

FINANCIAL REPORTING AND TAX COMPLIANCE IN KOSOVO: AN ANALYSIS OF IMPLICATIONS OF BOOK-TAX DIFFERENCES

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ABSTRACT

The study examines the relationship between financial and tax accounting rules, explicitly focusing on book-tax differences in Kosovo as a transitional economy. Despite a longstanding tradition of development in accounting and taxation, substantial institutional and public discourse regarding the differences in financial and tax regulations have been absent. Surprisingly, even constitutional tax principles did not catalyze debates regarding this alignment. Historically, the discussions and treatments on this subject have predominantly been confined to academic circles and tax authorities. Kosovo's official bodies have not publicly expressed their viewpoint on the relationship between financial accounting and tax accounting rules. This lack of communication also applies to discussions about the Common Consolidated Corporate Tax Base (CCCTB) proposal, the newly developed Business in Europe: Framework for Income Taxation (BEFIT), and the IF/OECD/EU Pillar 2 (and Pillar 1) proposals. The study emphasizes the need for a broader discussion on book-tax differences and systematic alignment to promote Kosovo's economic development and integration into the European Union financial system.

Key words: *financial reporting, tax accounting, compliance, Kosovo, tax implications, transition economy.*

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1. INTRODUCTION

Many countries have extensively debated the relationship between financial accounting and tax accounting. Although Kosovo has a rich tradition in accounting and taxation, substantial institutional and public discourse analysis on harmonizing financial and tax regulations still needs to be conducted.¹ This lack of engagement demonstrates the limited influence of constitutional tax principles in initiating discussions about the relationship between financial accounting and general taxation.² In recent decades, there has been an increasing interest in the subject, though largely confined to academic circles and tax authorities. Historically, Kosovo has not officially commented on the relationship between financial and tax accounting, especially in the context of the European Union (EU) proposals on the Common Consolidated Corporate Tax Base (CCCTB)³ or the recent Business in Europe Framework for Income Taxation (BEFIT) and IF/OECD/EU Pillar initiatives.⁴ The evolution and changes in financial accounting rules have largely prompted debates within tax authorities, stressing the need to define the accuracy of taxable value determinations.

It is important to highlight the crucial role that international donors have played in developing Kosovo's financial reporting environment. Collaborations with organizations such as the World Bank, USAID, and the EU have been instrumental in creating the country's legal and institutional foundation for financial reporting. These partnerships have developed significant legislation and standards, supported the establishment and licensing of professional accounting bodies, and enhanced Kosovo's accounting and taxation framework.⁵

Although the initial absence of discussions on financial accounting and tax compliance may imply a passive approach to financial governance, Kosovo's progress in accounting and taxation has been stagnant. The discussions that began in 1998 showcase an increasing awareness of the need for alignment

¹ Bureau of Economic and Business Affairs (EB): *Investment Climate Statements: Kosovo*, The U.S. Department of State, 2023.

² James, S.: The relationship between accounting and taxation, *Working Paper*, University of Exeter, 2002, pp. 1-23.

³ European Commission (EC): *Common Consolidated Corporate Tax Base (CCCTB)*, Taxation and Customs Union, 2016.

⁴ European Commission (EC): *Initiative for a Directive on Business in Europe: Framework for Income Taxation (BEFIT)*, Public Consultation Paper, Commission Work Programme, Conference on the Future of Europe, 2022.

⁵ Centre for Financial Reporting Reforms (CFRR): *Strengthening Corporate Financial Reporting in Kosovo and Introducing Sustainability Reporting Requirements*, The World Bank Workshop, 2023.

between financial and tax accounting practices. This awareness stems from internal reflection, global accounting standards, and changes in tax regulations. The world faces the challenge of aligning business profits for accounting and taxation, seeking a balance between economic growth, fair tax collection, and compliance with international standards.

The international dimension is essential when examining the significant impact of global organizations and donor agencies on Kosovo's financial development. The introduction of Kosovo Accounting Standards, establishing the Kosovo Financial Reporting Standards Board (KFRSB), and licensing the Society of Certified Accountants and Auditors of Kosovo (SCAAK) are interconnected developments. Kosovo plays an integral role in shaping its financial future, participating actively in the global integration narrative rather than merely receiving international expertise.⁶ As Kosovo progresses, international collaborations will play a key role in shaping the future of its accounting and taxation environment, along with the challenges and opportunities they present.

Businesses must align their accounting practices with tax regulations in a globalized business environment, which is essential for their financial health and compliance. These distinctions are even more crucial for countries like Kosovo as they develop their regulatory environment while considering broader European standards. It has practical implications for businesses operating in Kosovo. Incorrect classifications or misunderstandings can lead to major financial consequences, including potential penalties and inaccurate financial statements. As Kosovo evaluates its position regarding the integration into the EU, local businesses and foreign investors must ensure compatibility and address any differences with EU accounting and tax standards. Additionally, the relevance of this subject extends to auditors, tax consultants, and financial professionals in Kosovo who must be knowledgeable about accounting and tax regulations to provide accurate advice and ensure compliance.

For emerging economies like Kosovo, clarity and consistency in financial and tax regulations are crucial for attracting foreign direct investment. Investors prioritize transparency and predictability. By effectively aligning its financial and tax systems, Kosovo can position itself as an attractive destination for investment. As Kosovo improves its regulatory framework, the relationship between accounting and tax rules will significantly influence policy decisions. Policymakers must find a balance between generating state revenue and facilitating a favorable business environment for corporations. A comprehensive

⁶ Centre for Financial Reporting Reform (CFRR): *Report on the Observance of Standards and Codes (ROSC) on Accounting and Auditing in the Republic of Kosovo*, The Program of Accounting Reform and Institutional Strengthening (REPARIS), The World Bank, 2012.

understanding of these issues is crucial for ensuring that policies are both practical and effective. Kosovo can facilitate smoother regional integration by making its financial and tax systems compatible with broader European norms.⁷ For businesses, the gap between financial reporting and tax regulation is not merely a compliance issue; it also poses considerable risks. Exploring these compliance and regulatory requirements is crucial for corporate governance, helping protect businesses from potential liabilities and reputational damage.⁸

Transparent and accurate financial reporting encourages confidence among the general public, shareholders, and stakeholders. By understanding the relationship between tax regulations and business practices, stakeholders can comprehensively view a company's health and performance. Maintaining financial integrity and compliance in businesses is essential for the credibility of a country's financial systems and has broader economic implications related to EU integration efforts.

