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# #34 Accounting errors, financial information and presumption based taxation: the Portuguese case

António Martins; Cristina Sá

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## >> FICHA TÉCNICA

## ACCOUNTING ERRORS, FINANCIAL INFORMATION AND PRESUMPTION BASED TAXATION: THE PORTUGUESE CASE

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## >> ÍNDICE

## >> RESUMO

Este artigo analisa a base jurídica e contabilística que justifica a aplicação de presunções na tributação do rendimento das pessoas coletivas. Evidencia-se a relação entre os erros existentes nos registos da contabilidade financeira e a utilização de presunções pelas autoridades fiscais.
Este trabalho contribui para a literatura na medida em que oferece uma análise sistemática dos critérios utilizados pelos tribunais fiscais portugueses para decidir quando é que os registos contabilísticos das empresas deixam de ser utilizados pelas autoridades fiscais como método para o cálculo do imposto e as presunções podem, portanto, ser utilizadas para esse efeito.
Considerando a regra geral de que o rendimento sujeito a imposto é determinado com base nos registos da contabilidade (embora com ajustes estabelecidos no Código do IRC), as presunções são uma exceção notável a esta regra bem estabelecida. Como tal, os académicos, as autoridades fiscais e os contribuintes têm interesse em saber como é que os tribunais validam ou não a abordagem autoridades fiscais na utilização de presunções.

## >> ABSTRACT

*The purpose of this paper is to analyse the accounting and legal basis that justify the application of presumptions in the taxation corporate income. The connection between errors on recording transactions by the financial accounting system and the use of presumptions by tax authorities will be highlighted.*
*The paper contributes to the literature by offering a systematic analysis of the criteria used by Portuguese tax courts to decide when accounting data can be disregarded by tax authorities and presumptions can therefore be used as a tax computation tool.*
*Given that the general rule is to base taxable income on accounting records (albeit with adjustments established in Corporate Income Tax Code) presumptions are a striking exception to this well established rule. As such, tax researchers, tax authorities and taxpayers have a significant interest in knowing how do courts validate or deny tax authorities' approach when using presumptions.*
***Keywords**: Accounting errors, taxation and presumptions, financial fraud*

## >> 1. INTRODUCTION

The application of presumption based taxation (or so-called indirect methods of taxation) as established by Article 88 of the Portuguese General Taxation Law[1] (GTL) can result from a variety of reasons. Many of them exhibit a strong connection to financial accounting. In fact, the mentioned article of the GTL states that accounting "irregularities", "errors" and "inaccuracies" may constitute grounds for presumption based taxation[2].

The crucial question that is not addressed by the legal text of the GTL is how to establish the frontier that, once being crossed, justifies discarding accounting data and basing the computation of taxable income on presumptions or indirect methods. That is, how to define the boundaries of what is a sufficient level of errors or irregularities to break the link between book income and taxable income, and compute the later through the use of presumptions. As we shall see, jurisprudence, by case law, can greatly help accountants, taxpayers, tax lawyers, tax auditors and other interested parties in such a clarification of the meaning of the legal formula.

The purpose of this paper is therefore to analyse the reasons that justify the application of indirect methods, focusing on those that show a connection to errors or flaws that plague operations or transactions recognized by the financial accounting system.

The paper contributes to the literature by offering a systematic analysis of the criteria used by Portuguese tax courts to decide when accounting data can be disregarded by tax authorities, and presumptions can be used as a tax computation tool. Given that the rule, in many countries, is to base taxable income on accounting records (albeit with adjustments established in Corporate Income Tax Codes) presumptions are a notable exception to this well established rule. As such, taxpayers have a significant interest in knowing how do courts validate or deny tax authorities' approach when using presumptions.

In this light, the paper has also potential value to professionals in the accounting and tax fields. They are often confronted with tax audits that apply indirect methods of taxation. Therefore, knowing the jurisprudential trends in the judgment of such, usually complex, cases is an important issue.

1 The Portuguese designation is Lei Geral Tributária
2 "Presumption based taxation" means that accounting records are disregarded and other basis (e.g. margins on purchases, sector average profit rate, fuel consumption, etc) are used for arriving at an alternative measure of (presumed) taxable income.

