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ACCOUNTING TREATMENT OF INCOME TAX ON DIVIDENDS PAID BY ESTONIAN COMPANIES

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ABSTRACT

This paper focuses on the accounting treatment of dividends and corporate income tax due upon the distribution of dividends in Estonia. The research problem is related to the accounting principles and comparability issues in distribution-based tax legislations. This paper aims to analyse whether the accounting of income tax in Estonia contradicts the selected accounting principles and if so, how it contradicts them. The author has selected the matching principle and the conservatism principle. The paper also aims to present the issues with comparability with other companies domestically and internationally. This paper provides suggestions on how the comparability could be improved in a way it does not contradict the selected accounting principles. The study is conducted by using a literature review and the author's analysis. Besides the acts and standards, previous articles and interpretations are used. The study reveals that accounting of income tax under both accounting standards in Estonia contradict the matching principle but do not contradict the conservatism principle. This paper will provide two possible solutions to relieve the comparability problem without contradicting the selected principles. Improved comparability could be achieved by using deferred tax liability or income tax provision. Both of the methods have many advantages and disadvantages that are discussed at the end of the paper. According to the author's analysis, the income tax provision method would be most suitable for improving the comparability.

Keywords: Accounting, IFRS, EAS, income tax, dividends

INTRODUCTION

Estonia has a unique corporate income tax system (hereinafter 'CIT system'). Latvia and Estonia are the only countries in Europe using the CIT system where companies pay income tax only when the profit is distributed, and from the profit they distributed. However, this does not apply fully to Estonian credit institutions, i.e. banks (TuMS §471(1))[1]. Because Estonian companies do not necessarily pay income tax every year, Estonia is thought to be tax heaven by a misconception. This is based on the idea that Estonia has an income tax rate of 0 per cent for the companies. These impressions are incorrect since all the ways the company wants to distribute its profit triggers the income tax liability. Most of the other European countries have a CIT system where the companies' income after expenses is taxed every year regardless of whether they distributed profit or not. This is called a profit-based tax system. In this case, companies can usually distribute the dividend without paying extra tax upon the event of declaration or payment of dividends.

This Estonian CIT system seems to create few contradictions between accounting principles such as matching principle and conservatism principle due to the accounting treatment of income tax paid only in the case of the distribution of a profit. Accounting principles are worldwide guidelines to obtain reliable and comparable numbers in financial statements (Tuovila, 2019). Besides the accounting principles, all the countries require companies to follow a set of accounting standards either country-specific or international. The Estonian government has recognized two different accounting standards that companies are allowed to use. Most of the companies in Estonia are micro- or small entities (Statistikaamet, 2019) that are allowed to use the Estonian Accounting Standards (EAS). EAS is based on IFRS for small- and medium-sized companies but it has fewer requirements for reporting. Large companies, regulated entities[2], and publicly traded companies have to use International Financial Reporting Standards (IFRS). The goal of the IFRS is to ensure the similar treatment of accounting and reporting in different countries. Smaller Estonian companies that are not publicly traded are still allowed to use IFRS if they prefer so. These standards have small differences in a way Estonian CIT is reported and how the principles

[1] TuMS means *Tulumaksuseadus* which is the Estonian Income Tax Act.
[2] Such as banks and insurance companies

mentioned above are contradicted. This paper examines how matching and conservatism principles are contradicted in IFRS and EAS. It also investigates if there is a possible way of accounting that does not contradict the principles but still ensures the reliability and comparability of the numbers.

Although the Estonian CIT system is not that new, there are no studies directly comparing and analysing these two accounting standards and how they comply with selected accounting principles. There are articles on the implementation of IFRS in Estonia and on the history of accounting standards in Estonia but those do not address the problems arising with the abnormal tax legislation. However, there has been a lot of interest in the Estonian CIT system in the legal field, but they exclude the accounting aspect of this arising from the system. This paper will combine the Estonian CIT system and both ways of accounting in Estonia. The paper aims to analyse the compliance of the reporting of the income tax due to the distribution of dividends with the matching principle and the conservatism principle in Estonia. The aim is also to analyse the comparability issues caused by the current accounting and reporting systems in Estonia. This paper will provide two different solutions to improve the comparability between Estonian and foreign companies. Also, the advantages and disadvantages of the solutions are discussed.

The structure of the paper follows a logical line starting with the introduction to Estonian corporate income tax system and how it has formed to be able to understand what makes it special and how the income tax is levied. This part includes legal aspects of income taxation as well as laws and rules for the accounting of the companies in Estonia. The second part of this paper focuses on the accounting standards and how the income tax due to the distribution of dividends should be reported under IFRS and EAS. It also deals with the accounting of dividends under both standards. This part includes also examples and demonstrations on how the income tax should be reported. After the accounting standards, accounting principles are introduced and discussed. Also, analysis on whether the accounting principles are contradicted or not and if yes, then how they are contradicted is conducted at that part. The third part combines all the information gained up to that point. Firstly, it analyses the differences and similarities between these two accounting ways and sums up the contradictions with the accounting principles. Secondly, it deals with the comparability issue and introduces two possible ways to improve the comparability by using different accounting methods available already in both standards. There is also an analysis of the advantages and disadvantages of these two suggestions and the kind of problems which would need to be faced if chosen to follow either of the suggestion.

1. ESTONIAN CORPORATE INCOME TAX SYSTEM

Estonian Income Tax Act defines the bodies obliged to pay corporate income tax in Estonia. Corporate taxpayers include all the resident companies and permanent establishments of foreign companies in Estonia (TuMS §6(4)). Income Tax Act counts a company as a resident in Estonia if it is established according to Estonian law or it is a European Public Limited Company or a European Association which has a registered seat in Estonia (TuMS §6(2)). The permanent establishment includes all the business entities that have "permanent economic activity … carried out in Estonia." (TuMS §7(1)). Business activities "conducted in Estonia through a representative authorized to enter into contracts on behalf of the non-resident" are as well considered as permanent establishments (TuMS §7(2)).

Since regaining independence in 1991, Estonia has had three different Income Tax Acts. From 1991 till the end of 1993 the CIT law was separated from personal Income Tax Act. (Lehis, Klauson, Pahapill, & Uustalu, 2008) During those years, companies paid a flat rate depending on the year. For example, in 1992 companies paid 26 per cent income tax from all the income earned (Pomerleau, 2015). Thereafter the personal and corporate Income Tax Acts were combined to one new act which entered into the force at the beginning of 1994. It faced a lot of changes during the years it was in effect leading to a law which did weaken the taxable income and made the application of the act inefficient and impended the whole competition. (Lehis, Klauson, Pahapill, & Uustalu, 2008, p. 15) Both acts levied the tax on income when it was earned like in a classical CIT system. The third act on income tax entered into the force from the beginning of 2000. The new law released the companies from year-to-year income tax obligations, in the case of not distributing any income (TuMS §6(2)). The change was made in hope of more rapid economic growth, activating businesses and creating new jobs for people (Baltic News Service, 1999) as well as tempting investors (Lehis, Klauson, Pahapill, & Uustalu, 2008, p. 15) from private and public sector to invest in companies to boost their business activity. This act also enabled equal treatment for legal persons regardless of the economic activity (Lehis, Klauson, Pahapill, & Uustalu, 2008, p. 15).

The income tax rate has changed to a considerable extent during the years. At first, there was only one rate, 26 per cent, applied to resident companies and permanent establishments (TuMS 1999, §4(1)). However, the applicable rate was not simply 26 per cent but the tax rate was divided by the sum of 100 per cent minus the tax rate. In practice, when the tax rate was 26 per cent, the taxable income was multiplied by 26/74 to derive the tax payable (TuMS 1999, §4(3)). This rate was effective for four years before it was reduced to 24 per cent in 2005. After that, the rate was reduced by one per cent every year for 3 years resulting in 21 per cent in 2008. (Estonian Tax and Customs Board, 2020) From the beginning of 2014, the tax rate was modified again. This time, the government reduced the tax rate for distributed profits from 21 per cent to 20 per cent from the beginning of 2015. This meant that the taxable income was multiplied by 20/80 to get the tax payable (TuMS §4(1)2)).

