



A Study of the Impact of the Income Smoothing and Prior Period Adjustments on Tax Assertiveness and Tax Diagnostic Difference Decrease in Tehran Stock Exchange

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ABSTRACT

The purpose of this research is to study the impact of the Income Smoothing and Prior period Adjustments on Tax assertiveness and Tax diagnostic difference decrease. The study is based on the analysis of samples include 123 companies listed in Tehran Stock Exchange for the period of 2008 to 2012. The samples are selected through the Systematic Elimination Method. Two independent sample T- Student Test was used to study accuracy of the hypotheses. The results indicate that, with regard to the Tax assertiveness and Tax diagnostic difference; there is a significant difference between income smoothing and unincome Smoothing companies and companies with more and less Prior Period Adjustments.

Keywords: Tax assertiveness and Tax diagnostic difference, Income Smoothing, Prior Period Adjustments

INTRODUCTION

Income tax expense is one of the most important expenses of the firms. Firms usually make an effort to reduce it to pay less tax to the government and to discharge less liquidity [1]. Mostly, these decisions are taken by the executive's management [1]. According to the Agency theory, executives management always follow their personal benefits that is not necessarily corresponding to all beneficiaries' interests (including, shareholders and government) and they may have tax policies which could lead to imposing some expenses on the shareholders and government. For example they can manipulate the amount of computable income and expense for the tax determination in different years in order to transfer tax expense to future periods. Through accounting policy selection the earning is managed and estimated by executives. They also affect the decisions which are related to the resources allocation [2]. The main justification of management for making use of Prior period Adjustments is the better reflection of Changes in the operating environment and investment [3]. The Adjustments of Prior period reduce Consistency in financial reporting and the ability of users of financial Statements in precise evaluation of firm Performance [1]. Executives apply Personal judgment in financial reporting and they make Changes in financial structure. These changes mislead Beneficiaries about firm Performances [4].

Tax is one of the influential factors in financial information which was common in human societies from long ago, and different forms of its collection was inevitable for the government. Tax issues are the most effective tools in the hands of any government, since they are responsible for their crucial duties [5]. The main sources of income tax are legal entities and corporate income [6]. It is expected that calculated accounting income be in agreement with taxable income, because financial information required to calculate the tax is provided by the prepared legal and financial statements which are in accordance with accepted accounting standards, but in practice there is a difference between accounting income by the taxpayer and diagnostic taxable income by auditors of tax. Policies of the reduction of taxable income arose in the financial reporting from late 1990 to early 2000. By manipulating the balance, managers try to reduce the amount of tax payable. Consequently, there will be a gap between declared income (book income) and taxable income. Cross sectional analysis shows that tax policies arose for distortion of financial reporting and the results of empirical research also proves this topic [7].

Pour-Heydari and Aphlatuni in their paper investigated managers' incentives for income Smoothing using the discretionary accruals (items), results indicated that the main motivation for income smoothing using the discretionary accruals (items) are incentives such as income tax and deviation in operating activities [8]. Sartori has studied the issue of effects of strategic tax behaviors on corporate governance. He showed that strategic tax policies have a negative impact on corporate governance, because they tend to increase agency costs, transaction costs and they have a negative impact on transparency. Therefore, inevitable plans seem to have a positive impact (not only on tax compliance, but also) on corporate governance [9]. Balakrishnan et al. investigated in his research whether aggressive tax planning firms have less transparent information environments. They found that managers increase the volume of disclosure in an attempt to mitigate these transparency problems. Overall, their results suggested that firms face a trade-off between financial transparency and aggressive tax planning thereby potentially explaining why some firms appear to engage in more conservative tax planning than would otherwise be optimal [10].

Steijver and Niskanen examined the tax aggressiveness of private family firms, relative to their non-family counterparts. They found that private family firms appear to be less tax aggressive than private non-family firms. Results showed that firms with a higher CEO ownership stake are less eager to engage in tax aggressive behavior, while CEOs with a lower ownership share are more eager to engage in tax aggressive behavior. Their results show that the presence of an outside director in the board improves the monitoring effectiveness thereby limiting possible rent extraction behavior by the CEO [11]. Babajani and Abdi in their research have found out that there is no significant difference between average of difference percentage of taxable income assertiveness and conclusive in companies that have Criteria of corporate governance in comparison with companies that have not Criteria of corporate governance, whereas in both groups there is a significant difference between average of difference percentage of taxable income assertiveness and conclusive [12]. Khastoo indicated that there is significant relationship between dual chairman-CEO role and out director's ration tax aggressive behavior [1].

