Accounting profits, tax profits and unitary taxation (revisited)

Accounting Profits, Tax Profits and Unitary Taxation (Revisited)

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Abstract
Unitary taxation requires the adoption of a set of rules that enables a combined group tax profit base to be determined. Setting aside questions of which entities should be included and how the resultant profit should be allocated to relevant jurisdictions, this article focusses on the question of what is an appropriate base, and whether accounting principles, in particular external financial reporting principles, are fit for this purpose. The authors contribute to the ongoing debate on this issue, now even more salient in relation to the digital economy and the "unified approach" proposed by the OECD, by considering more recent changes in both financial reporting and taxation. The article concludes that there is considerable preparatory work to be done before an appropriate base for unitary taxation can be developed, if that is even possible.

Introduction

> "From the perspective of a lawyer, financial reporting is a strange practice that seeks to describe and evaluate many events that only exist as a result of legal relations. In making its description, financial reporting often departs from the general legal rules that set the context of the events it seeks to describe, e.g. as to entities, ownership and what is an asset. This lack of consistency with the basic legal rules makes it hard for an income tax law to follow financial reporting in many situations."[1]

The question of the relationship between accounting profit and tax profit is debated from time to time: a flurry of interest occurred, for example, as international financial reporting standards (IFRS) were evolving and implemented, as attempts to standardise accounting principles and rules led to speculation that accounting profit could be used as the corporate tax base.[2]

The prospect of aligning accounting and tax profits has also given impetus to debates about unitary taxation, under which the profits of a multinational enterprise (MNE) are combined and then allocated

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[1] P. Harris, "IFRS and the Structural Features of an Income Tax Law" in G. Michielse and V. Thuronyi (eds), *Tax Design Issues Worldwide, Series on International Taxation* (Alphen aan den Rijn: Wolters Kluwer Law International, 2015), Vol.51, 95–96.
[2] In respect of the UK see J. Freedman, "Ordinary Principles of Commercial Accounting - Clear Guidance or a Mystery Tour?" [1993] BTR 468; J. Freedman, "Defining Taxable Profit in a Changing Environment" [1995] BTR 434; J. Freedman, "Accounting Standards: a Panacea?" [2004a] *The Tax Journal* 9; J. Freedman, "Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges" [2004b] *eJournal of Tax Research* 71; S. Green, "Accounting Standards and Tax Law: Complexity, Dynamism and Divergence" [1995] BTR 445; G. MacDonald and D. Martin, "Tax and Accounting a Response to the 2003 Consultation Document on Corporation Tax Reform" [2004] *Tax Law Review*, The Institute for Fiscal Studies; P. Sikka, "Accounting and taxation: Conjoined twins or separate siblings?" (2016) 41(4) *Accounting Forum* 390; G. Whittington, "Tax policy and Accounting Standards" [1995] BTR 452; A. Wilson, "Financial Reporting and taxation: marriage is out of the question" [2001] BTR 86. In respect of the US, where there is considerable debate about book-tax differences, see M. Desai, "The Divergence Between Book and Tax Income" (2003) 17 *Tax Policy and the Economy* 169.
For a more global perspective see W. Schön, "International Accounting Standards — A 'Starting Point' for a Common European Tax Base?" (2004) 44 *European Taxation* 426; W. Schön, "The Odd Couple: A Common Future for Financial and Tax Accounting?" (2005) 58 *Tax Law Review* 111.

to the jurisdictions in which the MNE operates according to a predetermined formula. The adoption of some form of global unitary taxation would be a radical departure from the existing system of taxing cross border commercial activity but, nonetheless, proponents defend the idea of radical change on the assumption that it would correct the apparent inefficiencies and injustices in the current profit allocation mechanism through the method of applying arm's length pricing between affiliates. Although the term unitary taxation can refer to several models that treat groups of entities as a single entity for tax purposes,[3] in this article, the authors use the term to mean the version that entails establishing a unitary tax base and subsequent distribution of that base to relevant jurisdictions by means of a formula, sometimes referred to as global formulary apportionment.

Discussion of unitary taxation as an alternative to the current system has been taken up by a number of socially focussed NGOs[4] and lobby organisations.[5] The published work on unitary taxation[6] has gained increased significance in recent years and has lent support to the reinvigoration of the common consolidated corporate tax base (CCCTB) in the EU, subsequently rebranded as the common corporate tax base (CCTB). Much of the focus of debate has been on the development and impact of the formula for apportionment[7]; much less attention has been given to developing an appropriate base. More recently, the question of using, for tax purposes, figures derived from accounting has arisen tangentially in relation to the digital services tax in the UK, under which revenues attributable to user participation must be determined in order that the appropriate share can be attributed to the UK for taxing purposes. The Government position paper on the digital economy in March 2018 acknowledges that taking user participation into account may lead to significant divergence between tax and accounting profits.[8]

Picciotto, quoting from the G20 mandate for the OECD's Base Erosion and Profit Shifting (BEPS) Project, suggests that reform of the international tax rules is necessary to ensure that MNEs are taxed "where economic activities occur and value is created".[9] He concludes from this "that MNEs should be treated in accordance with the business reality that they operate as single firms",[10] observing that the BEPS proposals "remained unclear and complex on the crucial question of criteria for allocating profits".[11] Historically, the allocation of profits between jurisdictions has contained elements of both an independent entity and a unified approach and this is reflected in the allocation methods adopted in practice.[12] Rogers and Oats,[13] in this *Review*, present evidence from a longitudinal study of transfer pricing professionals that suggests that increasing dissatisfaction with arm's length pricing has resulted

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[3] S. Picciotto (ed.), *Taxing Multinational Enterprises as Unitary Firms* (Institute of Development Studies, 2017) describes several approaches to unitary taxation in addition to formulary apportionment that treat transnational groups as unitary firms, specifically residence based worldwide taxation and destination based corporate tax (at 27).

[4] See for example C. Godfrey, *Business Among Friends: Why corporate tax dodgers are not yet losing sleep over global tax reform* (Oxfam, 2 May 2014), available at: *https://www.oxfam.org/en/research/business-among-friends* [Accessed 14 February 2020]; Christian Aid, *No more shifty business* (February 2013), available at: *https://www.christianaid.org.uk/resources/about-us/no-more-shifty-business-2013* [Accessed 14 February 2020] and ActionAid, *Levelling Up: Ensuring a fairer share of corporate tax for developing countries* (July 2015), available at: *https://www.actionaid.org.uk/sites/default/files/publications/levelling_up_final.pdf* [Accessed 14 February 2020].

[5] e.g. The Greens in the European Parliament.

[6] See for example Picciotto (ed.), above fn.3.

[7] Petutschnig, for example, explores the interaction between the proposed CCCTB formula and limitation on benefits clauses in M. Petutschnig, "Common Consolidated Corporate Tax Base and Limitation on Benefits Clauses" [2018] BTR 68.