The latest adjustment to the tax rates for the business entities entered into the force at the beginning of 2019. It added the second tax rate, 14 per cent, to reduce the tax burden for companies paying similar amounts of dividends regularly. (Estonian Tax and Customs Board, 2019) It applies to the profit distributed earliest during 2018.

1.1. Main features

The Estonian CIT system includes two different tax rates for resident companies and permanent establishments. However, that does not necessarily mean that they pay corporate income tax every year since companies do not pay CIT if the profit is not distributed to owners or shareholders. (Estonian Tax and Customs Board, 2019) This allows companies to reinvest their net income to acquire new investments (assets) or keep the money in the bank account. Start-ups are particular ones who benefit from this since they will have more money to invest in new assets that generate future cash inflows for a company. This arrangement also enables faster and more stable growth for the new companies. This is a good chance for the start-ups to use the whole income wisely since the investors do not demand any dividends yet knowing the business is in the stage where they need all the money available.

Both tax rates are related to cases where the profit, or part of it, is distributed in a form of dividends or other transactions to owners or shareholders. Estonian Income Tax Act specifies the transactions upon which the tax is levied under the CIT besides the distribution of dividends. In includes transactions such as the provision of fringe benefits, gifts and donations. (TuMS §48-52) The first tax rate is 20 per cent of tax which means the multiplier of 20/80 to get the taxable amount. In this case, there is no withholding tax deducted from the payment for the recipient of the profits. (Estonian Tax and Customs Board, 2019) This is the rate that companies generally use when distributing profits.

The second tax rate is 14 per cent of the profit distributed during the year. This means that the company pays CIT with the multiplier of 14/86. Using solely the reduced tax rate is only allowed for the companies that fulfil the following requirements. Firstly, the company has to have distributed dividends regularly. Secondly, the value of dividends distributed during the year of taxation has to be equal to or lower than the average amount of dividends distributed during the last three years. However, if the value of dividends distributed is over the average from last three years, the company pays income tax at the reduced rate to the extent of the average and everything that goes over the average is taxed with the normal rate of 20 per cent (Estonian Tax and Customs Board, 2019).

When the dividend is paid to a natural person, the company withholds 7 per cent tax from the amount paid to the recipient of the profits distributed (Ibid.) This allows the government to receive the whole 20 per cent CIT. At the same time, it encourages companies to pay dividends regularly since the company will bear a smaller part of the income tax, 14 per cent, compared to the situation where it does not distribute dividends regularly and bears the whole 20 per cent. This, in turn, increases the yearly cash inflow for the government from corporate taxes. However, withholding of tax is not used if the dividend is paid to a resident legal person, permanent establishments, or non-resident legal person so the company will still pay only 14 per cent in these cases (TuMS §40-41). The following figure clarifies the taxation system in Estonia.

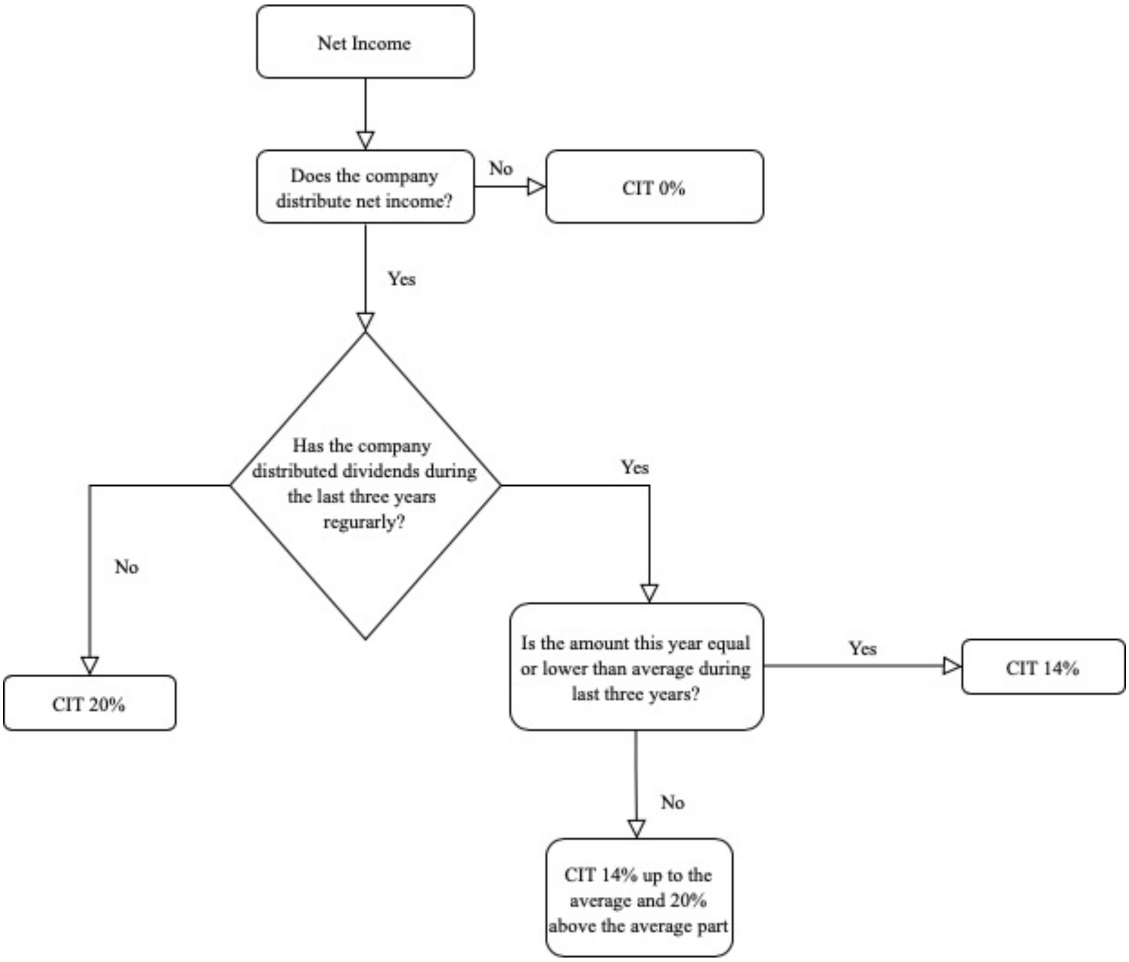

Figure 1. The corporate income tax system in Estonia

The difference in timing is not the only thing that separates the Estonian CIT system from other systems. Most of the countries with the classical CIT system, which means taxing the profits every year, have some kinds of rules about carrying forward the losses from previous years (Albert, 2008, p. 3). Since in Estonia the income tax is paid only from the distribution of the dividends or other transactions mentioned above, there is no need for special tax provisions about the carrying forward the losses for taxation purposes (Lehis, Klauson, Pahapill, & Uustalu, 2008, p. 2). An Estonian company simply records the net loss they make to retained earnings. Company is allowed to distribute dividends when the value of the accumulated retained earnings is above zero. Although the company is making a loss, it does not mean that the company will not pay any income tax from those years the make losses. This is possible since companies have to pay income tax on the other ways of distribution such as fringe benefits, gifts and donations too.

This kind of CIT system has many advantages and disadvantages for the government and the companies. The main advantage for companies is the easiness and simplicity to understand the system as well as report and pay the taxes (Lehis, Klauson, Pahapill, & Uustalu, 2008). This system attracts companies from other countries to expand their business to Estonia, for example, in a form of permanent establishment. It also supports local entrepreneurs and start-ups and enables them to grow without tax burden on earned income. In the long run, this increases the number of companies and legal entities as residents in Estonia which eventually increases the tax revenue for the government. Since companies pay taxes when distributing profits, the government may receive very different amounts of income tax revenue every year. Although, the tax inflow for the government will become steadier over time. In addition to the government receiving the taxes late, the main disadvantage for companies is the reduced comparability to other companies due to the timing of the tax. The tax legislation also affects the way the companies implement the accounting standards which in the case of Estonia emphasizes the issues with comparability.

