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## **The Connection between Accounting and Taxation from the Perspective of Preparing the Financial Statements**

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Nexhmie Berisha Vokshi<sup>1</sup>

**Abstract:**

*Business organizations apply international and national accounting standards to construct publicly available financial statements and financial reporting, but the respective goals, principles and requirements of accounting and taxation are not always the same.*

*Based on this fact, this paper aims to address important issues related to the presentation of the economic reality in Kosovo, where the existence of the accounting-taxation relationship when preparing financial statements produces its effects depending on the degree of intensity that characterizes this relationship.*

*Using research results, this paper provides an overview of the reporting regulatory framework in both reporting areas and points to the correlation between financial and fiscal reporting in the preparation of financial statements, classifying this relationship in one of the five categories recognized in international literature.*

**Keywords:** Accounting, taxation, accounting information, financial statements, financial reporting, fiscal reporting.

**JEL classification:** M41, H29.

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<sup>1</sup> Associate Professor, PhD, Faculty of Economic, University of Prishtina, Kosovo  
e-mail: [nexhmie.berisha@uni-pr.edu](mailto:nexhmie.berisha@uni-pr.edu); [nexhmie\\_vokshi@yahoo.com](mailto:nexhmie_vokshi@yahoo.com)

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## 1. Introduction

All those who are in charge of making decisions within a business organization and the tax authorities are interested in accounting and the information it provides. Therefore, it is very of paramount importance that the information on the elements contained in the financial statements is accurate, coherent and well-founded in the legal regulations. Without such information or with incomplete information, their decision-making would be improper and ineffective.

This is precisely the issue tackled by this paper, by researching the degree of knowledge and implementation of legal regulations by professionals during the preparation of financial statements. Therefore, the purpose of this paper is to gain information about the current situation of business organizations, whether they are oriented towards the rigorous application of accounting and fiscal regulations in order to represent their economic activity in the financial statements.

To achieve the research goal, research objectives were established, such as: knowledge of regulatory requirements regarding financial and fiscal reporting, as well as the empirical research based on attitudes and statements of professionals regarding their application of accounting and fiscal rules when preparing financial statements. To accomplish the research goal and to carry out the research, secondary and primary data will be used, which will be obtained through a questionnaire designed for the purpose of this paper. The survey sample consists of professional employees (accountants and auditors) of 264 business organizations. The methodology used for data processing employs descriptive statistics and quantitative analysis.

## 2. Literature review

The issue of financial and fiscal reporting and the relationship between these two areas of reporting has always existed and has continuously developed over time. This is because accounting rules are not always the same as fiscal ones. This is why this relationship has always been and continues to be a research target of different scholars. The overarching theme of this paper is that this relationship is far more complex than it seems and that both areas are dominated by constant changes because of changing times. In particular, numerous studies have been conducted in many countries in Europe, such as Norway, Poland, Great Britain, Denmark, Sweden, Finland, the Czech Republic, etc. These studies aimed at comparing developments in the respective countries with European samples. Although early tax rules allowed, in principle, a division between financial and fiscal accounting, companies were oriented towards approximating their policies on fiscal rules until the revision of the respective laws (Jindrichovska and Kubickova, 2016).

The relationship between accounting and taxation is recognized as a very important element at the level of financial reporting (Lamb *et al.*, 1998). This paper is based on

four countries: Great Britain, USA, France and Germany. Thus, the empirical study on the relationship between fiscal rules and accounting practices has presented a classification in five categories, as in Table 1 below:

**Table 1.** *Association between accounting rules and fiscal rules*

<b>Case I</b>	<b>Independent association</b>	<b>Accounting and fiscal rules are different</b>
<b>Case II</b>	Identical association	Accounting and fiscal rules are the same
<b>Case III</b>	Primacy of accounting rules	Accounting rules are more detailed, accounting influences taxation and fiscal practice follows the accounting practice
<b>Case IV</b>	Primacy of fiscal rules	Fiscal rules prevail and are used for accounting and taxation, there is no clear rule for financial reporting
<b>Case V</b>	Dominance of fiscal rules	Financial reporting rules are swept aside

*Source: Lamb et al. 1998.*

It is obvious that the first case relates to the disconnection of fiscal rules and practices from financial reporting practices and rules, while the other four cases present different forms of association. More specifically, the fourth and fifth cases are clear cases of fiscal framework's impact in the choice of accounting policies. The research was based on the framework of 15 influencing factors. The paper resulted in the classification of these countries in one of the five categories of the above-mentioned cases.