[8] HM Treasury, *Corporate tax and the digital economy: position paper update* (March 2018).

[9] Picciotto (ed.), above fn.3, 1 quoting G20, *Tax Annex to the St. Petersburg G20 Leaders' Declaration* (2013), available at: *http://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf* [Accessed 21 February 2020], 4.

[10] Picciotto (ed.), above fn.3, 1.

[11] Picciotto (ed.), above fn.3, 2.

[12] Picciotto (ed.), above fn.3, 6.

[13] H. Rogers and L. Oats, "Emerging Perspectives on the Evolving Arm's Length Principle and Formulary Apportionment [2019] BTR 150.

in tax practitioners moving from a position of strenuous opposition to formulary apportionment to a more accommodating stance.

The practical barriers to any change from the current international tax system to unitary taxation are significant, and the early exclusion of this topic from the BEPS debate signals considerable resistance from institutions, corporations, advisors and politicians. The work of the International Centre for Tax and Development amongst others helps to stimulate debates about the existing system of taxing MNEs and also about any alternative methods that could be developed and adopted. More recently, however, the OECD has released, in May 2019, details of its Programme of Work in relation to the taxation of the digital economy.[14]

Having failed to resolve the vexed issue of the appropriate mechanisms for taxing the digital economy, Action 1, *Addressing the Tax Challenges of the Digital Economy*, of the OECD BEPS Project[15] brought into existence the Task Force on the Digital Economy, as a subsidiary body of the Committee on Fiscal Affairs, which embarked on a series of consultations seeking public input. This has become a highly politicised issue on which progress is urged by the G20. The May 2019 Programme of Work[16] has potential for far reaching impact on the way multinationals are taxed. The work is divided into two Pillars, Pillar 1 dealing with the allocation of income between jurisdictions[17] and Pillar 2 dealing with minimum levels of taxation to prevent base erosion (GloBE).[18] Supporting documents produced by the OECD Secretariat were released in October and November 2019 (Public Consultation Documents)[19] to assist the Inclusive Framework in its ambition to achieve consensus among 130 participating countries by the end of 2020. The tight timeframe is in part a result of the implementation of several unilateral measures which have been taken in various countries to impose digital services taxes or similar, which potentially will create a patchwork of rules that will be detrimental to efforts to achieve global consensus.[20]

The relevant strand of the Pillar 1 proposal for the purposes of this article is "the 'significant economic presence' proposal" that would allow countries to tax a share of the multinational's profit in the absence of physical presence. The proposal uses the concept of "fractional apportionment" which is reminiscent of US state formula apportionment, the EU CCCTB mechanism and global formulary apportionment. The October 2019 unified approach identified by the OECD Secretariat includes calculating a "routine" profit and "residual profit", although importantly the proposal does not define these terms or how they should be calculated.

The Pillar 2 proposal is in four parts: a minimum tax required to be paid by the shareholder if the company has not paid sufficient tax (an income inclusion rule); a switch from exemption to credit

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[14] OECD, *OECD/G20 Inclusive Framework on BEPS: Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (*Programme of Work*) (Paris: OECD, 2019), available at: *www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm* [Accessed 14 February 2020].

[15] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD Publishing, 2015), available at: *https://doi.org/10.1787/9789264241046-en* [Accessed 14 February 2020].

[16] OECD, *Programme of Work*, above fn.14.

[17] OECD, *Programme of Work*, above fn.14, Ch.II, "Revised Nexus and Profit Allocation Rules (Pillar One)".

[18] OECD, *Programme of Work*, above fn.14, Ch.III, "Global anti-base erosion proposal (Pillar Two)".

[19] OECD, Public Consultation Document, *Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (Pillar One Document), available at: *https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf* [Accessed 21 February 2020]; and OECD, Public Consultation Document, *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two, 8 November 2019 – 2 December 2019* (Pillar Two Document), available at: *https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf* [Accessed 21 February 2020].

[20] For a discussion of these issues see L.V. Faulhaber, "Taxing Tech: The Future of Digital Taxation" (2019) 39 *Virginia Tax Review* 145.

method for branches subject to a low effective tax rate (a switch over rule); denial of deduction for related party payments that are not subject to a minimum rate (an undertaxed payment rule); and a matching rule requiring that treaty benefits be tethered to adequate taxation in the other state (a subject to tax rule).

For present purposes, it is important to note that these proposals require new calculations; for routine and residual profits under Pillar 1 and for the amount of undertaxed payments and the minimum tax under Pillar 2. The OECD Public Consultation Documents note, in regard to the determination of the tax base, that the appropriate starting point is the relevant accounting rules, subject to adjustments to align accounting income with taxable income, acknowledging that the use of different accounting standards may result in increased compliance costs and distortions.[21] It is not clear what adjustments will be required to convert accounting profits into taxable profits; an issue that has dogged previous discussions about the appropriateness of using accounting profits for tax purposes given the myriad different approaches to both in different jurisdictions. The move towards a globally agreed tax base for GloBE will be a major departure from current practice and may open the door for adoption of the Pillar 1 unified approach and ultimately for global unitary taxation more broadly.

This article seeks to contribute to this ongoing debate by reconsidering the relationship between financial accounting profit and tax accounting profit. It should be noted that the authors do not have a preference either for the current system or for any alternative system such as some form of unitary taxation. The authors do not seek, or even argue for, an “optimal” tax system, recognising that any tax system is a product of history, politics, practicalities and in application a certain measure of “horse trading” between vested interests. The authors’ concern is to revisit the question of whether profits calculated for accounting purposes can sensibly be used for taxing purposes. One point to note here is that, unlike taxation, accounting recognises that income does not have a true geographical source and, as it is concerned with firm level performance and effectively blind to jurisdictional borders, does not need to differentiate between jurisdictions. The need for tax systems to determine a geographical nexus arises because of the need for each jurisdiction to determine its share of global profits in order to tax them.

The structure of this article is as follows. In order to examine the relationship between financial accounting profit and tax accounting profit, in section 1 the authors provide some reflections on the nature of a corporation and how a corporation’s commercial activities are recorded in the accounts. In section 2, the authors explore some of the characteristics of accounting profit and their origins. In section 3, the authors discuss the implications of recent changes to accounting regulations. Finally, section 4 contains some concluding comments.

1. Corporations, activities and books of record

At a very basic level the actions, events, contracts, arrangements, etc. that constitute the utilisation of the assets, property and resources of a corporation[22] are recorded in that corporation’s books of account or books of record (hereafter “the books”),[23] often in monetary form. The books form the informational foundation of: 1. internal decision making; 2. the production of published financial statements; and 3. the determination of any income, profits and gains (referred to hereafter as, collectively, “profits”) that create a tax liability. It is the latter two with which this article is concerned, that is, the frameworks that

[21] OECD, Public Consultation Documents, above fn.19. For example, Pillar One Document, 14; and Pillar Two Document, 9.

