) find that adoption of IFRS attracts foreign analysts and improves their forecast accuracy, suggesting an increase in comparability. Armstrong et al. (2010) find that investors respond positively to IFRS adoption for firms with lower information quality prior to adoption, suggesting that IFRS adoption had positive effects on the information environment for these firms. Landsman et al. (2012) find increased information content in firms' earnings announcements following IFRS adoption.

However, several papers find costs (or fail to find benefits) of IFRS adoption. Atwood et al. (2011) do not find differences in earnings persistence and cash flow predictability when comparing IFRS to (non-U.S.) Local GAAP. They also find that cash flow predictability is lower for IFRS when compared to U.S. GAAP. In addition, Krishnan and Zhang (2019) find both earnings persistence and cash flow predictability are lower for IFRS when compared to Canadian GAAP.

Several of these studies also highlight how the documented effects of IFRS adoption often depend on country-specific characteristics, such as the country's legal environment or enforcement of the standards (Armstrong et al., 2010; Byard et al., 2011; Landsman et al., 2012). Along similar lines, Daske et al. (2008) document that the capital-market benefits of IFRS adoption are concentrated in jurisdictions with stronger legal enforcement and for firms with incentives to be more transparent. The authors also find that many countries made concurrent improvements in enforcement and governance, suggesting that their documented improvements surrounding IFRS adoption may relate, at least in part, to these other concurrent changes. Christensen et al. (2013, p. 147) find that substantive changes in enforcement explain most of the positive effects of IFRS adoption on market liquidity for European countries, concluding that "the change in accounting standards seems to have had little effect on market liquidity." Brown et al. (2014) find changes in audit and accounting enforcement activities around IFRS adoption have additional explanatory power in relation to market development, financial transparency, and earnings management. One interpretation is that changes in enforcement, and not in accounting standards (i.e., IFRS), explain their capital market effects. An alternative view is that IFRS adoption, bundled with changes in enforcement, is necessary to achieve the desired outcomes (Barth and Israeli, 2013).

Isidro et al. (2020, p. 280) expand the discussion on how country-specific characteristics affect the outcomes from IFRS adoption by examining other concurrent changes to "economic, political, and social events" in addition to changes in enforcement surrounding IFRS adoption. They show 'synchronicity spikes' of several characteristics around IFRS adoption. After controlling for 21 time-varying characteristics, the authors fail to find a significant effect of the change in accounting standards on the magnitude of accruals, their test metric. The paper expands the number of characteristics that influence reporting quality, and find that social, economic, and

other institutional characteristics should also be considered when examining outcomes from IFRS adoption. Overall, the relation between IFRS and earnings quality remains unclear. Additionally, prior literature (Daske et al. 2008; Christensen et al. 2013; Brown et al. 2014; Isidro et al. 2020) does not consider the potential effects on earnings quality resulting from a concurrent change in book-tax conformity in some jurisdictions upon IFRS adoption in the E.U.<sup>3</sup>

## 2.2. *Book-tax conformity and earnings quality*

Prior literature examining the association between book-tax conformity and earnings quality generally examines two distinct settings. The first setting, the *Tax Reform Act of 1986* (TRA 86), allows for an examination of the link between *changes* in book-tax conformity and earnings quality resulting from a change in the tax law. These studies examine a subsample of firms that were required to change from calculating taxable income under the cash basis to the accrual basis, more closely aligning their taxable income with their accrual basis financial reporting income. The second setting generally uses cross-country analysis to examine the association between different *levels* of book-tax conformity and earnings quality. Overall, the literature largely suggests a negative association between tax-induced increases in and higher levels of book-tax conformity and earnings quality. Below, we summarize the policy debates on book-tax conformity, prior literature on book-tax conformity, and how prior literature informs the debate on book-tax conformity.

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<sup>3</sup> Isidro et al. (2020) control for “book tax independence” (based on Li et al. (2018)) in their subsequent tests on the relation between country-level variables and reporting quality. They do not use this variable, however, in their specific tests examining concurrent changes and their relation to financial reporting upon IFRS adoption. In addition, our approach also varies from Li et al. (2018), which we explain in detail in the subsection 3.1.

### *2.2.1 Policy debates on book-tax conformity*

Within the U.S., research indicates that the divergence between financial and tax income increased during the 1990s (e.g. Plesko, 2002; Desai, 2003; Desai, 2005) leading to an increased focus on book-tax conformity in policy discussions. The divergence led to debates in the academic literature and among policymakers as to the costs and benefits of conforming financial and tax reporting. Studies attempting to trace the discrepancy between book and tax income in the U.S. have not come to a consensus, with potential explanations including depreciation, research and development expenses, tax sheltering activity, and non-qualified stock options (e.g., Desai, 2003; Hanlon and Shevlin, 2005; Lampenius et al., 2021). Most recently, Lampenius et al. (2021) find that U.S. firms engage in tax avoidance strategies by taking advantage of opportunities to both reduce their tax base and their tax rate. In their sample of U.S. domestic and multinational corporations, they generally find that domestic corporations are more likely to engage in tax base avoidance, taking advantage of bonus depreciation and the R&D tax credit, while multinational corporations are more likely to engage in tax rate avoidance, shifting income to lower taxed jurisdictions. The use of tax base versus tax rate avoidance by different firms reinforces that any proposed changes to book-tax conformity would also need to examine potential changes to the tax rate (e.g., Desai and Dharmapala, 2009b; Hanlon and Maydew, 2009).

Proponents of increased book-tax conformity argue that the large differences between financial and tax reporting result from managers acting opportunistically to inflate financial income and mislead investors while also engaging in overly aggressive tax strategies to avoid paying income taxes. Prior research suggests that companies may inflate financial reporting earnings, while at the same time reducing taxes, because corporations in the U.S. have two sets of financial statements – one for investors and another for tax authorities (Desai, 2005; Desai and

Dharmapala, 2009a). As financial and tax reporting increase in conformity, managers must evaluate the tradeoffs between financial reporting choices and their tax planning objectives (Shackelford and Shevlin, 2001; Hanlon and Heitzman, 2010). Proponents of conformity argue that firms would provide a more truthful earnings number if book-tax conformity were increased. Desai (2005) argues that the corporate tax system would work as a corporate governance tool to protect minority shareholders, implying that increased book-tax-conformity would contribute to reduce managers' opportunistic behavior. The claim is that the Internal Revenue Service (or another tax authority) would become an additional monitor to induce a better alignment between managers and shareholders (Desai and Dharmapala, 2009b). The reasoning behind this rationale is that firms would not want to inflate earnings reported to investors if it would result in higher taxes. Firms would also not want to understate earnings to save taxes since investors would view lower earnings negatively. Proponents also argue that conforming financial and tax reporting would broaden the base for tax reporting, allowing for a concurrent lowering of the corporate tax rate (Desai and Dharmapala, 2009b).

Those opposed to increasing book-tax conformity argue that financial income and tax income serve two different purposes. As noted in *Thor Power Tool Co. v. Commissioner* (439 U.S. 522 [1979]), the primary goal of taxation is equitable collection of tax revenues, while the primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and other users of the information. Political, social, and economic goals influence tax laws, while conservatism drives financial reporting (Hanlon and Heitzman, 2010). Those opposed to increased book-tax conformity raise concerns that managers' flexibility to communicate firm performance would likely be restrained by the tax authority's information requirements, thus decreasing earnings quality (Hanlon and Shevlin, 2005; Hanlon et al., 2008, among others).

### *2.2.2 The Tax Reform Act of 1986*

At the same time that TRA 86 lowered the corporate tax rate from 46 percent to 34 percent, it also increased book-tax conformity for a subsample of firms. Several studies examine firm responses to the TRA 86 decrease in tax rates and consistently find evidence of tax-induced earnings management. Results suggest that firms manage financial earnings downwards, either by accelerating expenses or deferring income, in order to report lower levels of taxable income in higher tax rate years (Scholes et al., 1992; Guenther, 1994) and create tax losses to carry back to higher tax rate years (Maydew, 1997).

Prior to TRA 86, publicly traded firms faced lower levels of book-tax conformity, with taxable income being calculated on a cash basis and financial reporting income being calculated on an accrual basis. However, TRA 86 changed the level of book-tax conformity for a subset of these publicly traded firms by switching them from the cash basis to the accrual basis for taxable income purposes. Guenther et al. (1997) exploit this setting to examine the trade-off between financial reporting and tax objectives. Their results suggest those firms required to increase book-tax conformity by using the accrual method to compute taxable income defer income recognition for financial reporting purposes in order to engage in tax planning. Hanlon et al. (2008) use the same setting to examine how the increase in conformity affects earnings informativeness and find a loss of earnings informativeness for the sub-sample of firms forced to increase book-tax conformity.

Together, these results suggest firms respond to increased book-tax conformity by understating financial earnings in order to save taxes, resulting in a decrease in earnings informativeness. Further supporting the decrease in earnings informativeness, Blaylock et al. (2017) find that the subsample of firms experiencing increased book-tax conformity from TRA 86

have a higher cost of equity capital. These firms shift their capital structure towards debt and away from equity in response to the increase in the cost of equity capital. One of the implications discussed in Blaylock et al. (2017) is that increasing book-tax conformity does not necessarily reduce tax avoidance, since firms would shift their structure towards more tax-deductible interest expenses.<sup>4</sup>

### *2.2.3 Cross-country examination of book-tax conformity and earnings quality*

Several studies examine the level, or degree, of book-tax conformity and its relation to earnings quality. Ali and Hwang (2000) examine the relation between country-specific factors and the value relevance of financial accounting data. They find that the information content of earnings is lower for countries whose tax rules significantly influence financial accounting measures, suggesting a negative association between high book-tax conformity driven by tax rules and earnings quality. Focusing on the U.S., Hanlon et al. (2005) show that conforming financial income to tax income would likely result in a 50 percent loss of information.

Using international data, Atwood et al. (2010) develop a comprehensive measure of book-tax conformity and use their cross-country measure to study the relation of a country's level of book-tax conformity with earnings persistence and cash flow predictability. The authors develop an empirical metric, based on the residuals of a regression that uses pre-tax book income, foreign pre-tax book income, and dividends to explain the variation of current tax expense. They rank countries based on their metric and show that those with higher levels of book-tax conformity exhibit lower earnings persistence and cash flow predictability. Blaylock et al. (2015), using the same empirical measure, show that higher book-tax conformity is also related to more earnings

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<sup>4</sup> The argument brought by Blaylock et al. (2017) could also be applied, by analogy, to that made by Desai (2005), that increasing book-tax conformity would reduce upwards earnings management, since there is a possibility of an offsetting effect on taxes by firms relying more on debt and, therefore, on tax-deductible expenses.

management.<sup>5</sup> Overall, prior results are consistent with increased book-tax conformity reducing earnings quality.

