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WORKING PAPER

The Changing Relationship Between Tax and Financial Reporting in Spain

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The Changing Relationship Between Tax and Financial Reporting in Spain

Abstract

The degree of connection between tax and financial reporting is regarded as a key factor in the study of international accounting differences. The position for Spain is briefly outlined in previous research but without examination of any specific accounting issues except, in outline only, depreciation and the tax-free revaluation of assets from 1977 to 1983. The absence of a detailed study of the major tax/accounting linkages for Spain is of particular importance because the relationship is regarded as having changed dramatically in the early 1990s, from a position of tax dominance. In order to measure the links between tax and financial reporting, we adopt the methodology of Lamb *et al.* (1998) by assessing major accounting topics using a five-case classification shown as Table 1. We refute the proposition that suggests that the link between tax/accounting has been reduced substantially.

Keywords: tax, accounting, Spain.

Journal of Economic Literature Classifications: M41

The Changing Relationship Between Tax and Financial Reporting in Spain

1. Introduction

The degree of connection between tax and financial reporting is regarded as a key factor in the study of international accounting differences (e.g. Doupnik and Salter, 1995; Choi, Frost and Meek, 2002, ch. 2; Radebaugh and Gray, 2002, ch. 2; Nobes and Parker, 2002, ch. 2). Hoogendoorn (1996) summarises the position for 13 European countries as an introduction to papers concerning tax/accounting links on those countries. Lamb *et al*. (1998) look in detail at the issue for four countries. However, Spain is not included in any of this literature.

The position for Spain is briefly outlined by Blake *et al***.** (1997) but without examination of any specific accounting issues except, in outline only, depreciation and the tax-free revaluation of assets from 1977 to 1983. Labatut and Pardo (1995) examine the accounting and tax rules for the special case of legal mergers (*fusiones*), but this is not relevant for our paper. Gallego and Galende del Canto (1995) examine the accounting and tax rules for the single issue of research and development costs, and we refer to this later.

The absence of a detailed study of the major tax/accounting linkages for Spain is of particular importance because the relationship is regarded as having changed dramatically in the early 1990s, from a position of tax dominance. For example, Gonzalo and Gallizo (1992) suggest:

> In the past, commercial law was not a major source of accounting standards, and this meant that tax regulations were the main driving force for bookkeeping and its regulation by specific rules. The main purpose of business accounting in Spain, as in other southern European countries, has been to enable companies to discharge their tax obligations. Therefore, the main users have been the tax authorities, and to a lesser extent banks, shareholders, and other owners of businesses. But it is the tax authorities who, with the issuance of standards regulating the valuation, naming, and recording of items – mainly with a view to taxes on income and sales and

> excise taxes – have shaped the accounting practices of companies, from sole proprietorships up to the largest Spanish corporations. (p.76)

Similarly, Martinez (2001) states that the first *plan general de contabilidad* (PGC) of 1973 was:

> … excessively rigid and more concerned with the content of the accounts from the point of view of taxation than with a meaningful reflection of the economic situation of the companies. (p.1112)

A major reform to Spanish accounting occurred with the implementation of the Fourth, Seventh and Eighth EU Directives on company law by means of Acts of 1988 and 1989 and revision in 1990 of the *PGC*. These came into force in 1990 and 1991. The implication in the literature is that this reduced the tax/reporting linkage (Gallego and Galende del Canto, 1995, p.361).

A further important change occurred in 1995 when the Tax Law (Law 43/1995) was approved, replacing the Royal-Decree of 1982. This included revisions to take account of the changes to accounting requirements of the 1990s.

This paper seeks to test in detail the hypothesis that there have been major changes in the Spanish tax/reporting relationship since 1989. In particular, this can be expressed as a testable proposition:[1]

> P_1: The close linkage between tax and financial reporting that prevailed in Spain before 1990 has been substantially diluted.