2. ACCOUNTING

2.1. Accounting regulation

Estonian state regulates the accounting of companies in the Accounting Act (RPS). Regarding the Accounting Act, the companies must use accrual-based accounting (RPS §5). This means that the transactions should be recorded when they occur, not when the money or other way of payment changes the owner (Weygandt, Kimmel, & Kieso, 2015, p. 102). Estonian resident companies have to use double-entry bookkeeping (RPS §6) and keep all the accounting related documents to provide proof to tax authorities if needed (RPS §12(1)). Double-entry bookkeeping means that every journal entry has to include both credit and debit side and the total amounts have to be equal (Powers, Crosson, & Needles, 2014, p. 42). This means that when a company buys supplies for cash with a value of 100 euros, it debits supply expense and credits cash. This also affects the t-accounts and by that the financial statements of the company.

Every year a company has to prepare an annual report which includes the required financial statements and management report for the fiscal year (RPS §14(1)). The report must be submitted every year within the six months starting from the end of the financial year. Estonian Accounting Act states the two financial reporting standards the companies can use in their yearly reporting. These standards are the IFRS and Estonian Accounting Standards (EAS) (RPS §17(1)). Financial statements required regardless of which accounting standards are used, include a statement of financial position, income statement and notes to the financial statements. Besides the previous statements, cash flow statement and changes in owner’s equity are required from the companies using the International Financial Reporting Standards (IFRS) and large and medium-sized companies using EAS (RPS §15). However, micro and small-sized companies using EAS are allowed to comprise the cash flow statement and changes in owner’s equity if they want but it is not required (RPS §15 (21)).

These Estonian accounting rules come mainly from the European Union's legislation. For instance, the reason for the usage of accrual-based accounting comes from EU legislation. Directive 2013/34/EU states the requirements for annual and consolidated financial statements in article 6. Article 6(1)(d) states that "amounts recognized in the balance sheet and profit and loss account shall be computed on the accrual basis". Article 1 in the same directive obligates member countries to adopt these rules in their national legislation to assure the similar treatment of accounting as well as similar reporting in its member countries. Yet not all the practices come from EU legislation such as double-entry bookkeeping. Juta Tikk argues that double-entry bookkeeping established its place in Estonian bookkeeping practice during 1942 when Estonia was under the occupation of Germany and had to obey the rules and standards set by them (Tikk, 2010, p. 344)). Many other European countries introduced the double-entry bookkeeping already at the beginning of 1900s, but Estonia had to follow rules set by Soviet government during those times and they allowed the usage of double-entry bookkeeping only in a few situations. However, double-entry bookkeeping is nowadays a norm for accounting in Europe and most countries around the world.

2.2. Accounting standards

2.2.1. International Financial Reporting Standards

IFRS has many standards, guidelines and implementation recommendations. Most of them are not directly related to taxes and the distribution of dividend so, in this paper, only the ones that have a direct impact on the accounting treatment of dividends in Estonia and income tax levied upon their distribution are considered. The first standard, IAS 12, focuses on the calculation of income tax and how it is recorded in different situations. It is the most important standard to take into account when thinking of accounting treatment of dividends in Estonia. The second standard is IAS 7 and it focuses on the statement of cash flow and how the items should be recorded in them.

IAS 12 directs the right way to account the income tax under IFRS. (Deloitte, 2018) In the case of Estonia and other countries that have distribution-based taxation, there is no deferred tax based on IAS 12.57A (KPMG, 2020, p. 7). This means that companies are not required to record deferred tax since the distribution of profit is not usually certain at the end of the accounting period. However, IAS 12.82A requires companies in distribution-based tax legislation to report the possible income tax effect from the dividends. It does not specify whether the amount should be based on the current year's profit or the maximum amount of dividends that can be distributed.

Since there is no deferred tax obligation, Estonian companies will record the previous year's income tax during the year the income tax is paid (Kallasmaa, 2020, p. 5). That creates a comparability issue with Estonian and foreign companies that record the tax liabilities during the year the relative profit is earned. The income tax expense arising from the payment of dividends is not recorded in the income statement. According to IAS 12.58(a) taxes arising from "a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity" are not recorded in a profit or loss statement. This means that the income tax due to the distribution of dividends is recognized straight in equity under retained earnings, not in an income statement (IAS 12.61A).

In practice, the tax liability is recorded as current tax liability when the company announces that it distributes profits. Since tax liability arises at the moment of the recognition of dividends, the tax should be recorded in a journal entry that debits retained earnings and credits tax payable. Dividends are recorded in an entry where retained earnings are debited, and dividends payable is credited. At the time of the payment of dividends, the dividend payable is debited and cash credited. When the tax is paid the journal entry should debit tax payable and credit cash. For example, a company has a net profit of 250,000 during the first year in operation in 2019. On the first of March 2020, the company held an annual meeting where shareholders decided to distribute 100,000€ worth of dividends to the owners of the shares. Since the company has not distributed dividends before, it has to pay 20 per cent income tax on the distributed income. The payment of dividends is decided to be the first of May in 2020 and the income tax is paid on the 10th day of the following month from the payment due to the regulation in Estonia (SORAINEN, 2012, p. 12). Figure 2 shows the journal entries the company makes and figure 3 shows the simplified financial statements for the year 2020.

1.3.2020	Retained earnings (dividends)		100 000	
		Cash dividend payable		100 000
	Retained earnings (tax)		25 000	
		Income tax payable		25 000
1.5.2020	Cash dividend payable		100 000	
		Cash		100 000
10.6.2020	Income tax payable		25 000	
		Cash		25 000

Figure 2. Journal entries

Cash flow statement	
Cash flow from financing activities	
Dividends paid	-100 000
Income tax from paid dividends	-25 000

Statement of Financial Position	
Equity	
Common stock	50 000
Retained Earnings	125 000
(net income 250,000 minus dividends and income tax)	

Figure 3. Financial statements for the year 2020

As can be seen from figure 3, there is no income statement since neither tax expense nor dividends affect it under IFRS. Income tax is recorded directly under the retained earnings (figure 2) since the item that triggers the tax expense is recorded under the equity. In most cases, income tax arisen from the declaration of dividends in Estonia is reported under cash flow from financing activities, not under cash flow from operations as it is done in normal profit-based tax legislation. The reason is that in Estonia income tax from the distribution of dividends can be considered to relate more strongly to financing than normal operations of the company because an Estonian company can operate without paying any income tax but the financing activity, of which a payment of dividends forms part, triggers the liability to pay income tax.

Regarding IAS 7.35, paid income tax may be recorded under the cash flow from financing activities if the tax can be specifically identified with financing activities. Estonian Accounting Act states that companies can report operating activities by using a direct method or indirect method but investing and financing activities should be reported by using only the direct method (RPS §19 (3) and 4)). The Accounting Act does not specify in which category the income tax should be reported so the decision power remains in companies. The reason why some of the Estonian companies report the income tax from the distribution of dividends under the cash flow from financing activities is that they think the income tax paid relates rather to the optional financing activity which is the payment of dividends than directly to the operations of a company. Doing so, it is separated from the other tax obligations such as income tax paid in other countries. Direct method shows only the gross receipts and payments in each category whereas indirect method adjusts the net profit and net loss with the non-cash transactions. However, both of the methods report the income tax similarly even though the rest of the items are recorded differently.

2.2.2. Estonian Accounting Standards

Even though EAS is separated from IFRS, it is still based on IFRS for small and medium-sized companies (SME IFRS). The main differences with the IFRS are the reduced disclosure obligation and simplified accounting and management of different accounting areas (Larson & Street, 2004, p. 100). For example, one difference compared to IFRS for SMEs is that Estonian micro and small companies can issue a shortened version of an annual report which is not allowed under SME IFRS (EAS 2.56). Shortened version means that companies have to issue only income statement, the statement of financial position and notes to the financial statements. Compared to IFRS, EAS is a simplified version where there are more examples in the standards, and they are explained in more common language so that even the entrepreneurs that might not have accounting background will understand the standards and will know how to record and report the items. EAS also matches better the needs of micro and small companies in accounting since they are less time consuming than IFRS which also reduces the accounting costs for companies that are at the beginning of their journeys. When it comes to the accounting treatment of income tax based on the distribution of dividends, EAS 2, 8, and 15 should be reviewed.