Other studies (Artsberg, 1996) conducted in this field display reveal the existence of a link between financial and fiscal reporting, which reflects the fundamental differences between them, the approaches and criticisms of the double reporting system (Baldacchino *et al.*, 2017). Such a study on the relationship between accounting and fiscal reporting has also been conducted in 13 European countries, with particular focus on discovering whether there are differences and interdependence between the two reporting areas (Hoogendoorn, 1996). The paper makes an essential distinction between the six countries where fiscal and accounting rules are interdependent and the seven countries where fiscal and accounting rules are independent (Averina *et al.*, 2016). The paper claims that in the relationship between accounting and taxation in Europe, two essentially distinct structures can be distinguished: the first structure can be called "independent" and the second "dependent". The first implies that the determination of the accounting profit is independent of the determination of profit for fiscal purposes. Companies can choose different accounting policies for taxation and accounting purposes. The second implies that accounting is influenced by taxation. However, even between these two groups, differences can be made based on the different impacts of tax effects on individual and group accounts.

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Desai (2005) states that due to the fact that the double reporting system allows accounting for both tax revenue and for tax purposes, the quality of profit reporting will decrease, because the dual nature of corporate profit reporting can contribute to simultaneous degradation of profit reporting for capital markets and for tax authorities. Keeping the two financial statement formats allows business organization managers to lose the accuracy of their tax savings in capital markets, and consequently of their profits for the tax authorities (Mahboud, 2017).

It seems that issues regarding differences or matches between financial and fiscal reporting have been the subject of many scholars and debates. In this regard, a discrepancy between the two reporting frameworks will lead to improper decision making by managers, as it is presumed to have misleading information. Since business organizations may face double reporting, this paper will highlight Kosovo's reality on this issue.

## **2.1 Current accounting and taxation regulatory frameworks**

Business organizations in Kosovo defined under the legal framework as commercial units ('Law no. 06/L –032 on Accounting, Financial Reporting and Auditing', 2018) are required to prepare financial statements in accordance with International Accounting Standards (IAS), regulations, administrative instructions and by-laws issued by the Kosovo Council for Financial Reporting (KCFR). This legal framework provides a conceptual framework, which regulates the accounting and financial reporting system for all elements contained in the financial statements.

The legal requirements regarding the preparation of financial statements and the auditing of business organizations are determined from the point of view of their size ('Law no. 06/L –032 on Accounting, Financial Reporting and Auditing', 2018). The legal requirements for fiscal reporting require from taxpayers to keep their books and records in accordance with tax legislation and relevant administrative instructions.

The required books and records include ('Law No. 05/L -028 on Personal Income Tax', no date): a sales book, in which all sales and returns must be recorded; a purchase book, in which all purchases and returns must be registered; a cash receipts journal and a cash payment journal related to the sales book and the purchase book; a capital account that includes the opening balance sheet, increases in capital, expenses to be capitalized, depreciation rates, depreciation losses, cash and closing balances; books and other records according to accounting standards to give an accurate account of all income and expenses in order to make an accurate determination of due taxes; the contents of the required books and records and any required bookkeeping and recording, including those in electronic form, shall be defined by a by-law.

Business organizations with up to € 50,000 or less gross annual income from business activities for the tax period, may choose to prepare the books and records listed above.

