The relationship between financial and tax accounting in Albania

Ilda Duhanxhiu[1]
Valbona Kapllani[2]

Typically 'income tax' laws rely on financial accounting data to determine the taxable income of a business entity, although financial and tax accounting have different goals and requirements. The purpose of this paper is to explore the relationship between financial and tax accounting rules in Albania. The study employs a mixed methodology, comprising a review of the legislation, institutional framework and context, and semi-structured interviews with accountants, academics and institutional players. By reviewing the development of this relationship during the past 20 years, we aim to identify and explain the major divergences at present between two sets of rules.

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1. Introduction

Over the past two decades, as many other developing countries, Albania has strengthened its accounting regulations as part of broader programs of the market-oriented regulatory reform. The central element of this process, especially in the second decade, has been the

[1]**Ilda Duhanxhiu**,PhD Candidate, Department of Accounting, Faculty of Economics, University of Tirana, Albania, ilda.duhanxhiu@euro-audit.com
[2]**Valbona Kapllani**, PhD, Lecturer at the Department of Accounting, Faculty of Economics, University of Tirana, Albania, valbona.kapllani@unitir.edu.al

introduction and adoption of IFRS[3]s following the widespread IFRSs adoption in the EU.

International accounting literature provides evidence that IFRSs improve accounting quality and potentially reduce the cost of equity capital (e.g. Barth et al., 2005; Bushman et al., 2006; Daske et al., 2008). However the adoption of IFRSs has raised several questions and concerns, especially regarding its impact on the tax accounting and vice versa. Accounting rules and tax rules are two concepts developed by different authorities and used by heterogeneous groups of users serving different purposes. IFRSs are formulated to accomplish the objectives of financial reporting[4] including providing information that is useful to investors, creditors and analysts in making rational investment and credit decisions. Tax rules (e.g. income tax law) are formulated, in part, to encourage certain kinds of behavior by taxpayers on the premise that such behavior is good for the economy as a whole. So, contrary to financial accounting, tax accounting serves only to one user, the government (tax offices).

Some researchers argue that alignment of the tax and financial accounting rules could improve the perceived equity of the tax system, reduce tax compliance cost, and enhance tax compliance levels. While others are convinced that full convergence of commercial and tax accounts cannot be achieved and should not be the aim.

The main focus of this paper is a systematic examination and critique of the development of financial and tax accounting in Albania from the 1990s until the present day. This period can be considered the formative years of the accounting profession in Albania. The historical development of the relationship between financial and tax and

[3] *IFRS as used in the paper should be taken as International Financial Reporting Standards issued by the International Accounting Standards Board and International Accounting Standards issued by its predecessor, the Board of the International Accounting Standards Committee.*

[4] *We use financial reporting and financial accounting as interchangeable terms.*

accounting is characterized by a weak position of the accounting profession and the intervention without regard of tax law to either accounting principles or existing accounting practices. The tradition of financial reporting in Albania is still quite young compared to some other countries. It is also noteworthy that until 2008, when the implementation of IFRSs entered in force, financial reporting in Albania was, almost, entirely guided by tax rules.

Although it is a well-known fact that taxation depends on financial accounting, this relationship it is not an easy one. The examination of the relationship between accounting and taxation provides insights for national regulators and policy makers to make better informed policy decisions. The paper is organized as follows: the next section provides a theoretical overview of the objectives of financial and tax accounting. Section 3 reviews in detail the development of Albanian accounting law and tax regulation during the past 20 years. The fourth section presents and analyses actual divergences between financial and tax accounting in Albania. This analysis is supported by interview work with accountants, academics and other institutional representatives. The final section concludes.

2. Overall of Financial and Tax Accounting Objectives and Users

Accounting is often called the language of business and as languages evolve in response to the changing needs of society, so does accounting. According to King (2006) tax accounting is developed as a distinct dialect from financial accounting due to public policy and business issues. Although at the beginning of their "relationship", financial accounting and tax accounting were in some accord, today the accountants have to work hard to reconcile their respective conflicting objectives. Accounting rules and tax rules are two concepts developed by different authorities and serving different purposes.