Under EAS, the income tax from the distribution of dividends is reported in the income statement, the cash flow statement and the notes to the financial statement. EAS 8.46 states that the income tax expense arising from the payment of dividends or other assets under the income tax law should be recorded during the period the tax has arisen. This means that the income tax expense from profit earned in 2019 but distributed in 2020 should be recorded as an expense in 2020. CIT due to the distribution of dividends is reported in the income statement visually the same way as any other company would record it under the profit-based tax legislation. However, the difference is that companies in profit-based tax systems record the income tax during the same year the profit is earned whereas in Estonia the tax is recorded during the year it is paid which might be for example eight years after the profit was earned. Every company using EAS has to issue an income statement even the micro and small companies. EAS has two different formats for income statement but they do not differ in a way the income tax is recorded. Both ways have the same ending of the income statement where the tax is deducted from profit before tax. The format for the income statement is presented in appendix 1. Even though the presentation of the income tax in the income statement is same than for the companies in profit-based tax legislations the calculation of the tax amount is calculated very differently.

The second statement, where income tax can be found, is the cash flow statement. Income tax can be recorded under two different activities –operating or financing activities. EAS 2.38 states that paid income tax should be reported under cash flow from operating activities, but income tax from the distribution of dividends can be reported under cash flow from financing activities if a company wants. Since EAS 2.38(d) does not obligate companies to report the income tax under financing activities, they are allowed to report it under the cash flow from operating activities if preferred. The visual presentation is similar to the IFRS or dividends under EAS.

EAS 15 focuses on what to include in the notes to the financial statements. For companies issuing a full annual report, points 5-58 of EAS 15 state the required disclosures to be written into the notes. EAS 15.26 focuses on equity under which also dividends belong. It does not clearly say anything about the dividends since they should be recorded in financial statements. However, point 26(e) states that notes to equity should express “other changes in equity, if not described in the statement of changes in equity” which could be seen in a way that distributed dividends may be disclosed in the notes if the company wants. Disclosure of income tax, in turn, is stated more explicitly. The note about income tax must include information about the possible future income tax expense from the distributed dividends if the entire net income received during the year would be distributed as dividends (EAS 15.43). This does not mean that the possible income tax expense is expensed yet or recorded in any other ways in the company’s bookkeeping. This is just a piece of information for external users about the maximum income tax expense from the distribution of dividends that might affect the company’s next year’s result. Company has also a liability to separate all the different components of income tax stated in the income statement. This means that it separates the income tax gained from distributed dividends and tax expenses or benefits arisen from foreign subsidiaries if a company has them. (EAS 15.44)

For micro and small companies, which issue the shortened annual report that does not include cash flow statement or the statement of changes in equity, the disclosure requirements are a little bit different and shortened as well. Small companies have two options, either do the full disclosure presented above or use the requirements in EAS 15.59. Micro-sized companies have even more discretion since they are allowed to use both ways the small-sized company can use but besides that, it can us the disclosure requirements stated in EAS 15.60. Neither of the points allowed in the case of the shortened annual report, say anything about the requirements for disclosure of dividends or income tax from dividen

ds. However, EAS 8.45 states that “According to the Estonian tax acts, the entities cannot pay out all their available shareholders’ equity, but a portion of it will cover the income tax on dividends. No provision for the income tax on dividends shall be recognized before the dividends are declared, but disclosures regarding it shall be made in the notes”. This indicates that small and micro companies do have to specify the value of income tax in the case of distributing the maximum possible amount of profits to the in the notes.

2.3. Accounting principles

One way to define accounting standard is “a common set of principles, standards and procedures that define the basis of financial accounting policies and practices“ (Kenton, 2019). This means that accounting standards set the rules on how certain items in bookkeeping are calculated, how they are shown in annual reports and what kind of journal entries a company is allowed to make. The goal of the accounting standards is to ensure the quality of financial reporting (Barth, Landsman, & Lang, 2008, p. 468) and the uniformity between the companies that are using the same accounting standards (Sunder, 2010, p. 100). Accounting standards also ensure the comparability of the different companies in different countries if the companies are using the same accounting standards. Even though companies in different countries use the same reporting standards, they are not directly comparable due to differences in tax laws. For example, a company that pays 30 per cent CIT on all the income earned has lower a net income than an Estonian company which does not pay CIT since it did not distribute profits. This may cause a wrongful analysis of a few ratios, such as profit margin ratio and assets turnover if the analyst is not aware of differences in tax laws. Countries can choose by themselves which accounting standards to require and from what kind of companies. However, there might be some restrictions if the country is part of some union. In the case of Estonia, it has to obey the regulations and directives given by the European Union regarding the accounting standards. The EU regulation (EC) No 1606/2002 requires all the companies listed in the EU member countries to use the IFRS in their accounting and it allows member countries to choose by themselves if they extent the requirement of IFRS to non-listed companies as well (European Commission, 2020).

In 1995, Estonia created new accounting rules which were aligned with IFRS by law being the first country in Europe to do so. However, there were still items missing from the law such as guidelines on how to calculate inventory or the cost of it subsequently. (Alver, Alver, & Talpas, 2014, p. 240) Estonian companies have been allowed to use IFRS instead of EAS from the beginning of 2003 when new accounting law and new accounting standards were entered into the force. (Haldma, 2003, p. 509) After that, the main change was in 2004 when Estonia adopted the EU law which set the criteria which companies are obligated to use the IFRS instead of nation’s own accounting standards. Besides the publicly traded companies, IFRS is required from the following companies who do not trade in regulated markets: credit institutions such as banks, insurance companies, financial holding companies, investment firms and mixed financial holding companies (IASB, 2016). All the other companies are allowed to use IFRS even the smallest ones, which is not a normal practice in some countries (IASB, 2016), for example, in Brazil domestic companies not traded in regulated markets are not allowed to use IFRS (Deloitte, 2019). Generally, Estonia suggests small- and medium-sized (SME) companies to use Estonian Accounting Standards issued by the Accounting Board of the Republic of Estonia since it is much simpler compared to IFRS (Republic of Estonia E-Residency, 2019).

2.4. Conflicts with accounting principles

Accounting principles play an important role in every countries' own accounting standards as well as on the international level such as in IFRS (Powers, Crosson, & Needles, 2014, p. 12). They are like a core for the whole accounting system. Accounting principles are generated to ensure that companies worldwide have essentially similar accounting. Without these principles, it would be difficult for investors to understand financial statements from companies from other countries and evaluate them. Even though these principles set ground rules and helps investors to evaluate financial statements, it does not mean that all the financial statements would be directly comparable with each other's since they use different financial reporting standards. For example, different accounting standards have different guidelines to evaluate the value of the assets and the investor should not make any major decisions without knowing how the used accounting standards work. These principles are not a new invention as they have existed already for hundreds of years. Accounting principles include several rules considering very basic events of bookkeeping such as the moment when the transactions should be recorded and how to decide which transactions should be recorded (Powers, Crosson, & Needles, 2014, p. 12). Accounting principles instruct and obligate companies to report actual and reliable numbers in their financial statements. (Tuovila, 2019)

Since neither of the two sets of accounting standards requires the usage of deferred tax in the case where the income tax is paid from the distribution of dividends, the income tax is not recorded during the same period with the relative revenue. This seems to contradict one of the most basic principles in accounting – matching principle. In matching principle, the company should record the expenses related to the revenue during the same period the revenue is recorded (Weygandt, Kimmel, & Kieso, 2015, p. 103). A contradiction arises when a company earns profit in the year 2019 and during spring 2020 it decides to distribute the last year's profits. This means that the revenue was earned during the one fiscal year but the entry for the expense matching the revenue is made during the other fiscal year. It is important to use the matching principle to get reliable numbers every year and to ensure the comparability of company's financial statements year to year for management board and other internal users as well as for external users. For example, if a company makes a profit in year 1 but records the income tax expense in year 2 when the dividends are distributed, the profit from year 1 is higher than it should be according to matching principle. Furthermore, it distorts also next year's profit calculations as well since the tax burden fall to this year due to the payment of taxes. In the worst scenario, the company makes less operating profit in year 2 than the tax expense due to the distribution of dividends from year 1 is, so the company seems to be loss-making even though it is not.

