

G. Gavana, G. Guggiola and A.  
Marenzi

Evolving Connections between Tax  
and Financial Reporting in Italy

2010/1



UNIVERSITÀ DELL'INSUBRIA  
FACOLTÀ DI ECONOMIA

<http://eco.uninsubria.it>

In questi quaderni vengono pubblicati i lavori dei docenti della Facoltà di Economia dell'Università dell'Insubria. La pubblicazione di contributi di altri studiosi, che abbiano un rapporto didattico o scientifico stabile con la Facoltà, può essere proposta da un professore della Facoltà, dopo che il contributo sia stato discusso pubblicamente. Il nome del proponente è riportato in nota all'articolo. I punti di vista espressi nei quaderni della Facoltà di Economia riflettono unicamente le opinioni degli autori, e non rispecchiano necessariamente quelli della Facoltà di Economia dell'Università dell'Insubria.

These Working papers collect the work of the Faculty of Economics of the University of Insubria. The publication of work by other Authors can be proposed by a member of the Faculty, provided that the paper has been presented in public. The name of the proposer is reported in a footnote. The views expressed in the Working papers reflect the opinions of the Authors only, and not necessarily the ones of the Economics Faculty of the University of Insubria.

© Copyright G. Gavana, G. Guggiola and A. Marenzi

Printed in Italy in January 2010

Università degli Studi dell'Insubria

Via Monte Generoso, 71, 21100 Varese, Italy

All rights reserved. No part of this paper may be reproduced in any form without permission of the Author.

# Evolving Connections between Tax and Financial Reporting in Italy\*

Giovanna Gavana<sup>†</sup>, Gabriele Guggiola<sup>‡</sup> and Anna Marenzi<sup>§</sup>

## Abstract

The mandatory introduction of IFRS for the E.U. listed companies in 2005 raised several issues about its influence on the link between tax and financial reporting. Either a greater degree of alignment or, at the opposite, a reduction of the reciprocal influence might have been expected, *a priori*, for different reasons. Half a decade later, it's possible to provide some first answers to these issues. We analyse, using the methodology developed by Lamb *et al.* (1998), the evolution of the relationship between tax and financial reporting in Italy after the introduction of IFRS for listed companies in 2005. Among European countries, Italy represents an interesting case study because IFRS have become

---

\* We especially thank Christopher Nobes and Antonio Majocchi for helpful suggestions. The results of the analysis were discussed and shared with Carlo Rossi (PricewaterhouseCoopers) and Riccardo Zeni (KPMG) and the CFOs interviewed within the project “International accounting principles and macro level impacts deriving from a change in the accounting rules”, lead by CrESIT (University of Insubria). Grants from Ministero dell’Università e della Ricerca Scientifica (MIUR) and from University of Insubria (FAR) are gratefully acknowledged.

† Giovanna Gavana, Professor of Accounting, Department of Economics, University of Insubria, via Monte Generoso 71, 21100 Varese, Italy; e\_mail: [giovanna.gavana@uninsubria.it](mailto:giovanna.gavana@uninsubria.it).

‡ Gabriele Guggiola, Assistant Professor of Public Economics, Department of Economics, University of Insubria, via Monte Generoso 71, 21100 Varese, Italy; e\_mail: [gabriele.guggiola@uninsubria.it](mailto:gabriele.guggiola@uninsubria.it).

§ Anna Marenzi, Full Professor of Public Economics, University of Insubria, via Monte Generoso 71, 21100 Varese, Italy; e\_mail: [anna.marenzi@uninsubria.it](mailto:anna.marenzi@uninsubria.it) (corresponding author).

mandatory, for listed companies, also as concerns individual, and fiscally relevant, accounts. Therefore, two accounting systems, one based on IFRS and one based on Italian Gaap coexist, originating the emergence of two rather different linkages between tax and financial reporting. IFRS and tax reporting exhibit a high degree of disconnection, while Italian Gaap, in line with a continental European accounting tradition, are closely related to tax rules. The analysis will point out a rapidly evolving situation, with links between both accounting systems (IFRS and Italian Gaap) and taxation getting tighter as a consequence of the tax reforms of the last few years.

**JEL Classification:** H20; H25; M41.

**Keywords:** Taxation; Accounting; International Financial Reporting Standards (IFRS); Italy.

## 1. Introduction

The relationship between tax and financial reporting differs widely among countries and evolves in time. Various contributions have analysed the issue and have provided with some useful interpretation keys. Nobes and Parker (1995) identify a high level classification of the different nature of the relationship between the two reporting systems in Anglo-Saxon versus continental European countries while Hoogendoorn (1996) analyses the interdependence of tax and financial reporting in thirteen countries. Freedman (2004) highlights the drawbacks of a full alignment.

The issue has gained a growing relevance in the last decade.

As of 1<sup>st</sup> January 2005 all E.U. listed companies had to prepare their consolidated financial statements in accordance with IFRS. The transition towards an

“investor oriented” set of accounting standards raised several puzzles about the potential consequences on the evolution of the relationship between tax and financial reporting in the European countries. On one hand, the result of IFRS adoption could have been a reduction of the degree of alignment between the two systems: there are several concerns about the suitability of IFRS as a basis for tax reporting, and many countries were, in view of the transition, on the brink of cutting off the dependence of taxable on accounting profit (Schön, 2004). On the other hand, some countries, such as U.K., were moving towards a higher degree of alignment of local Gaap with IFRS and of taxable with accounting profits.

The topic is relevant for, at least, two reasons.

On one hand, the reliance of many European taxation systems on accounting figures has represented one of the main impediments to the adoption of IFRS for individual accounts and to a full convergence among accounting systems. The calculation of a corporate tax base following IFRS principles would have major drawbacks<sup>1</sup>: the two systems obey to different purposes and a full alignment between tax and financial reporting may lead to a certain degree of tax pollution that would lower the quality of financial information provided to the markets. As a consequence, local Gaap continue to be used in many countries for individual, and fiscally relevant, accounts and by unlisted companies, leading to the emergence of a “two standard” system (Larson and Street, 2004a and 2004b) that has hindered accounting harmonization among different countries and, within each country, between listed and unlisted companies. As previously observed, the European countries had two,

---

<sup>1</sup> There is an on-going debate on the suitability of IFRS as a tax base (among others James, 2002; Schön, 2004; Gammie *et al.*, 2005; Jacobs *et al.*, 2005).

opposite, available strategies in order to overcome this condition. A reduction of the reliance of tax reporting on accounting figures would have reduced the problems of extending to individual, and fiscally relevant accounts, the adoption of accounting standards that are not always suitable for tax reporting. Vice versa, considering IFRS as a starting point for the calculation of the fiscal base and fixing with specific regulations the problems originated by this choice, would have partially removed the impediments to a full convergence of European countries' accounting systems. This option has been considered within the discussion on the identification of a common consolidated corporate tax base (CCCTB).<sup>2</sup>

On the other hand, the analysis of the evolutions of the link between tax and financial reporting following IFRS adoption can provide an interesting contribution to the environmental determinism literature. The tax system is considered one of the environmental factors that may strongly influence the evolution of the accounting systems (Nobes and Parker, 2008) and this causal effect have been extensively analysed. With few exceptions, the reverse effect (i.e.: the influence of accounting systems on tax rules) has not been adequately investigated; the IFRS transition process allows to study the effects of the adoption of a homogeneous, and exogenously given, set of accounting standards in countries with various accounting traditions and characterised by a different degree of reliance of tax on financial reporting figures.

---

<sup>2</sup> The quantitative effects on companies' tax burden in case of a potential IFRS adoption as a tax base have been analyzed in several papers (among others Eberhartinger and Klostermann, 2007; Haverals 2007; Kirsch and Olsson, 2008).

Half a decade after the introduction of IFRS, it's possible to observe the first evidences of the effects on the relationship between tax and financial reporting and it's therefore possible to provide some preliminary answers to the questions raised by the transition process. In the paper we analyse the evolution of this relationship in Italy after the mandatory introduction of IFRS in 2005.

We consider Italy an interesting case study for several reasons.

First because, as a consequence of the mandatory adoption of International Financial Reporting Standards<sup>3</sup>, tax and accounting rules have been evolving rapidly in the last few years. The Italian government opted for an extensive implementation of European Union Regulation 1606/2002, requiring listed companies to draw up both consolidated and individual accounts in accordance with international accounting standards. Individual accounts have direct fiscal relevance, by virtue of the derivation principle and, therefore, the adoption of IFRS caused major changes in the tax rules that have been modified, on several occasions, in order to allow a more direct reliance on accounting figures for fiscal purposes. The analysis of the Italian case can therefore provide a significant contribution to the environmental determinism literature allowing to highlight the effects of the adoption of an exogenous set of accounting standards on the complex relationship between tax and financial reporting.

Second, though unlisted companies have, in some cases, been allowed to adopt IFRS, a majority of them still continue to use Italian Gaap. As a result, two accounting systems cohabit in the Italian scene, the first based on "investor oriented"

---

<sup>3</sup> From now on IFRS, which will refer both to International Financial Reporting Standards and to the International Accounting Standards issued before 2001.