### *2.3. Hypothesis development: IFRS adoption and concurrent changes in book-tax conformity*

We propose using variation in book-tax conformity across E.U. countries to disentangle the effects of IFRS from concurrent changes in book-tax conformity. To do so, we first identify countries whose financial and tax accounting are independent of each other in both the pre- and post-IFRS periods (*Independent*), where the adoption of IFRS did not change the starting point for calculating taxable income. This group allows us to more directly examine the effects of IFRS adoption on earnings quality. Our second group of countries uses the same starting point for both financial and tax reporting pre-IFRS (Local GAAP) and shifts to using IFRS for financial reporting while continuing to use Local GAAP for tax reporting in the post-IFRS period (*Decoupled*). These countries have decoupled their tax reporting from their financial reporting in the post-IFRS period. This group allows us to examine the effect of financial reporting-induced changes in book-tax conformity on earnings quality since any incremental changes in earnings quality in this sample as compared to the *Independent* sample represents the concurrent effect of IFRS adoption on earnings quality through changes in book-tax conformity. We explain our identification strategy in greater detail in Section 3.

Our first hypothesis examines the relation between IFRS adoption and earnings quality in countries where we do not expect an institutional change in book-tax conformity following IFRS

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<sup>5</sup> Watrin et al. (2014) also test the relation between earnings quality and book-tax conformity in the E.U. The authors develop a book-tax conformity measure based on book-tax-differences in the separate financial statements. They show that countries with higher book-tax conformity present more downwards earnings management, lower earnings persistence, and lower cash flow predictability. Overall, their conclusions are consistent with those of Atwood et al. (2010) and Blaylock et al. (2015). Atwood (2014), however, raises several concerns about Watrin et al.'s (2014) research design, such as self-selection issues (e.g., some countries may choose between IFRS or Local GAAP in their separate financial statements).

adoption. As previously mentioned, prior literature examining IFRS adoption generally finds improvements in the information environment and that these improvements coincide with other concurrent changes in institutional factors (see De George et al. (2016) for a thorough review of the literature). In addition, more recent work does not find a relation between IFRS adoption and financial reporting quality after controlling for a set of concurrent changes (Isidro et al., 2020). Given the mixed evidence from prior literature, we do not make a directional prediction with respect to the average effect of IFRS adoption on earnings quality when holding book-tax conformity constant, since it may be conditional on other concurrent changes. Therefore, we state our first hypothesis in the null form:

*H1: Earnings persistence and cash flow predictability do not change following IFRS adoption for firms from countries in the Independent group.*

Our second hypothesis examines the effect on earnings quality from decoupling financial and tax reporting. While prior literature examines the effects of tax-induced changes to book-tax conformity (e.g., Guenther, et al. 1997; Hanlon et al., 2008), our setting provides evidence on the effects of a financial reporting-induced change to book-conformity by examining differences in earnings quality between countries that decoupled their financial and tax reporting upon IFRS adoption (*Decoupled*) and those that were already using a separate set of rules as their starting point for calculating taxable income (*Independent*).

Prior studies find that tax-induced changes in book-tax conformity and levels of book-tax conformity are negatively related to earnings quality (Hanlon et al., 2008; Atwood et al., 2010; Blaylock et al., 2015), suggesting that the *Decoupled* group will experience incremental gains in earnings quality following IFRS adoption as a result of the decrease in book-tax conformity. Therefore, we present our second hypothesis in alternative form:

H2. *After IFRS adoption, the effects on earnings persistence and on cash flow predictability are more positive for firms in the Decoupled group, when compared to those from the Independent group.*

Hypothesis H2 predicts that the *Decoupled* group will see greater gains in earnings quality following IFRS adoption as a result of decoupling financial and tax reporting. However, given that the *Independent* and *Decoupled* groups use different starting points for calculating taxable income post-IFRS (e.g., Local GAAP vs. Tax statements), it is unclear if the *Decoupled* group will experience similar levels of earnings persistence and cash flow predictability as the *Independent* group in the post-IFRS adoption period. First, if we fail to find support for Hypothesis H2, we expect the *Decoupled* group to exhibit lower levels of earnings quality post-IFRS. If we find evidence of incremental gains in earnings quality for the *Decoupled* group as predicted by Hypothesis H2, the level of earnings quality post-IFRS may still be lower than that of the *Independent* group if the post-IFRS level of book-tax conformity between IFRS and Local GAAP is greater for the *Decoupled* group than the level of book-tax conformity between IFRS and Tax statements for the *Independent* group. If the level of book-tax conformity for the *Decoupled* group is similar to that of the *Independent* group post-IFRS, we would expect that both groups would exhibit similar levels of earnings quality post-IFRS. Finally, if the level of book-tax conformity for the *Decoupled* group is less than that of the *Independent* group post-IFRS, we would expect the *Decoupled* group to exhibit higher levels of earnings quality post-IFRS. We illustrate each of these four potential effects in Figure 1.<sup>6</sup>

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<sup>6</sup> For simplicity, Figure 1 presents firms in the *Decoupled* countries with lower level of earnings quality in the pre-IFRS period. We do not provide an expectation for the difference in the pre-IFRS period. In the Additional Analysis section, we show that both high and low book-tax conformity countries in the *Decoupled* group exhibit lower levels of earnings quality in the pre-IFRS period (when compared to firms from countries in the *Independent* group). In addition, Figure 1 presents both groups as experiencing an increase in earnings quality after IFRS adoption. We do not provide, however, an expectation for the effects of IFRS adoption bundled with other time-varying characteristics.

[Insert Figure 1 here]

Since both groups of countries use decoupled financial and tax reporting in the post-IFRS environment, in our third hypothesis, we examine if firms in countries in the *Decoupled* group exhibit similar levels of earnings quality as those in the *Independent* group. Stated formally:

*H3: In the post-IFRS adoption period, the levels of earnings persistence and cash flow predictability are not different for firms in the Decoupled group, when compared to those from the Independent group.*

### **3. Research design**

#### *3.1. Identification strategy*

There are 27 countries that are members of the E.U., after the withdrawal of the United Kingdom in 2020.<sup>7</sup> We use the mandatory adoption of IFRS in 2005 to identify the pre- and post-IFRS periods.<sup>8</sup> As we rely on a difference-in-difference design, we need to identify the treatment and control groups. Our treatment group consists of countries that use Local GAAP as the basis for both tax and financial reporting in the pre-IFRS period and switch to using IFRS for financial reporting in the post-IFRS period. We refer to these countries as having “decoupled” their tax and financial reporting in the post-IFRS period (*Decoupled*) since they no longer use the same initial starting point. Our control group (*Independent*) consists of countries that do not use Local GAAP as the basis for tax reporting in both the pre- and post-IFRS periods. We describe the three steps of our identification strategy below.

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<sup>7</sup> There were 28 countries until the United Kingdom left the E.U. in 2020. We include the U.K. in our analyses since it was a member of the E.U. during our sample period. Information about the countries that are members of the E.U. is available at [https://europa.eu/european-union/about-eu/countries\\_en](https://europa.eu/european-union/about-eu/countries_en).

<sup>8</sup> We do not consider the following countries in our identification strategy because their adoption of IFRS did not occur in 2005 or they were not members of the E.U. for our full sample period: Bulgaria, Croatia, Cyprus, Malta, and Romania.

Our first step is to analyze the relation between financial reporting and tax reporting in the pre-IFRS period. To increase assurance about our classifications, we cross-check information using multiple sources, such as reports published by the European Commission (EC) and previous literature.<sup>9</sup> Accordingly, the five countries that use Local GAAP as the basis for financial reporting and a separate set of rules for tax reporting are: Denmark, Ireland, the Netherlands, Poland, and the United Kingdom.<sup>10</sup> We use these five countries to create our control group (*Independent*).

Since the remaining countries in the E.U. have regulations that formally connect taxation to financial accounting in the single financial statements (SFS), our second step is to consult the IFRS Foundations' website to identify countries that prohibit IFRS for SFS.<sup>11</sup> Following IFRS adoption, some countries allowed or prescribed IFRS for use in the SFS, which legally linked taxation to IFRS. The resulting effect on book-tax conformity is unclear since it depends on the degree of change from Local GAAP to IFRS. Other countries prohibited the use of IFRS for financial accounting in the SFS and continued to use Local GAAP as the starting point for calculating the tax base. In these countries, the starting point for taxable income continues to be based on Local GAAP while the starting point for financial income shifts from Local GAAP to IFRS. In this setting, book-tax conformity decreases since financial and tax reporting have been “decoupled” in the post-IFRS period. We argue that this group of countries provides the clearest

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<sup>9</sup> Before IFRS adoption in 2005, two reports were developed for the Commission of the European Communities (CEC, 1992) and for the European Commission (EC, 2002), providing a detailed comparative analysis of taxation within the E.U. The first report refers to countries that we include in the *Independent* group as those in which “there is no linkage between both sets of accounts” (CEC, 1992, p. 51). The second report uses the term ‘independence’, meaning “that income determination for accounting purposes is in principle independent from income determination for tax purposes” (EC, 2002, p. 400). In addition, European journals, such as the *European Accounting Review (EAR)* and *Accounting in Europe (AE)*, have special issues on IFRS-related topics. Descriptions about accounting and taxation for each jurisdiction are provided by academics based on the respective jurisdiction.

<sup>10</sup> We find support in the literature for each country: Denmark (Christiansen, 1996), Ireland (Pierce, 1996), the Netherlands (Hoogendoorn, 1996), Poland (Jaruga et al., 1996), and the United Kingdom (Lamb, 1996). Recent research confirms that there is still no formal linkage in the IFRS period (e.g., André et al., 2021).

<sup>11</sup> An exception is Latvia and Estonia, where the tax base is dividends paid. In the other countries, tax rules are formally linked to the financial accounts used in the SFS. Tax rules modify the income in the financial accounts to arrive at taxable income.

setting in the remaining IFRS-adopting countries to identify the direction of the change in book-tax conformity.<sup>12</sup> We identify the following countries as experiencing this change in book-tax conformity: Austria, Belgium, France, Germany, Spain, and Sweden.<sup>13</sup>

As a final step, we review prior literature and identify countries that do not converge their Local GAAP to IFRS during the post-IFRS period (i.e., decoupling effect occurs, and it is sustained). Otherwise, financial reporting (i.e., Local GAAP ‘substantially converged’ to IFRS) would not be decoupled from tax reporting. In the post-IFRS period, five of the six countries do not converge Local GAAP to IFRS: Austria, Belgium, France, Germany, and Sweden.<sup>14,15</sup> We define these countries as our treatment group (*Decoupled*). We summarize financial and tax reporting characteristics for both our *Independent* and *Decoupled* groups in Figure 2.

