

THE CONNECTION BETWEEN LEGAL REGULATION OF FINANCIAL ACCOUNTING AND TAXATION ON CORPORATE INCOME TAX

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ABSTRACT

Foreign scientists recently have given more attention to problematic questions of corporate income tax connection with financial accounting, and have also emphasized financial accounting importance to tax law. However, despite the fact that there are some publications which assess transactions for financial accounting and taxation purposes in practical view in special press, there is less scientific research on corporate income tax connection with financial accounting. As a consequence, this article aims to reveal the connection between legal regulation of financial accounting and taxation on corporate income tax. Publication analyzes legal relationship between financial accounting and corporate income tax, scientific literature about the article topics and pragmatic (practical) disclosure of connection between financial accounting and corporate income tax. The result of the article shows that these two elements are strongly connected and the analysis of their legal relationships could simplify the administration of tax burden of corporate income tax.

INTRODUCTION

In the recent works by law scientists, a necessary need for law science to “open its shutters completely at last“ is stressed (Van Den Bergh, R., 2014) and be not afraid to use knowledge of other fields (economic science) that assist in formulating comprehensively justified findings of investigation in such a specific branch of law as finance (tax) law, the more so, that in modern mobile business world, the relevance of interdisciplinary research is obtaining an increasing value, and due to increasingly enhanced interaction between social sciences (especially between law and economics) it is not sufficient to limit themselves to the “sheer“ theory of law or economics.

One famous scientist in his work *Public Finance* which was published in 1892 affirmed that accumulation of the monetary resources funds for the state needs and usage of such funds has a vital importance for the whole political organization (Bastable, Ch. F. 1892, 2). That means that state seeking its purposes as a political organization shall accumulate the necessary monetary resources for the implementation of these purposes and rational it allocate, use. Thus state shall pursue the relevant activities in the financial field. The most important source of the revenue of the State Budget are taxes. The Constitutional Court of the Republic of Lithuania (hereinafter – The Constitutional Court) in its 15 March 1996 ruling explained that, according to the Constitution, five legal forms of the state budget revenues may be singled out: regular taxes, other compulsory payments, dues, receipts from the state property, and other income. They are specified in particular laws (Provisions of the Official Constitutional Doctrine of the Constitutional Court of the Republic of Lithuania: 1993-2009, 2010, 1048). Over the past

decade, corporate income tax is one of the most important revenue monetary sources in countries. In order to determine the corporate income tax rate payable (to fulfil properly payer's tax obligation), it is necessary to access information on the real status of payer's property and its financial condition, to identify which, financial accounting comprehensively governed by legislation is required. In what these statements could be relevant and important for scientific research in law? The answer will be definitely revealed in this article.

This article aims to reveal the connection between legal regulation of financial accounting and taxation on corporate income tax. Analysis is based on the systemic review of the plenty of scientific literature, common review of legal regulation of financial accounting and corporate income tax, European Union (hereinafter – the EU) legal regulation projects and practical examples, tax dispute settlement institutions case-law.

The result of the article shows that legal regulation of financial accounting and corporate income tax are strongly connected and the analysis of their legal relationships could simplify the administration of tax burden of corporate income tax.

LEGAL RELATIONSHIP BETWEEN FINANCIAL ACCOUNTING AND CORPORATE INCOME TAX

By this research it is sought not only to present the theoretical overview of relation between the taxation on corporate income tax and financial accounting legal regulation, but also to analyse this problem thoroughly on the basis of practical examples, not avoiding also specific proposals regarding solutions to problems of evaluation methods of business facts fixated in financial accounting, still to the extent which is relevant and necessary to assure proper fulfilment of tax obligation (it should be noted additionally that on the whole financial accounting is an important part not only to compute the corporate income tax but also other type taxes and their administration, still, as far as other taxes are concerned, financial accounting is relevant more in the technical aspect, therefore, in the thesis, namely relation between the corporate income tax and financial accounting legal regulation is analysed).

It is important to mention that beginning of tax obligation shall mean a counting of tax base for which evaluation are necessary the basis of the legally valid documents which must contain all the mandatory requisites of financial accounting documents provided for by the legal acts that regulate financial accounting. In other words, financial accounting is a legal basis for calculating taxes and appropriate execution of tax obligation.

