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**The Interface Between Financial
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A Summary of Current Research**

by

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The Interface between Financial Accounting and Tax Accounting: A Summary of Current Research

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Abstract

Generally Accepted Accounting Principles (GAAP) and the more recent International Financial Reporting Standards (IFRS) form the basis of the accounting transactions and reports used in taxation accounting. However this has always been an uneasy relationship. One apparent factor contributing to this is that these two accounting processes serve different purposes. The aim of this study is to research international literature and experience to gain an insight into the basis and form of this divergence.

The Interface between Financial Accounting and Tax Accounting: A Summary of Current Research

1.0 INTRODUCTION

Financial accounting and taxation accounting have different purposes and requirements. Accounting involves the preparation of information for the purposes of control and decision-making and may require interpretation as well as simply recording factual information. The main purpose of taxation is usually to raise revenue but it is also used as an instrument of government economic and social policy. For a tax system to operate successfully within the law it requires a degree of certainty that may not always be appropriate for financial and commercial accounting. Furthermore there may be alternative methods of preparing accounts that are equally acceptable in terms of accounting standards but the choice of which might be inappropriately influenced by the taxation implications.

In recent years decisions in a number of cases appear to have indicated a move towards an even greater reliance on accounting for tax purposes (see Section 3). While commercial accounts prepared on the basis of financial reporting standards may often be the most appropriate basis for taxation reporting and the preparation of tax returns, this is not always so. An example of the adoption of a Financial Reporting Standard into the New Zealand tax legislation shows that there will always be differences, and that perfect harmonization between taxation and accounting is unlikely. The global move towards International Accounting Standards could also be seen as a reason for reviewing the tenuous relationship between accounting principles and practise and taxation law, and a step to harmonising the tax base. However by looking at the New Zealand situation it is suggested that the adoption of the International Financial Reporting Standards will itself have tax consequences, irrespective of any desire to incorporate these standards into the tax legislation. There are different levels of dependency within countries and no country is able to avoid the difficult relationship between accounting and taxation. The evolving tax law influenced by many factors may be sliding away from the original intentions of tax policy makers. It is therefore suggested that tax law should be continually reviewed to ensure that it is meeting the needs both of modern business practice and the principles and integrity of the tax system.

This paper examines the relationship between accounting and taxation in order to isolate areas of divergence between them. The different purposes of accounting and taxation, difficulties in applying the relevant economic concept of income, the continual process of evolution of both accounting and taxation and the administrative effectiveness, objectivity and precision required of a tax system are considered in Section 2. Following this general discussion and summary the next two sections address the specific environment and relationships of accounting and taxation reporting in the UK and New Zealand. Section 3 considers the UK perspective, discussing prominent cases and the apparent move towards the accounting basis for taxation. Section 4 introduces the New Zealand perspective and notes as an example that differences exist between Financial Reporting Standard No. 4 and the tax legislation which has embodied this standard. However these countries have not been able to consider the interface of the accounting and taxation processes in isolation. Consequently Section 5 looks at the historical and international dimension, showing a range of different, and changing, relationships between accounting and taxation of different countries throughout the world. A recent development which influences the relationship of financial and tax accounting in most developed countries in the world is the introduction and adoption of International Financial Reporting Standards (IFRS). The application of IFRS and their compatibility with taxation reporting is discussed in Section 6. By summarizing the current research the different areas of conflict between the two systems, financial accounting and the calculation and satisfaction of tax liability (taxation), are identified.

2.0 ACCOUNTING AND TAXATION

Variables such as revenue, expenditure and profits are used by both financial accounting and taxation. They are dealing with and reporting on the same transactions and circumstances. Sometimes they are calculated the same way, but frequently there are circumstances in which different figures are appropriate for each of the systems. The fundamental point of course is that accounting and taxation exist for different reasons. One clear view from the US held that: “financial accounting and tax accounting are not the same. They have different objectives, are subject to different rules and serve different purposes” (Green, 1995, p. 449).

There are several reasons why financial reporting rules and practices might not always be appropriate for determining final tax liability. These include the purposes of accounting and taxation, difficulties in defining the concept of income, the continual evolution of accounting and taxation and the ever desirable aim for administrative effectiveness.

2.1 The Purposes of Accounting and Taxation

The purpose of accounting is usually stated to be the provision to interested parties of information relevant to stewardship, control and decision-making. The interested parties may be internal (management) or external (such as shareholders, creditors, tax authorities).

Further elaboration of the concepts behind the development of accounting standards is to be found in the *Framework for the Preparation and Presentation of Financial Statements* published by the International Accounting Standards Committee (IASC). This is summarised, for example, by Nobes and Parker (2002). As they indicate, the *Framework* supposes that the main purpose of financial statements is to provide information to various users to improve their financial decision-making.