IFRS and the second based on “creditor protection oriented” Italian Gaap (Cristea and Saccon, 2008). This interesting institutional scenario allows analysing the parallel evolutions in the relationship between the two accounting systems and tax rules.

Finally, since the adoption of IFRS, the legislator has amended the Italian Tax Code in some substantial aspects. It is interesting to analyse to what extent these regulatory changes have been influencing the relationship of domestic Gaap with tax reporting, also considering that the publication of IFRS for SMEs, in July 2009, is likely to enhance the adoption of the international accounting standards for all Italian companies.

In order to assess and analyse the evolutions of the link between tax and financial reporting in Italy we use the methodology developed by Lamb *et al.* (1998). This methodology, perhaps the most effective one allowing a formal classification of the relationship between the two systems, has been applied to the U.S., U.K., France and Germany (Lamb *et al.*, 1998), Norway (Nobles and Schwencke, 2006) and Spain (Oliveras and Puig, 2007). Gee *et al.* (2010) extend the methodology to consolidated financial statements and apply it to the U.K. and to Germany.

This paper adds to the previous literature by analysing, within this framework, the Italian case, where both IFRS and domestic Gaap are used, by different companies, for individual and fiscally relevant accounts. In this way, it provides also a first comparison between the “investor-oriented” IFRS and a tax system traditionally relying on accounting figures, such as the Italian one, and allows an international comparison with the other countries so far considered by other contributions using the same methodology.

The paper proceeds as follows: section 2 briefly goes through the main tax and accounting reforms following the adoption of IFRS in 2005; section 3 recalls the methodology used in Lamb *et al.* (1998) and provides an application to the Italian case; section 4 analyses the Italian case in an international perspective; section 5 discusses the results and concludes.

## **2. Recent trends in Italian tax and accounting rules**

In Italy the linkage between tax and financial reporting has traditionally been based on the derivation principle, and taxation relied heavily on accounting results as a starting point for the calculation of taxable income (among others, Rocchi, 1996; Zambon, 2002). As a consequence, the decision to extend the use of IFRS to the annual accounts of certain types of companies<sup>4</sup> changed in depth the nature of the relationship between financial reporting and taxation.

### **INSERT TABLE 1**

Table 1 summarises the main recent developments concerning the relationship between tax and financial reporting.

In the first period of the adoption of IFRS, the Italian legislator stated that IFRS were tax neutral, considering them not suitable for tax purposes. This choice

---

<sup>4</sup> Through the Legislative decree 28th February, 2005, No.38, Italy is one of the few Member States that used extensively the options in Article 5 of the E.U. Regulation 1606/2002. In particular, listed companies, banks and other financial institutions are required to adopt IFRS, both for consolidated and individual accounts, while unlisted companies presenting consolidated accounts in accordance with IFRS and all subsidiaries within an IFRS group are permitted to use them for the preparation of their individual accounts. It should be noticed that, though the mandatory adoption of IFRS for the individual accounts started from 2006, an earlier adoption was permitted from 2005.

was mainly due to the significant conceptual differences between the IFRS and Italian Gaap frameworks and to the fact that financial reporting has historically relied on Italian Gaap as the basis for the computation of taxable income.

From an accounting point of view, we notice that annual accounts prepared under Italian Gaap are “creditor protection oriented”, with great emphasis on the use of the prudence principle in presenting a true and fair view of a company’s financial position and result of operations<sup>5</sup>. Within this accounting approach, unrealised gains cannot be included in the measurement of business income and the valuation criteria are closely related to historical costs. Notwithstanding the introduction, in 2003<sup>6</sup>, of the substance over form principle in the Italian Civil Code, a significant distance remains between Italian Gaap and IFRS, since the mentioned principle is subject to some important departures<sup>7</sup>. Also, the implementation of the recent EU Directives on annual accounts, which introduced some concepts proper to IFRS, has not affected the measurement of assets and liabilities but only the content of the notes.

From a fiscal point of view, principles such as the prevalence of substance over legal form and fair value accounting were not accepted because they entailed an excessive degree of discretion. Full acceptance of IFRS concepts in the fiscal sphere would have left room for excessive tax planning and would have caused many

---

<sup>5</sup> Manufacturing, commercial and services companies draw up their annual accounts in accordance with the Italian Civil Code, following the Fourth Council Directive 78/660/EC, and the accounting practices formulated by the national standard setter (Organismo Italiano di Contabilità - OIC).

<sup>6</sup> Legislative decree January 17th, 2003, No.6.

<sup>7</sup> For example, the substance over form principle does not apply to financial leases for what concerns Italian Gaap.

disputes between companies and government tax auditors. Furthermore, the tax neutrality of IFRS safeguarded equal tax treatment between companies, despite the different accounting system adopted. Therefore, as from 2005, financial and tax accounting have significantly diverged for IFRS adopters. Because dealing with a double track for tax and financial reporting proved to be quite onerous also for large public companies, after a few years a second “revolution” changed the relationship between financial and tax accounting. With the Finance Act 2008 and the subsequent operating decree<sup>8</sup> (hereinafter jointly referred to as the Finance Act 2008) the Italian legislator accepted the use of the IFRS classification, qualification and temporal imputation criteria<sup>9</sup> for tax purposes and, thus, established the dismissal of a legalistic and formal approach, recognizing the substance over form principle. The connection between tax and financial reporting, after a three-year long parenthesis, became tighter, though with a significant exception: tax rules still prevail on IFRS as far as valuation criteria are concerned.

Also unlisted companies continuing to issue their financial statements in accordance with Italian Gaap<sup>10</sup> were affected by some significant changes to their

---

<sup>8</sup> Law December 24th, 2007, No.47 and Decree April 1st, 2009, No.48, respectively.

<sup>9</sup> The qualification criterion concerns the selection and allocation, within a reference scheme, of the relevant events in order to allow their representation in the financial statement; the classification criterion drives the allocation of the main events in the financial statement on the basis of the category of the source of income (revenues, interests, etc...); finally, the temporal imputation criterion concerns the allocation of the events across different accounting periods.

<sup>10</sup> In practice, the majority of companies permitted (but not required) to prepare their individual accounts according to IFRS, still continues to use the operationally easier (and more tax oriented) Italian Gaap.

fiscal regime. In particular, the Finance Act 2008 simplified the computation of the tax base and made the alignment between tax and accounting figures closer. Consistently, the main amendment to the tax rules was the repeal of both accelerated depreciation and “extra accounting” tax adjustments (i.e. adjustments posted solely for tax purposes)<sup>11</sup>.

By allowing taxation to rely more on the accounting results<sup>12</sup>, the legislative intervention of 2008 reduced the burden of compliance, but made the tax system extremely complex as a result of the different rules in force for different taxpayers (IFRS adopters and companies reporting under Italian Gaap).

Using the methodology in Lamb *et al.* (1998), we will investigate to what extent the introduction of a new set of accounting standards can impact on the relationship between financial and tax reporting for all taxpayers, in order to shed some light on the recent trends in the Italian tax system.

---

<sup>11</sup> Extra accounting adjustments had been introduced by the tax reform enacted in 2004 (Legislative decree December 12th, 2003, No.344). According to this law depreciation, other adjustments of value and provisions, having only a fiscal relevance, were deductible if indicated in the reconciliation prospect of the tax return.

<sup>12</sup> The paper focuses on corporate income tax (IRES). It should be reminded that, as from 1998, Italian companies are subject also to a regional business tax (IRAP) that levies the company's EBIT, excluding the deduction of labour cost, write-down of receivables, depreciation of fixed assets other than amortizations, provisions for risks and other provisions. With the Finance Act 2008, Italian legislator established that IRAP tax basis is exclusively driven by the financial reporting, regardless of the set of accounting standards adopted.

### 3. Assessment of tax and financial reporting links

Lamb *et al.* (1998) proposed a methodology in order to classify tax and financial reporting links according to the different degree of connection or disconnection. The methodology has been applied, in their paper, to analyse and to compare these links in U.S., U.K., France and Germany taking 1996 as a reference year. Nobes and Schwencke (2006) analyse developments occurred in Norway over a 30-year period up to the adoption of IFRS while Oliveras and Puig (2007) go through different fiscal and accounting reforms in 1989, 1994 and 2003 in Spain. ). Gee *et al.* (2010) analyse and update the cases of U.K. and Germany and extend the methodology to consolidated financial statements.

#### **INSERT TABLE 2**

As reported in Table 2, Case I (Disconnection) refers to those cases where tax and financial reporting are independently regulated, while Case II (Identity) consists of the arenas in which there is one and the same set of tax and financial reporting rules.