[Insert Figure 2 here]

While our setting allows us to examine consequences stemming from a financial reporting change to book-tax conformity, we acknowledge that we are not able to hold the level of book-tax

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<sup>12</sup> If IFRS is prohibited for SFS (and, consequently, for tax reporting), then book-tax conformity should decrease, since the starting point for financial and tax reporting is no longer the same (i.e., they are no longer both based on Local GAAP). In this case, *decoupling* is not related to a change in the tax code. If IFRS is required for SFS, *decoupling* occurs only if there is a concurrent change in the tax code to avoid the direct effects of a change in accounting standards. In this case, it is less clear if *decoupling* exists and the degree to which it exists. If it exists, it is also related to a change in the tax code. If IFRS is allowed for SFS, then *decoupling* occurs only if companies opt to use Local GAAP or if there is a change in the tax code to avoid tax effects if IFRS is their choice. Allowing a choice for SFS may also raise concerns about self-selection incentives (Atwood, 2014), becoming a strategic choice.

<sup>13</sup> Watrin et al. (2014) provide a list of nine countries that prohibited IFRS for SFS. The three additional countries are Hungary, Romania, and Slovakia. We exclude Romania because it adopted IFRS after 2005. Hungary allows and Slovakia requires the use of IFRS for SFS. We, therefore, exclude those countries to avoid concerns about different reporting incentives and misclassification. Information about IFRS adoption in each jurisdiction is available at: <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/> (Accessed on 08 February 2021).

<sup>14</sup> Prior literature provides support for each jurisdiction: Austria (Eberhartinger and Klostermann, 2007; Fülbier et al., 2017), Belgium (Jorissen and Maes, 1996; Jorissen, 2017), France (Frydlander and Pham, 1996; Le Manh, 2017), Germany (Pfaff and Schröer, 1996; Fülbier et al., 2017), and Sweden (Artsberg, 1996; Marton, 2017). It is important to highlight that we consider rules applied to separate financial statements, and not consolidated financial statements. Our classifications based on prior literature align with information provided by Big4 audit firms (e.g., EY, PWC) on country-specific differences between Local GAAP and IFRS.

<sup>15</sup> Spain revised its Local GAAP to be ‘substantially converged’ to IFRS in 2007 while also changing its tax legislation to “avoid significant impacts” (Mora, 2017, p. 202). Since *decoupling* in Spain is conditional on a change in accounting standards and a concurrent change in the tax code, we exclude Spain from our analyses.

conformity constant across countries in each sample. For example, both Atwood et al.'s (2010) sample and Blaylock et al.'s (2015) sample largely consists of firm-year observations prior to IFRS adoption. Looking at each respective paper's Table 1 analysis of book-tax conformity, we note that countries in our *Decoupled* group exhibit different levels of book-tax conformity (Atwood et al., 2010, pg. 118; Blaylock et al., 2015, pg. 155). Their findings indicate that while Belgium and Germany could be labeled as 'low book-tax conformity' countries, Austria and France would be labeled as 'high book-tax conformity' countries. It is unclear, therefore, if the average level of earnings quality for those countries will be different when compared to those in the *Independent* group. As a result, we do not provide an expectation for the differences in earnings quality across the two groups for the pre-IFRS period.<sup>16</sup>

### 3.2. Research Design

To test our hypotheses, we largely follow Atwood et al. (2010) and estimate the following model using OLS:

$$\begin{aligned}
 EARN_{it+1}(CFO_{it+1}) = & \alpha_{\text{year}} + \alpha_1 EARN_{it} + \alpha_2 POST_t + \alpha_3 EARN_{it} \times POST_t + LOSS_{it} \\
 & + LOSS_{it} \times POST_t + CONTROLS + \varepsilon_{it}
 \end{aligned} \tag{1}$$

where  $EARN_{it+1}$  ( $EARN_{it}$ ) equals earnings before extraordinary items for firm  $i$  in year  $t+1$  (year  $t$ ) scaled by average total assets; and,  $CFO_{it+1}$  equals cash flow from operations for firm  $i$  in year  $t+1$  scaled by average total assets.  $POST_t$  is a binary variable equal to one for years following IFRS adoption, and zero for years prior to IFRS adoption. We exclude the transition years of 2004 and 2005 from our regression analysis.  $LOSS_{it}$  is a binary variable equal to one if pre-tax book income

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<sup>16</sup> We provide an additional test controlling for the level of book-tax conformity in the pre-IFRS period (high or low book-tax conformity). Results are consistent with high book-tax conformity countries exhibiting lower levels of earnings quality in the pre-IFRS period than low-BTC countries for cash flow predictability. We do not find a difference for earnings persistence. We present and discuss the results in the Additional Analysis section.

for firm  $i$  in year  $t$  is negative, and zero otherwise. We separately estimate Equation 1 for firm-year observations in the *Decoupled* and *Independent* groups and cluster standard errors by firm.<sup>17</sup>

In Equation 1, the coefficient on  $EARN_{it}$  ( $\alpha_1$ ) represents earnings persistence (when the dependent variable is  $EARN_{it+1}$ ) or earnings ability to predict future operating cash flows (when the dependent variable is  $CFO_{it+1}$ ), in the pre-IFRS period. This serves as the basis for comparisons between the *Decoupled* and *Independent* groups before a change in accounting standards and the *decoupling* effect for the former.

Our first hypothesis examines the relation between IFRS adoption and earnings persistence (cash flow predictability) for the *Independent* group. The coefficient on  $EARN_{it} \times POST_t$  ( $\alpha_3$ ) represents the effect on earnings quality after IFRS adoption. If IFRS adoption is associated with increased earnings persistence (cash flow predictability), we would expect a positive estimated coefficient for the *Independent* group ( $\alpha_3 > 0$ ).

Our second hypothesis examines if firms in countries experiencing a decoupling effect experience incremental gains in earnings persistence (cash flow predictability) relating to the decrease in book-tax conformity following IFRS adoption. To test this hypothesis, we test the differences in the estimated coefficient on  $EARN_{it} \times POST_t$  ( $\alpha_3$ ) across the two groups (*Decoupled* and *Independent*). If firms in the *Decoupled* countries experience incremental gains in earnings persistence (cash flow predictability) relating to the decoupling effect, we expect  $\alpha_3$  to be significantly more positive in the *Decoupled* sample than in the *Independent* sample.

Our third hypothesis examines if the level of earnings persistence (cash flow predictability) differs across our *Decoupled* and *Independent* samples following IFRS adoption. To test this hypothesis, we test if the level of earnings quality, i.e.  $(\alpha_1) + (\alpha_3)$ , differs among the two groups.

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<sup>17</sup> In untabulated analysis, we replace year fixed effects in Equation 1 with  $POST_t$ , a binary variable equal to one for the post-IFRS period and zero for the pre-IFRS period. Our conclusions remain unaffected.

A finding that there is no statistically significant difference across the two groups suggests that both groups exhibit similar levels of earnings quality in the post-IFRS period.

Since prior literature shows that time-invariant characteristics and several concurrent changes in economic, sociological, regulatory, and political characteristics explain the effects on earnings quality (e.g., Atwood et al., 2010; Isidro et al., 2020), we run different specifications of our base models to control for those characteristics, as described below.

Our first set of controls considers three time-invariant characteristics used by Atwood et al. (2010): legal tradition, ownership concentration, and investor rights. We use data provided by Djankov et al. (2008), who calculate the measures for an expanded number of countries and revise estimates for the anti-director rights index used in La Porta et al. (1997; 1998).<sup>18</sup> Since the three characteristics are highly correlated, we follow Atwood et al. (2010) and use exploratory factor analysis using the principal components method to create a common factor and use this factor as our control variable.<sup>19</sup>

We base our second set and third set of controls on Isidro et al. (2020). Our second set of control variables is based on 72 country characteristics identified by Isidro et al. (2020) as relating to reporting quality.<sup>20</sup> Since our sample consists of 10 countries, instead of the 35 countries considered by Isidro et al. (2020), we exclude two characteristics due to that lack of variance: number of parties competing in legislative elections (*legislcomp*) and number of veto players

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<sup>18</sup> Djankov et al. (2008) do not provide data for Poland regarding ownership concentration. Dzierżanowski and Tamowicz (2004) calculate ownership concentration for Polish companies for the 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> largest blockholdings. We use their information for Poland, by considering the median of blockholding of voting shares by the three largest shareholders. Since ownership concentration in Poland is the highest in the *Independent* group (55 percent), we also perform sensitivity analyses by using the second highest value as a benchmark for Poland: Denmark (40 percent). Our inferences remain unchanged.

<sup>19</sup> See Appendix A for variables definitions.

<sup>20</sup> 21 out of the 72 characteristics are, in fact, time-varying characteristics. Isidro et al. (2020) calculate their averages and add them to the other 51 time-invariant characteristics for their tests about the relation between those characteristics and *levels* of reporting quality. The data for the 72 characteristics was made available from the authors at: <https://data.mendeley.com/datasets/dvgmbh7z3z/1> (Accessed on February 8<sup>th</sup> 2021).

(*veto*). We follow Isidro et al. (2020) and use exploratory factor analysis using the principal components method to extract the first four factors and use these four factors as controls in our base models. Our third set of controls considers 21 country characteristics that changed during the IFRS adoption period (Isidro et al., 2020). While the authors do not test earnings persistence or cash flow predictability, we use their controls to mitigate concerns that other factors may explain the effects on earnings quality and further isolate the effect of a change in book-tax conformity for the *Decoupled* group.<sup>21</sup>

Finally, our fourth set of controls considers both time-invariant and time-varying characteristics. We use the 21 time-varying characteristics and re-estimate the exploratory factor analysis using the principal components method for the remaining 49 time-invariant characteristics used by Isidro et al. (2020), again extracting the first four factors to use as control variables. We then include both types of controls in our base models.

## 4. Results

### 4.1 Sample selection and descriptive statistics

We use all firm-year observations from 1997 to 2015 with sufficient data available in the Compustat Global database.<sup>22</sup> Our sample comprises data for five countries classified in the *Decoupled* group (Austria, Belgium, France, Germany, and Sweden) and for five countries classified in the *Independent* group (Denmark, Ireland, the Netherlands, Poland, and the United

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<sup>21</sup> Our design differs from Isidro et al. (2020), since we rely on firm-level data in our regressions. We use the data sources provided in their paper and use controls at the firm-level whenever is possible (for example: proportion of domestic institutional holdings). See Appendix A for variables definitions and sources.

<sup>22</sup> Our primary analysis focuses on years 1998 through 2014. Compustat Global is less populated for data before 1997, so we follow prior literature and use 1997 to create lagged variables and use 1998 as our initial year (e.g., Wiczynska, 2016; Demmer et al., 2019). We end our sample in 2014 and use 2015 to create forward-looking variables to avoid contamination from changes in regulation (MiFID II) and the withdraw of the United Kingdom from the E.U. (i.e., Brexit) (Deloitte, 2014). In sensitivity analyses, we follow Pownall and Wiczynska (2018) and Isidro et al. (2020) and rerun our base models for the period 2001 to 2013. Inferences remain unchanged.