Our discussion of the topic focuses on understanding how irregularities and errors affect the reliability of accounting information as a basis for taxable income computation. The analysis is mainly based on some important jurisprudence regarding the type and relevance of accounting errors as a legal basis for the application of presumptions.

Given that the concept of accounting errors can present interpretation complexities, its use by the Portuguese tax administration as a basis for the use of indirect methods is controlled by courts. Hence the importance of jurisprudential analysis, in order to uncover trends in the interpretation of rules whose actual implementation does not seem straightforward.

The paper is organized as follows. In the first section, we analyse the concepts of irregularities, errors and frauds in accounting. In this context, the NCRF 4 – "Accounting policies, changes in accounting estimates and errors"[7] is particularly dissected. Then, we discuss why these phenomena occur and who are the economic agents mostly affected by them. Finally, in the main section of the paper, we analyze the problem of demarcating the frontier between technical corrections linked to specific or localized accounting problems and the use of indirect methods, when errors are so broad that justify the discarding of accounting records as a basis for computing taxable revenue.

[3] In 2010 Portugal adopted a new financial accounting system, closely linked to International Accounting Standards. NCRF means" Norma Contabilística e de Relato Financeiro", the equivalent of "IFRS".

## >> 2. IRREGULARITIES, FRAUD AND ACCOUNTING ERRORS: BRIEF CONCEPTUAL ANALYSIS.

The problem of accounting errors, its impact on financial statements and the criteria for distinguishing between error and fraud, is an old one. We will now focus on this issue, since the application of indirect methods of taxation may result from accounting irregularities, errors and inaccuracies.

Regarding the origin of accounting errors, in a broad and economic sense, Christensen (2010: 1827-1828) argues that error is intrinsic to accounting systems, as it is to all information systems that seek to represent synthetically and objectively a corporate environment that is truly complex and subjective. According to this author, accounting serves several purposes in the context of economic systems, with diverse and contradictory interests. Conflict between users is common. Thus, errors arise out of this conflict.

Even if we adhere to Christensen´s thesis, it is necessary to seek a more practical level of analysis in order to understand the distinction between the concepts of error and fraud in accounting. In the Portuguese case, Lourenço and Sarmento (2008: 34-35) state that "error", in the context of accounting, will emerge from a random, unintentional or deliberate act caused by negligence or ignorance. "Fraud" is understood as an intentional or deliberate act, in order to obtain illicit or illegal benefits.

The distinguishing feature between error and fraud would be the intentional nature of fraud. Error would result from a fortuitous action, not intentionally malicious and not with the purpose to distort the true financial performance of firms that disclose accounting information. An irregularity can be seen as an intentional act that does not, however, have the purpose of generating an illegal advantage.

The authors highlight the difficulty that often exists in distinguishing such concepts. This difficulty is also evidenced by Mulford and Comiskey (2002), who propose a distinction between error and fraud. It is based on the fact that in "errors" the imposed boundaries of the Generally Accepted Accounting Principles (GAAP) are not exceeded, whereas in fraud these limits are surpassed, with the intent to mislead users of financial information (e.g., investors, suppliers and employees).

In the words of Mulford and Comiskey (2002: 36):

> "It is possible that there is no premeditated intent to mislead when financial statement amounts are reported outside the boundaries of GAAP. In the absence of intent such financial statements are considered to be in

> error. When errors are discovered, adjustments to correct financial statements call for restatements of prior period amounts".

As we will see, the discovery of an error may determine several consequences. Everything depends on the type of error and the respective materiality. The aforementioned authors also stress that fraud occurs when the dividing line of the legitimate choice of alternatives faced by preparers of financial information (e.g., FIFO vs. average cost; straight-line depreciation or the digit method) is exceeded. However, this apparent certainty in the definition of the criterion that separates error from fraud is tempered by the authors. They emphasize that determining the line at which aggressive accounting turns fraudulent is more art than science.

Concerning the distinction between error and fraud in the Brazilian case, Santos et al (2006: 2) state that the Brazilian Accounting Standards define fraud as an intentional act of omission or manipulation of data, tampering of documents and records to produce misleading financial statements. On the other side, error would result from an unintentional act of omission, neglect or misinterpretation of facts in the preparation of financial statements.

Once again, the intentional nature to falsify financial information - with the aim of gaining an advantage for some economic agents - is placed at the centre of this distinction. Finally, let us see the Portuguese context to understand how current accounting standards deal with accounting errors.

