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**The Relationship Between Tax  
Regulations and Financial Accounting: a  
Comparison of Germany, Spain and the  
United Kingdom**

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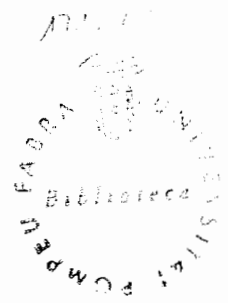
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## Abstract

This paper examines the relationship between tax regulations and financial accounting in three countries. Germany has a binding link between tax and accounting, as commonly portrayed in the literature. This link tends to lead to conservatism and consistency, and is justified on those grounds. However, we find some exceptions where the link actually works against conservatism and can lead to inconsistency. Spain has moved from a strong traditional tax-accounting link to a formal separation, although some curious results of the traditional link continue. In the UK, although the link is not formally binding, tax factors have a variety of powerful impacts on accounting regulations. Thus the paper challenges the stark contrast commonly identified in the literature between Germany and the UK in this respect, while identifying a recent deliberate change in Spain.

The Relationship between tax regulations  
and financial accounting: a comparison  
of Germany, Spain and the United Kingdom

Introduction

One reason for international differences in accounting practice that is commonly cited is variation between the impact of taxation requirements on tax law. Germany and the UK are frequently cited as contrasting examples in this respect. For example Llewellyn and Naylor (1993) assert:

"UK accounting practices have developed separately from tax law ...whereas German accounting has been significantly affected by tax rules"

Nobes (1992) offers a 'two-group classification' of the accounting environment in a number of countries. One group, headed by the UK, has as a 'general accounting feature' the observation 'tax rules separate' and as a 'specific accounting feature' the observation 'No tax-induced provisions.' The other group, including Germany and Spain, has as a contrasting 'general accounting feature' the observation 'tax-dominated' and as a 'specific accounting feature' the observation 'Tax-induced provisions'.

Nobes (1989) points out that the issue of the extent to which 'taxation regulations determine accounting regulations' can be seen 'in a negative way' by looking at the extent to which deferred taxation is an issue. He cites the UK, the Netherlands, and the USA as countries where deferred tax has caused controversy in contrast to

France and Germany where 'the problem does not really exist to be solved' because 'to a large extent ... the tax rules are the accounting rules' (p.8).

This paper examines and contrasts the relationship between tax regulation and accounting regulation in Germany, Spain and the United Kingdom, with a view to considering the validity of the stark contrast which is generally drawn between the two approaches.

### The German Legal Position

The link between tax accounting and financial accounting has been explicit in Germany from the introduction of income tax in 1874 in the states of Bremen and Sachsen. In 1920 the concept was introduced into the national income tax code and in 1934 the term 'Massgeblichkeitsprinzip' was introduced into the German tax code (Haller 1992). This term can be translated as the 'principle of bindingness' (Nobes 1989, p.8-9) or 'principle of congruency' (Haller 1992 p.310). Taxable income is computed, in principle, by comparing an opening and closing tax balance sheet, the Steuerbilanz. This balance sheet is based on the published financial balance sheet, the 'Handelsbilanz'. Under the Massgeblichkeitsprinzip:

- a) Generally Accepted Accounting Principles as laid down in Commercial Law apply to the financial balance sheet and, for issues not covered in tax law or where there is no conflict in tax law, these principles apply in the same way in the tax balance sheet.