## **2.2 Empirical analysis of connection between taxation and accounting in the framework of preparation of financial statements**

The primary data used for this empirical study are derived from the interviews conducted with the accountants and auditors employed in business organization (the selection sample consists of 264 business organizations). The interviews were carried out through a questionnaire, whose structure consists of research questions addressed to respondents, as follows:

1. When preparing the financial statements, are you led by fiscal rules and then you make adjustments for your accounting needs?
2. When preparing the financial statements, are you led by accounting rules and then you make adjustments for your fiscal needs?

The above research questions raise the following hypotheses:

*H<sub>1</sub> = When preparing the financial statements, business organizations are governed by fiscal rules (they are used for both accounting and taxation);*

*H<sub>2</sub> = When preparing the financial statements, business organizations are governed by accounting rules (accounting influence on taxation).*

The methodology used for data processing is that of descriptive statistics, as well as the cross-tabs analytical method, in order to further analyze the dependence between dependent variables (the research question) and the selected independent variables that represent the characteristics of respondents, such as level of education, familiarity with legal regulations, work experience, and their continuous professional training. Further, this leads to the establishment of two sub-hypotheses:

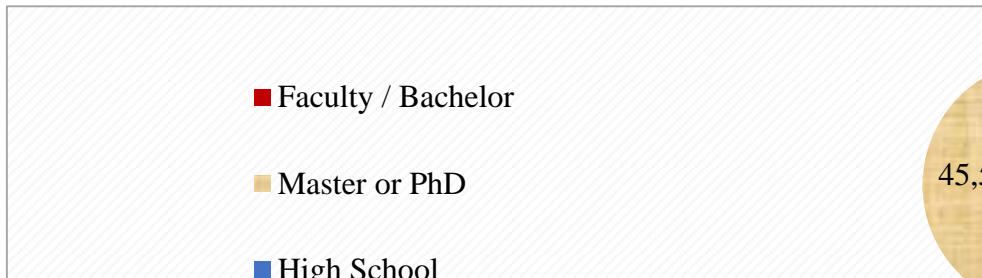
*H<sub>1i</sub> = There is a significant connection between the characteristics of the respondents and their being governed by fiscal rules when preparing the financial statements (taxation influence on accounting);*

*H<sub>2i</sub> = There is a significant connection between the characteristics of the respondents and their being governed by accounting rules when preparing the financial statements (accounting influence on taxation).*

## **3. Research results**

Analysis of data representing the characteristics of the interest group shows that out of 264 participants, 53.4% or 141 of them had a bachelor's degree, 45.5% or 120 persons had obtained a Master or PhD degree and the remaining 1.1%, or 3 of them, had only completed the high school.

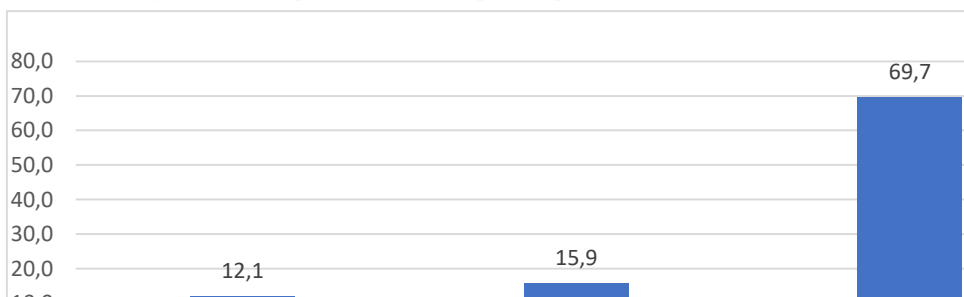
**Figure 1. Educational levels of participants**



Source: Author.

In terms of professional experience, 184 of them or 69.7% answered over 6 years, 42 or 15.9% answered 4-6 years, 32 or 12.1% have worked for 1-3 years and the remaining 6 answered that they had been practicing their profession for less than a year.

