Tax Effects of Book-Tax Conformity, Financial Reporting Incentives, and Firm Size

Kenny Z. K. Hung Chan; Lin; Feng Tang


ABSTRACT

This study employs a natural experiment to examine the tax effects of a change in the level of conformity between tax and financial reporting in China for firms with different financial reporting incentives. We find that in a full book-tax conformity system, firms with incentives to report higher book income pay significantly higher income tax (per dollar of sales) than do firms without the same incentives. Although we do not find similar evidence in a non-conformed system, we observe cross-sectional variation in taxes paid by firms of varying sizes: by exploiting non-conforming financial reporting rules to a greater extent, large firms pay proportionately lower taxes than do small firms. To improve financial reporting quality, many countries have adopted International Financial Reporting Standards (IFRS) that may affect book-tax reporting differences. Our results suggest that this policy alternative is less desirable from a tax perspective. Therefore, accounting standard setters and securities regulators around the world should consider not only how such a change is intended to benefit capital markets, but also what unintended consequences this policy choice might have for government revenue. Our results also strengthen the government policy position on giving more tax relief to small firms.

Data Availability: All data are available from public sources.

https://doi.org/10.2308/jiar-50404

You do not currently have access to this content.

View full article

Sign in

Don't already have an account? Register
Aggressive Financial Reporting and Tax Reporting. The Company is a gathering place of interest from stakeholders who each have a different purpose. One of the stakeholders having an interest is the government in the tax framework. Book Income represents pre-tax income for firm i in year t based on company's financial statements. The aggressiveness of financial reporting is shown by earnings management activities (Kamila and Martani, 2014). The tax aggressiveness measured using tax evasion does not affect the firm's value. This finding is in line with Prasiwi (2015) that proves that tax evasion which is one form of tax aggressiveness has no significant effect on firm value. Then the equivalence between taxes imposed on the seller and taxes imposed on the buyer requires different percentages that produce the same effective tax level. In addition, there is a political issue: Imposing the tax on buyers makes the presence and size of taxes more transparent to voters. First, consider a tax imposed on the seller. At a given price p, and tax t, each seller obtains p – t, and thus supplies the amount associated with this net price. There are two main effects of a tax: a fall in the quantity traded and a diversion of revenue to the government. These are illustrated in Figure 5.4 "Revenue and deadweight loss". First, the revenue is just the amount of the tax times the quantity traded, which is the area of the shaded rectangle.