In other words, financial accounting is necessary for the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners, and other stakeholders. Financial accounting gathers and summarizes financial data to prepare financial reports such as balance sheet and income statement for the organization's management, lenders, suppliers, investors, tax authorities, and other stakeholders. Financial accounting theory accents two gradual categories asset → ownership or ownership → asset. These categories disclose that asset which is recognized in financial accounting must always have an owner. Axiom is defined as an asset which is equal to ownership and this relationship is described by scientists as the

fundamental financial accounting equation (Warren, C. S.; Reeve, J. M.; Duchac, J. E.; 2007, 54; Bukevičius, J., 2009, 33; Goldberg, L., 2002, 2; Vanzante, N., 2013, 35).

It could be revealed that the fundamental financial accounting equation was researched by scientists of economics. On the other hand there is not disclosed in scientific literature that nature of the fundamental financial accounting equation is based on legal relations. If an asset is not an object of legal relations (there is not ownership of this asset), than the fundamental financial accounting equation can not be recognized. The conclusion of the last sentence is based on the systemic review of financial accounting theory, legal regulation of financial accounting elements and practise. Consequently, the fundamental financial accounting equation presupposes the legal nature of financial accounting. According to the legal nature of financial accounting, analyzed core subject-matter of economics (financial accounting) must also become a core subject-matter of law.

As the following analysis declares, financial accounting rules can be used for recognising income and costs as well as tax law norms (corporate income tax example). In addition to this, tax investigation shall mean monitoring the tax payer's activities by the tax administrator, which includes an analysis of tax returns, customs declarations, documents and any other information available about the tax payer, also visiting taxpayers, controlling their activities with a view to identifying and eliminating any deficiencies and contradictions in respect of the calculation, declaration and payment of taxes. In this view, financial accounting could be described as an instrument of taxpayer control for purposes of tax investigation. So it is important to reveal that these arguments express meaningful point why research of financial accounting is necessary for tax law or why it is important to analyse the legal relationship between financial accounting and corporate income tax.

ANALYSIS OF SCIENTIFIC LITERATURE ABOUT PROBLEMS ON TAXATION AND FINANCIAL ACCOUNTING

Recently, the connection between legal regulation of financial accounting and taxation on corporate income tax as the subject of scientific research have been met more and more frequently disclosed in the works of authors from west Europe countries, paying attention to the fact that increasing number of law scientists, still not economic science representatives, in their works, emphasize the need for systematic works in legal and financial-accounting analysis. Due to this reason, the works of such scientists also should be investigated in order to provide additional arguments why it is important to analyse the connection between legal regulation of financial accounting and taxation on corporate income tax. As a consequence, the main arguments of scientific literature of such research and main thesis are being disclosed in this article.

One British economist, pointed out that "lawyers themselves will take from the economics theory any experience beneficial to them and due to this, they will have a decisive advantage against economists when carrying out research in some specific fields they know better" (Posner, R. A., 2004, 310), for example, in tax law. Some authors had criticized the statements that law is a matter for persons with legal education only, and that economic science is a matter doctors of economic sciences are concerned about and nobody else, accepts this approach (Posner, R. A., 2004, 310). Not only in the works by

such authors but also by other scientists (Hayek, F. A. von., 1998, 173–175; Hayek, F. A. von., 1999, 83 – 86; Dworkin, R., 2005, 291 – 293, 295; Berman, H. J., 1999, 27), one can read that interdisciplinary approach and application of specific knowledge of economic sciences to research in law is a feature of constructive legal regulation creation, to be encouraged and reasonable. It should be noted that in theory of law one can meet even ideas maintaining that taxation, tax income levying in the state budget and reallocation (hence application of financial accounting standards necessary to impose corporate income tax on legal entities, as after the provisions of financial accounting have been incorporated into the rates of tax on profits, they become tax provisions) are not a subject of economics (economics is not interested there) but that of jurisprudence only. The latter statement is postulated in the so called libertarian theory (Internet Encyclopedia of Philosophy: A Peer-Reviewed Academic Resource. Robert Nozick, 2014) and also it may be discernible in such a paradigm of law as utilitarianism (Davies, H.; Holdcroft, D., 1991, 205 – 212). Nevertheless, not making an absolute the validity of these theories, and not denying interdisciplinary approach of the thesis itself, it should be stressed that intellectual, technical and economic development of mankind is constantly affecting the law, therefore, over the last decades, beside the traditional institutions regulating legal relations, new, complex and detailed legislation occur that regulate important fields of economic-legal relations (Didžulis, L., 2012, 161, 168 – 169). In this case, the analogous insights by one Lithuanian law researcher have been cited regarding complex and detailed legislation, regulating important fields of economic relations. The author also emphasizes the signal from the market when applying substantive law to take into account a specific structure of financial sector together with finance business features (Didžulis, L., 2012, 161, 168 – 169). In addition, scientists points out that law experts that specialize themselves in specific sub-branches of law not only must, but also are obliged to investigate economic science institutions, which is justified by both the results of the newest research conducted and their successful subsequent application to the practice of law (Van Den Bergh, R., 2014).