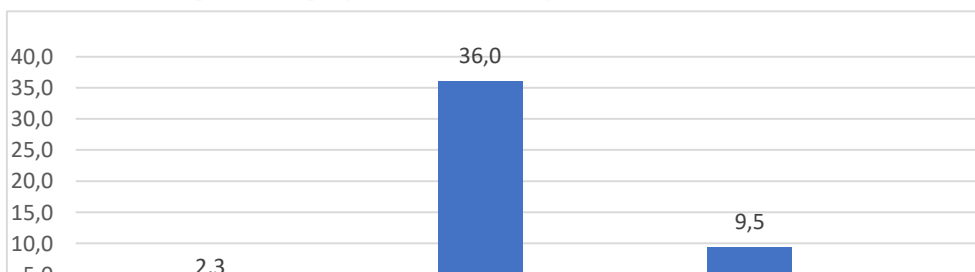
**Figure 2. Professional experience of the participants**



Source: Author.

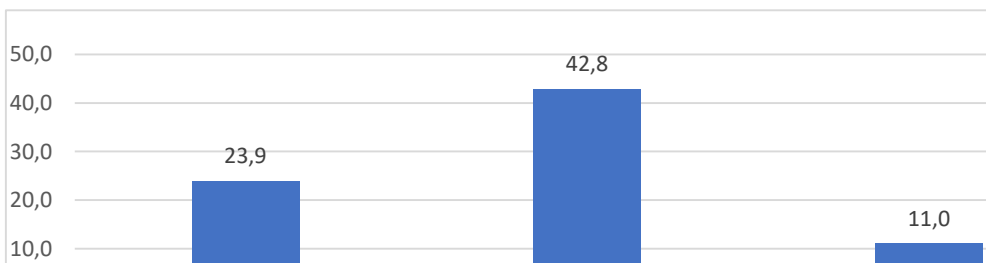
In the question on participation in professional trainings, 95 or 36% of them have occasionally attended trainings, 77 or 29.2% attend training sessions very often, 61 or 23.1% of the participants do so often, and 25 or 9.5 % rarely attend trainings, while 6 respondents have never attended any trainings.

**Figure 3. Participation in professional trainings**



Source: Author.

**Figure 4.** Knowledge level of legal framework by participants



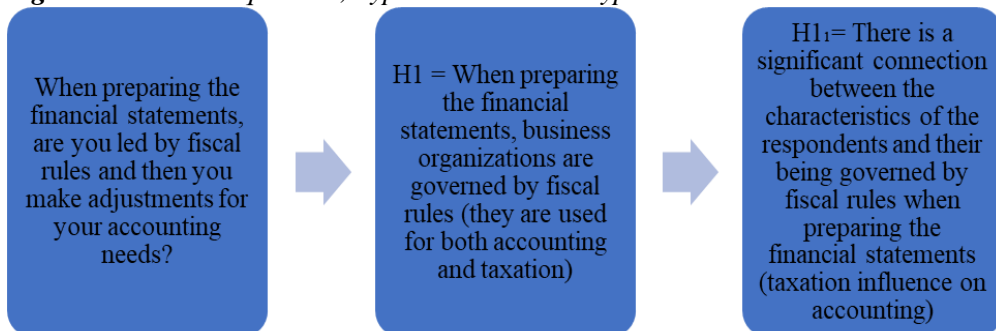
Source: Author.

Asked about the legal framework, a large part of the respondents, about 42%, answered that they have enough knowledge, 23.9% answered that they do not have good knowledge of the law or have average knowledge, while 22.3% answered that they have very good knowledge of the law. The rest of the respondents, or 11%, answered that they have little knowledge.

### 3.1 Analysis of data related to research questions and hypothesis H1

Analysis of data related to the research question: “When preparing the financial statements, are you led by fiscal rules and then you make adjustments for your accounting needs?”

**Figure 5.** Research question, hypothesis and sub hypothesis



Source: Author.

**Figure 6.** Preparation of financial statements under fiscal rules, followed by adjustments or modifications under accounting rules



Source: Author.

Respondents were asked for their opinion on the preparation of financial statements under fiscal rules, followed by adjustments or modifications under accounting rules. The results show that 49.2% totally disagree, 16.7% fully agree, 14.4% remained neutral and 15.5% partially agree.

