International Financial Reporting Standards

– Effects on Swedish taxation

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Date: June 12th 2006, 15-17, room 342

Master's thesis in 3100,

Accounting and Financial Management

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Abstract

The aim of this thesis is to examine the legal situation with regard to the IFRS-transition in Sweden. Sweden has a close linkage between accounting and taxation, which means that accounting rules have a material impact on taxation. IFRS currently applies only on group level, and the group is not subject to tax. However, there are already indirect tax effects to be seen since accounting practice in Sweden has changed due to IFRS. The most significant potential effect on taxation in a Swedish context is fair valuation of certain assets. If IFRS is applied on legal-entity level under current tax rules, unrealized gains would set the realization principle and the principle of economic double taxation out of play. Therefore, the linkage is threatened by IFRS's accounting philosophy and is currently subject to scrutiny by an investigating committee that will issue a solution in 2007.

Keywords: IFRS, accounting, taxation, economic double taxation, realization, unrealized gains, legality principle

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Abbreviations

AB	Limited liability company
ABL	Companies Act
ARC	Accounting Regulatory Committee
BFL	Book Keeping Act
BFN	Swedish Accounting Standards Board
EC	European Community
ECJ	European Court of Justice
ED	Exposure Draft
EFRAG	European Financial Reporting Advisory Group
EU	European Union
GAAP	Generally accepted accounting principles
GFBL	Old Book Keeping Act
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IL	Income Tax Act
RegR	Swedish Supreme Administrative Court
RR	Swedish Financial Reporting Standards Council
SAC	Standards Advisory Council
SIC	Standards Interpretations Council
SMEs	Small- and Medium sized companies
ÅRL	Annual Accounts Act

1 Introduction

This chapter will introduce the reader to the question at issue and the purpose and limitations of the thesis. The structure of further sections is also provided.

1.1 Background

Internationalization of industry and commerce has intensified immensely over the last decades. In order for companies to remain competitive, cross-border activities and establishments are becoming increasingly important. This development calls for a common accounting language. The private sector non-governmental body International Accounting Standards Board (IASB) has made significant achievements on the field of harmonizing accounting standards over the last years.[1] In July 2002, the European Union (EU) enforced the IAS Regulation,[2] which requires all listed companies in the EU to prepare their consolidated financial statements in accordance with IASB's International Financial Reporting Standards (IFRS).[3] The enforcement of the Regulation lead the EU one step closer to its strategic goal for the union "*…to become the most competitive and dynamic knowledge-based economy in the world*…"[4]

The IAS Regulation entered into force in January 2005 and is directly applicable in member states. In a Swedish context the IAS Regulation has caused actions on several levels in society. From an accounting point of view it is generally considered favorable to apply IFRSs since the accounting methods provided reflect companies' financial positions and results in a business-economics perspective. Furthermore, the fact that IFRS has become an international standard enhances the comparability cross-borders and thus facilitates investment decisions. An extension of IFRS-compliance to individual accounts is also considered favorable from this perspective. This would e.g. facilitate the preparation of group financial statements.

However, since taxes are levied on legal-entity level, such an extension would cause problems. The Swedish tax system is closely related to the accounting system and the main rule in Swedish tax law stipulates that the accruals in the accounting records determine when an item is taxed. Through this linkage, accounting according to IFRS would impact on taxation. Since the current scope of IFRS-

[1] Before 2000, the organization was called International Accounting Standards Committee (IASC).
[2] Regulation 1606/2002.
[3] International Accounting Standards (IAS) was the name of the accounting standards issued under IASC.
[4] COM (2001) 582, p. 3.

compliance is limited to consolidated accounts, the impact on taxation is not yet direct. Convergence to IFRS is however a priority and these efforts have caused indirect effects to occur already.

1.2 Purpose

This thesis examines effects on taxation due to the IFRS-transition in Sweden. The purpose is to investigate the legal situation with regard to this transition. The linkage between accounting and taxation convey that the legal situation of accounting is examined as the field has a material impact on taxation. Furthermore, the thesis investigates both current effects of the transition and effects that would arise assuming that IFRS is applied on legal entity level. The presentation of these hypothetic effects are justified by the current discussion in Sweden on whether or not to permit IFRS-compliance on legal-entity level and furthermore, by the efforts to converge to IFRS within the boundaries of national law. Based on these discussions, the thesis concludes by discussing the suitability of admitting IFRS affect the Swedish tax system, i.e. if IFRS calls for disengagement between accounting and taxation.

1.3 Method and limitations

The thesis is written according to traditional juridical method, implying that the primary source is legislation. In descending order of importance, preparatory works, case law and literature have been used.

The thesis is limited to investigate companies subject to the regulations in the Annual Accounts Act of 1995 (ÅRL). This implies that effects on financial companies for which other annual accounts acts apply (ÅRKL and ÅRFL) are not within the scope of this thesis.

The outline and approach of the thesis has been designed for an international audience since it is written within the Wintercourse project under the Stockholm School of Economics Department of Business Law. A draft of the thesis was presented at the EUCOTAX Wintercourse which took place at the University of Tilburg in April 2006. Finally, the thesis does not claim to be exhaustive with regard to the effects on the covered fields, but rather to highlight the key developments and effects brought on by the Swedish IFRS-transition.

1.4 Structure

In chapter two, the thesis starts off by presenting the IASB which is the organization developing IFRSs. This information provides a background and understanding of the organization and, more importantly, of the key features and purposes of the IASB body of rules. Chapter three presents the efforts of the EU to harmonize accounting in the union. The chapter focuses on the actions relating to IFRS.

Chapter two and three provide a background for the subsequent chapters of the thesis. In chapter four and five, the legal framework of Swedish accounting and the developments due to the IFRS-transition are presented. Furthermore, the basic principles and provisions of the tax system are laid out followed by an explanation of the linkage between accounting and taxation. The boundary between the engaged and disengaged area are presented and exemplified by case law.

In chapter five, the effects of the IFRS-transition are discussed. The chapter starts off by discussing the institutional perspective of the transition, i.e. considering the constitutional aspects of the fact that IFRS indirectly influences the Swedish tax base. Next, the current effects and the potential direct effects on taxation are presented. This presentation is based on the effects of fair value accounting under current regulations. Eventually, the essay assesses whether it is appropriate to maintain the current linkage given the developments on the field of accounting or if disengagement between accounting and taxation is probable.

2 IASB and the development of IFRSs

Standardization of financial statements has become increasingly important over the last decades. The argument that like transactions and events ought to be reported in the same way has made the lack of generally accepted criteria for choosing accounting policies subject to debate. Originally, such arguments were put forward on the national level, but the growth of multinational companies and the general globalization developments of the finance market have made such efforts significant also in an international context.[5] Prevailing accounting differences are results of a variety of societal, economic and legal factors combined with different perceptions of user needs between countries that have caused definitions of the elements of financial statements, e.g. concerning assets, liabilities, equity, income and expenses, to develop in disperse directions.[6] The IASB has gained significant influence on the field of international accounting harmonization, not least because of the decision by the EU to legally enforce IFRS-compliance through the IAS Regulation. Below, the board and its operations are presented.

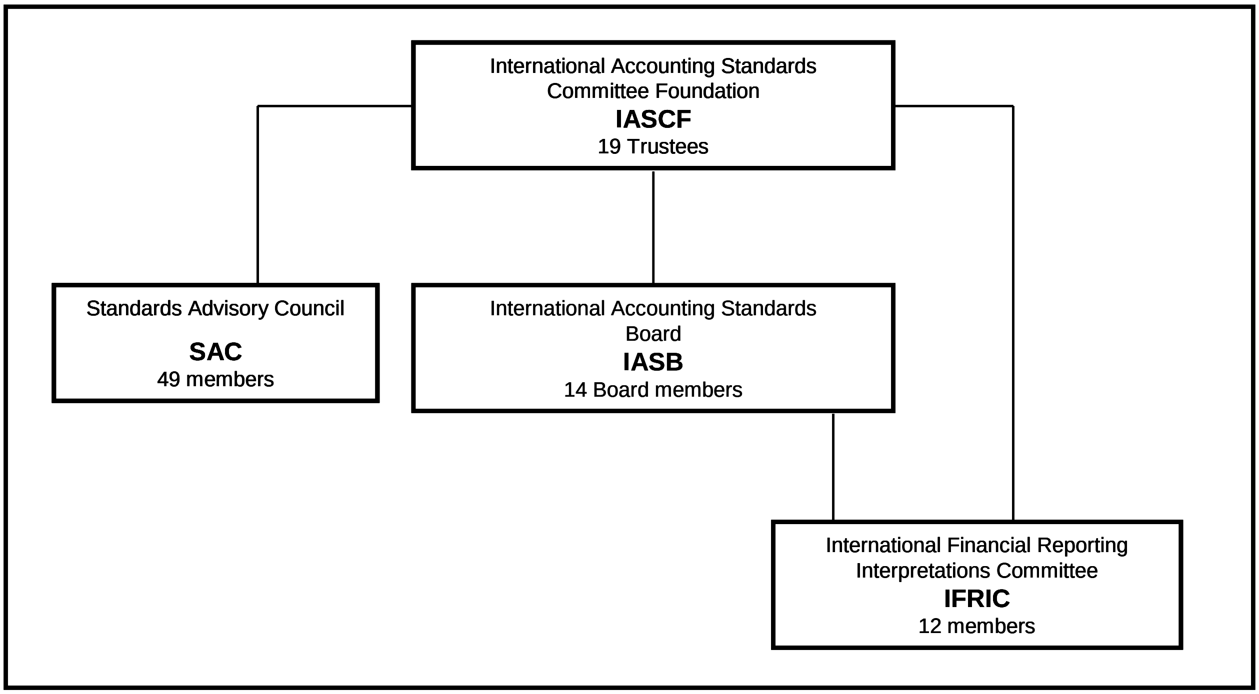
2.1 The IASB

IASB is a private body comprising accountants, companies, users and academics from 9 countries. The organization operates without national bias and the members are selected in order to attain the best available combination of technical skills and background experience of relevant international business and market conditions.[7] The organization is committed to "*developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements*".[8] In addition, the standards shall be understandable and enforceable.[9] In order to accomplish the goal of harmonization, IASB co-operates with national standard-setters.

The International Accounting Standards Committee Foundation (IASCF) is the parent entity of IASB. The Foundation's main bodies are IASB and the Trustees. The Standards Advisory Council (SAC) provides counsel to the IASB on the priorities of work and informs on the implications for users and preparers of proposed standards. The task of SAC is to encourage interested parties to take part in the standard-setting process.[10] The International Financial Reporting Interpretations Committee (IFRIC)[11]

[5] Hjelström, p. 9.
[6] IFRS 2005, p. 32.
[7] IASC Constitution, para. 20.
[8] IFRS 2005, p. 3.
[9] www.iasb.org. 2006-03-15.
[10] http://www.iasb.org/about/general.asp, 2006-03-15.

provides timely guidance by issuing interpretations of standards and thus promotes a rigorous and uniform application of IFRSs.[12] IFRIC is the sole body with the authority to interpret IFRSs. The EU has one representative with observer status in this committee.[13] The Trustees run the operations of the foundation by appointing members of the other bodies and exercises oversight and raises funds for the operations. The IASB has the exclusive responsibility for developing IFRSs. The term IFRS includes IFRSs, IFRIC interpretations, IASs and SIC interpretations.[14]



Organization chart IASB

2.2 Development of IFRSs

IFRSs are developed through a formal system of due process and consultation which involves users and preparers of financial statements, academics, state authorities and others.[15] Before issuing a final standard, the IASB must publish a draft for public comment which is called Exposure Draft (ED). Transparency is the key in the process of developing IFRSs. Therefore, all meetings of the IASB are open to public observation. Moreover, the IASB commonly publishes the bases of its conclusions after reviewing an ED or issuing a new standard. The process of standard development can in several

[11] The predecessor of IFRIC was called the Standard Interpretation Committee (SIC).
[12] IFRS 2005, p. 4-5.
[13] http://www.iasb.org/about/general.asp. 2006-03-15.
[14] IAS 1, para. 11.
[15] See Hjelström, pp. 90.

respects be compared to the preparation of traditional legislation. In line with this reasoning, the Basis-for-Conclusion documents can be compared to preparatory works of the IASB standards.[16]

2.2.1 IASB Framework

The purpose of the IASB Framework for the Preparation and Presentation of Financial Statements is to describe the basic concepts underlying financial statements prepared in accordance with IFRS.[17] The Framework defines the objective of financial statements, identifies the qualitative characteristics that make information in financial statements useful and defines the basic elements and concepts of recognition and measurement in financial statements.[18]