The requirements of a tax system can be quite different. This has been made very clear, for example, in a case before the US Supreme Court, *Thor Power Tools Company v. Commissioner of Internal Revenue* 58L Ed. 2d.785 at 802 (1979). The case was concerned with matters related to inventory accounting procedures and additions to bad debt reserves and that accountants might be more conservative for commercial reasons than was appropriate for the assessment of tax. It was stated that:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Furthermore, there are other reasons why taxation might deviate from accounting concepts of income. While the most obvious purpose of taxation is to finance public expenditure (for further discussion see, for instance, James and Nobes, 2004), the extent and magnitude of taxation in modern economies also makes it a powerful instrument of government economic and social policy in its own right. While it is true that some taxation measures might be introduced to improve economic decision-making, others are implemented for very different

reasons. There may therefore be all manner of modifications to income as it might be normally understood before arriving at the appropriate figure for tax purposes. Surrey's (1973: vii) concept of tax expenditures ably describes the situation that 'those provisions of the federal income tax containing special exemptions, exclusions, deductions and other tax benefits were really methods of providing governmental financial assistance'.

Even when such tax provisions exist for purely economic reasons, it does not mean that they will necessarily coincide with the purposes of financial accounting since the government may be taking account of wider public economic interests rather than the specific economic reasons that pertain to that tax provision. For example with depreciation, where the amounts allowed for capital expenditure may be adjusted for the purposes of taxation in order to encourage private sector investment.

On the other hand the government might decide that certain activities normally considered perfectly acceptable for commercial purposes should not be given tax concessions. One UK example consists of the tax treatment of certain expenses. For business reasons it is desirable to take account of all the costs incurred in generating revenue. However, some expenses may not be allowable for tax purposes. For instance, the cost of entertaining customers and the cost of gifts, unless it is a modest amount and for the purposes of advertising, are not allowed for tax purposes. The original reason seems to have been to prevent extravagance and tax avoidance.

Nevertheless the disparity between accounting and taxation can be more fundamental than adjustments to an accepted figure for income. It is worth considering some of the problems there have been in dealing with the concept of income and attempting to establish a workable definition of income.

2.2 Defining the Concept of Income

Crucial to both financial accounting and tax accounting is the concept of income. This is a much maligned and confused concept which is at the base of both processes. It is in fact one of the most important variables that both financial and tax accounting are attempting to measure, yet the concept defies an accurate and clear definition.

One of the main difficulties confronting tax law is capturing economic reality. Indeed Prebble (1994) argued that the complexity of modern tax systems arises from trying to fit tax law

around the ‘natural facts of economic life’. Eminent economists have struggled for years to develop an appropriate definition of income. Fisher (1930, p. 3) memorably described income as a ‘series of events’ and examined the nature of its psychic experience. More conventionally, Hick’s (1946) approach to the definition of income is still widely accepted. He pointed out that if a person expects to receive the same amount in every future period as he receives in this one, then it is reasonable to say that this is his income in this period. However if he expects, say, to receive a smaller amount in the future then not all his current receipts should be regarded as income – some part would reflect a change in his capital position. Hence Hicks produced his classic definition that income is the amount a person can consume during a period of time and still expect to be as well off at the end of the period as he was at the beginning. However, this is not an operational definition suitable for either accountants or tax officials. Hicks went on to say that businessmen and economists are usually content to use one or other of a series of approximations to the ‘central meaning’ of his definition which have an easier practical application than his more theoretical definition.

It is significant that major developments in the economic theory of income were made in the specific context of taxation, particularly by Haig and Simons. Haig (1921) defined income as ‘the money-value of the net accretion to economic power between two points of time’. Simons (1938), in developing his definition, pointed out that many writers had previously tried to formulate definitions ‘with the most curious results’. His own definition was that income is gain and is the algebraic sum of the market value of rights exercised in consumption plus the change in value of property rights between the beginning and end of the period in question. In other words it is the sum of ‘consumption and accumulation’. Such a definition, like that of Hicks, therefore, includes capital gains as income. It is thus difficult to use as an operational definition of income as discussed in the Report of the Meade Committee (1978, p. 30-33).

The difference between the accounting concept of income and the tax or legal concept of income is displayed in the income pyramid of Holmes (1999). He suggests that “the broadest notion of income is psychic income, for which consumption expenditure might, for practical reasons, be a proxy.” However, he argues that:

a more theoretically robust surrogate, which takes account of the benefits that arise from saving or wealth accumulation, is the foundation concept of income ... The foundation concept can also be viewed as changes in wealth prior to consumption (Haig’s approach) or as a combination of consumption and changes in net wealth over a period (Simons’s approach). Both interpretations

of the foundation concept of income incorporate movements in unrealised market values. (p.203)

Haig (1921) proposed two opposite bases for measuring income: a consumption approach based on the value of goods and services from which utility is obtained, or alternatively an income approach based on money receipts plus non-monetary receipts and imputed income from the recipient's own efforts and assets. Simons (1938) breaks down Haig's accrual of economic power into the methods by which it can be applied either as consumption expenditure or saving (ie the net change in wealth after consumption).

Economists have introduced criteria such as periodicity, productivity, and permanence to determine income. Holmes suggests these features have influenced the legal concept of income and constricted the broad equity based notion of income.