The accounting treatment of Estonian CIT under IFRS seems to contradict the other basic accounting principle - conservatism principle. According to Steven Bragg "The conservatism principle is the general concept of recognizing expenses and liabilities as soon as possible when there is uncertainty about the outcome, but to only recognize revenues and assets when they are assured of being received." (Bragg, 2019). This means that companies should not record revenues that are not certain to avoid presenting the net income higher than it is in reality but to record all the highly possible expenses to show the external users that the company may have extra expenses that lower the net income incurring from uncertain events. According to this, an Estonian company should record the possible income tax expense if there is a high probability that the company distributes dividends after issuing the financial statements. EAS 8.45 requires companies to record the income tax that is levied if the company distributes the maximum amount of owner's equity in the notes for the financial statements. The maximum amount of owner's equity is not the book value but the value that can be distributed so that owner's equity covers the income tax too (EAS 8.45). IFRS 12.82A has a similar point with EAS 8.45 but it does not specify whether the amount should be the maximum income tax of the possible income tax for the next year. Conservatism principle is an important principle in accounting since it should ensure the reliability of the financial statements. External users will be misled through financial statements if the possible future expenses reducing the future profit are not disclosed. So, when the company records the possible expenses, the external user may prepare for the reduced net income when he or she knows that a company has a high certainty to have an extra expense.

3. ANALYSIS

3.1. Differences and similarities

Neither of the reporting standards requires or allows the usage of deferred tax liability in a recording of an income tax from the distribution of dividends in the case of distribution-based tax legislation such as Estonia. Even though the treatment of income tax is similar, the reporting of it differs between IFRS and EAS. According to the IFRS, companies are not allowed to report the income tax expense in the income statement but requires companies to record it under the equity where the dividends are also recorded. This means that under IFRS the tax expense does not affect the net income in any period. EAS, in turn, guides companies to record the income tax expense in the income statement during the period it is paid, not when the profit is earned. This means that the net profit for the current period is lower than it would be in reality considering only the expenses related to the current period's operations. This causes inequality between Estonian companies since the net income reported under IFRS is more comparable between other Estonian companies using IFRS than between two Estonian companies using EAS. Neither of the reporting ways is directly comparable to foreign companies due to the CIT system in Estonia and different numbers in statements due to the recording of income tax expense.

For example, company A is situated in Finland which has a profit-based tax system and company B is based in Estonia. Both companies use IFRS as their reporting standards. They have the same revenue and operating expenses from the last three years. However, the net income differs substantially due to the different tax expense treatment in distribution-based and profit-based tax systems. The differences in net income, in turn, affect the comparability more deeply than just the plain comparisons of net incomes. Net income is part of the most common profitability ratios such as return on equity, return on assets and profit margin. If an external user of the financial statements makes conclusions about the profitability of the company without taking into account the income tax for Estonian company, it may invest into a company that is not as profitable as the investor thought. For example, using the number above the profit margin in 2018 (net income divided by revenue) for company A is 17,5 per cent where it is for company B 25 per cent.

Company A - Finland
Income Statement for year

	2018	2019	2020
Revenue	100 000	150 000	130 000
Operating expenses	75 000	120 000	110 000
Operating income	25 000	30 000	20 000
Tax expense	7 500	9 000	6 000
Net income	17 500	21 000	14 000

Company B - Estonia
Income Statement for year

	2018	2019	2020
Revenue	100 000	150 000	130 000
Operating expenses	75 000	120 000	110 000
Operating income	25 000	30 000	20 000
Tax expense	-	-	-
Net income	25 000	30 000	20 000

Figure 5. Income statements

Besides the income statement, income tax expense is recorded in the cash flow statement. Both reporting standards guide companies to report the income tax in the cash flow statement similarly. IFRS and EAS allow companies in distribution-based tax legislations to choose whether they want to report the tax under the cash flow from operations or under the cash flow from financing activities. They both allow the usage of an indirect method in the operating activities and require the usage of the direct method under financing activities. Even though the reporting standards are similar it does not mean that companies are directly comparable. For example, two Estonian companies regardless whether they use the same standards or not, may record the income tax under different categories which means that the users of the financial statements cannot blindly compare the numbers of the companies. This applies also to the companies outside Estonia. In addition to the different calculation of the income tax, companies in profit-based tax legislations have to report the income tax under the cash flow from operating activities whereas the Estonian company using the same standards may report it under financing activities. However, if two Estonian companies record the income tax expense under the same category, they are comparable with each other regardless of whether they follow the same standards or not.

The third place where the income tax should be disclosed in is the notes to the financial statements. Both of the accounting standards require companies to disclose the possible dividends in the notes. However, the difference is that IFRS does not state whether the maximum amount of income tax should be disclosed or the amount the company might pay during the next year. EAS, in turn, requires companies to record the maximum amount of income tax if the maximum amount of owner's equity would be distributed.

To conclude, the comparability issue arises from the combination of national tax legislation and the application of the IFRS or EAS between Estonian and foreign companies as well as between two Estonian companies. Tax legislation affects the tax rate and the application of accounting standards as the tax is not paid on the profit earned but the distribution of a profit. Application of the accounting standards, in turn, leads to the different treatment of tax which causes comparability issues between companies. Investors or other users of financial statements cannot directly compare different companies if they are based in the countries that have different tax rules. For example, a Finnish company using IFRS is not directly comparable to the Estonian company using IFRS due to the differences in the accounting treatment of income tax. However, they can make conclusions more directly if the companies are based in the same country or countries that have similar tax systems and tax rates.

Even though IFRS and EAS differ from each other in the ways of accounting income tax on dividends, they contradict the matching principle and conservatism principle similarly. As explained before, according to the matching principle the expenses related to the earned revenue should be recorded during the same period with the corresponding revenue. This applies to income tax expenses as well, even though there has been discussion about the relevance of matching principle in a tax expense reporting. For example, Drinkwater and Edwards discuss in their article whether the income tax is even an expense. They argue that expenses should generate revenue and there is no revenue if there are no expenses (Drinkwater & Edwards, 1965). This means that the company could not earn any revenue without paying income taxes and the income tax should not be an expense it does not end up increasing the revenue. This could mean that the income tax should not be considered as an expense. If the income tax would not be an expense, the matching principle should not be concerned. However, there is no decision yet not to use matching principle with income taxes so, this paper considers income tax as an expense that should be matched with the relative revenue. This means that in the case of Estonia, the accounting treatment of income tax on the distributed dividends contradicts the matching principle under both standards. Neither of the accounting standards allows companies to record the income tax expense during the same period with the relative revenue. Even though both of them require the companies to disclose the possible income tax expense in the notes to the financial statements it still does not match the revenue and the expense during the same period.

Conservatism principle is much harder to examine compared to the matching principle. It has a nature of being open to interpretations which makes it difficult to investigate whether the company has contradicted conservatism principle or not. For example, one company's management board considers that a 60 per cent chance of the distribution of dividends is high enough to report the income expense and dividends in the notes whereas the other company's management board thinks that the same percentage is too low to be reported. It is hard to say whether the percentage is high enough to demand companies to report it in the notes or not, especially because the definition of the principle does not specify any probability that should trigger the liability to report expenses. Accounting treatment of income tax due upon distribution of dividends under EAS does not contradict the conservatism principle at a fundamental level since EAS 8.45 requires companies to report the maximum value of income tax payable if all the possible owner's equity is distributed. IFRS, in turn, requires companies in distribution-based tax systems to report the nature and the amount of the uncertain income tax expense if it is possible (IAS 12.82A). This means that companies disclosing the amount of possible income tax payable during the next year or the maximum amount of income tax payable in the case the maximum amount of dividends is distributed do not contradict the conservatism principle in their accounting. Since the Estonian income tax expense on the maximum amount of dividends should be easily detected, all the Estonian companies using IFRS should disclose the amount of income tax in the notes. The small difference between the accounting standards does not matter here since fundamentally both ways disclose the possible expense on the notes so that external users of financial statements can be aware of the possible liabilities company may face. However, the question may be raised whether the maximum possible amount of income tax provides enough information for the short-term investor or analyst who is trying to predict the result for the next few years and whether this should this be improved to enable the short-term profit prediction. Since this question lies outside the scope of this thesis, it will not be addressed more closely.