The Framework is not a part of IFRS, and hence does not override potential contraventions with existing IFRSs.[19] However, it makes the principles-based approach of the IASB possible by providing guidance for resolving questions without need for increasingly specific standards, extensive interpretations and other detailed implementation guidance.[20] The Framework is concerned with general purpose financial statements.[21] Such financial statements are directed towards the common information needs of a wide range of users, e.g. shareholders, creditors, employees and the public at large.[22] According to the Framework, the objective of financial statements is to provide information about the financial position, performance and cash flows of an entity that is useful to these users in making economic decisions, i.e. to provide decision usefulness.[23]

2.2.1.1 Qualitative characteristics

To achieve decision usefulness, the Framework provides qualitative characteristics. The four principal characteristics are understandability, relevance, reliability and comparability.[24]

Understandability refers to that information should be readily understandable to users with reasonable knowledge of business economics and accounting.[25] Relevance is accomplished when information facilitates users' economic decisions by helping them to evaluate past, present and future events or to confirm and/or correct previous assessments. A subcategory to relevance is materiality. An item is

[16] Bjuvberg 2005, p. 68.
[17] Alfredson et al, p. 56.
[18] IASB Framework, para. 5.
[19] IASB Framework, para 2, 3.
[20] Alfredson et al, p. 57.
[21] IASB Framework, para. 6.
[22] See IASB Framework, para. 9.
[23] IASB Framework, para. 12-13.
[24] IASB Framework, para. 24.
[25] IASB Framework, para. 25.

material if it may influence a user's economic decisions and thus depends on size.[26] Another component of relevance is timeliness, which implies that information must be provided to users in the period when it is most likely to influence their decisions.[27]

Information is not useful if not reliable. The Framework identifies a number of attributes that make information reliable[28]; Information must be free from material error and be decision neutral. Furthermore is must faithfully represent the transaction or event it claims to represent. Financial statements should reflect the substance of transactions and not merely their legal form. A common example of the substance-over-form principle regards accounting for leased assets, which should be recognized in the balance sheet of the lessee as assets under certain conditions.[29] Valuations under conditions of uncertainty should include a reasonable degree of caution. Prudence should not, however, be used to deliberately understate assets or income or overstate liabilities or costs. Such valuations would not fulfill the requirements of neutrality and hence, not be relevant.[30] Finally, the information in financial statements must be complete within the boundaries of materiality and cost.[31] In practice a balance must be found between relevance, e.g. the consideration of price changes, and reliability, e.g. the significance of verification.

Comparability is a characteristic comprising the need for information to enable users to identify trends over time and to evaluate a company's relative financial position, performance and changes in performance. This requires consistency in reporting over time in individual companies and between companies. However, consistency does not override the introduction of improved accounting standards.[32]

2.3 Key features of IFRSs

In later sections, the thesis describes the effects on Swedish taxation that IFRSs currently impose and are likely to impose in the future. Furthermore, it aims to evaluate whether it can be considered appropriate to let IFRSs affect the Swedish tax base. Therefore, this section points out the key features of the IFRS-regime.

[26] IASB Framework, para. 26-30.
[27] Alfredson et al, p. 64.
[28] IASB Framework, para. 31-38.
[29] See IAS 17 para. 10.
[30] IASB Framework, para. 37.
[31] IASB Framework, para. 31-38.
[32] IASB Framework, para. 39-42.

IFRSs are accounting standards developed for world-wide applicability and the primary purpose is to satisfy the information needs of owners and other investors. As such, they lack linkages to any specific economic or legal environment. The set of rules is investor oriented in the sense that it aims to generate financial statements with focus on decision usefulness. This implies that compliance with IFRS provides forward-looking reporting. The Framework provides a foundation of common definitions and qualitative characteristics that serves as a tool of reference to several parties and secures the principles-based approach. Principles-based accounting systems leave room for judgment but the Framework ensures that this judgment does not amount to a free choice in the hands of the preparers.

Since IFRS is meant to provide investor information about the future economic benefits that are expected to be generated by the business, management shall describe the position of the company according to their best estimate.[33] The feature of discretion brings uncertainty to the reported numbers in the financial reports, especially when valuation is carried out according to valuation models based on expected discounted cash flows.[34] In order to balance and adjust for discretion, IFRS contains abundant disclosure requirements and the status of disclosures is equal to the information in the income statements and balance sheets.[35] This enables external users of financial reports to make their own assessments of the reliability of the values presented in the financial statements.[36] Disclosure requirements are abundant especially due to the features of fair-value valuations.

2.3.1 Measurement bases – Fair values

The Framework acknowledges a variety of measurement bases to be used in financial statements. The main rule is still that historical cost shall be used at initial valuation of assets.[37] The Framework also prescribes other measurement bases based on fair values.[38] An increasing number of standards require or permit initial valuations and revaluations to be carried out using a fair value concept when such assessments can be carried out reliably.[39] Fair values are primarily based on market values. If no active market exits for an asset, valuation is carried out by reference to market values of similar assets. If no similar assets exist, other valuation models are used, e.g. methods based on discounted cash flows.[40] The current situation on the field of measurement can be described as rather ad hoc in nature.[41] The

[33] See e.g. IAS 38, para. 22.
[34] See e.g. IAS 41, para. 20.
[35] SOU 2003:71, p. 107.
[36] SOU 2003:71, p. 107.
[37] See e.g. IAS 16 para. 15 and IAS 38 para. 24.
[38] IASB Framework, para. 100.
[39] See e.g. IAS 16 para. 29, IAS 38 para. 72 and IAS 40 para. 30.
[40] See e.g. IAS 41, para. 17-19.
[41] Alfredson et al, p. 70.

Framework does not provide concepts or principles on this topic, which is questionable with regard to the impact on the reported numbers in the financial statements. This deficiency is recognized by the IASB, which has begun to work on a conceptual measurement project that will expand the IASB Framework on this critical area.[42]

This thesis discusses five IFRS-standards that either require or permit initial valuation and/or revaluation at fair value. Standards that currently *require revaluations* at fair value are e.g. IAS 39 Financial Assets and IAS 41 Biological assets.[43] Standards that provide a choice between valuation at fair value and valuation at historical cost, i.e. *allow* valuation at fair value, are IAS 16 Property, Plant and Equipment, IAS 38 Intangible assets and IAS 40 Investment Property.[44]

The unrealized gains and losses stemming from increases and decreases in fair value are required either to be recognized as revenues or expenses in the income statement or to be recognized in the balance sheet in a fund of unrestricted equity. Value changes of financial instruments (IAS 39), agriculture (IAS 41) and investment property (IAS 40) are required to be recognized in the income statement[45] whereas value changes of property, plant and equipment (IAS 16) and intangible assets (IAS 38) are taken directly to unrestricted equity.[46] The different treatments of value changes can be concluded to relate to the varying possibilities to determine a fair value that is reliable and the varying possibilities to realize a value change. The more liquid an asset, the stronger the reason to recognize value changes in the income statement, even though they are not realized.[47]

The use of other measurement bases than historical cost aims at enhancing the information value of the balance sheet as the accounting records will better comply with the concept of a true and fair view of a company's financial position and performance.[48] The concept of a true and fair view is the legal standard of the EC Accounting Directives and it is also stipulated in Swedish accounting legislation. However, even though fair-value valuations contribute to a true and fair view, this feature is posing great difficulties in many EU member states. This is especially true for countries that have a linkage

[42] Alfredson et al, p. 70.
[43] IAS 41 para. 12, IAS 39, para. 46.
[44] IAS 16 para. 29, IAS 38 para. 72, IAS 40 para. 30.
[45] IAS 39 para. 55, IAS 41 para. 26, IAS 40 para. 35. Financial instruments that are not available for sale and not derivative instruments may also be allocated to unrestricted equity, see SOU 2005:53, p. 41.
[46] IAS 16 para. 39, IAS 38 para. 85.
[47] Bjuvberg 2005, p. 64, Knutsson 1996, p. 87.
[48] Bjuvberg 2005, p. 61.

between accounting and taxation and have relied on the principle of prudence and historical-cost valuation in order to minimize their tax burden.

3 IFRS in the EU

The Fourth Directive marked the advent of accounting harmonization in the EU.[49] The Directive requires limited liability companies to prepare financial statements that show a true and fair view of assets, liabilities, financial position and result. Furthermore it states how financial statements are to be prepared. The Fourth Directive was followed by the Seventh Directive[50] which contains requirements on the preparation of consolidated financial statements. These two Directives are commonly referred to as the Accounting Directives. Although the Accounting Directives provided a common ground for accounting in the EU, the frequent occurrence of options and the non-consistent implementation among member states hampered comparability of financial statements cross-borders. A Commission communication in 2000 proposed that all companies listed on a regulated market should be required to prepare their consolidated accounts in accordance with IFRS. In addition, the Accounting Directives were proposed to be subject to modernization as they would continue to provide the basis for financial reporting by all limited-liability companies in the EU.[51] The modernization efforts should reduce conflicts with IFRSs and bring the Directives up-to-date with modern accounting developments.[52] In addition, the communication highlighted the need for legal endorsement of IFRSs on the EU-level.[53] The results of this communication are presented in the sections below.

3.1 The IAS Regulation

A breakthrough in the harmonization efforts was made when the IAS Regulation[54] entered into force. The decision to use a Regulation instead of a Directive contravened the traditional harmonization approach of the EU. Unlike a Directive, a Regulation is directly applicable in member states.[55] The choice of this instrument was due to two factors. First, the Commission and the member states were in a hurry because of the intention to establish an internal market for financial services by 2005.[56] Second, by using a Regulation member states could not restrict the application of IFRS or impose further accounting requirements by the companies covered. Thus, for IFRS-companies, member states can not restrict accounting options available under IFRS or issue new accounting standards.[57] The IAS

[49] 78/660/EEC.
[50] 83/349/EEC.
[51] COM (2000) 359, p. 6, p. 9.
[52] COM (2000) 359, p. 10.
[53] COM (2000) 359, p. 7.
[54] Regulation 1606/2002.
[55] Ståhl & Persson Ö, p. 26.
[56] Bjuvberg 2005, p. 48.
[57] Van Hulle, p. 12.

Regulation is directly applicable to some 7000 companies in the EU. However, indirectly far more companies are affected in their role as members of a group required to apply IFRS.[58]

Article 4 of the IAS Regulation stipulates the requirement for companies listed on a regulated market to prepare their consolidated financial statements in conformity with IFRSs adopted by the Commission.[59] "In conformity with IFRS" is a wording that in practice requires *full IFRS compliance*. By guidance from the definition of "IFRS" in IAS 1 paragraph 11, it can be concluded that financial statements shall not be claimed to be prepared in conformity with IFRS if they do not satisfy all requirements in all applicable standards as well as all applicable interpretations from IFRIC (SIC).[60] The IAS Regulation applies since January 1, 2005.

Article 5 of the IAS Regulation provides an option for member states to permit or require an extension of IFRS to listed companies' individual accounts and to unlisted companies' individual and/or consolidated accounts. If a member state chooses to exercise the option in Article 5, companies that are required to/volunteer to comply become subject to the same requirement of full IFRS as companies under Article 4. The implications are e.g. that the companies in question can not choose to apply IFRS's valuation rules but refrain from its disclosure requirements. Neither is it possible to comply with some standards and neglect others.[61]

3.1.1 Endorsement process

The endorsement process is designed to ensure that IFRSs leave their character of private standards behind and legitimately become a part of EC law. The endorsement process is conducted on two levels. On the political level, the Commission is assisted by the Accounting Regulatory Committee (ARC) which comprises representatives from the member states. This is stipulated in article 6 of the IAS Regulation. On the private level, the European Financial Reporting Advisory Group (EFRAG) supports the Commission with technical expertise in the assessment of IFRSs.[62] In order to facilitate endorsement, EFRAG proactively works with bringing the European interest forward to the IASB, e.g by sending comment letters to the EDs. In practice, the Commission starts off by formally asking EFRAG for their opinion on whether to endorse an IFRS. If EFRAG approves, the Commission drafts

[58] Van Hulle, p. 12.
[59] The Commission adopts IFRSs through an endorsement process. This process is described below in section 3.1.1.
[60] SOU 2003:71, p. 75.
[61] SOU 2003:71, p. 76.
[62] http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#status-adoption. 2006-03-26.

a proposal for adoption of the standard. This proposal is discussed and voted upon by ARC. Eventually the Commission formally decides on endorsement on the basis of ARC's opinion.[63]

In order for an IFRS to be endorsed by the Commission it must fulfill three criteria stipulated in article 3 of the IAS Regulation. Firstly, the standard should not be contrary to the principle of a true and fair view in accordance with the Accounting Directives. Secondly, the standard should be conducive to the European public good, and at last it should meet basic criteria as to the quality of information required for financial statements to be useful for users.