**Table 2.** Preparation of financial statements under fiscal rules, followed by adjustments for accounting needs, versus education levels (in percentage)

	What is your education level?			Total
	Undergraduate/ BS	MA/PhD	High school	
Totally disagree	47.5	52.5		49.2
Disagree moderately	1.4	5.0	100.0	4.2
Agree moderately	20.6	10.0		15.5
Neutral	16.3	12.5		14.4
Fully agree	14.2	20.0		16.7
Total	100.	100.0	100.0	100.0

**Source:** Author.

The research question "that the financial statements are prepared under fiscal rules, followed by adjustments or modifications under accounting rules", cross-examined with the question "what is your education level?" shows that the education level influences the negative response of accountants and auditors. The higher the level of education, the more they deny that the financial statements are prepared according to fiscal rules, then adjusted to the accounting ones. Of those who have obtained a master's degree or a PhD, 57.5% disagree with this, compared to 20.0% who agree. Even between those with bachelor degrees, 48.9% disagree, meanwhile only 14.2% agreed with this assertion.

**Table 3.** Preparation of financial statements under fiscal rules, followed by adjustments for accounting needs, versus professional experience (in percentage)

	How many years have you practiced your profession?				Total
	1-3 years	4-6 years	over 6 years	Less than a year	
Totally disagree	18.8	42.9	57.6		49.2
Disagree moderately		11.9	3.3		4.2
Agree moderately	28.1	19.0	9.8	100.0	15.5
Neutral	43.8	14.3	9.8		14.4
Fully agree	9.4	11.9	19.6		16.7
Total	100.0	100.0	100.0	100.0	100.0

**Source:** Author.



Regarding work experience, professionals working for more than 6 years (60.9% of them) and those working from 4 to 6 years (56.8% of them) do not agree that financial statements are prepared according to fiscal rules and then adjusted as appropriate under the accounting rules. Professionals with less than one year of experience are neutral in their attitudes (43.8%), while 18.8% do not agree. It is obvious that professional experience influences the statements and attitudes of professionals who disagree with the assertion.

**Table 4.** *Preparation of financial statements under fiscal rules, followed by adjustments for accounting needs, versus professional trainings (in percentage)*

	How often do you attend professional trainings?					Total
	Never	Occasionally	Rarely	Often	Very often	
Totally disagree		42.1	44.0	37.7	72.7	49.2
Disagree moderately	50.0	6.3		3.3		4.2
Agree moderately		17.9	12.0	19.7	11.7	15.5
Neutral		18.9	32.0	9.8	7.8	14.4
Fully agree	50.0	14.7	12.0	29.5	7.8	16.7
Total	100.0	100.0	100.0	100.0	100.0	100.0

*Source: Author.*

The data in the table above show that even participation in trainings influences the opinion of accountants and auditors who disagree that the financial statements are prepared under fiscal rules and then adjusted under accounting rules. 72.7% of those who attend trainings very often, and 50.0% of those who attend trainings often, disagree with this assertion, while those who never receive any trainings are divided into 50.0% who disagree moderately and 50.0% who agree completely.

**Table 5.** *Preparation of financial statements under fiscal rules, followed by adjustments for accounting needs, versus knowledge of legal framework (in percentage)*

	How much do you know about the legal framework?				Total
	I have an average knowledge	I have sufficient knowledge	I have little knowledge	I have a lot of knowledge	
Totally disagree	46.0	50.4	20.7	64.4	49.2
Disagree moderately	4.8	2.7	17.2		4.2
Agree moderately	22.2	13.3	20.7	10.2	15.5
Neutral	14.3	12.4	31.0	10.2	14.4
Fully agree	12.7	21.2	10.3	15.3	16.7
Total	100.0	100.0	100.0	100.0	100.0

