Comments on the Inland Revenue (Amendment) (No. 7) Bill 2018 - Amendments for Aligning Tax Treatment of Financial Instruments with their Accounting Treatment

This article provides our personal views on the Inland Revenue (Amendment) (No. 7) Bill 2018. Specifically, we focus our discussion on the Amendments for Aligning Tax Treatment of Financial Instruments with their Accounting Treatment.

First, we view that allowing taxpayers to elect whether to align their tax and accounting treatments of financial instruments represents a good proposal. This election would allow taxpayers to choose tax calculation methods that best fit their financial and operating needs, and help them to save tax reporting costs. However, the Committee should also be aware of the impacts of such election on financial reporting because the election itself would inevitably change firms' book-tax conformity levels.

Prior research suggests that because of the adoption of International Financial Reporting Standards (IFRS), firms are more likely to manipulate earnings by exploiting the fair value accounting (He et al. 2012). Therefore, there could also be some earnings management opportunities associated with the adoption of fair value accounting for financial instruments in Hong Kong. If we allow firms to elect an alignment of their tax and accounting treatments of financial instruments, this will reduce the differences between accounting and tax reporting (i.e., increase the book-tax conformity level). There are a lot of debates on how the change in book-tax conformity levels affects the financial reporting quality. Findings of some recent studies on earnings management suggest that firms have more earnings management when book-tax conformity increases (Atwood et al. 2010; Blaylock et al. 2015; Watrin et al. 2014; Wong et al. 2015). For example, Blaylock et al. (2015) report that earnings management (in forms of income smoothing, overall financial reporting discretion, and avoidance of small losses) increases when book-tax conformity increases. Wong et al. (2015) find that firms would manage their income in book-tax conforming ways (not book-tax non-conforming ways) when they have high earnings management incentives. On the contrary, some may argue that as increasing book-tax conformity would increase tax cost for upward earnings management (i.e., firms need to pay tax for every dollar they report as profits), the alignment of tax and accounting treatments would reduce upward earnings management.

We are not sure to what extent the findings of prior research could apply in Hong Kong as we have limited research on how book-tax conformity level affects financial reporting in Hong Kong. Nevertheless, we urge the Government to note the potential impacts that could be possibly arisen from the election of the alignment of tax and accounting on firms' financial reporting practices (and associated outcomes). Especially, we need to protect the interest of minority shareholders. Therefore, if firms can show their elections in their financial statements, this information can provide useful input for financial statement users to evaluate firms' reporting aggressiveness. As such, we suggest adding a clause in S18H(1)(b) and requiring the entity to indicate such election in the financial statements.

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Agnes W. Y. LO (羅慧儀博士)[a] and Raymond M. K. WONG (黃敏剛博士)[b]

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[a] Associate Professor, Department of Accountancy, Lingnan University, Hong Kong

[b] Associate Dean, College of Business, City University of Hong Kong, Hong Kong