PRACE NAUKOWE
Uniwersytetu Ekonomicznego we Wrocławiu

RESEARCH PAPERS
of Wrocław University of Economics

Nr 351

Finance and Accounting – Theory and Practice

edited by
Jacek Adamek
Magdalena Swacha-Lech

Publishing House of Wrocław University of Economics
Wrocław 2014

Copy-editing: Elżbieta Macauley, Tim Macauley

Layout: Barbara Łopusiewicz

Proof-reading: Barbara Cibis

Typesetting: Beata Mazur

Cover design: Beata Dębska

This publication is available at www.ibuk.pl, www.ebscohost.com,
Lower Silesian Digital Library www.dbc.wroc.pl,
The Central European Journal of Social Sciences and Humanities http://cejsh.icm.edu.pl
and in The Central and Eastern European Online Library www.ceeol.com,
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Information on submitting and reviewing papers is available on
the Publishing House's website
www.wydawnictwo.ue.wroc.pl

ISSN 1899-3192
ISBN 978-83-7695-406-6

The original version: printed

Printing:
EXPOL, P. Rybiński, J. Dąbek, sp.j.
ul. Brzeska 4, 87-800 Włocławek

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Streszczenia

PRACE NAUKOWE UNIWERSYTETU EKONOMICZNEGO WE WROCŁAWIU
RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS nr 351 • 2014
Finance and Accounting – Theory and Practice ISSN 1899-3192

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TAXES AND FINANCIAL ACCOUNTING

Summary: The paper deals with the uneven approach to financial accounting in practice, where preference is given to so called tax accounting that fails to meet one of the goals of financial accounting − true and credible − does not provide a true and fair view. The paper presents particular examples of the complex accounting of value added tax from advance payments at the breakpoint of two accounting periods as well as examples of income tax accounting − particularly the introduction of long-term assets into company books and their depreciation.

Keywords: financial accounting, value added tax, income tax.

DOI: 10.15611/pn.2014.351.02

1. Introduction

The paper deals with the uneven approach to financial accounting in practice, where preference is given to so called tax accounting that fails to meet one of the goals of financial accounting − true and credible − does not provide a true and fair view. The paper presents particular examples of the complex accounting of value added tax from advance payments at the breakpoint of two accounting periods as well as examples of income tax accounting − particularly the introduction of long-term assets into company books and their depreciation.

As an auditor I often face the 'financial accounting vs. tax accounting' problem, where tax accounting is adapted to tax legislation and the principal goal of financial accounting is therefore not fulfilled.

The generally accepted goal of financial accounting is "to keep the accounting books in a way so that the **financial statements provide a true and fair** description of the subject of accounting and the financial position of the company (as a reminder, the financial statements cover the balance sheet, profit and loss statement, annex to financial statements). Czech accounting legislation determines how to keep accounts but also allows for certain departures from the approved methodology in order to provide a true and fair view.

The following paper presents a few accounting transactions which have been considerably affected by tax legislation, especially value added tax (VAT) legislation and legal entity income tax (LEIT) legislation.

2. VAT vs. financial accounting

The vast majority of problems is caused by **VAT** legislation. After several amendments in recent years, VAT reporting, particularly input VAT claiming, as well as the posting of a tax document, is a quite complex task. In the past the posting of a received tax document (invoice) into company books was rather simple. Now the posting of the same accounting transaction is quite complicated and requires multiple entries by multiple accountants. As a result the costs for accounting systems and administration increased as did the amount of work for accounting, as well as for the inspection bodies. This led to a decrease of labor efficiency. (I dare to say the government income from VAT did not change much, only the cash flow was affected by the monthly off-set. VAT is newly paid from advance payments and input VAT is claimed a month after it is paid by the supplier.)

Example 1: Claiming VAT deduction at the break of accounting periods

a) Former method of accounting

A company received a tax document dated 10.1.2008 with a taxable fulfillment date of 31.12.2007 for the cleaning works performed in the company building in December 2007. Input VAT could have been claimed **in December 2007** and the tax document posted into the company books for the year 2007. The claim for VAT deduction by the client and VAT paid by the supplier were both realized jointly in the same accounting period.