[22] References to a corporation in this article are references to a limited company that is engaged in some form of commercial activity. This article does not therefore consider “not for profit” corporations.

[23] The books of account or books of record will include not only the nominal ledger and associated accounts in which some form of double entry recording occurs but will also include the evidence of various of the activities undertaken by the corporation that may not be entirely captured by double entry recording. For example, the books of account or books of record will include title documents (relating to land and buildings, patents, etc.) and contractual agreements (for example, lease agreements or employment contracts).

enable corporations to move from the information recorded in the books to the production of the financial statements or the determination of taxable profit.

It is mundane to acknowledge that significant differences exist between the two practices and hence, of necessity, between the two frameworks. These differences are linked in part to the different purposes that underlie accounting practice as compared to tax practice, which are captured by considering the following basic questions:

- What is being measured or determined?
- For whom is it being measured or determined?
- Why is it being measured or determined?
- On what basis is it being measured?

These questions are useful to highlight key areas of difference between accounting and taxation. For corporate income tax, as readers of this *Review* will be well aware, what is being measured or determined is an amount that the government estimates to be subject to tax. This varies considerably over time and between jurisdictions. Profit subject to tax is measured in order to determine what contribution the taxpaying entity should make to the state in the form of tax. It is only measured for one stakeholder, the government[24]; and it is measured largely on the basis of realised incomes and costs. In the context of accounting practice the answers to these questions are quite different.

In section 4 (the authors' discussion and conclusions) the authors argue that the use for tax purposes of any part of the financial statements that are the product of accounting practice without acknowledging both: 1. the significant differences that exist between the practice of accounting and the practice of tax; and 2. how the answers to the questions above are *necessarily* different, is foolhardy.

2. Accounting, accounting practice and the nature of profit

The accounting standard setting process for the UK is a double layered system. Since 2015, all publicly quoted companies have been required to report using IFRS, which are issued by the International Accounting Standards Board (the IASB). Since then, IFRS have also been adopted by many UK public sector organisations such as the NHS and for the Whole of Government Accounts (WGA). Small and medium sized companies, private companies and other organisations such as limited partnerships, trusts and off-shore companies are permitted to report under a different system of UK domestic accounting standards (known as UK Generally Accepted Accounting Practice, UK GAAP), issued by the Financial Reporting Council (FRC), which has reduced disclosure requirements compared to IFRS. In addition to reduced disclosure, there are some differences between IFRS and UK GAAP in the treatment of particular items in the financial statements. The most significant differences relate to the treatment of intangible assets, including: the criteria for determining which intangibles can be included in the balance sheet; the treatment of goodwill, which must be amortised over a finite life under UK GAAP but can be considered to have an infinite life and be subject to regular impairment reviews under IFRS; and the policies permitted for the valuation of inventory.

It is important to note that neither of the accounting standard setters relating to the UK are Government bodies. The FRC is a company limited by guarantee, which is financed by the large accounting firms and its board of directors is appointed by the Secretary of State for the Department of Business, Energy and Industrial Strategy. It includes a Conduct Committee and the Financial Reporting Review Panel, which together monitor the application and interpretation of accounting standards by organisations. The IASB has no power to enforce the accounting standards it issues, largely because the mechanisms for policing and enforcing accounting regulations exist at the national, domestic level in each country and not at an international level. In the UK, it is therefore the FRC who monitors the interpretation and application of IFRS as well as of UK GAAP. Following the collapse of Carillion and other large UK

[24] Although the authors acknowledge that estimations of tax liabilities are a necessary precursor to determining distributable profits under the Companies Act 2006 and therefore are for the benefit of shareholders.

companies, the *Kingman Report* (2018).[25] recommended significant changes to the FRC in terms of its governance, powers, culture and ways of working.

In the rest of section 2, the authors consider further the basic questions posed in section 1, above, in the context of the framework of existing rules and principles relevant to the practice of accounting, in particular in the creation of financial statements for the purposes of reporting to stakeholders. The authors also examine the origins of some of the ideas currently used in accounting practice. Before doing so, however, the authors clarify how accounting regulations came into being.

2.1 What is measured?

In accounting, particularly financial reporting, the ideas emanating from classic economic theory, such as Fisher's.[26] and Hicks'.[27] theories of income measurement, have been very influential, principally in the US but also in the development of IFRS.[28] The basis of these theories is that income is defined as the change in economic value of an organisation over a period of time. It should be noted, however, that several academic authors have claimed that the way in which these theories are used by the accounting regulators is based on a fundamental misreading of Hicks' work.[29] In the following discussion, the authors focus on the development of accounting thinking in this regard and its influence on the design of accounting standards, since this is important if accounting standards are to be considered as possibly relevant and useful in the design and construction of a unitary tax base.[30]

For financial accounting purposes, what is being measured or determined is an estimate of the economic value generated by a firm. The proxy used by the IASB, in their Conceptual Framework, to represent this measure is seen in the definition of income as the change in value of assets and liabilities.[31] It is only under the assumptions of a perfect economic world that the IASB definition of income would represent the economic value generated. In this case, with perfect markets and full, transparent disclosure, where all assets and liabilities could be recorded at their fair (market) values and everything could be measured with certainty, the economic value generated by a firm could be measured using a Hicksian-type model of income. In this case, the change in the value of the net assets of the firm over a period of time would equate to the profit earned for that period and also to the change in the firm's equity market valuation. In practice, of course, the firm's market value and accounting book value can diverge significantly and income measurement differs from this ideal in a number of key respects. Markets, be they markets for financial instruments (such as equity shares), information, or goods and services, are frequently far from complete and perfect; disclosure of information by firms is partial and less than transparent and accounting rules and practices are affected by the political behaviour and relative power wielded by the parties involved, who are competing to pursue their own self-interests.[32] In accounting, therefore, the intention is to create a measure of a firm's financial performance (profit) that best represents the change in economic value, given the market imperfections under which the firm operates.

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[25] J. Kingman, *Independent Review of the Financial Reporting Council* (2018), available at: *https://www.gov.uk/government/publications/financial-reporting-council-review-2018* [Accessed 14 February 2020].

[26] I. Fisher, *The Nature of Capital and Income* (New York: Macmillan, 1906).

[27] J.R. Hicks, *Value and Capital – An Inquiry into Some Fundamental Principles of Economic Theory*, 2nd edn (US: OUP, 1975).

[28] In the economics literature and in some strands of the accounting literature, writers tend to use the terms income or earnings when referring to profit.

[29] For example, see M. Bromwich, R. Macve and S. Sunder, "Hicksian Income in the Conceptual Framework" (2010) 46(3) *Abacus* 348, discussing the IASB's interpretation.

[30] This term is used here to mean the tax base for the economic unit or group in aggregate.

[31] IASB, *The Conceptual Framework for Financial Reporting* (IFRS Foundation, 2018), available at: *https://www.ifrs.org/projects/2018/conceptual-framework/* [Accessed 18 February2020].

