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SMEs and Individuals**

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# *Improving Taxpayer Accounting for SMEs and Individuals*

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## **I. INTRODUCTION**

Taxpayers use several accounting rules to keep “adequate” or “proper” records for tax purposes. These include the professional accounting standards and relatively simple cash or accrual rules for small and medium entities (SMEs). The paper cites the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB) that many developing countries use to formulate national accounting standards. Since the advanced economies that are IASB members also issue independent authoritative standards (Appendix I), the paper uses the term IFRS interchangeably with other terminology such as the Generally Accepted Accounting Principles (GAAPs) in a global and original US context.<sup>2</sup>

Tax agencies find it difficult to meet their voluntary compliance and enforcement goals because SMEs and other hard-to-tax entities (HTTs) fail to keep proper records (Bird &

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<sup>2</sup> IASB replaced the International Accounting Standards Committee (IASC) in 2001 and adopted the International Accounting Standards (IAS) issued by the IASC ([www.iasb.com](http://www.iasb.com)).

Oldman, 1990; Terkper 2003).<sup>3</sup> They also have to deal with tax planning, evasion and avoidance by large firms that ostensibly keep proper records while exercising significant discretion in applying and interpreting the IFRSs. The tax rules for controlling these activities often result in major divergences between taxable incomes and financial accounting profits. As noted in Part II, while the courts may cite or accept the standards as evidence in settling tax and accounting cases, they now tend to rule in favor of the tax rules (Porcano & Tran 1998).

Nonetheless, the financial records are necessary for the success of tax reforms (Bird 2003; Tait, 1988) because they form the basis for calculating taxable incomes. In spite of their importance, many tax administration reforms do not highlight the relevance of the financial and tax accounting rules sufficiently. The paper discusses what constitutes adequate or proper records for large entities and SMEs. It notes that the lack of appropriate and cost-effective rules may increase compliance costs for SMEs that cannot keep complex records and for large entities that must comply with the accounting standards and complex anti-avoidance tax rules (Sandford 1994).

In general, tax laws state or imply that large entities would comply with the full or “complete” IFRSs while among other administrative options, SMEs and individuals only need to comply with simple accrual, cash and presumptive accounting rules. These relatively “incomplete” rules—also known as net worth, single entry, simple, modified or hybrid techniques—are still deemed adequate for SMEs under tax laws.

Secondly, the paper stresses that contrary to popular view, the basic or core elements of a stratified accounting framework for SMEs and large entities may not change significantly with other tax measures. For example, if SMEs do not apply the non-itemization and pooling rules discussed in Part III as primary rules, they may not be able to reduce the compliance costs associated with financial accounting. Indeed, as secondary rules, the tax rules may rather increase compliance and administration costs since they impose additional accounting requirements on SMEs and tax offices.

Thirdly, the paper notes that the SME accounting rules should emphasize simple *accrual-based* “medium-entity” rules because SMEs are not homogeneous (Terkper 2003). These rules should differ from the *cash accounting or presumptive tax* rules for small- and micro-SMEs. Furthermore, countries should harmonize their SME tax and financial accounting rules even though, as noted in Parts II and III, this often fails in countries with a common law tradition. Nonetheless, this goal is worth pursuing since the two sets of rules do not diverge widely for SMEs and individual taxpayers whose main goal of keeping records is to meet tax obligations (Porcano and Tran, 1998). Finally, the rules

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<sup>3</sup> HTTs are SMEs and some large entities that take advantage of weak administrative capacity in tax offices. Bird notes that all taxpayers are potential HTTs under such weak tax structures (see Bird & Oldman 1990 & Bird 2003). Engelshalk (2005) suggests that SMEs in some transition economies keep records but lack guidance on proper accounting procedures. See also Thuronyi 1996 and Terkper 2003.

should reduce or eliminate the burden of recordkeeping and filing for individuals under non-rebuttable *presumptive* and *withholding* tax options.

Part II discusses the general goals and processes of accounting as background for the specific SME and large entity issues covered in Part III. Both sections cover the full standards and the exceptions for SMEs in professional standards or business and tax laws. Part IV concludes the paper with a summary of the main issues.

## II. GENERAL NATURE OF ACCOUNTING

What standards or records do taxpayers need and why are these often complex for SMEs? Part II provides a background for the paper with a comprehensive review of the documents and records needed to adhere fully or partially with standard practice.

### A. Goal of tax accounting

The purpose of *financial* (and management) accounting is to record, analyze and report on business transactions to enable managers, owners and other stakeholders make effective decisions. Taxpayers need the records to calculate and pay their taxes, penalties or interest—or claim credits and refunds. Tax offices also need good records to enforce the law, report to treasuries, and manage operational budgets well. While a consideration of tax office records is beyond this paper, in summary, weak tax office records often reflect inadequate treasury and budget rules and worsen non-compliance by making it difficult to control taxpayer records, revenues and budget resources.

The taxpayer accounting records discussed in Section C are necessary for self-assessment or voluntary compliance and enforcement programs. They form the basis for calculating taxable incomes for all taxpayers, except low-income individuals and small SMEs under non-rebuttable presumptive and withholding tax regimes. The paper stresses that the setting of appropriate accounting rules in tax reforms for large entities and SMEs can significantly enhance tax compliance and administration.

### B. Importance of the standards (IFRS or GAAP)

The effectiveness of IFRSs depends on factors such as a country's legal tradition and stage of development, including the maturity of its financial and fiscal systems. The rules have limited acceptance or application in large informal economies and, also, countries differ in the extent to which the tax and financial accounting rules may diverge. Nonetheless, the quality of accounting in all economies tends to depend on the size and complexity in organization and operations of large entities and SMEs.

## Regulatory framework

The calculation of taxable income under *tax laws* depends implicitly or explicitly on the IFRS rules and on the accounting and reporting rules in *corporate or business laws*. Taxpayers also adhere to relevant *judicial rulings*—notably on the recognition, measurement and timing of transactions—to meet tax obligations (Krever 1997). In a fiscal context, the coding or classification of tax transactions should comply with *treasury* or budget laws.

As noted later, while these various sources have common elements, tax and financial accounting regimes often have different goals and outcomes. The maximization of profits by businesses often conflicts with raising optimum tax revenues—with the courts now ruling more in favor of the tax rules in the event of conflict (Tran 1998).

## Importance of accounting standards

Some countries codify the GAAPs as bases for uniform professional, business and tax accounting rules. However, the GAAPs evolve in common law countries as discretionary or mandatory rules for accounting bodies. As Bird (2003) notes, they evolve slowly in developing countries even though they also tend to codify the GAAPs (Part III, Table 7). While the GAAPs were originally popular with large private companies, they now apply to SMEs and non-profit or public entities. As noted in Part II, the prime SME standard is UK's Financial Reporting Standard for Small Entities (FRSSE) but the IASB also has a draft SME accounting standard.

Appendix 1 summarizes the current IFRSs and underlying principles that accounting bodies apply to *profit and non-profit* entities in the *private* and *public sectors*. They cover *general* or *specific* topics such as the form of financial statements, depreciation, inventory, and even tax treatment in business records.<sup>4</sup> As noted, standards such as the FRSSE also cover SMEs but even the modified rules they incorporate may be too complex for several small taxpayers, especially those in underground economies in developing countries. However, they are appropriate for formulating the medium-entity rules that the paper strongly advocates in Part III.

While the courts may cite the IFRSs or accept them as evidence, they uphold the divergent goals of financial and tax accounting rules. They also tend to give precedence to the latter. For example, Section 446 of the US Tax Code (1986) recognizes the basic dependence of taxable income on approved accounting practice—provided the accounting method used in the books of accounts clearly reflects the taxpayer's income. Between 1920 and 1960, the courts appeared to support conformity of the tax and accounting rules but the “final complete rejection of GAAP and financial accounting for

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<sup>4</sup> See IAS 12 (Income Taxes); UK's Financial Reporting Standard (FRS) 19 (Deferred Taxes); FRS 16 (Current Taxes); Statement of Standard Accounting Practice (SSAP) #5 (Accounting for VAT).

tax purposes occurred in a 1979 US Supreme Court (Thor Power) case” (D’Ascenzo and England 2005).<sup>5</sup>

Despite potential benefits, countries fail to harmonize the accounting and tax rules for reasons such as (a) the different goals of the two rules; (b) uncertain IFRS rules that lead to latitude in their interpretation and application; (c) separate historical processes for setting the rules; (d) potential difficulties in using common tax and accounting rules to achieve fiscal goals (e.g., tax incentives) and (e) make management decisions (see D’Ascenzo and England, 2005; Tran/Porciano and Tran 1997-99).<sup>6</sup>

### Accounting principles

The standards are based on several conventions, assumptions, principles and concepts such as the matching, historical cost, accrual/realization, materiality, prudence, and double entry rules (Appendix 1). In relation to effective bookkeeping, the *double entry* rule requires entities to record the “receiving” and “giving” sides of transactions or exchanges in the accounts (Section D). The *accrual* rule requires the entry of transactions on commitment and not when the parties receive or pay cash—which is the exception for *SME cash accounting*.

The dual (debit and credit) entries maintain the *accounting equation* as the basis for financial accounting. It is expressed as assets = equity *plus* liabilities (or, in terms of net worth, equity = assets *less* liabilities) and implies that the value of assets must be equal to their sources of funding at all times. SMEs make it difficult to maintain the equation for businesses because they fail to comply with the *entity* rule, which requires strict separation of business and personal transactions. Finally, the special SME rules often set aside the accrual and *materiality* rules by allowing SMEs to keep cash records and expense or write-off most capital items to the income statement on current year basis (Section C).