2. Methodology

In order to measure the links between tax and financial reporting, we adopt the methodology of Lamb *et al*. (1998) by assessing major accounting topics using a five-case classification shown as Table 1. The assessment is made by a direct examination

[1] We use the word "proposition" rather than "hypothesis" in order to avoid the implication that it will be subject to statistical testing.

of the tax rules and the reporting rules in 1989 and again in 1994 and in 2003, that is at dates between the two major changes mentioned in section 1. For some topics, where accounting rules are more specific than the tax rules but still allow choice (i.e. in principle, Case III topics), there may still be a tax influence in that one of the accounting choices has a more favourable tax result. Where there is scope[2] for this "reverse effect", we follow the approach of Lamb *et al.*, and score Case III[†].

There are some references to Spanish practices in an EU-wide survey that included 30 Spanish companies (FEE, 1991 and 1992). These data relate to financial statements of 1989 and we use them where possible for that year. However, the FEE surveys cover consolidated statements, which were purely optional in 1989, so the surveys need to be interpreted with care. We also refer to a study of the practices of 60 Spanish companies for the years 1992 to 1995 by Lainez *et al***.** (1999). One potential further source of information is the analysis of deferred tax. However, the disclosures by Spanish companies are generally not sufficiently detailed to be able to identify for which topics the financial reporting and tax practices are different.

In order to compare Spain with the four countries of Lamb *et al.* (i.e. France, Germany, the UK and the USA), we not only use their case system but also their choice of 15 major accounting topics. However, we add the topic of financial assets which was not covered by Lamb *et al.* because they based their list on International Accounting Standards of the time. The resulting list of 16 topics is shown as the first column of Table 2.

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[2] We interviewed: Jordi Bueno from PricewaterhouseCoopers, Carme Jover, independent consultant; Albert Sagues, independent consultant; Anselm Constans a former auditor from PricewaterhouseCoopers; Emili Gironella, Gironella Velasco Auditores; Joan Borges and Antonio Torrente, Gabinete Rocafort Asesores Asociados.

Table 1 Cases of linkage between tax and financial reporting

Case I	**Disconnection**	The different tax and financial reporting rules (or different options) are followed for their different purposes.[1]
Case II	**Identity**	Identity between specific (or singular) tax and financial reporting rules.
Case III	**Accounting leads**	A financial reporting rule or option is followed for financial reporting purposes, and also for tax purposes. This is possible because of the absence of a sufficiently specific (or singular) tax rule.[2]
Case IV	**Tax leads**	A tax rule or option is followed for tax purposes, and also for financial reporting purposes. This is possible because of the absence of a sufficiently specific (or singular) financial reporting rule.
Case V	**Tax dominates**	A tax rule or option is followed for tax and financial reporting purposes instead of a conflicting financial reporting rule.

[1] Such disconnection will be recognised when distinct, independent and detailed tax and financial reporting operational rules exist. Even if measurement outcomes are essentially the same, the particular arena may still be characterised as Case I; the independence and completeness of the sets of rules 'disconnects' tax and accounting in an operational sense.
[2] This case may be either *de facto* identity or an instance where financial reporting is the 'leader'. It may be difficult to distinguish between the two circumstances. However, both indicate a *prima facie* financial reporting influence on tax.

Table 2 Tax linkage in material arenas of financial reporting in Spain

	Arena	1989	1994	2003
1	Fixed asset measurement	IV	IV	IV
2	Lease classification	V	I	I
3	Depreciation			
	(a) normal	IV	IV	IV
	(b) excess	I	I	n.a.
4	Contingencies, provisions	I	I	I
5	Grants and subsidies	I	I	III
6	Research and development costs	III†	III†	III†
7	Inventory valuation:			
	(a) flow assumptions	IV	IV	III
	(b) other areas	II	II	III
8	Long-term contracts	III	III†	III†
9	Interest expense			
	(a) capitalisation	II	III	III
	(b) other	II	II	II
10	Foreign currency transactions	I	I	III
11	Non-consolidation purchased goodwill	II	I	II
12	Pensions	I	I	I
13	Policy changes and fundamental errors	IV	II	III
14	Scope of the group	I	I	I
15	Fines, charitable donations, entertaining expenses	I	I	I
16	Financial assets	II	II	II