True and fair view is the legal standard in EC accounting law.[64] This implies that all rules shall be read bearing this principle in mind. The most important feature of this concept is the overriding rule in article 2.5 of the Fourth Directive which stipulates that a company under certain circumstances is required to deviate from the rules of the Directive if they are incompatible with the requirement of a true and fair view. In the endorsement process, the requirement of a true and fair view implies that an IFRS will be acceptable if it corresponds to current accounting philosophy as laid down in the Directives.[65] Since the Accounting Directives have been amended in order to align to IFRS, this endorsement criterion would nowadays be easily fulfilled.[66] The requirement of conduciveness to the European public good is of political nature. It secures that standards which would raise serious implementation problems or decrease member states' relative competitiveness are not endorsed.[67] Finally, the requirement of decision usefulness refers to that the standard should meet the qualitative characteristics of the IASB Framework. Although these criteria might seem easily fulfilled, two IFRSs have not completely passed the endorsement process, namely IAS 39 and IAS 32.

3.2 The Modernization Directive

Due to the low feasibility of a total extension of the IAS Regulation to annual accounts in the short run, the Commission proposed a modernization of the Accounting Directives. As companies that are not subject to the IAS Regulation will continuously prepare their accounts according to the requirements stipulated by the Accounting Directives it is important that a level playing field exists between

[63] Van Hulle, p. 16.
[64] The requirement of a true and fair view is stipulated in articles 2.3-5 of the Fourth Directive and in articles 16.3-5 of the Seventh Directive.
[65] Van Hulle, p. 15.
[66] See section 3.2.
[67] Van Hulle, p. 16.

companies that apply IFRS and those which do not.[68] In 2001, Directive 2001/65/EC allowed member states to "permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives".[69] This Directive was followed by the Modernization Directive[70] which removed all existing conflicts between the Accounting Directives and IFRS and introduced accounting options provided by IFRS that were not allowed in the Directives.[71] The purpose of these amendments is to facilitate the transition from national to international standards without forcing companies to full IFRS compliance. The key amendment was the possibility for member states to "permit or require in respect of all companies or any classes of company the valuation of specified categories of assets other than financial instruments at amounts determined by reference to fair value".[72]

[68] 2003/51/EC, p. 5.
[69] 2001/65/EC art. 1. Implemented in the Fourth Directive in art. 42a.
[70] 2003/51/EC.
[71] 2003/51/EC, para. 15.
[72] 2003/51/EC, para. 12. In the Fourth Directive this rule is found in art. 42e.

4 Accounting and taxation in Sweden

This chapter will introduce the systems of accounting and taxation in Sweden. The prevailing rules and principles of accounting impact on taxation due to the existence of a linkage between the two fields. Swedish tax rules have been developed with the purpose of creating a linkage between accounting and taxation and the determination of taxable income is thus dependent on the design of the accounting system. This dependency is stipulated by the reference in the Swedish Income Tax Act (IL) that generally accepted accounting principles (*god redovisningssed*, hereafter referred to as GAAP) and the accounting records of the companies as a main rule should control taxation as regards allocation of income and costs to a particular period. To enable a discussion of the prevailing dependency between the systems and furthermore the changes that IFRS brings in this context, the following sections will present the basic principles of the Swedish accounting system and tax system respectively. The third headline of this section discusses the linkage. Moreover, the difficulties of determining the boundaries of the engaged area, i.e. where accounting and taxation are dependent, are highlighted by examples from case law.

4.1 Accounting

Sweden has a complex regulatory system and accounting serves many different purposes. Accounting law is interrelated with other fields of legislation, such as tax law and company law.[73] The relation to tax law is of importance due to the linkage between accounting and taxation. Accounting also impacts on dividend decisions and other company law issues.[74] Furthermore, financial reports impact e.g. on corporate governance, creditworthiness assessments and contracts.[75] In addition they are intended to serve purposes of a broad variety of groups in society. This implies a stakeholder perspective of accounting.[76]

4.1.1 Basic accounting principles

Swedish accounting principles have historically been heavily influenced by international trends, primarily from Germany and the US.[77] The principles of accounting are dynamic, i.e. accounting methods change over time, and the basic principles follow this development. The pace of development on the field of accounting is high which makes static interpretations of accounting principles

[73] See e.g. Westermark, p. 253.
[74] Bjuvberg 2005, p. 108.
[75] Artsberg 2006-01-20, p. 9.
[76] For further information on the stakeholders of accounting, see e.g. Knutsson 1996, pp. 31 and Bjuvberg 2005, pp. 34.
[77] Artsberg 2003, p. 133.

impossible.[78] Thus, principles are exchangeable over time and more importantly, the hierarchy of principles can be subject to change. [79] Moreover, the content assigned to a specific principle can vary. When GAAP[80] is founded, basic accounting principles are of high importance.[81]

Article 31 of the Fourth Directive required the Swedish legislator to stipulate some basic accounting principles in law, 2:4 ÅRL.[82] However, they were already prevailing in practice. The principles are going concern, consistency, prudence, realization, neutrality, accruals, entry by entry and continuity.

Going concern requires that valuation should be carried out with the presumption that the company will survive in a foreseeable future, 2:4 p. 1 ÅRL. Thus, assets are valued according to requirements in legislation and norms, cf. IASB Framework para. 22.[83] Consistency requires the same principles of valuation to be applied over the years, 2:4 p. 2 ÅRL. This requirement ensures comparability between financial years. The requirement does not, however, prohibit changes of valuation principles. New legislation, accounting standards, or by the fact that a change significantly improves the quality of the financial accounts, i.e. improves the true and fair view of a company's result and financial position motivate changes, cf. IASB Framework para. 41.[84]

The prudence principle has traditionally been the all-embracing Swedish accounting principle in the sense that it has been central to all income measurement and allocation of income and expenses to particular periods.[85] Thorell wrote in 1984 that "the prudence principle is an expression of a *deliberate* underestimation of assets and overestimation of liabilities." [86] This leads to an accelerated recognition of expenses and postponement of revenues. Since then, the content of the prudence principle has definitely been influenced by international accounting developments. ÅRL states that valuation shall be carried out with *reasonable* prudence in order to avoid a too optimistic picture of a company's financial position and performance, 2:4 p. 3 ÅRL. Basically it stipulates that in *cases of uncertainty* the common valuation principle it to value assets low and liabilities high.[87] The extent of prudence is limited by the

[78] Thorell 1984, p. 91.
[79] Kellgren, pp. 60.
[80] See section 4.2.
[81] Thorell 1984, p. 138.
[82] The principle of prohibition of setting off (2:4 p. 5 ÅRL), is found in art. 6 of the Fourth Directive, SKV Handledning 2005, p. 58.
[83] Johansson, p. 12.
[84] Knutsson 1996, p. 84, Thorell 1984, p. 102.
[85] Thorell 1996, p. 123.
[86] Thorell 1996, p. 123.
[87] Knutsson 1996, p. 84.

requirement of providing a true and fair view, 2:3 ÅRL.[88] This is more in line with the assigned contents of prudence in the IASB Framework[89] than Thorell's explanation in 1984. However, the content assigned to the Swedish prudence principle is still considerably more conservative than IASB's, especially with regard to how prudence affects the interpretation of the realization principle. The realization principle is expressed in 2:4 p. 3 a ÅRL. A strict application of the realization principle conveys that revenue recognition occurs at the transfer of ownership and when a verifiable value can be established.[90] This prevents accounting for unrealized gains. Unrealized gains are also prevented by the principle of historical cost valuation, i.e. both current assets and tangible assets are valued at acquisition value, see 4:3 ÅRL. Nowadays, practice and Swedish complementary standard setting[91] accepts revenue recognition for value gains that formerly were considered unrealized.[92]

Another basic principle is neutrality, expressed in 2:4 p. 3 c ÅRL. It is expressed by the requirement to consider all realized value decreases, disregarding if the company makes a profit or loss a certain year. The principle aims to prohibit that the reported result in the financial statement is subject to discretion by the preparer, cf. IASB Framework para. 36.[93] The accruals concept implies that income and expenditures shall be related to the financial year they belong, 2:4 p. 4 ÅRL. Thus, the time of payment is not independently significant for the accruals procedure, cf. IASB Framework para. 22. The accruals concept can also be considered to comprise the matching principle. This principle primarily implies that, as a first step, revenues of an accounting period are determined. Thereafter, the expenses incurred to obtain these revenues are established.[94] Different items among assets and liabilities shall be valued entry by entry, 2:4 p. 5 ÅRL. E.g. all accounts payables are valued individually. In 2:4 p. 5, the principle of prohibition of setting off is stipulated. This requirement aims at enabling users of financial statements to make use of all individual posts that can be useful when conducting and analysis of the financial statements.[95] Finally, continuity implies that the closing balance for one financial year shall be equivalent to the opening balance the following year, which relates to the principle of comparability.[96]

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[88] Knutsson 1996, p. 84, Prop. 1995/96:10 part 2, p. 184.
[89] IASB Framework, p. 37.
[90] Johansson, p. 13.
[91] See section 4.3.
[92] Knutsson 1996, p. 85.
[93] Knutsson 1996, p. 88.
[94] Knutsson 1996, p. 88.
[95] Knutsson 1996, p. 90.
[96] Thorell 1996, p. 125.

The principles of 2:4 ÅRL is the closest equivalent to a framework that can be found in Swedish accounting law. Compared to the IASB Framework it is, of course, very brief. An interpretation of 2:4 ÅRL however shows that most of the qualitative characteristics are comprised by the rule. The increasing influence of the IASB Framework in Swedish accounting law is due to the ongoing transition from a transactions-based to a balance-sheet approach. A transactions-based accounting approach focuses on the income statement, which makes principles such as matching, realization and prudence important. On the other hand, a balance-sheet approach treats the income statement more like a residual that results from value changes of assets and liabilities.[97] In such a system, e.g. the substance-over-form principle is important.

The remaining differences between the IASB Framework and the basic principles of the Fourth Directive and ÅRL today can be related to the remaining relative significance of the principles of realization and historical cost in Swedish accounting practice. However, ÅRL has been amended in line with the modernization of the Accounting Directives in order to allow valuation at fair value of financial instruments, 4:14 a ÅRL and certain other assets, 4:14 f and g ÅRL.[98] The rules are applicable to listed companies and companies in a group subject to IFRS-compliance. These amendments are direct convergence efforts to align national law to IFRSs. However, some resistance to IFRS's accounting philosophy will probably remain in the foreseeable future due to the linkage between accounting and taxation. This issue is further discussed in section 5.4.1.

4.2 GAAP – Legal standard

The legislation on financial accounting in Sweden is primarily regulated by two laws, ÅRL[99] and the Book Keeping Act of 1999 (BFL).[100] BFL states which entities are required to maintain accounting records and how to handle the current recording of transactions. ÅRL stipulates specific rules for certain accounting entries, the basic accounting principles described above and requirements for the preparation of annual accounts, group annual accounts, interim reports and disclosures. These laws are skeleton laws and need to be extended by supplementary standards for interpretation. This is understood by the reference to GAAP in 2:2 ÅRL and 4:2 BFL. The fact that GAAP fills accounting law with content makes it the legal standard on the field of accounting.[101]

[97] Bjuvberg 2005, p. 59.
[98] 4:14 f and g are not yet in force, as of now they will enter into force at the beginning of 2009.
[99] ÅRL is based on the Accounting Directives.
[100] Additionally, there are specific accounting acts regulating the annual reporting of financial companies (ÅRFL, ÅRKL). These are not within the scope of this thesis.
[101] Prop. 1995/96:10, part 2, p. 11, Bjuvberg 2005, p. 43.

In isolation, GAAP has next to no substance and therefore must be filled with contents in order to be applicable. However, two basic features of GAAP are presented by Bjuvberg.[102] First, the term comprises an intrinsic dynamic which is represented by the need to align accounting standards to developments in society. Thus, the content of GAAP has a character of a “perishable”. Secondly, there is an intrinsic subjectivity feature to GAAP. This comprises the frequent possibilities for a subject to choose between two or more accounting methods within the boundaries of GAAP. Furthermore, several interpretations within the framework of one method can be possible.