Items	Amount in CZK	Debit account	Credit account	Accounting period
Expenses – cleaning 12/2007	100,000	518 (services)	321 (suppliers)	2007
VAT 20%	20,000	343 (VAT)	321 (suppliers)	2007

Benefits:

- very simple book entry
- easy checking (confirmation of claims / liabilities, easy inventory of accounts, link between claimed VAT and expenses / purchases)

b) The new method of accounting:

A company received a tax document dated 10.01.2013 with a taxable fulfillment as of 31.12.2012 for cleaning of the company building in December 2012. Input VAT could have been claimed in **January 2013** and the tax document posted into the company books in January 2013, however from the financial accounting point of view these expenses belong to December 2012 and the liability arises as of 31.12.2012.

Items	Amount in CZK	Debit account	Credit account	Accounting period
Expenses – cleaning 12/2012	100,000	518 (services)	383 (deferred expenses)	2012
VAT 21%	21,000	343 (VAT)	321 (suppliers)	2013
Accruals and deferrals	100,000	383 (deferred expenses)	321 (suppliers)	2013

Disadvantages:

- biased liabilities (balance) as of 31.12.2012 (complications at confirmation of claims and liabilities, missing liability)
- complex inventory of account 383 – deferred expenses
- direct link of expenses to tax document in 2012 is missing
- complications with claiming VAT as expenses in 2012 (at audit)

Example 2: Accounting of advance payments and tax documents

A. Former method of accounting:

A supplier of materials asked for the payment to be made in advance (by e-mail communication). On 24.7.2007 the customer made the payment. The supplier received the payment on 26.7.2007 and supplied the material on 2.8.2007. A single tax document was issued by the supplier as of the delivery date, i.e. 2.8.2007. The customer posted this transaction into the company books in a simple way as of 5.8.2007.

Items	Amount	Debit account	Credit account
Payment from bank account	12,000	314 (provided advance payments)	221 (bank account)
20% VAT following taxable fulfillment according to tax document	2,000	343.A (input VAT)	321 (suppliers)
Posting into expenses based on tax document	10,000	111 (material procurement)	321 (suppliers)
Settlement of advance payment	12,000	321 (suppliers)	314 (provided advance payments)

Benefits:

– simple book entry,
– transparency of accounting operations (mutual links),
– easy checking (confirmation of claims / liabilities, inventory of accounts).

B. New method of accounting

A customer was asked by the supplier of materials (by e-mail) for an advance payment for the delivery of the materials. On 24.7.2012 the advance payment was reimbursed, whereas the supplier received the payment on 26.7.2012. The ordered materials were supplied on 2.8.2012. The supplier issued a tax document as of the day of receipt of the advance payment. As of the materials delivery date (i.e. 2.8.2012) the supplier issued a settlement tax document (invoice). Customer posted the transaction into company books as follows:

Items	Amount	Debit account	Credit account
Payment from bank account	12,100	314.100 (advance payments made)	221 (bank account)
Tax document for advance payment –21% input VAT	10,000	314.200 (advance payments made – tax documents)	321 (suppliers)
21% input VAT (from tax document)	2,100	343.100 (input VAT)	321 (suppliers)
Settlement of advance payment made	12,100	321 (suppliers)	314.100 (advance payments made)
Settlement tax document	10,000	111 (material procurement)	321 (suppliers)
Advance payment clearing	10,000	321 (suppliers)	314.200 (advance payments made – tax documents)

Disadvantages:

– multiple book entries,
– complex sequence of book entries,
– accumulation of balances on individual analytical accounts 314 (advance payments made),
– extensive checking (confirmation of claims/liabilities, inventory of accounts).

In this case there are more variants of posting and each individual accounting unit may have its own method of posting set, even with regard to the options offered by the information system and method of settlement (clearing) by the supplier. The transaction requires multiple book entries to meet the requirements set by VAT legislation.

3. Legal entity income tax vs. financial accounting

Financial accounting is also quite considerably subordinated to income tax legislation, for example the technical appreciation of long-term assets and repairs are subordinated to tax regulations, long-term assets are depreciated using tax rates, adjusting entries are only generated for claims (due to tax reasons), costs that should be − from the financial accounting point of view and as a reason for beingcareful − posted directly on the expense accounts are instead accrued as deferred expenses (e.g. working clothes, costs for moving, costs associated with new production projects etc.).

Example 3: Tax depreciations in accounting

Companies often use so called tax depreciations, i.e. the amount of depreciations posted on company accounts is equal to tax depreciations.

A company started to operate the machine (and put it in the accounting books) in November 2012. The value of the machine was CZK 1 million. Since 12/2012 it started to depreciate the machine (stamping machine) and claimed the tax depreciation for 2012. It claims even depreciations based on 3 depreciation rate with a depreciation period of 10 years. Monthly accounting depreciation would be CZK 8,333.00, i.e. CZK 100,000.00 per year. In the last (tenth) year the depreciation would be CZK 91,667.00.