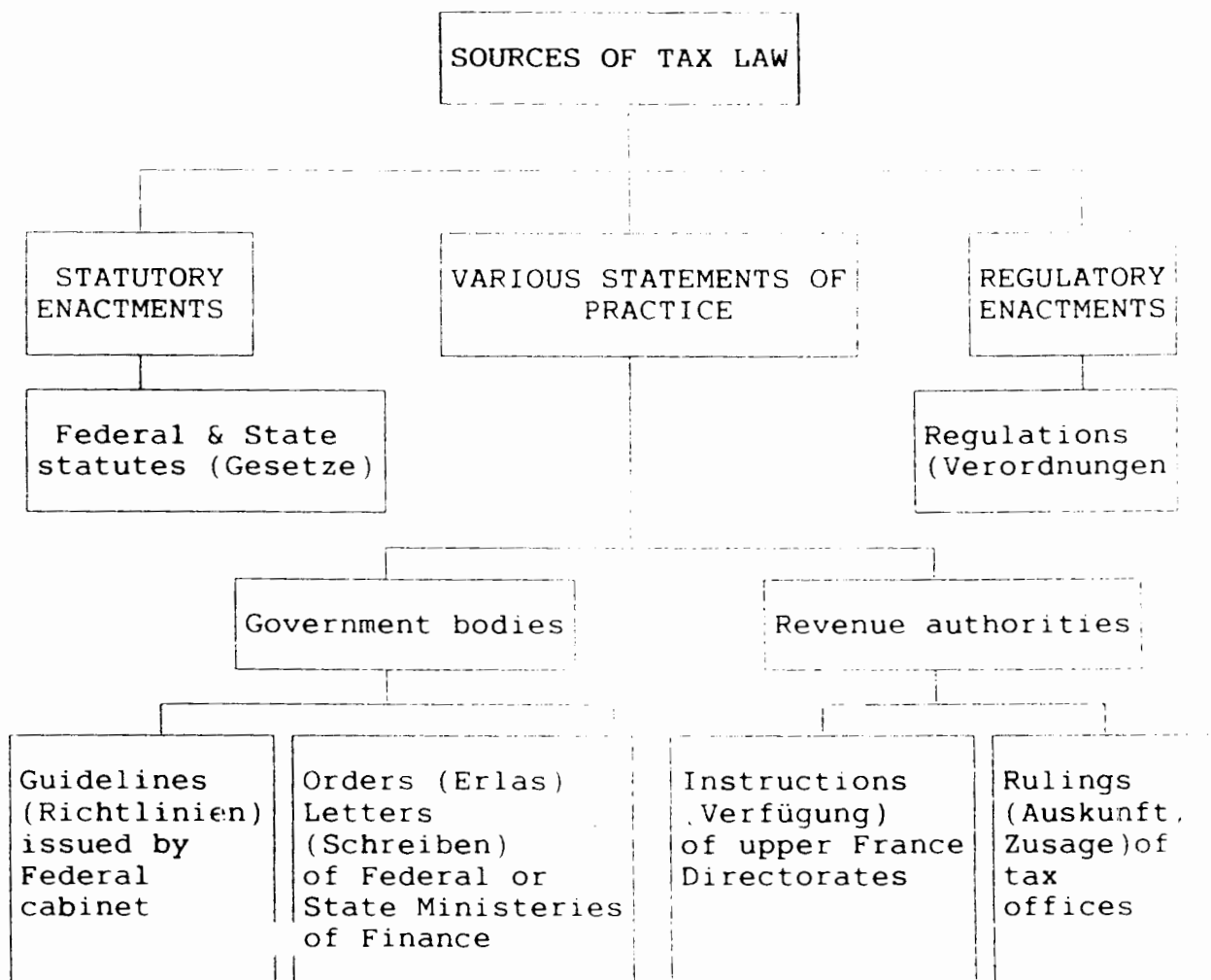
b) In some cases tax regulations may offer opportunities to reduce taxable income compared to the provisions of commercial law. These tax benefits may only be enjoyed if they are reflected in the financial balance sheet as well as the tax balance sheet, so that in practice firms will accept these tax regulations as a constraint on their choice of accounting policy in the financial accounts.

c) In certain special cases the tax regulations may increase taxable income compared to the provisions of commercial law. In these cases the tax regulations must apply in the tax balance sheet so that the 'massgeblichkeitsprinzip' has no effect.

Many firms use one united Balance Sheet, the 'Einheitsbilanz', in which case the notes to the accounts must disclaim any valuation options given in commercial law which are not covered by the tax law.

Commercial Accounting law is laid down in the commercial code - the Handelsgesetzbuch (HGB) - which incorporates the provisions of the EC fourth and seventh directives. Figure 1 summarises the sources of tax law.

Figure 1



The tax code does not embody many specific accounting regulations as there is a general provision that commercial accounting principles apply.

When deciding on what sources of authority to apply when drawing up a set of company accounts accountants will consider:

1. The general rules in the commercial code.
2. The specific provisions of the commercial code.
3. Provisions specific to a particular type of entity.
4. Tax law.

Only if these sources of authority do not cover a specific issue will recourse be had to the pronouncements of the Institut der Wirtschaftsprüfer (IdW). An observation made to us by a partner in a leading professional practice was that while the IdW commands high professional respect the extensive coverage of accounting topics by law and regulation means that no tradition of following professional guidance has built up; he cited the failure of the IdW's proposals on inflation accounting in the 1970's as an example of this lack of influence.

The massgeblichkeitsprinzip is generally recognised as a central and distinctive feature of German accounting regulation. Thus Haller (1992) observes "the German situation is, with regard to the intensity, the role, and the closeness of interdependence, a special one." (p.311), while the Massgeblichkeitsprinzip is also referred to as the "authoritative principle". (Arthur Anderson 1991).

