TAX RESEARCH
Financial Accounting versus Tax Accounting - Tax Rules' Impact on Investment Decisions

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Abstract

This paper provides guidance for all those interested in research related to tax. In the study are included three main areas dealing with taxes and about taxes: (1) the role of information in corporation tax expenditures under the rules and laws of the country against financial statements according to international accounting standards, (2) case study PTK; how much effective tax and tax on extra profit has it paid (3) the impact of tax rules on investment decisions - the reasons and profits of the company and the host country. We will try to summarize here the three areas of study and come to some conclusions on how to deal with fiscal policy in Kosovo. In addition, we will offer our opinion on some interesting and important questions for future research.

Keywords: Taxation, Corporate Income Tax, Deferred Tax, Adjustments in Spending, Tax Avoidance, Tax Evasion, Tax Havens, Investments.

1. Introduction

In this paper we will try to make a connection between tax accounting and financial accounting, tax avoidance through company policies, transfer of tax avoidance tax evasion, attracting foreign direct investments through tax rate

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movement. So, the paper will be divided into three main parts, before continuing to the conclusions and recommendations regarding the findings in this paper.

The first part deals with the relation and differences between financial reporting for management purposes, shareholders and other interested parties on the status of the company with tax reporting purposes. The present paper will attempt to demonstrate that the tax rate (the rate in Kosovo is 10%) will not be applied to the accounting profit, but it will be applied after the regulation of expenditures and revenues according to the laws on taxation of corporate income, which differ from International Accounting Standards. This section will also include the part of the management accounting profit through taxes.

The second part will contain an example regarding PTK. All kinds of expenses will be deductible or partially deductible. Discrimination of PTK through Regulation 10/2006, Article 2.2, which foresees an additional tax or extra tax for profit up to 30 % (MEF/TAK: 2006). This regulation states that: "For this additional tax to be applied on subjects, two criteria must be met: a) the subject must make annual gross income of over 100 million Euros, and b) enjoy a dominant position in the relevant market. Practically, this law has affected the stopping of foreign direct investment.

The third part deals with the question: Why tax rules affect investment decisions? If PTK would not pay almost 50 % of profits on behalf of the tax, it would be eligible to be invested, if it hadn't had to pay the dividends to government (€ 340 million).

2. Tax Accounting versus Financial Accounting

The differences between the financial reporting and tax reporting are defined as differences relating to the same transactions, but various reports (Hanlon and Heitman: 2010).

Upon completion of this part we shall be able to answer these questions: Are profits managed through tax accounting? What are the profits or losses of the company, whether the company would report for tax purposes as well as for management purposes?

In this section, we shift our attention to the reporting of income tax on the taxable corporate strategy used by companies to pay less tax and the amount of money saved from less tax could be invested elsewhere. Tax avoidance does not mean tax evasion, because tax avoidance is in

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accordance with the laws of the country. We will first discuss the theory of corporate tax avoidance. This includes the relationship between shareholders, management, and government and potential agency issues that may arise in corporate tax avoidance. Avoiding taxes has consequences for managers, shareholders, creditors and the government. The difference between income tax and accounting revenues depends on many factors. Most of these factors are the result of the two systems which have different objectives, and these objectives shall be governed by the laws and rules defined by the state (accounting for tax purposes) and on the basis of International Accounting Standards -financial reporting (now on referred as IAS).In theory IAS's objective is to show a more realistic value of the firm and to inform the stakeholders (shareholders, potential investors, company employees, senior management, board of directors, etc.). Rules and laws dealing with taxes are affected by many macroeconomic factors, legislators and state interests. Lawmakers set the tax rules in order to increase revenue and stimulate the local economy**.**

Each state has different tax rate, which are contingent to specific country policies (Ahmeti: 2013).

The differences between income tax and accounting can be divided into two main types: temporary differences and permanent differences. Temporary differences: The transaction is included in both books (e. i. in the calculation of net income and taxable) but in different time periods (and these differences sometimes are referred to as the time difference) (Scholes et al.: 2009).

Permanent differences: The transaction is involved only in a book (e. i. in net income or taxable ones) but never in the other.