[32] R.L. Watts and J.L. Zimmerman, *Positive Accounting Theory* (Englewood Cliffs, NJ: Prentice-Hall, 1986); S. Zeff, "'Political' Lobbying on proposed Standards: A Challenge to the IASB" (2002) 16(1) *Accounting Horizons* 43.

It is important to note, at this point, the difference between the terms "income" and "profit" as used in financial reporting. While there is a fixed, single definition of the term income in the IASB Conceptual Framework (which is the change in the value of assets and liabilities, mentioned above), a published set of accounts contains several different measures of profit, which cover various components of income. The overall change in net asset values is usually termed "comprehensive income" and disclosed in a separate financial statement (the statement of comprehensive income). The required disclosure under IFRS, particularly under International Accounting Standard (IAS) number 1 ("Presentation of Financial Statements"), is structured so that it is possible for readers of accounts to identify, from the main income statement, which parts of the comprehensive income derive from core business activities (termed "operating profit" or "profit before interest and tax") and which parts derive from other activities of the firm or other factors that do not arise from normal trading, such as currency fluctuations, revaluations of pension funds or changes in the market value of non-current assets, which appear as items of "other comprehensive income". It is also possible within operating profit to separately identify the costs of financing the firm, taxation, indirect overheads, profits or losses from other sources such as joint ventures and profits associated with discontinued activities. In addition to these mandatory disclosures, firms also frequently disclose other measures of their profit voluntarily, such as earnings before interest, taxation, depreciation and amortisation (EBITDA).

2.2 The questions of to whom we account and why

In the accounting world, the question of why economic value is measured is usually considered jointly with the question of for whom is it measured. The primary objective of the financial reporting system is taken to be the provision of information for two main purposes: first for the purpose of making economic decisions by the users of the reports (the decision–usefulness function); and, secondly, for the purposes of controlling, monitoring and rewarding the performance of managers in the firm (the stewardship function).[33, 34, 35] Over time, views have changed about the scope of the relevant economic decisions, the identity of those taking them and the nature of the stewardship function. This has caused successive accounting regulatory bodies to place different degrees of emphasis on the two objectives and to arrive at different conclusions about the extent to which one set of information can serve both purposes. It is also the cause of significant differences between the two main, global, financial reporting frameworks currently operating in practice, the IFRS[36] and the standards created by the US Financial Accounting Standards Board (the FASB).[37]

Research into these matters[38] has concluded that since markets are imperfect in practice, it is not possible to determine accurately the value of assets (or liabilities) as it is impossible to forecast accurately the future economic benefits (costs) associated with them, which are needed for estimating fair values. Given the different interests of the competing parties, there is clearly no possibility of certainty in the measurement of profit, nor of creating a perfect set of rules to meet every possible case that might arise in practice. Therefore, in addition to the rules, such as in IFRS and US Generally Accepted Accounting Principles (US GAAP), there must be an additional means of ensuring that accounting, in practice, fulfils its intended purposes, thus achieving what is referred to in the literature as "functional completion".[39] In the case of financial reporting this function is fulfilled by the

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[33] H. Edey, "The Nature of Profit" (1970) 1(1) *Accounting and Business Research* 50.
[34] R. Macve, "Conceptual Frameworks of Accounting: some brief Reflections on Theory and Practice" (2010) 40(3) *Accounting and Business Research* 303.
[35] S. Zeff, "The Objectives of Financial Reporting: A Historical Survey and Analysis" (2013) 43(4) *Accounting and Business Research* 262.
[36] IASB, above fn.32.
[37] FASB, *Concepts Statements* (2009–2019), "Concepts Statements 4–8", available at: *https://www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1176156317989* [Accessed 18 February 2020].
[38] For example, R. Ball, "International Financial Reporting Standards, (IFRS): Pros and Cons for investors" (2006) 36 (Special Issue) *Accounting and Business Research* 5.
[39] Ball, above fn.39.

accounting principles contained in the accounting Conceptual Frameworks.[40] There has been a long and contentious debate on what is the appropriate balance between detailed rules and general principles, needed to achieve effective accounting regulation (hereafter "accounting rules"). Historically, the US regulators[41] and the IASB have taken different views, with the US favouring more detailed rules and the IASB favouring greater use of principles.[42]

To a large extent, these differences of view are driven by the question of for whom the accounts are produced. Some of the earliest expositions of the objectives of financial reporting were delivered in the US in the 1920s when the requirements of the taxation system were seen as an integral part of corporate financial reporting. For example, in 1922, Paton[43] identified the government as a main stakeholder in the financial reporting process and suggested that "federal income and profit taxes" should be disclosed in the accounts as a distribution of net income, in the same way that dividends to shareholders are shown as a distribution of profit rather than as a cost to the organisation. Paton was a proponent of the entity theory of accounting, under which the figures disclosed in the financial statements are compiled from the viewpoint of the managers of the firm. The theory recognises a wide range of stakeholders in the financial reporting process, none of whom is given precedence. Later statements of financial reporting objectives from the US adopted the alternative, proprietary, view of the firm[44] where financial statements are constructed from the viewpoint of the owners (proprietors), that is, the equity investors. In 1966, the American Accounting Association published a *Statement of Basic Accounting Theory*[45] that was based wholly on the decision–usefulness approach, deriving from the work of Staubus.[46,47]

In 1973, the American Institute of Certified Public Accountants (the AICPA) produced a report on their research into financial reporting objectives, entitled *Objectives of Financial Statements: Report of the Study Group on the Objectives of Financial Statements* which became known as the *Trueblood*

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[40] For example the IASB *Conceptual Framework for Financial Reporting* (2010), available at: *https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/* [Accessed 18 February 2020]; and for later developments see IASB, *Exposure Draft, Snapshot: Conceptual Framework for Financial Reporting* (2015), available at: *http://archive.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx* [Accessed 18 February 2020]. The 2018, revised, version of the framework was made generally available from the IASB in January 2019 (IASB, above fn.31).

[41] FASB and the Securities and Exchange Commission (SEC).

[42] Following the Enron and Worldcom scandals in the US, the SEC commissioned a study and produced a report recommending the adoption of principles-based standards in the US (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (2002), available at: *https://www.sec.gov/news/studies/principlesbasedstand.htm* [Accessed 18 February 2020]). This led directly to the establishment of the Norwalk Agreement (FASB (2002), available at: https://www.fasb.org/news/nr102902.shtml [Accessed 7th February 2020]), a Memo of Understanding, established between the FASB and the IASB on the development of joint accounting principles and joint accounting rules. The joint IASB/FASB programme has, in practice, proved to be far from harmonious and the convergence project broke down in 2012 amid some rather acrimonious press reports (e.g. R. Crump, Editorial, "IASB branded 'not fit for purpose' as it clashes with FASB", *Accountancy Age*, 6 July 2012), available at: *http://www.accountancyage.com/aa/news/2193181/iasb-branded-not-fit-for-purpose-as-it-clashes-with-fasb* [Accessed 18 February 2020]). The joint statements on accounting principles issued during the convergence project generated a significant amount of critical comment during the exposure process. To a large extent, the difficulties in forging joint regulations arise from fundamental differences in the FASB and the IASB philosophies about the purposes of financial reporting, which lead to differences in ideas about the processes of measurement, recognition and valuation.