### The standards and tax administration

Full compliance with the IFRSs is relatively complex and often associated with large entities. In contrast, most SMEs need only *simple or modified* accrual or cash rules to comply and reduce costs. Part III discusses SME standards and simple tax rules such as

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<sup>5</sup> Thor Power Tool (1979) 439 US 522 and earlier cases such as Eastman Kodak Co. (1976) 534 F.2d 252. Income statements may show high business profits and virtually no taxable incomes. This may be due to the government’s own tax incentives as well as aggressive tax planning, evasion and avoidance.

<sup>6</sup> For discussion of the symmetry (harmonization) and divergence between tax and accounting rules—covering judicial, legislative and fiscal issues—see (D’Ascenzo and England, 2005; Porciano and Tran, 1998; Tran 1997-99; and OECD 1987). As the studies show, divergence is wider in Anglo-Saxon or common law states (e.g., UK, US, Canada and Australia) than some European states with codified laws (e.g., France, Holland, and Denmark). The deciding factors in developing countries include historical ties to the advanced countries, market-economy trends in former Soviet states (e.g., EU accession countries), drafting norms that incorporate the GAAPs in tax laws (Table 7), and globalization.

the US-IRS *hybrid* rules and the Australian Tax Office (ATO) Simplified Tax System (STS). While these may follow basic double entry and accrual rules, they also allow the majority of SMEs to adhere to only cash accounting rules.

Adherence with the full IFRS is also necessary but not sufficient to comply with tax laws for controlling tax planning, avoidance and evasion. The laws include general anti-avoidance regulations (GAAR) for activities such as transfer pricing, thin capitalization, and currency translations that do not meet basic *arms length* principles. These private or public tax rulings may be simple or complex and require taxpayers to adjust the business profit to derive the taxable income (Section C and Part III).

The tax rules add to the IFRS disclosure and consistency rules that make the financial records meaningful for tax, investment and other purposes. They add to traditional costs of self-assessing or using experts to comply. While taxpayers may derive some benefits from keeping the records (e.g., better management controls) and complying with the tax rules (e.g., avoidance of double taxation), in general, the net cost of complying reasonably with the accounting and tax rules could be high. Tax reforms should streamline the accounting rules to assist SMEs lower the compliance costs that can be a multiple of administration costs (Sandford, 1994 & 1989).

### C. Basic accounting processes

This section discusses the range of activities or transactions and the documents and books or records that taxpayers need to comply with the IFRSs and simple rules.

#### Overview of basic accounting process

The goal of financial accounting is to record transactions that entities classify as *operating*, *investing* and *financing* activities. The term *transaction* refers to activities that are measurable and realizable in currency units (Appendix 1). Hence, while the meetings with a customer may be potentially profitable, they become transactions for accounting purposes when the entity receives an order and signs a binding contract.

The initial step in accounting is to use codes or *chart of accounts* to classify the *documents* and facilitate the initial entries into *journals* or *subsidiary records*. The entries are “posted” to *accounts* in the *ledger* and *cashbook*. After “balancing” the accounts, they are used to extract a *trial balance* and prepare the *financial statements* at the end of the period. The financial statements include the *operating* statement, *balance sheet* and *cash flow* statement. Taxpayers “adjust” the records at the end of the year (a) to ensure proper matching of incomes and expenses by separating the *flow* and *stock* items; and (b) to bring the records in line with the tax laws.

**Table 1: Two sides of an account and effect of double entries**

Groups of transactions and type of accounts	Journal, ledger and cashbook records			Financial Statements
	Debit entry	Credit entry	Balance	
<b>Current – operating activities (for the period)</b>				
Sales and other incomes	Decrease (-)	Increase (+)	Credit	Income Statement
Purchases and expenses	Increase (+)	Decrease (-)	Debit	Income Statement
Profit (Loss)	Decrease (-)	Increase (+)	Debit/Credit	Income Statement
<b>Current – working capital (end-period)</b>				
Current assets	Increase (+)	Decrease (-)	Debit	Balance Sheet
Current liabilities	Decrease (-)	Increase (+)	Credit	Balance Sheet
<b>Capital – investing &amp; financing activities (end-period)</b>				
Fixed assets	Increase (+)	Decrease (-)	Debit	Balance Sheet
Long-term liabilities	Decrease (-)	Increase (+)	Credit	Balance Sheet
Equity (Profit/Loss)	Decrease (-)	Increase (+)	Credit	Balance Sheet

Table 1 summarizes the *high-level* transactions and the processes for “entering” them in ledgers and preparing the financial statements. The remaining paragraphs in this Section discuss the nature of transactions (including working capital, discussed later), records and financial statements (and adjustments) in more detail.<sup>7</sup>

### Importance of transactions

Taxpayers are required to classify their transactions as *operating (including working capital)*, *investing or financing* activities to prepare the financial accounts properly. Appendices II and III show the linkages between these activities and their effect on profits and taxable incomes.

*Operating activities:* The operating activities are *current or flow* items for a period and consist of incomes and expenses. The *purchases* and *sales* giving rise to these items relate to the goods or service for which an entity is established. The entity may also incur other *expenses* and earn other *incomes* (e.g., wages and interest).

*Investing activities:* The *investing* activities are *capital or stock* items that refer to the *fixed assets* (e.g, vehicle and premises) used to support the operating activities over multiple periods. Given the restricted meaning of sales and purchases, the literature refers to the buying and selling of fixed assets as *acquisitions and disposals*.

*Financing activities:* The *financing* activities are stock items referring to long-term funding of the assets. The two main sources are from owners (i.e., *equity* or capital, net of accumulated profits or losses) and from outsiders (i.e., *loans or credits*).

The operating activities determine the taxable profit directly and may result in substantial *working capital* needs (as described below) in addition to an entity’s investing and financing activities.

<sup>7</sup> Readers who are familiar with accounting—or find it technical—may skip or skim through the remainder of this section and move to Part III, on the accounting requirements for large entities and SMEs. Readers may also use Table 1 to follow the discussions in the remaining sections.

## Working capital and expensing

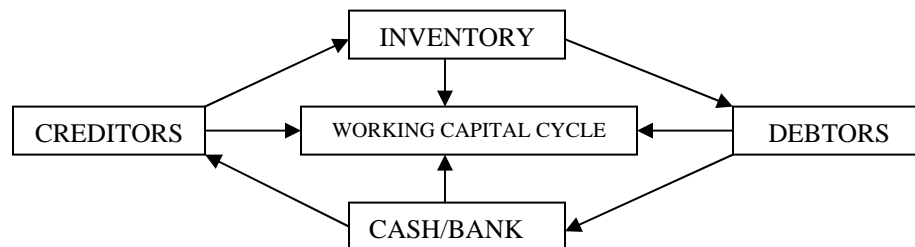
The process of summarizing operating activities to determine the profit or loss and the accrual or cash options for recording transactions depends on the magnitude and need for working capital, investing and financing activities over multiple periods.

As Box 1 shows, the operating activities result in *short-term financing or investing* decisions known as *working capital*. To expand or facilitate operations, an entity invests in inventory and enters into *credit* (as opposed to *cash*) transactions with suppliers or customers. It also *accrues* or *prepays* incomes or expenses that involve future payment of cash for current items and vice versa. The *working capital cycle* adds to the need to raise funds to buy fixed assets—which the entity *amortizes or depreciates, writes-off, expenses or operationalizes* over the period of use of the assets. Depreciation is also a major “adjustment” item since the *capital or investment allowances* in tax laws take precedence over them.

The basis of *accrual accounting* is the commitment of incomes or expenses and not actual receipts or payments—or the basis of *cash accounting*. Large and medium entities (LMEs) record most operating (working capital), investing and financing items on accrual basis because they often hold inventories and defer receipts and payments. In contrast, since many small SMEs deal in cash transactions that may not material, they only need a simple cashbook to meet their accounting obligations.

### Box 1: Working capital concept

The operating activities that generate working capital cycle often start with securing funds internally (i.e., cash) or externally (e.g., bank overdraft and *creditors*) to hold *inventory* or stocks (prior to sales) and extend credit to customers or *debtors*. This circulating activity is the lifeblood of a business.



The inventory, debtors and cash or near-cash (e.g., bonds) are *current assets* while the creditors and overdraft are *current liabilities*. The difference between the two is the *working capital*. If the current assets are not sufficient, the business may utilize its long-term funds (loans and equity) to fill the gap.

## Business documents and books of accounts

The accounting records depend on reliable and accurate *business documents* as proof or evidence of the transactions and the entries into *journals* or *subsidiary* records. These records are then “posted” to relevant *accounts* in a *ledger and/or cashbook*.

*Source documents and accounts:* Taxpayers must classify the source documents well to maintain proper accounting records that include purchases and sales *invoices*, *credit and debit notes* (for reversing invoices), and *cash receipts*. An account is the historical record of specific operating (incomes and expenses), investing (current and fixed assets) and financing (equity and liabilities) activities in a *ledger* or *cashbook*. The *debit* and *credit* entries in an account (Tables 1 and 8) follow the double entry or “golden” rule—debit the ‘receiving’ account and credit the ‘giving’ account—to validate the *accounting equation* (Section B).

*Accounting records:* As a book of prime entry, the *journal* is used to classify all the transactions prior to entry or “posting” into *accounts* in the *ledger* or *cashbook* (i.e., a one-sided ledger for cash items only). The entries must conform to a code or *chart of accounts* for specific incomes, expenses, liabilities, assets and equity. The accounts are “balanced” or closed periodically (e.g., monthly) or continuously under automated systems by offsetting the debit entries against the credits. As Table 1 shows, a *debit balance* is an asset or expense account and means total debits exceed total credits. A *credit balance* is the opposite for incomes, equity or liabilities.