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Table 1: Typical Temporary Differences

Issue	Accounting books	Tax books
Unearned revenue (cash received in advance)	Deferred income before income by firms which provide goods or services for which it is paid	The extension is not allowed, then revenue is recognized when taken money
Long-term construction contracts	The percentage of completion or completed contract (revenue is recognized on the completion of the contract)	Percentage of completion (revenue is recognized over the life of the contract)
Profit on sales of installation (customers promise to pay in some future period)	Total profit included before sales	Delayed profit until money received
Bad debts	Expenses deemed uncollectible by management, recorded in the same period of the sale, setting up accounts receivable	The deductible as bad debts meet a series of rules set forth by the respective countries
Warranty expenses	Costs based on management's projections of future costs warranty by linking current period sales	Deductible until paid.
Deferred compensation	Recorded as expenses when obligations were emanated(when the employee receives deferred compensation)	Deductible until paid.
Retirement benefits obligations (after retirement)	Recorded as expenses when obligations were emanated (when the employee receives deferred compensation) and based on current assumptions.	Deductible until paid.
Compensation of stocks evaluated	Application of low-cost market may be registered	Reservations unauthorized, loss recognized when the stocks are sold at a lower value.
Prepaid expenses (rent, insurance)	Recorded as expenditures when benefits are received	Deductible when paid
Depreciation	Methods, useful lives and the value determined by management	Accelerated depreciation method under the modified accelerated cost system described by the asset life
Intangible Assets-Goodwill	They can exist in all books(purchase accounting and tax basis following steps merger, amalgamation), can exist in balance but not taxed in books (book purchases but not in its tax base after the merger, amalgamation)	
Intangible assets and research-development underway	For accounting purposes, research and development costs are recorded as expenses when incurred. In a union set to purchase, the amount of the purchase price set by the last payment of the costs of research and development, a direct spend on books. If there are steps in the tax base, the tax temporary differences can occur later.	

Source: Scholes et.al. (2009)

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Financial Accounting (reporting for management purposes) includes all revenues and expenses at the time of occurrence (in accrual basis), while accounting for tax purposes does not recognize some of the revenues and expenses that the company has realized (recognized as revenue and expenses which are not permitted under the laws of the state where the company operates) (Jacek: 2011).

Another difference between book and tax accounting books is the purpose of the company to use a strategy of aggressive reporting or reporting purposes and for tax purposes. An example, if the company intends to show the highest profit (in order to increase the stock price or maintaining the desired level), blowing income, and then the company will pay more tax.

Table 2: The examples of conservative, aggressive and fraudulent accounting

Accounting issue	Conservative accounting	Aggressive accounting	Fraudulent accounting
Revenue recognition	After sale, when risk has passed to buyer	At sale, although risk remains	Non-existent sale (fictitious invoices, etc)
Depreciation	Accelerated over shorter period with low salvage values	Straight-line over longer period with optimistic salvage values	Treating assets-in-use as assets-under-construction (to delay depreciation)
Interest costs	Expensed when incurred	Capitalized in fixed assets	Capitalizing costs of debt that is not related to any specific assets
Estimate of bad debts	High estimate	Low estimate	Lack of write-offs of fictitious receivables established to support non-existent sales
Treatment of advertising, R + D, etc.	Expense	Capitalize	Classifying operating expenses to R&D expenses to increase the amounts capitalized.
Goodwill	Estimated with objective valuation of identifiable assets at acquisition	Overstated by undervaluation of identifiable assets at acquisition	Falsifying subsidiaries' financial statements to avoid impairment of goodwill

Source: Jacek (2011)

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When treated with a conservative accounting - there will be no tax avoidance and tax will be paid as it is. When a company uses aggressive/creative accounting, there will be a delayed payment of taxes and that amount which can be invested stored elsewhere - it's avoidance of tax under the applicable laws and regulations. When the company does not record sales at all, then we are not dealing with strategies to avoid taxes, but we are dealing with tax evasion.

2.1. Application of tax accounting - case study PTK – JSC

We will take an example in Kosovo, PTK, respectively, year 2007 (base year), 2010 and 2011, while for 2012 will take only rounded data and will look better into the differences between profit accounting (in accounting books) and profit after adjustment of revenue and expenditure. Any transaction that occurred in PTK is registered under Kosovo Accounting Standards or in the absence of those standards is based on International Accounting Standards. (PTK: 2012).