3.2. Possibilities to improve comparability

The problem of comparison of financial data with other companies arises from several reasons. Firstly, the amount of income tax paid by an Estonian company cannot be compared with foreign companies due to the different tax bases. This should not be considered as a major problem since external users of financial statements do not generally compare or analyse income tax paid due to the different tax rates and different tax legislations on from what companies pay CIT. Secondly, the amount of net income for a year is not directly comparable since Estonian companies using IFRS do not record income tax expense from the distribution of dividends in income statement like companies in profit-based tax legislations do. This is also a problem with companies using EAS since the income tax expense is not allocated to the years the profit is gained but recorded only in one year which may increase the income tax expense to relatively high numbers. Example 1 proves this point below. If an investor or other external user of financial statements do not know this, it can lead to false conclusions, for example, in a decision whether to invest or not to invest in a company. Thirdly, the differences in a calculation of net income for the year affects all other financial statements too. Net income is transferred to retained earning if not distributed as dividends, so it affects the statement of financial position and the statement of changes in equity. The net cash flow from operating activities is not directly comparable between Estonian and foreign company since the income tax paid due to the distribution of dividends do not need to be recorded in the operating activities in the case of Estonia. This applies also to the cash flow from financing activities because Estonian company may record the income tax paid due to the distribution of dividends there and foreign companies do not usually have that kind of expense.

Example 1. Let's assume that these following companies do not have any extra cash in the bank account besides the amount of net income for the year. Company A is based in a country that has profit-based tax legislation such as Finland and company B is based in Estonia which has distribution-based tax legislation. Both of them uses IFRS in their accounting. Company A has a profit before taxes of 100,000 and income tax of 40,000 so the net income for the year is 60,000 which could be distributed to shareholders fully. Company B has the same net income for the year, 60,000, but it cannot distribute the whole amount since it has to pay CIT after distributing the dividends. So, company B could distribute only 48,000 since it has to pay 12,000 of income tax based on 20 per cent tax rate.

3.2.1. Using deferred tax

There are a few ways the financial statements of the companies in distribution-based tax legislation could be made more comparably. However, it would require changes in both accounting standards, IFRS and EAS. The first way to fix the comparability issue is to change the standards in a way that it would require all companies to record a deferred tax liability. This would mean that a company should estimate the value of dividends to be distributed next year to be able to record the income tax expense and short-term tax liability already during the current year. This option would reorganize the recording of income tax in a very similar way the companies in profit-based tax legislations do. They make a journal entry on the last day of the year that records both income tax expense and income tax liability for the next year. If this option would be applied in Estonia or other distribution-based tax systems, it would make the financial statements look visually similar and remove the problems in comparison of net income to the extent of income tax comparison related problems. However, the issues with different tax bases and tax rates would remain but those are things that cannot be changed by modifying the accounting standards.

Even though this would seem a very good way to make the financial statements more comparable, it would cause more work and modifications of financial statements afterwards. For example, if a company has recorded a tax expense and deferred tax liability on the 31st of December in 2019. The management board estimates that the company will distribute 2 per cent of the net income of 1,000,000 as they did last three years. It would mean that the company distributes 20,000 euros as dividends which is equal to the average from the last three years resulting in the tax rate applicable of 14 per cent. This means that the company records the tax expense and deferred tax liability of 3,684 euros. In the annual meeting on 15th of March 2020, the shareholders decide that a company will distribute 50,000 euros of dividends which means 30,000 euros more than an average distributed dividend during the last three years. Now the company has two different tax rates, 14 per cent (applicable rate 14/76) for 20,000 euros and 20 per cent (applicable rate 20/80) for the other 30,000 euros. The income tax equals to 11,184 euros which is 3,684 euros plus 7,500 euros. So, the company has issued income statements that are based on the tax expense of 3,684 euros, not 11,184 euros as is should have.

If a company recorded different amount of income tax expense than the reality was, it would have to do corrective journal entries after issuing the statements, change to the opening balances for the current year's accounts has to be made (IFRS 8.42). This would apply also to cases where the company distributes fewer dividends thus the income tax expense is lower, or the company would not distribute dividends at all so there is no income tax expense for the year. The usage of deferred tax would also raise questions about what happens if the company recorded the tax expense related to profits in year X but distributed the dividends more than two years after the gaining of the revenue. Income tax liability is a short-term liability which means that it should be paid during the next 12 months (Weygandt, Kimmel, & Kieso, 2015, p. 482) so if the dividends are recognized later than that, it would create problems with the created liability and how should it be offset. The correction will cost a lot of money and delay the potential financing to the time after the correction of the financial statements.

The usage of deferred tax liability would also cause problems if a company makes a loss in some years and profit in other years. For example, a company has a share capital of 20,000. It makes a pre-tax profit of 200,000 during the first year of operations and a loss of 180,000 during the next year. Due to the usage of deferred tax, a company has to record an income tax liability of 50,000 (tax rate 20 per cent, applied rate of 20/80) during the first year. This means that the profit recorded in the retained earnings is 150,000 and total owner's equity is 170,000. During the second year, the company does not record any income tax liability since it made a loss. This means that the whole loss is recorded to retained earnings. Now, the value of accumulated retained earnings is -30,000 and total owner's equity is -10,000. Negative owner's equity means that the company has more liabilities than it can cover at the moment (Clark, 2020). In Estonia, this would mean that a company has to decrease its assets in the ways mentioned in the Commercial Code (ÄS §176 and §301)[3] or in the worst-case scenario to submit a petition for bankruptcy (ÄS §180(51) and §306(31)) according to the Bankruptcy Act (PankrS §1(3))[4].

Since the liability is calculated based on the first year's profit, not the possible amount to be distributed, it should be possible to offset the liability. The simplest way to do it is to offset the whole income tax liability. The first entry would debit income tax liability and credit income tax expense with the amount of 50,000. Now, the profit attributable to retained earnings is 200,000 instead of 150,000 so the additional 50,000 has to be recorded to equity with the entry that debits profit and credits retained earnings. The situation in the example would change so that the retained earnings would be 20,000 and total owner's equity after year two would be 40,000. However, the problem with this arises if the company distributed the 20,000 during year 3 since there is no income tax liability for the amount. If the income tax would be reassessed based on the accumulated profit it would remove the problem with the distribution of the remaining retained earnings. In this case, accumulated profit is 20,000 and the tax for that would be 5,000 so 45,000 of the value of the current tax liability would be returned to retained earnings. The retained earnings after the refund would be 15,000 which is the accumulated profit minus the tax based on the accumulated profit. This would mean that the company could distribute the 15,000 and have a tax liability recorded already based on the whole amount.

This way to increase the comparability would also satisfy the requirements of the matching principle since the income tax expense and the relative revenue are recorded during the same

[3] ÄS means *Äriseadustik* which is the Estonian Commercial Code
[4] PankrS means *Pankrotiseadus* which is the Estonian Bankruptcy Act

period. This also goes in a line with the conservatism principle since it records the income tax expense as soon as it is probable. Every company will distribute all the retained earnings at some point, either during the years of operation or at the liquidation if it has the cash to do that, so, the expense has been recorded as soon as possible. As can be seen from the previous examples, the usage of deferred tax would cause a great amount of extra work to correct the entries and accounts. Even though this would improve the comparability with foreign companies, I would not suggest changing the accounting treatment on income tax due upon distribution of dividends to this since the cost in resources outweighs the benefits this method would provide. It has also too many problems related to the Estonian tax system which has two different tax rates.

