

# THE GOING CONCERN'S ACCOUNTING PRINCIPLE AND ITS INCORPORATION IN CORPORATE INCOME TAX LAW OF SPAIN

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## **ABSTRACT**

*The main goal of this paper is to understand how the going concern's accounting principle was merged in the Spanish corporate income tax law. During this study the national tax law dispositions was analysed and an effort was made towards understanding what kind of tax figures or tax rules obey the investigated accounting principle in the studied jurisdiction. For this purpose, the spanish tax law was examined, particularly the - Ley del Impuesto sobre Sociedades. The results show that the going concern accounting principle was incorporated in the spanish accounting and tax laws, mainly because it assumes the accounting profit as a starting point to determine the taxable profit. Therefore, the accounting principles are incorporated, expressly or implicitly, in Spain's jurisdiction. It is possible to find the going concern accounting principle in several tax figures, such as the deduction of tax losses, the reinvestment and the capitalization reserve. The recognition or use of these fiscal figures by the company shows its determination in continuing to develop its activity. The case of the deduction of tax losses is one example because it makes sense that the company's taxable capacity can be determined under several tax periods and not an isolated period. Another is the case of reinvestment. When the legislator foresees an exemption, a reduction or a deferral of the tax bases in consequence of the reinvestment he deduces that this entity is fuctionig in continuity and will continue to operate in a predictable future.*

**Keywords:** *accounting principle, corporate income tax law, going concern, Spain*

## **1. INTRODUCTION**

In the 40's, a study of Paton and Littleton (1940, p. 7) assumed the "continuity of activity" as a "basic concept or assumption" that "constitutes a suitable foundation for the discussion of accounting standards which follows". They also emphasize that the entities' liquidation is not an ordinary situation, because the normal expectation is for the companies to continue their activity. But the importance of this assumption was reinforced with individual studies earlier (Littleton, 1938; Paton, 1922). As Sterling (1968) referred the "going concern" seemed to be an accounting concept totally accepted, and it has been a "necessary axiom". So, some literature did not explicitly reject it, assuming it tacitly as a model (Sterling, 1967; Wixon, 1965; Zlatkovitch & Association, 1966). Having a status as an axiom it would be expected for it to have been largely developed, but that is not the case. It was defended by Sterling (1968) and these assumptions are still unaltered today (Berglund, Eshleman, & Guo, 2018; Holzmann & Munter, 2015; Kaczmarczyk, 2018). Some authors have argued that the going concern is a necessary assumption to accounting (Paton & Littleton, 1940). Others defend that it is a necessary concept to the corporation's management (Grady, 1965; Trainor, Phillips, & Cangialosi, 2018). On the other hand, there are also those relate the going concern postulate with the company's successful activity, assuming that its continuity is not expected if the entity presents continuous losses (Grady, 1965; Graham, 1959). The relevance of the going concern accounting principle was also recognized by international accounting associations. "The primary function of accounting is to accumulate and communicate information essential to an understanding of the activities of an enterprise". "To accomplish this function most effectively, accounting must to develop within a definite framework of concepts and standards" (American Accounting Association, 1957, p. 536).

In the same document, the American Accounting Association (1957) recognizes the accounting underlying concepts, in which is included the "Enterprise Continuity". In this document it is possible to read that "in the absence of evidence to the contrary, the entity is viewed as remaining in operation indefinitely". This work also assumed that entities' commercial circumstances are in continuous alteration, but it is expected that conditions of the business activity will continue to satisfactorily maintain the enterprise's ability to operate. With this assumption it is expected that the assets will continue to be useful to the company's main objective and for the purpose they were purchased. On the other hand, it is expected that the liabilities will be paid on the maturity date. In order to achieve this the Executive Committee of the American Accounting Association (1948) developed the accounting concepts and standards underlying the corporate financial statements. Likewise, the American Institute of Certified Public Accountants (1973) considered "The basic objective of financial statements is to provide information useful for making economic decisions". IASC designed both the going concern and the accruals basis as "fundamental hypothesis" and "fundamental accounting assumption" (Alba 2004).