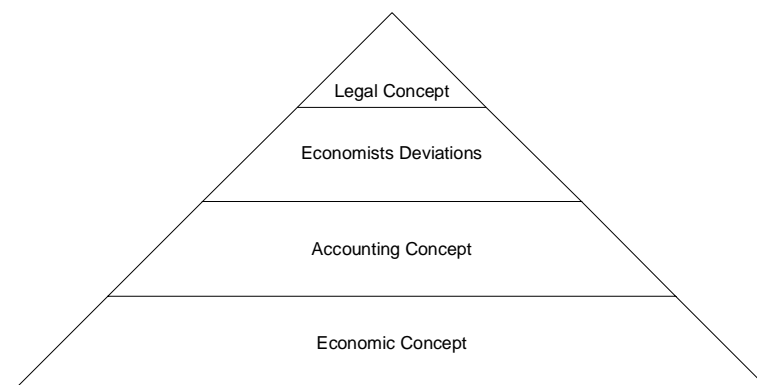
As stated by Holmes (1999, p. 204):

The accounting discipline has traditionally narrowed down the foundation concept of income to recognise only realised gains from market transactions. However, accountants now recognise the theoretical shortcomings of their notion of income. By adopting (at least in principle) a comprehensive income approach, they are moving towards the foundation concept of income. Some unrealised gains are now included in the accountants' notion of income, but largely on an ad hoc basis.

Holmes (1999) has developed an income pyramid shown in Figure 1. The income pyramid comprises:

- a *Legal concept*: inflow periodicity, product of labour or property realisation separate from source, profit making purpose or motive, ordinary meaning, convertible non-monetary benefits.
- *Economists' deviations*: periodicity, productivity, and permanence.
- an *Accounting concept*: market transaction, realised gains, selected unrealised gains.
- an *Economic concept*: unrealised value changes consumption expenditure, psychic income. (p.205)

Figure 1 Income Pyramid



Source: Holmes (1999, p. 205)

There is an increasing exclusion of items that comprise income from the lower levels of the pyramid to the legal concept. The legal concept of income is much narrower than the economic or accounting concepts, because as Holmes states (1999, p. 206):

... of the judicial requirement that income must not be recognised unless certain features are present in the receipts or benefits that a person obtains, the principal consequence of which is that many real economic gains or benefits fall outside the artificial legal concept of income ...

The traditional legal interpretation of income by the courts has breached generally agreed (at least by most economists) basis conditions for an income tax system based on ability to pay or taxable capacity. The judicial interpretation of income has failed the tests of horizontal equity (some gains are simply left out of the tax base), vertical equity (excluded capital gains are allegedly largely derived by the ex ante wealthy members of a society), neutrality (resources are diverted to producing non-taxable gains), and inefficiencies (dead-weight costs to the economy arise from the socially unproductive activity of converting what would otherwise be taxable income into non-taxable gains).

The accounting and legal concepts of income, and the theories of economists include the notion of gain, but qualify this general principle.

The deviant economists overlaid their periodicity, productivity, and permanence of source requirements. Accountants overlaid their transactions and realisation requirements. The legal concept of income includes features from both of those diversions from the foundation concept (for example, periodicity and realisation) and added its own criteria, such as incomings, convertibility into cash, legal form, and “ordinary” usage.

The legal concept of income falls short of the foundation concept because of the doctrine of precedent. The development of concepts in law can be delayed when an issue arises for the first time for decision and the outcome is one that does not reflect the way in which society is moving. In this sense, the decisions in the nineteenth and early twentieth century cases that addressed the question of income have constrained the development of the legal concept of income later in the twentieth century. Conversely, economists and accountants have moved on without being bound by precedent. (Holmes 1999, p. 203).

As the legal concept of income is much narrower and different in nature to the accounting concept it is apparent that accounts and reports prepared for financial purposes will differ from those prepared for taxation and the filing of tax returns.

The scope for divergence between accounting principles and taxation is considerable. Much relates to the scope for allocating revenue or expenses to capital or current account - the balance sheet or the profit and loss account. What might be appropriate for the needs of financial accounting might not be so for taxation. Specific areas of concern include current

financial provisions for likely or expected future events – as illustrated in Section 3 below. A different manifestation of possible differences as to the correct approach can be seen in terms of the ‘matching principle’ as discussed for example, by Macdonald (1995). Essentially the principle can be applied in one of two ways. One is to match specific expenditures against specific revenues they generate (the revenue basis). The other is to match the expenditure against the revenues of the time period in which the expenditure is incurred (the time basis). An example given was of advertising expenditure which can be matched either to the period in which it was incurred or to the periods in which the revenue it generated accrued. Naturally the alternative possibility can lead to divergence in the accounting and tax approaches to these matters.

It is interesting to note that a possible reason for the success of Value Added Taxes (in the UK) and Goods and Services Tax (in New Zealand) and, indeed, almost all other OECD countries could be that they are not based on the spurious concept of income but on a transactional concept of the invoice document.

2.3 The Continual Evolution of Accounting and Taxation

In addition to existing difficulties, both accounting and taxation are in a continual process of development. The different rate, method and direction in which each is developing perpetuate the conflicts that result between the two systems. Sir Thomas Bingham put this well when he stated in *Gallagher v. Jones [1993] STC 537 at 555* with respect of accepted principles of financial and commercial accounting that:

As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights happen.

Taxation as well is frequently modified and reformed. This process is described, for example, by James (2002) where the status quo can be seen as subject to constant and changing pressure for and against reform and the result is a continually developing compromise between such forces. William E. Simon, a former Secretary of the US Treasury, once said that ‘The Nation should have a tax system which looks like someone designed it on purpose’ (US Treasury, 1977). Tax systems are most often changed on a piecemeal basis in a continual process of responding to particular pressures as indicated above. The result is, for example in the case of an income tax, that the tax base does not always match accounting or economic definitions of income. In the UK the Meade Committee (1978, p. 70) pointed out that the UK

income tax had features, such as the treatment of much industrial investment and pension funds, that made the effects of tax in some cases similar to those of an expenditure tax.