[43] W.A. Paton, *Accounting Theory, with Special Reference to the Corporate Enterprise* (New York: The Ronald Press Company, 1922).

[44] Zeff, above fn.36.

[45] American Accounting Association (AAA), *A Statement of Basic Accounting Theory* (Evanston, IL: American Accounting Association, 1966).

[46] G.J. Staubus, "The Residual Equity Point of View in Accounting" (1959) 34(1) *The Accounting Review* 3.

[47] G.J. Staubus, *A Theory of Accounting to Investors* (Berkeley: University of California Press, 1966).

Report.[48] The main conclusion of the research was that, within the decision–usefulness model, the range of potential decision-makers to whom financial statements were addressed should be narrowed down to include only the providers of capital, shareholders and lenders. Since this point, all subsequent US pronouncements on the objectives of financial reporting have been rooted in the idea that reports should provide economic information relevant to the decisions taken by shareholders and, to a lesser extent, creditors.

In contrast to this, the UK has historically taken a rather different approach to determining the objectives of financial reporting and, until recently, explicitly identified a wider group of stakeholders, including the government. Various commentators have suggested that this may be as a result of differences in the relative power wielded by the accounting professions, particularly the UK accounting institutes and large professional firms, and the bodies representing the capital markets, such as the SEC in the US.[49, 50] The early attempts to define the objectives of financial reporting in the UK included *The Corporate Report*,[51] which identified a wide group of users of financial information and suggested, in addition to traditional balance sheet and income statements, six novel financial statements to meet the needs of these different groups. Among these was a "statement of money exchanges with government", designed to reflect the interests of the government as a stakeholder in the firm, largely through the corporation tax system. Although this statement was never adopted widely in practice, the UK's first complete Conceptual Framework for financial reporting, the *Statement of Principles*,[52] separately identified "governments and their agencies" as one of the primary stakeholder groups in the financial reporting process. When IFRS were adopted by quoted UK companies in 2005, the associated Conceptual Framework, created by the International Accounting Standards Committee (now the IASB), also still referred to a wide range of users of financial reports.[53]

2.3 The politics of convergence in accounting

Between 2005 and 2012, the IASB and FASB made an attempt to converge their accounting standards, which ultimately proved unsuccessful.[54] In the joint IASB/FASB Conceptual Framework issued in 2010, as part of the convergence project, the only users of financial reporting identified were the providers of capital.[55] This is linked directly to the idea that financial reporting information is produced for decisions about investment. This implies, for example, that current values of assets and liabilities are more important than historic values and that forecasting future cash flow is more important than recording historic transactions, which is an approach that is incompatible with many of the ideas in the existing international accounting standards. Examples of such accounting standards include: the standard relating to the valuation of property, plant and equipment (IAS 16, "Property, Plant and Equipment"), which allows for valuation at historic cost; the standard relating to provisions (IAS 37, "Provisions, Contingent Liabilities and Contingent Assets"), which currently requires that provisions are measured at the best estimate of the expenditure required to settle the present obligations resulting from past events, as opposed to forecasting future obligations, including estimates of the risks and uncertainties involved; and the standard relating to inventories (IAS 2, "Inventories"), which requires

[48] American Institute of Certified Public Accountants, *Objectives of Financial Statements: Report of the Study Group on the Objectives of Financial Statements* (AICPA, 1973), also known as the *Trueblood Study Group Report*.
[49] K.V. Peasnell, "The Function of a Conceptual Framework for Corporate Financial Reporting" (1982) 12(48) *Accounting and Business Research* 243.
[50] Zeff, above fn.35.
[51] Accounting Standards Steering Committee (ASSC), *The Corporate Report. A discussion paper published for comment by the Accounting Standards Steering Committee* (London: The Institute of Chartered Accountants in England and Wales, 1975).
[52] Accounting Standards Board (ASB), *Statement of Principles for Financial Reporting* (London: Financial Reporting Council, 1999).
[53] IASB/IASC, *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[54] See, above fn.41.
[55] IASB, above fn.31.

that inventories are valued at the lower of their historic cost and their net realisable value. Following its split from the FASB, the IASB's thoughts concerning the users of financial reporting have been expressed more recently in its 2018 revisions to the Conceptual Framework. This version of the Conceptual Framework was published solely by the IASB, rather than jointly with the FASB, and in it the IASB specifically re-introduced the term "stewardship" into its guidance on financial reporting objectives, which implies a wider constituency of users of financial reports.[56]

It is clear that the mixed measurement basis allowed in the valuation of assets and liabilities, by the Conceptual Framework and IFRS, results ultimately in a balance sheet that does not approximate closely to the original idea of economic value. It can be seen from this that the questions of why and for whom this value (economic or otherwise) is being measured have been contentious and complicated in financial reporting. However, regardless of which users of accounts are acknowledged explicitly in the Conceptual Framework, a variety of stakeholders still exists in practice, including managers, shareholders, lenders, auditors, employees, investors, the government and regulators. Accounting profit, in this sense, is more multifunctional than tax profit. In this context, the role of accounting regulations, such as the IFRSs, is to contribute to reducing the level of uncertainty in accounting numbers that arises from the complex environment in which they are produced, and to strike a balance between the interests of the parties in the financial reporting process, since the adoption of different rules and principles and accounting methods will impose different costs on the various interested parties.[57]

The main problem with financial reporting convergence has been that, despite pressure for the global integration of accounting rules and practices, the political and market forces affecting the individual firms, national regulators and national professions remain at the local level.[58] The breakdown of the FASB/IASB convergence project was undoubtedly a blow to the attempt to create a set of global accounting standards and, in the end, the individual approaches of the two parties proved too dissimilar to combine. Hail, et al.[59] conclude their analysis of whether the US should adopt IFRS with the statement that the US could add specific disclosure requirements on top of IFRS disclosure, in order to "assert its leadership in the area of capital market-orientated reporting". This is the crux of the problem for financial reporting. The capital market orientation of the US could not be satisfied by requiring extra disclosure in IFRS accounts, it is a fundamentally different basis of reporting from that used in the development of IFRS. These differences were characterised by Zeff[60] as being "functionalist" and "representationalist" approaches to financial reporting, the former describing the US approach and the latter the IASB approach. The differences have shown themselves primarily in: the debates about the use of fair values[61] for assets and liabilities; the need for conservatism (or prudence) in valuing assets or liabilities and in reporting profit; and the debate over the concept of stewardship and its role as an objective of financial reporting.