It is the contrariety of financial accounting and tax accounting objectives which make attempts to reconcile the two difficult. While the IFRSs are formulated to accomplish the objectives of financial reporting, tax rules are formulated, in part, to encourage certain kinds of behavior by taxpayers.

The objective of the general purpose financial reporting, as set forth in The Conceptual Framework for Financial Reporting issued by the IASB in September 2010, is to provide financial information about the reporting entity to existing and potential investors, lenders and other creditors and aiding their decision making process. In contrast, the objective of tax accounting, as part of the tax system is to protect the public treasury and improve the amount and timing of tax collections. Government imposes taxes to raise revenue, redistribute wealth and encourage economic activity. Thus, on one side, taxation represents a powerful instrument for government economic and social policy, and on the other side, it makes the government an involuntary partner of the business entity. For the business entity, tax accounting is an area of financial accounting in which the entity report to the tax authorities. The tax law may change every legislative session. Financial accounting based on IFRSs, involves a certain measure of judgment, certain flexibility in the assessment of entity's transactions in order to provide a true and fair view. In contrast, taxation is guided by the interest of equal treatment of all taxpayers. Thus, flexibility cannot be allowed to the same extent; uniformity is necessary to provide a reliable basis for tax assessment.

Several studies have explored the relationship between financial accounting and taxation and the possible implications related to the IFRSs adoption. According to Nobes (2003), current international accounting standards setters pay little regard to tax implications and would be unlikely to add taxes to the list of considerations and pressures they must take on board already. Alley and James (2005) concluded that the relationship between accounting and taxation is an evolving one, and countries should not be developing tax policy and practice in isolation. Freedman (2008, 2004) demonstrated that full convergence of commercial and tax accounts will not be achieved and should not be the aim. According to her the neutrality of taxation maybe a desideratum but governments will not wish to give up the ability to use tax as an economic tool. Gielen and Hegarty (2007) suggest being very cautious since when it comes to drafting tax accounting rules based on IFRSs, all of the major issues arise out of details on technical accounting matters. Hanlon, Maydew, and Shevlin (2008) demonstrated that increasing book-tax conformity results in earning that are less informative.

In conclusion, there is much debate on the extent to which financial accounting and tax accounting should be related. The two sets of rules differ because they are intended to achieve different objectives.

3. The Development of Albanian Accounting and Tax Law

In early 1990s as many other countries of Central and Eastern Europe, Albania began its process of transition from a command economy to a market economy. An important component of this process was the accounting and tax reform aimed to adopt the accounting and tax practices of the developed economies through the introduction of new accounting and tax legislation, improvement of accounting education, and the creation of new accounting and tax institutions.

The development of accounting law

In the former socialist economy, the role of accounting was limited to the statistical figures needed for the central authorities. There was no public disclosure of accounting information and no independent accounting profession. So the two major objectives of accounting reform were: (i) the establishment of new accounting system that would meet the demands of a market driven economy and take into consideration the EU Directives, and (ii) the creation of independent accounting profession (Sudar, 2001; Cela, 2004).

In January 1993, Albanian parliament approved the law "On accounting" and in July of the same year the government approved the General Accounting Plan. The preparation and modification of accounting legislation was the responsibility of the Ministry of Finance; the accounting profession, at infancy at the time, was not involved in this process. Sudar (2001) and Cela (2004) have analyzed the factors which contributed to the selection of an accounting model closer to the Continental European tradition of accounting. Beside the historical tradition in accounting and the lack of experience/knowledge about other accounting systems based in standards, the main reason of such choice was the need to support the fiscal system with adequate information for tax calculations. Somehow the government had to adapt the previous state –controlled accounting system to meet the demands of new users of market economy as well as state demands for tax collection.

The law "On accounting" was first effective for financial statements for periods beginning at 1 January 1994. The law and "General Accounting Plan", as well as other acts and decrees emanated from Ministry of Finance during the following years, included all aspects of financial accounting, and outlined the measurement rules and fundamental accounting principles to follow in order to record accounting transaction and other details. This law represented also a formal attempt to implement the Fourth and Seventh EU Directives in Albanian accounting regulation. In line with EU Accounting Directives, the law adopted accounting principles such as 'going concern', 'consistency', 'matching', 'accruals', 'historical cost', and 'prudence' (art.54-58). However since Ministry of Finance was the only responsible for drafting the accounting regulation as well as tax regulation and collection, the emphasis was given to compiling proper accounting records and on adhering to tax regulations.