The tax accounting link is supported by the "Betriebsprüfungen", audits performed by the tax authorities on individual companies every three to four years. One practitioner we spoke to commented on the inconsistency of approach in these audits. He cited a case where a normally acceptable bad debt provision was challenged by the tax auditor, and added:

"Obviously, very much depends on the particular Betriebsprüfer (auditor); some of them would not even look at receivables for reasons of materiality, others only watch these smaller amounts (and forget about significant things such as incorrect stock valuation). In principle, the tax authorities are absolutely free to see whatever



they wish to see.

We have seen some clever clients who have deliberately drawn the Betriebsprüfer's attention to trivial mistakes in order to deviate them from the real issues."

### The Massgeblichkeitsprinzip and the European Community

Haller (1992) observes that the German government successfully resisted a proposal that the EC fourth directive should require separation of tax accounting and financial accounting rules (p.321).

He further observes:

"In Germany all groups concerned, the political parties and the government, have agreed that in implementing the EEC directives an increase in the tax burden on the firms must be avoided in all circumstances. This attitude of a taxation-neutral implementation of the EEC accounting rules had a very substantial impact on the transformation of the Directives into German law because of the existence of the 'Massgeblichkeitsprinzip', which (as a sacred cow) has not been changed or even restricted by the legislator. Consequently, there was the strong intention to change the accounting principles as little as possible in implementing the Directives, because nearly all changes would have had an influence on the tax computation. Thus the principle of congruency was the main reason for the very conservative

transformation of the fourth Directive in Germany. This effect becomes very clear especially in regard to the 'true and fair view' principle which has been interpreted in Germany in a quite different and much weaker manner than, for example, in Great Britain." (P.317).

The very implementation of the EC fourth directive has been seen as being delayed in order to consider the impact of reforms on the tax position (Brooks and Mertin 1985).

The initial proposed directive on European accounting harmonisation did not include a 'true and fair view' override, imposing a legalistic approach on accounting. (Stein 1971, p.356). It was the UK accounting bodies that successfully lobbied for an amendment to the proposed Directive that would impose the 'true and fair view' override and thereby preserve their traditional role (Hopwood et al, 1990, pp.84-85).

Busse von Colbe (1984) offers a translation of the German draft law introducing the EC fourth directive, with a comment on the 'true and fair view' as follows:

"In spite of the pretentious formulation it is supposed that for practice there will be no principal changes" (p.123).

Busse von Colbe goes on to offer the opinion:

"This view, that the true and fair view concept will not have serious consequences for financial accounting in Germany, corresponds to the majority of opinion in German practice."

Ordelheide (1993) argues that within the European context 'true and fair view' must be interpreted not by reference to previous practice in one EC member state, the UK, but by reference to the EC fourth directive within which the term makes its main appearance in European law. Since that directive is based on a legalistic approach to accounting, with a more conservative approach to valuation principles than has been traditional in the UK, then the European court might interpret the 'true and fair view' as being applicable in a more restricted way than has been the case in the UK:

"It might well be that by this Great Britain gets back its 'Trojan Horse', but now filled with a legalistic system instead of a professional one, with the addition of being characterised by the more prudent accounting of the continent." (p.83).

#### The Matching of the Massgeblichkeitsprinzip with other user needs

Application of a close tax-accounting link tends to lead to a conservative approach to accounting. As Macharzina and Langer (1991) summarise the position:

"German accounting in general is rather conservative. The impact of the tax law largely determines accounting for individual financial statements. Expenses therefore are only considered to be tax deductible if the commercial accounts contain the same figure. This may lead to considerable distortions in the presentation of net worth, financial position, and results" (p.195).

Busse von Colbe (1984) offers a list of reasons why this

conservative orientation in accounting suits the German economic environment:

- a) The power of worker representatives on supervisory boards means that high reported profits could lead to high wage claims.
- b) Banks, the major source of finance for German industry, have direct access to financial data from their representatives on company boards and therefore are not dependent on published accounts.
- c) Shareholders may claim up to a fixed percentage of company profits as dividends, so that high reported profits can lead to related cash outflows.
- d) Creditor protection is best served by conservative accounting principles.

Effectively, a generous set of tax allowances means that the government reduces its claim for revenue on business. The tax-accounting link means that, 'in a sense of fairness', as Haller (1992 p.314) puts it, the claims of other parties, both investors for dividends and employees for wages, are similarly reduced.

### Specific Examples

Two examples of the tax-accounting link are offered by way of illustration.