3. The basis of accounting information

Having outlined some of the complexities relating to the first three basic questions (the what, who and why questions) in relation to accounting, the authors now consider the fourth, the question about the basis of accounting information. In discussions concerning the role of accounting in a unitary tax base, some commentators[62] highlight the importance of the capital maintenance concept, as applied in

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[56] IASB, above fn.31.
[57] Ball, above fn.39.
[58] Ball, above fn.39.
[59] L. Hail, C. Leuz and P. Wysocki, "Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Future Scenarios for U.S. Accounting Standards" (2010) 24(4) *Accounting Horizons* 567, 585.
[60] S. Zeff, "The Evolution of the Conceptual Framework for Business Enterprises in the United States" (1999) 26(2) *Accounting Historian's Journal* 89.
[61] Under fair value accounting, assets and liabilities are recorded at a "fair", arm's length, market value or an estimation of a market price.
[62] For example, R. Murphy and P. Sikka, "Unitary Taxation: The Tax Base and the Role of Accounting" in Picciotto (ed.), above fn.3.

accounting, and criticise the application of different maintenance concepts to different aspects of financial reporting. The concept of capital maintenance states that profit should only be recognised once a firm has maintained the value of its capital. The interpretation of what this means in practice clearly depends on how capital and costs are defined and measured so the concept is critical to the debate about the nature of profit.[63] Many writers have suggested that, traditionally, the objective of stewardship has been associated with the system of historic cost accounting and therefore is more consistent with principles of taxation, which on the whole require chargeable gains to be realised. In contrast, the objective of decision–usefulness in financial reporting tends to be more associated with the use of fair value accounting.

In the context of the CCTB debates, it has been suggested[64] that the reason why both the IASB and FASB frameworks are incompatible with the CCTB is because they are "heavily focussed" on fair valuation rather than revenue recognition, and the CCTB specifies that profits and losses can only be recognised for tax purposes when they are realised.[65] Rather than being solely based on fair values, accounting profit derives from a mixed valuation base. Currently, IFRS permit the use of fair values for the valuation of property, plant and equipment,[66] the impairment of assets,[67] the valuation of intangible assets,[68] the valuation of financial instruments,[69] the valuation of investment property,[70] measuring share-based payments,[71] valuing the minority (non-controlling) interest in business combinations,[72]valuing financial liabilities[73] and in some aspects of revenue recognition.[74] As noted earlier, there are several different versions of profit and what some commentators[75] refer to as "accounting profit" is disclosed in the accounts as "comprehensive income", usually in a different financial statement from operating profit (the comprehensive income statement). It is here that the changes in fair values of assets and liabilities tend to appear. In a firm's main income statement, the profits disclosed derive from the operating activities of the business and are based on realised (earned) income and matching costs. However, the definition of realised (earned) income in IFRS has changed over time. One of the joint standards issued under the IASB/FASB convergence project, was adopted by the IASB and thus in the UK, as IFRS 15 (accounting for "Revenue from Contracts with Customers"), which came into effect for year ends on or after 31 December 2018.[76] Prior to IFRS 15, revenue was accounted for under the old IASB standard, IAS 18, on the basis of whether the rights and responsibilities of ownership, for example of goods, had been transferred to the customer. Under the new standard, revenue is accounted for on a contract-by-contract basis and based on whether the firm has satisfied the specific terms (performance obligations) of each contract. This change has significantly affected the pattern of revenue recognition for specific industries and firms such as mobile phone companies, long-term contract businesses, the construction, aerospace and engineering industries and the technology sector.

[63] The main capital maintenance concepts used in accounting include nominal financial capital maintenance (associated with historic cost accounting) and operating or physical capital maintenance (associated with replacement cost accounting and fair value accounting).
[64] For example, by Murphy and Sikka, above fn.63.
[65] European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base* (Strasbourg: 25.10.2016, COM(2016) 685 final), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf* [Accessed 18 February 2020].
[66] IAS 16, "Property, Plant and Equipment". Note the IAS (International Accounting Standards) are the forerunners of the IFRS, issued by the IASB, still currently in force.
[67] IAS 36, "Impairment of Assets".
[68] IAS 38, "Intangible Assets".
[69] IAS 39/IFRS 9, "Financial Instruments: Recognition and Measurement".
[70] IAS 40, "Investment Property".
[71] IFRS 2, "Share-based Payment".
[72] IFRS 3, "Business Combinations".
[73] IFRS 13, "Fair Value Measurement".
[74] IFRS 15, "Revenue from Contracts with Customers", see also below.
[75] For example, Murphy and Sikka, above fn.63.
[76] Another relevant change in IFRS that will affect the reporting of income and the value of assets and liabilities in the balance sheet for years ending 31/12/19 onwards is the issue of IFRS 16, "Leases", which will mean that many leased assets and associated financing commitments that would previously not have appeared on the balance sheet must now be included.

Although it may be too early to judge at this point what the effects of adopting IFRS 15 might be in practice, it seems clear that the new standard is likely to introduce more estimation and subjectivity into the process of recognising income. Organisations are now required to allocate the whole price of the contract to each of the specific obligations they have to complete to fulfil the contract, in proportion to the fair (market) value of each separate obligation. In practice, each obligation under the contract might not exist separately or might not have a market value in isolation from the other elements of the contract and thus estimates and trade-offs have to be made. The new regulations have also resulted in items of deferred revenue (amounts of income received/invoiced by a company in advance of earning it, such as a deposit) and accrued revenue (where a term of a contract has been fulfilled but not yet invoiced) appearing far more frequently in balance sheets.

The case of IFRS 15 provides an example of how the principles followed by IFRS (and in this case US financial reporting standards too) complicate the relationship between tax and accounting profit. Starting from the idea that financial reports are used by investors and creditors led the IFRS and FASB to base the revenue recognition standard on the notion that revenue should reflect the increase in value of a firm caused by the performance of specific obligations under contracts with customers. The concept behind this is that the income reported reflects the economic activity (the parts of the contracts completed) in the accounting period, regardless of whether invoices have been issued relating to that activity or whether cash has been received. It might appear, superficially, that recognition of revenue based on the firm's specific contracts would bring the financial reporting treatment of revenue closer to the tax treatment, reflecting the idea of realised income and based on completing a transaction. In practice, however, the use of fair values in IFRS 15 means that the pattern of revenue recognition becomes less like the traditional transactional basis, which is likely to identify the issuing of an invoice or receipt of cash as the trigger for recognising income.

Despite this, if, as some commentators suggest,[77] the most contentious issues in tax arise after EBITDA, the operating profit of a firm may be a more appropriate starting point for a tax base than comprehensive income and they are correct to note that no single capital maintenance concept underlies accounting profit. Ball[78] notes:

> "It is simply incorrect to view the prevailing financial reporting model as 'historic cost accounting'. Financial reporting, particularly in common law countries is a mixed process involving both historical costs and (especially contingent on losses) fair values."