There is a continual incremental development of both accounting and taxation but unfortunately they are not developing at the same rate and in the same direction. This indicates a need for tax legislation to be constantly reviewed to ensure it still meets the policy objectives it is intended to achieve.

2.4 Administrative Effectiveness, Objectivity and Precision

On a more practical level, certainty of measurement is particularly important for taxation. Taxation therefore tends to rely on accounting rules that are transactions-based in contrast with the traditional accounting measurement of profit that is accruals-based. Furthermore, as Whittington (1995) points out, a tax system needs to rely on precise and verifiable transactions while good financial accounting should also take account of more subjective aspects.

Of course, both require accuracy, but for administrative effectiveness, it is particularly important for a tax system that tax liability is based on precise variables. Hence, for example, in the UK context, allowance for pension contributions for tax purposes is done on a contributions basis. That is an objective, verifiable and precise variable. A more appropriate method for accountants might be to take an actuarially-based and more subjective view of an estimate of the increase in net obligation over a period (IAS 26). There is clearly much more scope for honest differences of opinion in such an accounting approach, as well as for manipulation to avoid taxation.

A very clear statement of this point was also made in the *Thor* (58L Ed. 2d.785 at 802 (1979)) case:

Financial accounting, in short, is hospitable to estimates, probabilities and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes.

A useful example arising from both the differences in the purposes of accounting and taxation and the need for administrative effectiveness for taxation is the treatment of depreciation in the UK. Depreciation, of course, is a prudent accounting measure representing the allocation

of the cost or “other amount substituted for cost” (IAS 16, para 6) of a fixed asset over time. Accounting principles require the charging of depreciation and its disclosure. However, in the UK depreciation is one of the expenses that may not be deducted in the calculation of taxable income. Instead there is a system of capital allowances laid down by the government. This is partly because capital allowances take the form of a system of accelerated depreciation that is used by the government to encourage investment in certain fixed assets. It is also because the calculation of depreciation can be subjective and might be influenced by a desire to reduce taxation. Capital allowances therefore have often been quite different from the sums charged for the purposes of calculating commercial profit.

Accounts prepared in accordance with taxation laws are used to measure the past and by nature of their purpose must be clearly verifiable desirably to a transaction. Amongst the many purposes of commercial accounts is the need to provide a basis for predicting the future. They may be based on history but they are also designed to forecast and predict the future so that they may be more useful for decision making.

These generic view points of accounting and taxation have summarised some of the problems of using financial accounting for the preparation of taxation returns. It is now possible to proceed to a more specific study of the UK perspective and then the New Zealand perspective in order to address the environment and relationships of accounting and taxation reporting in each country.

3.0 THE UK PERSPECTIVE

In the UK, the issue of using accounting principles in determining tax liability has been the subject of considerable discussion – see, for example, Freedman (1987, 1993 1995 and 2004). Normally accounting practice is the starting point in calculating taxable income and will generally prevail unless it is modified by specific tax law. There is a judicial view that the courts in the UK retain the right to modify the figures generated by accepted accounting practice. Although there have been some attempts by the Inland Revenue to do so, recent cases seem to indicate a trend confirming the importance of commercial accounts as the basis of tax calculations.

Sir Thomas Bingham stated in *Gallagher v. Jones [1993] STC 537 at 555-556* that:

I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question (b) is not one of two or more rules applicable to the situation and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business.

While such an approach might in general be appropriate to establish the facts of the case, the law would, of course, prevail if there were statutory provision to the contrary or if there were doubts about such facts. In *Sun Insurance Co. v. Clark* [1912] 6 TC 59 at 78 Lord Haldane stated that:

It is plain that the question of what is or is not profit or gain must primarily be one of fact and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when...some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap.

Nevertheless the courts in the UK do not consider themselves bound by accounting practices as made clear by Lord Denning in *Heather v. P.E. Consulting Group Ltd* [1972] 48 TC 293 at 32:

The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of which is capital and which is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants, however eminent.

A further contribution is described by Freedman (1995, p.434) as the famous dictum of Pennycuik V.-C. in *Odeon Associated Theatres Ltd. v. Jones* [1972] 48 TC 257 at 273.

The concern of the court in this connection is to ascertain the true profit of the taxpayer...In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so...At the end of the day the court must determine what is the correct principle of commercial accountancy to be applied.

However, two cases have reinforced the acceptability of accounting practice being used also as the basis for taxation. In *Johnston v Britannia Airways Limited* [1994] STC 763 the Inland

Revenue argued that the accounting practice followed by the company should not be used for tax purposes. Britannia Airways operated aircraft that have to be certified as airworthy. Among other things, this required the aircraft engines to be given a major overhaul every 17,000 flying hours – in practice about once every three or four years. For the relevant accounting period the company calculated the average costs of an overhaul per hour flown and multiplied that by the number of hours flown by the engine and deducted the resulting figure from the profit and loss account. The Inland Revenue disallowed this treatment for tax purposes and argued that no provision should be made before the first major overhaul when the costs should be capitalised and then amortised over the period between that overhaul and the next overhaul. However it was held that the company's accounting treatment was the most accurate estimate of the profits and other methods, including the Inland Revenue's, were less effective. Knox J. stated (*Johnston v Britannia Airways Limited [1994] STC 763*):

The court is slow to accept that accounts prepared in accordance with accepted principles of commercial accountancy are not adequate for tax purposes as a true statement of the taxpayer's profits for the relevant period. In particular, it is slow to find that there is a judge-made rule of law which prevents accounts prepared in accordance with the ordinary principles of commercial accountancy from complying with the requirements of the tax legislation.