3.2.2. Using income tax provision

The other way to improve the comparability of the financial statements would be the creation of income tax reserve or provision. However, current IFRS 37 which deals with provisions does not allow the uncertain tax income expense to be recorded as a provision since it does not completely meet all the conditions stated in IFRS 37.14. If a company was allowed to record the possible income tax expense to provisions, it would be able to record the expense during the same period with the revenue without the need to do corrective journal entries after the annual meetings. This would resolve the problems with the postponement of the payment of the dividends to the future since provisions are allowed to have uncertain timing. Recording the income tax as the provision would affect all the financial statements. When a company records the provision, it debits income tax expense and credits income tax provision. It means that the income tax expense would be reported in the income statement and it would reduce the net income for the year similarly with the companies from profit-based tax systems. Provision, in turn, would be recorded as income tax provision in the statement of financial position under the equity and the statement of changes in equity. When the company decides to distribute dividends, it debits income tax provision and credits cash without having to record extra tax expenses if the amount in the provision is enough to cover the income tax payable due to the current distribution of dividends.

Here is an example that demonstrates the differences in the accounting of income tax in the case of the current way under IFRS and a probable way with the provisions. The company did not distribute any dividends during the first three years of operations but on the 31st of March in 2020 it decided to distribute dividends worth of 50,000 euros. This means that the tax rate is 20 per cent thus 20/80 applicable rate. When using the provisions, the management board decides to record the maximum possible amount of income tax in the case the whole operation income would be distributed. Here it can be seen that the current way to account income tax from dividends under IFRS keeps the net income higher due to the lack of income tax expenses and by that the retained earnings higher compared to using the provision. Provision reduces net income every year by the income tax expense the management board expects to be faced when the dividends are distributed. This leads to a lower net income and through that lower retained earnings. However, the total equity remains the same in both cases because the income tax provision is recorded under the equity. When the company finally distributes the dividends, under current way the company cannot distribute the tax burden to the years it gained the net income but has to record it straight to the equity instrument which is retained earnings. Under the provisions, the company has already recorded the tax expense to the years it made a profit so now it can use the provision it has accumulated during the years and the year 2020 will not face a high burden of income taxes. After the distribution of dividends, the total equity remains the same.

Using current IFRS

Income statement for year

	2017	2018	2019	2020
Revenue	100 000	120 000	150 000	110 000
Operating expenses	70 000	80 000	115 000	90 000
Operating income	30 000	40 000	35 000	20 000
Tax expense	0	0	0	0
Net income	30 000	40 000	35 000	20 000

31.3.2020	Retained Earnings	50 000	
	Dividends payable		50 000
	Retained Earnings (tax)	12 500	
	Income tax payable		12 500

Statement of financial position at the end of the year

	2017	2018	2019	2020
Equity				
Share capital	50 000	50 000	50 000	50 000
Retained Earnings	30 000	70 000	105 000	62 500
Total equity	80 000	120 000	155 000	112 500

Using provisions

Income statement for year

	2017	2018	2019	2020
Revenue	100 000	120 000	150 000	110 000
Operating expenses	70 000	80 000	115 000	90 000
Operating income	30 000	40 000	35 000	20 000
Tax expense	7 500	10 000	8 750	5 000
Net income	22 500	30 000	26 250	15 000

31.3.2020	Retained Earnings	50 000	
	Dividends payable		50 000
	Income tax provision	12 500	
	Income tax payable		12 500

Statement of financial position at the end of the year

	2017	2018	2019	2020
Equity				
Share capital	50 000	50 000	50 000	50 000
Retained Earnings	22 500	52 500	78 750	43 750
Income tax provision	7 500	17 500	26 250	18 750
Total equity	80 000	120 000	155 000	112 500

Figure 8. Example of the differences in accounting of income tax under IFRS

The situation under EAS is very similar to the IFRS. At the moment, it is prohibited to record the income tax under provisions since they do not fulfil the similar requirements in the EAS 8.9. Even though the EAS has the same benefits and problems than IFRS regarding the possible use of provisions when recording the income tax, there is a difference in visual execution and the value of the accounts. This is demonstrated using the same example than used with IFRS. However, in the case of EAS, the net income for the year 2020 is relatively lower than in previous years due to the tax burden. The tax is also recorded differently, not straight to the equity as it was done under IFRS.

Using current EAS

Income statement for year

	2017	2018	2019	2020
Revenue	100 000	120 000	150 000	110 000
Operating expenses	70 000	80 000	115 000	90 000
Operating income	30 000	40 000	35 000	20 000
Tax expense	0	0	0	12 500
Net income	30 000	40 000	35 000	7 500

31.3.2020	Retained Earnings	50 000	
	Dividends payable		50 000
	Income tax expense	12 500	
	Income tax payable		12 500

Statement of financial position at the end of the year

	2017	2018	2019	2020
Equity				
Share capital	50 000	50 000	50 000	50 000
Retained Earnings	30 000	70 000	105 000	62 500
Total equity	80 000	120 000	155 000	112 500

Using provisions

Income statement for year

	2017	2018	2019	2020
Revenue	100 000	120 000	150 000	110 000
Operating expenses	70 000	80 000	115 000	90 000
Operating income	30 000	40 000	35 000	20 000
Tax expense	7 500	10 000	8 750	5 000
Net income	22 500	30 000	26 250	15 000

31.3.2020	Retained Earnings	50 000	
	Dividends payable		50 000
	Income tax provision	12 500	
	Income tax payable		12 500

Statement of financial position at the end of the year

	2017	2018	2019	2020
Equity				
Share capital	50 000	50 000	50 000	50 000
Retained Earnings	22 500	52 500	78 750	43 750
Income tax provision	7 500	17 500	26 250	18 750
Total equity	80 000	120 000	155 000	112 500

Figure 9. Example of the differences in accounting of income tax under EAS

Usage of provisions would flatten the burden of income tax expense in both cases especially when the company does not distribute dividends regularly or the amount of dividends varies a lot from year to year. This would also make the net income of Estonian companies more comparable between foreign companies and by that effect to all the other financial elements in the statements that have a connection with net income of income tax expense. However, this kind of system that records an expense in a certain period even if the expense is uncertain, will cause the net income to be more unreliable because the recorded expense may not correspond to actual expense. Yet, the current system has the same problem since the net income for the year is higher if the company did not distribute dividends that year than it would be if the income tax related to that year's distributed net income was allocated to the corresponding year. Still, there is a difference between the current system's problem and possible usage of provision. When a company records the actual income tax expense that was originated from the distribution of dividends, the management has hardly any way to alter the value of net income. Whereas, if the management board was allowed to choose the amount of income tax expense and provision, they could reduce the income tax during the current year to make the net profit positive instead of negative. The solution could be a certain percentage that companies would have to use when calculating the amount of provision from the operating income. This could be 20 per cent or 14 per cent depending on whether the company distributes dividends regularly or not. However, it would be easiest to decide only one tax rate to use despite the regularity of the dividend payments, for example 20 per cent, to avoid the recalculation of tax provisions and corrective entries if the company cannot meet the requirements to use the reduced percentage. If the two percentages will be used in this system, it should be decided how the corrective entries are made if those are even required. The correction of the entries would happen similarly to the deferred tax. This would affect the opening balances of all the statements issued after the corrected year which would require a lot of extra resources like in the deferred tax too. On the other hand, if the corrective entries would not be required, the company would not have enough value in tax provisions to distribute the maximum amount of dividends which leads to a problem how to resolve the situation.

This way of accounting the income tax on dividends is in a line with the matching principle as well since the income tax expense is recorded during the same period with the relative revenue. This is also in line with the conservatism principle for the same reasons. Using provision would be a better way to improve comparability compared to the usage of deferred tax if there would be only one tax rate in use. With a single tax rate, this method does not need any corrective journal entries or modifications to the opening balances for accounts related to income tax. This would also be a better way to treat the income tax on dividends than either of the current accounting standards. The reason this would be better is that the numbers related to net income or profitability would be more comparable to foreign companies as well as to other Estonian companies since the timing of the distribution of dividends would not affect the net income.

