THE RELATIONSHIP BETWEEN ACCOUNTING AND TAXATION: A BRIEF INTERNATIONAL LITERATURE REVIEW

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This paper analyses the international literature regarding the relationship between accounting and taxation in the last 20 years. To this purspose we reviewed the 3 international economic databases (EMERALD, EBSCO and SCIENCE DIRECT).
We have found various studies approaching this relationship, the main research being performed due to the differences between them in the accounting systems that govern the world countries.

Keywords: accounting, taxation, accounting systems

JEL Classification: H25, H29, M40, M41

Introduction

The relationship between accounting and taxation is a relationship that existed, exists and will always exist; the question is related to the intensity, interrelation and mutual consequences.
When accounting intersects with taxation, many topics can be discussed. Literature gives us a rich source of documentation at the crossroads of accounting with taxation and the relationship that exists between them, the last aspect representing the object of study undertaken.
The study is intended to be an analysis of key studies that have addressed this relationship in the international literature, waiting to identify the key areas that are approached, namely accounting paradigm within the studies undertaken may be included.

Research methodology

Methodology approached followed to identify the articles from economical databases (EBSCO, EMERALD and SCIENCE DIRECT) that treated the phrase "the relationship between accounting and taxation". It was selected only the items that meet the following requirements: (1) articles are written in English (2) articles are full text, (3) selected articles were cited at least twice in the other papers.
The achieved is a qualitative research using inductive method, longitudinal analysis, identified as the positivist current.

Key areas identified

A lot of studies have examined the relationship between accounting and taxation in last two decades. These studies cover both national and various European and international countries, in this respect, the analogue method was used. In this regard, studied like the following can be mentioned: Haller (1992); Radcliffe (1993); Hoogendoorm (1996), Blake *et al.* (1997); Lamb, Nobes and Roberts (1998); Porcano and Tran (1998); Aisbit (2002); Doupnik and Salter (1993).
Doupnik and Salter (1993) have developed a classification of countries based on accounting schemes, obtaining their classification based on similarities of accounting standards, similar features of capital markets, namely the similarities corporate governance mechanisms. Eight accounting regimes have been developed, thus: (1) North American; (2) Anglo-Saxon; (3) Nordic; (4) Latin developed; (5) Latin developing; (6) Germanic; (7) Japanese and (8) Asian developing. Francis *et al.* (2002) realized a classification of financial accounting and tax compliance in relationship between accounting and taxation, based on each of the 8

aforementioned accounting regimes. The authors identified 3 level of compliance which defines the accounting systems, as follow:
- *Low level of compliance*: North Amercian and Anglo-Saxon accounting systems;
- *Moderate level of compliance*: Nordic, Latin developed and Asian developed accounting systems;
- *High level of compliance*: Germanic, Latin developed and Japanese accounting systems.

The debate that surrounds the connection between accounting and taxation has been and still exists and as a consequence we can characterize it as being extremely intensive. Haller (1992) studied the development of the relationship between accounting and taxation in Germany treating it from an historical point of view. Moreover, Radcliff (1993) addressed the same relationship in terms of UK and France, using the analogue method. The author noticed some similarities between the two countries' accounting practices. The author focused on the example of adjustments deductibility for inventory distortion value, ordered but not delivered, even more, being the fact that both countries have denied the deduction for such adjustments. If the previous study was focused on determining the elements of similarity, the study conducted by Porcano and Tran (1998) focused on determining the factors founded in divergences surrounding the relationship between accounting and taxation. These divergences concerned the implications arising for the alignment of taxation rules with accounting rules. The study is one that can be qualified as being fundamental research and explores the relationship between accounting and taxation in countries were Anglo-Saxon accounting system is implemented: USA, UK, Australia, Canada and New Zealand.

The study conducted by Boross, Clarkson, Fraser and Weetman (1995), addresses issues regarding the new accounting system from Hungary since 1992. As a major difficulty discoveded in the steps taken towards to implement the new system,the link between taxation and accounting was mentioned. The authors mentioned that tax rules have priority in preparing financial statements or cost calculation judging under detrimental bases regarding the new accounting rules.