Kosovo's journey through financial accounting and taxation complexities amidst historical and contemporary challenges presents a compelling narrative. Although the country's relationship with international bodies has influenced its financial environment, its internal motivation for growth, alignment with global standards, and pursuit of financial accounting and tax conformity highlight its way forward. The primary purpose of this study is to analyze the relationship between financial reporting and tax compliance in Kosovo, focusing on the implications of book-tax differences. The research seeks to identify the challenges and opportunities that arise from Kosovo's current accounting practices as the country transitions its economy toward EU integration. The research is essential as it emphasizes the distinctive attributes of Kosovo's accounting environment and provides a model that other transitional economies might adopt. Understanding these dynamics is crucial for policymakers, investors, and international agencies involved in economic development and regulatory reforms in post-conflict and transitional regions. The findings aim to enhance the understanding of the financial reporting challenges faced by Kosovo, laying the groundwork for future reforms and improving the quality of financial information in the country.

⁷ European Commission (EC): *A fair share – Taxation in the EU for the 21st century*, Directorate-General for Taxation and Customs Union, 2018.

⁸ Centre for Tax Policy and Administration (CTPA): *Compliance Risk Management: Managing and Improving Tax Compliance*, Guidance note. Forum on Tax Administration Compliance Sub-group, 2004.

2. EVOLUTION OF FINANCIAL AND TAX ACCOUNTING PRACTICES IN KOSOVO

Historically, each country has independently created and established its financial and tax accounting rules. Governments, the accounting profession, or independent accounting boards sometimes establish accounting rules. For most of the historical development, Kosovo's financial and tax accounting rules have not resulted from ideas implemented by accountants, accounting boards, or interest groups directly involved in their implementation. Instead, these rules have been shaped by state regulation and the economic system models that have existed in Kosovo (initially as part of a federal system of the former Yugoslavia and later after the establishment of the United Nations Interim Administration Mission in Kosovo – UNMIK).^{9,10}

The development of Kosovo's financial and tax accounting regulations, influenced by the various political and socio-economic systems the country has experienced, can be categorized into four developmental stages. The first stage lasted from 1945 until the breakup of the former Yugoslavia in the 1990s. The second phase covers the years from the 1990s to the establishment of UNMIK in 1999. The third stage extends from 1999 until Kosovo declared independence on February 17, 2008. The final stage began in 2008 and continues to the present day.

The rules governing financial and tax accounting have been influenced by each country's distinctive design and development. In some countries, these rules are established by the government; in others, they are determined by the accounting profession or independent accounting boards. Despite a long development tradition in Kosovo's accounting and tax fields, there has been no genuine public or institutional discussion regarding the compatibility of financial and tax regulations. The constitutional principles of taxation did not significantly influence the initial discussions regarding the relationship between financial accounting and taxation. Donors, including the World Bank, USAID, and the EU, supported the establishment of the necessary legal and institutional infrastructure for financial reporting. This assistance led to the adoption of the first legislation addressing financial reporting: Regulation 2001/30 on Financial Reporting of Business Organizations in Kosovo.¹¹ The introduction

⁹ Dërmaku, A., Peci, B., Hoti, A.: Review of Accounting Developments during 1945-2016 in Kosovo and Challenges for the Future, *EuroEconomica*, 2(36) 2017, pp. 73-77.

¹⁰ Peci, B.: Tax Reforms in Balkan Countries – Kosovo Case, *Thesis Kosova*, (2) 2009, pp. 39-67.

¹¹ United Nations Mission in Kosovo (UNMIK): *Regulation no. 2001/30 on Financial Reporting of Business Organizations in Kosovo*, 2001.

of Kosovo Accounting Standards led to establishing the Kosovo Financial Reporting Standards Board (KFRSB). The Society of Certified Accountants and Auditors of Kosovo (SCAAK) was also licensed, and the first auditors and certified accountants received their official licenses. This support has continued to the present day. Furthermore, the new financial reporting law, No. 06/L-032, which covers Accounting, Financial Reporting, and Auditing, results from assistance funded by international donors.¹²

Kosovar Accounting Standards were utilized until 2011 when legal changes were implemented to regulate this field. In 2011, Law No.04/L-014¹³ on Accounting, Financial Reporting, and Audit was adopted by the Kosovo Parliament. This law established the Kosovo Council for Financial Reporting (KCFR) as the successor to the Kosovo Board for Standards on Financial Reporting (KBSFR). It was supported by the donor community, including the EU, USAID, and the World Bank, and was primarily harmonized with relevant EU directives (specifically the 4th and 8th Directives). According to Article 5 of Law No. 04/L-014, all large, medium, and small enterprises that are either joint stock companies or limited liability companies are required to fully apply the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS) when preparing their financial statements.

The rules for financial reporting are different from those for tax reporting. As a result, businesses often face challenges due to the discrepancies between these two systems. This issue was particularly highlighted by Kosovo's traditional "non-dependency" approach to tax accounting. The adoption of IAS/IFRS in 2011 intensified these challenges. The IAS approach emphasizes "substance over form," which conflicts with the tax law principle of "form over substance." As a result, IAS taxpayers had to maintain separate records for tax purposes in addition to their accounting records. This situation, often referred to as "double deck," led to increased compliance costs.

The relationship between financial and tax reporting becomes evident while drafting financial statements. A survey conducted by *Berisha-Vokshi*¹⁴ outlines this relationship. In the survey, 264 accountants and auditors from different business organizations in Kosovo were interviewed. The primary questions were: (i) Do you follow fiscal rules when preparing financial statements,

¹² Pllana, N., Dharmo, S.: Impact of donor assistance on developing the financial reporting system – the case of Kosovo, *The Business and Management Review*, 12(1) 2021, pp. 364-376.

¹³ Law No. 04/L-014 on Accounting, Financial Reporting and Audit, Official Gazette of the Republic of Kosovo, No. 11, 2011.