A *trial balance* is a list of debit and credit balances from the ledger at a point in time. It facilitates the *adjustments* of operating (working capital) and capital items and the preparation of financial statements at the end of the year. The trial balance confirms, without necessarily validating, the arithmetical accuracy of the double entry rule and accounting equation, as expressed by the balance sheet discussed below.

## Financial statements

The financial statements summarize the ledger balances at the end of the period (IAS 1). They consist of the (a) *operating statement*—for determining the profit or loss for the period; (b) *balance sheet*—to show the working capital, investing and financing items at the end of the period; and (c) *cash flow statement*—to show net change in cash or near-cash for all activities between the start and end of the accounting period.

*Operating statement:* The operating statement offsets total *sales and incomes* against *cost of sales* and *expenses* to determine the *profit or loss* for the period (Table 2).

**Table 2: Details of a basic Income Statement**

Items	Effect on Profit	Description	SME Features
Sales or incomes	+	Total income from sales	Mainly cash receipts
Cost of sales (COS)	-	Purchases (net of inventory)	Special inventory rules (Table 6)
Gross profit (=)	+(-)	Sales less COS	COS may be mainly cash items
Expenses	-	Including non-cash (depreciation)	Pooling and expensing (Table 6)
Net profit before tax (=)	+(-)	Gross profit less expenses	Nearly equal to taxable income
PIT/CIT	-	Tax due for the accounting period	Owners’ share of profit
Profit after tax (=)	+(-)	Profit for distribution/investment	Further adjustment for PIT

The income statement is a *final account* for closing the *operating or current* account balances after making the necessary adjustments for working capital, depreciation and

accruals. The process involves the transfer (and offset) of the income and expense account balances to the debit and credit sides of the income statement. The balance or net profit (or loss) has a corresponding entry in the equity or capital account. After paying or making provision for taxes, the entity may distribute the after-tax-profit to the owners or reinvest in the business by increasing the equity or capital account balance in the ledger. A loss reduces the value of owner's equity.<sup>8</sup>

*Balance sheet:* The balance sheet is a statement (not an account) that shows capital (or stock) and current or flow (working capital) account balances after compiling the income statement (Table 3). It expresses the accounting equation (assets = equity plus liabilities) and shows the fixed assets at original or historical costs (less accumulated depreciation). However, the standards may allow entities to record the assets at market values under circumstances such as inflation (IAS 29).

**Table 3: Basic elements of a Balance Sheet**

Items	Effect	Description	SME Features
Current assets (CA)	+	<i>Operating</i> stock items	Inventory usually not material due to
Current liabilities (CL)	-	<i>Operating</i> stock items	expensing; mainly debtors & creditors
Working capital (=)	+(-)	CA less CL (Box 2)	Not material
Fixed assets	+	<i>Investing</i> items	Pooling and expensing (Table 6)
Long-term liabilities	-	<i>Financing</i> items	Mainly bank loans
Net Assets (=)	+	Assets less liabilities	Mainly from owners' equity—few
Equity (=)	+	Equity or capital	securities market transactions

*Cash flow statement:* IAS 7 requires entities to prepare cash flow statements to show the source and application of funds from the *operating, investing, and financing* items (Table 4). It consists of adding the net cash flow from operations to the changes in working capital, investing and financing items. The net change is the difference in cash and liquidity (i.e., cash *plus* near-cash) at the start and end of the period.

**Table 4: Cash flow statement**

Items	Effect	Description	SME Features
Operating activities	+(-)	Net operating income	Non-cash capital flows may not be
Change in working capital	+(-)	CA & CL (Balance sheet)	material due to pooling and
Current capital items	+(-)	Depreciation	expensing
Investing activities	+(-)	Changes in fixed assets	Increase/decrease in asset "pool"
Financing activities	+(-)	Net financing	Mainly flows from owners and
Long-term debt	+(-)	Non-owners	bank loans
Owner's capital	+(-)	Owners	
Net change in cash	+(-)	Cash at start less at close	Mainly liquid cash

<sup>8</sup> Sole proprietors and partners take the share of profit as drawings while companies distribute dividends (approved at annual general meetings {AGM}) to shareholders.

## Complexity of records

The complexity of accounting records depends on several factors, including the organization and operations of taxpayers.

*Complexity of transactions:* As noted earlier, the working capital, investment and financing activities of many small SMEs are not material. Hence, they require only a *cashbook* and simple income statement (and balance sheet) to comply. If required, the cash flow statement is a summary of the cashbook. In contrast, the records for large and medium entities (LMEs) may be relatively complex.

*Audited and published financial statements:* Corporate and listing laws require LMEs to publish the financial records after submitting them for auditing to show a “true and fair” of the entity’s activities to investors and other stakeholders. The financial statements must “disclose” extraordinary or significant items, change in accounting policies, estimates and errors as explanatory notes or sub-classifications (IAS 1 and 8). As discussed in Part III, some tax laws require taxpayers to attach the “audited accounts” to the tax returns or produce them upon demand.

*Consolidated financial statements:* Parent companies prepare group financial records to cover inter-firm transactions with subsidiaries and other associates. In addition to several accounting rules (IFRS 3 and IAS 14, 24 and 28), these must comply with public or private tax rulings and agreements (e.g. tax treaties and GAARs). These may cover complex and conflicting rules in different tax and accounting jurisdictions. The principal goal of most complex tax rules is to control transactions such as transfer pricing, thin capitalization and acquisitions or mergers. They minimize the incidence of double taxation but also create opportunities for tax planning, avoidance and evasion. The risks may come from tax preferences such as tax holidays, investment allowance, rates and tax bases. It is apparent that only large entities need to prepare these group records and comply with the rules.

*Adjustments and taxable profits:* As noted in Section B, taxpayers adjust their records because the tax law takes precedence over financial accounting rules. Often this means that the business income, expenses or profit is not synonymous with assessable income, deductible expenses and taxable income. With the exception of small SMEs under final presumptive tax and simple cash accounting rules, the accounts need adjusting for even records that comply with the IFRS.

### III. ACCOUNTING BY TAXPAYERS

It is apparent that “adequate” or “proper” records is relative and covers accrual or cash rules for large entities and SMEs—in line with the complexity of organization and operations. SMEs tend to be sole proprietorships or partnerships with simpler records than large corporate entities that need detailed records for complex domestic or foreign operating, financing and investing activities (see Appendix IV).

This Part emphasizes the need for simple or modified accrual rules for *medium-sized* SMEs. These should be distinguished from the presumptive tax and cash accounting rules for *small* and *micro-SMEs* because SMEs are not homogeneous (Terkper 2003). These different SME rules can make the compliance costs less regressive among large entities and SMEs (Evans 1997; Chattopadhyay and Arindam 2002). To achieve this goal, tax offices should harmonize the different sources of SME accounting rules, including the GAAPs as well as tax and business legislation.

Section A discusses the core tax accounting requirements in tax laws while Sections B and C cover the options for meeting those obligations. The *accrual-based* options are suitable for LMEs while the simpler *cash* accounting and *presumptive* tax options (with or without accounting records) are suitable for micro and small SMEs. Section D summarizes some adjustments for bringing the financial records in line with the tax laws. Section E discusses measures to assist taxpayers to comply with their accounting obligations, including the use of tax practitioners and accounting software.

### **A. Basic taxpayer accounting requirements**

The basic accounting obligations are similar under most tax laws but with exceptions for small SMEs under cash accounting and presumptive tax regimes. The laws also have additional requirements for large complex entities. The paper adds the need for uniform modified accrual and cash rules for medium entities.

*Keeping adequate records:* Tax laws explicitly or implicitly require taxpayers to keep records that comply with the IFRS (Section B) but they also recognize the need for cost-effective and feasible options for SMEs (Section C).

*Filing of tax returns:* Taxpayers prepare and file returns to pay the tax due or claim a credit after “adjusting” the financial records. The adjustments match the incomes and expenses properly and reconcile the accounts with the tax law (Section D).

*Cooperate with tax auditors:* Taxpayers must produce the accounts on demand for tax audits. Consequently, tax laws require them to retain the records for about four to six years or apply to the tax authorities to destroy them within this statutory period.

Some laws require taxpayers to attach “audited” financial statements to the tax returns instead of keeping the records for tax audit and enforcement purposes. While external audits give better proof of compliance with the GAAPs or tax laws, they do not replace or exempt taxpayers from tax audits or inspections.

## B. Full accrual accounting for large taxpayers

Tax laws should oblige large entities to comply in sufficient detail with the IFRS and accounting provisions in business or tax laws. This Section provides a brief summary only since the paper deals mainly with SMEs.

*Accounting principles:* The entities in this category should comply fully with the accrual, double entry and other accounting principles. In addition to their statutory accounting and listing obligations, large corporations should adhere to the tax rules that aim to eliminate double taxation or minimize uncertainty, litigation and lengthy audits from tax planning, evasion or avoidance activities.

*Accounting records:* Large entities often automate the accounting records to show detailed flows or stocks of operating, working capital, financing and investing activities. Under corporate and financial market reporting and disclosure rules, they must disclose sub-items, comparative figures, explanatory notes, and significant changes in policies, estimates and errors (IAS 1 and 8). The rules also cover group or consolidated accounts for parent and subsidiaries companies (IAS 27/28).