As regards the determination of the substance of GAAP, a look at the preparatory works of the Bookkeeping Act of 1976 (GBFL) and the law bills of ÅRL and BFL is helpful. In the preparatory works of GFBL, the official investigator claimed that GAAP should be defined in the light of actual practice of a qualitative circle of companies required to maintain accounting records.[103] The primary source of GAAP was thus considered to be found in practice and the issuance of recommendations and comments on accounting practice aimed to codify this. In the ÅRL law bill, the Government proclaimed that GAAP evidently entails the obligation to comply with law and the basic accounting principles stipulated by law, in particular to the requirement of a true and fair view in 2:3 ÅRL. Furthermore, it is argued that GAAP still should be based on practice but that significant importance must be attributed to recommendations issued by authoritative bodies such as the Swedish Accounting Standards Board and the Swedish Financial Accounting Standards Council.[104] This means that the reference to GAAP required companies to align to the practice developed by authoritative bodies to complement and interpret legislation. However, the prohibition to violate the rules of law with reference to GAAP is expressively stated.[105] The law bill of BFL elaborates further on what should be understood as GAAP.[106] It expresses that prevailing practice should not be the only determinant of GAAP, but neither is it appropriate to let every recommendation issued by authoritative bodies constitute GAAP. The conclusion is therefore that GAAP, as far as possible, should be determined by traditional interpretation of requirements in laws and other regulations. This interpretation should be conducted with regard to the wording of the rules of law, their purposes and the basic principles they rely on. Only when such an interpretation is not sufficient to solve a specific issue, complementary

[102] Bjuvberg 2005, p. 100-102.
[103] SOU 1973:57, p. 94.
[104] Prop. 1995/96:10 part 2, p. 181. For standard-setting bodies, see section 4.3.
[105] Prop. 1995/96:10 part 2, p. 181.
[106] Prop. 1998/99:130, p. 187.

standard setting shall be considered. This complementary interpretation should be based on practice, although not exclusively. It is the Government's opinion that the development of GAAP should not be limited to prevailing practice but be open to new accounting methods that constitute a further development of accounting principles stipulated in law or prevailing in practice. This encourages the dynamics of GAAP. As standard setting bodies can not have regulatory power as stipulated in the constitution[107], the ultimate definition of GAAP is a decision left to the Supreme Administrative Court (RegR) and possibly the European Court of Justice (ECJ).[108] The recommendations issued by authoritative standard setting bodies should, however, be attributed very strong significance when it comes to defining GAAP.[109] According to Bjuvberg, the prevailing legal status of the recommendations issued by authoritative standard setters is close to law.[110]

In conclusion, GAAP has developed from focusing on prevailing practice to a more complex definition where the recommendations from authoritative standard setters are attached with very strong significance. In fact, nowadays there is a significantly strong presumption that the recommendations of authoritative standard setters express GAAP.[111] This presumption is, of course restrained by the boundaries of accounting law.

4.2.1 True and fair view in Swedish legislation

The requirement for the balance sheet, the income statement and disclosures to be prepared in order to give a true and fair view of a company's financial position and performance is stipulated in 2:3 ÅRL. The Swedish legislator has chosen to keep GAAP as legal standard as opposed to the concept of a true and fair view which is the legal standard of the EC Directives.[112] In EC law this is an overriding concept.[113] The Swedish legislator, however, considered the content of the concept to be uncertain and prohibited deviations from explicit rules in ÅRL even though such actions would be motivated by the requirement of providing a true and fair view. The rules in 2:4 ÅRL have been interpreted by the ECJ as secondary to the requirement of a true and fair view.[114] This implies that the true-and-fair-view concept overrides the fundamental principles of accounting. It can indeed be considered awkward that the concept of a true and fair view is prohibited to override a specific rule of law but allowed to deviate

[107] See section 5.2.
[108] Bjuvberg 2005, p. 95.
[109] SKV Handledning 2005, p. 55.
[110] Bjuvberg 2005, p. 95.
[111] Bjuvberg 2005, p. 106. See also Norberg, p. 332.
[112] Thorell 1996, p. 110.
[113] See section 3.1.1.
[114] SKV Handledning 2005, p. 57.

from the principles of which the rules are based.[115] The ground for the decision by the Swedish legislator to refrain from implementing the overriding concept was the assessment that it would be wrong if a company which has prepared its accounts according to ÅRL would feel insecure of the compliance of the preparation.[116]

It is eventually a task of the ECJ to interpret the concept of a true and fair view, but the Swedish legislator claims that it is probable to take its starting point in the accounting in the individual case. GAAP, on the other hand, is a result of conveying with legislation, practice and recommendations. In addition, GAAP is an established concept in Sweden and thus provides more guidance. However, the legislator points out that all applications of GAAP, whether in recommendations or in practice, must be aimed at presenting a true and fair view.[117] Despite the uncertainties surrounding the concept, it can be assumed that conveying with law, recommendations and general advice generally also will lead to a true and fair view.[118] According to Thorell, the existence of the provision of a true and fair view in Swedish legislation is unnecessary under prevailing circumstances. The term is not attributed with any material content except for being an overall requirement on accounting, and can thus be compared to the principle of a legible presentation stipulated in 2:2 ÅRL.[119]

4.3 Swedish standard setting

As mentioned above, authoritative standard setters have a profoundly strong position when it comes to the development of GAAP. The most important standard setters today are the governmental Swedish Accounting Standards Board (BFN) and the private Swedish Financial Accounting Standards Council (RR).[120] BFN is responsible for the development of Swedish GAAP, 8:1 BFL, and issues accounting standards to non-listed companies.[121] BFN has delegated the responsibility of GAAP development for listed companies and companies that through size are of public interest to RR. The recommendations issued by these bodies are not legally binding. However, as the recommendations are presumed to constitute GAAP, deviations from the recommendations are in most cases violating the law.[122,123]

[115] Artsberg 2003, p. 157.
[116] Artsberg 2003, p. 157.
[117] Prop. 1995/96:10 part 2, p. 12., Thorell 1996, p. 112.
[118] Prop. 1995/96:10 part 2, p. 182., Thorell 1996, p. 114.
[119] Thorell 1996, p. 119.
[120] Finansinspektionen is another authoritative standard setter which issues standards to financial companies. These companies are regulated by special annual accounts acts, ÅRKL and ÅRFL, and are not within the scope of this thesis.
[121] www.bfn.se, 2006-03-25. BFN issues several types of recommendations; general advice (*BFNs allmänna råd*, BFNAR), guidelines and statements. However, the thesis refers to these as “recommendations”.
[122] SKV Handledning 2005, p. 97.
[123] For more information about BFN and RR, see www.bfn.se and www.redovisningradet.se.

The recommendations issued by RR are based on the IASB Framework. Until 2003, RR translated the IASB standards and adjusted them to Swedish conditions. The recommendations deviated from IFRSs in cases when ÅRL prohibited a certain accounting treatment or if other special reasons prevailed. These "other reasons" relate to the linkage between accounting and taxation, see section 4.6.5. This method applies to recommendations RR 1-RR 29 which cover practically all topics dealt with by the IASB. The IFRS-transition made the previous recommendations inapplicable for the preparation of group financial statements in listed companies. As a consequence, RR has issued two new recommendations, RR 30 and RR 31. RR 30 states some additional requirements stipulated in 7:32 ÅRL and RR 31 require IFRS-companies to prepare interim reports in compliance with IFRS.[124]

Regarding the individual accounts of listed companies, RR has issued RR 32 on accounting for legal entities which replaced RR 1-RR 29 for these companies.[125] The recommendation is founded on the philosophy that individual and group accounts as far as possible should be prepared using the same principles.[126] The main rule in RR 32 is that the annual accounts shall conform to IFRS. The regulation technique in RR 32 differs from the previous recommendations by referring directly to IFRSs and only state cases where exceptions or additions are at hand. Hence, additions and exceptions do still exist with regard to ÅRL and taxation but the deviations are considerably less than before.[127] According to Bjuvberg, the altered technique of RR's standard setting does not affect the strong legal status of its recommendations.[128]

The strategy of BFN in the development of standards was, until 2003, to take RR's recommendations as a starting point and interpret and simplify them in order to suit non-listed companies.[129] However, in February 2004 BFN announced a fundamental change in the technique of standard development.[130] The decision was founded on the opinion that the set of accounting rules had become too extensive and complex for small- and medium sized enterprises (SMEs). The previous strategy divided unlisted companies into three groups, namely small, medium-sized and large unlisted companies based on number of employees and the value of net assets.[131] The deviations and simplifications were optional, i.e. companies could choose to apply a more sophisticated accounting method from either a higher

[124] http://www.deloitte.com/dtt/article/0,1002,sid%253D38902%2526cid%253D85056,00.html, 2006-02-20.
[125] RR 1-RR 29 are no longer being updated. An eventual annulment of these recommendations is likely.
[126] RR 32, p. 6.
[127] Bjuvberg 2005, p. 40.
[128] Bjuvberg 2005, p. 319.
[129] Artsberg, 2006-01-20, p. 28.
[130] Dnr 28/04.
[131] http://www.bfn.se/index.asp?/redovisning/BFN_VAG/tillampning/vl_tillampning.asp, 2006-05-16.

BFN-group or the corresponding RR recommendation. Hence, there was no requirement of comprehensive compliance but this freedom of choice was applicable recommendation by recommendation and at times even for specific accounting principles.[132] As a consequence, the reporting of results became to a large extent discretionary and the information in the financial reports hard to interpret.[133] According to the new approach there will be four comprehensive sets of rules. Companies will be categorized based on company type and size, and report in line with their category. It will still be possible for companies to choose a more sophisticated set of rules although under the requirement of full compliance to the rules of the chosen higher category.[134] The first category includes sole proprietorships and partnerships owned by natural persons (K1). The second includes small limited-liability companies (AB) and co-operative economic associations (K2). The third category comprises medium sized companies (K3) and the fourth category consists of IFRS-companies (K4). An important purpose of the development of K1 is to provide as simple rules as possible that harmonize the accounting and taxable result.[135] For K2, the set of rules will be based on the prudence principle, valuation at historical cost and explicit rules of materiality.[136] For K3, no material has yet been published. For K4, BFN will presumably not develop rules but refer to RR 32. The intention is that there will be no need for further standard setting for companies applying either one of the BFN set of rules. In developing K1-K3 the accounting principles will rely on the Fourth Directive and ÅRL, which enables BFN to align the standards to IFRS.[137] However, BFN states that the rules of K1-K3 will be independent from the rules of IFRS.[138,139]

4.4 Taxation

This section intends to illustrate that tax legislation in some fundamental aspects differs from the purposes of accounting and that the linkage between accounting and taxation has been possible to maintain because of the preservation of the prudence principle in Swedish accounting. Compared to Swedish accounting legislation, tax legislation is much more detailed. Despite this level of detail, it is shown by the presented cases from practice in section 4.6 that confusion prevails on whether individual tax rules express that the accounting records shall be followed at taxation as regards accruals or if accruals shall be determined by reference to the tax rule alone.

[132] Dnr 28/04, p. 1.
[133] Dnr 28/04, p. 1.
[134] Dnr 28/04, p. 2.
[135] http://www.bfn.se/bfn/remiss_vl_k1.pdf, 2006-05-24.
[136] http://www.bfn.se/bfn/Remissbrev%20_K2.pdf, 2005-05-24.
[137] Bjuvberg 2005, p. 37.
[138] Dnr 28/04, p. 3.
[139] The current developments of the categorization can be followed on www.bfn.se.

4.4.1 Basic principles of a company tax system

The purpose of a tax system is to *raise state revenues* on a periodical basis.[140] In designing such a system, it is common ground between economists and tax experts that an "ideal" company tax system should be *equitable, efficient, effective, simple, and provide certainty*.[141] These principles are presented in order to provide a background when discussing the appropriateness of letting the IASB set of rules influence taxation.

The principle of equity has two dimensions, namely that taxation should be fair and that taxes are levied according the taxpayers' ability to pay. The ability-to-pay principle requires that taxes are levied according to taxpayers' contributive capacity and is founded on the assumption that the marginal benefit of consumption is decreasing.[142] Fairness holds that taxpayers in the same economic circumstances should receive equivalent tax treatments.[143] The requirement of efficiency comprises a principle of neutrality. A neutral tax system does not influence the taxpayers' economic decisions, e.g. choice of corporate form.[144] Effectiveness relates to the tax system's ability to accomplish its basic objectives, i.e. to generate the desired level of revenues and set the intended economic incentives.[145]

The operations of tax systems should be as simple as possible. This regards the minimization of costs for taxpayers as well as for the state, i.e. both compliance costs and administrative costs should be minimized. This principle is certainly easier to follow in cases when a linkage between accounting and taxation prevails, as the taxpayer can rely on the financial accounts and only make adjustments. Since taxes are mandatory transfers of individual wealth to the state, certainty regarding the determination of a taxable event and the exact amount of its consequences are important.[146] Furthermore, tax rules that lead to high volatility of profits and losses over the lifetime of a business or that allow for strategic allocation of income and expenditures to different fiscal years should be avoided.[147]

The taxable result shall reflect the increases and decreases of economic power in the hands of a person during a certain period of time.[148] Hence, the result of a period that is subject to taxation should fairly reflect these changes in wealth. However, the fact that the tax assessment, as opposed to the financial

140 Schön, p. 434.
141 See SEC (2001) 1681, p. 26, see also LLMS, pp. 36.
142 LLMS, p. 24.
143 SEC (2001) 1681, p. 23.
144 SEC (2001) 1681, p. 23, LLMS, p. 37.
145 SEC (2001) 1681, p. 24.
146 SEC (2001) 1681, p. 25.
147 Schön, p. 434.
148 Schön, p. 433.

accounts, gives rise to an actual cash flow makes it sensible not to tax those increases in company wealth that have not yet been transformed into cash, i.e. have not been realized by sale or another transaction. Otherwise the taxpayer might have to sell other assets than cash or take up a loan in order to pay the tax bill. The need to protect the taxpayers' assets against these risks makes a conservative approach in tax law sensible.[149]

4.5 Swedish tax policy

Taxes are compulsory contributions from individuals to the state and municipals and are therefore levied on the basis of law as stipulated in the Swedish Constitution, 8:3 RF. This is an expression of the principle of legality in a tax context. This legal right of the individual can be expressed as "nullum tributum sine lege", no taxation without law.[150] The decisive power regarding taxes is limited to the Riksdag (the Swedish Parliament), and taxes can only be levied following a regulation passed by the Riksdag, 8:7 RF. This implies that the normative power on the field of taxation can not be delegated to the Government or another subordinated organ.