As with previous research, there is a concentration on unconsolidated financial statements because consolidated statements are not directly relevant for tax. In cases where the rules or practices for large and small companies differ, we assess large companies and mention the difference in the text. We do not consider the rules or practices relating to banks and insurance companies where these differ from those of the generality of companies.

3. Assessing the links

In this section, we examine the relationship between tax and financial reporting for the 16 topics of Table 2 for 1989, 1994 and 2003.

1. Fixed asset measurement

Revaluation of fixed assets has been periodically allowed in accounting legislation (Gonzalo and Gallizo, 1992, pp.122-4; Martinez, 2001, pp.1139-40). Until 1995, revaluations were common (FEE, 1992, p.107) because they were not taxable and the revalued amount could be depreciated for tax purposes in the following years. This was an example of a Case IV (tax leads).

The 1995 Tax Law specifies that the amount of any revaluation should be disclosed in the notes to the financial statements and that, in principle, revaluations are not taxable unless another tax law makes them so. However, the 1996 revaluation[3] applied a 3% tax on the increment (Diaz and Torre, 2001, pp.2263-6). In consequence, in comparison to previous revaluations, fewer companies revalued[4] (Hervás, forthcoming). This still suggests a Case IV (tax leads).

[3] Royal Decree Law 7/1996.

[4] The 1996 revaluation was very complex, conditioned to the finance structure of the company, and a 3% tax was required. The previous one had been shortly before, in 1993. For these reasons, many companies decided not to make use of this revaluation opportunity. Further information taken from an article from a consulting company, J. Olano Associats; www.olano-associats.es/articulos.html?art11.htm].

2. Lease classification

The PGC of 1973 treated all leases as operating. However, a tax law of 1977 (art. 25.1-25.4)[5] established that, if a lease contained a purchase option, it became a finance lease upon which depreciation was allowed in addition to the periodic rental payments. The FEE survey (1992, p.159) suggests that a majority of listed companies capitalised some leases. This suggests a Case V; that is, tax considerations overriding the accounting guidance[6] of the PGC.

The 1990 PGC introduced into accounting legislation the distinction between operating and finance leases on the same basis as the tax law. The treatment of finance leases under tax law remains the same, with periodic payments being deductible as well as depreciation. For accounting purposes, depreciation and a finance expense are charged instead of the rental payments.[7] This is Case I (disconnection).

3. Depreciation

(a) Normal

Tax legislation clearly specifies the methods allowed and the maximum deductible (Royal Decree 2631/1982, Articles 45-46; and Royal Decree 537/1997, Articles 1-5) whereas accounting legislation establishes very general guidelines (PGC 1973 and 1990). In principle, depreciation for financial reporting should be calculated independently from tax regulations. However, in practice companies charge these tax-regulated amounts (Gonzalo and Gallizo, 1992, p.132). The straight-line method is required for tax purposes for many types of assets, although reducing balance is allowed for some. The FEE survey (1992, p.110) suggests majority usage

[5] Tax Law 26/1988 (Seventh Additional Disposition) elaborated this for banks and similar institutions.
[6] The PGC of 1973 was not compulsory but was the most detailed guidance on financial reporting.
[7] Tax Law 1992, Article 13 e) and Tax Law 1995 Article 128.5, 128.6 and 128.7.

of straight-line depreciation for financial reporting, as do Lainez *et al*. (1999, p.108). This topic has always been a Case IV (tax leads).