One, provided to us by a practitioner, relates to the Erfindervergütungen (inventor's remuneration). In certain circumstances where an engineer makes an invention that is registered on behalf of the company then the company may be obliged to let the employee participate in future profits. Frequently engineers do not know of their entitlement and their employers abstain from informing them. Nevertheless, the company will make a provision for the potential compensation payments that may arise. When the employee has left the company the prospect of payment becoming due becomes progressively smaller, to the point where the tax authorities may query the ongoing validity of the provision.

Accounting for pension costs offers an interesting example of how the Massgeblichkeitsprinzip may lead to less conservative accounting. Seckler (1992 pp.238-239) identifies two ways in which German accounts tend to underestimate the impact of pension obligations:

- a) Accruals are not made for pension arrangements made via company welfare funds even though the labour court has held that the company is ultimately liable for these obligations. They are disclosed in the notes to the accounts.
  
- b) Tax law lays down some artificial and restrictive actuarial assumptions for computing the present value of pension liabilities including exclusion of employees under the age of 30, disregarding of future pay increases, and a fixed discount of 6%

## The Spanish Legal Position

Since the 1950's the tax/accounting relationship has gone through three very different stages:

### a) From the mid 1950's to 1978

Up until 1978 most businesses were taxed, not by reference to any measure of profit, but by a process known as 'Estimación Global'. This process involved the Spanish tax authorities in prescribing, for each business sector, the total tax to be borne by that sector. The society representing businesses in that sector then determined the basis on which the tax burden should be allocated among its members. Since accounts were not required for tax purposes many small businesses found no reason to employ an accountant. Thus the tax system for smaller businesses had no direct link to the accounts. However this system had a strong indirect impact on delaying the growth of an accounting profession in Spain.

### b) From 1978 to 1989

In 1973 Spain had introduced a Plan General de Contabilidad (PGC), or accounting plan, similar to the French accounting plan of 1957. This plan was initially applied on a voluntary basis. In 1978 the Government granted a tax amnesty to those firms undertaking to apply the PGC. Thus a tax incentive was used to promote an improvement in the quantity and quality of accounting disclosure.

The transition from the Franco regime to democracy was accompanied by important changes to bring legislation into line with other European countries. As we have seen, there was a strong French influence on the first PGC. In line with this French tradition, tax rules prevailed over accounting rules. As Cea (1988) observes, the accounting profit would coincide with the taxable profit (p.30). Cubillo (1983) commented that "tax law establishes channels through which accountancy must run, so that it is fiscal data that is recorded in place of accounting data" (p.56). Similarly Gonzalo and Gallizo (1992) observe that at this time "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" (p.76).

One example of this situation is that the accounting treatment of finance leases was identical to the tax treatment, unlike the situation in most European countries.

In 1979 the Asociación Española de Contabilidad y Administración de Empresas (AECA) was formed. During the 1980's AECA took the initiative in proposing a number of detailed accounting standards. According to Gonzalo and Gallizo this work was, in part, a 'reaction' against the 'predominantly tax orientation' of the PGC.

c) 1989 onwards

With the entry of Spain into the European Community in 1986 an important process of revision of legislation began. With the

enactment of a new company law in 1989, and the issue of a new PGC applicable to all firms in 1990, accounting profit was separated from taxable profit. Labatut (1993) summarises the position:

"The anglo-saxon approach of separating and considering independently accounting and tax principles is now firmly established" (p.208)

and

"The Plan repeals all the tax based requirements which impose requirements on accountancy" (p.220).

#### Differences between accounting profit and taxable profit

Spanish firms now prepare their financial accounts in line with the Plan General de Contabilidad, normally supplementing this with the non-mandatory recommendations of AECA. At the same time, taxable profit is computed in line with tax law. In line with IAS 12, taxation is regarded as a cost of the year in which related profit is earned. As Cañibano (1991) observes: "Taxation should be recognised in the year it arises, not when it is paid, being similar to wages, finance charges, or any other type of expense."

Amat and Monfort (1992) offer a table summarising some major examples of differences between accounting and taxable profit (see figure 2).



Figure 2

Differences between accounting profit and taxable profit

Timing differences

Provision for doubtful debts  
Provision for obsolescence  
Pension fund provision  
Differences in stock valuation  
Differences in depreciation  
Deferred income on credit sales  
Finance leasing

Permanent differences

Amortisation of Goodwill  
Tax penalties  
Items disallowed for tax purposes  
Directors' fees  
Special tax allowances for reinvestment

Attributable to an earlier or later fiscal year

Attributable to the current fiscal year

Considering some of these examples in more detail:

- a) An accounting provision for doubtful debts may exceed that allowed for fiscal purposes.
- b) For some items the tax authorities use a cash basis rather than an accruals basis. Chafer and Martinez (1993 pp.38-39) explore these in detail.
- c) For tax purposes only FIFO and AVCO are acceptable stock valuation bases, while accounting law also accepts LIFO.

d) Chafer and Martinez (1993 p.44) explain the permanent timing difference that can arise from reinvestment of the sale proceeds in a sale and leaseback arrangement.