Cases III to V entail different degrees of connection and supremacy of accounting or tax rules. Case III (Accounting Leads) arises when accounting rules are more detailed than tax rules, so that tax practice adheres to accounting practice. However, if accounting rules allow different options and the final choice is possibly taken in order to obtain the desired tax effect, a Case III<sup>†</sup> occurs (Accounting Leads but with a reverse effect). Vice versa, we classify the link as a Case IV (Tax Leads) if a tax rule is applied instead of a vague or not sufficiently detailed accounting rule. In Case V (Tax Dominates), finally, a tax rule is followed against an existent accounting rule.

Lambs *et al.* (1998) identify and analyse 15 accounting arenas on the basis that they affect the computation of taxable income and are sufficiently significant to be covered by an International Accounting Standard. Nobes and Schwencke (2006) add to the analysis the topics of financial assets and impairment of tangible assets, for which newly established accounting standards had meanwhile become available.

We will use the complete set of 17 accounting arenas as a perimeter for our investigation. The list of the arenas and the results for the Italian case are shown in Table 3. The classification has been derived through the analysis of accounting and tax rules. As suggested by Lamb *et al.* (1998), the scores have been discussed among the three authors and confirmed by the consultation of accounting experts<sup>13</sup>. Both *de jure* and *de facto* aspects have been considered in our study. We limited the analysis to individual accounts, consolidated ones being irrelevant, under Italian law, for fiscal purposes.

### **INSERT TABLE 3**

We will consider two reference years: 2005 and 2008.

We have chosen 2005 as a first key year mainly because this is the year in which IFRS were introduced into the Italian accounting system. As already mentioned, in the beginning IFRS were assumed as tax-neutral, so that IFRS adopters were required to convert their financial reporting in accordance with Italian Gaap and, then, to make all the tax adjustments necessary to compute taxable income. Thus, from 2005 up to the Finance Act 2008, the link between IFRS and taxation was, substantially, a complete Disconnection (Case I).

At the same time, in 2005 the general reform of corporate taxation<sup>14</sup> had become fully effective and had started to influence the connection between accounting and taxation. For the purposes of our analysis, this legislative intervention tried to correct the age-old anomaly<sup>15</sup> of the reverse dependence of financial reporting from tax rules introducing the “extra accounting” approach. Before this fiscal device, companies used to charge to the Profit and Loss Statement (P&L) certain values having uniquely a fiscal relevance, such as accelerated depreciation. This practice was originating tax pollution of financial reporting and, using the Lamb classification, would have determined various Tax Dominates cases. The reform has significantly reduced the influence of tax rules on the preparation of financial reporting: this explains the absence of Case V (Tax Dominates) and the frequency of Case I (Disconnection) in Table 3.

The second key year is 2008, when tax law recognised the fiscal relevance of IFRS qualification, time imputation and classification criteria, modelling for the first time the linkage between IFRS and Italian tax reporting. This change, consequent on the Finance Act 2008, has been significant for at least two reasons: first, it has defined up to what extent IFRS may be appropriate for tax purposes and, second, it has shown how the introduction of a new set of accounting standards may contaminate the relationship between domestic Gaap and taxation.

---

<sup>13</sup> We shared the classification in Table 3 with two partners of major accounting firms and with a selection of CFO from Italian companies of different industries and dimensions.

<sup>14</sup> The tax reform was enacted in 2004 (Legislative decree December 12th, 2003, No.344).

<sup>15</sup> See Zambon, 2002.

Furthermore, due to the civil law roots of the Italian legal system, characterised by an extensive and detailed regulation of each specific tax and accounting topic, many arenas could be erroneously classified, at a first glance, as Case I (Disconnection). In fact, though many fiscal figures, in virtue of the derivation principle, substantially rely on accounting ones, originating a Case III (Accounting Leads), tax and accounting rules are anyway specified up to a point in which, possibly, they could be classified as Case I (Disconnection). Such an assessment would misunderstand the true, substantial classification. Because of this particular legal environment, we qualify as Disconnection only the arenas for which the different purposes of tax and accounting legislation justify the presence of two sets of detailed and complete rules.

Whenever a case is not fully classifiable in a clear-cut way within one of the five categories, we will classify the link in the most suitable category according to a global perspective, signalling possible items for which a different score would apply.

In the following part of this section we will comment on the classification of links between tax and financial reporting for IFRS adopters and for companies still preparing their individual accounts in accordance with Italian Gaap. The Appendix provides references to the tax and financial reporting laws and accounting standards that have been examined in order to complete Table 3.

### **3.1 IFRS adopters**

With the aim of safeguarding equal tax treatment between IFRS adopters and the remaining companies (neutrality principle), the introduction of IFRS came with the complete disconnection between financial and tax reporting for all the arenas shown in Table 3. For this reason, we have omitted column 2005 for IFRS adopters.

This disconnection trend was partially reversed with the Finance Act 2008, which allowed the use of IFRS qualification, time imputation and classification criteria for tax purposes. By contrast, the fiscal limits for depreciation, provisions and valuations are still in force and the fiscal criteria concerning specific items (for example, dividends and management fees treated on a cash basis) keep prevailing on the accounting ones<sup>16</sup>. The fiscal treatment of leases represents a clear example of the acceptance of IFRS qualification criteria and refusal of IFRS valuation criteria. Notwithstanding the legal form of the contract, for leases that meet the conditions to be classified as finance leases under IAS 17, depreciation charges and interest costs (instead of the contingent rent payable) are deductible but the amount of these deductions is subordinated to the current fiscal limits<sup>17</sup>.

Although Disconnection (Case I) remains quite common, IFRS accounting has started to influence the computation of taxable income, as proved by the presence of various Case III (Accounting Leads) in Table 4. In one accounting arena (normal depreciation) a Tax Leads connection (Case IV) has been detected while one Accounting Leads but with a reverse effect connection (Case III †) has emerged for what concerns interests capitalization.

In detail, Disconnection (Case I) can be observed for various reasons.

---

<sup>16</sup> The easier example of the acceptance of the IFRS classification, qualification and temporal imputation criteria for tax purposes is the treatment of lease arrangements. Notwithstanding the form of the contract, for leases that meet the conditions to be qualified as a finance lease under IAS 17, depreciation expenses and interest costs are now deductible, instead of contingent rent payable, but the amount of these deductions is still subordinated to the current fiscal limits.

<sup>17</sup> TUIR (“Testo Unico delle Imposte sui Redditi”), Article 102, paragraph 1 and 2; TUIR, Article 96.

First, the Italian tax system is generally based on the “taxation on realization” principle, and does not recognise accrued capital gains or losses, while IFRS figures reflect assets' fair value increases and decreases and impairment losses. We detect this form of linkage, as described in the Appendix, for tangible assets measurement if the revaluation model is applied; impairment of tangible assets, because losses are not deductible; and foreign currency transactions, since tax rules do not recognize either positive or negative unrealised exchange differences at the closing date.

Second, as remarked by Lamb *et al.* (1998), distinct, detailed and complete tax rules disconnect tax and financial reporting. We score this case as Disconnection when it reflects different purposes driving tax and accounting law. Instances of this kind of Disconnection are the tax treatment of contingencies and provisions and interest costs (not capitalised); concerning the former, Italian Tax Code strictly lists expenses that have fiscal relevance and, for both, sets restrictions to the maximum amount deductible per year. A more complicated case of Disconnection emerges in the arena of financial assets. Concerning their classification, tax law only distinguishes between two categories of financial assets, current and fixed financial assets, and it is therefore a difficult task to reconcile IFRS with the fiscal classification. With regard to their valuation, the wide use of fair value in the measurement of financial assets required by IAS 39 is one of the most controversial issues in the debate about the suitability of IFRS for tax purposes because, as a general tax principle, capital gains or losses should assume relevance only at realization. Nevertheless, the Italian Tax Code accepts IFRS valuations for certain categories of financial assets. For example, fair value has fiscal relevance for all financial assets held for trading (HFT), for bonds and similar assets designated “at fair value through profit or loss”; impairment losses have fiscal relevance for bonds

and similar assets, loans and receivables available for sale (AFS) and held to maturity (HTM) financial assets. Furthermore, the tax rules use the IFRS derecognition criteria for bonds and similar assets. There are other occurrences that clearly illustrate this Case I: government grants and subsidies, fundamental errors, fines, charitable donations and entertaining expenses.

Third, Case I arises when accounting and tax rules adopt a different valuation criterion. In particular, the Italian Tax Code does not recognise the impairment of purchased goodwill and prescribes an 18-year minimum amortization period for this item. Moreover, in conformity with the principle of the continuity between last year's closing balance sheet and the subsequent opening balance sheet, tax law prescribes the recognition of the effects of policy changes in the year in which the change is applied (while IFRS require a retrospective correction). We classify within this type of Disconnection also the arena "scope of the group", since consolidated accounts are not fiscally relevant.

A more interesting case, though confined to a close number of items, is represented by the arenas qualified as Accounting Leads (Case III), because they are an example of how IFRS and corporate income tax can be linked. There is an ongoing debate on the suitability of IFRS as a tax base (among others James, 2002; Schön, 2004; Gammie *et al.*, 2005, Jacobs *et al.*, 2005 and Eberhartinger and Klostermann, 2007), and the Italian case provides an interesting, and unique, accounting setting in order to analyse this issue and to evaluate the impact of a transition to IFRS pointing out potential drawbacks of their use for tax purposes. Moreover, many aspects of IFRS that have been accepted by tax law differ substantially from the accounting treatment stated by Italian Gaap, creating a potential source of inequality among companies in comparable economic situations.