*Practical considerations:* Tax agencies should not make exceptions to the IFRS—and tax rules—for LMEs with statutory corporate or financial market obligations to maintain proper records. As Sandford (1989) notes “a company is required to publish annual accounts for the benefit of its shareholders and may, in any case, collect the data required for management purposes”. In practice, for example, taxpayers in a large taxpayer unit (LTU) should support the tax returns with records that comply with IFRS, corporate law and tax rules. Indeed, large entities often self-assess and may rather take advantage of weak capacity in tax offices to avoid or evade taxes.<sup>9</sup> As noted in the next section, most complex adjustments relate to large entities and SME accounting normally involves relatively few divergence issues.

## C. Modified accrual and cash accounting for SMEs

The cost-effective modified, hybrid, simple or cash accounting rules for SMEs to meet accounting and tax obligations are from several sources, including—

- *Accounting standards*—these are mainly, simple accrual rules such as UK’s FRSSE or IASB’s draft SME Discussion Paper.
- *Business (corporate) laws*—simple accrual rules and abridged financial statements for SMEs to meet statutory reporting and audit requirements.

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<sup>9</sup> They may classify the transactions improperly while appearing to comply with the GAAPs or posting data flawlessly into the automated systems. Tax agencies need trained staff to identify complex forms of non-compliance among large entities, including verifying the automated records.

- *Tax laws*—simple tax computations and cash or accrual rules to facilitate official assessments and self-assessment by SMEs (e.g., US hybrid and ATO Simplified Tax System [STS]—see [www.treas.org](http://www.treas.org) and [www.ato.au.gov](http://www.ato.au.gov)).

Even though there is no standard definition for SMEs for accounting purposes, there is sufficient criteria for separating the *modified accrual* records for *medium-sized SMEs* from the presumptive and cash accounting rules for *small- and micro-SMEs*. Where necessary, tax laws should also exempt small SMEs and low wage earners under non-rebuttable withholding and presumptive tax regimes from most accounting and filing obligations. Finally, countries should make an effort to harmonize the tax rules and SME standards to avoid increasing compliance costs inadvertently.

### Definition of SMEs for accounting purposes

There are no uniform definitions for SMEs in accounting but there is sufficient guidance for formulating medium- and small-SME accounting rules. The accounting bodies base the primary test on the lack of public interest in—or accountability on the part of—an entity (Box 2). In this regard, the IASB delegates the use of quantitative criteria (e.g., turnover, assets and employees) to its national accounting bodies.

#### Box 2: SME accounting standards and proposals

The IASB SME Discussion Paper (June 2004) states that all entities need to apply the full standards or IFRSs in line with the need to prepare financial statements under the Board's basic accounting framework (IASB 2003). Consequently, the Paper makes a *rebuttable presumption* (with automatic *fallback* to the regular standards) for applying the proposed SME standards. The key points to consider are:

- The SME standards are *not intended for use by publicly accountable entities* with reporting and securities market listings requirements. All other entities are potential users of the SME standards.
- Prescribed characteristics should be left to national accounting bodies to evaluate and, therefore, the proposed SME standard *should not include general quantitative "size tests"*.

UK's FRSSSE also excludes entities with a "*public interest*"—reporting and securities market listing obligations—in their operations from applying the SME standards. In addition, however, it sets other *quantitative criteria* in line with EU law. These include turnover threshold (GBP5.6m), balance sheet total (GBP2.8m), and average number of employees (below 50).

In contrast, as Table 5 shows for a developing economy, tax agencies tend to rely on quantitative measures to segment taxpayers for reforms such as large taxpayer units (LTUs), self-assessment, presumptive taxation and VAT (Baer 2002 and Ebrill & others 2003). The quantitative criteria may also be ideal for developing countries with large informal sectors and weak corporate or financial market practices.

Table 5. Example of classification of taxpayers in a small economy

Category	Type of Record	Typical form	Annual Turnover (indicative only)
Large	Full GAAPS	Corporate & few partnerships	Above \$250,000
SME medium	Modified GAAPS	Corporate & partnerships	\$50,000 - \$250,000
SME micro	Cash accounting	Partnerships & sole proprietorships	\$25,000 – 50,000
SME small	Presumptive	Sole proprietorships	Below \$25,000

The quantitative measures—as shown for a small developing economy (Table 5), UK’s FRSSE (Box 2), and Australia’s STS (Box 3)—depend on a country’s stage of development (e.g., as reflected in national output and maturity of its financial and business operations). The categories overlap and are seen as progressively guiding SMEs to move from simple cash to accrual accounting methods. The IASB (2004) states that the “financial reporting standards for SMEs should ... allow easy transition for those SMEs that become publicly accountable or choose to switch to full IFRSs”.

### Why medium-entity accounting rules

The case for separate modified accrual rules for medium-SMEs is based on many factors, including:

- sufficient guidelines in existing and proposed SME standards to record the operating, investing and financing activities at an intermediate stage;
- many corporate entities that tend to be medium SMEs have pre-existing reporting obligations under business laws;
- medium entities are relatively formal and use full or partly qualified staff, tax practitioners, and accounting software to prepare their records (Section E);
- after initial costs or updates of accounting systems, SMEs with formal structures appear to have problems with frequent changes in the tax law than with keeping records under stable conditions (Wallschutzky & Gibson, 1993);
- corporate SMEs, even if they are private, have a statutory obligation to keep records which, as often pertains in corporate laws, need not be detailed;
- a high VAT registration threshold can eliminate small SMEs from the tax base and facilitate integrated direct and indirect tax controls for medium-SMEs, through basic documentation (e.g., VAT invoices and receipts); and<sup>10</sup>

<sup>10</sup> In general, the records for income taxes are more complex than VAT or customs duties because taxpayers need only basic documents to file indirect tax returns—which uniquely under VAT, leads to substantial credit and refund claims. However, these records form the basis for the income tax records.

- medium entities have revenue potential and, therefore, tax agencies need to isolate them to ensure better compliance.

While some medium entities may adopt the pure cash accounting rules discussed later, these should apply mainly to small- and micro-SMEs. Medium-SMEs should also be subject to presumptive taxation under exceptional circumstances only.

### Modified accrual rules for medium-sized entities

Tax agencies should use the GAAP rules and business and tax laws to formulate uniform modified, simple or hybrid accrual or cash rules for medium-entities.

*Accounting principles:* Accounting standards such as the FRSSE and business or tax laws include several *modified rules* for reducing SME compliance costs. These cost-effective rules still require SMEs to conform to the accrual, double entry, business entity and other principles in their basic form. In practice, however, the *hybrid* or *simple* rules allow SMEs to use either cash or accrual methods to comply. As with cash accounting, accountants, practitioners and tax officers often reconstruct the income statement from rudimentary records to calculate the taxable income. They use so-called “*net worth*”, single entry or *incomplete* rules (Box 3) to achieve this goal.

#### Box 3: What is the Net Worth Method?

Under this method, businesses calculate the profit or loss by comparing the value of the entity or *net worth method* (i.e., equity = assets – liability) at the start and end of the period.

Item	Effect	Description
Capital at close	+	Current year’s assets less liabilities
Less: Capital at start	-	Past year’s assets less liabilities
Change in capital (=)	+	Operating and capital flows in current period
Add: Drawings	+	Outflow of non-operating items during period
Less: New capital	-	Inflow of capital during period
Operating profit/loss (=)	+(-)	Operating income for the period

In many cases, the accuracy of the net worth method depends on the precision with which a taxpayer can derive the elements in the table from its “*single entry*” or “*incomplete*” records.

*Accounting records:* Many medium-sized SMEs are likely to have formal operations with reasonably good staff and internal controls. Taxpayer using the modified rules should maintain the source documents, journals, cashbook and ledgers, preferably using standard accounting software and bank instruments to support their operations. While the documents may include bank statements, duplicates or stubs, credit/debit card receipts, tax laws should be pragmatic since several medium SMEs in developing countries may still operate in the informal sector and engage in small transactions that require the use of only cash records.

*Financial statements:* SMEs applying the modified rules need to prepare the financial statements in only *abridged*, *simple* or *condensed* form. They do not need explanatory

notes and sub- items because of the simple nature of their transactions and lack of “public interest” in their operations (Box 2). While some medium entities may branch accounts, these are not as complex as group accounts and, in principle, the subsidiary of a parent company may not be eligible to use the SME standards (IASB 2004). It is these exceptions—and not always a difference in core principles—that separates the modified and full IFRS records.

*SME tax and accounting rules:* The standards and business and tax laws often include several special accounting rules and principles for SMEs. These include

- *eligibility*—as noted, these are based on quantitative or qualitative criteria;
- *cash accounting options*—entering accounting data in ledgers and preparing the financial statements on the basis of actual receipts and payments;
- *aggregation*—placing classes of fixed assets (e.g., motor vehicles) in “pools” or using standard values in lieu of itemizing incomes or expenses;
- *non-material/de minimis rule*—writing off small values of expenses, assets and incomes in the year to avoid capitalization, accruals or depreciation;<sup>11</sup>
- *prorating*—using using standard ratios or fractions to apportion common business and personal expenses such as rent and utilities; and
- *abridged financial statements*—preparing only simple income statements and balance sheet without detailed explanatory notes and sub-classifications.

Table 6 shows extracts from Australia’s STS scheme for simplifying accounting entries and records for SMEs.

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<sup>11</sup> Most special SME rules apply the materiality rule in substance (e.g., *pooling* involves classes and not individual assets and the *de minimis* rule writes off assets with small values as direct expenses).