We also recall the fundamental type of research carried out by Alley and James (2006), which addresses the relationship between accounting and taxation in terms of different objectives pursued by each of the two areas, the difficulties encountered in applying economic concepts and evolutionary process involving by both areas.

The degree of independence varied temporal and territorial belonging among the classifications of Nobes and Parker (1981) (*macro-economic orientation*), and Choi and Mueller (1992) (*micro-economic orientation*).

Micro-economic orientation refers in fact to that financial statements that are prepared primarily for shareholders and their development is not influenced by tax rules. The financial statements portraint a true picture of companies, and also, such an approach generates two types of results: accounting and tax result.

Macro-economic orientation, on the other hand, acknowledges the influence of tax rules; the companies prepare financial statements, mainly to the interests of creditors or state in order to determine the results focused on tax purposes.

A first approach used in order to asses these debates was the distinction that is made when it comes to two groups of countries, thus: countries influenced by Anglo-Saxon accounting system (e.g. USA, UK and Canada) and those under Continental accounting system influence (e.g. Italy, France, Portugal, Spain).

Using the classification of accounting systems under the aegis of the two approaches mentioned above, it is what the literature refers as the disconnection between accounting and taxation. The disconnection is primarily explained by the method of calculating of accounting and tax profit.

Accounting profit is calculated applying the principles and accounting rules, while the tax profit is calculated taking into account the tax rules. The profit calculated using two different methodologies, connote major differences.
It can mentioned that the introduction of the Fourth European Directive has produced major changes in the legislation of many European Union (EU) countries, from macro-economic orientation to micro-economic orientation towards greater independence of accounting to taxation. The implementation of the Fourth Directive was seen as a genesis point of breaking the link between accounting and taxation (Christiansen, 1996).
Blake *et al.* (1997) focused on some dilemmas associated with the relationship between accounting and taxation, dilemmas and controversies such as:
- Tax considerations that support this link, and secondly, issues related to obtaining economic picture through the faithful representation of financial statements for some international users, and even fellow countrymen, which indicates that this goal can not be achieved as long as the link is a strong one;
- Addressing the issue of harmonization of national accounting practices at European level the fundamental link between tax and accounting rules, and accounting system is identified as a major obstacle;
- Main benefits from residing in "breaking" the link, experiencing large listed companies, while maintaining relations benefits are felt by small companies (since it not involves additional costs in the consolidated accounts as the large listed companies);
- In regard to this link, the practitioners supports the efforts of "breaking" this link, but this is not yet possible, maintaning the relationship having a major impact not only on accounting policies and practices but also spilling on the accounting conceptual framework.

The authors also highlights the fact that Sweden offers an unusual example of country that deals with two different pathways, as, legal system is based on a close relationship between accounting and taxation, while the private sector tries to "break" this link. The authors focused on ways regarding the directions in which Swedish accounting practitioners are willing to broke the link between accounting and taxation in order to develop relevant and comparable financial statements for accounting information users.
Two EU countries (Germany and United Kindom) were identified as distinctive and contrasting leaders in European accounting tradition of Anglo-Saxon and Continental origin, and an assesment was conducted regarding the major differences between those two countries. The differences are presented in **Table 1**.

Table 1 *The differences between Anglo-Saxon and Continental Accounting System*

Anglo-Saxon Accounting System (including United Kindom)	Continental Accounting System (including Germany)
Fair view	Legal view
Shareholder orientation	Creditor orientation
Disclosure of accounting information	Secrecy of accounting information
Tax rules separate	Tax dominated
Substance over form	Form over substance
Professional standards	Government rules

Source: *Nobes (1992) and Blake et al. (1997); Author projection*

The distinction between Anglo-Saxon and Continental accounting system, based on the relationship between accounting and taxation, is treated by Lamb, Nobes and Roberts (1998). The authors explained in more detail the two directions involved, as following:
- Historical link between accounting and taxation (the existence of taxation determin, to some extend, the existence of accounting);

- Degree of separation or rather contemporary connection between financial and tax reporting in respect of calculating the profit, an indicator considered to be very important in any economic activity.