Tax treatment follows accounting rules (Case III) concerning the classification of leases, research and development costs, inventory valuation and pension costs.

Until 2008, the classification of financial leases denoted a Disconnection case and “extra-accounting” adjustments were allowed in order to deduct the positive differences between contingent rents and depreciation charges (plus financial costs). This Disconnection arose because Italian Gaap, requiring all leases to be treated as operating leases, were used as a reference for the computation of taxable income. After the Finance Act 2008, a complete alignment of tax and IFRS classification has been introduced: for operating leases, contingent rents continue to be deductible for tax purposes while, as concerns finance leases, depreciation and financial costs have become deductible<sup>18</sup>. Under IAS 38, research costs should be expensed while development costs should be capitalised; tax rules accept the IFRS qualification, classification and time imputation criteria so that accounting leads again. Regarding inventory valuation, tax rules allow the same flow assumptions permitted by IFRS but, once companies have chosen the flow assumption for financial reporting, this method has to be maintained also for tax purposes<sup>19</sup>. Concerning pensions, contributions to the social security system are classified as a component of labor costs and, as such, these costs are completely tax-deductible; contributions paid by the employer to additional pension plans are also tax deductible.

---

<sup>18</sup> This arena specifically concerns the classification of lease arrangements. With reference to the deductible amounts, it should be noted that depreciation charges and interest costs are deductible within the limits clearly established by the Italian Tax Code (TUIR, Article 102, paragraph 2 and Article 96).

<sup>19</sup> Accounting experts confirmed that a reverse effect might be relevant concerning the use of LIFO, that is not admitted according to IFRS.

With regards to normal depreciation, the link between tax and financial reporting originates the only one Case IV (Tax Leads). IFRS adopters keep following the common practice to apply in financial reporting the specific coefficients established by tax rules<sup>20</sup>. This "bad habit" is justified by the simplicity of managing a unique set of bookkeeping for financial and tax purposes.

The only Case III† (Accounting Leads but with a reverse effect) detected concerns, instead, the capitalization of interest costs. Nevertheless, IFRS 23 requires, since January 2009, the capitalization of interest costs if certain requirements are fulfilled, and therefore a Case III (Accounting Leads) would be detected nowadays.

Long-term contracts represent a special case of Identity. As from 2007, tax rules have adhered to the best accounting practice by requiring the percentage-of-completion method, so that a substantial Identity arises<sup>21</sup> (Case II). This "IFRS compliant" amendment also applies to the computation of taxable income for companies using Italian Gaap.

### **3.2 Italian Gaap companies**

Italian unlisted companies keep preparing their individual accounts in accordance with domestic Gaap. In fact, Italy's industrial structure is mostly formed

---

<sup>20</sup> The coefficients, depending on the industry and asset type, are established by a decree of the ministry of Economics (D.M. December 31st, 1988).

<sup>21</sup> IAS 11 requires the use of the percentage of completion method if some specific conditions (ie.: if the advancement status can be estimated). Though there can be some room for discretionality, as emerged during the consultations with the accounting experts interviewed, auditors are usually quite strict on IAS 11 application and the percentage of completion method is usually applied whenever the required conditions hold.

by small and closely held companies and the option to adopt international accounting standards has been used only in very few cases. These entities do not consider providing investors with market-oriented information as a priority and, for their accounting culture, the transition to IFRS would be too costly and complex a process<sup>22</sup>. In practice, fiscal rules have a high degree of influence on the accounting systems of these companies, where the same person/office is often responsible for drawing up both financial reporting and tax returns and accounting results are rarely subjected to external audit.

As expected, both in 2005 and in 2008, the score reported in Table 3 signals a significant presence of Cases III† and IV. In particular, in 2005 we find 7 arenas in which, for simplicity and/or to gain tax relief, accounting numbers are determined having in mind tax motivations (Case III†) or applying directly tax rules (Case IV). From 2008 “extra accounting” tax adjustments have been disallowed, tightening the relationship between tax and financial reporting. The reasons for this can be found, mainly, in the need to save tax compliance costs, by accepting accounting results every time they are not clearly in conflict with the objectives of taxation (among others Nobes, 2003; Gammie *et al.*, 2005). Not surprisingly, as a consequence of the enhancement of the derivation principle, instances of tax pollution have resurfaced and, in 2008, cases allowing some degree of tax-related influence on accounting (Case III† and IV) passed from 7 to 8.

---

<sup>22</sup> A specific project has been undertaken by the IASB that led to the publication, on July 9th, 2009 of a an International Financial Reporting Standard designed for use by SMEs. Topics considered not relevant for SMEs have been omitted by the standard and, where IFRS allow accounting policy choices, the IFRS for SMEs only allows the easier option.

With reference to the arenas scored as Case III† in Table 3, they arise because accounting law permits different options and, in practice, companies opt for the most fiscally convenient one when drawing up their accounts. In this category we can find research and development costs, interest costs (capitalization), flow assumptions for inventories and financial current assets. Subject to specific conditions, the Italian Civil Code allows companies either to capitalise or to expend research and development costs and interest costs relating to internally generated fixed assets. Since tax rules accept the accounting treatment, a reverse effect often occurs as a consequence of companies' tax planning. Concerning flow assumptions, if a company, to compute business income, adopts one of the methods allowed by the Civil Code (LIFO, FIFO or average weighted cost), the resulting amount will be valid also for tax purposes. Tax rules are substantially aligned to the accounting ones, but, in practice, once again, companies will choose in financial reporting the flow assumption most suitable for fiscal purposes.

Fiscal interferences with financial reporting emerge also in Case IV. Differently from Case III†, where tax motivations drive the choice among the options given by accounting law, in this arenas (qualified as Tax Leads) companies either directly apply tax guidelines for financial reporting purposes or make use of the discretion allowed by the accounting rule in order to maximize fiscal deductions. In both reference years, the treatment of the revaluation of tangible assets, normal depreciation, write down of receivables and non-consolidation purchased goodwill are topics generally configuring a Case IV. As detailed in the Appendix, when a specific law permits revaluation, companies' choices (on whether and to what extent to revalue) generally depend on fiscal convenience rather than on accounting reasoning. With respect to depreciation of fixed assets, Italian Gaap require the

depreciable amount to be allocated on a systematic basis over an asset's useful life, whereas under tax rules depreciation is deductible only if charged to the income statement and up to the amount established by a Decree of the Ministry of Economics. In practice, in preparing financial reporting, it is common to use the maximum depreciation rates allowed by tax law and to consider as expenses all depreciable assets that cost less than € 516.46<sup>23</sup>. Though under Italian Gaap receivables are treated separately from financial assets, we consider them within this arena for making the comparison easier. In preparing financial reporting, a write down of receivables is necessary when the net realizable value is lower than the face value and, from a fiscal point of view, a tax rule specifies the upper limits to the deductible amount of the write down of receivables. The relationship between tax and accounting rules would configure a Disconnection, but, in practice, companies are induced either to expand the write down to gain the maximum fiscal deductions or to keep it down in order to stay within the fiscal limits of deduction. Hence the case de facto qualifies as a Tax Leads (Case IV). Finally, purchased goodwill should be amortised over five years; a longer period of amortization (maximum ten years) is allowed by accounting law only if it can be justified. The Italian Tax Code prescribes an 18-year minimum amortization period and, therefore, this relationship between accounting and tax rules would be, in principle, a Disconnection. Anyway, once again, the presence of a limit to deductibility drives companies to lengthen the useful life of goodwill in order to align, as far as possible, the depreciation charges for tax and financial reporting purposes.

---

<sup>23</sup> As allowed by tax law (TUIR, Article 102, paragraph 5).

Cases where tax treatment follows the accounting one, without the possibility of a reverse effect (Case III), exist in the field of leases (all leases classified as operating both from a fiscal and from an accounting point of view), inventory (valuation at the lower of cost and net realizable value), pensions (to which arguments similar to the IFRS apply) and changes in accounting policies.

The arena of long-term contracts has changed its score from Case III† in 2005 to Case IV in 2008. Until 2007, tax rules relied on the method used in financial reporting, allowing the valuation of this accounting item using either the completed contract or the percentage-of-completion method, therefore originating a potential reverse effect (Case III†). As we noticed, tax rules have adhered, since 2007, to the best accounting method stated by international accounting standards (percentage-of-completion). Given the current requirement of fiscal law, most companies adopt this method also for accounting purposes (Case IV).

As explained in the Appendix, the different principles and purposes underlying accounting and tax rules justify Disconnection with respect to the arenas of impairment of tangible assets, contingencies and provisions, government grants and subsidies, financial fixed assets, foreign currency transactions, scope of the group, fundamental errors and fines, charitable donations and entertaining expenses.