**Table 6: Australia's Simplified Tax System (STS) for small businesses**

Topic	Description
Goal	The goal of STS is to provide an alternative cash or accrual method for determining taxable income to reduce compliance costs for SMEs.
Eligibility	SMEs with (a) last 3-year past or future average annual turnover of less than A\$1 million (excluding GST) and (b) total adjustable value of depreciating assets at the end of the year of A\$3 million. Entities assess these factors on a year-by-year basis.
Cash accounting	Entities may follow simple cash and accrual method. For cash accounting, ordinary income from sale of goods, fees or commissions will be included in assessable income on receipt. General deductions for operating expenses, professional fees and commissions would be recognized and claimed only when paid.
Simplified depreciation	Apportion depreciable tangible assets between private and business use and write off the business portion of the "pool" as follows: (a) immediate write-off—capital expenditure below A\$1,000; (b) assets with less than 25 years effective life—place in a <i>pool</i> ; depreciate on diminishing rate of 5 percent. Write-off pool when it falls below A\$1,000; pro-rate value of assets acquired midstream; and exclude proceeds of sale in pool (i.e., recognize balancing charge or capital gain when the value of the asset is exhausted). Apply normal depreciation rules for assets with over 25 years effective life.
Simplified (inventory) methods	No stocktaking or adjustment required where the change in value of opening and closing stock is less than A\$5,000. No stock adjustment is required if the opening stock is above A\$5,000 but the difference between the opening and closing stocks is less than A\$5,000.

Source: ATO ([www.ato.gov.au](http://www.ato.gov.au)).

The *US-IRS cash or hybrid accounting rules* also allow SMEs (with exception of partnerships or C Corporations) to apply the *cash rules* if 3-year average turnover (gross receipts) is below US\$1 million. Certain non-farming partnerships and C Corporations can also use the cash rules if the turnover falls below US\$5 million—provided they do not deal principally in inventories or merchandise. Service providers (without merchandizing as a major activity) have a higher average turnover threshold of US\$10 million (Witner and See, 2006). Finally, SMEs can use a *hybrid method* that implies *accrual* for inventories and *cash accounting* for other items.

*Harmonization of tax and accounting rules:* Tax reforms need to harmonize the tax and accounting rules for SMEs to reduce compliance and administration costs. These rules do not diverge significantly for SMEs and individuals who keep records mainly to meet tax obligations (Porcano and Tran, 1998). The use of common rules will also ensure that SMEs do not view the special tax rules as secondary to the IFRSs or the corporate law. For example, the pooling of assets and non-itemization of expenses—and even a change from scheduler to single PIT regime—may not explicitly preclude medium SMEs from preparing cash or *modified* records for tax and accounting purposes. Similarly, while a high VAT threshold may eliminate small SMEs from the VAT base, medium-SMEs may still have to maintain duplicate income tax records.<sup>12</sup>

<sup>12</sup> Ivanova, Keen and Klemm (2005) emphasize this point in assessing the impact of Russia's flat tax. They stress that much of the gains may be due to several tax administration initiatives. Some medium entities could persist in keeping separate tax records for business and management purposes.

**Table 7: Ghana—Examples of codification of tax and accounting rules**

Topic	Provision in laws	Sources
Accounting rules	Accounting for tax purposes shall be according to the generally accepted accounting principles (GAAPs)	Inland Revenue Act (IRC) s25
Meaning of Gaps	The “generally accepted accounting principles” means the rules of the Institute of Chartered Accountants (Ghana).	Inland Revenue Regs (IRR) s11
Eligibility	Subject to approval by the Commissioner, taxpayers shall be eligible to use cash or accruing method. However, a company shall account for tax purposes on accrual basis.	IRC s25
Accounting methods	Cash accounting—records incomes on receipt and expenses or outgoing on payment	IRC s26
	Accrual accounting—records income when receivable and expenses when payable	IRC s27
	A <i>company</i> shall use accrual accounting; a <i>person</i> may apply to use cash accounting	IRC s25
Stocks or inventory	Taxpayers using the cash method shall use prime cost (accrual uses absorption method). Where items are not readily identifiable, use FIFO or average-cost method	IRC s31
Depreciation pool	Assets shall be pooled according to classes/rates: Class 1 (40%)—Computers and data handling equipment Class 2 (30%)—Automobiles Class 3 (50-80%)—(i) Mineral and petroleum assets; (ii) building & structures; (iii) plant & machinery Class 4 (20%)—Railroad equipment/vehicles; vessels; aircraft Class 5 (10%)—Building and structures (other than 3) Class 6 (10%)—Intangible assets	IRC s20 Sch III.
Advanced accounting topics	Profit or dividend stripping, double taxation, income splitting, transfer pricing and thin capitalization	IRC s55, s68-71

As Table 7 shows for Ghana (a common law country), many developing countries tend to codify the tax and accounting rules. Tax administration reforms should ensure consistency among the standards and the business and tax laws. The rules should make provision for especially corporate SMEs that prefer to prepare dual accounting and tax records to meet different goals (e.g., minimize tax liability under the tax rules while adopting the financial accounting rules for banking or dividend purposes).

*Practical considerations:* Corporate SMEs, VAT-registered entities and professionals (e.g., accountants, lawyers, doctors and artists) should apply the modified rules because they are capable of employing staff or using practitioners and accounting software to comply (Section F). As VAT-registered entities, most of them can use the VAT invoices and other documents (for claiming input tax credit or refunds) to prepare income tax records. Finally, unlike the non-rebuttable or final nature of the presumptive taxes for small-SMEs, the tax rules should allow medium-sized SMEs with adequate records to claim credits for the advance or *minimum* taxes they pay.

### Cash accounting and presumptive taxation for small SMEs

In practice, countries with weak administrative capacity tend to impose patent or non-rebuttable presumptive taxes on small and micro-SMEs on a wide scale. In principle, however, all SMEs that do not apply the accrual standards should keep cash records. Box 4 summarizes the meaning of cash accounting, which can often be confusing.

**Box 4: Meaning of cash accounting**

Cash accounting means that entities are required to record all operating, investing and financing activities as they receive and pay cash—not on commitment of income or expenses, which is the basis of accrual accounting. A few points need clarification.

While the *cashbook* shows all capital and current flows on cash basis in the cashbook, the *income statement*—for determining business and taxable incomes—should include only current flows. In principle, SMEs should capitalize any *material* investing and financing items and show them in a Balance Sheet (however, simple). In practice since (a) these are often *immaterial* or (b) subject to *expensing (including depreciation) rules* (Table 6), SME may be allowed to write them off to the income statement within the same period (or over relatively short periods). Finally, cash accounting is often subject to strict *constructive rules* to avoid tax evasion and avoidance (e.g., deemed payments or receipts upon transfer of goods but with deliberate deferral of cash flow to take advantage of profitability or liquidity).

*Accounting principles:* Since the modified rules increase compliance costs for *small and micro SMEs* with few transactions, tax laws should allow them to apply cash accounting and presumptive tax rules. These SMEs have little or no fixed assets and their working capital often consists of cash and accounts receivable and payable for major customers and suppliers. Their rudimentary records may not conform to the accrual or double entry rules and, as noted, it is common to use the *incomplete* or *net worth* rules to reconstruct the income statement to derive the tax liability (Box 3).

*Cash records:* The *cashbook* shown in Figure 1 is the main record for micro and small SMEs that do not ledger records and financial statements. Despite the simple nature of the records, SMEs may still fail to maintain cash invoices and receipts to support the cashbook entries. Nonetheless, tax agencies regard these records as “adequate” for tax purposes, including their use to rebut presumptive, minimum or administrative assessments. SMEs that keep cash records should prepare the income statement from these records to determine taxable incomes or business profits.

**Figure 1: Example of Columnar Cash Book**

Section 1		Section 2				Section 3					
Date	Details	Totals		Operating (incomes & expenses)				Working Capital		Investing	Financing
		DR	CR	Sales	Others	Purchases	Others	Debtors	Creditors	Assets	Loan/Equity

Section 1 of the *columnar* cashbook in Figure 1 is simple and shows the total debits and credits for the extensions in Sections 2 and 3. The relatively complex columns for operating (Section 2) and investment or financing (Section 3—to provide more details for “others” in Section 2) activities clearly show that *cash accounting is also not uniform for SMEs*. While many small-SMEs need only Section 1 to comply, micro and medium SMEs should use the other columns to make the accounts transparent for all transactions. Since Sections 2 and 3 show incomes, expenses, assets, liabilities and equity, given

adequate *expensing* provisions (Table 6), SMEs with few credit activities may use only a cashbook in lieu of the ledger records. In economies where the use of banks is relatively widespread, SMEs should use bank statements and other instruments to support their transactions and records further.<sup>13</sup>

*Financial statements:* The keeping of cash records should not preclude SMEs from preparing simple financial statements. Indeed, the lack of corporate responsibility for SMEs with formal structures (e.g., partnerships) may make it cost-effective to prepare such statements more easily under the rules in Box 3. Tax practitioners, employees, and tax officials should use the net worth approach to prepare the income statement and derive the taxable income from SME incomplete records.

*Presumptive taxation:* Presumptive taxes are estimated assessments imposed on SMEs that fail to keep adequate records.<sup>14</sup> The estimates often derived from financial and economic surveys of firms, industries or sectors to determine the tax liability, based on standard indicators such as sales, purchases, profit margins, floor space and employees. The regimes cover medium and micro SMEs that should take credits for the amounts paid—provided they maintain good records and tax offices do not use the estimates as minimum taxes for controlling tax evasion and avoidance. In contrast, many small SMEs pay *non-rebuttable* taxes without recourse to records or tax returns—normally in quarterly or monthly installments to ease SME liquidity concerns and protect revenues. Tax offices also impose final withholding taxes on SME imports and domestic purchases but medium entities can avoid these payments by obtaining a tax clearance certificate.

