The Relationship Between Accounting and Taxation

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Abstract

Although accounting principles and practice normally form the basis for tax assessment, there are reasons why there should be variations between the figures used for commercial accounting and tax assessment. These include the different purposes of commercial accounting and taxation, difficulties in defining economic concepts and the administrative effectiveness required of a tax system. This paper also examines recent developments in the UK and discusses the wider perspective of practice in Europe. It concludes that the relationship between accounting and taxation is an evolving one and further developments are to be expected.

Key words: accounting, taxation

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The Relationship Between Accounting and Taxation

An important dimension of management is the financial implications and one aspect is the taxation implications of commercial decisions. It may not be fully appreciated by all those researching and studying management that the accounts may be modified for the purposes of taxation and that this might have a bearing on the most profitable way to operate the business.

The purposes and requirements of commercial accounting principles and taxation are not always the same. 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 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 influenced by the taxation implications in an inappropriate way.

The recent *Secan*[1] case in Hong Kong has stimulated renewed interest in such issues. After a brief summary of the outcome of the case, this paper looks again in Section 2 at accounting and taxation. Section 3 examines the UK perspective and Section 4 turns to a wider and more European perspective. Finally Section 5 draws some conclusions.

1. The *Secan* Case

The *Secan* case relates to prepaid revenue expenses - those that are amortised or charged against profits in a subsequent period or periods. However, the finding of the Court of Final Appeal has wider implications than just the immediate issues involved. In particular it was held that the tax position should be based on the accounting

[1] ***Commissioner of Inland Revenue* v. *Secan Limited & Ranon Limited* 5 HKTC 266.**

treatment of such expenses. Lord Millet delivered the unanimous judgement of the Court and stated:

> Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the [Inland Revenue] Ordinance, no further modifications are required or permitted.[2]

Lord Millet went on to comment on the relevant provisions of the Ordinance as follows:

> …But the profits of a business cannot be ascertained without deducting the expenses and outgoings incurred in making them, and the [relevant section of the Ordinance] is not needed to authorise them to be deducted…It permits outgoings to be deducted only to the extent to which they are incurred in the relevant year. In this respect there is no difference between the law of Hong Kong and the law of England. In both jurisdictions expenses and outgoings are deductible in the year in which they are incurred and not otherwise.[3]

The UK perspective is discussed further below but the position of the Hong Kong revenue authorities has been revised as a result. It is clarified in the *Notes* issued by the Inland Revenue Department (2002, p. 2) as follows:

> The Department's revised position in relation to prepaid revenue expenses…is that the tax treatment should follow the accounting treatment of such expenses, provided that the treatment in the accounts is in accordance with the prevailing generally accepted principles of commercial accounting and is not inconsistent with any provision in the Inland Revenue Ordinance.

The accounting treatment of a prepaid expense would be accepted if it complied with the relevant Statement of Standard Accounting Practice of the Hong Kong Society of Accountants. For foreign companies with accounts prepared on the basis of standards different from Hong Kong, it would be acceptable if: (i) the treatment of prepaid expenses complied with the relevant accounting standard of the home jurisdiction of the company or International Accounting Standards (ii) is consistent with the facts or otherwise appropriate to determine the true profit or loss of the business and (iii) is consistent with the Inland Revenue Ordinance.

The case regenerated interest in more general issues about the relationship between accounting principles and taxation. It is important to be clear why there may be a divergence in the ways in which some matters may be treated. Furthermore the

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[2] ***Ibid*. at 330.**

relationship is unlikely to be fixed indefinitely and there may well be further significant developments in the future.

2. Accounting and Taxation

At first sight, it might be thought that the calculation of variables such as revenue, expenditure and profits should be the same for the purposes of both commercial accounting and taxation. Quite often this is true, but there are circumstances in which different figures are appropriate. 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'. (quoted in Green: 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 economic concepts and administrative effectiveness. These are discussed in turn, followed by a summary of the UK perspective and then a wider view outlining briefly some international differences.

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.

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[3] ***Ibid*. at 331.**

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*[4] 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, 2002), 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 accounting since the government may be taking account of wider public economic interests. The example of depreciation is discussed below, where the amounts allowed for capital expenditure

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[4] **58L Ed. 2d.785 at 802 (1979)**

may be adjusted for the purposes of taxation in order to encourage commercial investment.

On the other hand the government might decide that certain activities normally considered to be 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 or to allow such methods to be used to avoid tax.

Nevertheless the disparity between accounting and taxation can be more fundamental than adjustments to an accepted figure for income. It might be worth briefly mentioning some of the problems there have been in establishing a workable definition of income.