In 1991, Swedish fiscal legislation underwent a major reform with the purpose of creating a more neutral, efficient and fair tax system. The major implication of the reform was that the abundant possibilities of making provisions in order to reduce taxable income were abolished since they were found to slow down the movement of capital.[151] As in many other European countries, the tax rate was lowered and accompanied by a simultaneous widening of the tax base with the result of keeping the total tax burden intact.[152] The ability-to-pay principle is of significant importance in Swedish taxation, which is especially visible by the progressive income taxation. The overall development of taxation philosophy leans toward a less interventionist regulation and a dominance of neutral rules. As a result of the Swedish EU-membership, EC-law is a part of the internal Swedish legislation.[153] However, direct taxation is not within the competence of the EU. Tax rate and tax base determination is therefore a national concern.[154]

[149] Schön, p. 435.
[150] LLMS, p. 601, see also Hultqvist, p. 112.
[151] LLMS, p. 222.
[152] LLMS, p. 223.
[153] LLMS, p. 21.
[154] Persson & Österman P, p. 67.

4.5.1 The principle of economic double taxation

Swedish tax law applies economic double taxation. This is a choice of political nature which is often justified by the principle of neutrality. The implication of this principle is that business income is subject to tax twice. A legal entity is a separate tax subject according to 6:3 IL, and its taxable result is derived by deducting expenses from revenues, 14:21 IL. Expenses are defined as expenditures incurred in order to acquire and maintain income, 16:1 IL. Distributions to owners do not fulfill the definition of expenditures and are therefore not tax deductible. Next, shareholders are taxed for dividends and capital gains emanating from holdings in companies, 42:1 IL. Hence, income is first taxed on company level as business income and a second time on natural-person level as a dividend or capital gain. In cases when companies own shares in other companies and profits are distributed from one legal entity to another, the principle of double taxation implies that profits are subject to tax several times before reaching the natural persons who are the eventual owners. This phenomenon is called chain taxation. This is an undesirable effect which the legislator has solved by admitting exemptions. Hence, dividends and capital gains from business-related shares are exempt from taxation according to 24:17 and 25a:5 IL.

4.6 The linkage between accounting and taxation

It has already been stated that a close linkage between accounting and taxation prevails in Sweden. This linkage only prevails in the income class schedule business activities and does therefore only affect corporate taxation. Below, the design of the Swedish linkage is explained and exemplified.

4.6.1 Pros and cons of a linkage

An argument frequently put forward as an advantage of linking taxation to the accounting records is that it facilitates the tax assessment for companies as only adjustments to accounting profit must be made. Under a disengaged regime two separate reports must be prepared and therefore a strong linkage is generally considered favourable from the companies' point of view.[155] The choice to link taxation to accounting is not only a pragmatic solution. Schön argues that "tax theory and current legislative practice leaves one alone when it comes to the allocation of wealth- increasing or wealth decreasing items to the respective periods".[156] Hence, the accounting records can provide helpful guidance to determine an appropriate definition of the taxable result for a period. Furthermore, "income itself can

[155] Cf. SOU 1995:43, p. 92 and Kellgren pp. 136.
[156] Schön, p. 434.

hardly be described differently for tax and accounting purposes as it eventually is the same economic reality that both systems aim to reflect".[157]

The principal disadvantage is that the linkage affects the quality of accounting by encouraging companies to account with concern to tax effects. This frequently results in tax driven accounting, i.e. deliberate underestimations of profits, which contravenes the concept of presenting a true and fair view of financial position and performance.[158] In this respect the linkage is hampering the development of GAAP. A resistance to new accounting rules can be expected in case they affect the tax burden negatively. A common argument for the dismissal of the linkage is that international investors have difficulties understanding the Swedish financial reports since they include items such as untaxed reserves in the balance sheet and appropriations in the income statement.[159]

For smaller companies with few stakeholders the advantages of a strong linkage obviously crowd out the disadvantages but for companies raising capital on the capital market the question is more complex. The requirements on the financial reports as regards quality and information are higher both due to the large amount of stakeholders and the requirements of compliance with international accounting standards. In addition, larger companies are generally better equipped than SMEs to handle disengaged regulations.[160]

4.6.2 Basics of the linkage

The linkage is expressed in chapter 14 IL. 14:2 IL stipulates that the taxable result shall be calculated according to the accruals concept (*bokföringsmässiga grunder*) and that GAAP shall be followed for tax purposes in allocating items to a particular period if nothing else is explicitly stipulated by law. The accruals concept has no definition in the legislation. According to the law bill, however, it requires that the taxable result is calculated on an accruals basis.[161, 162] GAAP has no definition in tax law, but from practice it is clear that the term has the same content as in accounting law.[163] 14:4 IL stipulates that the accounting records shall found the calculation of the taxable result as regards the allocation of income and expenditures to a particular period. This rule expresses that as a main rule, the accrual method used in the financial accounts shall also be used for tax purposes. The choice of method in the financial

[157] Schön, p. 434.
[158] See Kellgren pp. 131.
[159] SOU 2005:53, p. 73.
[160] SOU 2005:53, p. 74.
[161] SKV Handledning 2005, p. 26.
[162] For a current discussion of this concept, see Westermark pp. 250.
[163] SKV Handledning 2005, p. 26.

accounts is thus binding to both the taxpayer and to the fiscal authorities. It is through 14:4 IL that the material rules of accounting impact on taxation. The boundaries are defined in 14:2 IL, i.e. in order for the accruals of the financial accounts to be followed at taxation they must comply with GAAP, otherwise they must be adjusted, 14:5 IL. Furthermore, specific tax rules have priority over the financial accounts.[164]

The reference in 14:2 and 14:4 IL to accruals implies that the linkage does not influence the scope of taxation, i.e. the extent to which an item is taxable or a cost is deductible. This is also supported by the preparatory works of IL where the legislator states that the accounts lack material significance when determining the scope of taxation.[165] Hence, whereas the scope of GAAP in an accounting context is wide, for tax purposes it only serves to give the answer to the question when to allocate income and expenditures. The basics of accruals for tax purposes are therefore relatively simple; either they follow GAAP or a specific tax rule.[166]

As mentioned above, the intrinsic subjectivity of GAAP frequently results in that the taxpayer is able to choose between several accounting methods, or that choices occur within the framework of one method. The taxpayer can then be expected to choose the method resulting in the most favorable tax treatment. The only limitation to such a choice is that it complies with the principle of a true and fair view, a limitation with minor significance in practice.[167]

4.6.3 Material and formal linkage

The material and formal linkage comprise the engaged area.[168] If the accruals of income and expenditures for tax purposes are determined by the accruals according to the accounts (and not by specific tax rules) a material linkage prevails.[169] Income and expenditures are then recognized at the same point in time in both systems. The material linkage is the main rule on the field of corporate income taxation as regards accruals. It is stipulated in 14:2 and 14:4 IL.

In cases where specific favourable tax rules require a specific treatment in the accounting records in order to be applicable, a formal linkage prevails. In these cases, tax rules can determine the treatment

[164] Bjuvberg 2005, p. 184.
[165] Prop. 1999/2000:2 part 2, p. 180.
[166] This is, according to Bjuvberg, a strong simplification. The author emphasizes that the accounting records are significant for taxation both in terms of the scope and classification, see Bjuvberg 2005, p. 172. See also Kellgren, pp. 25.
[167] Bjuvberg 2005, p. 184.
[168] For an illustration of the engaged and disengaged area, see Westermark, p. 258.
[169] Kellgren, p. 105.

for both tax- and accounting purposes of a certain transaction. These specific tax rules are deviations from the main rule that the financial accounts shall determine the outcome at taxation.[170] The clearest example of the formal linkage is the rules concerning "depreciation in accordance with the accounts" (*räkenskapsenlig avskrivning*), 18:13 IL. This is the most favourable tax-law-depreciation method. The rule stipulates that the method can only be applied if the taxpayer has maintained accounting records in an orderly fashion that are completed with a financial statement and *if the deduction for tax purposes corresponds to the depreciation in the financial statement*, 18:14 IL. The requirement that the deduction shall correspond to the depreciation in the financial statement is establishing the formal linkage. In order to fulfil the requirement of correspondence, the excess depreciation, i.e. the difference between tax-law depreciation and economic depreciation, is recognized as an expense in the income statement as an appropriation. This expense is merely fictitious since it does not correspond to an event from a business-economics perspective. The purpose is to provide a tax credit. In the balance sheet this appropriation is recognized as an untaxed reserve. This accounting treatment prohibits the temporary untaxed profit which arises due to the deduction in the income statement to be distributed. Another example where a formal linkage prevails is provisions for tax allocation reserve, 30:3 IL.[171]

In cases where there are specific tax rules that express an accrual solution, no linkage prevails and the tax rule alone determines taxation. This is called the disengaged area. Examples of this field are residual-value depreciation of tools and equipment, depreciation deductions on buildings, and calculations of capital gains at disposal of buildings and securities.[172]

4.6.4 The boundary between the engaged and disengaged area – case law

As has been mentioned above, the extent of the engaged area can be hard to determine.[173] The assessment of whether a tax rule expresses an accrual solution, and thus has priority over the accrual method in the accounts is unclear in many cases. In order to close in on the boundary of the engaged and disengaged area it is useful to divide tax rules into three categories.[174] These are; no tax rules for a transaction, specific tax rules with a formal reference to the accounting records and specific tax rules without an explicit reference to the accounting records. Below, cases from practice are presented to illustrate this issue.

[170] SOU 2003:71, p. 81.
[171] Kellgren, p. 125-127.
[172] SOU 2003:71, p. 81.
[173] See Westermark, p. 258-259.
[174] See Norberg p. 327 and Bjuvberg 2005, pp. 192.

The first category includes transactions for which *no tax rules exist for a transaction*. In these cases, the treatment according to GAAP is followed at taxation. This includes e.g. leasing, sponsoring and pre-paid contracts. An example from case law is **RÅ 1999 ref. 32 (Key Code)**[175] **–** The case regards accrual of income from pre-paid contracts. The question was how to accrue income from service contracts stretching over a number of years. This is a question of revenue recognition, and the fundamental issue is when the service shall be considered to be performed. The company argued that the service was performed linearly over the lifetime of the contract, and wanted to accrue income in that pace. The tax authorities on the other hand, claimed that the service was performed at the time of invoicing and thus argued that the whole amount should be subject to taxation the same year. RegR first concluded that the question belonged to the engaged area. Hence, if the accrual of income in the accounts followed GAAP, they would be followed for tax purposes as well. RegR ruled that more than one accounting treatment was possible under GAAP with regard to revenue recognition, the percentage-of-completion method or the completed contract method. The company's accounting treatment could therefore found taxation. This ruling is a clear example of the dynamics and subjectivity comprised by GAAP and that the choice of accounting treatment in the annual accounts shall control taxation in these cases.[176]

The second category includes transactions regulated by *specific tax rules with a formal reference to the accounting records.* This category can be exemplified by **RÅ 1998 ref. 18**[177] (advance ruling) **–** The case regarded accrual of work in progress. According to a previously applicable accounting standard, revenues for work in progress should be recognized according to the completed contract method, i.e. when the project was finished. Tax law was established in accordance with this method and stipulated that, as a main rule, the accounting treatment for work in progress should be followed for tax purposes. However, accounting had developed towards the percentage-of-completion method, where revenue is recognized in pace with the completion of the project. The question was how this new accounting treatment would affect taxation. RegR ruled that the tax regulations regarding work in progress were minimum valuation rules. This interpretation has two consequences. Firstly, the valuation in the accounts shall be followed if it is not lower than the minimum value according to tax law. Secondly, if the valuation in the accounts is higher than required by tax law, taxation follows the valuation in the accounts.[178] Hence, the case belonged to the engaged area.