Nevertheless, the relevance of the thesis topic cannot be evaluated in the context of finance (tax) law science only – issues on relation between corporate income tax and legal regulation being analysed in the thesis partly could be developed and analysed further not in the context of law, but that of economic science (audit, financial accounting, public finance). Attention should be paid to the fact that while analysing the extent of research of the problem being investigated in this study in foreign countries, it has been noted, that in these countries an increasing number of namely legal researchers carry out their work related to this problem. For example, some scientific researchers (for example, C. P. Mitran, D. Nerudova, H. Bohušova, L. Lehis, M. Bebeselea, P. L. Vesterdorf, P. Svoboda, R. Dorsey and others) recently have raised problematic issues concerning relation between corporate income tax and financial accounting legal regulation increasingly actively; they emphasize relevance of transfer of financial accounting provisions to the laws on corporate income tax in their countries. The topics being analysed by such authors justify the relevance of this topic to the research in the finance and tax law in the Republic of Lithuania as well. The following authors (A. Ivanauskienė, B. Jefimovas, D. Pučkienė, G. Kalčinskas, J. Bikienė, J. Bukevičius, J. Mackevičius, K. Rudžionienė, K. Senkus, R. Budrionytė, R. Kanapickienė, R. Subačienė, V. Lakis and others) in the Republic of Lithuania have mentioned in their works relation

between the financial accounting and corporate income tax:, still, just generalizing in the context of economic science (from the perspective of financial accounting), not going deep into the problems of corporate income tax and financial accounting legal regulation. Therefore, the thesis topic is especially relevant in the sense of novelty and need to analyse such a legal regulation through provision of proposals how to administrate the corporate income tax and fulfil payers' tax obligations more effectively.

It should be noted that in the works of the Lithuanian Republic law researchers, one can notice insights, on the basis of which some links can be found for genesis of thesis topic relevance and “maturation” to launch investigation. It should be agreed with precise observations dated 2002, maintaining that, in order to comply with requirements set for positive law, such as reflexivity (ability to show social life) and dynamics (ability to keep pace with life, sometimes formally remaining unchanged), the positive law is forced “to overstep itself” and its own dogmatic system; that not so much the system of positive law should be stressed, but importance of legal system that includes much more elements significant in the sense of social attitude than just legal norms and other parts of a legal text; that law becomes increasingly complex, in reality it becomes including everything and requiring specific professional knowledge (Galginaitis, J., 2002, 35, 37) (for instance, specific financial accounting knowledge as means for creating justified substantive rates of taxation on profits). Other author also agrees on the latter, he stresses linkage between economic science and law science (Vaišvila, A., 2004, 217). In addition, it could be specified a tendency – an increasing influence of financiers and auditors (financial accounting specialists) in law, and is referring to these fields as “fields, closely linked to law” (Kūris, E., 1997, 395 – 396), while it could be specifically highlighted, that until there is no accounting of income, no corporate income tax could exist (Užubalis, G., 2011, 171).

To sum up, research of scientific literature definitely reveals the importance of this publication topic.

PRAGMATIC (PRACTICAL) DISCLOSURE OF CONNECTION BETWEEN FINANCIAL ACCOUNTING AND CORPORATE INCOME TAX

After analysis of scientific literature it is also important to apply pragmatic research method in this article. Consequently, practical disclosure of connection between financial accounting and corporate income tax is being revealed in this part of publication.

To sum up the usual legal regulation of corporate income tax of Europe countries it could be observed that the tax base of corporate income tax should be described as a taxable profit. Usually for the purpose of calculating taxable profit of a company, the following shall be deducted from income: 1) non-taxable income; 2) allowable deductions; 3) limited allowable deductions. It is important to mention that result in financial accounting (accounting result in profit/loss report) must be corrected for the purpose of calculating corporate income tax. Usually rules how to fill annual tax return of corporate income tax is based on correction principle from result in financial accounting to taxable result. For example, the taxable profit is derived from the financial accounting result, amended for tax purposes in Lithuania as the same principle inherent in Bulgaria, Netherlands, Slovakia, Slovenia and other countries. Thereby, corporate income tax is an example which illustrates why research of financial accounting is necessary for tax law.