Thus, NCRF No.4 – "Accounting policies, changes in accounting estimates and errors", §5, states that:

> "Prior period errors: are omissions and misstatements in financial statements of the entity of one or more prior periods, arising from the non use, or misuse of, reliable information that:
>
> (a) was available when financial statements for those periods were authorized for issuance, and
>
> b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of these financial statements.
>
> Such errors include the effects of mathematical errors, mistakes in applying accounting policies, oversights or misinterpretations of facts and fraud."

Is it worth highlighting a feature of this definition of accounting errors. Indeed, errors, as defined, include also fraud. It might be thought that the distinction between error and fraud, explicitly shown before, would be merged here. The two concepts are used in an unusual similar way.

However, it should be noted that this Standard establishes criteria to correct or restate financial information. Thus, the essential feature of the

Standard is the definition of the type of errors that, when committed in prior periods, require corrections to financial statements in future periods.

Therefore, within the meaning of (unintentional) misapplication of accounting rules when they are materially relevant, errors have a similar consequence to fraud: the restatement of financial statements, in order to restore their reliability.

This means that, in our view, NCRF nº 4 does not equate error with fraud in what concerns their nature. When, in a given period, materially relevant errors and accounting frauds that affect the reliability of those statements are discovered what follows is the restatement of financial statements. The range of phenomena covered by the definition of errors contained in NCRF nº4 is understandably wider, to encompass phenomena that originate quantitative changes in accounting items.

Hence, NCRF nº4, §36 specifies:

> "36- Errors can arise in respect of the recognition, measurement, presentation or disclosure of financial statements' elements. Financial statements do not comply with NCRF if they contain material errors or immaterial errors made intentionally to achieve a particular presentation of financial position, financial performance or cash flows of an entity. Potential errors from the current period discovered in that period are corrected before the financial statements are authorized for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in financial statements for that subsequent period."

Concluding this section, it can be argued that the accounting distinction between error and fraud lies in the degree of intentionality and consequences of each other. The materiality of errors will determine the potential restatement of financial statements. The previous analysis has an eminently accounting nature. As we will see, for tax purposes - and in particular for decisions about whether to apply "presumptions" or "indirect methods of taxation" - accounting errors and irregularities are viewed through a quite different perspective.

If accounting errors and frauds are a regularly exposed phenomena, what are the reasons for their existence?

## >> 3. ERRORS, FRAUDS AND THEIR STAKEHOLDERS

The users of financial information are often surprised with disclosures on "accounting irregularities", especially by the management of large companies. Consequently, results from prior periods have to be revised, usually downwards.

The Portuguese Newspaper 'Jornal de Negócios' of November 20, 2012, reported:

> "HP is extremely disappointed to find that some former officers of Autonomy committed accounting inaccuracies, misrepresentations and failures in disclosure, to boost the company financial metrics before the acquisition of Autonomy by HP (...). The U.S. company reported its accounts today and disclosed the recognition of an impairment of 8.8 billion dollars related to Autonomy in its fiscal fourth quarter. Most of this recognition (over 5 billion dollars) is due to such "misrepresentations" that HP considered to have been committed with the "intent to mislead" investors and potential buyers."

The "game" of manipulation of financial information has many names and forms. Here are some examples, taken from the wide range of cases described in Mulford and Comiskey (2002).

Here are some designations:

- aggressive accounting
- creative accounting
- earnings management
- income smoothing
- fraudulent report

What are the reasons behind the practice of such acts from the management? The answer lies in the rewards that this manipulation can induce, such as, for example:

A- Effect on share prices

Fraudulent information may, if such informational vices are only known to a selected group of insiders, lead to higher prices of securities. It may also cause lower volatility in prices and, therefore, reduce the cost of capital (Damodaran, 2011). In a context of incentives through the allocation of stock options to high level managers, fraudulent information may increase the value of these financial options and significantly increase managers´ wealth. If the compensation of corporate officers is dependent not on share appreciation but on reported accounting income, it is also clear the incentive to manipulate recorded revenues and expenses.

B- Effects on debt rating and on the enforcement of clauses in loan covenants

Obtaining a higher credit rating is another frequent reason to induce earnings manipulation. The lower cost of debt improves financial outcomes and conveys an image of financial strength (De Fond and Jiambalvo, 1991; Mulford and Comiskey, 2002; Damodaran, 2011).

