EXPLORING THE IMPACT OF TAX DIVERGENCE IN FINANCIAL REPORTING. A CASE OF ALBANIA (2022)

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Abstract:
The interplay between tax divergence and financial reporting in Albania has assumed growing importance. This research, grounded in a post-positivist paradigm, seeks to elucidate the connection between these variables and discern which exerts the greater influence. The methodology is a qualitative dimension involved in the analysis of secondary data from businesses and the examination of tax laws and accounting standards. We elaborate the topic by taking on the one hand the main items of Accounting Standards and on the other hand the main items of the tax legislation in force. Furthermore, the research incorporates a quantitative component using a questionnaire to collect perceptions from professionals. This adds a descriptive or cross-sectional element to the research, but the primary emphasis remains on exploration and understanding, making it predominantly an exploratory research type, employing an ex-post-facto methodology.
The study reveals that in the Albanian context, tax regulations wield a substantial impact on the practices of financial reporting. Variations in tax laws often prompt the application of creative accounting techniques, leading to information imbalances that can have ramifications for decision-making. Notable instances have illuminated how tax divergence can yield discrepancies in financial reporting, compelling the necessity for regulatory adaptations and elevated reporting standards.
From this research, several pivotal recommendations have emerged. These emphasize the synchronization of legal and accounting frameworks through the reduction of permissible accounting and tax methods. This strategic alignment aims to enhance comparability while minimizing opportunities for divergence. Management is encouraged to acknowledge the significance of effective tax planning, institute a robustly supervised Code of Ethics, and actively endorse its observance. Tax authorities are urged to invest in expanded training, with an urgent imperative for streamlining tax legislation. This paper offers valuable insights for stakeholders such as investors, management, policymakers, regulators, to enhance financial transparency, benefit and compliance by addressing the impact of tax divergence on financial reporting in Albania.

Keywords: tax divergence, financial reporting, tax laws, accounting standards

Introduction

Contemporary business operations can be characterized as a symbiotic relationship involving the exchange of information between parties possessing pertinent data and those individuals or entities affected by and interested in said information. Those in possession of this information are motivated to present what aligns with their preferences and interests, while those seeking this information aspire to receive accurate, complete, and timely data. Notably, distinct information requirements give rise to various reporting needs, resulting in reports that often exhibit disparities. This tax-accounting divergence can manifest in a multitude of forms, with financial reporting differing significantly from tax-related reporting or, in some instances, representing an amalgamation of both. The impact of tax divergence has become a topic of increasing importance. The impact of tax divergence, especially in the context of different reporting standards beyond accounting norms, has emerged as a critical concern.

This topic is of great importance because it reveals a complex interaction between tax and accounting practices, which directly affects a company's financial health and investment, financing or other decision-making processes. Understanding these intricacies is essential for both investors, management, regulators and policy makers as it can illuminate how companies optimize their financial statements to minimize tax liabilities while complying with regulatory standards and to enhance tax compliance and the reduction in frauds. Furthermore, this paper sheds light on the ethical and legal implications of these practices.

In the realm of accounting research, the term "tax divergence" is introduced as a novel concept aimed at capturing the nuanced variations between tax laws and accounting standards, consequently resulting in divergent reporting practices. One facet of tax divergence manifests in the form of tax rulings, where mandatory tax law requirements differ from

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corresponding accounting standards, necessitating distinct reporting approaches. Conversely, scenarios may arise where tax laws exhibit flexibility or impose no specific mandates, affording leeway for accounting reporting to precede or deviate from tax-related requirements. Therefore, tax divergence will related to the differences in reporting between tax law requirements and accounting standards requirements leading to two different frameworks and basis for reporting.

The main question and related sub questions of this research study are as follows:

Main question: What is the relationship between tax divergence and financial reporting in Albania and which imposes their own rules more on the other?
Sub question 1: How does the concept of tax divergence influence financial reporting practices in Albania, and what are its applications in assessing the impact on financial statements and disclosures?
Sub question 2: To what extent does the utilization of creative accounting in Albania's financial practices result from or is independent of tax divergence, and what are the underlying motives, methods, and purposes of such creative accounting practices?
Sub question 3: Are there any notable cases or examples in Albania where tax divergence has led to significant discrepancies or challenges in financial reporting, and how were they addressed by regulatory authorities or the affected entities?