#### Actualizacion - a special case

'Actualizacion' is a system devised in Spain to give business some relief from the effects of inflation. When 'actualizacion' is permitted then firms may revalue their fixed assets in line with the rate of inflation. The revaluation surplus is tax free, while depreciation on the revalued amount is tax allowable. In order to obtain this tax benefit the revaluation must be reflected in the financial accounts. Nationwide, actualizacion was allowed in 1977, 1979, 1981 and 1983.

Recently the autonomous parliament of the Basque country approved a law allowing firms in that region to apply actualizacion each year. The result of this is that in this respect the tax-accounting link will continue. The result is to distort the comparability of accounts not only on an international but also on a regional basis.

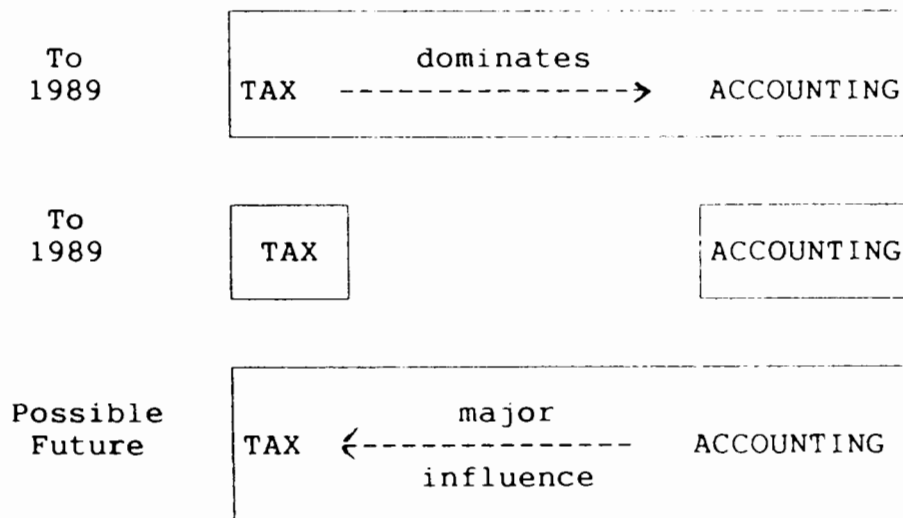
#### Summary and Prospects

Figure 3 offers a summary of our view of the tax-accounting relationship in Spain. Up until 1989 tax and accounting practices were strongly linked and tax dominated. In 1989 the link was broken.

Although this was, apparently, a response to the requirements of the EC fourth directive, it should be borne in mind that Germany, as we have seen above, had already set a precedent for implementing that directive while preserving the tax-accounting link. AECA played a major role in developing a stream of Spanish accounting concepts independent of fiscal rules.

Currently, the finance ministry is investigating the possibility of reforming tax law in line with accounting law. Thus, in the future, we may once again see a close tax-accounting link, but this time dominated by accounting principles rather than tax considerations.

Figure 3 - Summary of Spanish Position



The UK Legal Position

Pinson and Thomas (1985) summarised the UK legal position on the relationship between profit as computed by accountants and taxable profit as follows:

"The Tax Acts do not prescribe general rules as to the manner in which annual profits or gains should be determined for tax purposes. The Acts assume that the trader will prepare an account showing his profit and loss for the accounting period and that this account will be prepared in accordance with correct principles of commercial accounting. The profit or loss disclosed by this account will be the profit or loss for the purpose of Case I or II of Schedule D, as appropriate, subject to any adjustments which may be required by the Tax Acts or may be needed to comply with established principles of revenue law" (p.29).

An extensive body of case law has built up on the question of when the accounting profit should be 'subject to adjustment' to comply with the established principles of revenue law. A frequently cited judgement is that described by Burgess (1972) as 'a very lucid statement of the court's policy' by Pennycuick V.C in *Odeon Associated Theatres Ltd v Jones* (1971 2 All E.R. 407, 414):

"In ... ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy ... 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"

and:

"at the end of the day the court must determine what is the correct principle of commercial accountancy to be applied."