Moreover, it is usual to include protective covenants, or safeguards, in loan contracts. These clauses impose to the debtor the achievement of targets, periodically measurable, for certain indicators such as EBITDA/sales, debt ratios, or liquidity levels. The pressure for reaching such contracted financial targets can induce manipulation of accounting data.

In this wide range of ways to manipulate information, it is not easy to draw the line that separates an allowed flexibility, according to the principles established in GAAP-IFRS, from fraud.

Let us then look at some examples of manipulation by two U.S. companies, drawn from Mulford and Comiskey (2002).

The Fine Host Company began to capitalize (e.g., recognizing as intangible assets rather than expenses) expenses involved in obtaining contracts for the supply of its products. Instead of annual expenses, they were recognized as assets, thereby increasing the annual income. These values of recognized assets amounted to:

- 1994: 234,000 USD
- 1995: 3,446 million USD
- 1996: 6,277 million USD
- 1997: 13,798 million USD

In 1997, the capitalized total represented 22% of assets and 44% of equity book value. However, in December 1997, the company announced that it had discovered “material errors” in financial reporting. The chairman of the board of directors resigned, the company was removed from the stock exchange and the Securities Exchange Commission (SEC) launched an investigation.

The results (restated) were as follows:

- 1994: profit of USD 3.3 million went for losses of USD 1.6 million
- 1995: profit of 3.8 million USD went for losses of 4.3 million USD
- 1996: profit of 6.5 million USD went for losses of 6.3 million USD

Following this discovery and the disclosure of these “material errors”, the company published the following clarification:

> "The principal adjustments to net income are the result of improper capitalization of overhead expenses, improper capitalization of assets and recognition of revenue prior to earning such income".

In a second case, in 2001, the company Leslie Fay Inc. revealed a financial fraud with the following characteristics:

1. a high amount of revenue was booked based on a simple transfer of inventory to a warehouse controlled by the entity,
2. the sale of a division was recognized as product sales, affecting operating income and not the "non-recurring income",

The core issue in fighting these practices is the need to prove that a material intention existed, from the part of managers, to falsify financial information. Nevertheless, in litigation, and for the entities that control the reliability of financial information, such as the US SEC, this is sometimes very difficult. The dilution of responsibilities, the role that auditors play, or not, in the validation of accounting manipulation or in its discovery, the conflict of interest between different services or departments of large companies and the consequent lack of cooperation in internal audits, are among the many factors that contribute to a complex relationship between error, fraud and its exposure.

As De Fond and Jiambalvo (1991) conclude from an empirical study of a sample of U.S. firms, the main reason behind the manipulation of accounting information lies in the self-interest of those who control the production of information, trying to maximize the respective personal utility (income). It is a consequence of the well-known agency cost in the relationship between owners and managers [7].

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7 De Fond and Jiambalvo research revealed 41 overstatement firms but only three understatement firms, which is consistent with an income-increasing motivation. Their analysis indicates that earnings overstatements are more likely when firms have diffuse ownership, lower growth in earnings, and fewer income-increasing GAAP alternatives available. Overstatements are less likely among firms that have audit committees. These results are consistent with the view that overstatement errors are the result of managers responding to economic incentives.

## >> 4. THE MATERIALITY OF ERRORS AND THE NEED FOR THE RESTATEMENT OF ACCOUNTING STATEMENTS

The role of financial information in decision-making is well known. If information contains errors, the correction of financial statements should be made. However, accounting standards make the restatement of financial statements depend on a criterion of materiality of error. It is, therefore, worth analyzing this question, even if it is peripheral to the topic discussed here.

In Portugal, NCRF No.4, §5 - "Definitions" -, contains what it should be meant by "material". It lays down that omissions or misstatements are material if they could, individually or collectively, influence users´ economic decisions based on financial statements. Materiality depends on the size and nature of the omission or misrepresentation in a given context. The size and nature of the item, or a combination of both, could be the determining factor.

> The same NCRF, §37, states that: (...) an entity shall correct prior period material errors retrospectively regarding the first set of financial statements approved after its discovery ".

What to conclude from this set of accounting principles?