Zemzem and Ftouhi studied The Effects of Board of Directors' Characteristics on tax aggressiveness. Results indicated that the board size and the percentage of women in the board affect the activity of tax aggressiveness. Return on assets and size of the firm are significantly and positively associated [13]. Bahadori et al. investigated effective factors on the decrease of Tax assertiveness and Tax diagnostic difference. The results indicated that there is a direct positive relationship between the prior period adjustments and the tax assertiveness and tax diagnostic. The less the prior period adjustments are the more decrease in the tax assertiveness and Tax diagnostic will be [14].

MATERIALS AND METHODS

In this study, the impact of the Income Smoothing and Prior years Adjustments on the difference between tax assertiveness and tax diagnostic in Iranian companies is discussed and up to now, no similar research in this subject has been conducted in Iran. In general, the study of influential factors on income tax and tax difference are the most important subjects for the tax affairs Organization and governments. This study is presented to provide a better understanding of the concept of taxes on income and improve the quality of tax assertiveness as well as to decrease tax assertiveness and diagnostic difference, more and more.

It is expected that Tax assertiveness conforms to Tax diagnostic because tax information for calculating is prepared by financial statements and law books. But actually, there is a difference between them. Different factors may influence on Tax assertiveness which can in turn affect Tax assertiveness and Tax diagnostic difference. Considering these factors are essential as it leads to better understanding of tax concept, Tax assertiveness and Tax diagnostic difference decrease, and Tax assertiveness quality increase.

This study is an applied research in terms of the objectives and is an analytical-descriptive research in terms of approach (operation). This study is also a causal research because it applies precedent data. The statistical population of this research includes the companies listed in Tehran Stock Exchange which are adjusted according to the following limitations: Due to different nature, they should not be included among the financial investment and brokering companies. They should be listed in stock exchange during the period 2008-2012 .The end of their fiscal year is mid of March.

Variables Measurement is Tax assertiveness and Tax diagnostic difference. The difference between tax assertiveness by firms in the declaration and tax diagnostic by the tax affairs organization for firm i in year t . In the explanatory notes of the financial statements (balance sheet, tax reserve), these two numbers are disclosed and the difference between the two can easily be calculated.

In order to measure this variable for each company, the variations in coefficients model (Ikal model) is used. In this model, the variance of income changes ratio to the variance of sales changes is calculated.

The income smoothing index calculation method is as follows: $CY = CV_{income\ i, t} / CV_{sales\ i, t}$

Where, $CV_{income\ i, t}$ = the Coefficient of Variation of income variations in company i during the t period, and $CV_{sales\ i, t}$ = the Coefficient of Variation of sales variations in company i during the t period. If $CY \geq 1$, Corporate is not income smoothing, otherwise, the company is earnings smoothing.

Prior period adjustments is the alteration to accounts of previous years or an adjustment made to accounts for previous years, because of changes in accounting policies or because of errors. A prior period adjustment can

be one of the following two items:

1. The correction of an error in the financial statements that were reported for a prior period; or
2. Adjustments caused by the realization of the income tax benefits arising from the operating losses of purchased subsidiaries before they were acquired.

This variable is obtained from the average of absolute value of the difference of the topic in the time period considered. In fact, the absolute value of the changes of every year must be calculated initially, and then they can be averaged out.

RESULTS

The results of descriptive statistics of variables at table 1 indicate that the mean of the Income Smoothing is .32. Therefore, most of the surveyed companies are not income smoothing. Because the coefficient of skewness of dependent variable is 4.102, thus the distribution is almost symmetric and Skewness has the right.

The results of research hypotheses testing are summarized at table 2. The results of descriptive statistics show that the tax assertiveness and tax diagnostic difference in non-smoother and smoothers companies is 11113.43 and 6054.31 respectively. The mean of non-smoother companies is more than the mean of smoother companies. The results of table 3 show that the test of Leuven is .004, in the level of error 5%. Therefore; the second row of T- test is used. The first hypothesis will be accepted, because $t = 2.005$ and the test significance level is smaller than 5%. Considering the fact that the upper and lower limit is positive in both communities, as a result the mean difference is significant in both communities. These results indicate that the mean of non-smoother companies is more than the mean of smoothers companies. These differences can also be observed in the descriptive statistics table.