*Source: Author.*

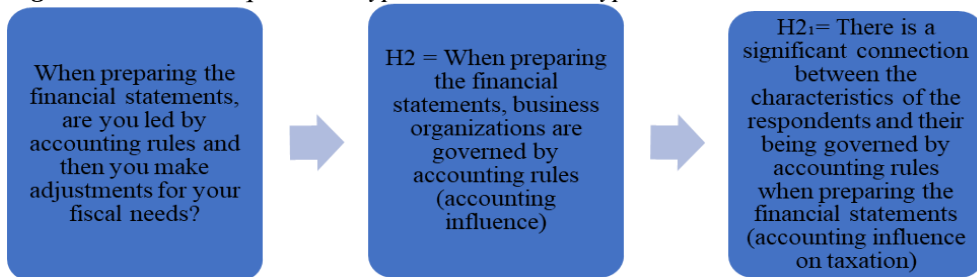
Knowledge of legal regulations by professionals influences whether they agree with the assertion that financial statements are prepared under fiscal rules and then adjusted or modified under accounting rules. 64.4% of those who have very good knowledge of the law, and 50.4% of those who have sufficient knowledge, did not agree, while of those with little knowledge of the law, only 20.7% of them disagree and 31.0% of them remain neutral with regards to this assertion.

The above results from the statistical analysis and the analysis of the relationship of the dependent variables with the independent ones reject the first hypothesis (H1) that in preparing the financial statements, business organizations are governed by fiscal rules (they are used for both accounting and taxation). Likewise, the results do not prove the first sub-hypothesis (H1<sub>1</sub>), because the characteristics of the respondents did not influence them to state they are governed by fiscal rules when preparing the financial statements.

### 3.2 Analysis of data related to research questions and hypothesis H2

Analysis of data related to the research question: “When preparing the financial statements, are you led by accounting rules and then you make adjustments for your fiscal needs”?

**Figure 7.** Research question, hypothesis and sub hypothesis



Source: Author

**Figure 8.** Preparation of financial statements under accounting rules, followed by adjustments or modifications under fiscal needs

100,0 %

Source: Author.

The data in this figure show that 53.0% of participants answered that they fully agree with this fact, about 15.5% agree moderately, about 15.5% are neutral and about 16.0% disagree with this assertion.

**Table 6.** Preparation of financial statements under accounting rules, followed by adjustments for fiscal needs, versus education levels (in percentage)

	What is your education level?			Total
	Undergraduate/BS	MA/PhD	High school	
Totally disagree	12.8	8.3		10.6
Disagree moderately	3.5	7.5		5.3
Agree moderately	18.4	12.5		15.5
Neutral	18.4	10.0	100.0	15.5
Fully agree	46.8	61.7		53.0
Total	100.0	100.0	100.0	100.0

*Source: Author.*

When this question is cross-examined with the level of education, 61.7% and 12.5% of practitioners with master or PhD degrees fully agree or agree moderately with this assertion, while 46.8% and 18.4% of bachelor-level professionals also agree fully or moderately with this assertion. Therefore, we can claim that the level of education influences professionals to agree with the fact that the financial statements of their business organization are compiled under accounting rules and then modified under fiscal rules.

**Table 7.** Preparation of financial statements under accounting rules, followed by adjustments for fiscal needs, versus professional experience (in percentage)

	How many years have you practiced your profession?				Total
	1-3 years	4-6 years	over 6 years	Less than a year	
Totally disagree	9.4	14.3	8.7	50.0	10.6
Disagree moderately		4.8	6.5		5.3
Agree moderately	18.8	4.8	16.3	50.0	15.5
Neutral	25.0	35.7	9.8		15.5
Fully agree	46.9	40.5	58.7		53.0
Total	100.0	100.0	100.0	100.0	100.0

*Source: Author.*

Professional experience also influences professionals to agree with the fact that the financial statements are prepared under accounting rules, and then the necessary adjustments are made under fiscal rules. Of those with an experience of 4 to 6 years, 65.2% of them agree totally or moderately with this, while only 14.3% disagree. Of

those with an experience of 1 to 3 years, 65.7% of them agree totally or moderately with this, while only 9.4% disagree. Also, of those with more than 6 years of age, 65.2% agree totally or moderately, compared to 8.7% who disagree. Of the professionals with less than one year of experience, 50.0% of them do not agree at all and 50.0% agree moderately.