One of the major areas of difference in the UK between taxable income and accounting profit has been in the treatment of depreciation. Edwards (1976) has explored this difference from a historical perspective. He points out that Income Tax was introduced in the UK in 1799 as a wartime financing measure and repeated in 1816. At that time the accounting profession was small and there was no general practice of preparing business accounts so that:

"in the absence of any readily available figure for business profit, the tax authorities were obliged to introduce their own rules."  
(p.302).

A simple rule of not recognising any form of capital expenditure was adopted and:

"In a labour intensive industrial community in which the rate of technological progress was only gradual, the hardship caused to business by this reluctance to grant relief is unlikely to have been particularly significant" (p.303).

Following the reintroduction of the Income Tax in 1842 on a permanent basis relief for the erosion of capital assets appears to have been given in one of two ways:

a) By generous allowances for repairs and renewals

b) As reported by one Special Commissioner in 1851/52, depreciation although not explicitly recognised in tax law was in some areas allowed:

"The fact is, we generally take, in the great manufacturing districts, the scale allowed by the manufacturers themselves."

In 1878 the system was rationalised by the introduction of a system of capital allowances to be laid down by the Inland Revenue.

Edwards sees the effect of this position in tax law as having been to retard the development of a consistent approach to depreciation by accountants. On the one hand some concerns were prone to write off capital expenditure to revenue in the year incurred in the hope of obtaining some tax relief; other concerns, wishing to boost reported profits, could cite legal cases and tax law which appeared to justify not providing depreciation.

Crump (1959) in an analysis of legal cases where a distinction has been made between accounting profit and tax profit summarises the distinction:

"The bias in all tax cases is only to admit figures in accounts which have been exactly quantified." (p.325).

Freedman (1987 a) b)) on the basis of an extensive review of case law on taxable income concludes:

"The courts have fluctuated between accepting accountancy practice

and rejecting it for tax purposes" (p.133).

Overall both the tax authorities and the courts in the UK have tended, therefore to be strongly influenced by accounting practice in their concept of taxable income, subject to the courts retaining ultimate control over the definition of taxable income; and with the notable exception of the tax treatment of the consumption of capital assets. This exception appears to have arisen from the development of tax practice prior to the development of accounting practice.

#### Tax factors in the development of UK accounting standards

From 1970 to 1990 accounting standards were formulated in the UK by the Accounting Standards Steering Committee, later renamed the Accounting Standards Committee (ASC); the latter term is used throughout this paper to avoid confusion. This body issued discussion documents called exposure drafts (ED's) on proposed standards, which when issued were called Statements of Standard Accounting Practice (SSAP's).

The issue of the tax effect of financial accounting reports has arisen explicitly in the formulation of a number of UK accounting standards.

ED 6, a proposed standard concerning the amounts at which stock and work in progress should be shown in the accounts, was issued in May 1972. The proposals were not implemented in a standard, SSAP 9, until May 1975, the delay being partly caused by discussion with the Inland

Revenue on two points:

- a) ED 6 proposed that the cost of stock should be computed on a full absorption basis. For companies not then using such a basis the result would be some uplift in the opening stock figure, and consequent concern that this uplift would be taxable. The accounting standards committee (ASC) held discussions with the Inland Revenue and obtained a statement from them that such increases would not be taxable because a change in stock valuation in response to a new accounting standard would be regarded as being for a "good reason". (ASC 1975). This ruling was based on existing Inland Revenue practice as reported in "The Accountant" (17.11.62, pp.648-649).
  
- b) ED 6 also proposed that long term contract work in progress be valued at cost plus attributable profit less foreseeable losses. For companies which had previously taken profit into account only on completion of a contract this involved an initial uplift in work in progress valuation on implementation of the new accounting rule. Inland Revenue practice was to tax profit on long term contracts at the point when this was shown in the accounts. The Inland Revenue insisted that the uplift be taxed but conceded that companies which were then not taking profit on long term contracts into account until completion could be permitted to compute taxable profit on existing contracts on the old basis, with only new contracts being taxed on the new accounting basis. Thus some relief from the cash flow tax effects of the new standard was given.



A further tax effect of SSAP 9 arose because of a requirement that LIFO should not be permitted for stock valuation. This had no UK tax effects, because LIFO was not accepted for tax purposes in the UK. However a problem was posed for UK companies with US subsidiaries because under the IRS regulations in force at that time any change to the LIFO figures for US subsidiaries made on consolidation would result in the US tax benefits of using LIFO being lost. It appears that a number of UK companies decided not to comply with SSAP 9 on this matter. The annual Survey of Published Accounts, published by the Institute of Chartered Accountants in England and Wales, and covering 300 major companies, reported the following number of cases of non-compliance with the ban of LIFO following the issue of SSAP 9:

<u>1977</u>	<u>1978</u>	<u>1979</u>
11	11	4

The 1979 Survey explains:

"Seven companies changed to the LIFO method in their group accounts now that the US International Revenue Regulations permit this basis to be used without penalty."