Kingdom). We consider firms with headquarters located in each of the ten countries that are listed in E.U. regulated markets.<sup>23</sup> The initial sample for firm-years with non-missing values for total assets is 33,751 observations for the pre-IFRS period and 31,477 observations for the post-IFRS period, totaling 65,228 observations.

We apply five screening procedures. We first delete firms whose headquarters are located in a different jurisdiction than their country of incorporation. Our classification between the *Independent* and *Decoupled* groups is based on each country's tax and financial reporting rules. E.U. countries may tax firms based on their country of incorporation or on their 'place of management.'<sup>24</sup> This procedure avoids misclassifying firms between the *Decoupled* and *Independent* groups. Second, we delete firms in regulated industries (i.e., financial and utility firms) and firm-years missing industry information. Third, we delete observations for early IFRS adopters and non-IFRS users, such as U.S. GAAP users.<sup>25</sup> Fourth, we delete observations relating to the transition years of 2004 and 2005. We exclude these years to avoid instances where 1) current variables in 2005 reflect IFRS and lagged variables in 2004 reflect a different reporting standard or 2) forward-looking variables in 2005 reflect IFRS and current variables in 2004 reflect a different reporting standard. Finally, we delete observations missing values for current earnings, one-year ahead earnings, and lagged total assets required in our regression model. Our final sample

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<sup>23</sup> Following prior research, we do not consider firms listed in unregulated markets, such as the Alternative Investment Market (AIM) at the London Stock Exchange (Christensen et al., 2013) since these markets do not necessarily require firms to use IFRS, potentially creating self-selection issues (e.g., Pownall and Wieczynska, 2018; Byard et al., 2021).

<sup>24</sup> We retrieve all information from OECD's Automatic Exchange Portal: <https://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/tax-residency/>. Accessed on April 17<sup>th</sup>, 2021.

<sup>25</sup> Voluntary and mandatory IFRS adopters have different incentives (e.g., Daske et al., 2013). We include only mandatory adopters in our sample to avoid self-selection concerns. *Regulation (EC) no. 1,606/2002* requires the application of IFRS from 2005. We delete observations for early adopters using two criteria: first, for adopters in 2001 or before, we delete all observations from our sample; second, for adopters between 2002 and 2004, we delete observations for those specific years. We rerun our analyses by excluding all observations for adopters between 2002 and 2004 and our inferences remain unchanged.

comprises 25,232 firm-year observations (13,139 in the pre- and 12,093 in the post-IFRS periods). We present our screening procedures in Table 1, Panel A.

[Insert Table 1 here]

We present our sample composition in Table 1, Panel B. In the *Decoupled* group, French firms represent around 43 percent (5,478 obs.) of the sample, followed by German (26 percent) and Swedish (21 percent) firms. In the *Independent* group, British firms account for 60 percent (7,443 obs.) of the sample, followed by Polish (18 percent) and Dutch (10 percent) firms.

We present descriptive statistics in Table 2, Panel A. Both in the pre- and post-IFRS periods, firms from the *Decoupled* group present lower future earnings, future operating cash flows, and current earnings (the tests of differences for the means are all significant at the one-percent level). In the pre-IFRS period, the incidence of losses is higher in the *Decoupled* group (test of difference for  $LOSS_{it}$  is positive and significant at the one-percent level). In the post-IFRS period, however, there is no difference in the incidence of losses (test of difference for  $LOSS_{it}$  is not significant). The comparisons between the means, medians, and standard-deviations for each continuous variable reveal significant heterogeneity, both in the pre- and post-IFRS periods and for both groups (*Decoupled* and *Independent*), justifying including controls in our regressions for time-invariant and time-varying country-level characteristics (Atwood et al., 2010; Isidro et al., 2020).

We present Pearson correlations between our four main variables in Table 2, Panel B. Correlations are all positive between current earnings, future earnings, and future operating cash flows (all significant at the one-percent level). The correlations between losses (indicator variable) and current earnings, future earnings and future operating cash flows are all negative (all

significant at the one-percent level). Results are similar to those presented in the previous literature (Atwood et al., 2010; Atwood et al., 2011).

[Insert Table 2 here]

#### 4.2. Tests of earnings persistence

We present results for earnings persistence in Table 3. Panel A presents results for our *Independent* group, and Panel B presents results for our *Decoupled* group. Panel C reports the tests of differences between the two groups. Model 1 presents results without additional controls. We consider different sets of controls in the next four columns: three time-invariant characteristics in Model 2 (Atwood et al., 2010), 70 time-invariant characteristics in Model 3, followed by 21 time-varying characteristics in Model 4 (Isidro et al., 2020), and the combination of 21 time-varying characteristics with 49 time-invariant characteristics in Model 5.

[Insert Table 3 here]

Our first hypothesis examines the change in earnings persistence following IFRS adoption for our sample of firm-year observations in countries not experiencing a concurrent change in book-tax conformity (*Independent*). Results in Panel A suggest a decrease in earnings persistence for this sample (coefficient on  $POST_t \times EARN_{it}$  is negative and significant across all specifications) rejecting the null hypothesis of no change in earnings persistence.

Our second hypothesis predicts that the effects of IFRS adoption through decreases in book-tax conformity will result in incremental gains in earnings persistence for the *Decoupled* group as compared to the *Independent* group. Results in Panel B reveal that a change in accounting standards bundled with a concurrent change in book-tax conformity increases earnings persistence after IFRS adoption for the *Decoupled* group, even after controlling other time-varying and time-invariant characteristics (coefficients on  $POST_t \times EARN_{it}$  are positive and significant across all

specifications). Taken together with the decrease in earnings persistence reported in Panel A for the *Independent* group, these results suggest that the *Decoupled* group experienced incremental gains in earnings quality relating to decreased book-tax conformity following IFRS adoption. We formally test our hypothesis in Panel C using tests of differences across the *Decoupled* and *Independent* groups. Results in Panel C support our second hypothesis. The differences across the two groups reveal that a change in book-tax conformity following IFRS adoption led to greater increases in earnings persistence for the *Decoupled* group than for the *Independent* group (the test of differences on  $POST_t \times EARN_{it}$  is positive and significant across all models).

Our third hypothesis examines if the positive effects on earnings persistence related to a change in book-tax conformity will be sufficient to lead firms in the *Decoupled* group to exhibit similar levels of earnings persistence to those in the *Independent* group. In the pre-IFRS period, firms from countries included in the *Decoupled* group exhibit lower earnings persistence than those in the *Independent* group (test of differences on  $EARN_{it}$  is significantly negative). However, as noted in Panel B, firms in the *Decoupled* group experienced a significant increase in earnings persistence following IFRS adoption ( $POST_t \times EARN_{it}$ ). Looking at the  $F$ -test of the sum of estimated coefficients for  $EARN_{it} + POST_t \times EARN_{it}$ , we find a significantly positive relation between current and future earnings in the post-IFRS period in both Panels A and B. These results suggest that current earnings are predictive of future earnings for firms in both the *Independent* and *Decoupled* groups following IFRS adoption. In Panel C, we report the test of differences in the level of earnings persistence across the two groups in the post-IFRS period. We do not find a statistically significant difference in earnings persistence between the two groups (i.e., the difference in the sum of estimated coefficients on  $EARN_{it} + POST_t \times EARN_{it}$  is not significant across the two groups). Taken together with our previous results, these results suggest that firms

experiencing decreases in book-tax conformity following IFRS adoption also experience an increase in earnings persistence, and this increased earnings persistence is similar to that of firms not experiencing decoupling effects with IFRS adoption. Finally, we note that losses are less persistent than positive earnings both for firms in the *Independent* (Panel A) and *Decoupled* (Panel B) groups ( $LOSS_{it} \times EARN_{it}$ ). Results in Panel C suggest that losses are less persistent in the *Independent* group, both in the pre- and post-IFRS periods (coefficients on  $LOSS_{it} \times EARN_{it}$  and on  $LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$  significantly lower for the *Independent* group). Results reveal that while positive earnings exhibit similar levels of persistence in the post-IFRS period across the two groups, losses still exhibit lower levels of persistence for the *Independent* group.

#### 4.3. Tests for cash flow predictability

We present results for cash flow predictability in Table 4. Panel A presents results for our *Independent* group, and Panel B presents results for our *Decoupled* group. Panel C reports the tests of differences between the two groups. Model 1 presents results without additional controls. We consider different sets of controls in the next four columns: three time-invariant characteristics in Model 2 (Atwood et al., 2010), 70 time-invariant characteristics in Model 3, followed by 21 time-varying characteristics in Model 4 (Isidro et al., 2020), and the combination of 21 time-varying characteristics with 49 time-invariant characteristics in Model 5.

[Insert Table 4 here]

Results in Panel A suggest IFRS adoption decreased the ability of current earnings to predict future operating cash flows (coefficients on  $POST_t \times EARN_{it}$  is negative and significant across all specifications) rejecting the null hypothesis of no change in cash flow predictability. Similar to earnings persistence, we find that predictability is lower when firms present losses

(coefficient on  $LOSS_{it} \times EARN_{it}$  is negative and significant across all specifications). Results in Panel B reveal that a change in accounting standards bundled with a concurrent decrease in book-tax conformity increases cash flow predictability after IFRS adoption (coefficient on  $POST_t \times EARN_{it}$  is positive and significant across all specifications). Results also indicate that cash flow predictability is not different between firms with positive and negative earnings (coefficients on  $LOSS_{it} \times EARN_{it}$  are not significant).

Looking at the tests of differences across the *Decoupled* and *Independent* groups in Panel C, we find that the *Decoupled* group experienced a greater increase in cash flow predictability following IFRS adoption (the test of differences on  $POST_t \times EARN_{it}$  is positive and significant across all models), supporting our second hypothesis. We also fail to find a difference in the association between earnings and future operating cash flows post-IFRS across the two groups (i.e., the differences in the sum of estimated coefficients on  $EARN_{it} + POST_t \times EARN_{it}$  is not significant across the two groups). While failing to reject the null is not statistical evidence, the lack evidence of a significant difference across firms in the *Independent* and *Decoupled* groups is consistent with our expectations regarding the third hypothesis. Finally, results indicate that losses have lower cash flow predictability in the *Independent* group, both in the pre- and post-IFRS periods (coefficients on  $LOSS_{it} \times EARN_{it}$  and on  $LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$  are significantly lower for the *Independent* group).