Defining Economic Concepts

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: 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.

In discussing Hick's contribution and the relationship between economic income and accounting income, Solomons (1961) also made it clear that periodic income is not an effective instrument of financial planning or control. Furthermore he pointed out, as indicated above, that taxation departs from the concept of income as the tax base every time it incorporates special allowances for depletion, provides for accelerated depreciation or permits an anomalous treatment of capital gains.

It is significant that major developments of 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'. In developing his own definition, Simons (1938) 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: 30-33).

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 commercial 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. The first 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.

Evolution of Accounting and Taxation

In addition to existing difficulties, both accounting and taxation are in a continual process of development. Sir Thomas Bingham put this well when he stated in *Gallagher v. Jones*[5] with respect of accepted principles of commercial accountancy 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.

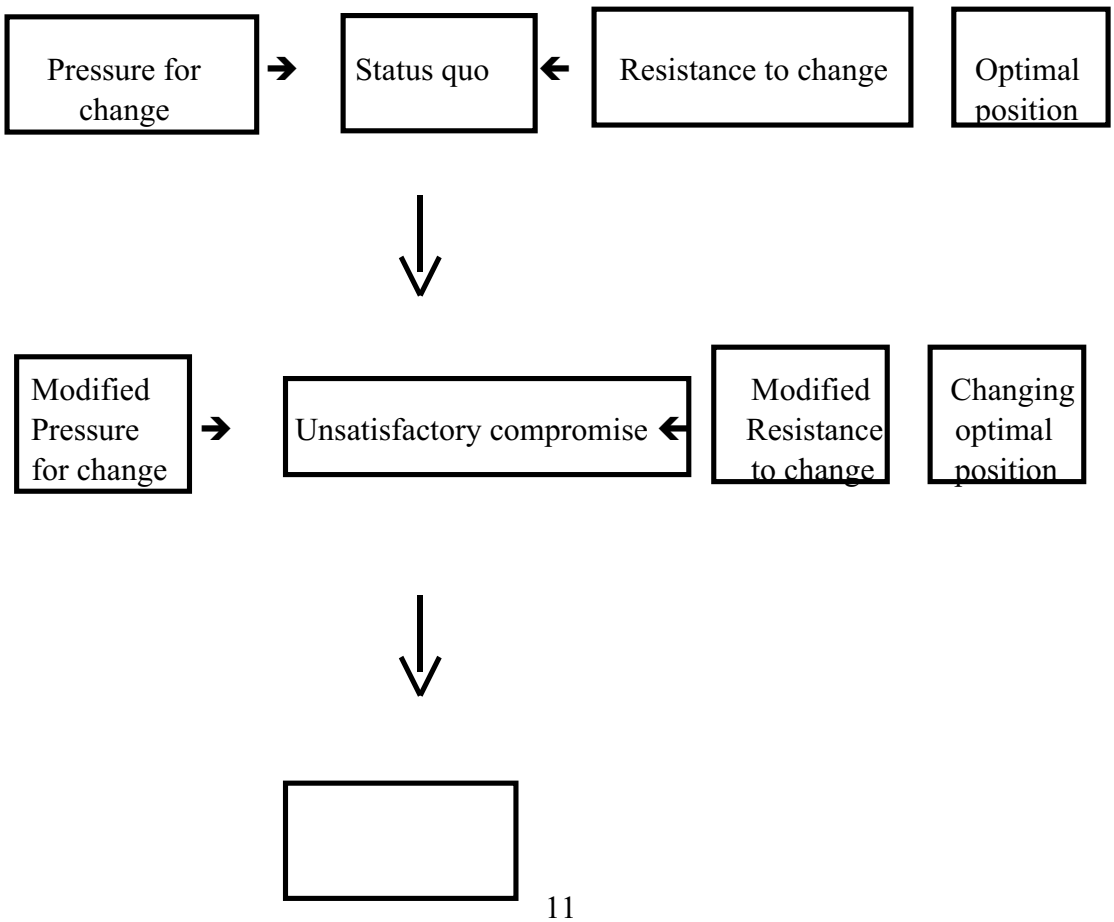
Taxation as well is frequently modified and reformed. This process is described, for example, by James (2002) where the status quo can be seen as subject to continuous and changing pressure for and against reform and the result is a continually developing compromise between such forces.