¹⁴ Vokshi, N. B.: The connection between Accounting and Taxation from the Perspective of Preparing the Financial Statements, *International Journal of Economics and Business Administration*, 6(4) 2018, pp. 34-47.

adjusting them as needed for accounting purposes? (ii) Do you adhere to accounting rules when drafting financial statements and make adjustments for fiscal requirements? The findings were clear: while business organizations prioritize accounting rules in presenting their economic activities, they are willing to make necessary adjustments or disclosures in their financial statements for tax purposes. Furthermore, referencing *Lamb's taxonomy*, Kosovo aligns with the third category, indicating a dependent relationship between accounting and taxation when preparing financial statements.¹⁵ However, the emphasis remains on accounting.

3. ANALYZING THE RELATIONSHIP BETWEEN FINANCIAL REPORTING AND TAX COMPLIANCE

The need to use the information of financial statements of economic entities is mainly expressed in the necessity of calculating the profit tax due to the state. In Kosovo, financial reporting for tax purposes is regulated by law. The tax legislation provides rules and detailed procedures regarding financial reporting that apply to both economic entities and tax authorities. Financial reporting according to taxes for economic entities is regulated by Law No. 06/L-105¹⁶, which deals with corporate income tax. According to Law no. 06/L-032, the annual tax declarations designed by the Tax Administration of Kosovo (TAK) for tax purposes are completed in accounting, financial reporting, and auditing. In Kosovo, economic entities with an annual turnover exceeding EUR 50,000 must pay corporate income tax at a rate of 10% on profit before tax (PBT) as stated in their financial statements.¹⁷ The above rules do not apply to insurance companies; however, they are subject to a 5% income tax on the gross premiums collected during the tax period. In contrast, banking and non-banking financial institutions must follow specific financial reporting regulations set by the Central Bank of Kosovo (CBK).

Along with the financial statements prepared in accordance with Law no. 06/L-032, corporations are also required to complete annual tax declarations as outlined by the Tax Administration of Kosovo (TAK) for tax purposes. The fiscal year is aligned with the calendar year, and companies must submit their

¹⁵ Lamb, M., Nobes, C., Roberts, A.: International variations in the connections between tax and financial reporting, *Accounting and Business Research*, 28(3) 1998, pp. 173-188.

¹⁶ Law No. 06/L-105 on Corporate Income Tax (CIT), Official Gazette of the Republic of Kosovo, No. 15, 2019.

¹⁷ Law No. 06/L-032 on Accounting, Financial Reporting and Auditing, Official Gazette of the Republic of Kosovo, No. 3, 2018.

annual income tax declarations, along with audited financial statements, by April 30 of the following year.

When examining the differences in financial and tax accounting rules in Kosovo, it is essential to consider the country’s regulatory practices in relation to EU standards. Table 1 below compares Kosovo’s financial reporting and tax compliance frameworks and those established by the EU. It highlights the similarities and differences between the two systems, emphasizing Kosovo’s distinctive challenges as it seeks to integrate more closely with the EU financial system. By analyzing factors such as financial reporting standards, tax frameworks, regulatory oversight, and alignment with EU policies, this comparison offers insights into the level of harmonization achieved and the areas that require targeted reforms. These improvements are necessary for enhancing Kosovo’s economic development and regulatory compliance.

Table 1. Differences in financial reporting and tax compliance standards between Kosovo and EU member states

ASPECT	KOSOVO	EU MEMBER STATES
Financial Reporting Standards	IFRS for large entities, national standards for SMEs	IFRS for listed companies, optional for SMEs
Tax Reporting Framework	Fixed corporate income tax rate at 10%	Varies, progressive or flat rates, with many deductions and credits
Book-Tax Differences	Mandatory distinct financial and tax records with specific adjustments	Encourages alignment but allows flexibility based on national regulations
Regulatory Bodies	Kosovo Council for Financial Reporting (KCFR)	Each state has its own bodies; coordinated by EFRAG
Integration with EU Policies	Partial, aligning progressively	Full compliance required
Tax Principles Applied	Form over substance principle	Substance over form generally favored
Standardization of Financial Statements	Mandatory standardized statements	Standardized for listed companies, varies for others
Impact of EU Integration	Working towards integration, adjusting regulations	Fully integrated, adherence to EU standards

Source: author’s compilation

Tax rules primarily focus on calculating the tax base, the timing of income recognition, deductible expenses, and the tax collection process. Among these, the timing rules are fundamental. They must align with business realities while establishing a clear framework for tax collection. A notable characteristic of Kosovo's tax system is its policy of reverse dependence between financial and tax accounting. This policy focuses on integrating financial accounting with tax regulations, ensuring that the financial statements of economic entities accurately represent their tax obligations. The concept of "reverse dependence" refers to a situation where financial reporting rules significantly impact tax accounting practices. This alignment occurs when tax liabilities are calculated based on figures and valuations taken from financial statements rather than through independent tax assessments. This practice is particularly common in systems where the financial reporting framework is more developed or reliable than the tax-specific framework. In Kosovo, this has resulted in instances where the principles of financial accounting inadvertently dictate tax obligations, potentially leading to discrepancies in both tax compliance and the integrity of financial reporting. "Formal dependence," on the other hand, refers to a regulatory approach where the tax accounting framework is directly linked to financial accounting standards. This connection ensures that entities follow financial reporting standards when preparing tax reports, thus maintaining consistency between profits reported for financial and tax purposes. In formal-dependence settings, tax laws may require adjustments or recalculations based on financial statements to meet specific tax requirements. It ensures that financial reports serve as the foundation for tax calculations.

Book-tax differences are reflected in various aspects of Kosovo's accounting and taxation framework. Certain tax benefits are contingent upon their recognition in financial accounts. For example, the availability of specific tax incentives, such as accelerated depreciation, relies on their proper representation in financial statements. This legal requirement ensures that tax advantages cannot be utilized without a corresponding effect on financial accounting. As a result, it discourages the distribution of untaxed profits and promotes transparency. The mandatory inclusion of these benefits in financial accounts serves as a safeguard that aligns with the overall policy objectives of the Kosovo tax system. Table 2 outlines the differences in adopting IFRS, highlighting financial documentation, the complexity of tax adjustments, and the level of regulatory oversight between Kosovo and EU member states. This comparison clarifies the differences in financial reporting practices and the degree of flexibility or stringency in regulatory environments. It emphasizes the customization of policies to meet the specific needs of businesses of varying sizes within each jurisdiction.