#### 4.4. Discussion about our main findings

Taken together, our results yield similar conclusions for both earnings persistence and cash flow predictability. In the pre-IFRS period, firms in the *Independent* group exhibit higher earnings quality than those in the *Decoupled* group. One possible explanation is that even bundling high- and low-BTC countries, the average effect for the *Decoupled* group still results in a lower level of

earnings quality when compared to firms from countries that have their taxes already *decoupled* from financial reporting.<sup>26</sup>

Overall, we offer three main results. First, we find that the change to IFRS, without a change in book-tax conformity, led to a decrease in earnings quality. Our results contribute evidence to the debate about the effects of IFRS-adoption on earnings quality by identifying a subsample of countries (i.e., *Independent* group) that experience a decrease in earnings quality. Second, we find that *decoupling* tax from financial reporting increased earnings quality for countries in the *Decoupled* group. Our results, therefore, contribute evidence to the literature on *changes* in book-tax conformity by indicating that a reporting-induced reduction in book-tax conformity increased earnings quality. We also contribute evidence to the book-tax conformity debate by presenting additional empirical evidence indicating that the direction of the change in book-tax conformity is negatively related to the change in earnings attributes. Finally, we find no evidence that earnings quality differs between firms in our *Independent* and *Decoupled* groups post-IFRS adoption. Thus, we complement prior literature by showing that countries with similar levels of book-tax conformity (in our case, with taxes *decoupled* from financial reporting in the post-IFRS period) also present similar levels of earnings quality. We also attempt to mitigate concerns that other characteristics could be driving our results by using different sets of time-variant and time-invariant controls throughout our analyses.

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<sup>26</sup> We provide an additional analysis comparing results among high and low book-tax conformity countries. We present and discuss the results in the Additional Analysis subsection 5.1.

## 5. Additional Analysis

### 5.1. Tests for the effects of decoupling for high-BTC versus low-BTC countries

As mentioned above, countries in the *Decoupled* group exhibit different levels of book-tax conformity in the pre-IFRS period. Atwood et al. (2010) find countries with higher levels of book-tax conformity exhibit lower earnings persistence and cash flow predictability. We, therefore, would expect that the effects of *decoupling* would be more pronounced for firms located in high book-tax conformity countries within the *Decoupled* group.

Using Atwood et al.'s (2010) methodology, we identify Austria and France as high book-tax conformity countries, and Belgium, Germany, and Sweden as low book-tax conformity countries in the pre-IFRS period.<sup>27</sup> We run our model (Equation 1) separately for the high and low book-tax conformity groups and then present comparisons across the two sub-samples (high and low book-tax conformity) and with the *Independent* group. If the positive effects of decoupling are more pronounced for high book-tax conformity countries, then we expect estimated coefficients on our variables of interest to be significantly higher in the high book-tax conformity sample.

We present results for earnings persistence in Table 5, Panel A. While results indicate that both high and low book-tax conformity countries exhibit an increase in earnings persistence after IFRS adoption, we do not find that the effect is more pronounced for high book-tax conformity countries (the test of differences on  $POST_t \times EARN_{it}$  in column 3 is not significant). Therefore, the positive effects of decoupling tax from financial reporting on earnings persistence are similar

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<sup>27</sup> Since Atwood et al.'s (2010) sample period includes the IFRS adoption year (2005), we rerun their empirical model for the pre-IFRS period (1997 to 2004). We rank countries within the *Decoupled* group in each year and then calculate the average level of book-tax conformity in the pre-IFRS period. We find similar results to those presented by Atwood et al. (2010): Belgium, Germany, and Sweden present lower levels of book-tax conformity, while Austria and France present higher levels of book-tax conformity.

across the two groups. When comparing each subsample (high or low book-tax conformity) with the *Independent* group, we find similar results than those presented in Table 3, Panel C. Both subsamples exhibit lower levels of earnings persistence in the pre-IFRS period (test of differences for  $EARN_{it}$  is negative and significant in columns 4 and 5). The effects of decoupling are positive for both subsamples (test of differences for  $POST_t \times EARN_{it}$  is positive and significant in columns 4 and 5). Finally, in the post-IFRS period, all subsamples (high, low, and *Independent*) exhibit similar levels of earnings persistence (test of differences on  $EARN_{it} + POST_t \times EARN_{it}$  is not significant in columns 3, 4, and 5).

[Insert Table 5 here]

We present results for cash flow predictability in Table 5, Panel B. Results indicate that both high and low book-tax countries exhibit an increase in cash flow predictability after IFRS adoption and IFRS adoption had a greater effect on cash flow predictability for high book-tax conformity countries (test of differences on  $POST_t \times EARN_{it}$  in column 3 is positive and significant). When comparing the two sub-samples, our tests reveal that the level of cash flow predictability is lower for high book-tax conformity countries in the pre-IFRS period (the test of differences on  $EARN_{it}$  in column 3 is negative and significant). In the post-IFRS period, countries from both subsamples exhibit similar levels of cash flow predictability (the test of differences on  $EARN_{it} + POST_t \times EARN_{it}$  in column 3 is not significant).

When comparing each subsample (high or low book-tax conformity) with the *Independent* group, we find similar results than those presented in Table 3, Panel C. Both subsamples exhibit lower levels of cash flow predictability in the pre-IFRS period (test of differences on  $EARN_{it}$  is negative and significant in columns 4 and 5). The effects of decoupling are positive for both subsamples (test of differences on  $POST_t \times EARN_{it}$  is positive and significant in columns 4 and 5).

Finally, in the post-IFRS period, high and low book-tax conformity countries exhibit similar levels of cash flow predictability when compared to those in the *Independent* group (test of differences on  $EARN_{it} + POST_t \times EARN_{it}$  is not significant in columns 4 and 5).

Overall, our results differ when considering the effects for IFRS adoption in high and low book-tax conformity countries regarding earnings persistence and cash flow predictability. While we find similar effects for earnings persistence across the two subsamples, we find that decoupling has more pronounced effects for high book-tax conformity countries in relation to cash flow predictability. Consistent with Atwood et al. (2010) we find lower earnings quality as proxied by cash flow predictability for high book-tax conformity countries pre-IFRS and greater positive effects related to decoupling post-IFRS. Since we fail to find a difference in their levels of earnings quality in the post-IFRS period, we interpret this to mean that the magnitude of the effects of decoupling for high book-tax conformity countries is significant enough to make firms exhibit similar levels of earnings quality to those in the low book-tax conformity group. When comparing each subsample with that from the *Independent* group, we find similar results with those presented in our main findings: lower earnings quality in the pre-IFRS period for countries in the *Decoupled* group, an increase in earnings quality for the group of countries that decouple tax from financial reporting post-IFRS, and similar levels of earnings quality in the post-IFRS period.

## 5.2. Earnings management

Our main analyses focus on two attributes of earnings quality: persistence and cash flow predictability. Since prior literature finds a positive association between book-tax conformity and earnings management (Blaylock et al., 2015), we next examine if we find similar results using an alternative proxy for earnings quality – absolute discretionary accruals. We estimate the modified

Jones model with lagged return on assets (Jones, 1991; Kothari et al., 2005; Blaylock et al., 2015).<sup>28</sup> We then use absolute discretionary accruals (*Abs\_DA*) in our test model, as follows:<sup>29</sup>

$$Abs\_DA_{it} = \beta_0 + \beta_1 POST_t + CONTROLS + \varepsilon_{it} \quad (2)$$

We follow Isidro et al. (2020) and control for the 21 time-varying characteristics. We estimate Equation 2 for the *Independent* and *Decoupled* groups separately and test differences across coefficients.

We present results for the *Decoupled* and *Independent* groups in the first and second columns in Table 6, respectively. Results indicate that both groups experienced a reduction in their levels of absolute discretionary accruals following IFRS adoption. We present tests of differences across the two groups in the third column. Results indicate no significant differences across the two groups. Taken together, results indicate that decoupling tax from financial reporting did not result in a statistically greater decrease in earnings management for the *Decoupled* group as compared to the *Independent* group.<sup>30</sup>

[Insert Table 6 here]

To further examine changes in earnings management following IFRS adoption, we use the two additional measures from Blaylock et al. (2015) that can be calculated at the firm-level:

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<sup>28</sup> Since our tests for earnings persistence and cash flow predictability are based at the firm-level, we also estimate earnings management at the firm-level. The number of firms in each industry is relatively small in E.U. countries. Therefore, we estimate absolute discretionary accruals using cross-sectional regressions by industry-group-year (i.e., separate regressions for *Decoupled* and *Independent* countries). We use Fama and French's 17 industry classifications and require at least 30 observations in each regression.

<sup>29</sup> In Equation 2, we replace year fixed effects with *POST<sub>t</sub>*, a binary variable equal to one for the post-IFRS period and zero for the pre-IFRS period. We do not include year fixed effects, since they would capture the effects of IFRS adoption (e.g., Wiczynska, 2016).

<sup>30</sup> We rerun our models using different sets of controls. Results are largely similar to those presented in Table 6. However, when we include controls for both time-invariant and time-varying controls, we do not find a reduction in earnings management following IFRS adoption in the *Decoupled* group and we only find weak evidence for a reduction in the *Independent* group (coefficient on *POST<sub>t</sub>* is negative and significant at the ten-percent level). We continue to find no significant differences across the two groups.

earnings smoothing and earnings discretion. In untabulated results, we see an increase in earnings smoothing in both groups after IFRS adoption, but we do not find a change in earnings discretion. With respect to earnings smoothing, we do not find a significant difference in the increase across the two groups. We also do not find significant differences either in the pre- or post-IFRS levels of earnings smoothing across the two groups or in any of the earnings discretion tests of differences across the two groups. Taken together, these results suggest that changes in book-tax conformity did not affect the level of earnings management.

### *5.3. Alternative sample period*

Recent papers examining the effects of mandatory IFRS adoption consider different time periods. To examine whether our results are driven by our sample period, we follow Pownall and Wieczynska (2018) and Isidro et al. (2020) and re-estimate our primary analysis using the sample period 2001 to 2013. We continue to find a decrease in earnings persistence and cash flow predictability for the *Independent* group following IFRS adoption. We also continue to find that the *Decoupled* group experienced incrementally greater gains in earnings persistence and cash flow predictability than the *Independent* group following IFRS adoption, which continues to support our previously documented benefits stemming from decreases in book-tax conformity through decoupling. Finally, we also continue to find that in the post-IFRS period, the *Decoupled* and *Independent* group demonstrate statistically indifferent levels of earnings persistence and cash flow predictability. Taken together, these results support that our choice in sample period is not driving our primary results.

## 6. Conclusion

We find that decoupling financial reporting from tax reporting increases earnings persistence and cash flow predictability. Our results are robust to the inclusion of different sets of time-varying and time-invariant controls used in the prior literature. Our empirical evidence indicates that, after IFRS adoption, decoupling explains a significant and economically relevant portion of the overall positive effects on earnings quality.

According to the IFRS Foundation, more than 140 jurisdictions require IFRS for all or almost all domestic listed companies.<sup>31</sup> Studies about IFRS adoption and comparisons between countries that adopted IFRS should consider if financial reporting is also the basis for taxation. Otherwise, conclusions could be related to decoupling financial from tax reporting, and not to the set of accounting standards and other characteristics. Finally, requiring IFRS for separate financial statements may bring an unintended consequence for financial statement users and should be considered by regulators and tax authorities. Future research could evaluate if countries that implemented a tax reform while requiring IFRS for separate financial statements are able to efficiently *recouple* financial and tax reporting without reducing earnings quality.