In our view, firstly and foremost, the concept of materiality, although having a definition that seems clear – information will be materially relevant if its disclosure could influence the decisions of economic agents– it is often of complex application.

Appealing to criteria of size and nature opens a wide field of subjectivity in applying the principle. For example, omitting the registration of an expense representing 2% of the total expenses is material or not? The error arising from the registration of some fixed asset in an inappropriate account (e.g., "basic equipment" instead of "administrative equipment") is material?

Understandably, most organizations adopt, in what concerns the scale, a criteria of relative importance. For the error to be material it is common to establish, for example, a quantitative dimension exceeding x% of sales, or y% of EBITDA, or z% of total assets.

In the U.S., many managers and auditors stressed the need for the SEC to define more precisely and objectively what is meant by "material". Acito et al (2009: 660) point out that the guidelines issued by various regulatory accounting and auditing bodies (including the SEC) provide general criteria for assessing materiality. However, they do not specify objective, or quantitative, criteria to determine whether a particular accounting error is material. Instead, accountants, managers and auditors must assess materiality based on professional judgment and in the light of specific circumstances. Several stakeholders have pressed SEC to issue a more concrete definition of materiality, criticizing the current guidelines as being too vague.

Materiality assessments, in order to determine the magnitude of an accounting error, are made by comparing the size of the error with the revenue, gross income, net income, total assets or equity. Although there are certain quantitative limits, such as, for example, 5% of net income, widely used in practice, it has often been stressed the importance of qualitative aspects and quantitative considerations as important elements in determining the limit of the materiality of errors.

As already stated, the detection of an accounting error firstly requires a value judgment about the respective materiality. Being considered material, it will imply - unless it is impracticable, according to the defined in §38 of NCRF Nº4 - the restatement of financial statements. The discovery of the error implies that the information is no longer reliable and requires modification.

Exploring now the relation between accounting and taxation, the judgement process arising from Article 88 of the GTL also contains a certain ambiguity and uncertainty. What is the limit for accounting data (because it contains errors and inaccuracies) failing to represent a reliable basis for the calculation of taxable income and the use of presumptions can be justified?

That is, if the accounting application of the materiality criterion exhibits a highly subjective component, so it is the delimitation of the frontier where the extent of the accounting errors precludes its use in the calculation of taxable income. The later since is also a matter that involving an appreciable degree of complexity and subjectivism.

The GTL defines the principles and attempts to exemplify such circumstances, but tax auditors will always have to judge whether errors and inaccuracies lead to a “substantial” or “material” deterioration of taxable income assessment that prevents the use of accounting as an essential basis for assess taxable income.

Sometimes, this judgment process paves the way for litigation. From the application of Article 88 of the GTL, companies will generally try to prove that accounting, even with errors and inaccuracies, can be the basis for assessing taxable income. In this context, what are the frontiers? How do Portuguese tax courts interpret them? These are topics for next sections.

## >> 5. ACCOUNTING ERRORS AND VICES, TAXATION AND INDIRECT METHODS: A FIRST APPROACH

Article 87 of the GTL, § 1, states that the assessment of taxable income by indirect methods may occur, among other reasons, because of "the impossibility of direct and accurate quantification" of the indispensable accounting data to its correct computation.

On the other side, Article 88 of the GTL establishes that:

> Impossibility of direct and accurate quantification of taxable income (...) may result from the following anomalies and inaccuracies when impeding the correct computation of taxable income:
>
> a) Lack of or inadequate accounting elements or statements, failure or delay in the exhibition of statutory books and records, or irregularities in its organization, even when the absence of these elements is due to accidental reasons;
>
> b) Refusal to present accounting and other documents required by law, as well as its concealment, destruction or falsification;
>
> c) Existence of different accounting books, with the purpose of simulating a certain income, and accounting errors and inaccuracies of operations not corrected within the financial period.
>
> d) Existence of manifest discrepancy between the declared value and the market value of goods or services, as well as of specifically identified facts that may justify a greater ability to pay than the one declared to tax authorities.

In search of an operationalization of the concept of "impossibility direct and accurate quantification", the GTL stresses the importance of several orders of accounting factors. Understandably, this occurs because if accounting income, as a rule, is the basis for the calculation of taxable income, then reasons for applying presumptions shall rest in accounting irregularities and errors.

