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Forum

From Disconnected to Integrated tax and financial systems A post-IFRS evaluation of evolution of Tax and Financial Reporting relationships based on the French case

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ABSTRACT

The globalization of financial markets has required the use of common reporting standards, notably the IFRS. These are impacting the accounting systems of many countries. However, accounting systems are also often used for national tax reporting. This creates a divergence in the reporting needs which existing accounting systems are unable to meet and some amount of duplication is therefore required for tax reporting and financial reporting. Previous studies have talked about linkages between accounting and taxation and have found aspects of their systems identical, disconnected, accounting dominated or tax dominated, and that this mix changes over time, with a definite evolutionary model. This conceptual paper, grounded in French empirics, examines whether since the new IFRS, the existing theoretical evolutionary model is adequate, and finds that it is not. It then proposes an alternative integrated accounting system to satisfy simultaneously the financial and tax reporting requirements. The integrated accounting system should result in economies.

1. Introduction

The influence of tax and financial reporting on accounting systems has slowly evolved over a century to produce a complex system necessitating reconciliation statements and notes. These complexities have trickled in over the years and each, individually, did not call for revamping the system. Now, this complicated relationship between accounting and tax is being changed by the introduction of IFRS, which would impact most countries. This is an opportune moment to study where we are going and to question if there is not a method to normalize the accounting system to make tax reporting and financial reporting simpler.

The convergence toward IFRS has come from the emergence of the need for consistent and common reporting standards and practices across countries. This emergence has created problems for economies where tax receipts are based on accounting profits: problem of lack of control on tax receipts. Ideally, there should be two separate systems: one for financial reporting to the financial markets and one for tax reporting to the tax authorities, but this generates a second problem: cost of duplication. The trade-off between the costs of instability of tax receipts and the costs of duplication have led different countries to use different systems of linkages between tax reporting and financial reporting to avoid duplication. In single systems, the more the differences in the requirements of tax reporting and financial reporting there are, the more the costs of following up. In the literature on international accounting, there is a continuum between identical systems (no control on tax receipts or incorrect economic information, but no costs of following up) and disconnected systems (control over tax receipts and correct economic information, but high costs of following up), and many countries are in between (Nobes & Schwencke, 2006). Despite the move to IFRS, "law and tax

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could still drive international differences in practice under IFRS" (Nobes, 2006, p. 243).

How do countries resolve these problems (providing economic information, control over tax receipts, avoiding duplication and limiting follow-up costs) and what influence does this have on the evolution of accounting systems? This paper is based on the case study of France and its vacillating behavior toward IFRS in view of its difficulty in accepting lower control over tax receipts (Raffournier, 2007).

It is still useful to maintain the distinction between Anglo-Saxon and Continental systems (Nobes, 1998). Each of these systems uses different methods to satisfy different reporting requirements. However, within the Anglo-Saxon model, the UK differs from the US and, within the Continental model, France differs from Germany (Lamb, Nobes, & Roberts, 1998). In general, in Anglo Saxon systems, there is a bias toward disconnected systems and in Continental systems; there is more interdependence between tax rules and accounting rules.

Moreover, the different systems of accounting–tax interrelationships are not fixed for all time but are evolving in each country (Lamb et al., 1998). For example, Germany has moved away from interdependence toward disconnection (Gee, Haller, & Nobes, 2010). Nobes and Schwencke (2006) propose a model of evolution of tax and financial reporting links and show that Norway evolved from a continental model to a model which has gone beyond the Anglo-Saxon models of USA and UK by 2005. As opposed to this, Oliveras and Puig (2005) show that the evolution of the Spanish system from 1989 to 2003 was rather limited and the influence of tax on accounting systems did not diminish considerably. However, except for Gee et al. (2010) who discussed Germany and the U.K. in 2006, none of the research applies to the post-IFRS adoption period. Our first research question is whether countries will follow the Nobes and Schwenke model or the Spanish exception. This question especially needs to be posed because since their research, IFRS has come in, creating modifications to national systems. We use the French example to show that a country may use the freeze response if it cannot satisfy both objectives.

Our second question, irrespective of the answer to this question, is whether either of these evolutionary paths is sustainable. We argue that all paths being envisaged continue to lead to problems.

Our third question is whether there is a new alternative which could create a new evolution in the future. This question becomes especially relevant because this is a time of change of accounting systems (IFRS, convergence between US GAAP and IFRS and other local GAAPs).

The first part of this paper looks at some interesting theoretical developments in this field of evolution of relationships of tax and financial reporting (essentially Lamb et al., 1998; Nobes & Schwencke, 2006) and focuses specifically on one model (Nobes & Schwencke, 2006; hereafter, the N&S model) which suggests that tax and financial reporting systems would move toward greater disconnection as well as to a Spanish exception to this model. The second part tests if this model of evolution is validated by applying it to France with recent developments of IFRSs. The post-IFRS study fills up the void mentioned above and updates extant research. At the same time, the findings modify the extant model studied in part I. A third part of this paper looks at whether the different paths which are possible are sustainable, and enumerates the difficulties with each. A fourth part of the paper recommends and develops the Didelot suggestion (Barbe-Dandon & Didelot, 2008) for future evolution of accounting systems in a different direction satisfying both reporting requirements.

2. Literature review of the relationship between financial reporting and tax reporting

2.1. The different reporting requirements from an accounting system

To explain the evolutionary model summarized, it is important to understand why tax and financial reporting systems are different and to look at the work of Lamb et al. (1998) on which the N&S model is based (Nobes & Schwencke, 2006).

The objectives of tax reporting and financial reporting are different. Tax reporting is for calculating the tax payable by the firm. The tax payable is itself contingent on how the firm responded to the different fiscal incentives the government provided to direct investments in different directions. For example, the government may want to increase investment in deserted areas to reduce the pressure on major cities and provide tax holidays, accelerated depreciation or investment allowances in these areas. To verify these, the tax authorities may also require booking the additional depreciation or allowances. Alternatively, by instituting taxes such as the alternative minimum tax, the tax rules may lead to a postponing of revenue recognition (Bazley & Tripp, 1989). These additional or different accounting entries modify the taxable income so that the corporation pays lower tax but it also lowers the reported earnings. The interference of such compulsory booking is a cause for concern for accountants who claim that it distorts the "true and fair view" principle or fair presentation. The likelihood of accountants succumbing to such pressure is higher in high tax countries because for small tax advantages, the company may prefer to avoid unnecessary booking of expenses. However, at times there is a trade-off between the true and fair view expressed by the income statement and that by the balance sheet, as is evident from the use of LIFO in the US (Jennings, Simko, & Thompson, 1996). However, Noreen and Bowen (1989) find that even when tax rules started allowing expense deduction for indirect costs (instead of capitalizing them) from 1973 to 1986 under the condition that the same rules be used in financial reporting, most manufacturing firms did not respond to this fiscal stimulus.[1] Thus, the firms may have preferred to report higher profits to the markets.

Financial reporting requirements, on the other hand, serve investors in the financial markets. The shareholders and other future investors want to know the value of the company and accounting provides information that might help in its calculation. This information helps in decision

[1] Partly because some firms were using direct costing even before the reform.