Table 2. Comparison of financial reporting regulations by enterprise size between Kosovo and EU member states

ASPECT	KOSOVO			EU MEMBER STATES		
	<i>Small Enterprises</i>	<i>Medium Enterprises</i>	<i>Large Enterprises</i>	<i>Small Enterprises</i>	<i>Medium Enterprises</i>	<i>Large Enterprises</i>
Financial Reporting Framework	IFRS for SMEs adoption	IFRS for SMEs adoption	Full IFRS adoption	Varies; some countries allow simplified reporting	Often require more detailed reporting, some flexibility	Full IFRS is required for all publicly listed companies
Rulebook on Financial Statements	Simplified, less comprehensive documentation	Detailed, moderately comprehensive	Comprehensive, aligning with IFRS	Directive allows flexibility depending on the entity	More comprehensive than for small enterprises	Requires comprehensive and detailed financial statements
Adjustments for Income Taxation	Minimal, simplified process	Moderate, detailed process	Extensive, detailed and complex process	Less prescriptive, varies widely	Generally more detailed than for small entities	Detailed adjustments required
Form for Tax Adjustments	Not required; integrated adjustments	Optional for clarity	Mandatory detailed form for adjustments	Not commonly specified; practices vary	More common than for small enterprises	Often required, reflects complexity
Dual Financial Statements	Not required	Not required, but detailed notes necessary	Required for distinct financial and tax reporting	Generally not required unless specified	More likely than for small enterprises	Commonly required, especially for listed entities
Common Adjusted Items	Depreciation, expenses	Depreciation, expenses, revenue adjustments	Depreciation, expenses, revenue adjustments, financial instruments	Similar adjustments, depend on regulations	Wider range of adjustments than for small enterprises	More extensive and complex adjustments
Regulatory Oversight	National financial authority oversight	National financial authority oversight	National and international standards oversight	National oversight with flexibility	Similar to small but with more stringent requirements	Strict EU-wide regulations enforced

Source: author's compilation

However, Kosovo aims to align with international accounting standards while customizing its policies to meet the country's specific needs. Kosovo's reverse dependence policy illustrates the dynamic relationship between accounting and taxation, aiming for a fair and efficient tax system while ensuring accurate financial reporting. However, a significant drawback is the potential for financial accounting to be contaminated by tax considerations. When finalizing taxes due to formal dependence, the interpretation and application of accounting rules may become overly influenced by these tax considerations. This "reverse dependence" can disrupt the calculation of accounting and tax profits. While the formal dependence of book-tax differences simplifies tax calculations and ensures better compliance in Kosovo, it also presents its own challenges. Balancing these concerns to optimize financial and tax accounting is an ongoing effort for policymakers in the country.

One clear example of reverse dependence in Kosovo can be seen in the treatment of certain reserves. These reserves may be exempt from taxation when recognized in financial statements. This condition encourages accurate and comprehensive financial reporting. Also, Kosovo could have implemented simplified accounting policies for small and medium-sized enterprises (SMEs), reducing the administrative burden on smaller businesses and facilitating tax compliance. However, while these simplified policies make the accounting process more accessible for SMEs, they may also lead to a greater level of reverse dependence, as tax considerations significantly influence accounting procedures. In the context of EU regulations, Kosovo carefully navigates the policy of reverse dependence. While certain aspects of book-tax differences align with the EU Accounting Directive¹⁸, others may pose potential discrepancies.

The concept of reverse dependence on book-tax differences is reflected in various aspects of Kosovo's accounting and taxation framework. Certain tax benefits are contingent upon their recognition in financial accounts. For example, specific tax incentives, such as accelerated depreciation, require representation in financial statements to be utilized. This legal requirement ensures that tax advantages are only available when recognized in financial accounting, thus discouraging the distribution of untaxed profits and promoting transparency. By mandating the representation of these benefits in financial accounts, the system aligns with the broader policy objectives of Kosovo's tax framework.

¹⁸ European Commission (EC): *Directive 2013/34/EU on the annual financial statements, consolidated financial statements*, The European Parliament and The Council of the European Union, 2013, pp. 3-6.

3.1. A COMPARATIVE ANALYSIS OF DIFFERENCES BETWEEN FINANCIAL AND TAX ACCOUNTING

In Kosovo, the financial reporting for economic entities from a tax perspective is regulated by various laws and administrative instructions. These include Law no. 06/L-105¹⁹ on Corporate Income Tax, Law no. 06/L-032²⁰ on Accounting, Financial Reporting, and Auditing, Law no. 05/L-037²¹ on Value Added Tax, and Administrative Instruction no. 07/2019²² from the Ministry of Finance. The relationship between financial and tax reporting has evolved, showing similarities and differences. As a result, the accounting treatments for various items in financial statements can vary depending on the perspective taken. In the following discussions, we will examine the items in financial statements that highlight differences from a tax reporting perspective.

3.1.1. DIFFERENCES IN STATEMENT OF FINANCIAL POSITION (BALANCE SHEET)

The statement of financial position shows considerable differences when analyzed according to IAS 1²³ and Conceptual Framework²⁴ versus tax reporting. These differences arise from applying divergent rules set by accounting standards and tax authorities. Financial reporting aims to provide a true and fair view of an economic entity's activities by properly recognizing the elements of financial statements and highlighting the information's qualitative characteristics. In contrast, tax reporting often lacks clear definitions and procedures for identifying items in the statement of financial position.²⁵ Accounting rules (IAS/IFRS) ensure that financial statements do not include inflated values from non-existent assets. On the other hand, tax regulations focus on preventing

¹⁹ Law No. 06/L-105 on Corporate Income Tax (CIT), Official Gazette of the Republic of Kosovo, No. 15, 2019.

²⁰ Law No. 06/L-032 on Accounting, Financial Reporting and Auditing, Official Gazette of the Republic of Kosovo, No. 3, 2018.

²¹ Law No. 05/L-037 on Value Added Tax (VAT), Official Gazette of the Republic of Kosovo, No. 23, 2015.