CONCLUSION

This paper is designed to consider the Estonian corporate income tax system on the income tax due to the distribution of dividends in the same paper with both accounting standards allowed to use in Estonia – IFRS and EAS. The paper analyses the accounting and reporting treatment of income tax under both standards. There are no previous studies that combine the fields of accounting and law of income taxes in Estonia. Issues between the European Union legislation and Estonian corporate income tax legislation been studied in a great length. There are also studies on the history of accounting standards in Estonia as well as the implementation of IFRS from small and medium entities. There are studies and articles on the comparison problems between U.S. GAAP and IFRS but not between EAS and IFRS. The paper aimed to analyse whether the accounting of income taxes contradicts certain basic accounting principles, and if so, how do they contradict the principles. The chosen accounting principles were matching principle and the conservatism principle. The aim of the paper was also to analyse the issues of the comparability of the financial statements due to the differences in the reporting of the income tax. Besides that, the paper aimed to propose methods available in both standards to improve the comparability between Estonian and foreign companies.

It is found that both sets of the accounting standards used to report the income tax on dividends in Estonia contradict the matching principle. Matching principle requires to report the expenses related to the revenue during the same period which is not the case in Estonia at the moment. Neither of the accounting standards allows the usage of deferred tax in distribution-based tax systems, so the companies record the income tax expense upon the distribution of the dividends not during the period the relative income is earned. Conservatism principle, in turn, is harder to examine and analyse due to the ambiguous nature of it. However, since the amount of possible income tax payable due to the possible distribution of all the retained earnings has to be disclosed in the notes to the financial statement under both accounting standards, neither of the accounting standards contradict the principle in a fundamental level. However, this may raise a question whether it is enough to report the maximum amount of income tax since it does not tell the possible cash outflows during the next year or few next years. Usually, a company does not distribute the whole retained earnings at a time but keeps some of it on the account.

The other aim was to examine the comparability issue of the financial statements due to the different accounting treatment of income taxes from the distribution of dividends. A reason for the comparability issue is a combination of differences in national legislation and differences in accounting practices. Estonian income tax legislation itself differs from most of the countries as the companies do not pay income tax if the profit is not distributed. Due to the different tax bases, the accounting treatment has to be different. Under IFRS, Estonian companies do not use deferred tax liability when recording income tax expense. This leads to the net income that is not comparable to foreign companies. Net income for Estonian company does not include tax expense even if the company paid taxes that year because it is recorded directly in the equity which means that the net income for Estonian company is higher than for a foreign company. This distorts, for example, the calculation of profitability ratios which are used to evaluate the company's performance. It may lead to unfavourable investment decisions or surprises if the investor is not aware of the differences. Deferred tax liability is not used in EAS either. However, the income tax expense is reported in the income statement in the year in which it has been paid, not straight through the equity. Even though it is recognized in the income statement it does not make it comparable with foreign companies since the Estonian income tax is not allocated to the possible corresponding years. An Estonian company may distribute dividends from more than last year's net income which means that the income tax burden might be relatively high and even drag the net income to negative numbers.

The comparability issue can be improved by changing the way the income tax is recorded. There are two ways introduced in this paper - the usage of deferred tax liability and the usage of income tax provisions. Both ways improve the comparability by recording income tax expenses every year to the income statement but have different disadvantages. This means that both proposed ways to improve comparability are in a line with the matching principle. The major problem with deferred tax is the multiple corrective entries that have to be done if the income tax recorded does not match the accrued expense. Provisions, in turn, do not have any major problems if the amount of tax is regulated by the authorities and the income tax expense recorded yearly matches to the maximum amount of income tax if the whole operation profit would be distributed. However, there might be small difficulties with the tax rate, and which one should be used when recording provisions. If the intention was to improve the comparability, the author's analysis suggests the usage of income tax provisions which would be easier to adapt and use since it does not require corrective entries done in yearly bases like the deferred tax liability would require.

This research provides a few possibilities for further studies. It includes, for example, studies to what extent the comparability issues affect the financing from foreign sources or what would be the difficulties if the provisions were applied to improve the comparability of the financial data provided by the Estonian companies. The latter could be also done in the case of deferred tax liability even though the author does not consider it to be a better way to fix the comparability issue.

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APPENDICES

Appendix 1. Format for income statement under EAS

Revenue	Revenue received from the sale of products, goods and services in the accounting period (accounted for according to ASBG 10 "Revenue Recognition")
Other income	Irregular income earned from business activities, incl. profit from the sale of property, plant and equipment, intangible assets, and investment properties; gain from revaluation of investment property; fines and interest on arrears received; net gain arising on exchange rate changes on trade receivables and trade payables (if the result is a net loss, it its recognised in "Other operating expenses")
Change in balance of agricultural produce	Changes in the balance of agricultural produce, whereas the decreases of balances are recognised as an expense and the increases of balances as a decrease of expenses
Gain (loss) from biological assets	The gains and losses arising from initial recognition of a biological asset at its fair value and from subsequent changes in fair value
Changes in inventories of finished goods and work-in-progress	Changes in inventories of finished goods and work-in-progress, whereas the decreases of balances are recognised as an expense and the increases of balances as a decrease of expenses ("negative expense")
Work performed by an entity in the production of non-current assets for its own purpose and capitalised	Materials and services that have been used in the production of non-current assets and that have been recognised as an expense under another income statement item are recognised as a decrease of expenses in this item ("a negative expense")
Goods, raw materials and services	The cost of goods, raw materials, and services purchased for core activities (e.g. production or sales activities)
Other operating expenses	The cost of services and supplies purchased for administrative and other purposes not directly related to core activities (e.g. the cost of bookkeeping services, consulting expenses, office expenses, advertising expenses, insurance, start-up and research expenses, expenses related to setting up provisions, the expense for the allowance of doubtful receivables, etc.)
Staff costs	Wages, bonuses, holiday pay, retirement benefits and other monetary and non-monetary compensations to employees for the accounting period (regardless of whether or not they have been paid out) and taxes thereon that are paid by the employer
Depreciation and impairment of non-current assets	Depreciation charge and impairment losses (write-downs and/or write-offs) calculated on property, plant and equipment, intangible assets and investment property recognised at cost
Significant impairment of current assets	Allowance for doubtful receivables, inventories and other current assets

Appendix 1 continued

Other expenses	Irregular expenses incurred during operating activities, incl. loss on the sale of property, plant and equipment, intangible assets and investment properties; loss on revaluation of investment property; fines and interest on arrears; net loss arising on exchange rate changes on trade receivables and liabilities to the suppliers (if the result is a net gain, it is recognised under the item "Other operating income")
Operating profit (loss)	
Profit (loss) from subsidiaries	Profit/loss calculated on investments in subsidiaries at equity method or fair value model dividend income and allowances and profit/loss from the sale of subsidiaries in case of cost method
Profit (loss) from associates	Profit/loss calculated on investments in associates at equity method or fair value model dividend income and allowances and profit/loss from the sale of subsidiaries in case of cost method
Gain (loss) from financial investments	Gain (loss) from long-term and short-term financial investments, incl. sale and revaluation to fair value
Interest income	Interest income on loans, bonds, finance lease agreements and other interest-bearing financial assets
Interest expenses	Interest expenses on loans, bonds, finance lease agreements and other interest-bearing borrowings
Other financial income and expenses	Profit (loss) arising from exchange rate changes of receivables and liabilities denoted in foreign currencies and related to financing and investing activities (e.g. loans given and received), interest income and other financial income and expenses not related to subsidiaries or associates or other financial investments
Profit (loss) before tax	
Income tax	Income tax expense on dividends (recognised at the time of declaring dividends) and income tax expense or benefit arising from foreign subsidiaries and deferred tax expense or income
Profit (loss) of the accounting year	
Incl. Share of profit belonging to the shareholders of the parent company	This item is used in the consolidated income statement for presenting the share of the group's profit (loss) that belongs to the shareholders of the parent company.
Share of profit attributable to the minority shareholders	The item is used in the consolidated income statement for presenting the share of the group's profit (loss) that belongs to minority shareholders.

Source: Rahandusministeerium (2018, 21), ASBG 2 Requirements for presentation in the financial statement, Explanation of income statement and statement of comprehensive income items, Income statement – format 1

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