*Practical considerations:* Many SMEs that pay presumptive taxes and keep cash records are family-owned or in informal partnership. As Sandford (1994) notes, “it may be that non-corporate taxpayers would not produce accounts at all if they were not considered to be necessary for tax purposes”. Tax agencies use the presumptive taxes to protect revenues and improve record keeping by SMEs in the informal sector.

As a basic rule, the *final* presumptive taxes should be restricted to vulnerable small SMEs only. Tax offices should assist micro-SMEs in particular to keep *cash records* and support them with cash invoices, bank statements, simple ledgers and memo data (such as an assets register). This is because the reconstruction of income statements from incomplete records is usually imprecise and depends on the skill with which tax officers or practitioners extract data or conduct interviews.

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<sup>13</sup> Countries such as US and Australia allow SMEs to use checkbook details (which banks use to help customers) in lieu of the cashbook (see guidelines: [www.ato.gov.au](http://www.ato.gov.au) and [www.usirs.org](http://www.usirs.org)).

<sup>14</sup> For further discussion of presumptive tax policy and administrative measures, see Engelshalk 2005, Terkper 2003 and Terkper 2003.

#### D. Tax adjustments, accounts and returns

A vital goal of tax accounting is to adjust the profit, prepare a tax account, file a return, and pay the tax due or claim a credit/refund. Taxpayers file the *income tax returns* annually—and the *indirect tax returns* more frequently—to account for the taxes due.<sup>15</sup> The IFRS regulates some aspects of these transactions (IAS 12/SSAP 5) that also tend to reflect the complexity in size and operations of taxpayers. Tax laws also include transition rules for converting from cash to accrual accounting.

*Tax adjustments:* As noted in Section B, since tax laws take precedence over financial accounting rules, the purpose of the adjustments is to bridge divergences between the two sets of rules. Even with full IFRS compliance, assessable incomes, deductible expenses and taxable incomes may not be synonymous with business incomes, expenses and profits. The adjustments, which vary in complexity with the size and operations of taxpayers, may affect an entity's profitability and liquidity positions substantially (Tran AV, 1998/ 1994).

LMEs make routine complex adjustments to comply with private or public rulings such as GAARs. These relate to complex transactions (e.g., thin capitalization and transfer pricing) and tax preferences (e.g., tax holidays, special rates, accelerated depreciation and tax bases). Apart from disallowing specific incomes or expenses, these rules often change the basis for apportioning or allocating incomes and expenses, especially for entities with complex domestic or foreign operations.<sup>16</sup>

Tax offices should use measures such as asset pools, expensing or non-itemization to limit the adjustments for SME. In general, the main adjustment that SMEs need to make is the disallowance of personal expenses because many small taxpayers do not separate the personal and business transactions in line with the entity rule. SMEs that itemize must also take account of rules that restrict transactions such as depreciation and stock valuation.

*Tax accounts and returns:* With exception of SMEs under final presumptive regimes, all taxpayers need to keep accounts for direct and indirect taxes. They must also file annual or other periodical tax returns and pay the amount due or, alternatively, claim a refund or

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<sup>15</sup> The income tax returns may cover the calendar (i.e., general), fiscal (i.e., government), or financial (i.e., taxpayer's accounting) year, with shorter or longer periods for commencement and cessation. In contrast, taxpayers file the VAT and excise duty returns more frequently on monthly or quarterly basis. The difference in fiscal and accounting periods and number of direct or indirect tax returns may result in significant adjustments to the records and also add to SME compliance costs (Tran 1997).

<sup>16</sup> For example, the US foreign tax credit rules classify incomes into nine categories—passive; high withholding tax; interest; financial services; shipping; dividends from non-controlled corporation; certain dividends from domestic sales corporations; certain distributions from a foreign sales corporation; and foreign sales corporation's taxable income; and unassigned/residual income.

credit. The law or regulations should allow SMEs to pay the annual estimated tax in installments to ease liquidity concerns.

As Table 8 shows, the tax account is a potential liability record that increases with credits (e.g., interest, assessments and penalties) and decreases with debits (e.g., interest and final, advance or withholding payments). Taxpayers make other debit and credit entries to reverse or adjust the original entries and correct errors. The balance on the account represents the amount due or refunds—to be paid or carried forward.

**Table 8: Basic structure of a Tax Account:**

Transactions	Debit	Credit	Remarks
Assessments		+	Original and revised tax liabilities
Penalties & interest payable		+	This is often the result of sanctions
Interest receivable	-		Compensation for overdue credit balances
Adjustments	-	+	Correction of errors, including assessments
Payments	-		Final, advance, withholding payments
Refunds		+	Overpayments and tax preferences
Balance (carried forward)	(-)	+	Amount due/entitlement

SMEs need only simple records, accounts and returns to meet even *accounts-based* obligations.<sup>17</sup> Some laws require taxpayers to attach or keep *audited* financial statements to support the tax returns. In principle, the external audit requirement need not apply to SMEs because of the lack of the “public interest” or accountability in their operations. Moreover, such audits are likely to increase their compliance costs. Alternatively, in practice, the “audit” rule should be less stringent for small and micro SMEs and should be synonymous with the preparation or reconstruction of income statements by registered tax practitioners.

*Transition rules:* Tax agencies need special transition rules because the liquidity and profitability benefits of using or converting to cash accounting can be significant, especially for medium entities. In general, the rules require taxpayers to adjust the current taxable income with the beginning and ending balances relating to stocks or inventories, accounts receivables, and accounts payables (including accrual and prepayments of other incomes and expenses). Other adjustments may be required for capital items such as fixed assets and depreciation.

### E. Individual non-business records

The simplification of SME records is a significant first step in reducing compliance costs for sole proprietors and partners paying personal income tax (PIT) on total business, investment and employment incomes. These taxpayers and wage earners also need to

<sup>17</sup> While VAT, excise and customs duties are *transaction-based* and do not require detailed records, some taxpayers may need detailed records to support transactions such as rescheduling, drawback or refunds and concessions. Some of these may require special allocation or apportionment rules.

adjust their gross incomes for items such as nontaxable incomes, scheduler rates and personal tax allowances and preferences.

### **Accounting requirements**

Individual taxpayers need to prepare personal accounts records and tax returns to show their taxable incomes and credits or refunds due. The complexity of the records depends on personal circumstances (e.g., substantial incomes from multiples sources), the tax structure (e.g., schedular regimes), and administrative (filing) procedures.

*Taxable and non-taxable incomes:* Individuals may derive the *total incomes* from business (i.e., profits), employment (e.g., salaries) or investment (e.g., capital gains, interest and rent). These may come from residential (domestic) or non-residential (foreign) sources. As a first step, individuals need to maintain careful records to facilitate the splitting of total incomes into their taxable and non-taxable elements.

*Schedular tax regimes:* Where different tax regimes apply, individual taxpayers (and entities) must split the *taxable incomes* further into their respective *assessable* bases. Usually, the applicable *tax rates* may be progressive or flat and creditable or final.

*Personal adjustments:* The final stage in determining the *taxable incomes* or actual amount due is to take account of personal, allowances, reliefs or deductions. Individuals also need to take account of various withholding and/or advance taxes.

- *Determining taxable income:* The reliefs include non-taxable incomes, personal allowance or threshold and itemized items such as education, insurance premiums, old age and other allowances. Some tax laws allow taxpayers to deduct a further *standard amount* in lieu of itemization.
- *Withholding and advance taxes:* Most individual incomes such as interest, wages, rent and capital gains are subject to withholding and advance tax payments. These also apply to SME imports and domestic purchases in some countries. As with the deductions from salaries and wages, self-employed persons often make these payments in monthly or quarterly. These final and creditable amounts vary in complexity with the schedular regimes

It is apparent that the adjustments may be simple for employees and self-employed persons with low wage or business income (and without substantial additional incomes from investments). In contrast, the income and adjustments from business and non-business sources for some taxpayers (e.g., partners and directors) may be complex. These taxpayers may even use experts to plan their tax affairs, for example, through family trusts and other non-profit organizations.

## **Simplification measures**

Tax policy initiatives such as reductions in schedular tax regimes can make the calculation of taxes less complex for individuals. In addition, however, tax offices need regulations and procedures that reduce compliance and administration costs.

*Single-source incomes:* For very low levels of income, tax laws and reforms should include a threshold at which the withholding or presumptive (advance) taxes for wages or enterprise profits would be presumed equal to final tax liability. This will make it unnecessary for them to keep records and file tax returns—with the option for preparing records to claim itemized personal allowances and possible refunds.

*Presumptive tax in lieu of all income taxes:* Many small self-employed persons do not earn substantial incomes from non-business sources—which source may even be exempt from tax (e.g., interest on savings and capital gain on primary residence). Hence, the administrative rules should include a rebuttable presumption that the official assessment for the principal business activity fairly represents the consolidated taxable incomes from all sources for the individuals (and even family units). Small SMEs that do not object to these official assessments should not keep further individual records and file tax returns.

*Single tax for direct and indirect regimes:* Tax laws should also allow small SMEs to pay a single presumptive amount to cover income tax and turnover tax (VAT) liabilities. This is necessary for countries with equalization VAT or sales tax regimes for SMEs. The assessments could even include business licenses and local government fees.

*Standard allowances:* The tax law should allow low-income (wage and non-wage) earners that file to use reasonably high standard personal deductions in lieu of itemization. Many low-wage earners (with no substantial incomes from investment or business) should use only simple tax records and returns to meet their obligations.