²² Ministry of Finance of the Republic of Kosovo: *Administrative Instruction MF-No. 07/2019 for the structure, content, and submission of annual financial reports*, 2019.

²³ International Accounting Standards Board (IASB): *IAS 1 – Presentation of Financial Statements*, 2023.

²⁴ International Accounting Standards Board (IASB): *Conceptual Framework for Financial Reporting*, 2023.

²⁵ Kastrati, A.: *Financial and tax reporting in Kosovo*, Tirana: European University of Tirana, PhD Thesis, 2016, pp. 81-84.

unreasonable capital expenditures, which could impact the tax base. In Kosovo, tax rules contain specific provisions for assets. For example, if a taxpayer incurs expenses for purchasing an asset priced at or below EUR 1,000, it is considered a current (operating) expense. However, this classification changes if the asset is part of a larger whole, where the total value exceeds EUR 1,000, and its useful life is more than one year; in this case, the asset is classified as a capital asset.

According to accounting standards (IAS 1), an asset is recognized on the statement of financial position when it is probable that future economic benefits will flow to the entity, and the cost of the asset can be reliably measured. There are no differing tax criteria for classifying assets for taxpayers. When distinguishing between financial and operating leases, the accounting standard (IFRS 16) and tax criteria state that all risks and benefits related to the asset are transferred to the lessee in a financial lease. In contrast, for an operating lease, all risks and rewards associated with the asset remain with the lessor.²⁶

According to IAS 38, an intangible asset is an identifiable non-monetary asset that lacks physical substance. Unlike goodwill, an intangible asset must be identifiable. According to the accounting standard, an intangible asset can only be recognized if it is probable that the expected future economic benefits from the asset will flow to the entity and if the cost of the asset can be reliably measured.²⁷ An intangible asset is recognized for tax purposes if it meets the relevant criteria under Law 06/L-105 on corporate income tax. Additionally, internally generated intangible assets qualify for recognition according to accounting standards.

From an accounting perspective, fixed assets and inventory represent a business's property. Fixed assets include tangible and intangible items such as machinery, vehicles, buildings, brands, and trademarks. In contrast, inventory consists of goods ready for sale, including raw materials or supplies used in producing those goods. In IAS 2, the recognition, valuation methods, and presentation of "Inventories" in the statement of financial position are clearly defined.²⁸ According to tax legislation, the criteria for recognizing, valuing, and presenting items in financial statements are based on accounting law. However, additional information is required from tax authorities, such as the inventory declaration form, which must be submitted at the end of the tax period.

²⁶ International Accounting Standards Board (IASB): *IFRS 16 – Leases*, 2023.

²⁷ International Accounting Standards Board (IASB): *IAS 38 – Intangible Assets*, 2023.

²⁸ International Accounting Standards Board (IASB): *IAS 2 – Inventories*, 2023.

According to IAS 32, a financial instrument qualifies as an equity instrument only if (a) it does not involve any contractual obligation to deliver cash or another financial asset to another entity and (b) it can be settled in the issuer's capital instruments.²⁹ The tax rules concerning financial instruments align with the accounting regulations. According to these rules, participating equity instruments are classified as liabilities. As a result, entities can treat dividends on these instruments as deductible expenses in their annual income tax returns. This deduction reduces taxable income, resulting in lower taxes owed to tax authorities, referred to as a "tax benefit."

Following IAS 37, a provision should be recognized when an entity has a present obligation, either legal or constructive, that arises from a past event. Additionally, it must be probable that settling this obligation will require an outflow of resources that provide economic benefits, and a reliable estimate of the obligation can be made.³⁰ If these conditions are not met, no provision will be recognized. When a provision is recognized, liabilities and expenses will increase, impacting the capital structure and profits. The standard distinguishes between provisions recognized as current liabilities for which an outflow of resources may be necessary to settle and contingent liabilities. Contingent liabilities are not recognized as liabilities because they are considered potential liabilities that still need confirmation regarding whether the entity has a current obligation that could result in an outflow of resources. While IAS 37 provides detailed guidance on recognizing provisions that impact financial statement items, tax legislation does not allow expected expenses and provisions created to cover losses to be considered deductible expenditures for income tax calculations.

Accounting rules require the recognition of contracts with onerous terms, meaning that the unavoidable costs of fulfilling the obligations under the contract exceed the expected economic benefits. If an entity has such a contract, it must recognize and measure the present obligation as a provision. However, tax legislation does not permit these provisions created to cover losses to be considered allowable expenses when calculating profit tax. According to tax legislation in Kosovo, pension contributions are deductible up to the limit of 15% of the gross salary.

The general accounting rule for estimating a provision state that the amount recognized as a provision should be the best estimate of the expenditure

²⁹ International Accounting Standards Board (IASB): *IAS 32 – Financial Instruments: Presentation*, 2023.

³⁰ International Accounting Standards Board (IASB): *IAS 37 – Provisions, Contingent Liabilities, and Contingent Assets*, 2023.

required to settle the current liability as of the balance sheet date. According to IAS 37, provisions are defined as liabilities that can only be measured based on the best estimate (considering risks and uncertainties) of the expenses necessary to fulfill the present obligation. Future events may influence the valuation of a provision if there is sufficient objective evidence indicating that they will occur. Due to the time value of money, provisions related to cash outflows that happen immediately after the reporting period are more challenging to estimate than those where cash flows of the same amount occur later. Therefore, provisions are discounted when the effect is significant. The discount rate used will be a pre-tax rate that reflects current market assessments of both the time value of money and the specific risks associated with the liability. Provisions are measured before tax, and the tax implications of the provision and any changes to it are addressed according to IAS 12.³¹ The tax rules do not provide for any deviation from the above rules.