ED 15, a proposed standard concerning depreciation, was issued in January 1975. ED 15 included a proposal that depreciation should be provided on all buildings. A number of companies opposed this requirement, but the most intense opposition came from property companies. The British Property Federation made a detailed submission opposing the requirement which they accepted would be "at first sight a normal accounting principle" but would have the effect

that "few (property) companies would be able to pay dividends." This problem of dividend payment arose out of the distinction for tax purposes between:

- a) investment properties, held with the intention of retention, where gains on sale would be subject to capital gains tax at 30%.
- b) Dealing properties, acquired with the intention of resale, where gains on sale would be subject to the corporation tax at the rate, in 1975, of 52%.

In view of the substantial difference in tax rates the Inland Revenue applied strict conditions to justify classification of a gain as relating to investment property. (Milnes and Tillett 1978, pp.1-2). These included a requirement that any gain on disposal be taken to a capital reserve, with provision in the articles of association that such gains should be non-distributable. In the early 1970's the UK experienced a high rate of inflation and high interest rates.

Property investment companies investing in new properties tended to be relying on future rent increases to make the investment profitable, accepting that current rental income would not cover related borrowing costs. Thus distributable profits were severely depressed. When the compensating benefits of rising prices were enjoyed, on sale of properties, the Inland Revenue conditions to enjoy capital gains rather than income status meant that the gains were non-distributable. The effect of the property depreciation requirement of ED 15 would have been to exacerbate this problem of

legally distributable profit. An analysis of the 1975 accounts of the six property companies making representations against the property depreciation requirement of ED 15 shows dividend cover to be:

<u>Company</u>	Accounts with no depreciation	Accounts with 2% depreciation assuming 2/3 of property to be buildings
A	1.9	0.9
B	1.7	No Profit
C	2	1.3
D	1.4	0.3
E	1.6	No Profit
F	1.1	0.2

Thus ED 15 would have eliminated or severely cut the dividend paying capacity of these companies.

In response to these representations the ASC exempted investment properties from the requirements of SSAP 12 on depreciation and subsequently produced a standard, SSAP 19, that prescribed annual revaluations for investment properties. Thus, in response to the tax-driven problems of depreciating investment property, the ASC introduced the only UK standard that prescribes revaluation.

In ED 29 on leasing, issued in 1981, the ASC referred to the possible tax implications of requiring finance lease capitalisation as one of

three possible 'economic consequences' that might arise. They reported on discussion held with the Inland Revenue:

"The publication of an Accounting Standard on leasing would not lead to any change in the practice of the Revenue in the tax treatment of either lessors or lessees, and that publication would not, of itself, lead to the Revenue seeking any change in the law governing the treatment for tax purposes of either lessors or lessees. The Revenue would of course regard the standard accounting practice, as reflected in a SSAP, as a factor to be taken into account in any review of tax law" (ASC 1981 para 28).

Taylor and Turley (1985) report that there were ten representations to the ASC on this issue, five on each side of the question as to whether the tax treatment of leases would be likely to change in line with an accounting statement prescribing finance lease capitalisation. Those worried by the Revenue's attitude included Booker McConnell who saw this as a 'guarded statement' (letter dated 10.2.82) and Burmah Oil who referred to the Revenue's 'particularly emphatic statement' (letter dated 30.3.82). A government green paper on Corporation tax argued the case for tax treatment in line with accounting treatment of finance leases, the relevant section commencing with a reference to ED 29 (HMSO 1982, s13.74). The phasing out of first year allowances in the 1984 budget substantially reduced the economic significance of this question.

The Inland Revenue have continued to treat finance leases in accordance with their legal form rather than the accounting treatment, so that the lessor receives capital allowances while

finance lease rentals are tax deductible as an expense of the lessee. However, in April 1991 Inland Revenue Statement of Practice SP 3/91 did pick up the SSAP 21 basis for allocating finance lease rentals, on the basis of the finance charge shown in the accounting period plus the depreciation charge on the leased asset provided that it is based on normal commercial accounting rules. Two points arise from this:

a) As Rayney (1992) points out:

"The Revenue statement breaks new ground in that it enables tax relief to be obtained for the commercial depreciation charge in the accounts. In future, this is likely to influence the choice of depreciation policy for new assets" (p.80, emphasis added).

b) Savary (1992) observes:

"In summary, I think that it is likely that the Revenue's practical approach is over generous, given the current state of the law. In addition, while I have a natural lawyer's reluctance to admit it, I think it may be correct in principle to follow the accountant's view of what is deductible, even if this does mean giving a taxpayer a deduction for a contingent liability" (p.121, emphasis added).