[175] See e.g. Bjuvberg 2005, p. 193-194, Norberg p. 331-332 and Alhager & Alhager p. 24.
[176] Falkman, p. 61.
[177] See e.g. Norberg, p. 332-334.
[178] Norberg, p. 343.

The third category contains *specific tax rules without an explicit reference to the accounting records*.[179] It is in this category the boundary between the engagement and disengagement is hardest to determine. In **RÅ 2004 ref. 81 –** it was established that the rule regulating expenditures for expandable equipment in 18:4 IL belonged to the disengaged area. Expandable equipment includes tools and equipment of little value with an economic life of maximum three years. The rule stipulates that expenditures for expandable equipment may be deducted immediately. The rule is constructed as a "may" rule, intuitively implying that a choice prevails, and that the rule should belong to the engaged area.[180] RegR established the ruling of the Council for Advance Tax Rulings. The Council stated that the regulations on deduction for expenditures for tools and equipment in general are "such specific tax rules that convey a deviation from the main rule that calculation of income is done in accordance with the financial accounts if these are prepared in accordance with GAAP."[181]

Another case, which was subject to debate before the amendment of the rule in question is **RÅ 2000 ref. 26. –** The case regarded the interpretation of the tax rules covering deductions for repair-and-maintenance expenditures on buildings, 19:2 IL. The main accounting rule for repair and maintenance expenditures was to deduct expenses on a continuous basis. However, if the expenditures classified as value-enhancing reparations they could under certain circumstances be capitalized. The question was whether it was possible to capitalize expenditures for value-enhancing reparations but still receive immediate deductions at taxation? The Council for Advance Tax Rulings considered this to be possible, i.e. it considered this rule to be a part of the disengaged area. However, RegR made a different assessment. According to RegR, the rule should be interpreted as a provision for taxpayers to choose, either to deduct the expenditure or to capitalize by adding the expenditure to the acquisition value. The purpose of the rule was, according to RegR, to align tax accounting to financial accounting and not to constitute a specific tax rule. Hence, the rule was concluded to belong to the engaged area.[182] The interesting feature of this ruling is that the item should be considered to belong to the engaged area, although no reference to an engagement was made in the tax rule. An amendment in the wording of the rule through the law bill Prop. 2003/04:16 did, however, re-classify this rule as belonging to the disengaged area.

[179] Bjuvberg 2005, pp. 207.
[180] See Norberg, p. 337.
[181] Bjuvberg 2005, p. 208.
[182] Norberg, p. 333.

Some conclusions regarding how to determine the boundaries between the engaged and disengaged area are the following. Transactions that are not regulated in tax law are covered by the engaged area i.e. the allocation of income and expenditures to a particular period shall be done in accordance with the accounting records and GAAP. However, in cases where there are specific tax rules that stipulate either a formal reference to the accounting records or that lack an explicit reference to the accounting records, the assessment is more complex. The rulings in the cases described above show that there is no clear pattern of how the boundary between the engaged and disengaged area is to be drawn. The actual tax regulations and the preparatory works of IL contribute to this confusion, e.g. the use of "shall" or "may" in the rules have shown to be unreliable in the assessment of whether engagement or disengagement prevails, which means that the actual wording of the regulations can not be relied upon. A tendency of the rulings is that RegR has relied on preparatory works and underlying purposes of the regulations to a large extent and that in cases where it is uncertain whether an item belongs to the engaged or disengaged area, RegR has been prone to assess that the rules are expressing an engagement.[183]

4.6.5 Heterogeneous accounting – Tax valves

The linkage has contributed to disperse accounting treatments in legal entities and groups. On legal entity level, accounting is often influenced by tax considerations whereas accounting on group level aims to accomplish a correct result from a business-economics perspective. A main rule of accounting law stipulates that the same valuation principles shall be applied in the individual and group accounts, 7:12 ÅRL. However, the rule allows deviations under particular circumstances. According to the law bill of ÅRL such circumstances are tax concerns.[184] Relying on this possibility to deviate, RR 32 allows exemptions from accounting treatments required by IFRSs for legal entities in order to provide a favorable tax treatment. These are referred to as tax valves.[185] In fact, the deviations on legal entity and group level have developed to become so disperse that two different sets of GAAP can be said to prevail, one tax influenced GAAP on legal entity level and one group-level GAAP.[186] This discrepancy can be questioned. However, RR argues that it is easier to develop GAAP in line with business-economic philosophy if the accounting treatments in groups and legal entities to a certain extent are disconnected.[187]

[183] Norberg, p. 335.
[184] Prop. 1995/96:10 part 2, p. 243.
[185] See Bjuvberg 2005, p. 72.
[186] Knutsson 2005, p. 511.
[187] Kellgren, p. 138.

The table below shows the IFRSs for which RR has created tax valves. Two examples from RR 32 will illustrate the concept. The first regards development costs and the second work in progress.

Standard		Subitem	Group level	Legal entity - Tax valve
IAS 11	Construction Contracts	Work in progress	Percentage-of completion	Completed contract
IAS 17	Leases		Financial lease	Operational lease
IAS 18	Revenue	Services (work in progress)	Percentage-of completion	Completed contract
IAS 19	Employee Benefits	specific requirements for deduction		requirement exempted
IAS 23	Borrowing Costs	Capitalization of interests	Capitalization	Recognition in IS
IAS 38	Intangible Assets	Capitalization of development costs	Capitalization	Recognition in IS

Tax valves provided by RR 32 on legal entity level

IAS 38 and RR 32 require that, under certain circumstances, development costs should be capitalized and depreciated over their economic life. In IL, the applicable rule stipulates that expenditures for research and development may be expensed. This rule only regulates the scope and not the accrual question.[188] Consequently, taxation will follow the accruals in the accounting records, i.e. the main rule of a material linkage applies. The tax valve in RR 32 provides an exemption from this accounting treatment by allowing the whole expenditure to be expensed in the accounts on legal entity level, although it is recognized in the consolidated accounts.[189] Recognition of expenses is thereby accelerated.

IAS 11 and RR 32 require work in progress to be accounted for in accordance with the percentage-of-completion method. This implies that revenue recognition takes place during the lifetime of the project. Another way of accounting for work-in-progress is by using the completed-contract method. According to this method, revenue recognition takes place when the project is finished. The tax rules regarding these transactions are considered minimum-valuation rules which, in essence, results in that taxation will follow accounting as regards accruals.[190] The tax valve in RR 32 allows the use of the completed-contract method on legal entity level. Revenue recognition is thus delayed.[191]

[188] On the difficulties of interpreting tax rules, see section 4.6.4.
[189] Bjuvberg 2004, p. 319.
[190] For a further explanation of the rule, see section 4.6.4 (RÅ 1998 ref. 18).
[191] Bjuvberg 2004, p. 319-320.

5 Effects of the IFRS-transition

This chapter will discuss some of the effects of the Swedish IFRS-transition. First, the constitutional issues arising from the fact that Swedish standard setting is facing a development where accounting standards issued by an international private standard-setting body is impacting on taxation are discussed. The impact stems from the influence of Swedish GAAP, via the engaged area, on taxation. If the application of IFRS is extended to legal entities the question of the appropriateness of IFRSs affecting the Swedish tax base occurs. Second, the current impact on taxation is discussed. Although the current application of IFRS causes no direct impact on legal entities, taxation is at least indirectly affected already. In the last section, the assumption is made that IFRS applies on legal-entity level and hence affects taxation directly. The emerging issue in a tax context is the effects of fair-value changes. Under current rules, problems occur both on the engaged and disengaged area as a consequence of the unrealized gains stemming from this valuation technique. For transactions on the disengaged area, it is shown that the political decision to maintain the principle of economic double taxation is challenged.[192] On the engaged area the realization principle is threatened.[193] Eventually, an assessment on whether the linkage can be maintained is made by evaluating the suitability for letting IFRS affect the Swedish tax base.

5.1 Introduction

Accounting in Sweden is serving many different purposes. The result according to the accounts determines the distributable amount and lays the foundation for taxation. These facts are explanatory for the traditional significance of the prudence principle and valuation at historical cost in Swedish accounting. Conservative accounting protects creditors and minimizes the discrepancy between the purposes of accounting and taxation. Indeed, accounting has traditionally been developed with concern to the fields that depends on the accounting records. Therefore, major contradictions between the systems have been avoided.

This harmony is now coming to an end. Sweden is in no position to refrain from a close alignment to international accounting developments and as IFRS got legally enforced by the EU through the IAS Regulation, the need for a close convergence to the principles of this set of rules has become emergent. From an accounting point of view, Sweden is well prepared. RR has issued recommendations based on

[192] See section 5.4.1.1.
[193] See section 5.4.1.1.

IFRS since the foundation with the purpose to create standardised accounting on the basis of a market perspective by ensuring relevance and a high level quality of financial statements.[194] This approach rearranged the hierarchy of stakeholders as it declared the stock market instead of the creditors as the most important receiver of accounting information.[195] Using the IASB Framework for standard development on national level enables a more conceptual view on accounting issues that aims to accomplish qualitative characteristics. Kellgren claims that the Framework in the long run is likely to supersede the position of the traditional accounting principles of e.g. prudence, realization and historical cost in Sweden.[196] The ongoing internationalization on the field of accounting is so influential that a paradigm shift can be claimed to take place.[197] This is not surprising as Sweden is a small country with several large multinational companies (MNCs). IFRS certainly provides an improved business-economic approach to accounting in comparison to what the traditional Swedish accounting system offered. Thus, from a capital market perspective this development is satisfactory. RR has facilitated the transition through an early start, and in addition the institutional accounting environment in Sweden makes transitions like these relatively smooth. However, there are some considerations to assess regarding the Swedish institute of standard setting, especially in the light of the current internationalization.

5.2 Tax base determination by private standard setters

As has been laid out above, the Swedish Constitution contains a principle of legality which in a tax context stipulates that taxes can only be levied by reference to law. The outer boundaries of GAAP are determined by accounting law, EC law and the IAS Regulation.[198] As long as standard setting keeps within these boundaries, the recommendations can be assumed to constitute GAAP. Then, on the engaged area, accounting records shall be followed for tax purposes as regards accruals.

The consideration of whether the prevailing order of standard setting is violating the legality principle arise from the fact that the standards issued by standard setting bodies have a very strong legal status even though they are not binding from a constitutional point of view. The need for standard setting stems from the choice to design accounting laws as skeleton laws. This is a choice that is founded on the need to keep up with the fast pace of development on the field of accounting. Explicit laws would have to be amended continuously and the lengthy process of legislation would hamper GAAP

[194] www.redovisningradet.se, 2006-05-20.
[195] Bjuvberg 2005, p. 39.
[196] Kellgren, p. 68.
[197] Bjuvberg 2005, p. 78.
[198] Bjuvberg 2005, p. 115.

development. RR has for long aligned Swedish accounting standards to the IASB recommendations, which implies that standard setting has developed from codifying existing practice to GAAP into implementing international accounting standards. The standard setting has in this sense become more comparable to traditional legislation.[199] In turn, BFN has used RR's recommendations as a basis for its recommendations to unlisted companies. The strong legal status attached to the Swedish accounting standards is therefore nowadays directly affected by private international standard setting.

Since the determination of GAAP is ultimately established by RegR, the prevailing very heavy impact of recommendations from qualified standard setting bodies with regard to the establishment of GAAP does not contradict the provisions of the constitution. Bjuvberg claims that the constitutional requirement is fulfilled since the prevailing order does not affect the scope of taxation, i.e. the extent to which an item is taxable or a cost is deductible, and thus the rule that taxation shall follow legislation is sustained. In addition, the legislator is free to disengage accounting and taxation at its own convenience.[200] However, even if no problems prevail between the constitution regarding how taxes are to be decided and standard setting, the prevailing order can be questioned.

If IFRS would be required on legal entity level, the IAS Regulation is directly applicable and the requirement to comply with IFRS legally binding. The endorsement process is a solution for transforming the private nature of IFRSs into EC law. The question of whether this procedure can be said to constitute a delegation of normative power to the Commission does not have a clear answer. If it would be classified as such, it would violate 8:7 of the Swedish constitution.[201] In addition, even though the EU formally has the final word on the endorsement of IFRSs, in practice it is still the private, international body IASB that would dictate the Swedish accounting rules and, given the linkage, taxation. The fact that the standards stem from an international private body over which Sweden has scarcely no insight, let alone influence, rise serious doubts.[202] In my opinion, the neutrality of the endorsement process can be questioned. The EU can well be considered to be very prone on endorsing IFRSs with regard to its ambitious aims of becoming the most competitive economy in the world. The amendments of the Accounting Directives show that the EU is very convinced about the superior accounting philosophy of the IASB. The fact that the Commission dismissed e.g. full endorsement IAS 39 and IAS 32 would however imply that this argument might not hold.