## 2. THE PRINCIPLE IN ACCOUNTING LAW

According to article 38 of the Spanish Commerce Code<sup>1</sup> annual accounts include the entities' economic transitions. These elements are registered and valued in accordance with generally accepted accounting principles, among which the going concern accounting principle. Line a) of that article states that unless proven otherwise, it will be presumed that the company continues to operate. The Capital Companies Law<sup>2</sup> does not make any express reference to this principle. It is the opposite of the preceding law, the Spanish Law of Anonymous Societies<sup>3</sup>. Article 37 of this law refers that only in exceptional cases will be allowed the non-application of the going concern accounting principle. In 1980 the Spanish Association of Accounting and Business Administration<sup>4</sup> recognized this concept as an accounting principle (AECA, 1980). Point three of the Spanish accounting law's conceptual framework, determines that in those cases in which the right application of this principle is not possible, the entity must apply the valuation standards that are more appropriate to reflect the true and fair view of economic transactions. Nevertheless, the notes to the annual accounts shall include all relevant information concerning the applicable criteria. The preparation of annual accounts should take into account all the information that may affect the going concern accounting principle, particularly the Spanish registration and valuation standard<sup>5</sup> - Norma de Registro y valoración (NVR) – number 23, that refers to the facts occurring after the close of the financial year. This standard determines that this assumption is not applied to the annual accounts if the managers know that the entities will cease activity. Even if this information is known after the end of the fiscal year (Constans, 2012). This situation occurs when the directors of the companies are aware that certain events that possibly will influence the normal operation of the company will occur. In this case, additional information must be given in financial statements. In spite of this, the Spanish accounting law refers that, if it is realistic to assume that it might be impossible for the entity to continue its normal business operation, the fall of the going concern assumption must be revealed explicitly. It also needs to be informed about the alternative hypotheses and reasons why the company can not be considered a running company. The reasons presented to justify these situations can be financial, operating, legal or other (Larraz, Hacienda, & Cuentas, 1999).

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<sup>1</sup> *Código de Comercio - Real decreto de 22 de agosto de 1885 (CC)*

<sup>2</sup> *Ley de Sociedades de Capital - Real Decreto Legislativo 1/2010, de 2 de julio (LSC)*

<sup>3</sup> *Ley de Sociedades Anónimas - Ley de 17 de julio de 1951 (LSA)*

<sup>4</sup> *Asociación Española de Contabilidad y Administración de Empresas (AECA).*

<sup>5</sup> *Norma de Registro y valoración (NVR)*

With this purpose the Resolution of October 18, 2013 of the Spanish Institute of Accounting and Audit of Accounts<sup>6</sup> - ICAC was published. This document clarifies the adopted criteria to formulate annuals accounts when the application of the going concern principle is not possible. It makes reference to concrete situations which may undermine this assumption, and which are not limited to corporate liquidation assumptions. These situations may occur due to the legal ownership and the corporate object. In the case of the legal ownership it can happen in situations such as mergers, divisions, separation of members, expulsion of members, cause of dissolution due to situation of equity imbalance, bankruptcy, dissolution and liquidation. In the case of corporate object it can occur due to deep disasters, catastrophes, real inactivity and partnerships of limited duration (ICAC & Lavandera, 2015).

### **3. CONCEPT IN CORPORATE INCOME TAX LAW**

The tax profit has an accounting basis (Smith, 2015). This means that corporate taxes uses the net profit obtained through the financial accounting to calculate the companies' taxes (Hines, 2005). The accounting profit is not assumed automatically, it is necessary to observe if corporate tax law has specific corrections at net profit (Crane & Beale, 2012). The determination of a corporate's profit needs to observe several principles known as Generally Accepted Accounting Principles or GAAP. So, if the corporate tax law assumes the companies' profit, it means that the accounting principles are designed for the tax domain (Nabais, 2018). One accounting principle is the going concern's accounting principle, that it is predicted in accounting legislation - Plan General de Contabilidad (Amat, Aguilá, & Marín, 2018). This principle is designed for the tax domain through the article 10.3 of LIS, in case of Spain (J.M. Queralt, Serrano, López, & Ollero, 2019). Thus, it is important to understand how this prediction is foreseen in accounting and tax law, particularly, in the tax law of Spanish companies. Although the LIS adopted the going concern accounting principle, it does not do it explicitly (Lapatza, Fernández, & Márquez, 2013). The accounting assumptions are tacitly accepted, without exceptions. The acceptance is made through the dispositions of article 10.3 (Ortega, 2015). Despite this, it is important to analyse how this principle is observed in this law. So, it is possible to identify situations that comply with this assumption. They are the negative taxes bases, reinvestment and the capitalization reserve. The tax losses obtained in a fiscal year can be compensated with positive tax bases obtained for the same taxpayer during the following fiscal years (Crane & Beale, 2012). In these terms article 10.1 of the LIS points out that the tax basis will be the income obtained in the economic year after deducing the offsetting of the tax loss carried forward by previous tax periods. This fiscal disposition has underlying the going concern accounting principle. It happens for several reasons. First, due to tax revenue, tax jurisdictions determine that the tax period is one year (Hines, 2005). The LIS recognizes corrections to the accounting profit in order to determine the real taxable capacity of the company. Nevertheless, the effective economic capacity of the entity can only accurate in the moment of liquidation (Sterling, 1968). Only at this time will the beginning and the end of its business' life will be known. The global profit of the company's life over the years will be obtained. Moreover, there are those who advocate a more radical taxation model, considering that business taxation should occur only when the company is liquidated (Mara, 2007). The economic ability of the companies only is real if there is a relationship with the different periods of business' life. In corporate income tax it happens due to the possibility to deduce tax losses in positive taxable bases of following fiscal periods. This process is fairer and representative of the real capacity of the entities in case the legal dispositions do not present a temporal limitation to compensate these tax losses. Any temporal limitation to the deduction, implies a departure from the taxation on the actual profit obtained, that is, the real profit. Article 26 of the same law presents the same idea.