A further problem in the development of an accounting standard on leasing arose because the accounting standards formulated by the ASC covered both the UK and the Republic of Ireland. At the time when ED

29 was issued Irish tax law provided that if a lessee capitalised a finance lease then first year allowances should go to the lessee rather than the lessor. In response to this ED 29 included a provision that:

"By reason of the law at present obtaining in the Republic of Ireland, this exposure draft is not intended to apply to financial statements prepared or audited in the Republic of Ireland" (ASC 1981 p.117).

Thus in 1981 the ASC appear to have taken the view that they would not wish to impose an accounting standard which would have these tax effects. When it came to implementing these proposals in a standard, however, the ASC appear to have been reluctant to proceed with this exemption. Consequently the Irish Institute of Chartered Accountants vetoed issue of a standard until the tax law in the Irish Republic was changed (see Brennan et al 1992 pp.75-76, Blake 1992 p.321).

In addition to these explicit tax factors influencing the evolution of accounting standards fiscal considerations had a substantial impact on the course of the UK debate on inflation accounting in the 1970's. As Kennedy (1978) points out, the development of recognition of the impact of inflation on monetary items within the context of a current cost based system arose from a debate over the taxable capacity of industry; notably from the arguments of Gibbs (1975; 1976). Arguments that a system of inflation accounting in the financial reports was linked to the search for a proper way of identifying taxable income in times of inflation had two elements:

a) A tax system based on a comprehensive recognition of the impact of inflation on company profits would encourage the adoption of inflation accounting by companies. Thus the Governor of the Bank of England observed:

"The hope that agreement is near on inflation accounting makes it a logical next step to examine the implications for the tax system. But there is a reverse connection. The adoption for tax purposes of principles similar to those advocated for accounting might greatly concentrate attention on how best to apply these principles and hasten the day when they were universal for accounting purposes" (Richardson 1980, p.11).

b) A full inflation accounting system would offer a better directed system of relief for the effects of inflation than that offered by the then system of tax reliefs.

Gibbs (1979) showed that in terms of inflation adjusted profits the then system provided 'a rough and ready system' for the corporate sector as a whole but, in real terms; left 'significant differences between the rates of tax paid by individual companies.'

#### The small company perspective in the UK

Walton (1993) points out that only a small minority of UK companies are listed and therefore dominated by financial market expectations. He argues:

"this would suggest that most companies would adopt accounting which emphasised prudence rather than matching, with a view to minimising the tax consequences, while the market-oriented companies are likely to accept higher taxation as a price of meeting market expectations" (p.10).

Preston (1989) considered a specific company's accounting system in depth. The company was a highly innovative record producer with a deliberately loose management style:

In contrast to the seemingly anarchic order of Axis's operations, its financial accounting process was remarkably conventional. ... The accounting system was an island of methodical order in an otherwise chaotic setting." (p.392).

On making enquiries Preston ascertained:

"The directors' answers to my enquiries on this point were unequivocal: the double-entry bookkeeping system and the bookkeeper were installed because of the Taxman (a common colloquialism for the revenue)." (p.392).

Thus the UK tax system affects not only accounting policy choice but also the design of the accounting system.

### Conclusion

A comparison of the three national approaches to the tax accounting link reveals a more complex comparison than the contrast identified



in the sources cited in the introduction to this paper. The German Tax-accounting link continues, indeed, to be firm; this is attributable to a broader set of user needs for which a conservative approach to accounting is appropriate. In one significant respect, pension costs, the dominance of tax law in Germany has made accounting practice less conservative than in the UK.

In Spain there has been a major change in the tax-accounting relationship as a result of implementation of the EC fourth directive. Indeed, Spain has been much more willing to adopt the spirit of EC harmonisation than either Germany or the UK. While the tax influence on accounting has been historically strong, and continues in some forms, there is now a move to reverse the traditional relationship.

In the UK, the tax-accounting relationship, although not strictly binding as in Germany, is strong both in principle and in practice. We find that the separation of tax and accounting depreciation is more a matter of historical accident than an application of any consistent theory. We observe a number of accounting standards that have been formulated in response to tax considerations, and we find the tax authorities adapting their approach in response to accounting standards. We also find that tax considerations are particularly potent in their influence on small company accounting.

Overall, therefore, we find the contrast between these three countries in relation to the tax-accounting link to be both less dramatic and more subtle than is generally implied in the literature.

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