(b) Excess

Before the enactment of the 1995 Tax Law, excess depreciation was sometimes allowed[8] as an investment incentive. In principle, commercially reasonable amounts should be charged in the income statement, leading to deferred tax (Case I), although small companies might not follow this.[9] Since 1995, excess depreciation is only allowed for tax purposes in small companies and in very specific cases.

4. Contingencies, provisions

The accounting regulations (PGC of 1973 and 1990) lay out the allowed provisions in general terms, and prudence is interpreted as requiring accrual for anticipated losses. However, tax law (1982 Royal-Decree, Art. 84; and 1995 Law, Art. 13.d) allows only those provisions related to specified third parties and when an obligation already exists. This is Case I.

5. Grants, subsidies

Until 1995, tax law specified that income received from grants and subsidies was immediately taken to the profit and loss account (Royal Decree 2631/1982, Article 91) whereas under accounting legislation income was recognised progressively as assets were depreciated (1973 and 1990 PGC). This was a Case I

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[8] For example, Royal Decree 2/1985, Art. 1.

[9] According to Carme Jover, specialist in small companies, no difference was made. According to Anselm Constans and Jordi Bueno medium and large companies accounted differently for accounting and tax purposes.

(disconnection). However, the 1995 tax law is not explicit in this area, so therefore this topic has become a Case III (accounting leads).

6. Research and development costs

In the 1973 PGC, there were only some general guidelines. In 1989 and before, taxation law specified more comprehensively that capitalised R&D costs could be amortised over a five-year period (Royal Decree 2631/1982, Article 65.2). In practice, R&D was only capitalised by a minority of companies (FEE, 1991, p.35), which might be to avoid complication or to maximise expenses for tax purposes (Case III†). An accounting resolution in 1992 (ICAC, 21st January 1992) specified the general conditions to allow capitalisation and required amortisation over a period of up to 5 years. This left the position at Case III†.

The new tax law of 1995 allowed an amortisation period in excess of 5 years once the project is finished and sometimes it can be freely amortised (Law 43/1995, Article 11). Gallego and Galende del Canto (1995) explain the rules. Lainez *et al.* (1999, p.108) show that all the companies in their sample used an amortisation period of up to 5 years until 1995, when a few companies started to use a longer period. Therefore, the formal position remains Case III because the accounting choice will be followed for tax purposes. However, to the extent that companies decide to capitalise R&D because they receive tax deductions in excess of the cost there is still a potential tax influence (Case III†).

7. Inventory valuation

(a) Flow assumptions

Until 1995, tax legislation allowed only average cost and FIFO, but accounting legislation permitted these and other methods as long as there were explanations in the notes to the financial statements (1982 Decree, Art. 80.1). In

practice, most companies used average cost or FIFO as allowed by tax law, although there was some small usage of LIFO (FEE, 1992, p.132; Lainez *et al.*, 1999, p.109). Therefore it was a Case IV.

Since 1995, tax legislation is absent in this area, therefore it has become a Case III.

(b) Other areas

Regarding the valuation of inventory, accounting rules (PGC 1973 and ICAC Resolution of 9th May 2000) and tax legislation (Royal Decree 2631/1982, Art. 76.2) both required a reasonable part of overheads to be included, therefore it was a Case II. Since 1995, tax legislation is absent in this area. It has become a Case III.

8. Long-term contracts

Until the PGC of 1990 income was recognised when the asset was delivered to the customer. Tax followed this, so it was a Case III.

After 1990 (except for construction companies),[10] income can be recognised using the percentage of completion basis. However common practice is still to recognise income when the contract is completed. Tax legislation remains absent in this area, so the use of the completed contract method postpones tax (i.e. Case III†).

9. Interest expense

(a) Capitalisation

Under the PGC of 1973, interest expenses could not be capitalised and the same was established by tax law (1982 Decree/Art. 53). This was a Case II.

From 1990, the PGC allows for capitalisation of interest costs in certain cases, and it is quite common (Lainez *et al.*, 1999, p.108) Tax legislation is not specific, therefore this is Case III.