It has always been the case in UK financial reporting that losses and potential losses have been valued at "fair value" and have been recognised earlier than potential gains, by application of the concept of prudence/conservatism. This principle was another that had previously figured strongly in the philosophy of the IASB but not that of FASB, which was excluded from the joint IASB/FASB Conceptual Framework. Following the breakdown of the FASB/IASB convergence project, the IASB has reintroduced prudence, along with stewardship, as a principle into its revised Conceptual Framework.[79] The important point about the concept of prudence is that it encourages an asymmetric treatment of gains and losses, whereby for potential losses, fair values and recognition before the point of realisation are used whereas for potential gains, historic costs and recognition based on realisation are used. This is seen clearly in the requirement, in IAS 2, to value inventories at the lower of their cost and their net realisable value. The need to remove the concepts of prudence and stewardship from the joint Conceptual Framework occurred in part because of the extent to which they conflict with the use of fair values in relation to the measurement of assets and liabilities. Whittington[80] provides an analysis

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[77] For example, Murphy and Sikka, above fn.63.
[78] Ball above fn.39, 14.
[79] IASB, above fn.32.
[80] G. Whittington, "Fair Value and the IASB/FASB Conceptual Framework Project: An Alternative View" (2008) 44(2) *Abacus* 139.

of the conceptual problems with the use of fair values in financial reporting and Penman,[81] although he is a noted advocate of fair values in theory, analyses some of the problems in their implementation in practice. The most significant of these derive from three main issues: first, the subjectivity of the valuation process for assets for which there are no active markets; secondly, that frequently no markets exist at all for liabilities; and, lastly, the fact that market values may not reflect the value of assets as they are used in the firm and thus their contribution to the firm's economic value. The intractability of these problems with fair values was significant enough to expose the differences in principles underlying the IASB and FASB approaches to valuation and measurement, which ultimately led to the breakdown of the convergence project and a less co-operative relationship between the two regulators.

While the presentation of financial statements under IFRS and US GAAP appears superficially similar, there are some notable differences in the accounting policies allowed under the two different regimes, which result in different profit figures.[82] For example, the US focus on detailed rules (see earlier) as opposed to principles, has resulted in a significantly different approach to the treatment of intangible assets, in comparison to the IFRS approach. In the case of development costs for new products or for processes used within the business, the IFRS principle for allowing such costs to be capitalised[83] (recorded as an asset) is based on the definition of an asset in the IFRS Conceptual Framework, that the expenditure will generate future economic benefits for the firm. Specific criteria are therefore applied to establish the likely existence of future economic benefits, based on the technical feasibility of the product or process, the firm's intent to complete the asset, the availability of sufficient resources to do so and an ability to sell the asset (if it is a product) in the future for more than it cost to complete. In contrast, the US GAAP approach is to expense all development expenditure in the period in which it is incurred, thus reducing operating profit, with the exception of computer software developed for external use,[84] which may be capitalised once technical feasibility is established. In general, IFRS also permits the revaluation of intangible assets to fair value whereas US GAAP permits only valuation at cost.

Another well-known difference between US GAAP and IFRS lies in the accounting treatment of inventories. In situations where the price of inventory is fluctuating during the year, firms often base the cost of goods sold included in the income statement and the value of year-end inventory in the balance sheet on average prices. This process requires an assumption about the flow of inventories over the year. While US GAAP allows firms to account for inventories on a last-in, first-out (LIFO) basis,[85] this policy is forbidden under IFRS.[86] The effect of this is that firms preparing their accounts under IFRS will value their inventory at the latest prices and record the cost of goods sold at prices that occurred earlier in the year. In a period when inventory prices are rising, the most common case, this means that compared to a firm reporting under US GAAP, the firm reporting under IFRS will report a higher value for its inventory and a lower cost of sales figure, and thus higher profit. In addition, where a write-down of inventory has occurred in a firm, for example due to fluctuating market prices, IFRS allows firms to reverse such a write-down if the trend in underlying prices reverses, whereas US GAAP forbids such a treatment. Overall, the presence of such differences observed between the two largest financial reporting systems in the world, US GAAP and IFRS, serves to illustrate that accounting profit is a changeable concept that can be used to represent different ideas in different contexts.

By this point, it is obvious that the answers to the four fundamental questions concerning the nature of profit are significantly more complicated for accounting than for taxation purposes. In addition to the

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[81] S. Penman, "Financial reporting quality: is fair value a plus or a minus?" (2007) 37 (sup 1: Special Issue, International Accounting Policy Forum) *Accounting and Business Research* 33.
[82] EY, *US GAAP versus IFRS: The Basics* (2018), available at: *https://www.ey.com/Publication/vwLUAssets/IFRSBasics_00901-181US_23February2018/$FILE/IFRSBasics_00901-181US_23February2018.pdf* [Accessed 18 February 2020].
[83] Under IAS 38, "Intangible Assets".
[84] Accounting Standards Code (ASC) 985-20, which provides guidance on costs of software to be sold, leased, or marketed.
[85] ASC 330-10-30 which specifies the most common cost flow assumptions used: 1. first-in, first-out (FIFO); 2. last-in, first-out (LIFO); and 3. weighted-average.
[86] IAS 2, "Inventories".

points about the range of potential stakeholders, conflicting objectives and mixed measurement bases, the practice of financial reporting involves concepts and definitions that have been described by some as too fuzzy to be used for taxation purposes.[87] The complicated processes through which accounting regulations are created and enforced also result in a wide range of possible accounting policies from which managers are permitted to choose, and a high level of subjectivity in that selection process.[88] There is a significant body of critical scholarship which posits that profit for the purpose of financial reporting is something of a chimera: it is recognised and measured in a manner designed simply to serve the interests of particular stakeholder groups and is socially constructed. This ephemeral nature of profit and its multiple purposes are matters of concern recognised by academics researching these areas. The chimeric nature of profit is ably captured in the title of a paper by Ruth Hines: "Financial accounting: In communicating reality, we construct reality".[89] The subsequent adoption of IFRS has not affected the relevance of this paper to financial reporting practice. On the contrary, the wider use of fair values, forecasting models and subjectivity associated with the adoption of IFRS tends to make the conclusion that the accounting profession constructs its own reality more relevant now than it was in 1988 at the time of publication.

4. Discussion and conclusion

Many discussions about alternative tax bases, including those relating to what is an appropriate base for global unitary taxation and, more recently, those relating to the taxation of the digital economy, have proceeded without precisely specifying how such bases are to be calculated. Indeed there often appears to be an assumption that determining an appropriate base will be unproblematic.[90] In the case of unitary taxation in the US it operates at state level, and this system is frequently put forward as a model of successful implementation of formulary apportionment. The unitary base is the profit determined by the Federal tax code which has the benefits both of uniformity and of being well understood. The difficulties that arise in that system stem from differences in the formula used to allocate the profits between states for the purposes of levying state level corporate income tax. In the case of a global or regional unitary tax that does not have a pre-existing defined base, the creation of an agreed base is profoundly problematic.