However, the question remains. What kind of irregularities, errors or vices must affect accounting that prevent its use as a basis for taxable income assessment? Where to establish the dividing line between technical tax adjustments (from minor accounting errors) and the total disregard of financial data because of a general contamination of taxable income from accounting errors or fraud?

Suppose two extremes. In one case, the accounting system of a certain entity presents, in the context of a tax audit and concerning machinery depreciation, the declining balance method when only straight-line depreciation was admitted. It would certainly be absurd to argue that such an error would prevent accounting to be the basis of taxable income computation. Once this error is corrected, all other elements remain valid, and the adjustment of net income is, so to speak, "local" or "specific". Such an error does not contaminate or vitiate, at a general level, accounting data upon which taxable profit is based.

At the other extreme, also under a tax audit, assume that there is clear evidence of sales not recorded, relevant bank dealings and cash movements unrecorded and also unexplained, persistently negative margins within a line of business usually highly profitable, and that the cross-check between purchases and inventories and suppliers reveals very large discrepancies. It would be hard to deny that accounting is not extremely vitiated, and sustain that it can continue to serve as the basis for assessing taxable income.

The problem, as it is well known, is that the clear cut dividing line of these two tax auditing situations is not often found in real life corporate cases. In many circumstances, there are doubts about whether a certain accounting error (or a set of errors and vices) is sufficient to call the whole accounting records into question as a basis to determine taxable income.

In general terms, what criterion should be followed? In our view, this criterion must take into account the degree of contamination of uncovered errors or irregularities to the total accounting records. That is, to analyse if the nature of such errors contaminates or vitiates the reliability of accounting elements so as to put into question the general credibility of the determination of income. Additionally, to assess if the extent or depth of errors prevents that, even by correcting them, the possibility of computing the actual earned income and the taxable income.

It is our view that in situations where the (localized or specific) correction of such errors is sufficient to restore accounting reliability or credibility, the use of indirect methods is not justified. But if, even with these corrections, justified reasons still persist to deny accounting a solid basis to compute taxable income, then indirect methods or presumptions should be called as a tax tool.

It should be emphasised that, in tax terms, we are far from errors and their treatment in an accounting perspective, previously mentioned. In that accounting perspective, it must be firstly determined whether errors are material, then checking if the retrospective restatement of financial statements is practicable and, if so, to determine the period under which such restatement should be performed. Errors, being material, are assumed as correctable, and accounting income is considered to be adjustable for the restatement of financial data.

Understandably, in tax auditing, a particular type of user is at issue: the State, with its power to impose taxes whose revenue is intended to meet the needs of the community. It is therefore understandable that the consequences of errors, in a tax audit, have a different treatment in relation to the financial information available for investors, customers, suppliers, unions and other agents than tax administration.

However, in our view, there is still an approximate common perspective. The consequence of errors in financial reporting is to be determined by its materiality assessment.  This process opens, as we have already seen, a considerable margin for subjectivity. However, in the context of errors or vices established in Article 88 of the GTL, one cannot escape to the following question:  when do errors contaminate accounting information in such a way that accounting records cannot be used for determining taxable income?  As such, both processes exhibit a significant influence of judgments.

Basto (2001) argues that the determination of income by presumptions can only be used when it is totally inappropriate to base it on the accounting records provided by the taxpayer. He adds that checking for anomalies is not a sufficient condition to apply indirect methods. It is particularly necessary that, as stated in the GTL, errors, anomalies and inaccuracies make it impossible to determine taxable income.

In applying those methods, tax auditors must prove that the use of indirect methods becomes the only way to determine the tax base.

## >> 6. SOME IMPORTANT JURISPRUDENCE: ACCOUNTING MANIPULATION AND THE FRONTIER FOR USING PRESUMPTIONS

In Case 025677[5] the Supreme Administrative Court (SAC)[6] ruled that the fact that a taxpayer accounting is plagued by errors and inaccuracies does not prevent the determination of taxable income from such accounting base if, after correcting these errors and inaccuracies, the actual or real income can still be obtained. Presumptions were, in this case, disallowed by the court.

This SAC position seems quite appropriate, and in line with Article 88 of the GTL, which states that only the impossibility to accurately quantify the taxable income may result in presumption based taxation. That is, the set of anomalies must be so broad as to invalidate the computation of taxable income.