The year 1995 was significant in that it saw with the support of EU PHARE program, the creation of Albanian Institute of Authorized Chartered Auditors (IEKA), whose members provide independent auditing services. The law "On accounting" provided also for the establishment of the certified accountant profession whose aim the provision of accountancy services. By the end of the 1990s the accounting and audit professions were still developing.

At the beginning of the second decade, the internationalization of Albanian business life, the decision of government to allow foreign accounting firms to conduct statutory audits in Albania and the establishment of accounting professional associations, such the Association of Accountants of Albania and the Institute of Certified Accountants (former LPKM) exposed the Albanian accounting profession closely to the international practice of accounting. At this period, the law "On accounting" was considered incomplete especially because of the increasing need to harmonize the Albanian accounting system with that of EU. This was part of the commitment from the Albanian Government side to sign the Stabilization & Association Agreement with EU. As a result of the revision process of the old law "On accounting", on April 2004 a new law "On Accounting and Financial Statements" was approved by the Albanian parliament. This new law, which came into force in 2008, appears to contain less detailed regulation than the old one. The law introduces the notion of accounting standards in Albanian accounting practice as a principle or general rule used to determine the appropriate accounting treatment and applicable for the preparation and presentation of financial statements. The development of Albanian Accounting Standards (NAS) is the responsibility of National Council of Accounting. The law requires that all entities to which it applies have to publish the financial statements by deposition at the respective Registry Court.

The year 2005 was also very important in the history of Albanian accounting because the National Council of Accounting (NCA) was formally re-established and the law on its activity was codified that year. Beside the development of national accounting standards in coherence with IFRSs, this national standard-setting body has the responsibility to develop the respective implementation guidance, to monitor the feasibility of standards in practice, to interpret and to analyze the problems faced by accounting practice, etc. According to new law and other acts and decrees emanated after from Ministry of Finance, starting January 2008 all banks, insurance companies, listed entities and big size entities (such as KESH, Albtelecom, etc.) should use the full set of IFRSs for the preparation and presentation of financial statements. While for the small and medium sized entities the NCA has developed, with the support of World Bank and the assistance of "PricewaterhouseCoopers," fifteen national accounting standards in compliance with IFRSs. In short, the new law shows signs of increasing international harmonization of the Albanian legislation with EU law and beyond.

There seems to be no requirement to monitor actual compliance with IFRSs or NASs and the law does not mention penalties for non-compliance with financial reporting regulations. However, the violations of the requirements of this law are subject to sanctions in accordance with the provisions of the Civil Code, Penal Code or other laws, based on demand charges made by the interested parties.

The development of tax law

The principal objective of tax reform was the adoption of the tax practices followed in developed countries through the introduction of tax legislation and the creation of tax authority's institutions. The process of drafting tax legislation was taken forward by the Ministry of Finance with the technical assistance of International Monetary Fund.

In January 1992 the Albanian parliament enacted the tax laws as: Law No.7543 'The tax on circulation of goods'; Law No.7544 'Profit tax'; Law No.7545 'For income tax of individuals in the private sector etc.' and Law No.7546 'For tax administration in the Republic of Albania'. At the beginning accounting law and tax law were in some accord. For example the article 3 of 'Profit tax law' (1992) stated: 'taxable profit is annual profit reflected in balance sheet. In order to calculate the taxable profit should be taken in account the depreciation rates of the Ministry of Finance.' One year later, the new law on 'Profit tax' article 4 stated: 'taxable profit is calculated on the basis of annual profit reflected in the balance sheet. Calculation of taxable profit is made according to law "On Accounting" and the guidelines issued by the Ministry of Finance'. During this period, for many businesses accounting is justified only as a mean for preparing a tax report and complying with tax regulations. With accounting profession at its infancy and the fragile business development, taxation may be considered a driving force in the development of accounting practice.

Although it was clear from the beginning that the tax administration was not able to handle a complicated tax law, during the 1990s these laws were amended on several occasions. There are at least three main reasons behind these amendments, especially in late '90s: (i) the need to curb tax revenues fall, (ii) to overcome economic and financial crisis created, and (iii) to consolidate the tax income and tax administration.