Corporate Income Tax in Kosovo is regulated (although with many gaps) based on Law no. 03/ L -162 under the policies of the Ministry of Finance through the Tax Administration of Kosovo (TAK). Research tax base is taken since 2007, starting from the principle that was last year when PTK had a monopoly and is in the tax rates and the Law on Corporate Income has changed drastically in recent years (2010, 2011 and 2012). The year 2007 was taken to see the difference in depreciation expense, which in 2007 had a negative value and there was extra profit tax of 30% (exclusively for PTK) while in 2010 and 2011 the amount of money goes in plus and as so it diminishes profits after expenses regulation (Assembly of Kosovo: 2009).

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Table 3: Corporate Income Tax and effective tax rate

Years	BASE YEAR 2007	2010	2011
Accounting profit	**97,705,668.07**	**37,656,255.42**	**51,534,116.60**
Adjustments to income	0	0	0
Adjustments to expenses: -Deductible expenses -representation expenses -depreciation -Other expenses TOTAL deductible expenses:	 (143,721.71) 0 (6,153,203.48) (6,556,396.00) **(12,853,321.79)**	 (4,795.61) (24,143.71) 8,242,901.29 (5,489,180.20) **2,724,781.78**	 (47,013.65) (23,878.98) 9,994,243.72 (3,603,792.22) **6,319,378.88**
Profit after adjustment of expenses:	110,558,989.86	34,931,473.65	45,214,737.73
Donations	248,589.33	568,100.02	182,138.00
Profit before tax	**110,310,400.53**	**34,363,373.63**	**45,032,599.73**
Tax on profit - by Kosovo Tax Legislation	**22,062,080.00**	**3,436,337.36**	**4,503,259.97**
Extra profit taxes 30%	**26,474,000.00**	**0.00**	**0.00**
Deferred tax expenses	(1,168,000.00)	**909,000.00**	**915,000.00**
Tax rate by Kosovo Tax Legislation	20% plus 30% in extra profit	10%	10%
Effective Tax Rate	**48.50%**	**10.90%**	**10.50%**

Source: Financial Statement – PTK, year 2007-2012

For year 2012 we shall give some general information: accounting profit was € 44,083,000.00 (rounding), the CIT paid tax was € 4,721,000 (rounding), while tax on tax accounting profit would be € 4,408,000 (rounding). Deferred tax expense is € 1,024,000.00. This shows that the effective tax rate in 2012 was 12.70% (financial statement – PTK- year 2007-2012).

Table 4: Difference between financial profit before tax and profit before tax by T.A.K

Year	Financial profit before tax	Profit before tax	Difference
2007	97,705,668.07	110,310,400.53	(12,604,732.46)
2008	80,830,854.54	83,899,216.80	(3,068,362.26)
2009	49,565,517.22	47,640,348.26	1,925,168.96
2010	37,656,255.42	34,363,373.63	3,292,881.79
2011	51,534,116.60	45,032,599.73	6,501,516.87
2012	44,083,000.00	47,210,000.00	(3,127,000.00)

Source: Financial Statement – PTK, year 2007-2012

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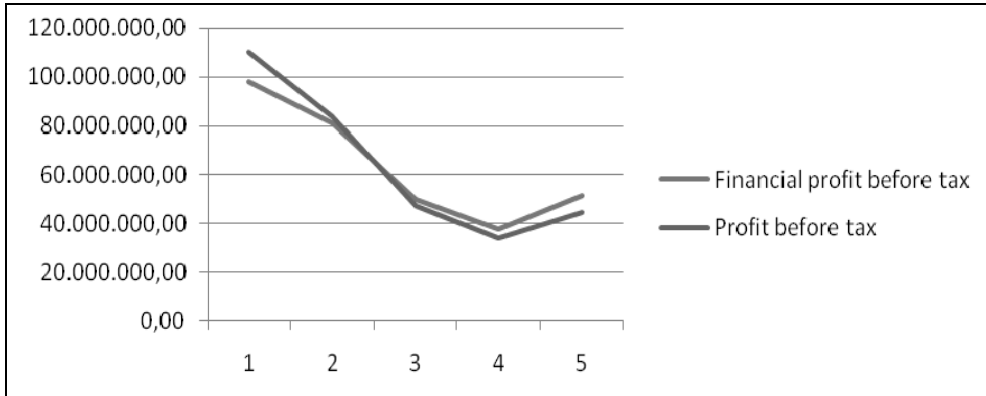
Figure 1: Difference between financial profit before tax and profit before tax by T.A.K