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[10] For which, the percentage method is compulsory when certain criteria are met.

(b) Other

Throughout the whole period both accounting and tax law[11] establish an accrual basis. This is Case II.

10. Foreign currency translation

Accounting legislation (PGC 1973 and 1990) establishes that only negative differences on the translation of unsettled monetary balances should be taken to the profit and loss account, although practice was not entirely uniform, at least in consolidated statements (FEE, 1991, p.246). Before 1995, tax legislation (Royal Decree 2631/1982, Article 51) recognised neither positive nor negative differences until the payments were paid or received, therefore this was a Case I (disconnection).

From 1995, tax legislation is not specific, therefore this topic has become a Case III (accounting leads).

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[11] Law 43/1995, Article 19.1.

11. Non-consolidation purchased goodwill

Before 1990, accounting legislation (PGC 1973) did not allow amortisation of goodwill and the same principle was established by tax legislation (Article 66, RIS). This was a Case II. In 1990, the PGC established a 5-year period of amortisation (or up to 10 years with supporting explanation), whereas tax legislation did not allow amortisation. Practice was varied (Lainez *et al.*, 1999, p.108). This was a Case I (disconnection).

From 1995, both accounting and tax law (Law 43/1995, Article 11.4) allow for a maximum of 10-years to amortise. This is a Case II (identity). (Royal-Decree 4/2004 allows for a maximum of 20-years to amortise (It will be a Case I).

12. Pension provisions

In Spain, companies pay into a social security system managed by the government that guarantees pensions. These payments are charged for accounting purposes and are completely tax-deductible. These defined contribution schemes do not give rise to provisions. On the other hand, some sectors have a general agreement by which a company provides a pension tied to specific conditions: retirement, number of years in the company, etc. Under the Law 8/1987, expenses related to externally funded pension obligations were only tax deductible if required by the general wages agreement. Otherwise, pension expenses are deductible only when the premium (or the pensioner) is paid (Gonzalo and Gallizo, p.135). Therefore, this was a Case I (disconnection).

The 1990 PGC made it compulsory for the first time to accrue for pension obligations that are not funded externally. Provisions could be gradually set up over 7 to 15 years. The provisions are not deductible until the worker is paid. This was not matched by any change in the tax law, so it remained Case I.

In 1999 accounting legislation eliminated internal pensions progressively and made external pensions compulsory (Orden of 29th December). Therefore, this remains a Case I.

13. Policy changes and fundamental errors

Before 1989, these issues were covered by tax legislation[12] but not by accounting rules. Art. 283 (c) of the tax law[13] stated that errors should be corrected through the income statement as soon as known. Regarding policy changes in amortization, they had to be approved by the government in order to be accepted for tax purposes.[14] This was a Case IV. The PGC of 1990 established that effects of policy changes should be reflected in the profit and loss account as an extraordinary amount. The amounts remained relevant for tax (Case II).

The 1995 Tax Law contains no instructions in this area, so accounting legislation is now more detailed (Case III).

14. Scope of the group

No clear definition of the group was available until 1989. Consolidation was not required and was uncommon. For accounting purposes, a group is now defined by the Accounting Law[15] that adopted the Seventh EU Directive.

The Tax Laws of 1977, 1995 and 2001(Article 2) include a tax group definition different[16] from the accounting definition, so the topic should be classified throughout as Case I.

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[12] Part 5. Valuation rules.
[13] Royal Decree 2631/1982.
[14] Article 57.
[15] Law 19/1989.
[16] For example, the subsidiary must be Spanish and held 75% or more.

15. Fines, charitable donations, entertaining expenses

Specific tax rules on the non-deductibility of these items are given in the Tax Law (1982 Decree Art. 125; 1995 Law Art. 14.1). This area therefore qualifies as Case I (disconnection).