In the second case - *Herbert Smith v. Honour [1999] STC 173* - the issue of prudence was raised explicitly. The Inland Revenue had argued that provision for anticipated expenses should not be allowed against current income. In *Edward Collins & Sons Ltd. v. CIR 12 TC 773 at 781* the Lord President (Clyde) stated the position as to future losses as follows:

...a prudent commercial man may put part of the profits made in one year to reserve, and carry forward that reserve to the next year, in order to provide against an expected, or (it may be) an inevitable, loss which he foresees will fall upon his business during the next year. The process is a familiar one. But its adoption has no effect on the true amount of the profits actually made, and does not prevent the whole of the profits, whereof a part is put to reserve, from being taken into computation in the year in question for the purposes of assessment.

This, of course, deviates from the concept of income discussed in the previous section. That would be more consistent with the view was taken in *Smith v. Honour [1999] STC 173 at 174* where it was held that:

A rule which prohibited the anticipation of liabilities would be inconsistent with resort to generally accepted principles of commercial accounting in many cases, since it would disallow any provision made in accordance with prudence. The generally accepted principles of commercial accounting themselves operated to preclude illegitimate anticipation.

So the general position, in the UK, seems to be that accepted principles of commercial accounting are usually the basis for determining tax liability unless there is some statutory provision that requires otherwise. However the courts still retain the right to determine which principle should be applied in particular circumstances.

These issues have been discussed in a series of articles by the Inland Revenue UK (1997, 1998, 1999a-c, 2001). It stated that recent court decisions have given an ‘evolving view’ of the interaction between accountancy and tax and there has been a closer alignment between the two. The Inland Revenue has also clarified the position with respect to ‘deferred revenue expenditure’. This it defined as allowable revenue expenditure that has been included in the balance sheet instead of being written off immediately to the profit and loss account as it is incurred. The expenditure is then written off to the profit and loss account over a period of time – either charged as an expense or amortised.

Interestingly the Inland Revenue stated that it had become aware that this matter was still being dealt with in different ways. In particular there may have been doubt about the correct way to deal with revenue expenditure that is classified as fixed assets as opposed to current assets. However, it has now been established that it does not make any difference for tax purposes where deferred revenue expenditure is held on the balance sheet.

The Inland Revenue UK (2001) has accepted that there is no statutory requirement that expenditure is tax deductible as it is paid or incurred. The starting point for timing purposes is the measure of accounting profits derived by generally accepted accounting practice. Expenditure which is revenue in terms of tax law, but which is deferred (or ‘capitalised’) and shown on the balance sheet can only be relieved for tax purposes when it is posted to the profit and loss account in line with generally accepted accountancy practice. Capital expenditure, of course, is inadmissible for tax purposes however it is treated in the accounts.

The UK Government Policy on International Accounting Standards is stated as:

“ – There is merit in further alignment of taxable and commercial profits.

- But if there are good policy reasons for departing from following accounting rules the Government is prepared to do so.” (Inland Revenue, UK website, 2005a, p. 9).

4.0 THE NEW ZEALAND PERSPECTIVE

The approach on the use of Financial Reporting Standards in the preparation of tax returns in New Zealand was evidenced by the recommendation from the Consultative Committee on the Taxation of Income from Capital (1991). This committee recommended an eclectic approach to the alignment between taxable income and accounting income in that:

- the Act should provide greater statutory detail on problem areas of tax accounting without attempting to provide a complete code for the calculation of income. Essentially, the extent of statutory detail is a matter of degree, however, the Committee believes that the quantum of taxable income should be determined by Parliament as far as is practically possible;
- the tax system should not rely on undefined principles of commercial accountancy practice as a primary basis for the calculation of income, however such practice should be a reference point for the Commissioner and the Courts in the interpretation and application of the Act. (para. 1.4)

The New Zealand Government's response to these recommendations was contained in the discussion document *Core Provisions: Rewriting the Income Tax Act* (Birch and Creech, 1995, paras 5.27 to 5.28):

5.27 In the light of these considerations, the Government has decided that it would be inappropriate at this stage to incorporate an explicit reference to GAAP [Generally Accepted Accounting Practice] in the core provisions of the Act. However, the Government is still interested in receiving submissions on whether there should be a reference to GAAP or commercial practice, either in the core provisions or in other Parts of the Act.

5.28 The Government also intends to undertake a more detailed analysis of references to accounting principles and practices when it considers the introduction of detailed timing rules.

In considering the recommendations of the Working Party and this Consultative Committee, Law (2004), states “the Government took into account the development of GAAP in New Zealand, which was, and remains, in a state of flux. The fact that the Income Tax Act serves a wider variety of user groups compared with accounting standards, and the potential conflict that may occur between financial and tax accounting practices, were also important

considerations. The policy approach in New Zealand to date has been to consider the appropriateness of incorporating GAAP into tax legislation on a case by case basis. To date, GAAP has been incorporated into the tax legislation for trading stock and research and development expenditure” (p. 41).