Source: Financial Statement – PTK, year 2007-2012

The major differences between the accounting books and records for tax purposes are presented as a "red flag" for investors. The greater the difference, investors will be more reluctant to invest in the company, given the fact that management is manipulating the numbers, applying various methods that would distort the company's data (Maydew: 2009).

According to records of PTK (under IAS) and the Law on Corporate Income Tax (C.I.T. - Law no. 03/ L -162), it is noticed that the profit before tax is not the same. While accounting profit is € 97,705,668.07, profit after adjustment of expenses goes to € 110,310,400.53 and as a result the tax payable rate is 22.58 %, by adding the extra tax costs in the amount of € 474,000.00 and costs of tax flushing, we find that the effective rate of tax is 48.50 %.

According to Law no. 03/L-146, deductible expenses are costs related to fines and penalties. Consequently the amount of € 143,721.71, for tax purposes, which is not allowed as a deductible expense for the company as it directly, affects the cost and profit.

Costs of representation - under the new law the amount to be deductable is 50 % of the total submit no more than 2% of gross turnover. In 2007 the law has foreseen that as an undeductable expense to be 2% from gross turnover, but before 2007 representative costs included advertising, representation, sponsorship, recreation costs, etc. According to data (law 03/L-162 on C.I.T.) in 2010 the amount of € 24,143.71 and 23,878.98 in 2011

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an amount of expenditure which was not over 2 % of annual turnover, but represents 50 % of the total cost of representation and as such is also undeductable expense for tax purposes, for purposes of reporting as they have already happened and reported as such.

Depreciation expense - PTK depreciation of tangible assets does not invalidate the law in force which has three categories which are to be depreciated by 5%, 20% and 10% (Law Nr. 03/L-162 on C.I.T.) For management purposes the company has assets of cases where a category of second-class is supposed not to invalidate the 20 %, but 7 %, 8 %, 15 % etc. (financial statement PTK), and as a result it also depicts the difference between the depreciation allowed by TAK and depreciation by management. As a result we presented the tax or Deferred tax Flushing. Another difference under the new law is that the law provides with that any asset which was purchased before 30th of June. The full depreciation is recognized for a year, while the assets were acquired from 1st of July. Impairment is recognized only 50 %[1]. The law provides that purchases of assets up to € 1,000 can be recognized as an expense, while purchases from € 1,000 to € 3,000 in total depreciated at the rate of 20 %. As this part is important to note because the law is in Albanian and it says, quote, "asset purchases up to € 1,000 can be recognized as expenses". While the law says the same in English, quote, "asset purchases up to € 1000 should be recognized as expenses. This causes confusion to internal employees, as well as the external auditors (although the total amount is not material).

Table 5: Expenses – Depreciation (in Euro)

Years	ATK	PTK	Difference
2010	25,790,368.33	17,547,467.04	8,242,901.29
2011	27,284,111.83	17,289,917.88	9,994,193.95

Source: Financial Statement PTK

[1] Although this part of the law is confusing and illogical given the facts that: 1. whether it applies this form do not have the straight-line method of depreciation of assets, 2. new law and the old law are identical in point where expected depreciation - except in the examples shown where this is the form of depreciation.

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Table 6: Net Book Value (in Euro)

Years	ATK	PTK	Difference	Tax	Deferred Tax
2010	126,225,676.60	108,828,204.24	17,397,472.36	10%	1,739,747.24
2011	104,155,229.25	96,752,000.56	7,403,228.69	10%	740,322.87

Source: Financial Statement PTK

Other costs at this point are: bonus for staff, accommodation and meals, salaries for travels abroad, bad debts, a fraction of the cost to the Kosovo Telecommunication Regulatory Authority, and damaged cards which have not yet been destroyed etc.