3.1.2. DIFFERENCES IN STATEMENT OF FINANCIAL PERFORMANCE (PROFIT OR LOSS)

Financial reporting under IAS/IFRS and tax reporting often shows discrepancies due to differing revenue and expense recognition policies.³² Financial reporting recognizes the components of financial statements according to established accounting principles and standards. The primary goal is to present high-quality information that accurately reflects the organization's rights and obligations. In contrast, tax reporting mainly emphasizes recognizing revenue to prevent tax evasion and minimize potential abuses.³³

Under IFRS 15, revenue is recognized when all the following conditions are met simultaneously: "(1) the economic entity has transferred the main risks and benefits of ownership of the goods and services to the buyer; (2) the amount of revenue can be reliably measured; (3) it is probable that the economic benefits associated with the transaction will flow to the entity; (4) the costs incurred, or that will be incurred, related to the transaction can be reliably measured."³⁴ The recognition of income under tax laws is regulated differently for businesses. According to the Value-Added Tax (VAT) Law, if an advance payment is

³¹ International Accounting Standards Board (IASB): *IAS 12 – Income Taxes*, 2023.

³² Kastrati, A.: *Financial and tax reporting in Kosovo*, Tirana: European University of Tirana, PhD Thesis, 2016, pp. 81-84.

³³ Ibidem.

³⁴ International Accounting Standards Board (IASB): *IFRS 15 – Revenue from Contracts with Customers*, 2023.

received, VAT liability will occur upon collection.³⁵ On the other hand, when a business receives an advance payment, it is required to calculate and remit the VAT on that amount, even if the goods or services have not been fully delivered. On the other hand, VAT is also charged when a sale is invoiced, which means businesses must account for VAT even if they have not yet received payment from the buyer. Entities become VAT obligors when their taxable supplies exceed the annual threshold of €30,000. This threshold aims to exempt small traders and service providers from the burden of VAT compliance. Once an entity surpasses this threshold, it must register for VAT, charge VAT on its taxable sales, and adhere to all reporting requirements established by Kosovo's tax authorities. In addition to crossing the annual turnover threshold, a business must register for VAT when its annual turnover or transactional limit reaches or exceeds the specified threshold within twelve months. Exemptions apply to certain goods and services, such as medical supplies and educational services, as detailed in VAT legislation. These exemptions are essential for ensuring the affordability and accessibility of vital services. According to IFRS 15, revenue from fixed-price construction contracts is recognized using the percentage-of-completion method. This method measures revenue based on the percentage of labor hours completed up to the reporting date in relation to the total estimated labor hours for each contract. Tax legislation requires that economic entities engaged in construction contracts maintain separate accounting records for each project. If multiple contracts exist within a project, each contract must also have its own separate accounting. This includes distinct records for all expenses and revenues, categorized by units of measurement such as sales, payments, and advances.

The IAS/IFRS provides clear definitions for incurred expenses and their recognition. However, certain restrictions limit recognized expenses for tax reporting. For instance, representation expenses can only be recognized up to 1% of the annual gross income. Tax authorities do not allow economic entities to recognize penalties or late payment interest as deductible expenses. Furthermore, if the economic entity does not pay salary expenses, they will not be recognized as expenses for the period they were incurred. For financial reporting, interest payable can be classified as either a current or capitalized expense, depending on the situation, but tax legislation places limitations on this classification. Additionally, tax legislation imposes restrictions on sponsorship costs. While these payments are considered expenses for financial reporting purposes, any expenses that exceed the legal limits will not be deductible for tax reporting. According to Law no. 06/L-105, sponsorship costs can

³⁵ Law No. 05/L-037 on Value Added Tax (VAT), Official Gazette of the Republic of Kosovo, No. 23, 2015.

be recognized as deductible expenses only up to a maximum of 10% of taxable income, calculated before this contribution is deducted.³⁶ Business gifts are generally not recognized as deductible expenses for tax purposes, except for those gifts that display the business's name and logo, which are considered part of representation expenses. According to tax legislation, payments to shareholders or related parties in the form of dividends, whether made by resident or non-resident individuals, can be deducted as expenses for tax purposes. In terms of accounting, bad debt expenses related to accounts receivable in a reporting period must be estimated and included in the income statement. However, tax regulations only allow deductions for bad debt expenses if there is convincing evidence of collection efforts, such as proof of a lawsuit against the customer. If a previously written-off bad debt is later collected, it is considered taxable income. Accounting rules require maintenance and repair expenses to be recorded in the income statement during the period they are incurred. However, tax regulations have a formula that requires a portion of repair and maintenance expenses to be capitalized. In future reporting periods, these capitalized expenses will reduce taxable profit over time until the capitalized amount is fully depreciated.

3.1.3. DIFFERENCES IN ASSET VALUATION, DEPRECIATION AND PRESENTATION

According to the conceptual framework and specific accounting standards, the recognition, valuation methods, depreciation, and presentation of items in financial statements are clearly defined. The necessary information to be provided in the explanatory notes is also specified. However, tax legislation requires more detailed information about these items, even though the criteria for recognition, valuation, and presentation in financial statements are based on accounting principles and standards.

According to IAS 2 and IAS 16, the valuation or measurement of a purchased asset or inventory includes all acquisition costs, transformation costs, and any other expenses incurred to bring the inventory or asset to its current location and condition.^{37,38} Based on the accounting standards mentioned, the cost of purchasing inventory or assets includes the purchase price, import costs,

³⁶ Law No. 06/L-105 on Corporate Income Tax (CIT), Official Gazette of the Republic of Kosovo, No. 15, 2019.

³⁷ International Accounting Standards Board (IASB): *IAS 2 – Inventories*, 2023.

³⁸ International Accounting Standards Board (IASB): *IAS 16 – Property, Plant and Equipment*, 2023.

taxes, and other related expenses (excluding any amounts recoverable from tax authorities). Additionally, it encompasses shipping and handling costs, along with other expenses that can be directly attributed to purchasing the particular inventory or asset. IAS 2 specifies that trade discounts and similar items should be deducted when calculating the cost of acquiring inventory or assets. Furthermore, the accounting standard states that inventory should be measured at the lower of its purchase cost or net realizable value, which is in line with the prudence principle. According to tax legislation, the cost of acquiring inventory or assets is based on the amount actually paid by the taxpayer for that acquisition, which may be increased by improvement costs and reduced by depreciation and other deductibles permitted by law.³⁹ According to Law No. 06/L-032, Article 12, economic entities are required to verify the existence and valuation of their assets at least once a year. This verification should be carried out through the inventory management process, which includes supporting documentation. In accounting terms, overheads refer to fixed costs or general expenses that a company must pay regardless of its business performance (output). These are recorded as operating expenses (OPEX) in the income statement. Additionally, according to IAS 23, borrowing costs can be capitalized as part of an asset's cost if they are expected to generate future economic benefits for the entity and can be reliably measured.⁴⁰ Other borrowing costs are recognized as expenses during the period in which they occur. For tax reporting, general costs (overheads) and borrowing costs are also considered expenses for that reporting period; however, disallowed expenditures are not deductible for tax purposes. According to accounting rules, the “*First-In, First-Out*” (FIFO) method estimates the cost of interchangeable inventory. This means that when similar inventories are used, the expense is recognized based on the first purchases made. For raw materials, the weighted average cost method is applied. It's important to note that tax reporting does not provide specific definitions or procedures for valuing interchangeable inventories.