This research study adopts a post-positivist paradigm, emphasizing reductionism, empirical evidence, and objectivity. It employs an ex-post-facto approach to analyze past events for cause-and-effect relationships. The research combines both quantitative and qualitative methods, primarily focusing on qualitative interpretation of primary and secondary data.
It is primarily an exploratory research approach, delving deep into existing literature, conducting qualitative analysis of secondary data, and utilizing a structured questionnaire to collect insights from professionals. The study aims to comprehensively examine the relationship between Accounting Standards and tax laws in Albania.
In Albania, tax regulations strongly influence financial reporting practices, often leading to creative accounting approaches and information disparities that impact decision-making. Prominent cases highlight the need for regulatory adjustments and improved reporting standards.

Materials and methods

The paradigm of this study is post-positivism, whilst this research study identified as ex-post-facto, which is interpreted as the analysis of what happened in the past to identify cause-and-effect relationships, takes into account circumstances and collects data to establish relationships, explain behaviors and explore (Kerlinger, 1973; Ormrod and Leedy, 2015).
The type of research is primarily an exploratory research approach. Exploratory research is conducted to gain a deeper understanding of a subject, identify variables, and generate initial insights or hypotheses. It involves a thorough exploration of existing literature and often includes qualitative data analysis to develop a foundational understanding of the topic. In addition to the exploratory aspect, there is also a qualitative dimension involved in the analysis of secondary data from businesses and the examination of tax laws and accounting standards. This qualitative analysis adds depth to the research, allowing for a nuanced understanding of the subject matter. We elaborate the topic by taking on the one hand the main items of the Accounting Standards and on the other hand the main items of the tax legislation in force. The treatment will be of a comparative type, first showing what the accounting reportings asserts and then how the issue lies in the tax legislation. Further, through the scientific method of Lamb 1998, the dominance of reports will be addressed, which report dominates the other and imposes its own rules.
Furthermore, the research incorporates a quantitative component through the use of a questionnaire to collect perceptions from professionals. This adds a descriptive or cross-sectional element to the research, but the primary emphasis remains on exploration and understanding, making it predominantly an exploratory research type. Regarding the questionnaire, it has three sections. The first section of the questionnaire has 6 questions, which have an informative nature about the respondent and the entity where the respondent works. The second section of the questionnaire serves to provide information regarding the use of tax divergence and its application in the form of a creative accounting in Albania. It consists of 11 quantitative and qualitative questions. The third and last section serves to provide information regarding the tax divergence in the theory-practice relationship and impact on financial reporting regarding financial statements or disclosure. The questionnaire consists of 11 questions and serves to obtain information about the spaces that the Albanian tax system has and that are used by the subjects without violating the tax legislation.
The questionnaire addresses 100 subjects and was completed by 96 individuals in different subjects, all with experience in their field, so 96% is the completion rate. These subjects have been in organizations of different sectors of the economy and different types of their form of creation, with different levels of employees and different annual turnover.

The selection of the study's location (Albania) is chosen for several reasons. Albania's recent economic and regulatory transformations, marked by a shift from a centralized to a market-oriented economy, create a unique regulatory environment that warrants in-depth study. The country's status as an emerging market adds complexity, presenting distinct challenges and opportunities for businesses. Exploring the interplay between tax policies and financial reporting in this context can yield valuable insights with broader applicability to other emerging markets experiencing similar transitions. Furthermore, Albania's pursuit of European Union integration introduces an additional layer of complexity, as aligning tax and financial reporting practices with EU standards becomes crucial. Investigating the impact of these dynamics on the regulatory landscape and business strategies provides a rich field for research and analysis.

Limitations worth mentioning are the accuracy and completeness of secondary data can be subjective; limitations in time and financial resources; the respondents in the questionnaire are in small number and we cannot say that it is represented quantitatively; non-answers in the questionnaire and their degree of accuracy is a limitation, as we encountered cases of answers within a questionnaire, which are in contradiction with each other.

This research study collects data from different companies and different tax laws and accounting standards at a specific point in time for 2022. Hence, this data approach is cross-sectional data. Data comes from primary and secondary sources. Initially, the sources of secondary data will be the review of existing literature providing answers to the use of creative accounting and tax divergence and accounting standards and tax laws. Regarding the primary data, it is collected through a questionnaire consisting of 3 sections as mentioned above in the methodology.

Results and Discussion

The results of the exploratory analysis regarding the relationship of tax laws and accounting standards were that tax legislation dominates and influences the financial reporting as follows:

• Effective tax rate in financial statements might be different to tax rates of tax laws.