Excess depreciation, fiscally recognised through “extra-accounting” adjustments (Case I) in 2005, is no longer allowed and therefore this accounting arena currently qualifies as N.A..

#### **4. International comparisons**

Italian accounting and fiscal rules have been traditionally linked by the so called “derivation” principle, so that fiscal figures relied heavily on accounting ones.

This is typical of continental European countries. In Anglo-Saxon and common law countries, where the importance of stock-markets is greater, accounting principles are far more market-oriented and, therefore, a high number of adjustments are necessary in order to derive taxable profits from accounting ones (Nobes and Parker, 1995; Nobes, 2003).

Notwithstanding a wide literature of international comparative analysis of the linkages between tax and financial reporting, a measurement of these links concerning the Italian scene has never been carried out. Nevertheless, it is worth performing this kind of analysis in this specific historical period also considering that, since 2005, two accounting systems have coexisted in Italy.

A useful framework for international comparisons has been proposed in Nobes and Schwencke (2006). Two indices of the degree of tax influence on financial reporting are derived. Since Cases III† (Accounting Leads but with reverse effect), Cases IV (Tax Leads) and Cases V (Tax Dominates) entail some degree of tax influence on financial reporting, whereas Cases I (Disconnection) represent a clear case of independence between the two systems, by subtracting the number of cases in the latter from the number of cases in the former group, a maximum index measuring tax influence on financial reporting is obtained. Case III† (which in some instances is a partly controversial measure of the influence of tax on accounting reporting) is excluded in order to obtain a minimum index.

Maximum and minimum indices concerning IFRS adopters (in the reference year 2008) and Italian Gaap companies (in 2005 and 2008) are presented in Table 5. This is the first case in which, to our knowledge, links between an IFRS based financial reporting and tax reporting are analysed.

In order to allow a comparative analysis, we include in the table the results of the former paper by Lamb *et al.* (1998)<sup>24</sup> and the results for the last year in the analyses of Nobes and Schwencke (2006) and Oliveras and Puig (2007), therefore comparing the Italian case with the U.K., U.S., France and Germany in 1996 and Norway and Spain in 2003. Though some change might have affected these countries' accounting and tax systems, this analysis allows us to compare the relationship between tax and financial reporting in countries with different accounting and legal traditions.

We leave for future research the task of extending the analysis of the quantitative influence of each arena in an international perspective.

#### **INSERT TABLE 4**

Concerning the relationship between IFRS and Italian tax reporting, we notice a high degree of disconnection. The maximum and the minimum index respectively score minus nine and minus ten, similarly to U.K. and U.S. scores. This is not surprising: notwithstanding the efforts of the Italian legislator to reduce the gap between IFRS and tax reporting, the former are driven by market-oriented principles, and tax reporting cannot rely on these standards without major adjustments.

The situation concerning Italian Gaap is quite different. The tax reform of 2004, by allowing the “extra accounting” approach for fiscal deductions, considerably reduced the influence of tax rules on financial reporting. As a consequence, the nature of the link between tax and financial reporting had become weaker. Since

---

<sup>24</sup> With the integrations in Nobes and Schwencke (2006) so to include the evaluation of financial

2007, with the abandonment of the “extra accounting” approach, accounting results have again reflected instances of tax interference<sup>25</sup>, and Italy now is positioned near Spain and France, at a middle distance between Germany (where the linkage of tax and financial reporting is historically very strong) and Anglo-Saxon countries.

To sum up, if we look at domestic Gaap, Italy positions itself within the continental European countries with strong links between tax and accounting reporting, while in terms of the relationship between tax reporting and IFRS Italy positions itself within the Anglo-Saxon group of countries. This struggles with the Italian accounting and fiscal tradition and, in fact, the government, after a few years of complete disconnection between IFRS and tax reporting, has introduced a higher degree of tax reliance on fiscal figures, though major disconnections persist between them.

## **5. Concluding remarks**

We have analysed the evolution of the relationship between tax and financial reporting in Italy following the mandatory introduction of IFRS for listed companies in 2005. The study of the Italian case is interesting for several reasons. First, it allows to analyse the reaction to the introduction of an “investor oriented” set of accounting standards in a country historically characterized by a “credit protection oriented” accounting system and by a high degree of reliance of fiscal on accounting figures. Second it allows, in accordance with the environmental determinism

---

assets and impairment accounting arenas, not considered in the original paper.

<sup>25</sup> We observe, both in the minimum and in the maximum index, a strengthening of tax and financial reporting links between the two considered years.

literature, to analyse the effects of the introduction of an exogenous set of accounting standard on the overall evolutions of the accounting systems and of the tax rules.

IFRS and domestic Gaap cohabit in the Italian accounting environment. As a result, the analysis revealed the emergence of two rather different linkages between tax and financial reporting. Companies using IFRS face a high degree of disconnection when converting financial to fiscal figures. The link between Italian Gaap and fiscal rules is stronger and, from this perspective, Italy is positioned within the European continental accounting systems, characterised by a high degree of reliance of fiscal rules on accounting principles.

The study points to a rapidly evolving situation.

IFRS were not initially recognised as relevant for fiscal purposes. Therefore, as we previously stated, a full disconnection would have been detected in 2005 and the initial IFRS implementation period has not been analysed further in the paper. Nevertheless, as the literature on environmental determinism predicts, the introduction of a new set of accounting standards may have major consequences on the evolution of the other environmental factors, and on the tax system *in primis*. In fact, the option of a full disconnection proved to be very costly for the taxpayers. First because, in order to convert IFRS income to tax base an intermediate step through Italian Gaap principles was, *de facto*, required, which duplicated compliance efforts. Then, since IFRS were not governed in detail by tax law<sup>26</sup>, many uncertainties emerged, originating an abnormal increase in interpretation queries to the fiscal agency. In practice, the significant differences between IFRS principles and

---

<sup>26</sup> The Tax Code only stated IFRS tax neutrality without specific provisions.

tax rules made clear that it was impossible to preserve full neutrality. Moreover, IFRS adopters soon began to exert political pressure in order to obtain at least partial acceptance of IFRS for tax purposes. This was finally established by the Finance Act 2008 that allowed the use, for fiscal purposes, of IFRS qualification, time imputation and classification criteria. The gap between tax and financial reporting was substantially reduced and, as a consequence, in 2008 various Cases III (Accounting Leads) have been scored. Anyway, since some IFRS aspects, such as the valuation criteria, have not been recognised, disconnection remains the prevailing feature of the link between IFRS and taxation<sup>27</sup>.

Since 2005, the evolution of tax law has also affected companies reporting under Italian Gaap. “Extra-accounting” adjustments, used in order to convert accounting profits into taxable profits without generating tax pollution, were disallowed, strengthening the derivation principle between fiscal and Italian Gaap figures.

The consultations with professional experts have confirmed that the differences in approaching fiscal matters between IFRS adopters and companies under Italian Gaap are not only due to the differences in the two sets of accounting standards. A typical IFRS adopter is a large, publicly traded company for which tax considerations are not completely excluded in drawing financial statements, but their main objective is to provide the market with high quality accounting information.

---

<sup>27</sup> There is, anyway, an on going debate on the possibility of further limiting the gap between IFRS and tax reporting, so to reduce tax compliance costs.

On the other side, given the Italian industrial structure, companies preparing their annual accounts under Italian Gaap are, often, closely held companies with no need to communicate detailed financial information to investors. Therefore, in drawing their financial statements, these companies assign a significant weight to fiscal considerations.

The paper provides some interesting indications for future research. It will be interesting to observe whether Italian Gaap and IFRS will continue to live as separate accounting systems or whether a higher degree of harmonization will be pursued, by extending the use of IFRS principles to a wider range of companies or by reforming domestic Gaap in accordance with international standards. As previously observed, many E.U. countries are somehow facing similar choices. If both accounting systems continue to coexist, the link between tax and financial reporting might evolve further: the status quo reveals some critical aspects, such as disparities between companies using IFRS and domestic Gaap and higher compliance costs for companies reporting under IFRS.

Moreover, it is worth to notice that no reverse effects (Case III†) have been detected among IFRS adopters, even if a case of Tax Leads (Case IV) has occurred. While Italian Gaap adopters still consider tax implications in drawing accounting figures, this appears not to be the case for entities reporting under IFRS, with the exception of normal depreciation arena. The complete disconnection between tax and accounting rules that emerged during the first few years after the transition, the deep cultural changes and the organizational efforts faced during the adoption process have led the accounting departments of large companies to turn from tax considerations. This is a somehow new practice, in a country historically characterised by a strong relationship between tax and financial reporting. As a

consequence, financial information provided under IFRS might prove to be of a higher quality level also because of the lack of tax pollution. The learning process on application of IFRS and further developments of tax rules such as those observed since 2005 might, however, invert this trend.

Tax and financial reporting are evolving rapidly and future dynamics will certainly deserve further attention.