[199] Bjuvberg 2005, p. 115.
[200] Bjuvberg 2005, p. 91.
[201] SOU 2003:71, p. 106.
[202] SOU 2003:71, p. 106.

Furthermore, the planned categorization launched by BFN, i.e. the creation of comprehensive sets of rules for companies based on company type and size, will further keep the constitutional debate going. The principle of allowing different accounting rules for different companies is occurring already, e.g. by the special annual accounts acts that apply to financial companies (ÅRFL and ÅRKL). Another example is the simplifications and alleviations in ÅRL that ease the burden on smaller companies, e.g. with regard to disclosure requirements and the presentation of annual accounts in 3:11 ÅRL. If the categorization is realized, which is highly probable, this will create several sets of GAAP depending on which set of rules companies apply. The rules applying in the different categories are likely to contain significant material differences, which is a major change from the prevailing order of simplifications for small companies.[203] Assuming that the linkage is maintained, the consequences are that the point in time for taxation will vary depending on which category a company prepares its accounts in accordance with. Consequently, similar transactions will not be subject to similar tax treatments any more. This violates the basic principle of fairness. The implications of the categorization are, however, yet impossible to quantify since the set of rules are not set.[204] However, assuming that the categorization violates the principle of fairness and that GAAP will get diversified and depend on the category a company reports according to, the standard setters' influence on taxation might become too strong considering the rules in the constitution. If accounting should be allowed to have such an impact on taxation, this should be stipulated in IL in a more apparent way.[205] The categorization is of interest in several aspects and is further discussed in the next section.

To conclude, it seems as if the constitutional issues of IFRS's impact on taxation are of importance even though it is not possible to claim that the prevailing order contravenes the legality principle. Looking at the development of the definition of GAAP, it is clear that the legislator deliberately has assigned a very strong significance to authoritative standard-setting bodies and that very special circumstances shall prevail if a recommendation issued by RR or BFN shall be considered to deviate from GAAP. The fact that GAAP, as the legal standard of accounting, entails an intrinsic dynamic combined with the presumption that the recommendations issued by authoritative standard setting bodies constitute GAAP makes the actions of standard setters powerful and efficient. The work of RR

[203] Bjuvberg 2005, p. 74.
[204] The current status of the development can be followed on http://www.bfn.se/. BFN has issued drafts for K1 and K2. The ambition is that the recommendations will be applicable from January 1 2007. No material has yet been published for K3. The ambition is to issue a draft in 2007 and that the set of rules will apply in January 2008.
[205] Cf. Artsberg 2003, p. 144.

and BFN is highly accepted by the business society and it can therefore be said that, so far, it is in the public interest that these structures prevail in order for Sweden to keep up with international accounting developments and remain competitive. In case of a requirement of full IFRS-compliance on legal entity level, the question of whether this implies a delegation of normative power to the Commission occurs which casts even more doubt on this issue. Finally, the upcoming categorization can be assumed to bring the discussion on the influence of standard setting on taxation to a new level.

5.3 Current effects

Since the application of IFRS is currently limited to consolidated accounts, one could assume that there would be no effects on taxation as it is the legal entity that is subject to tax. However, there are several indirect effects of the transition to be seen already. The legal entities of a group are affected by group-accounting principles. The internationalization has consequences on legal entities by a chain reaction, starting with that the IAS Regulation led to an amendment of the Accounting Directives which in turn lead to a corresponding amendment of ÅRL.[206] Furthermore, the altered standard setting approach of both BFN and RR that are direct consequences of the IFRS-transition impact or are about to impact on taxation. This section is devoted to discuss these current implications.

5.3.1 Accounting standards – a two tier development

The internationalization of accounting as such and the IAS Regulation in particular have caused a new line of development on the field of Swedish standard setting during recent years. The core belief of IASB is that it is appropriate to use the same concepts for financial reporting in all entities regardless of size, particularly regarding the concepts of recognizing assets, liabilities, income and expenses.[207] This suggests that IFRS should be applicable to all entities regardless of size but does not prohibit limited differences such as adjusting the requirement of disclosure depending on user needs and considerations based on cost-benefit analyses.[208] As has been described above, the interrelation between the standards of RR and BFN has now come to an end. RR has issued RR 32 for listed legal entities and BFN is now developing four comprehensive sets of accounting rules. The changes in standard setting approach signal that accounting is facing a two-tier development. On the one hand, RR is seeking to align its rules to IFRS as close as possible and on the other, BFN seeks to go back to old accounting values and align its standards to the linkage.

[206] Bjuvberg 2005, p. 49.
[207] IASB Discussion Paper, p. 15.
[208] IASB Discussion Paper, p. 15.

5.3.1.1 Categorization – Necessary for SMEs?

BFN's approach of using RR's recommendations as a starting point when developing rules for non-listed companies followed the core belief of IASB. Since RR developed its standards with IFRS as lodestar the convergence to international accounting has for long had a high priority, which is also highlighted by RR's decision in 1995 to translate the IASB Framework into Swedish. The ambition to keep the Swedish accounting environment as homogenous as possible can also be said to have been maintained by this approach. Considering that the two bodies have different target groups for their standards; RR listed companies and BFN unlisted companies, the need for deviating developments might not be surprising from a user perspective. The practical obstacles for SMEs to account in accordance with IFRS are apparent. IFRSs are developed primarily for companies operating on a global market that will gain, from an internal and external perspective, from applying internationally accepted accounting standards. The set of rules is already complex and will probably get even more detailed and demanding. The feature of fair-value valuation is gaining influence as well as the substance-over-form principle. In addition, disclosure requirements are becoming increasingly abundant. The accelerated ambition to converge accounting rules in the EU and globally, especially to US GAAP, implies that the accounting regulation in Sweden will most likely become even more complex in the future.[209]

Unlisted companies do not have the same stakeholders as listed ones. The advocates of creating separate rules for SMEs argue that the resulting information when applying some IFRSs is not relevant or even used by the users of SME financial information.[210] Even the IASB has lately admitted that a need for simplifications is needed. As of now, there is a Working Group under the IASB with the task to develop accounting standards suitable for entities that publish general purpose financial statements for external users but do not have public accountability, i.e. SMEs.[211] Hence, the categorization might be unavoidable with regard to the diverse needs of SMEs and MNCs.

It has been shown that, from a user point of view, the need for simplified accounting standards for SMEs are called for due to the complexity brought on by IFRS. However, in a tax context, the development of a categorization raises several issues, which relate to the linkage. The differences in the four categories will probably differ as regards the point in time for recognition of revenues and expenses. If the transaction belongs to the engaged area this impacts on taxation. Furthermore, some of the basic principles of tax systems that have been described in previous sections are threatened. First,

[209] Artsberg 2003, p. 144.
[210] IASB Discussion Paper, p. 10.
[211]http://www.iasb.org/current/active_projects.asp?showPageContent=no&xml=16_33_116_30102003.htm, 2006-05-16.

the fact that taxation will strike differently depending on category implies that taxpayers will regard the effects when making decisions such as form of establishment, which growth strategy to pursue and whether or not to make a public offering. This contravenes the neutrality principle. Furthermore, the fact that similar transactions will be treated differently depending on category is contravening the principle of fairness. Last, the creation of separate sets of rules can affect the symmetry of taxation, which opens possibilities for tax avoidance schemes.[212] Once again, the effects of the categorization are not yet possible to quantify.

The other tier of development, namely the ambition to converge to IFRS within the boundaries of national law, will be discussed next.

5.3.1.2 RR 32 and ÅRL-amendments

The decision by the EU to issue the IAS Regulation made the Swedish Government appoint an official investigation to evaluate the Swedish accounting rules, the IAS Investigation.[213] The two main conclusions of the investigation were that the option in Article 5 should be exercised by allowing IFRS on group and legal-entity level for all companies.[214] Secondly, it was suggested that ÅRL should be altered in order to align national accounting law to IFRS. The most significant change proposed was to allow fair value valuation for certain assets.[215] Based on this investigation, the legislator chose to introduce an *option* for non-listed companies to prepare their *consolidated* accounts in conformity with IFRS.[216] Full IFRS-compliance for other companies was not considered appropriate, partly on the basis of the linkage. However, amendments in ÅRL corresponding to the provisions of the Modernization Directive were made in line with the proposal of the investigation. The most important feature of the amendment is the possibility of valuation at fair value in accordance with IAS 16 Property, Plant and Equipment, IAS 38 Intangible assets, IAS 40 Investment Property and IAS 41 Biological assets.[217] The rules are found in 4:14 f and 4:14 g ÅRL. However, the enforcement of these regulations has been delayed several times and currently they are stipulated to enter into force at the inception of 2009. It can be mentioned in this context that financial instruments may be valued at fair value since 2004, 4:14 a ÅRL. These rules are applicable to listed companies and companies that are members of a group subject to IFRS-compliance. It can appear as if the ÅRL-amendments give companies room for

[212] Bjuvberg 2005, p. 74.
[213] SOU 2003:71.
[214] SOU 2003:71, p. 94.
[215] SOU 2003:71, p. 93.
[216] Prop. 2004/05:24, pp. 63.
[217] SOU 2005:53, p. 76.

discretion. The scope is, however, limited by GAAP. The intention is that the standard setters will specify the scope of application regarding the valuation rules.[218] Alignment of ÅRL is motivated since tax law and other fields of legislation prevent companies from volunteering for full IFRS-compliance. For example, a company might refrain from full IFRS compliance because it does not want to loose the tax-depreciation method "depreciation in accordance with the accounts", which is the probable effect of compliance with IAS 16. Thus, providing the possibility of convergence to IFRS within the framework of ÅRL promotes a successive convergence to IFRS without forcing companies to full compliance.[219]

The issuance of RR 32 is the other effort to converge to IFRS within the borders of accounting law and GAAP. The reason for issuing RR 32 is, according to RR, the belief that financial reports of a parent company should have the same quality as the group.[220] The tax valves provided by RR allow accounting methods on legal entity level that result in a favorable tax treatment.[221] The existing exemptions that relate to ÅRL-restrictions, ÅRL-valves[222], concern IFRSs that allow or require fair values. When 4:14 f and 4:14 g ÅRL which allow fair value valuation of property, plant and equipment, investment property, intangible assets and biological assets enter into force, the intention of RR is probably to remove the ÅRL-valves.[223] Due to the tax- and ÅRL-valves in RR 32 the probability of tax effects due to the IFRS-transition is limited. However, all tax valves from the old recommendations, RR 1-RR 29, have not been included in RR 32.[224] From an accounting point of view, the existence of tax valves is not desirable. According to 7:12 ÅRL, as a main rule the same accounting principles shall apply on legal entity level as on group level when financial reports are prepared.

5.4 Direct effects – assumption of IFRS-application on legal entity level

IFRS will directly affect taxation only if the rules apply on legal entity level. Even though the law bill of 2004 prohibited such possibilities, the possibility of an extension of the IAS Regulation is not out of the scope for the future; as mentioned above, SOU 2003:71 suggested that Article 5 of the IAS Regulation should be exercised in order to allow full IFRS to all companies. The basis of the investigator's conclusion was that a provision of such choices would stimulate the development of

[218] SOU 2003:71, p. 139.
[219] SOU 2005:53, p. 96.
[220] RR 32, p. 6.
[221] See section 4.6.5.
[222] Bjuvberg, 2006-05-18.
[223] Knutsson 2005, p. 511.
[224] Bjuvberg 2005, p. 94.

GAAP, improve comparability and increase competitiveness in an international perspective.[225] However, already when the rules in 4:14 f and g enter into force, the main issues that a full IFRS-transition would bring are realized, namely how to handle changes in fair values at taxation.

5.4.1 Fair values

Theoretically, fair value accounting seems to be the ideal measurement for the increase and decrease of economic power as it gives a full and real time picture of the assets and liabilities of a company.[226] However, fair value accounting according to IFRS fails to meet several requirements which are to be met by tax rules. Unrealized gains (and losses) that result from changes in value when assets are valued at fair value affect both the engaged and the disengaged area. On the engaged area, unrealized gains that are recognized in the income statement will be subject to taxation. This contravenes the realization principle. On the disengaged area, unrealized gains do not trigger taxation and can therefore be distributed without having been subject to taxation on the corporate level since they affect distributable earnings, see 17:3 ABL. This contravenes the principle of economic double taxation which is a principle the legislator is determined to maintain.[227]

The occurrence of fair values is not a new concept in Swedish accounting, e.g. inventory has for long been valued at the lower-of-cost-or-market rule, 4:9 ÅRL. The rules regarding appreciations and write-downs of fixed assets are other examples, 4:5 and 4:6 ÅRL. The difference in comparison to fair valuation in IFRS is that Swedish valuations have been carried out with considerable prudence, by requiring write-downs to be deducted through the income statement, and with regard to the maintenance of the principle of economic double taxation, by requiring appreciations to be taken to restricted equity.