Our findings for the post-IFRS period suggest that Atwood et al.'s (2010) continuous metric for book-tax conformity could be enhanced by considering the level of independence between tax and financial reporting (i.e., if they are decoupled or not). Future research could provide enhancements on how to measure the level of book-tax conformity in the post-IFRS period. Finally, our findings related to the ability of losses to predict future earnings and cash flows differ across the two groups. While we do not offer explanations for those results, future research could further examine the role that losses play in earnings quality.

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<sup>31</sup> <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/#analysis-of-the-166-profiles>

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**Appendix A**  
*Variable definitions*

Variables	Definitions	Sources
<b><i>Variables used in our base models for testing earnings persistence and cash flow predictability</i></b>		
$EARN_{it+1}$	Earnings before extraordinary items of firm $i$ for year $t+1$ , scaled by average total assets	Compustat Global
$CFO_{it+1}$	Cash flow from operations of firm $i$ for year $t+1$ , scaled by average total assets	Compustat Global
$EARN_{it}$	Earnings before extraordinary items of firm $i$ for year $t$ , scaled by average total assets	Compustat Global
$LOSS_{it}$	A binary variable equal to one if pre-tax book income for firm $i$ in year $t$ is negative, and zero otherwise	Compustat Global
$POST_t$	A binary variable equal to one for years following IFRS adoption, and zero for years prior to IFRS adoption	
<hr/>		
<b><i>Variables used in tests adding different sets of controls</i></b>		
<i>Controls used by Atwood et al. (2010)</i>		
$CommonLaw$	A binary variable equal to one if the country's legal tradition is common-law, zero if code-law	La Porta et al., (1998); Djankov et al. (2008)
$InvRights$	Investors' rights score developed by La Porta et al. (1998) and revised by Djankov et al. (2008)	Djankov et al. (2008)
$OwnCon$	Ownership concentration variable developed by La Porta et al. (1998) and Djankov et al. (2008), except for Poland. In the case of Poland, we use the sum of the median blockholdings on the three largest shareholders presented by Dzierzanowski and Tamowicz (2004).	La Porta et al. (1998); Djankov et al. (2008); Dzierzanowski and Tamowicz (2004)
<hr/>		
<i>Controls used by Isidro et al. (2020) - 21 'change' variables</i>		
$CreditR_{jt}$	Legal protection to creditors and borrowers of country $j$ for year $t$	The Global Competitiveness Report
$InstHoldDom_{it}$	Proportion of domestic institutional holdings of firm $i$ for year $t$	Thomson Financial
$InstHoldDom_{it}$	Proportion of domestic institutional holdings of firm $i$ for year $t$	Thomson Financial
$EnforAccS_{jt}$	Score of accounting and market enforcement of country $j$ for year $t$	Brown et al. (2014)
$EnforAudS_{jt}$	Score of auditing enforcement of country $j$ for year $t$	Brown et al. (2014)
$IntHoldFor_{it}$	Proportion of foreign institutional holdings of firm $i$ for year $t$	Thomson Financial

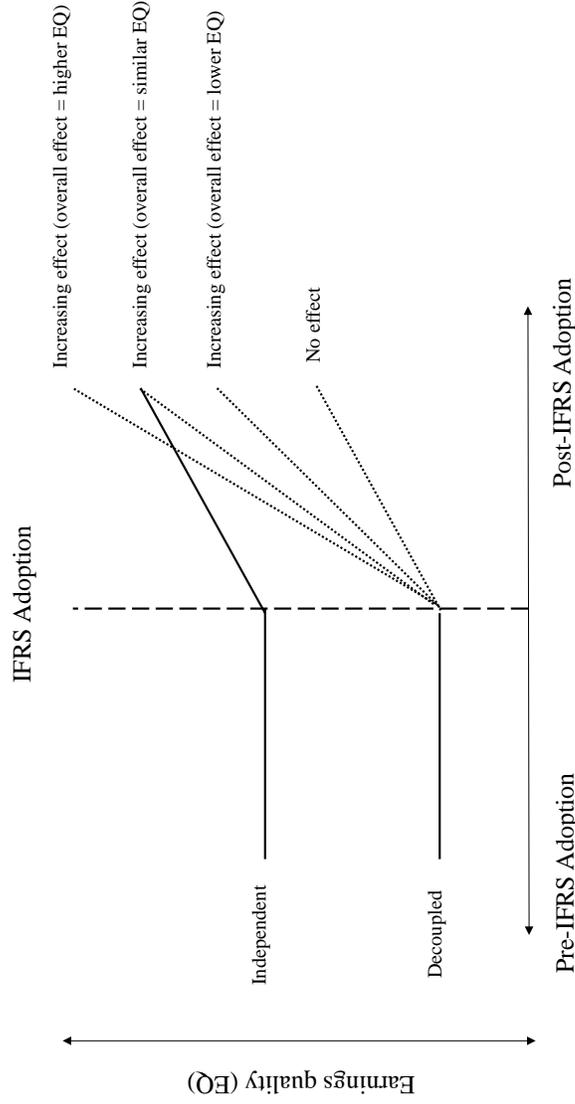
**Appendix A (cont.'d)**  
*Variable definitions*

<b>Variables</b>	<b>Definitions</b>	<b>Sources</b>
<i>Controls used by Isidro et al. (2020) - 21 'change' variables (cont.'d)</i>		
<i>ForeignInv<sub>jt</sub></i>	Net inflows of investment in foreign enterprises of country <i>j</i> for year <i>t</i>	World Bank Development Indicators
<i>GDP<sub>Cjt</sub></i>	GDP per capita of country <i>j</i> for year <i>t</i>	World Bank Development Indicators
<i>IndividW<sub>jt</sub></i>	Index 100 + %(completely agree with large income diff.) - %(completely agree income should be equal) of country <i>j</i> for year <i>t</i>	World Values Survey
<i>InfoKnow<sub>jt</sub></i>	Score of information and knowledge of country <i>j</i> for year <i>t</i>	Global Democracy Rankings
<i>JudIndep<sub>jt</sub></i>	Score of judicial independence of country <i>j</i> for year <i>t</i>	Global Competitiveness Report
<i>ListedF<sub>jt</sub></i>	Listed firms per 1,000 population of country <i>j</i> for year <i>t</i>	World Bank Development Indicators
<i>MarkCap<sub>jt</sub></i>	Market capitalization to GDP of country <i>j</i> for year <i>t</i>	World Bank Development Indicators
<i>PolitScore<sub>jt</sub></i>	Index of political quality of country <i>j</i> for year <i>t</i>	Global Democracy Rankings
<i>PolitStab<sub>jt</sub></i>	Score of political stability of country <i>j</i> for year <i>t</i>	Worldwide Governance Indicators
<i>ProprR<sub>jt</sub></i>	Score of property rights of country <i>j</i> for year <i>t</i>	Global Competitiveness Report
<i>RegQ<sub>jt</sub></i>	Score of regulatory quality of country <i>j</i> for year <i>t</i>	Worldwide Governance Indicators
<i>Religness<sub>jt</sub></i>	Principal component of religious attendance and importance of religion in life of country <i>j</i> for year <i>t</i>	World Values Survey
<i>Law<sub>jt</sub></i>	Score of the quality of the rule of law of country <i>j</i> for year <i>t</i>	Worldwide Governance Indicators
<i>Trust<sub>jt</sub></i>	Index equal to 100 + %(most people can be trusted) - %(can't be too careful) of country <i>j</i> for year <i>t</i>	World Values Survey
<i>U.S.Hold<sub>it</sub></i>	Proportion of U.S. institutional holdings of firm <i>i</i> for year <i>t</i>	Thomson Financial
<hr/>		
<i>Controls used by Isidro et al. (2020) - average of 70 institutional characteristics</i>		
<i>Data set and variable definitions made available online by Isidro et al. (2020)</i>		Available at: <a href="https://data.mendeley.com/datasets/dvgmbh7z3z/1">https://data.mendeley.com/datasets/dvgmbh7z3z/1</a>
<hr/>		

**Appendix A (cont.'d)**  
*Variable definitions*

<b>Variables</b>	<b>Definitions</b>	<b>Sources</b>
<i>Variables used in our additional analysis subsection</i>		
<i>Abs_DA<sub>it</sub></i>	Residuals from the Jones-Modified model including lagged return on assets of firm <i>i</i> for year <i>t</i>	Accounting variables from Compustat Global.
<i>EM1<sub>ip</sub></i>	Ratio of the standard deviation of operating accruals and the standard deviation of operating cash flows. The ratio is calculated for each firm <i>i</i> in each period <i>p</i> (either pre- or post-IFRS period).	Accounting variables from Compustat Global.
<i>EM2<sub>it</sub></i>	Ratio of absolute accruals and absolute operating cash flows of firm <i>i</i> for year <i>t</i>	Accounting variables from Compustat Global.

**Figure 1**  
*Expected effects of decoupling financial from tax reporting on earnings quality*



**Figure 2**  
*Financial and Tax Reporting in the pre- and post-IFRS adoption period*

Group	Countries	Reporting	Pre-IFRS	Post-IFRS	Concurrent Changes
Independent	Denmark, Ireland, the Netherlands, Poland, and the United Kingdom	Financial	Local GAAP	IFRS	IFRS + concurrent changes (without <i>decoupling</i> )
		Tax	Tax statement	Tax statement	
Decoupled	Austria, Belgium, France, Germany, and Sweden	Financial	Local GAAP	IFRS	IFRS + concurrent changes (including <i>decoupling</i> )
		Tax	Local GAAP	Local GAAP	

**Table 1***Screening procedures and sample composition*

This table presents our screening procedures and sample composition. Panel A presents our screening procedures. Our final sample of 13,139 firm-year observations pre-IFRS and 12,093 post-IFRS represent firms from 1998 to 2014, while using 1997 to create lagged variables and 2015 to create forward-looking variables. Panel B presents our sample composition.