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<sup>6</sup> Instituto de Contabilidad y Auditoría de Cuentas (ICAC)

This disposition allows the compensation of negative taxable basis without temporal limitation. This norm allows the reflection of the company's true taxable capacity. The following articles, 31.6 and 32.5 of the LIS, allow the deduction of the fiscal losses in the following years in the same terms referred previously. They refer specifically to the international double taxation and international double economic taxation, respectively. The reinvestment of the realization value is another situation that manifests the presence of the accounting principle under study. For several reasons big and small companies sell assets that are not related with their normal activity (Cholbi, 1997). Among them, the devaluation, the insufficient productive capacity, the equipment replacement needs or finding better business opportunities. These operations lead to the achievement of gains or losses. The result obtained is taxed income (DGI, 2008). However, most of the times companies sell goods of their non-current assets. They need to acquire other goods to replace the ones that were sold so that the company can continue its normal activity. But, when the profit obtained with the sale is taxed it implies the loss of economic capacity to make reinvestments in other assets (Morais, 2009). For this, tax law assumes some legal dispositions in order to reduce the taxation on this kind of income when there is an acquirement of new goods (Lapatza et al., 2013). These are tax benefits that can be tax exemptions or tax deferral (Juan Martín Queral, Serrano, Ollero, & López, 2009). Presuming that the entity has the intention to continue with its normal operation. When the legislator foresees an exemption, a reduction or a deferral of the tax bases, in consequence of reinvestments, he deduces that this is an entity that will continue to operate in a predictable future. Reinvestments require that the gain obtained with the sale will be directed to the acquisition of new asset in order to produce future economic benefits (L. A. M. Pascual & Zamora, 1998). The company can only prove a reinvestment was made by remaining in operation. If the reinvestment figure was not legally typed, the capital gain would be fully taxed at the time of the disposal of the asset (L. M. Pascual, Gálvez, Gómez, & Pino, 2013). In the LIS, it is possible to find some these kinds of situations. First, article 23.1 of the LIS assumes one reduction in 60% in the taxable basis in the gains obtained in the alienation of intangible assets. Then, concerning the mining tax regime, article 92.3 of the LIS considers a reduction of the taxable bases in a context of depletion of resources. This happens in the specific case of reinvestment in the subscription or acquisition of shares representing the capital stock of mining companies. Article 93 indicates the requirements to obtain this tax benefit. Finally, the final part of article 110.1.c) of the LIS, predicts the regime for partially exempt entities (Genders, 2019). The capitalization reserve is inserted in the Chapter that refers to "reductions in the taxable base" of the Law 27/2014 of November 27, as predicts article 25 of the LIS. This results in the non-taxation of that part of the profit that is destined to form an unavailable reserve. It does not establish any requirement of investment of this reserve in any particular type of asset. According to the preamble of the LIS, this measure is intended to promote corporate capitalization through the net equity increase. In addition it also encourages the improvement of businesses and their competitiveness. It shows a clear belligerence of the Corporate Income Tax in the replacement of the foreign capital with its own capital. The corporate capitalization, through the net equity increase, allows greater financial balance and, as a direct consequence, the permanence of the company in normal activity. The capitalization reserve, even though it does not have mandatory application in reinvestment, serves to finance the normal operation of the company, contributing to the "proper actions" of this type of economic agents. The companies' normal operation presupposes, among other requirements, the acquisition of production assets and the purchase of the equipment necessary for production. These actions promote the continuity and permanence of the company in the market.

#### 4. CONSLUSION

The accounting assumption of the going concern has recognized importance in different areas, such as the commercial, accounting and taxation areas. In the Spanish commercial law, this principle is invoked under the generally accepted accounting principles. The accounting law gives specific information on how the entities need to proceed if this assumption can not be obeyed. Therefore, annual accounts must be prepared taking as underlying a specific spanish registration and valuation accounting standard – NVR 23. The relevance of this tenet is also recognized by corporate income tax law. Here it is possible to find some tax figures that demonstrate the acceptance of this assumption. They are the reinvestment, the capitalization reserve and the possibility to deduce negative taxes bases. All that fiscal norms have as underlying the assumption that the entities will continue their activity. This recognition only happens because tax law assumes the profit determined in accordance with accounting standards, although under the possibility that the corrections of the tax will observe the income tax rules.

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