Law (2004) examines the recent New Zealand tax legislators' adoption of the Institute of Chartered Accountants of New Zealand's (ICANZ's) Financial Reporting Standard No 4 (FRS-4): Accounting for Inventories (ICANZ, 1994) and Financial Reporting Standard No 13 (FRS-13): Accounting for Research and Development Activities (ICANZ, 1995), in the taxation rules for trading stock and research and development expenditure, respectively. “The results of this analysis suggest that de jure harmonization of tax legislation and GAAP is fraught with difficulties because tax legislators face a different, and less well-recognised, set of constraints compared with the courts of law in the task of harmonization” (p. 40).

For example the differences that exist between the FRS-4: Accounting for Inventories and the tax rules for trading stock introduced in 1998 and now embodied in Subpart EB: Valuation of Trading Stock, in the Income Tax Act 2004 are discussed in detail in Law (2004, pp. 44-48). These differences demonstrate that despite there being a clear intention of adopting and using a financial reporting standard in tax legislation it will only operate for the different objectives of taxation if changes are incorporated.

This application of FRS-4 to the tax legislation in New Zealand indicates the unlikelihood of a perfect harmonization between taxation and accounting practices. Despite the desire in drafting New Zealand tax legislation to incorporate and use FRS-4 the adoption is not clean or simple. There are many exceptions and extra rules that have to be defined.

This section and the previous section have discussed the environment and relationships of accounting and taxation reporting in New Zealand and the UK. However these countries have not been able to consider the interface of the accounting and taxation processes in isolation. Consequently the following section looks at the global historical and international dimensions, showing a range of different, and changing, relationships between accounting and taxation of countries throughout the world.

5.0 HISTORICAL AND INTERNATIONAL PERSPECTIVES

The relationship between accounting and taxation has developed uniquely in each country giving an historical and an international dimension to this summary. For example Haller (1992) examined the relationship between financial and tax accounting in Germany and Radcliffe (1993) the relationship between tax law, and accounting principles in the UK and France. Radcliffe found that there were some similarities between practice in France and the UK. For example in both countries commercial accounting principles allowed a deduction for provisions for a decline in the value of trading stock ordered but not delivered, but both countries denied tax relief for such provisions. However, Radcliffe found a difference in the approach of the courts to the issue – with a British judicial presumption that the accounting treatment is not necessarily the final word whereas in France it was conclusive in the absence of specific tax law to the contrary.

A wider issue is that of tax harmonization. It is clear from the foregoing discussion that this is related to accounting harmonization and the approach of the courts to such questions in different countries. The progress of European tax harmonization has been reviewed recently by James (2003). One of the main authorities in this area was the Ruding Report (1992, p. 195) which found that in the Member States of the European Community, as it was then, taxable income was generally calculated on the basis of commercial accounting principles and was therefore related to the profits shown in company accounts. In some countries – Belgium, France, Germany, Greece, Italy, Luxembourg and Spain there was a close link between the accounts required for accounting and tax purposes. For other countries – Denmark, Ireland, the Netherlands and the United Kingdom the Ruding Report found the link between the two sets of accounts to be further apart. Significant differences were found in depreciation rules and tax rates, the tax treatment of losses, stocks and other expenses, provisions, especially for bad debts, and occupational pension plans, the taxation of capital gains, and adjustments to allow for inflation.

This topic has been further examined since. Hoogendoorn (1996) compared the relationship between accounting and taxation in thirteen European countries. He found that it was possible to identify two essentially different types of relationship, which he referred to as ‘independence’ and ‘dependence’ structures.

Hoogendoorn argued that the essential feature of 'independence' is that companies may use different accounting policies with respect to their commercial accounts and their tax calculations. Of course, there is never complete independence between accounting and taxation and each influence the other. Nevertheless, with that reservation, Hoogendoorn considered the UK position to be one of independence. The other countries in this category were the Czech Republic, Denmark, Ireland, Netherlands, Norway and Poland.

Dependence was considered to exist where either the commercial accounts were based on tax rules or that taxable income was determined by the commercial accounts. In both cases, the incentive to reduce or postpone taxation would lead to downward pressure on income figures. Of the European countries analysed Belgium, Finland, France, Germany, Italy and Sweden were considered to have dependence in the relationship between their accounting and taxation arrangements.

Hoogendoorn went on to classify the thirteen European countries into seven categories. He also noted that the relationship between accounting and taxation keeps changing. A particular trend was a movement towards more independence between accounting and taxation in several countries. One of the reasons was that the economies of Eastern European countries were becoming more market orientated and therefore commercial decisions relatively more important. Sweden and Finland were also identified as moving towards a more independent relationship with, for example, proposals in Sweden to remove the link between commercial accounting and taxation in several areas such as depreciation, the valuation of inventories, work in progress and warranty provisions.

Dependence between accounting and taxation can take several forms. One is that there is a choice between different accounting policies but the one that is chosen is the one that also has to be used for tax purposes. Tax considerations are therefore likely to be of major importance. Another example is that some countries have arrangements allowing for specific tax-free reserves provided they appear in the commercial accounts. In addition there are other tax concessions that are only available if they are shown in the commercial accounts. Finally tax rules are often used in commercial accounts where no specific accounting rules apply.