IAS 16 outlines how to measure property, plant, and equipment (PPE) after their initial recognition. An entity must choose either the historical cost model or the revaluation model as its accounting policy and apply this choice consistently across all categories of PPE. Under the historical cost model, PPE is recorded at its historical cost after initial recognition, minus any accumulated depreciation and impairment losses. In contrast, the revaluation model allows an item of PPE to be recorded at its fair value, provided that this value can be measured reliably. This is also adjusted for accumulated depreciation and

³⁹ Law No. 06/L-105 on Corporate Income Tax (CIT), Official Gazette of the Republic of Kosovo, No. 15, 2019.

⁴⁰ International Accounting Standards Board (IASB): *IAS 23 – Borrowing Costs*, 2023.

impairment losses. If the fair value of a revalued asset differs from its carrying value, a further revaluation is required. For tax reporting, clear definitions of measurement for recognized assets are necessary. According to Law No. 06/L-105, Article 16, Paragraph 3, the method for calculating the depreciation of tangible assets is based on the purchase cost, which includes tax obligations, fees, provision costs, packaging costs, transportation, and insurance costs incurred from the supplier.

Accounting standards (IAS 16) define depreciation as systematically allocating a tangible asset's depreciable amount over its useful life.⁴¹ A depreciable amount refers to the cost of a tangible asset minus its residual value. At least once a year, a tangible asset's residual value and useful life should be reviewed. Depreciation starts when the asset is available for use and continues until it is derecognized, even if it is not in use. According to accounting regulations, depreciation must be recorded as an expense in the income statement for the reporting period based on the applicable depreciation schedule. IAS 16 outlines two standard methods for calculating depreciation: (a) the straight-line method and (b) the declining balance method. Additionally, IAS 8 mandates that the chosen depreciation method should be reviewed at least annually. If there is a change in the pattern of benefit consumption from the asset, the depreciation method should be updated accordingly. For tax reporting, Law no. 06/L-105 classifies tangible assets into three categories for depreciation calculations: *Category 1*: Buildings and other construction structures (depreciated at 5%); *Category 2*: Automobiles and light trucks, heavy transport vehicles (depreciated at 20%); and *Category 3*: Plants and machinery; railway inventory and locomotives (depreciated at 10%).⁴²

According to accounting rules (IAS 38), depreciation begins when an intangible asset is available for use, and amortization ends either when the intangible asset is classified as held for sale or when it is derecognized.⁴³ The amortization method reflects how an economic entity expects to utilize the future benefits of an intangible asset. Typically, the straight-line amortization method is employed. No amortization is calculated for indefinite intangible assets, such as goodwill or brand names. However, the entity must conduct an annual review to determine whether these assets have been impaired. For tax reporting purposes, intangible assets are amortized using the straight-line method, and the allowance is based on the asset's useful life as defined in the legal agreement

⁴¹ International Accounting Standards Board (IASB): *IAS 16 – Property, Plant and Equipment*, 2023.

⁴² Law No. 06/L-105 on Corporate Income Tax (CIT), Official Gazette of the Republic of Kosovo, No. 15, 2019.

⁴³ International Accounting Standards Board (IASB): *IAS 38 – Intangible Assets*, 2023.

regarding its acquisition and use. If the useful life is not specified, amortization expenses can be recognized over a maximum period of 20 years.

To assess whether a fixed asset is impaired, the entity follows the guidelines in IAS 36. This standard outlines the process for evaluating the carrying amount of fixed assets, determining the recoverable amount of an investment, and recognizing or derecognizing any impairment losses.⁴⁴ The recoverable amount of an asset is determined by taking the greater of its net realizable value and its value in use. For tax reporting purposes, the treatment of asset impairment is limited; only documented impairments supported by valid evidence from competent authorities are accepted in cases of physical damage to these assets. According to accounting regulations, IFRS 13 requires or permits an entity to measure an asset at fair value (current market value) and to disclose information related to these measurements.⁴⁵ IAS 40 requires that any gains or losses resulting from changes in the fair value of investment property be included in the income statement (net profit or loss) for the period in which they occur. Tax regulations do not allow deviations from these accounting requirements.⁴⁶ Kosovo's tax system does not impose a tax assessment based on the market value of certain assets affected by certain transactions.

There are no exceptions to accounting rules regarding non-tax adjustments, such as immediate asset write-offs, accelerated depreciation, or tax-free reserves. However, the tax legislation does provide for tax credits and incentives. For instance, dividends received by both residents and non-residents are exempt from taxation. Additionally, extra tax deductions are available for purchasing new assets, such as plants and heavy machinery, and tax deductions for sponsorships in sports, youth programs, and cultural activities.

4. INTERPRETATION AND PRACTICAL IMPLICATIONS OF ACCOUNTING RULES AND TAX LEGISLATION

Kosovo's accounting rules should be interpreted according to the original methodology outlined in the accounting law. These rules are applicable for tax purposes due to a normative remission. The purpose of Accounting Directives is to ensure that financial statements present a true and fair view (TFV). Therefore, interpreting these accounting rules should focus on formalistic and

⁴⁴ International Accounting Standards Board (IASB): *IAS 36 – Impairment of Assets*, 2023.

⁴⁵ International Accounting Standards Board (IASB): *IFRS 13 – Fair Value Measurement*, 2023.