Profit is the objective of empirical research conducted by Tzovas (2006). The author tried to identify the underlying factors designed to support decisions for a court accounting policies of Greece, where tax and financial accounting coincide. Study results revealed that the design decisions on accounting policies do not exclude the influence of tax minimization. Moreover, it highlights the fact that the project objectives on the profit value may conflict the objectives to minimize the tax burden supported by companies.

Hoogendoorn (1996) has developed a taxonomy regarding the relationship between accounting and taxation in major EU countries. 13 countries were selected according to the stringency of the relationship and the possibility of maintain this connection was taken into consideration. The taxonomy considered is presented as follows:

- Accounting and taxation are charecterized as being dependent and this relationship is not expected to change. In these cases we do not find deferred tax regulations, and as a result, several alternatives are allowed. Both individual and consolidated accounts are therefore influenced by tax regulations, and representing countries such as Belgium and Italy are mentioned;
- Accounting and taxation are dependent and this relationship is not expected to change. There are few deffered tax regulations and fiscal influences. France and Germany are included in this category (Germany also may be included in the first category);
- Accounting and taxation are still dependent, but the aim of breaking the relationship between them is desired. We do not find strict regulations regarding deferred taxation, and representing countries such as Sweden and Finland are mentioned;
- Accounting and taxation are formally independent; in practice the connection between them being characterized as very strong. We can find there strict deferred taxation regulations, and representing countries such as Poland and Czech Republic are mentioned;
- Accounting and taxation are independent. Alternative regulation allows deferred taxation, and as representative country is recalled Denmark;
- Accounting and taxation are independent and there are also specific deferred taxation regulations, representing countries such as Ireland, UK, Netherlands and Norway are mentioned.

Aisbit (2002) conducted a further study, based on the Hoogendoorn (1996) study. The author concludes that a close relationship between accounting and taxation lead to difficult interpretation of financial statements results. Referring strictly to the study conducted by Hoogendoorn (1996), the author highlights that this is a dynamic study and that changes have occurred in recent years regarding the classification of countries into one category or another, and the financial statements may not be fully independent from taxation. The road to independence is "paved" with good intentions by induced upon acceptance and application of IAS.

Remaining within this boundaries, Radcliffe (1993) discuss about the distinction between *tax compliance* (which necessitates of general assumption that taxable income is calculated under Generally Accepted Accounting Principles) and *financial compliance* (as a financial reporting practice involving substantial dependence on the choice of a specific accounting practice in preparing financial statements, to be conclusive for tax purposes, and also, the inclusion of specific items is a necessary condition for the granting of tax exemptions). The author explains that the existence of compliance indicate the fact that there is a close relationship between accounting and taxation, and that both of them have the power to influence each other.

On the scope of financial reporting systems correlated with taxation, we can mention a reference book for the international literature, *Comparative International Accounting (Fourth Edition)*, written by Nobes and Parker (1995). The authors identified seven factors contributing to the permanent existence of differences between financial reporting systems, as follow: legal systems,