There have also been other classifications. For instance Nobes (in Nobes and Parker, 2002, p. 65) made a distinction between commercially driven accounting systems (often found in Anglo-Saxon countries) and government driven and tax dominated accounting systems (often

found in continental European countries). Lamb, Nobes and Roberts (1998) developed a method of assessing the extent of the connection between tax and financial reporting rules and practices in different countries. They suggested five types of connection and disconnection that might be summarised as follows:

- Case I Disconnection - Different tax and financial accounting rules
- Case II Identity - Tax and financial accounting rules are the same.
- Case III Accounting leads - Financial accounting rules are followed for both accounting and tax purposes.
- Case IV Tax leads - Tax rules are followed for both purposes
- Case V Tax dominates - Financial accounting rules are overridden.

Lamb *et al.* also used this classification to test the claim that there is a difference in terms of the connection between taxation and financial reporting between Anglo-Saxon and continental European countries. They used the United Kingdom and the United States as examples of the former and France and Germany as examples of the latter. They found that it was possible to distinguish the two Anglo-Saxon countries from the two continental European ones in terms of ‘relatively low and relatively high tax influence on financial reporting in a contemporary operational sense.’

A special issue of the Asia-Pacific Tax Bulletin (2002) highlighted the relationship between accounting and tax principles by publishing separate articles on the existing situation in Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam. “The issue of different interpretations in different jurisdictions will be a general problem of interpretation of accounting standards at an international level and not merely a tax problem” (Freedman, 2004, p. 86).

Following the Enron and WorldCom debacles there has been debate in the USA over closer alignment of taxable and accounting profits in order to prevent abuse of the reporting systems. The suggestion that has emerged from the ensuing debate is that public disclosure of tax accounts should be required, or that there should be more and better information provided on the book/tax reconciliation documents. The U.S. Treasury and Securities and Exchange Commission did not favor publication of tax accounts due to their detail, complexity and potential use to competitors. However there was consensus that the book/tax reconciliation information already required should be improved (Knott and Rosenfeld 2003a).

As Freedman (2004) states:

It would seem that complete alignment is neither possible, nor desirable. Nevertheless, in any tax system based on profit, the commercial accounts and tax accounts will almost certainly have the same starting place, so the interesting question becomes one of the degree to which there should be divergence rather than whether there should be divergence at all. In addition, to the extent that there is divergence, who should be the final arbiter of taxable profits in any given case? The matter could be one for the legislature, the courts or the accounting profession or, most probably, some combination of the three, but the relationship between these sources of definition will need management and regulation. (p. 77)

Macdonald (2002) in a TLRC Discussion Paper prepared for the Institute for Fiscal Studies, London asked for legislation setting out the accounting principles as they apply to taxation rather than leaving this to be decided by the courts based on unspecified principles. Nobes (2003) in a paper for the Association of Chartered Certified Accountants suggested a Conceptual Framework for the Taxable Income of Businesses under International Financial Reporting Standards. Freedman (2004) states:

The interaction between taxing legislation and principles and accounting standards will inevitably raise questions for the courts that are not questions to be answered purely on the accounting evidence. It can be agreed that there should be a legislative framework for divergence, but even Macdonald's and Nobes' models do not provide sufficient guidance to enable the role of the judges to disappear altogether. They have, and will continue to have, a role as gap fillers; a role which in this author's view will take them beyond mere adjudication on the facts and into the realm of developing legal rules for the application of accounting standards for tax purposes. (p. 87).

According to Freedman (2004) the courts should have a role in dealing with the following four categories of questions:

- 1) Does the accounting standard apply to the transaction at all?
- 2) Does the accounting standard itself introduce questions of law?
- 3) Are there two or more accounting practices which could properly be applied, or no specific standard but only general accounting principles? If so, which practice or principles are preferable for tax purposes?
- 4) Is the accounting standard proposed by the accounting evidence applicable in a tax context? (p. 87).

These questions are similar to those proposed by Sir Thomas Bingham in *Gallagher v. Jones*. Freedman's article argues that, "contrary to the views of many in the UK at present, there is also a multi-layered and ongoing role for the courts in the process of defining taxable profits." (p. 1)

A recent development which influences the global relationship of financial and tax accounting in most developed countries in the world is the introduction and adoption of International Financial Reporting Standards (IFRS). This is discussed in the next section.

6.0 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) AND THEIR COMPATIBILITY WITH TAXATION REPORTING

From 1 April 2001 the International Accounting Standards Board assumed responsibility for setting designated International Financial Reporting Standards. The IASC Foundation Constitution provides that the Trustees shall:

select members of the IASB so that it will comprise a group of people representing, within that group, the best available combination of technical skills and background experience of relevant international business and market conditions in order to contribute to the development of high quality, global accounting standards. [IASB website 2004 Para. 20]

It has been argued that globalization of accounting standards is the cue to disassociate tax and accounting (Freedman, 2004, p. 72). It is unlikely that governments will want to hand over control of their tax base to the International Accounting Standards Board, IASB (Knott and Rosenfeld, 2003) also the theory behind International Accounting Standards (IAS), and particularly its emphasis on fair value accounting, is departing from the central principles that have always been thought of as suitable for taxation purposes in the past (for example the traditional concept of realization - Wilson, 2001). In a 2001 EU Commission staff working paper, globalization of accounting standards is seen as a catalyst for the development of harmonized, but independent, tax accounting principles. The paper states:

Generally, it is clear that there is no prospect of fully matching tax and financial accounting in the future...To the extent that tax accounting will develop independently from financial accounting, Member States will be obliged to find autonomous rules for tax accounting purposes. In looking for such rules there is an opening for co-ordination and co-operation to start with common base rules, instead of each of the Member States trying to pursue individual solutions. (EU Commission staff working paper, 2001).