**Table 8.** Preparation of financial statements under accounting rules, followed by adjustments for fiscal needs, versus professional trainings (in percentage)

	How often do you attend professional trainings?					Total
	Never	Occasionally	Rarely	Often	Very often	
Totally disagree		20.0	24.0		3.9	10.6
Disagree moderately	50.0	6.3		3.3	3.9	5.3
Agree moderately		14.7		29.5	11.7	15.5
Neutral		22.1	44.0	9.8	3.9	15.5
Fully agree	50.0	36.8	32.0	57.4	76.6	53.0
Total	100.0	100.0	100.0	100.0	100.0	100.0

*Source:* Author.

Professional trainings also influence the respondents answer on whether the financial statements are prepared under accounting rules, and then the necessary adjustments are made under fiscal rules. Those who attend trainings very often (88.3%) and often (86.9%) agree fully or moderately with this assertion. Of those who occasionally participate in trainings, 51.5% of them agree fully or moderately.

**Table 9.** Preparation of financial statements under accounting rules, followed by adjustments for fiscal needs, versus knowledge of legal framework (in percentage)

	How much do you know about the legal framework?				Total
	I have an average knowledge	I have sufficient knowledge	I have little knowledge	I have a lot of knowledge	
Totally disagree	22.2	7.1	10.3	5.1	10.6
Disagree moderately	4.8	5.3	17.2		5.3
Agree moderately	17.5	18.6	10.3	10.2	15.5
Neutral	14.3	15.0	41.4	5.1	15.5
Fully agree	41.3	54.0	20.7	79.7	53.0
Total	100.0	100.0	100.0	100.0	100.0

*Source:* Author.

Even knowledge of the law influences whether professionals agree or not with the fact that the financial statements are prepared under accounting rules and then adjusted under the necessary fiscal rules. Of them, 89.9% who have very good knowledge of the agree fully and moderately, compared to those who know little

knowledge of the law, with 40.0% who agree fully and moderately, 41.4% neutral and 10.3% totally disagree.

These results from the statistical analysis and dependence analysis of the dependent variable with the independent ones, confirm the second hypothesis (H2) that during the preparation of the financial statements, business organizations are guided by the accounting rules (accounting influence on taxation), and even the second sub-hypothesis (H2<sub>1</sub>) that there is a significant connection between the characteristics of the respondents and their being governed by accounting rules when preparing the financial statements (accounting influence on taxation).

#### **4. Summary and conclusion**

This paper presented the situation regarding the orientation of business organizations in Kosovo under accounting and fiscal rules when preparing financial statements. The collection of data and information about business organization orientation and correlation between variables was conducted through the questionnaire and were processed using the quantitative analytical method.

The paper resulted in the fact that business organizations are oriented towards the implementation of accounting and fiscal regulations, but they are guided by accounting rules in terms of presenting their economic activities. This result was verified by the descriptive statistical analysis as well as by the analysis of significance between research questions and interest group characteristics. This determined the relationship between accounting and taxation in the context of preparation of financial statements as a dependent relationship with dominance of accounting, which classifies the country in the third category according to Lamb's taxonomy.

The orientation of the business organizations by the accounting regulation when preparing the financial statements is a positive indicator, because they consider accounting information as a very important and influential element in making decisions by the executives of the business organizations and all internal and external users of that information. The preparation of financial statements in conformity of legal regulations and standards provides a fair and reliable view of the business organization's financial position and its performance, as well as a proper assessment of its cash flow from its core activities.

On the other hand, the results showed that the business organizations are also oriented towards meeting fiscal requirements by making appropriate adjustments or disclosures of financial statements for fiscal needs whenever necessary. This is also the factor that influenced the presentation of the accounting-taxation relationship as a dependent relationship. Based on the research result, we consider that there is scope for further developments in the future with regard to accounting and taxations adjustments, so as to reduce as far as possible the difference between these two

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regulatory frameworks or to increase the harmonization between them, also through legal amendments, for which it would be beneficial to involve all stakeholders during regulatory changes.

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