capital providers, taxation, accounting profession, inflation, accounting theory and accidents of history (1995, p. 11).
The authors highlight as a crucial extent that tax rules may affect the accounting estimates in various accounting regimes. Deferred tax is an example, mentioning that it was an endless source of controversy in Anglo-Saxon accounting system (UK, USA), while in the Continental accounting system (France, Germany), where the controversy is minor (marked by the strong influence of tax accounting rules), (1995, p. 15).
Stoianoff and Kaidonis (2005) studied the accounting and tax system in Australia, in an attempt to identify the extent to which community may benefit from them (as social function) and the extent to which the both are emerging. The author's conclusion is bleak: both systems are disadvantages the society, supporting each other in an attempt to favor a certain class of society.
Gallego (2004) realized taxonomy of relationship between accounting and taxation standards, thus bringing into focus the concerns of Spain. The taxonomy realized by the author, aimed the regulations from USA, UK, International (IAS/IFRS) and Spanish regulations.
Oliveras and Puig (2005) proposed the following verifiable *statement*: "there was a great reduction in the influence of tax in Spain in the early 1990s" (not intentionally they used the term "hypothesis" instead of usual "statement" as the authors explain that they wanted to avoid the implications that are subject of statistical tests). Although we find the fact *stated* in the literature, as a result of reducing the tax accounting rule, the authors refuting this claim.
Making use by the classification introduced by Lamb *et al.* (1998), the authors tested the previous claim, concluding that the relationship between accounting and taxation has undergone major changes over the period before 1990, moving from a definite rule, to its dramatic reduction. Taking the sample as 16 items (including assessment of fixed assets, depreciation, leasing classification, research and development costs, long-term contracts, foreign currency transactions, pensions, financial assets, etc.), the authors followed their introduction in the five cases developed by Lamb *et al.* (1998) according to the specificities of each item, underlining the analysis for three years: 1989, 1994 and 2003. Half of items were placed in Case 3 "Accounting leads" in 2003, representing a decrease of fiscal rules compared to 1989, where only 2 of 16 items were classified in this case. For 2003 we have no item included in case 5 "Taxation dominates" unlike 1989.
For clarification we brought in carefully the classification of Lamb *et al.* (1998), which provides five criterias of classification for relationship between accounting and taxation, relationship characterized in terms of accounting rules, and taxation, as follows:
- *Case 1: Disconnection* (the acounting and taxation rules are pursued for different purposes to be fulfilled. Disconnection is possible when we have tax and accounting rules separate, independent and detailed);
- *Case 2: Identity* (this identity can be a *de facto* identity or when accounting is "leader". Regardless of which way we look accounting *prima facie* will affect taxation);
- *Case 3: Accounting leads* (it is possible when accounting rules or accounting options are adopted for financial reporting purposes and for tax purposes. This scenario is possible because of lack of specific tax rules to be sufficient);
- *Case 4: Tax leads* (it is possible when a fiscal rule or option is adopted for tax purposes and financial reporting purpose. This scenario is possible because of lack of specific accounting rules to be sufficient);
- *Case 5: Tax dominates* (a tax rule or option is imposed both for the financial and tax reporting, being in conflict with financial reporting rules).
Shaviro (2009) highlights the differences that arose between tax and accounting profit reported by companies, through the reporting of accounting profit semnficativ higher than fiscal profit. The author highlights that the problem of accounting manipulation is very present despite by implementation of the Sarbanes – Oxley Act. A recent study is conducted by James (2009), the

relationship between accounting and taxation being discussed both in UK and, from a wider perspective of it, in Europe. The author asserts the different goals pursued by accounting and taxation. According to author, the relationship between accounting and taxation is much more complex than it appears, and according to the jurisdiction where the relationship is dispute, there may be differences of perception or approach. The relationship between accounting and taxation is seen as the author characterized by progressive accents, since both, accounting and taxation, are dominated by permanent changes.

Conclusion

The relationship between accounting and taxation is conducted in the literature under various spectra or directions as: accounting standards, capital markets, corporate governance mechanisms, accounting procedures, in terms of transversal and longitudinal analysis, using analogue analysis , tax and accounting rules, the objectives of each of both scientific fields, micro-economic orientation versus macro-economic orientation, degree of independence that has a temporal and territorial accurate picture, tax compliance.

Accounting paradigms, identified as a result of browsing literature that treats the relationship between accounting and taxation, are: *The Antropological/Inductive Paradigm; Decision-Usefulness/Decision-Model Paradigm; Decision-Usefulness / Decision-Model Paradigm/ Agrregate-Market-Behavior Paradigm; Decizion-Usefulness/Decision-Maker/Individual-User Paradigm.*

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