

Accounting, tax and economic profit in the furniture company

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Abstract: *Accounting, tax and economic profit in the furniture company.* The presented paper analyses the fundamentals of accounting, tax and economic profit of the company, presents the differences between them, from the theoretical and practical view. The aim of our paper is to present a transformation of an accounting profit to a tax profit on the example of a selected furniture company, formulate proposals and correction steps to eliminated attributable items to the tax base to avoid the negative difference between the accounting and tax profit, from which the company pays a higher tax income. In the end of this study, we refer to the fact that the management of a company only on the base of accounting and tax profit is not sufficient for the needs of internal requests of companies, because it does not allow the managers to make optimal manager decisions.

Keywords: accounting, accounting profit, tax profit, economic profit, EVA, enterprise management

INTRODUCTION

The aim of the business in market environment is long-term economic prosperity of businesses subjects, which is affected by making profit. Profit is considered as an essential motivating factor and also expected (preferred) result of business. Profit analysis as an important economic factor from accounting and tax point of view is a difficult process, which in some cases has contradictory nature. In terms of profitability of invested assets is required its maximization, while from tax point of view it is its minimization.

The tax system of Slovak Republic (law on income tax) respects the basic principles embodied in accounting standards for costs and returns, their substantive and temporal connection with period given, therefore the economical result found in accounting is considered the starting base from which the tax result is found after complicated modifications, calculations and deductions – tax base and payable income tax. Identifying payable tax is necessary for quantifying of the profit after tax. However, enterprises must remember that monitoring and calculating of accounting and tax profit is necessary for external presenting (tax authorities, banks, creditors, and so on), but in terms of internal management has only predicative ability for effective business management. The result is that if companies want to succeed in current competitive environment, they must be able to manage their results in terms of internal needs. This requirement is satisfied by the category of company's economic profit.

The presented paper analyses the fundamentals of ***accounting, tax and economic profit of the company, presents the differences between them***, from the theoretical and practical view. *The aim of our paper is to present a transformation of an accounting profit to a tax profit on the example of a selected furniture company, formulate proposals and correction steps to eliminated attributable items to the tax base to avoid the negative difference between the accounting and tax profit, from which the company pays a higher tax income.* In the end of this study, we refer to the fact that the management of a company only on the base of accounting and tax profit is not sufficient for the needs of internal requests of companies, because it does not allow the managers to make optimal manager decisions.

MATERIAL AND METHODS

Economical result (profit/loss) is an important financial indicator, which presents success and effectiveness of the business, namely in relation to the capital invested. It is a basic information source and a measure of financial profitability of contributed capital for the accounting period. It characterizes in the financial form, whether the property invested into the business in the form of inputs is smaller or larger than the priced results in the form of outputs (Baštincová, 2007).

We can see profit (P) from three point of view, namely:

- a) accounting profit,
- b) tax profit,
- c) economic profit.

a) Accounting profit is determined by comparing costs spent on specific outputs and income for these outputs. In dependence on the amount of costs and revenues the accounting income has character of profit or loss. *This result consists of three components:*

- **profit from economic activities,**
- **profit from financial activities,**
- **profit from extra activities.**

If we sum of all three profit components, we will find the overall result of the entrepreneur. Profit is determined at the end of the accounting period.

b) Tax profit

To get a tax base for the purpose of calculation of net profit, it is necessary to adjust gross accounting profit by incomes and costs, which are included in addition of Slovak Republic (SR) charges (Act. no. 595/2003 Coll Income Tax). Gross accounting profit modified like this is a tax base from which we calculate the tax liability. We get the net accounting profit by its accounting to the costs and its deducted from the gross accounting profit. This procedure presents the figure 1.

TAX SYSTEM SR (Act 595/2003 Coll Income Tax)	ACCOUNTING SYSTEM SR (Act 431/2002 Coll accounting)
	ACCOUNTING PERIOD INCOME
	- ACCOUNTING PERIOD COSTS
	= GROSS ACCOUNTING PROFIT
+ GROSS ACCOUNTING PROFIT	
+ COSTS OVER THE TAX LAWS (tax non-deductible items)	
- INCOME OVER THE TAX LAWS (deductible items)	
= TAX BASE	
x TAX RATE = TAX LIABILITY (TAX)	- TAX LIABILITY
	= NET ACCOUNTING PROFIT

Fig. 1 Calculation of net accounting profit

c) Economic profit

Economic profit is not identical to net accounting profit. According to this concept, the company makes profit if the running costs but also *capital costs* are paid, especially *the equity costs*. If the company reports accounting profit, then reports economic profit as well, but only if the accounting profit is higher than the cost of own contributed capital (we assume that the interested paid on liabilities correspond to the costs of this capital). From reasons given flows that it is lower than accounting profit, and so by **absolute value of the equity costs**. Economic profit belongs to the group of operating profits that can be calculated

in three ways: Economic Value Added (EVA), Economic Profit (EP) and Cash Value Added (CVA).