## 6. References

- Cristea, S.M. and Saccon, C. (2008). 'Italy between applying national accounting standards and IAS/IFRS', in *Romanian Accounting Profession's Congress*, Bucharest, Ed. CECCAR.
- Eberhartinger, E. and Klostermann, M. (2007). 'What if IFRS were a Tax Base? New Empirical Evidence from an Austrian Perspective', *Accounting in Europe*, 4(2): 141-168.
- Freedman, J. (2004). 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges', *EJournal of Tax Research*, 2(1): 71-79.
- Gammie, M., Giannini, S., Lemm, A., Oestreicher, A., Parascandolo, P., and Spengel, C. (2005). *Achieving a Common Consolidated Corporate Tax Base in the EU*. Brussels: CEPS.
- Gee, M., Haller, A. and Nobes, C. (2010). 'The Influence of Tax on IFRS Consolidated Statements: The Convergence of Germany and the UK', *European Accounting Review*, 7(1): 97-122.

- Haverals, J. (2007). 'IAS/IFRS in Belgium: Quantitative analysis if the impact on the tax burden of companies', *Journal of International Accounting, Auditing and Taxation*, 16: 69–89.
- Hogendoorn, M.N. (1996). 'Accounting and Taxation in Europe - A Comparative Overview', *European Accounting Review*, 5 (Suppl.): 783-794.
- Jacobs, O. H., Spengel, C., Stetter, T. and Wendt, C. (2005). 'EU Company Taxation in case of a Common Tax Base', ZEW Discussion Paper No. 05-37, Mannheim.
- James, S. (2002). 'The Relationship Between Accounting and Taxation', Discussion Papers in Management, No. 02/09, University of Exeter.
- Kirsch, H. and Olsson, S. (2008). 'Financial accounting and tax accounting: Germany and Sweden as examples', *Skattenyt*, 2008: 746-757.
- Lamb, M., Nobes, C. and Roberts, A. (1998). 'International Variations in the Connections Between Tax and Financial Reporting', *Accounting and Business Research*, 28(3): 173-188.
- Larson, R. and Street, D. (2004a). 'Large accounting firms' survey reveals emergence of "two standard" system in the European Union', *Advances in International Accounting*, 17: 1–29.
- Larson, R. and Street, D. (2004b). 'Convergence with IFRS in an expanding Europe: progress and obstacles identified by large accounting firms' survey', *Journal of International Accounting, Auditing and Taxation*, 13: 89–119.
- Nobes, C. and Parker, R. (1995). *Comparative International Accounting*. 4<sup>th</sup> Ed. Hemel Hempstead: Prentice Hall.

- Nobes, C. (2003). 'A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under IFRS'. Certified Accountants Educational Trust: London.
- Nobes, C. and Schwencke, H.R. (2006). 'Modelling the Links Between Tax and Financial Reporting: A Longitudinal Examination of Norway over 30 Years up to IFRS Adoption', *European Accounting Review*, 15(1): 63-87.
- Nobes, C. and Parker, R.H. (2008). *Comparative International Accounting*. Harlow: Prentice Hall.
- Oliveras, E. and Puig, X. (2007). 'The Changing Relationship between Tax and Financial Reporting in Spain', *Accounting in Europe*, 2(1): 195-207.
- Rocchi, F. (1996). 'Accounting and Taxation in Italy', *European Accounting Review*, 5 (Suppl.): 981-989.
- Schön, W. (2004). 'International Accounting Standards – A “Starting Point” for a Common European Tax Base?', *European Taxation*, 10: 426-440.
- Zambon, S. (2002). *Locating accounting in its national context: the case of Italy*. Milano: FrancoAngeli.

## **Appendix - Technical explanation of the scores in Table III**

In the Appendix we consider, as accounting references, the Italian Civil Code (C.C.) and the accounting standards issued by the Italian standard setter “Organismo Italiano di Contabilità” (OIC). For tax law, we refer to the Italian Tax Code “Testo Unico delle Imposte sui Redditi” (TUIR). Concerning IFRS, we refer to the standards endorsed by the E.U..

### **1. Tangible assets measurement**

Under Italian Gaap and tax law, tangible assets are initially recognised at purchase or production cost, using the full cost approach (C.C., Article 2426, No.1 and OIC 16; TUIR, Article 110, paragraph 1). Revaluation of tangible assets is in principle not allowed in accounting legislation (C.C., Article 2423, paragraph 4), unless the revaluation is permitted or required by specific laws (e.g. the Finance Act 2006, Law Decree 185/2008); in most cases, revaluations have fiscal relevance and, where they are taxable (generally through a flat substitute tax), the revalued amount can be depreciated for tax purposes in the following years. In practice, where the revaluation is non-compulsory, the choice about whether to revalue is often led by its fiscal convenience. Thus, tax considerations prevail on accounting: this suggest a CASE IV. IFRS adopters recognise tangible assets considering all costs necessary to bring the asset into working condition. After the Finance Act 2008, tax law has accepted the IFRS qualification, classification and timing of computation criteria, thus admitting fiscal relevance to initial accounting value for depreciation. Later, if the revaluation model is applied, accrued capital gains or losses are irrelevant from a fiscal point of view. This is Disconnection (CASE I).

## **2. Impairment of tangible assets**

Impairment of tangible assets, as required by IAS 36, and the write down of an asset below its cost as prescribed by the Italian Civil Code (Article 2426, No.3 and OIC 16) are not deductible for tax purposes (TUIR, Article 101, paragraph 1). This topic qualifies as Disconnection (CASE I).

## **3. Depreciation**

### a) Normal

IFRS and Italian Gaap require the depreciable amount of a fixed asset to be allocated on a systematic basis over its useful life (C.C., Article 2426, n.2 and OIC 16). The depreciable amount is the carrying amount net of the estimated residual value. In practice, the residual value is nil and the straight-line depreciation method is commonly applied. Under tax rules, depreciation of tangible assets is deductible only if charged to P&L and up to the amounts established by a Decree of the Ministry of Economics and the depreciable amount is equal to historical cost (TUIR, Article 102, paragraphs 1 and 2). In practice, companies often apply the tax rules in preparing financial reporting for simplicity and to obtain tax relief. Therefore, it is common practice, both for companies reporting under IFRS and for companies reporting under Italian Gaap, to use the maximum depreciation rates allowed by tax law or to expense depreciable assets with a cost lower than € 516.46. This is a case in which tax rules are followed instead of accounting ones that allow companies to use a certain degree of judgment (CASE IV). A specific case might arise for what concerns the “component approach”. IFRS prescribe that significant components of a fixed asset with different useful lives be recorded and depreciated separately, and this requirement should limit the influence of tax rules on accounting policies even

though IFRS adopters might be tempted to allocate the cost of the asset in order to take advantage of the different fiscal depreciation rates. With the introduction of IFRS, tax law has allowed the component approach for the depreciation of land and buildings and extended this rule to all taxpayers, irrespective of the set of accounting standards adopted.

b) Excess

In the past, accelerated depreciation has been a fiscal device widely used by the tax authorities, either to stimulate capital expenditure or to counterbalance in part the effects of inflation on financial reporting. Until 2004, it was deductible only if charged to P&L, causing the most important tax pollution of financial reporting, in terms of both its amount and its frequency. In order to free the income statement from fiscal interference, the Finance Act 2004 (Law No.344/2003) allowed the “extra-accounting” recognition of accelerated depreciation (CASE I). As from 2008, accelerated depreciation has no longer been permitted and the arena is therefore classified as Not Applicable (N.A.).

#### **4. Leases classification**

In Italy, accounting for leases is based on the legal form of the arrangement. All leases are treated as operating and the contingent rents are charged to P&L on an accrual basis (OIC 16). Tax law relies on the accounting classification of leases and allows the lessee to deduct contingent rents charged to the income statement to the extent that the lease term exceeds the minimum period set by tax rules (CASE III). As from 2008, for finance leases, taxpayers must separate the finance cost implicit in the contingent rent, which is deductible according to the limits referred to in “9 - Interest” below (TUIR, Article 102, paragraph 7), lengthening the

deduction period of the lease costs. Until 2008, in accordance with the neutrality principle, tax law did not recognise the IFRS distinction between operating and finance leases. Consequently, for operating leases the two sets of rules were similar, while for finance leases, any positive difference between the contingent rent and depreciation plus finance costs was deductible by the lessee only through an “extra-accounting” adjustment. The Finance Act 2008 gives the IFRS classification full fiscal relevance: in operating leases, contingent rents are deductible for tax purposes (TUIR, Article 102, paragraph 7), whereas, in finance leases, depreciation and finance costs are deductible, but within the limits clearly established by the Italian Tax Code (TUIR, Article 102, paragraph 2 and Article 96). As far as the classification of leases is concerned, a case of Accounting Leads occurs (CASE III).