Although principles are the same but the different purposes of financial accounting and taxation determines that rules of income and costs are not always the same. In addition to this, courts also declare that not all rules of income and costs in financial accounting are the same in taxation. For example, Supreme administrative court of Lithuania in 2011 June 13 decision in administrative case No. A575–872/2011 [2011]; Commission on Tax Disputes under the Government of the Republic of Lithuania in 2010 January 22 solution No. S-22(7-396/2009) [2009] declared that financial accounting recognition rules of transactions are not applicable in taxation. However, Supreme administrative court of Lithuania in 2005 March 18 decision in administrative case No. A10 - 315/2005 [2005] stated that costs are recognized using the same principles in financial accounting and taxation and also Supreme administrative court of Lithuania in 2012 February 17 decision in administrative case No. A602-1161/2012 [2012] declared that income are recognized using the same principles in financial accounting and taxation.

Moreover, there are various practical problems how concrete transaction should be taxed on corporate income tax – solution of the problem usually could be given by research of financial accounting rules. For example, how to tax bitcoins? Bitcoin is a digital currency which uses peer-to-peer technology to operate with no central authority or banks. The answer is given according to financial accounting norms. In registering economic transactions and other events in financial accounting the greatest attention shall be paid to their substance and economic nature, rather than just formal presentation requirements. Analysis of financial accounting rules show that bitcoins could be registered in financial accounting as cash equivalents which should be shown in current assets article. In financial accounting, the income from the sale of bitcoins is recognized as the amount derived from deduction of purchase price from sale price. Usually legal regulation of corporate income tax states that for the purpose of calculating corporate income tax, an entity may use the universally accepted methods of recognising income and costs as well as methods of measuring inventories unless tax law provides otherwise. For the purpose of corporate income tax, the sale of bitcoins (as taxable income) shall be recognized as the amount derived from deduction of purchase price from sale price.

In addition to this, the importance of practical disclosure of connection between financial accounting and corporate income tax shall be justified by projects of the EU and national EU member projects.

This topic also is relevant in the law of the EU law. The results of working groups of tax law of European institutions clearly reveal the need to analyse the relation between corporate income tax and financial accounting legal regulation, thus transferring specific provisions of financial accounting to the regulation of imposition of tax on profit. The compromises, achieved by states members in the meetings of Direct Tax Working Group of the Council regarding Council's directive for the common consolidated corporate income tax base, which was included in European Commission Proposal dated March 16th 2011 (updated since 2016), and is analysed in a separate sub-topic of this thesis, clearly illustrate valuation of financial accounting provisions as an integral phenomenon acting in the tax legal relations in the aspect that in the legal regulation of financial accounting, there are some rules met, which, in the case of their incorporating into regulation of corporate income tax system, this phenomenon would be provided with more clarity and stability, which would cause stopping erosion in the corporate income tax base (Taxation and Customs Union. Platform for Tax Good Governance, 2014). This

is justified by specific examples: the conditions of taxable income recognition in such a directive project *expressis verbis* have been transferred from the 14th Article (hereinafter – the Article) of the 18th IAS “Income“, approved on November 3rd 2008 by Commission regulation (EC) No. 1126/2008, which adopts specific international accounting standards in accordance with European Parliament and Council regulation (EC) No. 1606/2002 (with amendments and additions), recognition of deferrals as condition of allowable deductions – from the 37th IAS “Deferrals, Indefinite Obligations and Indefinite Assets, approved on November 3rd 2008 by Commission regulation (EC) No. 1126/2008, which adopts specific international accounting standards in accordance with European Parliament and Council regulation (EC) No. 1606/2002 (with amendments and additions) etc. (Presidency to Working Party on Tax Questions - Direct Taxation, 2013, 15 – 16; General Secretariat of the Council to Delegations, 2013, 14– 6).

Systemic analysis of mentioned financial accounting legal regulation discloses that Income from the sale of goods shall be recognized for financial accounting and taxation purposes when the goods have already been sold and the amount of revenue can be measured reliably. Goods are sold when all the following conditions have been satisfied: 1) the selling entity has transferred to the buyer the risks and rewards of ownership of the goods; 2) the entity retains neither continuing managerial involvement nor effective control over the goods sold; 3) it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably; 4) the costs related to the sale transaction can be measured reliably. What is more, only that portion of expenses of the previous and reporting periods that is related to the income earned during the reporting period is recognised as costs. On the other hand, it could be revealed that for income recognition using the accrual principle in taxation on corporate income tax (the same also in financial accounting) must be followed these conditions: 1) the selling entity has transferred to the buyer the risks and rewards of ownership of the goods; 2) it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably; 3) the costs related to the sale transaction can be measured reliably. Consequently, costs recognition terms in financial accounting and for taxation purpose are: 1) only that portion of expenses of the previous and reporting periods that is related to the income earned during the reporting period is recognised as costs; 2) the costs related to the sale transaction can be measured reliably. In addition to this, there is a special term only for the appropriate executing of tax burden – to answer the question whether legal regulation of taxation on corporate income tax does not provide otherwise.