Year	Rate − tax depreciations	Tax depreciations	Rate − book depreciations	Book depreciations	Difference
1	**5,50%**	**55 000**	**0,83%**	**8 333**	**46 667**
2	10,50%	105 000	10,00%	100 000	5 000
3	10,50%	105 000	10,00%	100 000	5 000
4	10,50%	105 000	10,00%	100 000	5 000
5	10,50%	105 000	10,00%	100 000	5 000
6	10,50%	105 000	10,00%	100 000	5 000
7	10,50%	105 000	10,00%	100 000	5 000
8	10,50%	105 000	10,00%	100 000	5 000
9	10,50%	105 000	10,00%	100 000	5 000
10	10,50%	105 000	10,00%	100 000	5 000
11	0,00%	0	9,17%	91 667	–91 667
Total	*100,00%*	*1 000 000*	*100%*	*1 000 000*	*0*

From the table it is clear that in the first year the depreciations posted in the company books should only amount to CZK 8,333.00 (only for 12/2012). If a company posts the tax depreciations, in the first year it posts on the expense account the depreciation of CZK 55,000.00. In this way the depreciations are biased by CZK 46,667.00. In the following years the difference is CZK 5,000.00 and in the last year the difference is CZK 91,667.

Remark: In the vast majority of cases, tax depreciations are higher than real (book) depreciations should be. The real life of assets is longer than expected by tax legislation. This is not an issue from the carefulness point of view, however from the true and fair principle point of view, depreciations are higher than the real wear and tear and the remaining balance is undervalued.

Example 4: Commencement of assets use

According to accounting and therefore also tax regulations, the factual use of real estate may only begin upon the fulfillment of technical functions and meeting the obligations set by special legislation, i.e. upon final approval of the assets for use. In practice there are some cases when assets are used however not having been finally approved for use, e.g. due to hygienic/noise tests or other problems. Final approval may be carried out even one year after the building was put into use − therefore there is a time discrepancy between the factual use of real estate and their inclusion into the company books and the commencement of depreciations.

In January 2012 a building was acquired by the company. In 2-4/2012 the building was subject to reconstruction. In 5/2012 the machinery and equipment were moved in, while production has started from 6/2012. Due to some issues at the Real Estate Register (with the building acquired and the noise tests), the building was approved for use in August 2013. The acquisition price of the building was CZK 20,000.00 thousand. The company will depreciate the building over 30 years (book depreciations).

Monthly depreciations amount to CZK 55,556.00.

Items	Period	Months	Expenses in CZK
Depreciation expenses missing	6-12/2012	7	388 892
Depreciation expenses missing	1-8/2013	8	444 448
Total depreciations missing			**833 340**

It is obvious from the table that in 2012 the amount of CZK 388,892 was missing in the expenses, whereas in 2013 it was as much as CZK 444,448. As of 31.8.2013 the amount of CZK 833,340 is missing in the expenses and as of the same date the building is overpriced by the same amount. Should the financial accounting goal be preserved, the building would have to be depreciated starting from the date of its first use, over its gradual depreciation, disregarding the formal approval of the building for use (by the authorities).

4. Conclusion

Accountants often deal with the issue of how to post a transaction to satisfy the various needs of multiple stakeholders (users of financial statements, management, government), notwithstanding how simple these transactions are (e.g. procurement of material). In most cases, accountants make use of the safer variant because of their fear of potential sanctions, i.e. they enter transactions into company books on the basis of tax regulations, to the detriment of financial accounting goals − a true and fair view.

References

Act No. 563/1991 Coll., on Accounting.
Act No. 586/1992 Coll., on Income Taxes.
Act No. 235/2004 Coll., on Value Added Tax.

PODATKI A RACHUNKOWOŚĆ FINANSOWA

Streszczenie: W artykule przedstawiono podejście do rachunkowości finansowej w praktyce, w której preferowana jest tzw. rachunkowość podatkowa, a nie cele rachunkowości finansowej, czyli przedstawienie wiernego i uczciwego obrazu majątku przedsiębiorstwa. W opracowaniu pokazano konkretne przykłady skomplikowanego księgowania podatku od towarów i usług z zaliczek na przełomie okresów obrachunkowych oraz księgowe przykłady dotyczące podatku dochodowego − amortyzacji i ujmowania aktywów trwałych.

Słowa kluczowe: rachunkowość finansowa, podatek od towarów i usług, podatek dochodowy.