According to the law in force bonuses are deductible for the company, but part of the bonus, and the rest has to do with a trust (for the bonus) PTK distributed in March 2011 for 2010, PTK has therefore assigned as non-deductible costs for 2010 (€ 2,382,383.13) and in 2011 has emerged as the total amount deductible expenses. Although the law provides that expenses incurred by 31.03.2011 can be recognized as a deduction for the previous year, the PTK has not given the principle that tax is paid by salary bonus in February (PTK: 2011).

Accommodation and food - although not too large we presented it to show that accommodation is allowed as a deductible expense amounting to € 80 per night, while the amount of food to € 60 per day (regarding accommodation and food abroad).

Salaries for travel abroad - although the law allows as a deduction lodging and food, and other extra expenses, the staff by neglecting and knowing that the entire amount of 250 euro per day will be theirs and won't be taxed, so they never invoiced expenses.

The law provides that as gross salary should be introduced any income (in this case the amount of allowances should be included in gross salary and taxed). Because this revenue was not attached to employees on salaries, PTK has had to pay tax on their behalf.

Bad debts - is a very large and as such is not recognized by TAK starting from the principle that certain points must be met to be recognized as a deductible expense (although still presented as documentation is not accepted by the TAK and therefore represents the PTK as deductible expenses for tax purposes).

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In other expenses are also introduced some costs that are initially recorded as accruals, but the company did not have any documentation with which would indicate that they are correct. At the time when the company receives the documents, then they can be presented as a deduction.

A substantial sum of deductible expenses includes: costs of health insurance for family members of PTK that part paid by PTK (€ 1,736,543.61 to € 2,496,548.06 in 2010 and in 2011 – financial statement PTK). As explained by the Corporate Income Tax, I quote: "VAT paid on behalf of employees are not allowed as input VAT, but allowed as a deductible expense. While all other amounts paid on behalf of family members are not allowed as input VAT or as a deductible expense.

Scratch Cards - in 2010, PTK has had damaged Scratch Cards in the amount of € 189,114.68. For tax purposes they are not recognized as a deduction in 2010, but are recognized as a deduction in 2012 that were destroyed (in the presence of an official from CIT).

Big difference which is present between the accounting for tax purposes and for purposes of management, has introduced an uncertainty among investors and this is another reason for the decline in the value of the company. Investors are scared by the fact that the management with the sole purpose of gaining greater return are manipulating numbers, and any data in the statements can be inflated and unrealistic.

3. The impact of tax rules on investment decisions

Tax rules affect the level of profit before tax on assets. Tax rules also affect firms' financing decisions through their effect on the cost of financing the activities of the firm. It is said that a firm will take "a decision on capital structure "when deciding how to finance its activities. The firm's capital structure consists of various types of property claims, some referred to as debt and others called active. We emphasize that the costs of issuance of the instrument depends on the capital structure by which the tax treatment is given, which depends on whether the instrument is (1) debt, or hybrid active, (2) is issued to the employee, customer, related party, bank, or a number of other classes of suppliers of capital, and (3) issued by the corporation, partnership, or any other form of legal organization (Scholes et al.: 2009).

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It also depends on the tax jurisdiction in which the instrument is issued on the capital structure. Investments may enjoy one or more kinds of favorable tax status, including (ibid):

- Full exemption from taxation (e.g. bonds);
- Partial exemption or lower marginal rates of tax (for example, capital assets in many countries);
- Tax credits (for example, investment tax credits, loans targeted for jobs, and alcohol fuel credit, research and experimentation credit, home loans for low income, credit for investments in energy tax credit to pay, and rehabilitation investment credit);
- Tax deductions allowed faster rate than economic depreciation of the asset (for example, accelerated depreciation of business property, immediate expenses for research and experimentation costs and advertising costs);
- Taxable income allowed for lower rate than the increase in the economic value of the cash flows from the asset (for example, most of which add real value).

When tax rates are constant under the law for a time, firms faced with the experience of the utilization of net operating loss (NOL) typically face marginal tax rates lower than those that do not face the same. In the presence of net operating losses and other transfers, the current marginal tax rate is sensitive to changes in future tax rates under the law.