By the end of 1995, the first law "on value added tax" was introduced and implemented, which invalidated the previous law 'The tax on circulation of goods'. In December 1998, the Albanian parliament approved the new law 'On Income Tax'. The objective and the definitions of the law were stated more precisely. By the end of 1999, a new law 'On tax procedures in Republic of Albania' was implemented.

During this period, an important aspect of the Albanian business life was the internationalization of the financial sector through privatization of important banks and establishment of new ones as well as insurance companies. This led to the implementation of further changes to the tax system aimed to achieve: a favorable macroeconomic development, revenue growth, improved relations with business, and the improvement of tax administration. In 2008, as the result of the efforts to restructure and modernize the tax system, the new law 'On tax procedures' was drafted with support of international experts. This law is more substantial than the previous 1999 law. Beside the introduction of electronic filing and the establishment of anticorruption structure, the main aim of the changes in this law were to simplify, specify and supplement certain provisions according also to law 'On Entrepreneurs and Companies'.

In summary, during the last two decades the accounting and tax law in Albania, as the Albanian economy, has undergone significant changes because of internal and external pressures. These developments reflect the different goals of two sets of rules and the fact that taxation depends on financial accounting rules. Since this dependence may distort economic decisions of accounting information users concern about the potential for such distortions provides a rationale for analyzing the relationship among financial and tax accounting—the focus of this paper.

4. Major Differences between Two Sets of Rules

Methodology

The study's objectives were pursued through a mixed methodology comprising a *de jure* comparison between IFRSs and Albanian tax requirements and key informant interviews. The key informant interview refers to getting information from an individual who is considered to be particularly knowledgeable about the topic of interest (Bernard 2002; McCracken 1988). This mixed methodology allows us to obtain a deeper set of insights into this issue. The selection process of the key informants was based on criteria such as professional experience with IFRSs, previous or current commitment to institutions involved with Albanian accounting standard setting processes and influence on the development of Albanian accounting practices and taxation.

We conducted 15 semi-structured interviews during September - October 2011. In particular, three of our interviews were with key actors extensively involved in devising and/or evaluating accounting and tax reforms. Four were with academics which played a key role in the opening up of accounting research to IFRSs perspectives. Three interviews were with auditors and other five with chartered accountants who were employed in private sector or partner in a large consulting practice.

The interviews were conducted in face-to-face meetings. To guide each interview was designed a schedule comprising open ended questions on the actual differences between two sets of rules and the potential challenges in case of alignment of the tax and financial accounting rules. Interviews were recorded and transcribed to enable the content analyses of the text. Follow-up interviews were carried out through e-mail to clarify certain matters discussed in the interviews. To analyze the data we have used a deductive approach. The results are provided next.

Findings

The main theme in the interviews was the general concern regarding taxation and how the move toward the IFRSs would affect the calculation of taxable income. Based on data analysis as well as the *de jure* comparison, we have identified the following elements as source of actual divergences between two sets of rules:

Table 1

Summary of differences between two sets of rules

Item	IFRSs	Albanian Tax Rules
Assets - Property, plant and equipment (PP&E)	Must be estimated by reporting entity: • Useful life; • Amortization, depreciation and depletion • Revaluation.	The rate of amortization, depreciation is determined by tax law.
Assets - Intangible assets	Must be estimated by reporting entity: • Useful life; • Amortization; • Revaluation.	The rate of amortization is 15% based on straight –line method. Revaluation not permitted for tax purposes.
Goodwill	To be tested for impairment.	Capitalized and amortized 15% based on straight –line method.
Grants	Revenue-based grants are deferred and matched as expense incurred. Capital grants are amortized as depreciation is recognized.	Revenue is recognized when there is right to receive income upon the earlier of the income being due, paid or earned.
Impairments	IAS 16 and IAS 38 permit fixed assets and certain intangible assets to be carried at revalued amount.	Impairment losses are not permitted for tax purposes.
Inventory	Valuation of inventories of goods could be: FIFO & Average cost The inventory is stated at the lower cost or net realizable value LCM.	Impairment losses are not permitted for tax purposes.
Profit tax	When certain conditions are met, a deferred tax is recognized and displayed as noncurrent in balance sheet.	The amount reported is the tax payable to tax authorities. Some expenses may not be allowable for tax purposes.
Revenue from Construction Contracts	Use of method of percentage of completion is required. When the final outcome cannot be estimated reliably, a zero-profit method is utilized.	Revenue is recognized when there is right to receive income upon the earlier of the income being due, paid or earned.