In line with the discussion shown in the previous section, this means that the degree of contamination, or loss of accuracy, of accounting data and their disqualification as a basis to calculate the tax base must be clearly proved by tax auditors. Only then can they disregard accounting data and apply indirect methods to determine a presumed income that the company supposedly earned.

As noted by Basto (2001) the use of indirect methods is still a mean for determining the supposed real income a company earned. It is obviously not an accounting based amount, but an income that would, nonetheless, have been earned in the context of the presumed conditions of the business activity.

This SAC position is greatly relevant to tax auditors. Indeed, since errors and inaccuracies are detected, the function of tax audits is to prove that they are quite serious, strongly vitiating the accounting records, that book based income is longer a credible basis for determining taxable income.

A clear preference for the application of indirect methods as a last option is observed by courts. Only after demonstrating the impossibility to determine the actual income based corrections of accounting errors, is it assumed that earned income can be determined by the use of indirect methods. We are thus confronted with the distinction between diverse types of corrections. Since this is a critical question for our discussion, let us then also see how the SAC has dealt with this distinction.

[5] Ruling issued in 21- 03- 2001
[6] In Portugal, the SAC is the highest ranking court to rule on tax disputes.

In Case 037/07[7] the SAC held that:

> "In an arithmetic correction, the tax base is identified by the taxpayer in the face of the tax return file, so that the tax administration does not need to go through any method of evaluation - direct or indirect - to determine the due tax. The tax authority only corrects miscalculations, aiming to ensure the accuracy of self-assessed tax. It is therefore the result of a normal control function that tax administration performs ( ... )
>
> This is distinct from technical corrections that tax administration applies to taxable income under direct evaluation, e.g. when it aims to determine the real value of taxable income without resort to evidence or presumptions, still using taxpayer´s accounting data.
>
> These corrections are quantitative, although also qualitative: quantitative because they change the tax base, qualitative because these corrections are a consequence of a different legal impact given to the elements that the taxpayer presented.
>
> Finally, corrections may have another nature (...) that happens when tax administration applies indirect methods, changing the tax base through the use of presumptions or other information it holds."

As stated, this ruling points to the variety of acceptable corrections, given the control of tax auditors over the tax base declared by taxpayers.

On one side, there are the designated miscalculations or "mere errors of quantification". They may result, for example, from incorrect calculation of depreciations through an arithmetic lapse in their quantification, or from a wrong estimation of the discounted value in the recognition of a litigation provision. These errors are not the result of misinterpretation of the tax law, or errors and inaccuracies that vitiate the general role of accounting data.

On the other side, from the court´s perspective about "technical corrections", what is at stake here are corrections having a localized or quite specific nature, and that emerge from an inadequate legal qualification. It is the case, for example, of an expense that the taxpayer deducted by considering to it be proven and indispensable, but the tax auditor does not grant similar characteristics and denies its deductibility. As well as certain type of income that taxpayer exempted, but that in the interpretation of tax auditor should have been taxed. These are corrections that change the tax base. But, in the end, they still allow the computation of real income in accordance with accounting rules. Accounting is not plagued by irremediable errors, far from it. They can be corrected and, as a result of these corrections, the actual income is known.

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[7] Ruling issued in 24.06.2007

Finally, it should be mentioned the situation in which tax auditing, finding such a set of errors, disregards the whole accounting income and uses presumptions. In this case, the boundary of specific or technical corrections is clearly overtaken. Irregularities, improprieties and accounting errors assume such a deepness and extension that it is no longer possible to use accounting elements as a basis for calculating taxable income.

It should be noted that accounting entries are not completely set aside, even when applying indirect methods. If, hypothetically, it is proved that there was an extensive omission of sales, and when such omission cannot be mended by technical corrections, the use of indirect methods is often based the application of a margin on consumed goods. In other words, an accounting element (cost of goods sold) is still used.

However, in such circumstances, income is computed via a presumption procedure, according to which the recorded consumption of goods should have produced an estimated or presumed amount of sales. It is deemed that the conditions for the exercise of the activity would determine a certain attainable income, and that accounting, by omitting sales and contaminating the overall credibility of financial statements, is not suitable to calculate taxable income. When, in this case, accounting records still provide the value of consumed goods, it supplies a basic piece of the process. However, the general mechanism of income computation clearly deviates from the accounting logic (income - expenses) and follows an alternative design: the presumption of an attainable income, given the recognized expenses.