16. Financial assets

Accounting legislation (1973 PGC and 1990 PGC) and tax legislation (Article 17.1. RIS and Article 12.3 - 12.4, Tax Law 1995) coincide throughout the period, with only a few differences . Generally financial assets are valued at the lower of cost or market. This is a Case II identity.

4. Synthesis and international comparison

The assessments of Table 2 are combined in the three columns for Spain in Table 3. Unlike the equivalent table in Lamb *et al*., we have separated Case III and Case III† (the latter entailing potential tax influence on financial reporting). We suggest two measures of tax influence: (i) the excess of Cases IV and V over Case I, and (ii) the excess of Cases III† , IV and V over Case I. These reflect, respectively, "minimum" and "maximum" tax influence for the date concerned. The measures show that the implementation of the Fourth Directive in Spain caused some small reductions in tax influence but no major re-alignment. On balance, the linkage is approximately as close now as it was before 1990. This shows that Proposition 1 (of section 1 of this paper; concerning a significant reduction in tax influence) can be rejected, which runs against the general analysis in the literature.

Table 3 also contains the assessments for the four countries of Lamb *et al*. (1998), adjusted[17] for an extra topic (see Section 2) and for the split of Case III (see

[17] The extra topic is the measurement of financial assets. We score this: I for the UK and the USA because revaluations have no tax effect; III† for France because there are no tax rules but impairments below cost are tax deductible; and V for Germany because financial reporting followed the tax law that allowed a value lower than cost or market to be retained (HGB, §280).

above). As a result, Table 3 shows that Spain was, and remains, intermediate between Germany/France and the UK/US in terms of tax influence.

5. Summary, limitations and the future

We provide here the first detailed study on the operational linkages between Spanish tax and financial reporting for a substantial list of accounting topics. We extend the literature not only by covering Spain but by looking at developments over more than a decade rather than at one date. We also refine the techniques of the most detailed previous paper (Lamb *et al.*, 1998) by suggesting minimum and maximum measures of tax influence. The proposition in the literature is that the tax domination of Spanish accounting was substantially reduced from 1990. We refute that.

We note here three limitations of this research. First, although most topics can be categorised by referring to rules, in some cases it is not clear whether a Case III topic involves a reverse effect. To assess the possibility of this, we have had to rely on surveys for some topics for 1989 and 1992/5, and otherwise on some references in books and on the experience of six practitioners whose names we list in the acknowledgements. A second limitation is that the scores for the four countries other than Spain relate to 1996, so they are most suitable for comparison with the 1994 scores for Spain. A third limitation is that all the 19 topics or sub-topics of Table 2 are counted equally for the purposes of Table 3. We follow Lamb *et al.* in doing this, and no other basis is obviously better.

From 2005, International Financial Reporting Standards (IFRS) are compulsory in Spain for the consolidated statements of listed companies. This has no direct effect on unconsolidated statements or, therefore, on tax. However, there are plans to adapt the PGC gradually towards IFRS in the coming years. This may lead to amendments to tax law, possibly to establish further disconnections from financial

reporting (e.g. so that unrealised but recognised gains and losses from the use of fair values are not relevant for tax).

Table 3 International comparison of linkages

	Germany	France	Spain 1989	Spain 1994	Spain 2003	US	UK
Case I	2	4.5	7	9	5	12.5	13
Case II	0	5	5	4	3	2.5	2
Case III	5.5	2.5	1	1	6	1.5	1.5
Case III†	2	2	1	2	2	0.5	1.5
Case IV	6.5	4	4	3	2	1	0
Case V	3	1	1	0	0	0	0
n/a	0	0	0	0	1	1	1
Total	19	19	19	19	19	19	19
Cases IV/V – Case I	+7.5	+0.5	-3	-6	-3	-11.5	-13
Cases III†/IV/V – Case 1	+9.5	+2.5	-2	-4	-1	-11	-11.5

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