For these measures to succeed, tax agencies should implement high threshold and personal allowance policies for income tax and VAT. A high VAT threshold excludes many small and micro SMEs from maintaining both income tax and VAT records. Furthermore, tax laws can avoid “SME accounting creep” by regularly updating the presumptive tax surveys and adjusting or indexing the indicators to minimize the impact of inflation on them (Terkper 2003). The increase in taxable individuals with low incomes under both income tax and VAT regimes can also put enormous pressure on tax offices with low capacity.

## **F. Supporting taxpayers to comply**

Tax agencies should equip tax offices well to assist taxpayers to meet the accounting obligations. The policies should include the use of tax practitioners and accounting software since it is impossible to assist taxpayers through only tax offices.

*Laws, regulations and administrative directives:* SMEs need clear harmonized legal and policy frameworks to comply. In particular, the rules covering simple or modified accrual, cash and presumptive tax accounting should be explicit. In this regard, tax offices should augment the law with specific traditional programs such as the issuing of publications, sample records, and simplified forms for SMEs. Developing states also need to streamline the relatively complex regulations on tax planning, evasion and avoidance to give proper directives on the recognition, measurement, and timing of transactions, especially inter-firm transactions used to prepare group or consolidated accounts and financial statements.

*Use of tax practitioners:* Developing country should follow the advanced economies in using tax practitioners to assist SMEs to comply. They should have cost-effective certification and training programs to increase and improve the accuracy of records and the rate of filing among SMEs. The rules should allow qualified accountants to practice, subject to only continuing professional education requirements that cover changes in the tax laws. Given the cost of professional services, however, they should be proactive in training accounting technicians to assist SMEs (Terkper 2003).

The advances in technology discussed below also makes it necessary for these tax experts to automate the client records, using standard accounting software or special licensing schemes (Ainsworth 2005). The programs should include safeguards for avoiding excessive compliance costs, corruption, and collusion with clients to evade taxes (Hasseldine, 2000). In this regard, the operational guidelines should include codes of conduct that cover disciplinary measures and awareness of penalties in the tax laws to minimize known and potential risks.

*Automation:* Many small SMEs use *manual records* (e.g., cards or bound volumes of journals, cashbook or ledger) to prepare the accounts and financial statements. With the advances in technology, however, tax offices should encourage medium entities in particular to use the accounting software that is now widely available for all groups of taxpayers. The shift from legacy or in-house systems (that are expensive to develop and maintain) to standard applications (e.g., Peachtree, Quicken, and SAGE) with on-line updates, can improve the accuracy and reliability of SME accounting records.<sup>18</sup>

The OECD (2005) recommends that tax agencies and software developers work towards standardizing accounting software to make them more effective in reducing compliance and administration costs. This trend will definitely favor tax reforms in developing countries as well. Among others, the parties should ensure that the

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<sup>18</sup> Other uses of automation include electronic filing and payment, risk management (for better auditing and enforcement) and taxpayer services (e.g., through the use of websites). Taxpayers can also use programmable cash registers and computers store and classify goods, charge appropriate rates, and facilitate the allocation/apportionment of input taxes.

- software packages provide an electronic export facility for the information necessary to prepare tax returns;
- application software features comprehensive documentation to assist auditors and users to understand the system and its processing and environment; and
- application software creates adequate audit trails to assist auditors gain audit assurance and perform relevant compliance and substantive tests.

Automation increases the integration of many distinct processes described in this paper (Part II). In this regard, there must be effective internal controls to provide management assurance of the accuracy of the analysis and classification of transactions prior to entry into the accounting systems.<sup>19</sup>

#### **IV. CONCLUSION**

Accounting is necessary for enhancing tax compliance but many SMEs find it difficult and expensive to maintain proper or adequate records. Large entities may also have high compliance costs because complex accounting standards and tax regulations for controlling avoidance and evasion. Nonetheless, tax administration reforms do not appear to deal adequately with the proper framework of accounting rules for large entities and SMEs.

It is necessary for corporate plans to provide explicit directives on simple cash and accrual options for SMEs to comply at reasonable cost and, furthermore, minimize the indiscriminate application of cash accounting and final presumptive tax rules to all SMEs (Terkper 2003). Except for very small SMEs, tax laws do not eliminate the need for records that are proper or appropriate for the circumstances of specific taxpayers. In this regard, it is particularly important to develop modified medium entity accrual accounting rules, based on the harmonization of fiscal and business rules. All corporate SMEs, VAT entities, professionals and, small SMEs (especially those registering voluntarily for VAT or objecting to official assessments) should keep these simple, hybrid or modified records.

A tax agency's corporate plan should also include the use of practitioners programs and accounting software to improve compliance among SMEs. These are necessary because it is not feasible for only tax offices to assist taxpayers to comply. The main goal of the guidelines and programs for practitioners and taxpayers is to reduce compliance and administration costs. Special tax offices such as those catering for large entities (e.g., in an LTU) should have sufficient budget and appropriate systems and procedures to

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<sup>19</sup> An effective taxpayer accounting system facilitates tax audits through more efficient background checks, reviews of internal controls, as well as substantive and analytical tests.

monitor the application of the full standards by complex entities. At the same time, however, tax agencies also help smaller offices should help other offices to comply with the simpler cash and accrual rules.

### Appendix I: Summary of accounting standards

**Introduction:** Taxpayers should comply with the accounting standards such as the International financial reporting standards (IFRS), which consist of the basic rules that accounting bodies develop for their members. Most of the old bodies are registered or chartered voluntary and non-profit organizations.<sup>20</sup> Several advanced and developing countries still follow this tradition but others pass laws to establish their national accounting bodies and standards. The national bodies join international bodies such as the International Accounting Standards Board [IASB]<sup>21</sup> and the International Federation of Accountants [IFAC]) that coordinate and harmonize the principles and practice of accounting across national borders. These bodies also aim to harmonize the standards with statistical and fiscal rules used by treasuries.<sup>22</sup>

**Structure of accounting standards:** The standards are the rules but the accounting bodies have other pronouncements, with the following structure being typical—

*Standards:* These are mandatory rules that members of accounting bodies and businesses must to comply with to the fullest extent possible.

*Guidelines:* These recommend practices in financial reporting to improve management and accountability.

*Studies:* The studies provide advice on financial reporting, accounting and auditing issues. They are based on best practices and the most effective methods for dealing with the issues they address.

*Occasional papers:* The papers provide information that contributes to some segment of financial reporting and auditing. Typically, they cover case studies, often based on a particular country's experiences.

**Current IASB Standards:** A list of the current IASB International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) are shown below:

IFRS #	DESCRIPTION	IFRS #	DESCRIPTION
1	First-time adoption of IFRS	3	Business combinations
2	Share-based Payment	4	Insurance contracts
5	Non-current Assets held for Sale and Discontinued Operations		

IAS #	DESCRIPTION	IAS #	DESCRIPTION
1	Presentation of Financial Statements	26	Accounting and Reporting by Retirement Benefits Plans
2	Inventories	27	Consolidated and Separate Financial Statements
7	Cash Flow Statements	28	Investment in Associates

<sup>20</sup> Some national bodies that issue authoritative standards include the American Institute of Certified Public Accountants (AICPA) and, in the UK, Institute of Chartered Accountants of England and Wales (ICAEW); Association of Certified Chartered Accountants (ACCA); and Certified Institute of Management Accountants (CIMA). Other influential bodies are in Australia, Canada, France and Germany.

<sup>21</sup> In June 2002, the European Union (EU) adopted the new standards known as IFRS (International Reporting Financial Standards) for implementation by 2005. In 2005, the US Securities and Exchange Commission (SEC) also announced plans to adopt a similar measure.

<sup>22</sup> The tax accounting rules should conform to the *statistical and fiscal* reporting standards such as the IMF's Government Fiscal Statistics Manual (GFSM), which public entities and governments use to prepare their records. In 2003, IFAC, IMF/World Bank, and UN started a convergence program to reconcile the public sector standards such as IFAC's IPSAS with the GFSM and the UN standards.

IAS #	DESCRIPTION	IAS #	DESCRIPTION
8	Accounting Policies, Changes in Accounting Estimates and Errors	29	Financial Reporting in Hyperinflationary Economies
10	Construction Contracts	30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions
12	Income Taxes	31	Interest in Joint Ventures
14	Segment Reporting	32	Financial Instruments—Disclosure and Presentation
16	Property, Plant and Equipment	33	Earnings per Share
17	Leases	34	Interim Financial Reporting
18	Revenue	36	Impairment of Assets
19	Employee Benefits	37	Provisions, Contingent Liabilities and Contingent Assets
20	Accounting for Government Grants and Disclosure of Government Assistance	38	Intangible Assets
21	The Effects of Changes in Foreign Exchange Rates	39	Financial Instruments—Recognition & Measurement
23	Borrowing costs	40	Investment property
24	Related Party Disclosures	41	Agriculture

**Accounting principles:** The main principles underlying the accounting standards that guide the preparation of accounting records and financial statements include—

*Accrual:* Entities record their financial transactions as they fall due and not when they receive or pay cash.

*Dual aspect (double entry):* The accounts reflect the two sides of a transaction or exchange, which recorded as debit and credit entries in the ledger.

*Business entity:* A business is deemed to have a separate entity from its owner(s) and other parties or entities with which it enters into financial transactions.

*Going concern:* The entries assume that a business will continue in perpetuity from one period to another.

*Matching:* To determine the profit or loss, an entity must match its sales or income against the cost of sales and expenses for a period, including accrued items.

*Prudence:* Given a choice, accountants make decisions that understate incomes and/or overstate expenses.