Source: IFRS 2010, Albanian Tax Legislation 2010.

As indicated in table 1, the main areas of differences between two sets of rules relate to the recognition and the measurement criteria. The calculation of taxable profit begins with the profit calculated according to financial reporting rules. The interviewees believed that the move toward IFRSs will increase the number and the type of adjustments needed to move from calculating accounting profit to the taxable profit. Also, the interviewees expressed some concern about the subjectivity of profits under these calculations, because a larger number of adjustments have to be made to calculate taxable profit from IFRSs reporting profit. One interviewee reflected a commonly held opinion amongst the interviewees that at the moment most of accountants spend most of their time dealing with the tax officials and with other beaurocratic activities in trying to settle their tax liabilities.

Another interviewee also argued that due to the above mentioned differences not only the figures of profit will differ considerably, but also the financial statement analysis figures, such as debt/equity ratio, the return on assets ratio etc. will differ. Given the limited experience of accountants with IFRSs financial reporting, it is questionable as to how much the information in the accompanying notes will compensate for these differences.

There was a general agreement amongst all interviewees about the difficulties of fair value application and its reconciliation with taxation. IFRSs are oriented towards investors, and almost all IFRSs include fair value accounting, and are principle based. The tax system is aimed at guaranteeing the fiscal rights of the State, including historic cost accounting, and is rule based. The lack of adequate economic infrastructures in the country leads to difficulties in the application/measurement of fair value.

One interviewee recognized that theoretically, taxation depends on financial reporting, but at the actual state it is just the opposite. Because the noncompliance of tax regulations usually results in severe tax penalties and poor IFRSs monitoring mechanisms, most accountants choose to follow tax rules for reporting purposes. For example the valuation of assets is likely determined by taxation, leading to amounts reported on the balance sheet beneath the amounts according to IFRSs.

The interviewees expressed conflicting opinions about the alignment between financial accounting and taxation. For some the conformity between financial accounting and taxation is desirable for both entities and tax authorities. The conformity will reduce the compliance cost of processing information for the business entities and will help to detect or prevent any tax fraud or other manipulation to reduce tax liability.

Others argued that a complete alignment between two sets of rules is not possible since financial accounting and taxation have different purposes and requirements. An interviewee noticed also that a complete alignment may have important regulatory implications, since governments use tax as an economic tool and hence increasing the complexity instead of reducing it.

Irrespective of their different opinions about the alignment between financial accounting and taxation, the interviewees acknowledged the importance of: clear guidelines of how to calculate income taxes; improved accounting disclosure requirements; and continuous training of accountants and tax officials.

5. Conclusion

Accounting and taxation in Albania have come a long way, while experiencing most of the general and specific problems arising for transitional economies. The fact is that the requirements of the tax authorities for accounting information continue to predominate over those of other participants in market activities, such as creditors and investors. The participants in the interviews were concerned about the subjectivity of profits under IFRSs reporting and the use of fair value accounting. Given the limited experience with IFRSs reporting and poor monitoring mechanisms, it is unclear how the tax authorities will deal with this.

Also the interviewees expressed divergent opinions about the potential alignment between financial accounting and taxation. We believe that other aspects of IFRSs and taxation may be crucial to examine in order to make conclusions about this matter. However we suggest that the relationship between two sets of rules could be improved by: 1) clear guidelines on how to calculate income taxes, simple and explicit; 2) improved accounting disclosure requirements; and 3) continuous training of accountants and tax officials. We hope that our examination of the relationship between accounting and taxation may provide insights for national regulators and policy makers to evaluate the feasibility of any (partial) alignment objective and to make better informed policy decisions. Although there have been major changes in tax accounting and other regulations, the researchers have not fully explored the outcomes and implications of these numerous regulatory and enforcement changes. This area offer interesting setting for future studies.

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