Subsequently the EU Commission has developed a modified view, that globalization of accounting standards is an opportunity for finding a common base for tax across the EU, with a starting point in accounting profits (European Commission, 2003).

The UK Finance Act 2004 includes legislation which ensures that companies choosing to adopt International Accounting Standards (IAS) to draw up their accounts will receive

broadly equivalent tax treatment to companies that continue to use UK GAAP (UK Generally Accepted Accounting Practice). Sections 50 to 54, under the heading of accounting Practice and Schedule 10 (Amendment of enactments that operate by reference to accounting practice) FA 2004 contain all the new legislation. The legislation has effect generally for accounting periods beginning on or after 1 January 2005 (Inland Revenue, UK website, 2005b).

The UK Government (2004) when considering whether further departures from, or alignment with, commercial accounts are required when International Accounting Standards come into force has defined 11 categories in which departures from accounting may be permitted. They are; public policy, transfer pricing, structural issues, avoidance, tax neutrality, capital/revenue divide, fiscal incentives, symmetry, realisability and tax capacity, whether the commercial accounts are a 'true reflection' and a miscellaneous residual category.

In New Zealand, adoption of International Financial Reporting Standards (IFRS) will be allowed from 1 January 2005 and mandatory for financial reports for periods beginning on or after 1 January 2007. The adoption by itself will have immediate possible repercussions. Bradley (2004) suggests areas where the adoption of IFRS will impact directly on the tax liabilities of a company. Examples are:

Thin capitalization and deductibility of interest (s FG 8, ITA 2004).

Meeting the Solvency test after payment of a dividend (s ME 5(3), ITA 2004) or in relation to company amalgamations (s CG 2, ITA 2004).

There will also be significant changes to the treatment of derivatives (such as forward exchange contracts) and the treatment of intangibles. There will be possible changes to the debt / equity classification of some instruments. These will all affect the preparation of tax returns.

IFRS will require some companies to use a 'functional currency' rather than NZ dollars for accounting purposes. These companies will still need to keep accounts in NZ dollars for New Zealand tax purposes.

In the opinion of Bradley (2004) the adoption of IFRS has "the potential to significantly alter a company's tax liabilities". Because taxation systems are designed on a country basis the imposition of IFRS which are designed on a global basis must inevitably lead to further conflict between accounting and taxation reporting.

Among the suite of new IFRS to be adopted in New Zealand is NZ IAS 12, Income Tax. This standard focuses on deferred tax accounting which is the reconciliation of tax based and accounting based measures of performance and position. A high level of deferred tax can indicate divergence between the accounting and tax rules for one or more items. For example a more aggressive depreciation allowance for tax purposes than is followed for accounting purposes will generate a deferred tax balance. For this reason pulling the reconciliation apart into its components can be helpful to auditors, analysts and tax authorities alike.

Perry and Teixeira (2004) explain the fundamentals of NZ IAS 12 and contrast it with Statement of Standard Accounting Practice which it will replace. Despite adaptation of the IAS to New Zealand circumstances there will be many areas of difference and more information will need to be disclosed.

The fact that IAS 12 is necessary is a very clear statement that there will never be a perfect match between the statement of financial performance prepared by applying IAS and the assets and liabilities calculated using tax rules required by taxation legislation. The deferred tax balance (which is the aggregate of all the differences) is a powerful indicator of the tension between tax and accounting rules.

7.0 CONCLUSION

The relationship between accounting and taxation is an evolving one and more complex than first appears. In general there are sound reasons for accounting principles to form the basis for calculating tax liability and there is evidence that in the UK and in New Zealand there is a trend towards even greater reliance on commercial accounts for the purposes of taxation. However, there are also reasons why tax rules and practices should be different in some respects.

There is much written about the interaction and dependence of tax return preparation and commercial or financial accounting but there is a need for further documentation and understanding of the differences. The problem areas unique to each country need to be identified and recorded so that comparisons can be made and a global perspective identified.

Countries should not be developing tax policy and practice in isolation. There will always be international implications. A possibility of closer understanding and agreements with other countries in the context of international tax policy should always be considered.

Generally, the different objectives of tax and financial accounts make it desirable that the rules for each one are not unduly influenced by the rules for the other. At present international accounting standard setters pay little regard to tax implications and would be unlikely to take kindly to the suggestions that they needed to add tax to the list of considerations and pressure they must take on board already (Nobes, 2003), p. 38, as quoted in Freedman, 2004, p. 76). Commercial accounting considerations could be distorted by tax pressures. This is not to say that tax and financial accounting should operate in isolation from each other. Some mutual awareness and cross referencing will be valuable, but there will be clear differences, and these need to be made explicit and based on some established criteria and explicit and comprehensive principles (Freedman, 2004, p. 76).

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