*Panel A: Screening procedures*


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	<u>Pre-IFRS</u>	<u>Post-IFRS</u>
Firm-years with non-missing values for total assets (FY = 1997 - 2015)	33,751	31,477
Observations with headquarters not located in country of incorporation	(163)	(255)
Observations in regulated industries or missing industry identifier	(7,903)	(8,971)
Observations for early IFRS adopters and Non-IFRS users	(4,186)	(4,715)
Observations in transition years (2004 and 2005)	(3,044)	(2,105)
Observations missing data	<u>(5,316)</u>	<u>(3,338)</u>
Final sample	13,139	12,093

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*Panel B: Sample composition*


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<i>Decoupled group</i>	<u>Pre-IFRS</u>	<u>Post-IFRS</u>	<u>Total</u>
Austria	173	214	387
Belgium	392	473	865
France	2,828	2,650	5,478
Germany	1,500	1,880	3,380
Sweden	<u>1,468</u>	<u>1,218</u>	<u>2,686</u>
	<b>6,361</b>	<b>6,435</b>	<b>12,796</b>
<i>Independent group</i>	<u>Pre-IFRS</u>	<u>Post-IFRS</u>	<u>Total</u>
Denmark	583	553	1,136
Ireland	244	105	349
Netherlands	719	527	1,246
Poland	469	1,793	2,262
United Kingdom	<u>4,763</u>	<u>2,680</u>	<u>7,443</u>
	<b>6,778</b>	<b>5,658</b>	<b>12,436</b>

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**Table 2**  
*Descriptive statistics and correlations*

This table contains descriptive statistics and correlations. Panel A presents descriptive statistics for variables used in our main analyses partitioned into our *Decoupled* and *Independent* groups in the pre- and post-IFRS periods. Panel B presents Pearson correlations for variables used in our main analyses. In Panel A, \*, \*\*, and \*\*\* indicate significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed). In Panel B, bolded correlations are significant at the 0.01 level.

*Panel A: Descriptive statistics*

<b>Variable</b>	<i>Decoupled</i>			<i>Independent</i>			<b>Mean Difference</b>
	N	Mean	Std. Dev.	N	Mean	Std. Dev.	
<b>Pre-IFRS</b>							
<i>EARN<sub>it+1</sub></i>	6,361	-0.008	0.147	6,778	0.006	0.174	-0.013***
<i>CFO<sub>it+1</sub></i>	5,475	0.038	0.147	6,619	0.084	0.170	-0.046***
<i>EARN<sub>it</sub></i>	6,361	-0.013	0.157	6,778	0.000	0.175	-0.013***
<i>LOSS<sub>it</sub></i>	6,361	0.285	0.452	6,778	0.264	0.441	0.021***
<b>Post-IFRS</b>							
<i>EARN<sub>it+1</sub></i>	6,435	0.021	0.118	5,658	0.031	0.127	-0.010***
<i>CFO<sub>it+1</sub></i>	6,425	0.068	0.121	5,645	0.081	0.118	-0.013***
<i>EARN<sub>it</sub></i>	6,435	0.021	0.112	5,658	0.028	0.124	-0.007***
<i>LOSS<sub>it</sub></i>	6,435	0.222	0.415	5,658	0.211	0.408	0.010

**Table 2 (cont.'d)**  
*Descriptive statistics and correlations*

	<i>Decoupled</i>			<i>Independent</i>		
	$EARN_{it+1}$	$CFO_{it+1}$	$EARN_{it}$	$EARN_{it+1}$	$CFO_{it+1}$	$EARN_{it}$
<b>Pre-IFRS</b>						
$EARN_{it+1}$						
$CFO_{it+1}$	<b>0.621</b>			<b>0.643</b>		
$EARN_{it}$	<b>0.640</b>	<b>0.452</b>		<b>0.680</b>	<b>0.561</b>	
$LOSS_{it}$	<b>-0.496</b>	<b>-0.379</b>	<b>-0.721</b>	<b>-0.515</b>	<b>-0.459</b>	<b>-0.758</b>
<b>Post-IFRS</b>						
$EARN_{it+1}$						
$CFO_{it+1}$	<b>0.607</b>			<b>0.589</b>		
$EARN_{it}$	<b>0.681</b>	<b>0.493</b>		<b>0.662</b>	<b>0.509</b>	
$LOSS_{it}$	<b>-0.469</b>	<b>-0.370</b>	<b>-0.766</b>	<b>-0.447</b>	<b>-0.351</b>	<b>-0.697</b>
<b>Total</b>						
$EARN_{it+1}$						
$CFO_{it+1}$	<b>0.621</b>			<b>0.614</b>		
$EARN_{it}$	<b>0.660</b>	<b>0.479</b>		<b>0.672</b>	<b>0.534</b>	
$LOSS_{it}$	<b>-0.485</b>	<b>-0.379</b>	<b>-0.750</b>	<b>-0.487</b>	<b>-0.410</b>	<b>-0.732</b>

**Table 3**  
*Tests for earnings persistence*

This table reports the results of OLS regressions for earnings persistence. Panel A presents results for the *Independent* group, while Panel B presents results for the *Decoupled* group. Panel C reports tests of differences in the coefficients (*Decoupled* – *Independent* = 0). We present t-statistics in parentheses and cluster standard errors by firm in Panels A and B. \*, \*\*, and \*\*\* indicate significance of a two-tailed *t*-test at the 0.10, 0.05, and 0.01 levels, respectively. <sup>^</sup>, <sup>^^</sup>, and <sup>^^^</sup> indicate significance of a two-tailed *F*-test at the 0.10, 0.05, and 0.01 levels, respectively. #, ##, and ### indicate significance of a *chi-squared* test at the 0.10, 0.05, and 0.01 levels, respectively, for testing the differences among the two groups (*Decoupled* - *Independent*).

*Panel A: Independent group*

	Sign	Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	+	0.848*** (25.63)	0.849*** (25.50)	0.862*** (22.37)	0.856*** (22.55)	0.853** (21.46)
$POST_t \times EARN_{it}$	+	<b>-0.109**</b> (2.20)	<b>-0.109**</b> (-2.19)	<b>-0.112**</b> (-2.25)	<b>-0.120**</b> (-2.42)	<b>-0.121**</b> (-2.43)
$LOSS_{it}$	?	-0.025*** (-5.10)	-0.025*** (-5.09)	-0.024*** (-4.83)	-0.024*** (-4.85)	-0.024*** (-4.75)
$LOSS_{it} \times EARN_{it}$	-	-0.345*** (-8.11)	-0.347*** (-8.14)	-0.359*** (-7.80)	-0.354*** (-7.73)	-0.353*** (-7.52)
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
No. of Obs.		12,436	12,436	12,436	12,436	12,436
Adj. R-Squared		0.387	0.387	0.387	0.389	0.390
F Statistic		183.36 <sup>^^^</sup>	181.89 <sup>^^^</sup>	170.7 <sup>^^^</sup>	107.54 <sup>^^^</sup>	103.52 <sup>^^^</sup>
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		0.739 <sup>^^^</sup>	0.740 <sup>^^^</sup>	0.750 <sup>^^^</sup>	0.736 <sup>^^^</sup>	0.732 <sup>^^^</sup>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		-0.454 <sup>^^^</sup>	-0.455 <sup>^^^</sup>	-0.471 <sup>^^^</sup>	-0.474 <sup>^^^</sup>	-0.474 <sup>^^^</sup>
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.393 <sup>^^^</sup>	0.393 <sup>^^^</sup>	0.391 <sup>^^^</sup>	0.382 <sup>^^^</sup>	0.379 <sup>^^^</sup>

**Table 3 (cont.'d)**  
*Tests for earnings persistence*

*Panel B: Decoupled group*

	Sign	Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	+	0.693 <sup>***</sup> (19.38)	0.689 <sup>***</sup> (19.19)	0.696 <sup>***</sup> (17.92)	0.693 <sup>***</sup> (17.68)	0.697 <sup>***</sup> (17.79)
$POST_t \times EARN_{it}$	+	0.098 <sup>***</sup> (2.75)	0.099 <sup>***</sup> (2.78)	0.104 <sup>***</sup> (2.91)	0.102 <sup>***</sup> (2.89)	0.103 <sup>***</sup> (2.93)
$LOSS_{it}$	?	-0.010 <sup>***</sup> (-2.89)	-0.011 <sup>***</sup> (-3.00)	-0.011 <sup>***</sup> (-2.93)	-0.011 <sup>***</sup> (-2.94)	-0.010 <sup>***</sup> (-2.84)
$LOSS_{it} \times EARN_{it}$	-	-0.122 <sup>***</sup> (-3.13)	-0.119 <sup>***</sup> (-3.04)	-0.137 <sup>***</sup> (-3.32)	-0.137 <sup>***</sup> (-3.30)	-0.141 <sup>***</sup> (-3.42)
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
No. of Obs.		12,796	12,796	12,796	12,796	12,796
Adj. R-Squared		0.461	0.461	0.462	0.465	0.465
F Statistic		205.32 <sup>^^^</sup>	196.38 <sup>^^^</sup>	188.83 <sup>^^^</sup>	117.31 <sup>^^^</sup>	108.98 <sup>^^^</sup>
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		0.791 <sup>^^^</sup>	0.787 <sup>^^^</sup>	0.799 <sup>^^^</sup>	0.795 <sup>^^^</sup>	0.800 <sup>^^^</sup>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		-0.025	-0.020	-0.033	-0.035	-0.038
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.669 <sup>^^^</sup>	0.669 <sup>^^^</sup>	0.663 <sup>^^^</sup>	0.658 <sup>^^^</sup>	0.658 <sup>^^^</sup>

**Table 3 (cont.'d)**  
*Tests for earnings persistence*

*Panel C: Tests of differences*

	Sign	<b>Differences: <i>Decoupled - Independent</i></b>				
		Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	?	-0.154 <sup>###</sup>	-0.160 <sup>###</sup>	-0.166 <sup>###</sup>	-0.163 <sup>###</sup>	-0.157 <sup>###</sup>
$POST_t \times EARN_{it}$	+	<b>0.207<sup>###</sup></b>	<b>0.207<sup>###</sup></b>	<b>0.216<sup>###</sup></b>	<b>0.222<sup>###</sup></b>	<b>0.224<sup>###</sup></b>
$LOSS_{it}$	?	0.015 <sup>##</sup>	0.014 <sup>##</sup>	0.013 <sup>##</sup>	0.013 <sup>##</sup>	0.013 <sup>##</sup>
$LOSS_{it} \times EARN_{it}$	?	0.223 <sup>###</sup>	0.228 <sup>###</sup>	0.222 <sup>###</sup>	0.217 <sup>###</sup>	0.211 <sup>###</sup>
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$	?	<b>0.052</b>	<b>0.047</b>	<b>0.050</b>	<b>0.059</b>	<b>0.068</b>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		0.429 <sup>###</sup>	0.435 <sup>###</sup>	0.438 <sup>###</sup>	0.439 <sup>###</sup>	0.436 <sup>###</sup>
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.275 <sup>###</sup>	0.275 <sup>###</sup>	0.272 <sup>###</sup>	0.276 <sup>###</sup>	0.279 <sup>###</sup>

**Table 4**  
*Tests for cash flow predictability*

This table reports the results of OLS regressions for cash flow predictability. Panel A presents results for the *Independent* group, while Panel B presents results for the *Decoupled* group. Panel C reports tests of differences in the coefficients (*Decoupled* – *Independent* = 0). We present t-statistics in parentheses and cluster standard errors by firm in Panels A and B. \*, \*\*, and \*\*\* indicate significance of a two-tailed *t*-test at the 0.10, 0.05, and 0.01 levels, respectively. ^, ^^, and ^^ indicate significance of a two-tailed *F*-test at the 0.10, 0.05, and 0.01 levels, respectively. #, ##, and ### indicate significance of a *chi-squared* test at the 0.10, 0.05, and 0.01 levels, respectively, for testing the differences among the two groups (*Decoupled* - *Independent*).