There are several possible ways of modelling phenomena such as the development of tax systems and one helpful approach is the use of forcefield analysis. Some individuals might view the development of tax systems as a process of rational reforms in changing circumstances. The drawback with that optimistic approach is that it is not reflected in the actual process of tax reform and does not take account of the complex array of different interests and factors involved in the way tax systems develop and the nature of the political process itself. It also overlooks the considerable innocence of many contributors to fiscal discussions with respect to the overall characteristics of an effective and equitable tax system (James and Nobes, 1999: 20-103).

[5] **[1993] STC 537 at 555.**

Forcefield analysis reflects the reality that at any time there will be all sorts of different pressures for change developing, and there will also be a variety of forms of resistance to change. A summary of this process is illustrated in Figure 1. Here the pressure for change meets the status quo with the latter supported by an array of forces resistant to change. The optimal outcome might be identified perhaps, as in this example, somewhere behind the resistance to change. Eventually the pressure for change might overcome the resisting forces, but the latter remain strong enough to deflect change from the optimal position and the result is an unsatisfactory compromise. This, of course, is only part of the continuous process of change so, as also indicated in Figure 1, the pressure and resistance to change is modified but continues and the optimal position is also changing. The development of tax systems can only be properly analysed when it is appreciated that it is a dynamic process.

Figure 1 A Forcefield Approach to the Development of Taxation



Path of tax
development

Tax systems are therefore not always based on a set of consistent principles. 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: 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.

Administrative Effectiveness

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. 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*[6] 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 loss of value of a fixed asset over time. Accounting principles therefore 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.

3. 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 and 1995). 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, and there have been some attempts by the Inland Revenue actually to do so, but recent cases seem to indicate a trend confirming the importance of commercial accounts as the basis of tax calculations.

As long ago as 1892 Lord Halsbury in *Gresham Life Assurance Society* v. *Styles*[7] stated:

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[6] ***Ibid.***
[7] **[1892] 3 TC 185 at 188.**

> The thing to be taxed is the amount of profits and gains. The word 'profits' I think is to be understood in its natural and proper sense – in a sense which no commercial man could misunderstand.

Since that time there have been considerable technical developments in accounting practice. The requirement that a word such as 'profits' should still be clear to any 'commercial man' is not often heard. Much more recently Sir Thomas Bingham stated in *Gallagher v. Jones*[8] 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 of 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*[9] 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*[10]:

> 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: 434) as the famous dictum of Pennycuick V.-C. in *Odeon Associated Theatres Ltd*. v. *Jones*[11].

> 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

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[8] [1993] STC 537 at 555-556.
[9] [1912] 6 TC 59 at 78.
[10] [1972] 48 TC 293 at 322.
[11] [1972] 48 TC 257 at 273.

> '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*[12] 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[13]:

> 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*[14] - 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*[15] the Lord President (Clyde) stated the position as to future losses as follows:

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[12] **[1994] STC 763.**
[13] ***Ibid*. at 782.**
[14] **[1999] STC 173.**
[15] **12 TC 773 at 781.**

> …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 forsees 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* where it was held[16] 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 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 UK Inland Revenue (1997, 1998, 1999a-c, 2001[17]). 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 depreciated.

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 posted to fixed assets as opposed to current assets. However, it has now been established that it does not make

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[16] **[1999] STC 173 at 174.**
[17] **Accessible at http://www.inlandrevenue.gov.uk/bulletins/**

any difference for tax purposes where deferred revenue expenditure is held on the balance sheet.

The Inland Revenue (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.

4. A Wider Perspective

There is also an historical and international dimension – with the relationship between accounting and taxation developing differently in different countries. 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 harmonisation. It is clear from the foregoing discussion that this is related to accounting harmonisation and the approach of the courts to such questions in different countries. The progress of European tax harmonisation in general has already been discussed in this journal (James, 2000) and this particular aspect has been seen as obstacle. The Ruding Report (1992: 195) 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: 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.'

5. Conclusion

The relationship between accounting and taxation is an evolving one and more complex than might at first appear. 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 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. Sometimes there is no absolute rule – it depends on the circumstances. Sometimes one approach is seen as best in one country but not in another. For example, with reference to more general issues of taxation, Littlewood (2002: 212) wrote with respect to Hong Kong:

> Judged by criteria regarded by most of the rest of the world as axiomatic, Hong Kong's tax system is grossly flawed. That it has nonetheless succeeded suggests that there may be something wrong with these criteria, and with the theory that surrounds them.

It might be that the analysis of tax principles and policies is not yet sufficiently sophisticated to offer a full understanding of the ways in which tax systems can successfully achieve their objectives. This is also true of the present topic. It is clear is that with continuing developments in both accounting and in taxation, the relationship between the two is not fixed indefinitely.

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