Tax rates change over time; the same is done by the clientele of investment and financing. Because it is costly to change the customer's investment and financing as tax status changes, taxpayers put premium on strategies that enable activities to be reorganized as low cost.

For 2007, PTK has been required to pay an additional tax of 30%, as a result of an administrative instruction, concerning companies with a turnover of over € 100 million a year and monopolistic companies (MEF/TAK: 2006). Practically this administrative instruction has been developed exclusively for PTK. In 2009, when the final decision was made on the privatization of PTK, shareholders made the decision for no capital investments. The entire amount collected from company profits were deposited in banks in Kosovo. Following this decision, another decision came where the entire amount deposited had to go to the shareholders. When shareholders made these decisions, PTK had virtually no chance to develop. December 12th 2007 was the date when the second

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telecommunications operator IPKO mobile was licensed. From that moment on, although PTK had almost a monopoly in Kosovo (excluding some interferences by Serbian Mobtel), it began to lose the market on a galloping pace. PTK opportunities for capital investment were too big. Projects which PTK had provided remained only on paper.

Had not these occurrences taken place: there would not be no additional tax of 30 %, no dividend would be distributed (within 6 years are given € 340 million), there would not be a block on PTK capital investment and it could be invested in: wave antennas distribution throughout the territory of the Republic of Kosovo, enhancing the waves, investment in fiber optic and internet distribution throughout the territory of the state, along with the Internet through optical fibers would be emitted even cable television.

Later, in 2012, the shareholders decided to release shareholder investments. But it was too late. There was lack of money for the first investment. It was too late to invest in internet distribution, because the competition had already made its distribution throughout the territory of the Republic. Investment in cable television was too late and useless, starting from the principle that PTK competitors had already signed a contract with DIGITALB, and Kosovar families were already familiar with these programs.

The only possibility of salvation for PTK is its privatization, and that is the sooner the better, so that its value does not decline further. Impairment of PTK is the result of wrong policies by the shareholders, mismanagement and abuse by internal management, strengthening competition, loss of clientele, etc.

What hurdled foreign investors to come and invest in Kosovo? Despite some political obstacles, there are many legal obstacles regarding tax, which make foreign investors reluctant to invest in Kosovo.

It is true that Kosovo has the lowest tax rate (CIT) of 10%. But in Kosovo there has been in effect a regulation that has fulfilled the law in which it is stated, Article 2.1 of the Administrative. Order 10/2006/1 pursuant to Regulation no. 2005/56, I quote:" Additional tax to be applied to subjects must meet two criteria: 1. subject to annual gross income of € 100 million and 2. Have a monopoly in Kosovo. Starting from this principle, any foreign investor will not invest in Kosovo. In 2007 there were 20 % tax, plus extra profit taxes of 30%. Which means that if a global giant corporation would like to invest in Kosovo - should 44% of the profit be paid on behalf of the State Corporate Income Tax?

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In addition we present in tabular form C.I.T. and V.A.T. for Balkan Peninsula.

4. Conclusions and Recommendations

Kosovo Corporate Tax Law has many shortcomings and legal gaps where companies can exploit. But the principle does not apply to the legal gaps that need to be in favor of companies. If a company uses these gaps then there is a risk of being called a tax evasion and no one would dare to use them. As for the Flushing Tax, companies are able to utilize and show a greater profit for the purposes of management and shareholders, but there is a risk of losing the confidence of investors, thinking that the information in the financial statements are not real.

Big difference which is present between the accounting for tax purposes and for purposes of management, has introduced an uncertainty among investors and this is another reason of the decline in the value of the company. Investors are scared by the fact that the management with the sole purpose to show greater return are manipulating numbers, and any data in the statements can be inflated and unrealistic. The major differences between the accounting books and records for tax purposes are presented as a “red flag" for investors. The greater the difference, the more the investors will be reluctant to invest in the company, given the fact that management is manipulating the numbers, applying various methods that would distort the company's data.

With the introduction of the Administrative Instruction on surcharge, blocking of capital investment, the entire distribution of retained earnings in dividends name, strengthening of IPKO- the main competitor, mismanagement and misuse; the company's value has fallen drastically. It is therefore essential to privatize PTK as quickly as possible.

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