A situation when tax auditing detects errors that can be no longer fixed by simple technical corrections is illustrated in the next ruling. This ruling also shows the importance of evidence submitted by companies in the judicial procedure.

In the Case 01097/12[8] the use of indirect methods by the tax administration was under discussion, following an audit to a company whose corporate purpose was the production and sale of newspapers. The audit detected errors in the following areas:

1. non justifiable amount of paper consumption;
2. omission of newspapers' sales;

In this case, and from the Court´s perspective, the audit clearly exhibited accounting irregularities and errors producing a strong indication that accounting did not accurately reflect the financial position and the real earned income.

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[8] Ruling issued in 05.08.2013

The auditors provided a well documented proof and stated the legal appropriate reasons for using indirect methods. Consequently, the Court notes, the company needed to demonstrate facts that would disprove the occurrence of errors and irregularities pointed out by tax auditors However, in the Court's perspective, the defendant did not make use of such evidence, and the case was decided for the plaintiff.

The extent of irregularities and errors proven by the tax audit convinced the court that accounting was vitiated in such a way that it could no longer serve as a basis for the tax base computation. The defendant failed to oppose a convincing argument to the facts described in the audit report.

The court, given the specificity and length of accounting errors presented by tax authorities, required a defendant´s rebuttal based on a equally detailed assessment, which could undermine the economic and material base used by tax auditors to apply presumptions. Arguing, in a vague sense, for an incorrect reasoning from the tax auditors, without specifying precisely why, or to sustain that errors were deemed correctable but without specifying how, will be certainly a path that hardly merited the approval of the court.

Finally, we present a case that provides a set of reasons that induce the application of indirect methods. They come from accounting areas that are quite often influenced by errors: sales, inventories and cash flows.

In Case 01015/02[9] the SAC summarizing errors found by auditors stated that:

> "The defendant is a private limited company and operates as wholesaler of fish. There are usually 4 books simultaneously in use, without chronological, and often even numeric, sequence.
> There are no recorded cash inflows, the monthly sales value being obtained by the total sum of the tapes of each of set of bills. Records related to stocks inventories on 31/12 of years 1989, 1990 and 1991, do not allow to effectively control inventory inflows and outflows.
> There were errors in the accounting value of issued invoices; Maps nº7 and 8 reveal strong divergences between quantities of fish bought and sold, without appropriate explanations from the firm.
> There were omissions in accounting records related to sales, preventing the unambiguous knowledge of elements necessary to calculate the VAT."

In this case, the extent of the irregularities, its depth and impact on core variables in the calculation of the tax base, are so blatant that the taxpayer

9 Ruling issued in 13-11-2002

did not even consider to oppose the use of indirect methods. He went to court just to fight for a different application and quantification of presumptions.

This case exhibits a situation in which the plurality of errors, the key accounting areas that are contaminated, and the implication of errors in the overall income assessment process, produced a setting where it was unfeasible to use technical corrections to get the real income of the taxpayer.

This is a quite good example of the reasons that will lead to an unequivocal application of indirect methods, given the magnitude and type of errors that plague taxpayer´s accounting.

## >> 7. CONCLUSION

The general basis to compute corporation's taxable income is accounting records. However Portuguese LGT states that accounting errors and incurrences are ground for presumption based taxation. Based on jurisprudence we discussed the type and relevance accounting errors that constitute basis for the application of presumptions.

Accounting standards state that when financial statements contain errors they only should be correct if errors are materially relevant. But materiality criterion is not so objective regarding to the calculation of taxable income. There are accounting errors that support application of presumptions to calculate corporate tax and other accounting incurrences that still allow the use of accounting records to compute taxable income.

The judgment about the boundaries of accounting errors that allow the use of accounting as basis for taxation calculation is often decided by litigation. It's a question of interest to understand the frontier of accounting errors and inaccuracies that allow the application of income taxation based on accounting records and avoid the application of presumptions.

Portuguese jurisprudence provides strong evidence that presumption should only be applied if after the correction of accounting errors and incurrences corporate real income can´t be obtained. There is a clear option to apply Corporate Income Taxation using real profit based on accounting records instead of presumptions.

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