*Panel A: Independent group*

	Sign	Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	+	1.012*** (26.50)	0.975*** (25.69)	0.869*** (19.68)	0.868*** (20.10)	0.830*** (18.37)
$POST_t \times EARN_{it}$	+	<b>-0.187***</b> (-3.99)	<b>-0.198***</b> (-4.20)	<b>-0.182***</b> (-3.99)	<b>-0.180***</b> (-3.98)	<b>-0.177***</b> (-3.92)
$LOSS_{it}$	?	-0.001 (-0.12)	-0.002 (-0.38)	-0.011** (-2.32)	-0.011** (-2.26)	-0.014*** (-2.97)
$LOSS_{it} \times EARN_{it}$	-	-0.522*** (-11.44)	-0.474*** (-10.33)	-0.369*** (-7.28)	-0.369*** (-7.36)	-0.331*** (-6.44)
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
No. of Obs.		12,264	12,264	12,264	12,264	12,264
Adj. R-Squared		0.481	0.488	0.494	0.496	0.498
F Statistic		263.79^^	268.10^^	242.18^^	144.86^^	126.56^^
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		0.825^^	0.778^^	0.686^^	0.688^^	0.653^^
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		-0.708^^	-0.672^^	-0.551^^	-0.549^^	-0.508^^
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.303^^	0.304^^	0.317^^	0.319^^	0.322^^

**Table 4 (cont.'d)**  
*Tests for cash flow predictability*

*Panel B: Decoupled group*

	Sign	Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	+	0.584*** (13.08)	0.567*** (12.67)	0.524*** (10.95)	0.524*** (11.01)	0.507*** (10.57)
$POST_t \times EARN_{it}$	+	0.109*** (2.94)	0.113*** (3.02)	0.122*** (3.30)	0.119*** (3.22)	0.121*** (3.29)
$LOSS_{it}$	?	0.005 (1.11)	0.003 (0.74)	-0.001 (-0.14)	0.000 (-0.07)	-0.002 (-0.44)
$LOSS_{it} \times EARN_{it}$	-	-0.038 (-0.79)	-0.025 (-0.51)	0.012 (0.23)	0.013 (0.25)	0.028 (0.55)
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
No. of Obs.		11,900	11,900	11,900	11,900	11,900
Adj. R-Squared		0.443	0.446	0.451	0.452	0.454
F Statistic		221.78 <sup>^^</sup>	216.10 <sup>^^</sup>	192.32 <sup>^^</sup>	119.43 <sup>^^</sup>	109.99 <sup>^^</sup>
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		0.693 <sup>^^</sup>	0.680 <sup>^^</sup>	0.646 <sup>^^</sup>	0.643 <sup>^^</sup>	0.629 <sup>^^</sup>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		0.071	0.089	0.133 <sup>^</sup>	0.132 <sup>^</sup>	0.149 <sup>^^</sup>
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.655 <sup>^^</sup>	0.655 <sup>^^</sup>	0.657 <sup>^^</sup>	0.656 <sup>^^</sup>	0.657 <sup>^^</sup>

**Table 4 (cont.'d)**  
*Tests for cash flow predictability*

*Panel C: Tests of differences*

	Sign	<b>Differences: Decoupled - Independent</b>				
		Model 1	Model 2	Model 3	Model 4	Model 5
$EARN_{it}$	?	-0.428 <sup>###</sup>	-0.409 <sup>###</sup>	-0.345 <sup>###</sup>	-0.344 <sup>###</sup>	-0.322 <sup>###</sup>
$POST_t \times EARN_{it}$	+	<b>0.296<sup>###</sup></b>	<b>0.311<sup>###</sup></b>	<b>0.304<sup>###</sup></b>	<b>0.298<sup>###</sup></b>	<b>0.298<sup>###</sup></b>
$LOSS_{it}$	?	0.005	0.005	0.011 <sup>#</sup>	0.011 <sup>#</sup>	0.013 <sup>##</sup>
$LOSS_{it} \times EARN_{it}$	?	0.484 <sup>###</sup>	0.449 <sup>###</sup>	0.380 <sup>###</sup>	0.382 <sup>###</sup>	0.359 <sup>###</sup>
Three time-invariant controls			Yes			
70 time-invariant controls				Yes		
21 time-varying controls					Yes	Yes
49 time-invariant controls						Yes
Year Fixed Effects		Yes	Yes	Yes	Yes	Yes
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		<b>-0.132<sup>##</sup></b>	<b>-0.098</b>	<b>-0.040</b>	<b>-0.045</b>	<b>-0.025</b>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		0.780 <sup>###</sup>	0.760 <sup>###</sup>	0.685 <sup>###</sup>	0.681 <sup>###</sup>	0.657 <sup>###</sup>
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.352 <sup>###</sup>	0.351 <sup>###</sup>	0.340 <sup>###</sup>	0.337 <sup>###</sup>	0.335 <sup>###</sup>

**Table 5***Tests for effects of decoupling for high versus low book-tax conformity countries*

This table reports the results of OLS regressions for earnings persistence (Panel A) and cash flow predictability (Panel B) across pre- and post-IFRS adoption. Columns 1 and 2 partition the *Decoupled* sample into high and low book-tax conformity countries and present results from estimation of Equation 1 on each sub-sample. Column 3 presents tests of differences between coefficient estimates for the high and low book-tax conformity countries (column 1 – column 2). Column 4 presents tests of differences between coefficient estimates for high book-tax conformity countries and the *Independent* sample. Column 5 presents tests of differences between coefficient estimates for low book-tax conformity countries and the *Independent* sample. We present t-statistics in parentheses and cluster standard errors by firm in columns 1 and 2. \*, \*\*, and \*\*\* indicate significance of a two-tailed *t-test* at the 0.10, 0.05, and 0.01 levels, respectively. ^, ^^, and ^^ indicate significance of a two-tailed *F-test* at the 0.10, 0.05, and 0.01 levels, respectively. #, ##, and ### indicate significance of a *chi-squared test* at the 0.10, 0.05, and 0.01 levels, respectively, for testing the differences among the three groups (high book-tax conformity, low book-tax conformity, and *Independent*).

*Panel A: Tests for earnings persistence*

	Sign	(1) High BTC	(2) Low BTC	(3) High vs. Low BTC	(4) High BTC vs. Indep.	(5) Low BTC vs. Indep.
$EARN_{it}$	+/+	0.650*** (15.18)	0.715*** (12.75)	-0.066	-0.198###	-0.132##
$POST_t \times EARN_{it}$	+/+	<b>0.115**</b> (2.22)	<b>0.089**</b> (2.10)	<b>0.026</b>	<b>0.223###</b>	<b>0.198###</b>
$LOSS_{it}$	-/-	-0.020*** (-4.23)	-0.010* (-1.94)	-0.010	0.005	0.015#
$LOSS_{it} \times EARN_{it}$	-/-	-0.289*** (-5.23)	-0.109** (-1.97)	-0.180##	0.056	0.236###
21 time-varying controls		Yes	Yes			
49 time-invariant controls		Yes	Yes			
Year Fixed Effects		Yes	Yes			
No. of Obs.		5,865	6,931			
Adj. R-Squared		0.368	0.506			
F Statistic		61.58^^	73.86^^			
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		<b>0.764^^</b>	<b>0.804^^</b>	<b>-0.040</b>	<b>0.026</b>	<b>0.065</b>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		-0.175^^	-0.020	-0.155	0.279###	0.434###
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.475^^	0.695^^	-0.220###	0.081	0.301###

**Table 5 (cont.'d)***Tests for effects of decoupling for high versus low book-tax conformity countries**Panel B: Tests for cash flow predictability*

	Sign	(1) High BTC	(2) Low BTC	(3) High vs. Low BTC	(4) High BTC vs. Indep.	(5) Low BTC vs. Indep.
$EARN_{it}$	+/+	0.311*** (4.44)	0.591*** (11.77)	-0.279###	-0.700###	-0.421###
$POST_t \times EARN_{it}$	+/+	<b>0.221***</b> (3.90)	<b>0.072*</b> (1.48)	<b>0.149##</b>	0.408###	0.259###
$LOSS_{it}$	-/-	-0.004 (-0.80)	-0.008 (-0.34)	0.004	-0.004	-0.008
$LOSS_{it} \times EARN_{it}$	-/-	-0.001 (-0.01)	-0.002 (-0.97)	0.001	0.521###	0.520###
21 time-varying controls		Yes	Yes			
49 time-invariant controls		Yes	Yes			
Year Fixed Effects		Yes	Yes			
No. of Obs.		5,368	6,532			
Adj. R-Squared		0.412	0.485			
F Statistic		56.69^^	77.70^^			
<i>Sum of coefficients</i>						
$EARN_{it} + POST_t \times EARN_{it}$		<b>0.533^^^</b>	<b>0.663^^^</b>	<b>-0.130</b>	<b>-0.292</b>	<b>-0.162</b>
$LOSS_{it} \times EARN_{it} + POST_t \times EARN_{it}$		0.220^^	0.070	0.150	0.929###	0.779###
$LOSS_{it} \times EARN_{it} + EARN_{it} + POST_t \times EARN_{it}$		0.532^^	0.661^^	-0.129^	0.229###	0.357###

**Table 6***Tests for absolute discretionary accruals*

This table reports the results of OLS regressions for absolute discretionary accruals comparing the pre- and post-IFRS periods. We separately estimate Equation 2 across the *Decoupled* and *Independent* groups and report tests of differences in the coefficients. We present t-statistics in parentheses and cluster standard errors by firm in columns 1 and 2. \*, \*\*, and \*\*\* indicate significance of a two-tailed *t*-test at the 0.10, 0.05, and 0.01 levels, respectively. ^, ^^, and ^^^ indicate significance of a two-tailed *F*-test at the 0.10, 0.05, and 0.01 levels, respectively. #, ##, and ### indicate significance of a *chi-squared* test at the 0.10, 0.05, and 0.01 levels, respectively, for testing the differences among the two groups (*Decoupled* vs. *Independent*).

	Sign	<u><i>Decoupled</i></u>	<u><i>Independent</i></u>	<u>Test of differences</u>
<i>Constant</i>	+	0.073*** (14.69)	0.079*** (18.54)	-0.006
<i>POST<sub>t</sub></i>	?	-0.020*** (-3.06)	-0.018** (-2.43)	-0.002
21 time-varying controls		Yes	Yes	
No. of Obs.		9,408	9,631	
Adj. R-Squared		0.032	0.028	
F Statistic		6.68^^	13.26^^	
<i>Sum of coefficients</i>				
<i>Constant + POST<sub>t</sub></i>		0.053^^	0.061^^	-0.008