The results at table 4 show that the tax assertiveness and tax diagnostic difference in companies with less and more prior period adjustment is 3586.56 and 15712.83 respectively. The mean of companies with less prior period adjustment is more than mean of companies with more prior period adjustment. The results of the above table show that the test of Leuven is .000, in the level of error 5%. Therefore, the second row of T- test is used. The second hypothesis will be accepted, because $t = -3.878$ and the test significance level is smaller than 5%. It means that with regard to tax assertiveness and tax diagnostic difference there is a significant difference between companies with less and more prior period adjustment. Also considering the fact that the upper and lower limit is negative in both communities, as a result the mean difference is significant in both communities. These results indicate that the mean of companies with more prior period adjustment is more than the mean of companies with less prior period adjustment. These differences can also be observed in the descriptive statistics table. As shown in the above Table:

- 1- There is a significant difference between the income smoothing and unincome smoothing companies considering the tax assertiveness and tax diagnostic difference decrease.
- 2- There is a significant difference between companies with more and less Prior Period Adjustments, considering the Tax assertiveness and Tax diagnostic difference.

Table 1. Descriptive Data of the Study

Items	Y: $\Delta T_{i,t}$	X ₁ .income smoothing	X ₂ . Prior period adjustments
Valid	123	123	123
Missing	0	0	0
Mean	9403.23	0.32	14560.10
Median	3253.00	0.00	4298.00
Std. Deviation	17733.779	0.467	29912.313
Variance	314486909.030	0.218	894746483.154
Skewness	4.102	0.796	4.216
Std. Error of Skewness	0.218	0.218	0.218

Table 2. Group Statistics

	X ₁ .income smoothing	N	Mean	SD	Std. Error Mean
Y. ΔI	Income smoothing	84	11113.43	20686.853	2257.121
	Unincome smoothing	39	6054.31	7046.337	1128.317

Table 3. Independent Samples Test

Levene's Test	F	Sig.	t	df	Sig.	Mean Difference	Std. Error Difference
Equal variances assumed	8.544	0.004	1.485	121	0.140	5059.121	3406.905
Equal variances not assumed			2.005	114.102	0.047	5059.121	2523.429

Table 4. Group Statistics

	X ₂ . Prior period adjustments	N	Mean	Std. Deviation	Std. Error Mean
Y.Δ I	less	64	3586.56	6360.301	795.038
	more	59	15712.83	23232.199	3024.575

Table 5. Independent Samples T Test

Levene's Test	F	Sig.	t	df	Sig.	Mean Difference	Std. Error Difference
Equal variances assumed	22.533	0.000	4.017	121	0.000	-12126.268	3018.865
Equal variances not assumed			3.878	66.002	0.000	-12126.268	3127.321

DISCUSSION

The results indicated that assumptions in relation to income smoothing, Prior Period Adjustments were accepted to explain the tax assertiveness and Tax diagnostic difference in the Two independent sample (T-Student) Test. As a conclusion the income smoothing, the prior period adjustments have been effective on the tax assertiveness and Tax diagnostic. The results of test hypotheses related to the income smoothing corresponds to the results of Pour-Heydari and Aflatuni [8] research based upon the fact that the income tax is one of the major motivations for the income smoothing in the companies.

The results of study only in relation to Prior Period Adjustments Variable correspond to research results of Bahadori et al. [14]. They indicated that there is direct positive relationship between the prior period adjustments and the tax assertiveness and Tax diagnostic. The less the amount of prior period adjustments is the less tax assertiveness and Tax diagnostic will be. This means that if the changes in the income and expenditure figures decrease for the previous years, in this year, it is expected that tax assertiveness and Tax diagnostic difference be less effective. Because the items of prior period adjustments have the effect of tax, it leads to displacement of distributable income. Therefore it must be considered as a sign of tax assertiveness and Tax diagnostic difference. In accordance with the results of the hypothesis and the comparison with the previous research, it seems that other factors are involved in the tax assertiveness and tax diagnostic dereference decrease. Identifying these factors needs more research which can be taken into account in the future studies.

Tax policy in companies whose executives have fiscal policies with uncertainty and risk, should be noted. Because in such companies the probability of the occurrence of aggressive and ambiguous tax policy is greatly. The major items of prior period adjustments have the effect of tax, therefore they are extremely important and our recommendation is that corporate managers, take tax auditors review and audit items of prior period adjustments into account with greater sensitivity. Since in such firms, there is more possibility of tax evasion, therefore it should be investigated greatly.

Suggestions for Future Researchs:

Investigation on the impact of Earnings Management on tax policies in the firms. Investigation on the impact of the independent auditor opinion on tax assertiveness and tax diagnostic difference in the firms. Investigation on the impact of Restatement of financial figures on tax assertiveness and tax diagnostic difference in the firms.

Acknowledgements:

This research is extracted from a research project conducted in Islamic Azad University, Bandar Abbas branch and I would like to hereby express my sincere appreciation for the efforts exerted by the Deputy of Research as well as my research fellow in this project, Mr. Dehghani.

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