5.4.1.1 Tax effects on fair-value changes[228]

For tax purposes there are three categories of assets; capital assets, inventory assets and tools and equipment. The effects of value changes in these categories are different because of the varying design of the linkage. Assets classified as capital assets are disengaged and taxes are levied according to the realization principle, i.e. value changes do not cause tax effects until the assets are sold. Inventory assets are assets available for sale, 17:3 IL, and belong to the engaged area. Tools and equipment are machines and other tools and equipment intended for continuous use, 18:1 IL. Value changes in this

225 SOU 2003:71, p. 94-95.
226 Schön, p. 438.
227 See SOU 2005:53.
228 See SOU 2003:71 pp. 360 and Bjuvberg 2004, p. 322.

category triggers taxation through the tax-depreciation method “depreciation in accordance with the accounts”, chapter 18 IL, which stipulates a formal linkage.

Since inventory assets belong to the *engaged area*, value changes recognized over the income statement trigger taxation. Theoretically, unrealized gains arising from valuations of financial assets (IAS 39), investment property (IAS 40) and biological assets (IAS 41) would therefore affect the taxable result *if they are classified as inventory assets.* This is due to the fact that these standards allow or require value changes to be recognized in the income statement.

However, financial assets classified as inventory for tax purposes were disengaged in 2004. This was due to the enforcement of 4:14 a ÅRL that allows fair valuation of financial instruments. The disengagement was combined with a dividend-distribution-blocking rule in 17:21 IL. Biological assets are not defined in ÅRL, but IAS 41 states that biological assets are living animals and living plants.[229] For tax purposes, animals and plants (except for forests) are inventory assets. Since fair valuation is required for biological assets, value changes of these items will trigger taxation. For investment property, there is no requirement for revaluation at fair value, and in addition, investment property is in most cases classified as capital assets for tax purposes.

When unrealized gains belong to the *disengaged area* they can affect the distributable amount by increasing the result in the financial accounts without triggering taxation or by increasing unrestricted equity. If no restrictive measures are at hand to handle these unrealized gains, they can be distributed without having been subject to taxation at the corporate level.

Unrealized gains affecting the income statement without triggering taxation are e.g. changes in value of growing forests. A growing forest is not classified as an independent asset, but as belonging to the property where it grows. It is therefore indirectly a capital asset.[230] Financial assets classified as capital assets are not affected by the dividend-distribution-blocking rule in 17:21 IL and thus also belong to this category. If investment property classified as capital assets for tax purposes is valued at fair value, it will cause the same effect. Unrealized gains that are taken to unrestricted equity are e.g. value changes of internally generated intangible assets (IAS 38).

[229] IAS 41 para. 4.
[230] SOU 2005:53, p. 47.

To conclude; if IFRS would be applied under current legislation the following effects concerning fair values would occur. Firstly, unrealized gains which are recognized in the income statement or allocated to a fund of unrestricted equity that stem from items belonging to the disengaged area increase distributable earnings even though assets are not disposed of. These items could therefore be distributed without having been subject to taxation on the corporate level. Secondly, unrealized gains recognized in the income statement that stem from items belonging to the engaged area would trigger taxation and hence contravene the realization principle. These effects are not considered acceptable by the government and are the reasons for the postponement of 4:14 f and g and the prohibition of exercising Article 5 of the IAS Regulation.

5.4.2 Other tax effects

Full IFRS compliance on legal entity level would have the effect that tax valves offered by RR no longer apply.[231] The reason is that no such provisions are available in the respective IFRS-standards. Due to the engagement, the accruals for tax purposes must then be made in accordance with the accounting treatment prescribed by the applicable IFRS-standard. For the case of development costs of intangible assets (IAS 38) this implies that the right to deduction is postponed as the standard requires that an asset must be recognized and depreciated. For work in progress (IAS 11) revenue recognition is accelerated since the percentage-of-completion method requires revenue recognition during the lifetime of the project.

The most favourable tax-depreciation method, “depreciation in accordance with the accounts”, will probably be prohibited if legal entities apply IAS 16 (property, plant and equipment). Today, tools and equipment can be depreciated for tax purposes in five years, provided that the corresponding deductions are made in the accounts. This is a pure tax rule which can be maintained by the existence of excess depreciations and appropriations.[232] This provision is not found in RR 32, but receives legitimacy by GAAP. If IAS 16 would apply, it is not sure whether or not this depreciation method can be used, i.e. if IAS 16 will affect GAAP. If it would, the method would be prohibited.[233]

To conclude, full IFRS compliance on legal entity level will prohibit the use of tax valves for legal entities which will result in a less favourable tax situation. However, the prohibition of using tax valves is favourable from an accounting point of view as the same principles will apply on group level and

[231] For tax valves, see section 4.6.5.
[232] See section 4.6.3.
[233] Bjuvberg 2004, p. 323.

legal entity level, see 7:12 ÅRL. In addition, individual financial statements will be less influenced by tax concerns, which is also desirable. The prohibition of "depreciation according to the accounts" is favourable as well, as the formal linkage causes appropriations in the income statement and untaxed reserves in the balance sheet. This treatment is not internationally accepted. [234]

5.5 How to maintain the principle of double taxation

The intention of the Government is to maintain the principle of economic double taxation.[235] It is clear that this is not possible under current rules if fair values are allowed on legal-entity level. In order to solve these issues, the Government has appointed an investigating committee to evaluate how the linkage shall be designed in the future and how to maintain the principle of economic double taxation in an IFRS-accounting environment. The final report is due in 2007 but in 2005, a proposed solution was issued.[236] The committee discussed three methods which are presented below.

The first method considered was a tax dividend-distribution-blocking rule. Such a rule would solve the problem internally, i.e. within the field of tax law and hence enable the maintenance of economic double taxation without affecting the accounting records.[237] A tax dividend-distribution-blocking rule adjusts the taxable profit of a company by ensuring that distributed capital is subject to taxation. The blocking-rule is triggered by the choice to distribute earnings. In order for the blocking-rule to be efficient, it must be proportionate to the size of the distributed amount.[238] However, such a solution would probably be prohibited by EC-law due to the requirements of the Parent-Subsidiary Directive[239] that dividends are to be distributed cross-borders without being subject to income tax or tax at source.[240] Hence, the investigation discarded this method. The second method proposed was a civil law blocking-rule.[241] As such, it prohibits the distribution of capital that has not been subject to taxation. However, it would require amendments of ÅRL and ABL which is outside the scope of the investigation.

[234] Bjuvberg 2004, p. 323, SOU 2003:71, p. 375. See also SOU 1995:43.
[235] See SOU 2005:53, e.g. p. 71.
[236] SOU 2005:53.
[237] 17:21 IL contains a dividend-distribution-blocking rule covering financial instruments classified as inventory. The rule is a result of the enforcement of 4:14 a ÅRL, allowing fair valuation of financial instruments.
[238] SOU 2005:53, p. 32.
[239] 90/435/EEC.
[240] The reference is made to the ECJ-case C-294/99 Athinaïki Zythopoiia where a similar solution was ruled to constitute tax at source.
[241] SOU 2005:53, p. 33.

The third method proposed was to link the taxable result to the value changes in the accounts.[242] The linkage would cover both value changes recognized in the income statement and value changes that are taken directly to unrestricted equity. Hence, the proposal suggests that unrealized gains should be subject to taxation. Since the investigation was prohibited to pursue any of the first two methods, it was forced to suggest this one. However, it is strongly emphasized that the suggestion is unacceptable.[243] The primary argument is that it contravenes the realization principle. Secondly, it would contravene the ambition of convergence since no company would choose to use the opportunity of fair value valuation in ÅRL. However, currently RR 32 contains no exemptions from IAS 39 and IAS 41 which means that under current circumstances listed companies would be *required* to value financial and biological assets at fair value if 4:14 g ÅRL were in force. However, it is likely that RR 32 will be changed if fair valuation of financial instruments and biological assets would result in an unfavorable tax treatment.[244]

An alternative to the suggested complete linkage would be to require unrealized gains to be allocated to restricted equity.[245] Such a system would result in low compliance costs compared to other methods of maintaining economic double taxation. However, the investigator concluded that such a solution may interfere with company law and considered that further analysis was out of the scope for the investigation. Eventually, the investigator concluded that the enforcement of 4:14 f and g should be postponed.[246]

The committee, SamRoB, is currently working on the final suggestion on how the linkage ought to be designed. The next document is not likely to be similar to the one in SOU 2005:53. The tendency is rather leaning towards an expansion of the disengaged area. Arguments in support of this hypothesis are presented below.

5.6 Does IFRS call for disengagement?

The risk to violate the realization principle calls for a discussion on whether the linkage is still motivated. Is it reasonable to tax unrealized gains? The discussion of whether to maintain, discard or amend the linkage has been subject to debate for decades. SOU 1995:43 investigated the linkage and concluded that the quality of the financial reports ought to be enhanced by dismissing the formal

[242] SOU 2005:53, p. 33-34.
[243] SOU 2005:53, p. 70.
[244] SOU 2005:53, p. 27.
[245] SOU 2005:53, p. 37.
[246] SOU 2005:53, p. 37.

linkage and maintain economic double taxation by a distribution-blocking rule.[247] On the other hand, the investigator suggested a closer linkage with regard to the determination of acquisition values, e.g. capitalization of interests.[248] An investigation in 1998 also suggested disengagement on several fields.[249] However, none of these reports have resulted in a law bill.

The IAS Investigation which presented its conclusions in SOU 2003:71 concluded that IFRS should be allowed on legal entity level.[250] An argument for maintaining the linkage despite such an extension would be that profit measurement according to IFRS supposedly provides the most true and fair view of company performance available and that tax law also strives to levy taxes based on a fair result.

However, the investigator points out that from several aspects, IFRSs are not suitable for taxation.[251] To begin with, the investigator stresses that the investor perspective contradicts the Swedish fiscal interests. The discretion awarded to managers at the preparation of financial statements in accordance with IFRS is substantial. This especially regards fair-value valuations. Apart from the difficulties arising concerning controlling these values, it can be argued that taxation should be founded on more solid grounds. The dignity of disclosures under IFRS in order to balance the insecurity of discretional valuations can not benefit tax authorities since taxation must be founded on standardized numbers. Furthermore, the principle of fairness implies that a tax claim may not be subject to manipulation in order to avoid tax avoidance. This principle seems to be badly aligned with the discretion brought forward by IFRS. However, IFRSs are becoming increasingly detailed and the number of accounting options is continuously reduced in order to achieve better comparability.[252] The complexity of the IFRS set of rules implies a high risk of lengthy and complicated disputes between taxpayers and the Swedish Tax Authority. In addition, BFN can no longer give authoritative statements regarding the interpretation and application of IFRSs since this mandate belongs to IFRIC only. This would mean that the court of law loses a well functioning and smooth way to complement the investigation in complex tax cases.[253]

[247] SOU 1995:43, p.12.
[248] Norberg, p. 330.
[249] RSV Rapport 1998:6.
[250] See SOU 2003:71, p. 94 and p. 98.
[251] See Knutsson 2005, p. 512, and SOU 2003:71, p. 84. See also Bjuvberg 2005, p. 66.
[252] Schön, p. 437.
[253] Knutsson 2005, p. 512-515.

Since taxes give rise to outflows of cash, it is sensible that taxpayers are entitled to pay taxes according to the realization principle. IFRS will accelerate revenue recognition in many cases, e.g. with regard to work in progress. This implies a potential liquidity problem for taxpayers and more importantly it increases uncertainty in revenue measurement. The fact that revenue recognition triggers taxation whereas a subsequent loss will not lead to tax refunds under prevailing rules, may lead to unjustified prudence in valuations. The fact that IFRSs are complex and hard to understand even for experts does not make it sensible to expect that tax clerks should be able assess compliance. Furthermore, tax systems should be simple and IFRS risks to spread its complexity to the tax system.[254] At last, the volatility of fair values distorts predictability, which is of importance for a tax system to provide certainty.

In the light of these arguments, it may be concluded that the prevailing strong linkage is seriously challenged by the efforts to converge to IFRS within the boundaries of national law or to apply full IFRS in legal entities. However, a total disengagement is not likely. Accounting and taxation shares many terms and concepts and it would not be necessary and maybe not even possible to develop two totally independent systems. After all, it is the same reality that both systems aim to describe. Before some kind of disengagement can be proposed at all, a solution of how to maintain the principle of double taxation is required. The future is frankly in the hands of the SamRob investigating committee. In 2007, clarity on this issue can be expected to be established.

[254] Prop. 2004/05:24, p. 64.

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