In recent years the indicator *Economic Value Added* (economic value added – EVA), which is one of the possible methods of *economic profit* expressing, is promoted more and more in economic theory as well as in companies practice with advanced market economy. Therefore *EVA indicator* is understood as *a net income from business operations, reduced by the capital costs*. *The basic* algorithm for calculating **EVA** is as follows (Neumaierová, Neumaier, 2002):

$$\text{EVA} = \text{NOPAT} - \text{Capital} \times \text{WACC} \quad [1]$$

NOPAT - net operating profit after taxes

Capital - capital fixed in assets that are used for business operational activities

WACC - weighted average cost of capital

Economic profit can be expressed as the difference between **total income** and **economic costs** (it means explicit and implicit), as it can be seen from the following relation (Neumaierová, Neumaier, 2002).

$$\text{economic profit} = \text{total income} - \text{implicit costs} \quad [2]$$

Explicit costs are costs which are in the form of expenses (salaries, materials, amortization, rent, insurance, interest...) and in terms of accounting their monitoring is not a problem.

Implicit costs are costs caused by loss from the choice of alternatives in the company and they result from the use of resources belonging to the organization or to the owner of the company (own premises, buildings, capital...). This information is not evidenced in the accounting statements about costs, returns and profit.

Therefore *economic profit* is possible to express alternatively by the following expression (Neumaierová, Neumaier, 2002):

$$\text{economic profit} = \text{accounting profit} - \text{implicit costs} \quad [3]$$

The proposed method closely corresponds with the aim of the present paper, which is the presentation of accounting, tax and economic profit company and the differences between them. The issue of accounting and tax profit is applied and verified on the example of selected capital furniture company. The accounting profit of the company is determined for accounting period (calendar year) from the income statement analysis. The *tax non-deductible and deductible items to (from) the tax base* will be *identified* from cost-benefit analysis. Profit identified in accounting is considered as the starting base from which after difficult editing, conversion and deductions tax will be calculated – the tax base and income tax payable.

Finding the actual profit of the selected furniture company is solved by *mathematical method* in terms of valid SR legislation. Recommendations and possibilities how to avoid the creation of non-deductible items during the year will be proposed on the basis of the calculations of the tax profit and its comparison with the gross accounting profit in the selected company.

RESULTS AND DISCUSSION

As we can see from the Table 1, it was identified and calculated the gross accounting profit in the selected furniture company in the monitored period.

Tab. 1 Calculation of the accounting profit

Profit type	The difference (Profit + Loss -) in €
Profit from operating activities	+85 030,73
Profit from financial activities	-12 508,58
Profit from ordinary activities	+72 522,15
Profit from extra activities	0,00
Profit for the accounting period	+72 522,15

According to the calculation specified in Table 1, the monitored company reached a positive accounting profit, i.e. *profit of 72 522.15 €*. This has to be corrected also for the identification of tax profit for non-deductible (increase the tax base) and deduction items (reduce the tax base).

In the company the following non-deductible and deductible items has been identified from the accounting documents:

551000 – Depreciation of tangible and intangible assets

Company has bought a passenger car of cost 11 451.90 € in November 2008. In this month the car was also put into use. The company determined accounting depreciations of this car on 48 months.

Table 2 shows *the difference between accounting and tax depreciations and the determination of non-deductible and eventually deductible item to the tax base*. As depreciations for 2008 were recalculated by using the conversion rate to exchange SKK to EUR, there were also some cent differences in depreciation because of this currency conversion.