## **5. Contingencies and provisions**

Under Italian accounting law, liabilities for contingencies and provisions (and the related expense) cover losses and debts of a specific nature, whose existence is certain or probable and whose due date or amount is uncertain at the closing date (C.C., art. 2424bis, paragraph 3 and OIC 19). Against this general definition, the Italian Tax Code strictly lists which expenses for provisions and contingencies have fiscal relevance and specifies the upper limits to the amounts deductible (TUIR, Articles from 104 to 107). The limits to the deductible amounts apply also to IFRS adopters and this case remains a Disconnection (CASE I) for all taxpayers.

## **6. Research and development costs**

Under Italian Gaap, applied research and development costs that meet specific conditions can be either capitalised or expensed. If capitalised, they should

be depreciated over a maximum of five years (C.C., Article 2426, No.5 and OIC 24). Tax rules accept the accounting classification and, when research and development costs are capitalised, their amortization will start at the end of the research phase, in accordance with the fiscal regime (TUIR, Article 103); when recognised as expenses, the costs are deductible either in the period in which they have been incurred or within the following four periods (TUIR, article 108, paragraph 1). In practice, given the different options allowed by the accounting rules, companies are likely to choose in financial reporting the most convenient classification for tax purposes (CASE III†). As well known, under IAS 38, research costs should be recognised as expenses, while development costs should be capitalised and depreciated over their estimated useful life. Tax rules accept the IFRS qualification, classification and time imputation criteria and Accounting Leads (CASE III).

## **7. Inventory valuation**

### **a) Flow assumptions**

Concerning flow assumptions, the Italian Tax Code introduces, as a general rule, a lower limit to inventory valuation; however, if in the determination of taxable income companies adopt a method allowed by the Civil Code (LIFO, FIFO or average weighted cost; C.C. Article 2426, No.9 and OIC 13), the resulting amount is accepted also for tax purposes (TUIR, Article 92, paragraph 4). Tax rules are substantially aligned to the accounting ones, but, in practice, given the option allowed by the accounting rules, companies are likely to choose in financial reporting the flow assumption most convenient for tax purposes (CASE III†). Similarly, tax law accepts the flow assumption permitted by IFRS. However, the LIFO method, which is not allowed in financial reporting, can be applied for tax purposes through an explicit

option that companies must communicate to the tax authorities. As a result, the flow assumption used for the computation of taxable income may differ from that in financial reporting, giving rise to a Disconnection. In practice, since it is too expensive to maintain two different sets of accounts, companies usually apply for tax purposes the same flow assumption used in financial reporting (CASE III).

b) Other areas

In financial reporting inventories are valued at the lower of purchase or production cost and net realizable value (C.C., Article 2426, paragraph 1, No.9 and OIC 13) and this principle is reaffirmed also in tax regulations (TUIR, Article 92, paragraphs 1 and 5). Therefore the score is Accounting Leads (CASE III). As far as this topic is concerned, Accounting Leads also for IFRS adopters. Finally, a special case concerns the valuation of services. In fact, while tax regulations refer to the cost incurred till the end of the period (TUIR, Article 92, paragraph 6), IFRS require the use of the percentage-of-completion method to value services.

## **8. Long term contracts**

The Italian Civil Code (art. 2426, No.9 and No.11) allows companies to choose between the completed contract or the percentage-of-completion method to value long-term contracts, even though OIC No.23 considers the percentage-of-completion method as the best accounting practice and strongly encourages companies to use it whenever costs to complete estimates are reasonably reliable. Until 2007, tax rules accepted the method applied in financial reporting, therefore leaving room for a potential reverse effect in the choice of the valuation method (Case III<sup>†</sup>). With the change introduced by the Finance Act 2007 (article 1, paragraph

70, Law No.296/2006), tax rules now permit only the percentage-of-completion method (TUIR, Article 93). In order to have unified tax and accounting reporting, companies commonly apply this method, valid also for tax purposes (CASE IV). Since IFRS only allow the percentage-of-completion method whenever certain requirements hold, there is a substantial Identity between tax and accounting treatment (CASE II).

## **9. Interest**

### 10. Capitalization

Italian companies have the option to capitalise the interest costs related to investment in internally generated fixed assets (Civil Code, 2426, No.1 and OIC 16) and the tax treatment relies on accounting choice, thus, if interest costs are capitalised, tax law recognises them as part of the depreciable amount. This is Accounting Leads (CASE III); however, the choice of accounting policy, given the option in the Civil Code, can be influenced by the fiscal limit to the deductibility of interest costs recognised as expenses in Profit and Loss, so that – in practice – a possible reverse effect may occur (CASE III†). The same was true, up to the end of 2008, for what concerns IFRS adopters, and therefore the arena is classified as a Case III†). However, since January 2009, IAS 23 requires the capitalization of interest costs if certain requirements are fulfilled, and therefore a Case III (Accounting Leads) would be detected nowadays since, for interest costs, IFRS adopters do not have anymore the option between capitalization and expensing (and therefore the reverse effect does not take place anymore).

### 11. Others

The tax system follows financial reporting also in adopting the accrual basis for interest costs, but imposes restrictions to the maximum amount deductible in each period. A new method to determine the amount of deductible interest costs has been introduced by the Finance Act 2008. In particular, the net interest expense is deductible up to 30% of EBITDA and any excess can be deducted in the following years, up to the limit available in those years (TUIR, Article 96, paragraphs 1 and 2). This specific and detailed rule, justified by the different purpose of tax law, disconnects tax and accounting (CASE I). The fiscal restrictions to the maximum amount deductible also apply to IFRS adopters, even though the IFRS criteria for qualification, classification and time imputation of interest expenses are accepted for tax purposes (CASE I).

## **12. Financial assets**

Financial assets included in current assets are valued applying the same criterion established for inventories in both financial reporting (C.C., Article 2426, paragraph 1, No.9 and OIC 20) and tax regulations (TUIR, Article 94 and 92). As for inventories, a possible reverse effect may occur (CASE III†) given the option allowed by the Civil Code in choosing the flow assumption. In accordance with Italian Gaap, financial fixed assets are generally valued at their acquisition cost and written down in the presence of an impairment loss (C.C., Articles 2426, No.1 and No.3 and OIC 20). Revaluation of fixed financial assets is, in principle, not allowed in accounting legislation (C.C., Article 2423, paragraph 4) unless permitted or required by specific laws. Capital gains and losses assume fiscal relevance only upon disposal, except for financial assets qualifying for the participation exemption. The presence of specific and detailed tax rules suggests a Disconnection (CASE I). The wide use of fair value in the measurement of financial assets, under IAS 39, is one of the most

controversial issues in the debate about the suitability of IFRS for tax purposes, because, as a general tax principle, capital gains or losses become relevant only upon realization. Nevertheless, for certain categories of financial assets, the Italian Tax Code accepts IFRS valuations. For example, fair value has fiscal relevance for all financial assets held for trading (HFT) and for bonds and similar assets designated “at fair value through profit or loss” (TUIR, article 94, paragraph 4bis); impairment losses have fiscal relevance for bonds and similar assets, loans and receivables, financial assets available for sale (AFS) and held to maturity (HTM). Furthermore, the tax rules accept the IFRS derecognition criteria for bonds and similar assets, while maintaining the legal notion of realization for stocks (TUIR, Article 110, paragraph 1bis and 1ter). This arena is characterised by a complete and detailed tax regulation that disconnects fiscal and accounting reporting (CASE I).

Though under Italian Gaap receivables are treated separately from financial assets, we consider them within this arena for making the comparison easier. In preparing financial reporting (C.C., Article 2426, No.8 and OIC No. 15), a write down of receivables necessitates when the net realizable value is lower than the face value and, from a fiscal point of view, a tax rule specifies the upper limits to the deductible amount of the write down of receivables (TUIR, Article 106, paragraph 1). The relationship between tax and accounting rules would configure a Disconnection, but, in practice, companies are induced either to expand the write down to gain the maximum fiscal deductions or to keep it down in order to stay within the fiscal limits of deduction. Hence the case qualifies as a Tax Leads (Case IV) for companies reporting under Italian Gaap, while tax influence on IFRS adopters seems to be less significant (CASE I).

The arena of financial assets for companies using Italian Gaap, qualifies three categories: a reverse effect for the flow assumption concerning financial current assets; a Disconnection for financial fixed assets and a Tax Leads for receivables. Given the fact that the sample refers to manufacturing companies with a limited size, our consultations have confirmed that financial current assets and receivables are the most relevant items in this arena, so that we assign a score III<sup>+</sup>/IV.

### **13. Foreign currency transactions**

IFRS and Italian Gaap (C.C., Article 2426, No.8 bis and OIC 26) recognise in P&L unrealised gains and losses arising from the translation of foreign items at the closing rate; tax legislation recognises neither positive nor negative exchange differences unrealised at the closing date (TUIR, Article 110, paragraph 3). The tax rule differs from the accounting one, so that this topic is classified as Disconnection (CASE I).