• Valuation, initial measurement and subsequent revaluation of inventory is different from tax laws since revaluations, LCM or impairment are not recognized as per tax laws. The case of revaluations or impairment is relevant for all other assets. On the other hand, on derecognition of damaged/ obsolete inventory they are non-deductible expenses for income tax unless a specific procedure is followed.

• Differences between taxable income and accounting income can affect a company's cash flow. For example, if a company pays more taxes than it reports as income tax expense, it will have a lower cash flow, which can affect investment decisions.

• Accounting standards foresee the making of corrections by the economic entity, in case of evidence of special events which affect the financial statements drawn up but not yet declared. The tax legislation does not express itself in this case.

• Based on the requirements of accounting standards, differences between tax laws and financial accounting standards may lead to the recognition of deferred tax assets and liabilities in the financial statements.

• Depreciation rates as per tax laws differ from the accounting estimates that accounting standards allows to be made.

• Impairment of financial or non-financial assets of accounting standards, as per tax laws in Albania is not recognized, hence it is non-deductible expense.

• Revenue recognition according to accounting standards is done according to the phased model where the moment of recognition is the moment when the performance obligation for the identified independent components has been met in accordance with the terms of the contract based on its individual value in the market. This moment does not necessarily coincide with the issuance of the invoice. In the case of taxes, recognition is always on an invoice basis.

• According to accounting standard of finance lease, recognized expenses are depreciation and interest expenses; meanwhile, according to taxes, it is the payment of the rent based on the invoice

• Companies may have uncertain tax positions or tax contingencies that are disclosed in their financial statements. These reflect potential tax disputes with tax authorities, which are not recognized under tax.

To summarize the treatment according to Lamb et al. (1998), Nobes and Schwenke (2006) have used two indices. The minimum index is a conservative measure of the tax impact on financial reporting, so tax reporting has little impact on that of accounting reporting. The maximum index is a maximum (liberal) measure, where the impact of tax reporting is maximum over the accounting one.

The minimum index is 1.5, while the maximum is 3.5, so we see that tax reporting has maximum impact on accounting reporting. The cases of accounting identity and leadership of 2 and 3 are excluded, since we are not interested in the impact that accounting has on taxes, but we are interested in the impact that taxes have on accounting. As in most developing countries, Albania is still a country oriented towards tax reporting and that accounting suits it, so accounting in Albania is not regarded as a valued value that provides useful information but is often regarded only as mandatory and the reason why it is kept is only for the effect of tax reporting.

Regarding the questionnaire, it targeted highly educated professionals. Out of 96 respondents, 1 had a high school degree, 24 had a bachelor's, 65 had a master's, and 6 had completed a doctorate. The survey focused on entities subject to tax legislation, with 62 working in companies with turnovers between 8 and 100 million, 15 with turnovers between 100 and 500 million, 6 with turnovers over 500 million, 10 in businesses with turnovers between 5 and 8 million, and only 3 had turnovers under 2 million.

All respondents were aware of the benefits of creative accounting. The main benefits mentioned are tax avoidance, reduced borrowing costs, and increased stock prices. This reflects a unique situation in Albania, where the focus is on minimizing tax payments, unlike in developed countries where the aim is to increase profits for higher stock market ratings. Out of the respondents, 96.74% have used or heard of creative accounting methods.

The primary consequences of using creative accounting, as reported by survey respondents, included tax fines, legal and civil penalties, damage to a company's reputation, job loss due to increased responsibilities, harm to customers, shareholders, and negative long-term perspectives. This suggested that professionals in Albania prioritize fear and penalties over ethical considerations, influenced by vested interests and the long-term viability of their economic entities. The most common creative accounting techniques used in Albania involve altering depreciation policies, off-balance sheet activities, early purchases, and various recognition deferrals, while less commonly employed techniques include capitalizing research and development expenses and non-material asset expenses, among others. The primary motivators for using creative accounting were tax objectives, internal objectives, and financial manipulation

The survey also revealed that many respondents considered tax legislation in Albania to be ineffective, with only two respondents believing it was effective. This suggests that there are significant challenges in applying tax theory in practice. Regarding tax planning, most respondents viewed it as important but not to the extreme, highlighting the need for a balanced approach. The majority of respondents were aware of the concept of tax divergence and the benefits it could bring, particularly in reducing taxes.