*Historical cost:* The records show assets at original cost or value, at the time of entering into a contract.

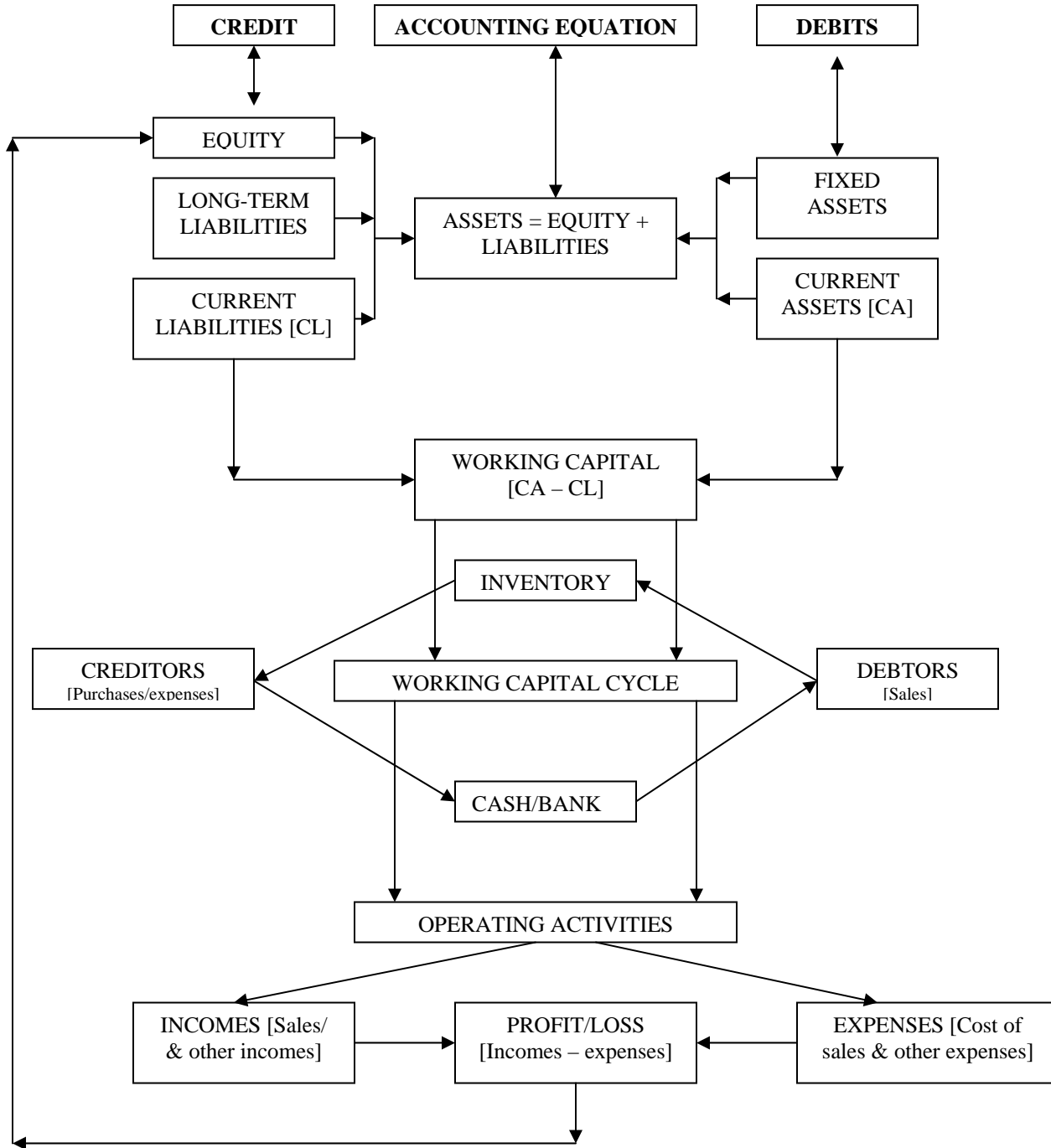
*Money measurement:* The transactions must be measurable in monetary terms in the books of accounts. It also assumes that the currency unit will remain stable or constant.

*Continuity or going concern:* The business entity operates in perpetuity or indefinitely until its liquidation.

*Consistency:* Businesses must use the same accounting policies and methods in reporting from one period to the other to facilitate comparison. They must disclose the effect of significant policy or accounting changes.

*Materiality:* Business entities must take account of the size of amounts and of substance over their form.

**Appendix II: Relationship among financing, investing and working capital activities**



**Appendix III: Relationships and measurement of profitability and capital utilization performance**

**BASIC RATIOS**

<p><b>Profitability</b></p> <p align="center">Operating profit <u>(Net Profit After Tax)</u> (Total assets)</p>	x	<p><b>Asset Utilization</b></p> <p align="center"><u>Sales</u> Operating Assets</p>	=	<p><b>Overall Performance (Return on Investment)</b></p> <p align="center"><u>Net Profit</u> Operating Assets      Sales</p>
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**ILLUSTRATION**

**PROFITABILITY  
(OPERATING STATEMENT)**

	Amt	%
Sales	300	100.0
Cost of sales	180	60.0
Gross margin	120	40.0
Other expenses	95	31.7
Profits before tax	25	8.3
Taxes	5	1.7
Profits after tax	20	6.7

**PERFORMANCE RATIOS**

*Profit Margin*

$$\frac{\text{Profit}}{\text{Sales}} = \frac{20}{300} = 6.7$$

*Return on Investment*

Profit margin x Assets Turnover = ROI  
6.7 x 1.3 = 8.7

*alternatively*

$$\frac{\text{Net Profit}}{\text{Operating Profits}} = \frac{20}{230} = 8.7 \text{ percent}$$

**CAPITAL UTILIZATION  
(BALANCE SHEET)**

	Amt	%
Current assets	140	82.4
Current liabilities	<u>60</u>	<u>35.3</u>
Working capital	80	47.1
Fixed assets	<u>90</u>	<u>52.9</u>
Total assets	170	100.0
Long-term liabilities	<u>40</u>	<u>23.5</u>
Represented by:		
Equity	130	76.5

*Asset turnover*

$$\frac{\text{Sales}}{\text{Total Assets}} = \frac{300}{230} = 1.3$$

**Appendix IV: Summary of SME (and large entity) accounting requirements**

Type	Purpose	Large Entities	Medium-sized SMEs	Micro-SMEs	Small-sized SMEs
<b>Basic documents – Evidence of transactions</b>					
Sales and purchase invoices; receipts; vouchers; etc.	Evidence of transactions and source for summaries in the journal.	Several credit invoices, including inter-firm records.	Mix of credit invoices (for debtors/creditors) and cash receipts.	Cash invoices & receipts (few credit records).	Cash invoices (if any) & receipts
Debit and credit notes	Reverse invoice values (errors and deficiencies).	Reflect complexity of invoice records shown above.			
<b>Subsidiary records – Analysis for “posting” to the ledger</b>					
Journal (book of prime entry).	Initial debit & credit analysis of transactions prior to entry in ledgers.	Separate purchases, sales and general journal.  Entities in group (branches, associates and subsidiaries) often keep own separate record.	One or more sub-journals (a single journal may be sufficient).  Often, no group records but some branches may keep separate records.	Single journal; may keep memo records (e.g., asset registers, debtors & creditors).  Some keep only one cashbook.	Often no journal; cashbook and other informal records.
<b>Ledger records – Double entry records</b>					
Ledger	Historical records of incomes, expenses, assets, equity and liabilities (i.e., operating, investing & financing activities).	Separate debtors, creditors and general ledgers.  Entities in a group keep separate ledgers.	One or more ledgers.  Some large branches may keep own ledgers.	Ledger or cashbook with memo records.	May keep simple ledger records.
Cash Book	Record of cash items; both a ledger and prime book of entry.	Multiple cash books, including separate for members in a group.	May keep more than one cashbook (e.g., branches).	Detailed columnar cashbook may be sufficient.	Basic cashbook only.
<b>Financial statements – period and end-year schedules &amp; reporting statements</b>					
Trial balance	List of debit and credit balances for preparing financial statements and validating double entry	Separate ledger for each member in a group.	Separate for major branches.	Simple for SMEs	Rare
Operating Statement (profit and loss account)	Summary of incomes and expenses accounts for the period (closes the current account items); net figure is profit or loss.	Detailed and separate for members of group (section for appropriation or distribution of profits).  Group (consolidated) income statement	Abridged cash or accrual statement; may involve branch accounts.  Separate section for profit distribution (e.g., partnerships & companies).	Simple cash or accrual statement for a few entities.  Profits accrue to owners and often taken out as drawings.	Rare—cashbook is sufficient.

<b>Type</b>	<b>Purpose</b>	<b>Large Entities</b>	<b>Medium-sized SMEs</b>	<b>Micro-SMEs</b>	<b>Small-sized SMEs</b>
Balance Sheet	Summary of asset, equity (including profit/loss) and liability account balances (after preparing operating statement).	Detailed balance sheet; for separate entities in a group  Group (consolidated) balance sheet may be required.	Abridged balance sheet, including branches.	Simple, based on cash book and basic ledger records (if any).  Net worth method to determine profit or loss.	Optional, often not required.
Funds flow statement	Statement of source & application of funds (i.e., change in liquidity) due to operating, financing & investing activities.	Detailed and separate for members in a group.  Group statement may be required.	Simple statement or summary of cashbook.	Simple but cash book summary often sufficient.	Not required.
Director's report	Further explanations (to support the financial statements).	Required for companies.	Required for companies.	Not required.	Not required.

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