### **14. Non-consolidation purchased goodwill**

Under Italian Gaap, purchased goodwill is amortised over five years; a longer period of amortization (maximum ten years) is allowed if it can be justified (C. C., Article 2426, No.6 and OIC 24). The relationship between accounting and tax rules could be classified as a Disconnection because the Italian Tax Code prescribes an 18-year minimum amortization period (TUIR, Article 103, paragraph 3). In practice, however, the presence of a lower limit to deductibility often drives companies to lengthen the useful life of goodwill in order to align, as far as possible, the depreciation charge for tax and financial reporting purposes (CASE IV). IFRS do not permit the amortization of acquired goodwill, which is subjected to annual impairment testing. The Italian Tax Code does not accept the IFRS measurement

criterion and imposes the amortization of goodwill in accordance with the above mentioned rules. When an impairment loss emerges, it is deductible only up to the amount of the tax depreciation charge. This is clearly a Disconnection (CASE I).

#### **15. Government grants and subsidies**

Tax law establishes specific rules for the taxation of revenue grants (TUIR, art. 85, paragraph 1, letters g and h), capital grants related to investment in depreciable assets and other kinds of capital grants (TUIR, Article 88, paragraph 3, letter b). In particular, for depreciable assets, tax law requires depreciation to be based on net historical cost of the grant. IAS 20 and OIC 16 account for grants and subsidies on an accrual basis and recognise them in P&L on a systematic basis over the periods in which companies record the related costs as expenses. Distinct and complete sets of rules disconnect tax and accounting (CASE I).

#### **16. Pensions**

The two main categories of pension costs are contributions to the social security system (through which the government guarantees public pensions) and additional pension plans. The former are classified as a component of labor costs (and not as a provision) and, as such, these costs are completely tax deductible. Therefore a Case III (Accounting Leads) emerges. Additional pension plans should be divided between “defined benefit” and “defined contribution” plans. In the first type of plans the benefits to the employee are established a priori, so that the risks associated with the performance of the pension plan are borne by the employer. In the case of “defined contribution” plans, vice versa, the burden of the risk is borne by employee. The different treatment of the two types of pension plans is regulated by OIC 19 and IAS 19. Contribution plans recognised by the tax authorities are

usually “defined benefit” plans. Contributions paid by the employer to this kind of plan (whether voluntary or required by collective labor agreements) are fully deductible, originating a CASE III, as concerns both IFRS and Italian Gaap.

#### **17. Policy changes and fundamental errors**

Under OIC 29, the effects of policy changes and corrections of errors are recorded as extraordinary items in P&L and adjustments to the comparative amounts are not allowed. There is not a specific tax rule for policy changes, but companies are only required to inform the tax authority about the change (TUIR, Article 110, paragraph 6), whose effect is absorbed in the year’s taxable income (CASE III, Accounting Leads). From a fiscal point of view errors are qualified as contingencies, and their treatment (some items are deductible while others are not) is governed in detail by tax law, thus determining a Disconnection (CASE I). Both policy changes and corrections of material errors are topics qualified as Disconnection (CASE I) with regard to the relationship between taxation and IFRS.

#### **18. Scope of the group**

As a part of the general corporate tax reform of 2004, the Italian tax system introduced tax consolidation rules (TUIR, Articles 117 and subsequent). Under these rules, the total consolidated taxable income is computed as the sum of the taxable incomes of the holding company and its subsidiaries based on their individual accounts. Because the consolidated accounts are not the starting point for group taxation, the choice of valuation criteria in consolidated accounts is not affected by fiscal considerations. It should be noted that also the concept of group relevant for tax purposes differs from the accounting concept. Since there is no tax influence on

group accounting, both for IFRS and for Italian Gaap, this arena can be classified as Disconnection (CASE I).

#### **19. Fines, charitable donations, entertaining expenses**

The deduction of fines is not permitted in accordance with the general principle of the relevance of expenses to the company's business established by the Italian Tax Code (TUIR, Article 109). Specific and detailed tax rules restrict the deductibility of charitable donations; in general, the deductible amount cannot exceed a certain percentage (1%-2%) of taxable income or a fixed amount (TUIR, Article 100). To the extent that entertaining expenses fulfill the requirements set by the Decree of the Ministry of Economics, they are deductible up to the amount specified by that Decree (TUIR, Article 108, paragraph 2). All topics in this arena are Disconnections (CASE I), regardless of the set of accounting standards adopted.

## Tables

**Table 1: Fiscal rules and tax-financial reporting relationship: recent developments in Italy**

	2005	2008	2009
	<b>Decree February 28°, 2005, No.38</b>	<b>Finance Bill 2008 (Law December 24th, 2007, No.244) and subsequent Decree April 1st, 2009, No.48</b>	
	The Italian government opted for the mandatory adoption of IFRS both for individual and consolidated accounts of listed companies. Unlisted companies presenting consolidated accounts in accordance with IFRS and all subsidiaries in IFRS groups are permitted to use IFRS for the preparation of their individual accounts.	IFRS classification, qualification, temporal imputation criteria are acknowledged for fiscal purposes. IFRS valuation criteria are not acknowledged for tax purposes.	
	Disconnection between tax and accounting rules according to the tax neutrality principle	Partial re-alignment between tax and accounting rules	
IAS adopters	----->	----->	
	“Extra-accounting” tax adjustments limited fiscal interference on financial reporting	Strengthening of the derivation principle (“extra-accounting” tax adjustments and accelerated depreciation disallowed)	
ITA Gaap companies	----->	----->	

**Table 2: Classification of links between tax and financial reporting**

<b>CASE I</b>	<b>Disconnection</b>	The different tax and financial reporting rules (or different options) are followed for their different purposes <sup>(1)</sup> .
<b>CASE II</b>	<b>Identity</b>	Identity between specific (or singular) tax and financial reporting rules
<b>CASE III/III †</b>	<b>Accounting leads (III)</b>	A financial reporting rule is followed for financial reporting purposes, and also for tax purposes. This is possible because of the absence of a sufficiently specific (or singular) tax rule.
	<b>Accounting leads but with reverse effect (III †)</b>	Financial reporting rules contain options or allow interpretations, some of which lead to lower or to later profit than others do. This is a motivation for choosing these options so that they will then also be used for tax purposes, in the absence of a specific or singular tax rule.
<b>CASE IV</b>	<b>Tax leads</b>	A tax rule or option is followed for tax purposes, and also for financial reporting purposes. This is possible because of the absence of a sufficiently specific (or singular) financial reporting rule.
<b>CASE V</b>	<b>Tax dominates</b>	A tax rule or option is followed for tax and financial reporting purposes instead of a conflicting financial reporting principle.

<sup>(1)</sup> Such disconnection will be recognised when distinct, independent and detailed tax and financial reporting operational rules exist for tax and financial reporting. Even if measurement outcomes are essentially the same, the particular arena may still be characterised as Case I; the independence and completeness of the sets of rules 'disconnects' tax and accounting in an operational sense.

Source: Adapted from Nobes and Schwencke (2006)

**Table 3: Tax links in the main accounting arenas in Italy**

Arena	ITA Gaap		IFRS
	2005	2008	2008
1 - Tangible assets measurement	IV	IV	I
2 - Impairment of tangible assets	I	I	I
3 - Depreciation			
(a) Normal	IV	IV	IV
(b) Excess	I	N.A.	N.A.
4 - Lease classification	III	III	III
5 - Contingencies and provisions	I	I	I
6 - Research and development costs	III†	III†	III
7 – Inventory valuation:			
(a) Flow assumptions	III†	III†	III
(b) Other areas	III	III	III
8 - Long-term contracts	III†	IV	II
9 - Interest:			
(a) Capitalisation	III†	III†	III†
(b) Other areas	I	I	I
10 - Financial assets	III†/IV	III†/IV	I
11 - Foreign currency transactions	I	I	I
12 – Non-consolidation purchased goodwill	IV	IV	I
13 – Government grants and subsidies	I	I	I
14 - Pensions	III	III	III
15 - Policy changes and fundamental errors	I/III	I/III	I
16 - Scope of the group	I	I	I
17 - Fines, charitable donations, entertaining expenses	I	I	I

**Table 4: International comparisons of tax and financial reporting links**

	Italy 2008 (IFRS)	Italy 2005 (ITA Gaap)	Italy 2008 (ITA Gaap)	Germany 1996	France 1996	Spain 2003	U.S.A. 1996	U.K. 1996	Norway 2003
Case I	11	8,5	7,5	2	4.5	5	13.5	14	15
Case II	1	0	0	0	5	3	2.5	2	2
Case III	5	3.5	3.5	5.5	3.5	6	1	1	1.5
Case III†	1	4.5	3.5	2	1	2	1	2	0.5
Case IV	1	3,5	4,5	7.5	5	2	1	0	0
Case V	0	0	0	3	1	0	0	0	0
N.A.	1	0	1	0	0	2	1	1	1
Total obs.	20	20	20	20	20	20	20	20	20
Maximum Index (III†+IV+V- I)	-9	-0,5	0,5	10.5	2.5	-1	-11.5	-12	-14.5
Minimum Index (IV+V-I)	-10	-5	-3	8.5	1.5	-3	-12.5	-14	-15