⁴⁶ International Accounting Standards Board (IASB): *IAS 40 – Investment Property*, 2023.

legalistic approaches while maintaining the principle of TFV.⁴⁷ A more formal approach may be necessary in certain situations, mainly when Kosovo's tax regulations differ from the Accounting Directives. If the rules of the Accounting Directives are interpreted strictly legally, concerns may arise regarding their compatibility with EU law.⁴⁸

Kosovo's fiscal administration and tax system need improvements to be effective. Addressing the misuse of financial accounting rules is essential to upholding the integrity of the nation's tax system and the overall financial environment.⁴⁹ Kosovo employs general and specific anti-avoidance rules to combat abuses. The General Anti-Avoidance Rules (GAARs) are the foundation against harmful financial accounting practices that could undermine the tax base.⁵⁰ These rules highlight vital principles such as the "true and fair view" principle, "substance over form," and the accrual basis of accounting, often referred to as the "matching principle."

In addition to General Anti-Avoidance Rules (GAARs), Kosovo has established regulations prohibiting abuse of rights, ensuring that legal actions are aligned with their intended purposes. Specific anti-avoidance rules may limit loss carryforwards, disallow certain expenses, and impose additional restrictions. Furthermore, Kosovo enforces clear guidelines for intragroup transactions, requiring that they reflect the arm's length principle. This principle applies to all tax forms and necessitates a transfer pricing adjustment for income taxes.⁵¹ Accounting adjustments are not solely dependent on reconciling differences between contract and market prices. Such differences are treated as accounting issues that can lead to tax complications if they violate transfer pricing rules.

⁴⁷ Vokshi, N. et al.: *Compilation of Accounting Regulation in Kosovo Through Two Packages of Standards: Kosovo Accounting Standards and International Accounting Standards*, *Middle Eastern Finance and Economics*, (16) 2012, pp. 122-130.

⁴⁸ European Commission (EC): *Directive 2013/34/EU on the annual financial statements, consolidated financial statements*, The European Parliament and The Council of the European Union, 2013, pp. 3-6.

⁴⁹ International Monetary Fund (IMF): *Staff Country Reports – Republic of Kosovo: Selected Issues*, (55) 2023, pp. 1-24.

⁵⁰ Waerzeggers, C. J., Hillier, C.: *Introducing a General Anti-Avoidance Rule (GAAR): Ensuring That a GAAR Achieves Its Purpose*, *International Monetary Fund*, (1) 2016, pp. 1-12.

⁵¹ Organisation for Economic Co-operation and Development (OECD): *OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations*, OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations, Paris: OECD Publishing, 20.01.2022, pp. 1-12.

4.1. PROCEDURAL IMPLICATIONS, SANCTIONS, AND REMEDIES

Understanding the procedures for interpreting accounting rules is crucial for assessing the potential for alignment between book and tax values in Kosovo. Given its unique financial and tax environment, Kosovo has specific implications for the interpretation of these accounting rules. During audits, the tax authority has the right to examine all aspects of the taxation process, including reviewing the taxpayer's accounting records to understand their impact on the tax base. However, discrepancies may arise between the tax base determined by the tax authority and the base inferred from accounting rules. These inconsistencies can result from different interpretations of tax laws or accounting regulations.

Violations of accounting rules can lead to penalties under tax law or, in severe cases, criminal prosecution. Errors found during tax audits are typically classified as accounting mistakes, requiring disclosures according to Kosovo's accounting standards.⁵² In cases of rights abuses, the tax authority assesses tax liability by considering all relevant factors, including potential tax liability under lawful circumstances. Accounting rules determine taxable profit in Kosovo unless specific tax regulations indicate otherwise.⁵³ Tax authorities cannot dispute accounting choices that comply with regulations, but only expenses recorded in financial accounts can be deducted. If accounting rules are misapplied, the taxable income may be adjusted.⁵⁴ Compulsory corrections may have accounting implications. When taxpayers need to report or exclude tax returns, tax authorities might use presumptive methods to determine taxable income.

5. CONCLUSION

Exploring the relationship between financial and tax accounting is not merely academic research but a practical necessity, particularly for emerging economies. Our analysis emphasizes the importance of aligning financial and tax systems to establish Kosovo as a potential investment hub. As Kosovo refines its regulatory framework, policymakers face the challenge of integrating accounting and tax rules to balance state revenue and ease of doing business. Strengthening ties with the European Union further highlights the significance of this alignment, as compatibility with European standards

⁵² Centre for Financial Reporting Reforms (CFRR): *Report on the Observance of Standards and Codes on Accounting and Auditing – Kosovo Update*, The World Bank, 2012.

⁵³ PricewaterhouseCoopers Kosovo: *Corporate – Income determination Kosovo Tax Newsflash*, PwC Tax Services, 2023.

⁵⁴ *Ibidem*.

can facilitate seamless regional integration. However, the issue extends beyond global perspectives. Commonly, businesses struggle with the disparities between financial reporting and tax legislation. This challenge goes beyond compliance; it is also about safeguarding corporate integrity and reputation. One key finding from the study is Kosovo's policy of reverse dependence on book-tax differences. While this approach simplifies tax computations and enhances compliance, it poses a risk of financial accounting being overshadowed by tax priorities. Reaching the balance between accurate financial accounting and tax optimization is an ongoing challenge. The requirement to reflect specific tax benefits, such as accelerated depreciation, in financial statements underscores Kosovo's commitment to transparency and the prevention of untaxed profit distribution.

Kosovo's financial and tax accounting journey highlights challenges and offers valuable insights for policymakers and businesses. The experiences of Kosovo illustrate the ongoing effort to connect these two accounting domains. Every policy change or institutional reform can significantly impact both the domestic economy and international relations. The study highlights the importance of professional development within Kosovo's accounting and financial sectors. As financial and tax accounting dynamics evolve, professionals must enhance their expertise. This involves fostering a culture of excellence, innovation, and ethics. Stakeholders, including shareholders and the public, play a vital role in this ecosystem. Their confidence in the financial system relies on clear and accurate financial reporting. The study contributes to understanding Kosovo's distinctive accounting environment by examining the relationship between financial reporting and tax compliance. It thoroughly analyzes the differences between book values and tax values in Kosovo, revealing the specific challenges and developmental paths that set Kosovo apart from its broader European counterparts. The proposed framework for future reforms suggests policy changes to align with EU standards, aimed at improving financial transparency and regulatory compliance.

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