Interestingly, the study found a division among respondents. Some aimed to minimize profit before taxation to pay as little tax as possible, while others were more interested in utilizing state agreements and regulations. This division likely stems from different backgrounds, with some dealing primarily with foreign entities and others with typical Albanian businesses. The study concluded that tax legislation in Albania needs to be adapted to align with practical realities and avoid conflicts between different laws, particularly the Tax Procedure Law and other tax-related legislation. The findings also emphasized the importance of fostering a better understanding of tax divergence and its implications among professionals.

In aligning with existing literature, the findings of this study echo patterns observed in prior research, suggesting a commonality in the behavior of developing countries. Specifically, the case of Albania reflects a prevailing orientation towards tax reporting, akin to the trajectory seen in many other developing countries. Notably, accounting practices in Albania are predominantly viewed as obligatory, with their primary purpose perceived as serving tax reporting requirements rather than being esteemed for the valuable information they can provide. This aligns with the prevailing sentiment in similar contexts where accounting is often seen as a mandatory compliance exercise rather than a strategic tool for decision-making. The congruence of these outcomes with earlier studies reinforces the broader trend of emerging economies prioritizing tax considerations over recognizing the inherent value of robust accounting practices.

In summary, this study shed light on the motivations and perceptions of professionals in Albania's accounting and taxation sector. It highlighted the need for more effective tax legislation and a balanced approach to tax planning while acknowledging the complexities of applying tax theory in practice. The findings provide valuable insights for policymakers and practitioners in the field.

Conclusions

Based on the results, this research study indicates that tax reporting has a significant influence on accounting reporting. Cases of identity and accounting dominance have been excluded, as our focus is on the impact of taxes on accounting, not the other way around. Like in many developing countries, Albania remains tax-centric, and accounting is adjusted accordingly. In Albania, accounting is not considered a valuable source of useful information but is often viewed as a mere obligation for tax reporting.

A careful analysis of the questionnaire responses reveals a general contradiction. This stems from the fact that our respondents include 28 young professionals, 16 with 11-15 years in the profession, and 23 with over 15 years of experience. This suggests, not empirically or scientifically, but in a general sense, a "conflict" between generations. This "conflict" arises from different educational levels, cultural and professional differences, reflected in their divergent knowledge and interpretation of accounting practices.

If creative accounting aligns with ethical and legal standards and generally accepted accounting principles (GAAP), it can have highly positive effects on companies and stakeholders. Current accounting regulations allow managers to choose and apply different methods in accounting, giving them the flexibility to implement creative accounting techniques. Creative accounting is widely used to "manipulate" (not just in a negative sense) third parties and provide information that suits business interests rather than what is necessary. Tax legislation offers ample flexibility and cannot keep up with the rapid pace of business practices. Taxation practices are dynamic, evolving, while tax legislation remains static.

Employees working in tax administration face significant challenges with experience, general knowledge, and accounting expertise. Even when practice finds support in theory, i.e., there is a legal basis, practical implementation is hindered by bureaucracy, lack of cohesion in the overall process, and a variety of other reasons requiring a holistic integration and solution.

In summary, in Albania, tax divergence and financial reporting are closely intertwined. Tax rules impact financial reporting practices, and the variation in tax regulations can lead to creative accounting techniques being used to exploit gaps in the law, creating information asymmetry. This can affect decision-making. Notable cases in Albania have shown how tax divergence can result in discrepancies in financial reporting, requiring regulatory authorities and companies to address the issues through regulatory changes or improved financial reporting standards. Balancing these elements is essential for transparency and fairness, and practical implementation remains challenging due to various issues.

In our quest to address a widespread issue, a set of crucial recommendations emerged such as combining both legal and accounting systems by reducing the number of allowable accounting and tax methods. This helps increase comparability and reduces divergence possibilities. From the perspective of management, they must recognize the importance of effective tax planning for businesses and encourage its practice and develop a Code of Ethics that is fully applicable and rigorously monitored for compliance. Regarding the perspectives of tax authorities, more training is needed and there is an immediate need for a simplification of tax laws.

Future research should aim to build upon the current findings by delving deeper into the specific drivers such as cultural, economic, political, or regulatory factors. Additionally, conducting cross-country comparisons, exploring the consequences of the tax prevalent orientation. Finally, considering the impact of international accounting standards on the interplay between tax divergence and financial reporting in developing economies. Such endeavors would contribute to a more nuanced and comprehensive understanding of these complex dynamics, providing valuable insights for practitioners, policymakers, and scholars alike.

Declaration of Conflict of Interests

After taking into consideration all the facts and circumstances, I confirm that this paper carries no ethical issues and all the work done in this study is according to the ethical standards and there is no conflict of interest of any kind.

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