Tab. 2 The difference between accounting and tax depreciation in €

Period	Accounting depreciation (AD)	Tax depreciation (TD)	Non-deductible item (AD > TD)	Deductible item (AD < TD)
2008	477,16	2862,98	-	2385,82
2009	2863,00	2863,00	-	-
2010	2863,00	2863,00	-	-
2011	2863,00	2862,92	0,07	-
2012	2385,74	-	2385,74	-

The analysed company has created an analytical account **501999 – Consumption of material (non-tax cost)**. Costs of material used are accounted on that account, which were paid by card from an account, but evidence in accounting is either missing or was destroyed. As the given materials did not satisfied the evidence condition, the entity defined it as *non-deductible item* for tax base.

Representation costs were accounted on account **513000 – Representation costs**, which are not accepted as tax deductible under the law of income tax. The account is therefore *non-deductible item* to the tax base in full amount.

Fines from the tax administrator were accounted on account **545000 – Others fines and penalties**, who did the tax control in 2008 on the tax income for the years 2006 and 2007. The account is *non-deductible item* to the tax base in full amount.

Revenue from the sale of services are accounted on account **602000 – Sales of services**. As these services are sold through a number of business partners, from which almost every one has other output data system for determination of the share of the income, condition of material and time coherence of revenue is not always observed with time period. Subject invoiced sales in the month in which his partner provided data necessary for billing. Here a considerable time lag occurred, sometimes even 6 months. In 2008 there was an income tax audit for the years 2007 and 2006, where the right time discrepancy in the billing of the services was sprained. The inspection showed that up to 2007 subject had to rate tax revenues of 39 621.52 €, which were invoiced in 2008, but earned or related to the year 2007. It means that the value 39 621.52 € is part of the final amount of the account balance. As the sales were already taxed once at 2007 for 2008 the business entity set it aside as a **deduction item** from the tax base.

The next table presents a comparison of accounting and tax profit, calculation of tax and profit after tax.

Tab. 3 Comparison of tax and accounting profit in 2008

Item	Suma (€)
Accounting profit before tax	72 522,15
Non-deduction items	1 487,59
Deduction items	- 42 007,34
Sum of non-deduction and deduction items	- 40 519,75
Tax profit	32 002,40
19% income tax	6 080,46
Accounting profit after tax	66 441,69

Accounting profit in comparison with the tax profit is higher above 40 519.75 €. The deductible items have the highest share in the difference as the difference between accounting and tax depreciation of tangible assets and the share of revenue which were time and material coherent to the previous accounting year and have been delivered to the subject after the inspection by the tax administrator.

As we say above, it was necessary to take certain steps in the context of proposals to address the elimination of item to be added, to prevent negative differences between accounting and tax results, from which the business entity is paying a higher income tax.

Proposals and recommendations for the elimination of non-deductible items:

- consistent evidence and storage of tax and accounting documents,
- establishing of internal rulebook of the accounting documents circulation,
- to claim the VAT deduction for all input documents, because VAT which is not claimed is a non-deductible item,
- in the case of payment to which a document is not passed to an accountancy office, this payment is not charged as cost (tax unrecognized), but as a claim to an employee or shareholder of the company - afterwards, he has to return it either to treasury or to a bank account,
- in the case of depreciation of tangible and intangible asset to use legal possibility not to apply the tax depreciation, and so have the opportunity to influence the tax base to some extent.

CONCLUSION

Enterprises have to respect some institutional frameworks and regulatory requirements of their business which are posed on them. The need for monitoring and calculating accounting and tax profit results from those requirements. But if companies want to be successful, they have to respect the requirements, which are not given by law, but result from

their internal needs. In relation to the profit of the company, the economic profit is an indicator, which can be measured, for example by the indicator of economic value added (EVA). The company achieves economic profit if not only running costs, but also the cost of capital (foreign and especially equity capital) are paid. Indicator EVA is also a financial analysis, management and staff motivation tool as well as business valuation tool.

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Streszczenie: *Księgowanie, podatki oraz zysk w przedsiębiorstwie meblarskim*. Praca analizuje podstawy księgowości, opodatkowania oraz zysku w przedsiębiorstwie, prezentuje różnice między nimi z teoretycznego oraz praktycznego punktu widzenia. Celem pracy jest prezentacja przemiany księgowego zysku przedsiębiorstwa do zysku ekonomicznego na przykładzie wybranego przedsiębiorstwa przemysłu drzewnego, sformułowanie propozycji i planu czynności korekcyjnych. W końcowej części prac y wykazano że zarządzanie firmą w oparciu o zysk księgowy i ekonomiczny nie jest wystarczające do podejmowania optymalnych decyzji.

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