Inter alia, a working group of the European Commission that launched its activity actively on June 10th 2013 regarding aggressive tax planning and double taxation (Taxation and Customs Union. *Platform for Tax Good Governance*, 2014), and an “Empirical Study of Applied Corporate Income Taxation for SMEs Compared to Large Enterprises”, organized by the European Commission (VVA-Europe Ltd. *SME taxation in Europe –An empirical study of applied corporate income taxation for SMEs compared to large enterprises*, 2013, 12–19) also implies simplification of the rules on imposition of tax on profits, thus nearing the basis of this tax to the accounting result.

When revealing the relevance and novelty of the thesis topic, it should be mentioned that since the beginning of the year 2015, the following institutions have launched their activity intensively: the State Tax Inspectorate under the Ministry of

Finance of the Republic of Lithuania (hereinafter – STI under FM) and a permanent working group of the Audit and Accounting Authority (hereinafter – the AAA), in the Republic of Lithuania specialists that analyses causes and cases of differences and similarities between provisions of the taxation of corporate income tax and financial accounting being managed in accordance with financial accounting rules, and classifies in respect of various topics (for instance, long-term tangible asset depreciation / amortization, income recognition etc.), thus seeking both to facilitate corporate income tax administration and assure quality of financial statements. The results of analyses being conducted by the permanent working group (cases of differences between the rules of corporate income tax and financial accounting met, their practical examples, identification methods) will be summarized and publicized on the websites of the STI under FM and the AAA. This will assist tax payers in identifying such differences and facilitate fulfilment of proper tax obligation. It should be noted, that STI under FM and AAA, some decade ago, also conducted similar collaboration in order to analyse and show differences between legal regulation of corporate income tax and financial accounting, still, this collaboration was interrupted, while material prepared at that time is not relevant at present. Thus, the existing practical problems and collaboration that starts between institutions “are sending a clear signal“ that at present there is a proper time instance to conduct also scientific research in the specific field of legal regulation being analysed, which could both assist such institutions to achieve constructive results and initiate potential changes in the legal regulation of corporate income tax, coordinating with financial accounting legal regulation.

The practical analysis of connection between financial accounting and corporate income tax also raises a question how legal differences of financial accounting and corporate income tax should be recognized for the purpose to evaluate proper legal tax obligations. The analyzed practice shows that separation of instances of recognition and final accountable / taxable result computing, based on application of accumulation principle when imposing tax on profit of legal entities, identifies that fixed and temporary (taxable and reckonable) differences between taxable / accountable income and expense occur even at the instance of recognition (the moment of primary business facts fixating in the financial accounting), but not when filling in the annual corporate income tax declaration / preparing profit and loss statement. In order to fulfil properly the tax obligation, encourage effectiveness of corporate income tax administration, it can be proposed to fixate the permanent differences in special non systemic – contingent registers, while temporary differences (taxable and reckonable) – in contingent and systemic accounts.

CONCLUSION

The differences between provisions of taxation on corporate income tax and financial accounting must not be absolutely abolished; still, they should be minimized, matching the rules of corporate income tax to the financial accounting provisions. Such an equalization of legal regulation can be justified by optimizing the costs of tax administrator and tax payers to administer / compute the corporate income tax, simpler declaration of corporate income tax and clearer application of the corporate income tax provisions.

Separation of the financial accounting from corporate income tax accounting (tax accounting) determines a clearer system of namely tax assessments of business facts that should be referred to by both tax payers who want to fulfil tax obligation properly and a tax administrator who controls the process of fulfilling this obligation. A legal concept of corporate income tax accounting (tax accounting) is to be proposed, which is possible in tax law theory: a field of financial accounting being regulated by the rules of corporate income tax in which the system of registration, classification and generalization of business operations and business events, expressed in money and intended for fulfilment of entity's tax obligation, is managed.

Prior to adopting amendments to the legal regulation of corporate income tax, also when tax administrator is preparing the comment on the taxation on corporate income tax, and this tax payers and tax administrator are assessing specific practical situations, it is purposeful at all times to assess possibilities of application of financial accounting provisions when imposing tax on profits.

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