There are two main possibilities for defining a unitary tax base. The consolidated profit of the group for accounting purposes could be used, with or without adjustments for tax purposes. Alternatively, a separate set of rules could be devised that define the unitary tax base without reference to the financial statements. In 2005, when the CCCTB proposals were being discussed in Europe, the use of IFRS for the corporate base was dismissed as

> "[it] was felt unlikely that the [IFRS] consolidation would be acceptable without adjustment and the scale of the adjustments would be such that there was no advantage in starting with [IFRS] consolidated figures".[91]

[87] For examples see M. Lamb, "Defining Profits for British Income Tax Purposes: A Contextual Study of the Depreciation Cases: 1875-1897" (2002) 29(1) *Accounting Historians Journal* 105.
[88] See, for example, R.M. Pierce-Brown and A. Steele, "The economics of Accounting for Growth" (1999) 29(2) *Accounting and Business Research* 157; T. Fields, T. Lys and L. Vincent, "Empirical research on accounting choice" (2001) 31(1–2) *Journal of Accounting and Economics* 255; E. Kvaal and C. Nobes, "International differences in IFRS policy choice: A research note" (2010) 40(2) *Accounting and Business Research* 173.
[89] R. Hines, "Financial accounting: In communicating reality, we construct reality" (1988) 13(3) *Accounting, Organizations and Society* 251.
[90] See for example M. Durst, "A Practical Approach to a Transition to Formulary Apportionment" in Picciotto (ed.), above fn.3.
[91] Cited in J. Lamotte, "European Union - New EU Tax Challenges and Opportunities in a (C)CCTB World: Overview of the EU Commission Proposal for a Draft Directive for a Common Consolidated Corporate Tax Base" (2012) 52(6) *European Taxation* 1.

The original draft CCCTB proposal did not start with an accounting basis and adopted instead a revenues less exempt revenues and deductible items approach (also known as the transactional approach) which has carried through into the 2016 draft CCTB directive.

Although, as indicated, the OECD's BEPS Project explicitly rejected unitary taxation, the Action Plan[92] does suggest that the complexity of modern commercial activity might require the adoption of special measures, which could even go beyond the transfer pricing arm's length principle in certain circumstances. For example, some type of formula could be agreed upon to allocate or apportion taxable profit that has been generated by a particular intangible asset.[93] However, applying a formula in the context of a particular transfer pricing matter is not the same as adopting an alternative system based on unitary taxation.

Although it would be a radically different way of taxing multinational enterprises compared to the method that now exists within the majority of national tax systems (and bilateral or multilateral agreements), it is entirely possible that at some time in the future, MNEs could be taxed on the basis of a system of unitary taxation; indeed this is the current direction of travel in relation to the digital economy. The likelihood of this hinges on the practicability of the component parts of such a system. Specifically, which entities would form part of the unitary group, how the unitary tax base should be calculated, the mechanism for aggregating the tax base for the participating entities and the formula for allocating the aggregated unitary tax base.

By identifying the different features of a framework of accounting (see section 2 of this article) as compared with a framework of tax and in interrogating each framework with the questions set out in section 1 of this article, it becomes clear that there are different rules of recognition. What is being measured within a framework of tax is some form of profit that has arisen as a consequence of the actions, arrangements, and transactions of any entity that is identified in the tax code as being a potential taxpayer. Profit as identified by a tax code is, in effect, shared between the taxpayer and the tax authority. Identifying and sharing any such profit sooner rather than later offers advantages to tax authorities and hence to governments. The framework of tax is thus not about measuring economic value at a point in time. Conversely, it could be argued that corporation tax is based on a flow, the value of which must be measured over a period of time, before the government share and timing of entitlement can be determined.

When a consolidated set of accounts is prepared, the balance sheet is based on the value of the net assets under the control of the shareholders of the parent company at a point in time. It is perfectly reasonable that the shareholders do not want to be misled about what they control and, because they are interested in the future value of their investment, that the consolidated accounts include some expected but unrealised changes in value. Hence the removal of intra-group transactions, the use of fair values for the valuation of certain assets and liabilities, the inclusion of certain intangible assets and the use of provisions to reflect expected future liabilities.

Despite this, it is important to realise that there are many different versions of accounting profit and the version found in a firm's main income statement, operating profit or profit before interest and tax, is (the previous discussion of revenue recognition under IFRS 15 notwithstanding) based primarily on the principles of realised income and matched costs. If the effects of depreciation and amortisation are also removed from this measure, to produce EBITDA,[94] then the resulting figure is more in line with the principles usually applied in assessing profit for tax purposes. Even so, the potential for earnings management by firms under both IFRS and US standards, or local variations of these frameworks, still

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[92] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 18 February 2020].
[93] See R.S. Avi-Yonah and I. Benshalom, "Formulary Apportionment: Myths and Prospects - Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3(3) *World Tax Journal* 371.
[94] This is the measure proposed by Murphy and Sikka, above fn.63.

renders a measure based on reported accounting profits less suitable for taxation purposes, where more certainty and objectivity is required. Tax rules have traditionally dealt with this issue by removing/replacing the main items that are associated with subjectivity and greater accounting policy choice such as depreciation, provision and the valuation of intangibles.

Setting aside the possibilities of dishonest reporting, accounting and tax rules and the practices associated with them vary considerably over time as each adapts to changing social and economic conditions. In both cases, the rules and practices also vary between countries. As noted earlier, even the increasing adoption of supposedly consistent international accounting standards is riddled with inconsistency, as countries make local adaptations and interpretations.[95], [96] Arguably this opens the way to accounting standard arbitration and places additional pressure on tax authorities to master the intricacies of accounting standards. Importantly, it is in the interests of the government of each country to retain as much control as possible over their own taxation arrangements and to leave themselves enough flexibility to change those arrangements should the need arise.

The relationship between accounting and tax profits is, of course, an issue that has been debated over a long period of time by numerous academics in many jurisdictions, including the General Editor of this *Review*.[97] There is no question that debates about the use of accounting concepts in tax continue to be important. These raise not only issues in taxation and accounting but also possibly more important issues associated with the relationship between commercial activity and society.

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[95] C. Nobes and S. Zeff, "Auditors' Affirmations of Compliance with IFRS around the World: An Exploratory Study" (2008) 7(4) *Accounting Perspectives* 279.

[96] C. Nobes, *International Variations in IFRS Adoption and Practice*, ACCA Research Report 124 (London: Certified Accountants Educational Trust, 2011), available at:*https://www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/rr-124-001.pdf* [Accessed 18 February 2020].

[97] See Freedman (1993, 1995, 2004a and 2004b), above fn.2.