

# The Effect of Accounting Costs on the Calculated Tax Income: A case study at Al-Fedaa State Company/ Tammuz Factory

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This research aims to address the knowledge bases of accounting costs and explain their impact on the calculated tax income, where the focus is on following modern methods through which an accurate measurement of the accounting cost can be reached in a way that helps improve both the calculated tax income and the company's returns. A hypothesis has been put forward fundamental to the research, according to which the accurate measurement of accounting costs has a positive impact on the calculated tax income and increases the final net profit of the economic units. The research was applied in the General Redemption Company/ Tammuz Factory, a formation of the Iraqi Ministry of Industry and Minerals, during the fiscal year ending on December 31, 2017. The company follows traditional methods of measuring accounting costs (even though competitors follow modern methods to measure their costs) and therefore there are negative impacts on both the calculated tax income and the final net profit. For the sake of testing the research hypothesis, the case study method was followed by using modern methods for measuring accounting costs, and then explaining their effect on the tax income calculated in the researched company. The research reached a set of conclusions, the most important of which is that the following methods of measuring cost will help provide appropriate and accurate information about the cost of products, as this has a positive impact on the calculated tax income and increases the net final profit.

**Key words:** *Accounting costs, Tax income, Profit, Products, Final profit.*

## **Introduction**

Many companies use traditional methods to measure accounting costs despite the existence of modern and appropriate methods to measure these costs. When these companies implement a cost accounting system, they have data to assist them in performing many functions such as planning, control and decision-making, especially if the cost system applied a high degree of inclusiveness, where it is possible to provide a flow of information in a timely and continuous manner for all levels of administration. Often the information provided by the traditional cost methods is inaccurate and does not help in the provisions of the control process and rationalisation of the decision making process, because these systems do not give detailed data about the product or service provided, making it difficult to accurately determine the costs of the product or service. One of the appropriate methods for measuring accounting costs is the method of determining costs based on Activity Based Costing (ABC), which is defined as the method of allocating accounting costs for activities that consume the resources that then allocates the costs of these activities to the products that consume the activities, to the extent that the product benefits from them. Companies should pay attention to tax, which represents a cash deduction imposed by the public authorities on the companies; hence the role of accounting costs and valuable methods on the taxable income calculated. The use of accounting costs to improve the income tax calculated and improve returns is far from tax evasion; it depends on the development of policies and procedures that either allow the financial reduction of management or else increase the amount of tax to the maximum commitment as much as possible, and take advantage of legal facilities granted to the Company.

## **The First Topic: Research Methodology**

### ***Research Problem***

The problem of research can be expressed through the following questions:

1. Will adopting modern methods of measuring accounting costs help provide appropriate and accurate information on the cost of products that are manufactured in economic units?
2. Does the accurate measurement of accounting costs have a positive impact on the calculated tax income and increase the final net profit after deducting the corporate tax amount during a specific time period?

### ***Research Objectives***

The research aims to address the knowledge bases of accounting costs and explain their impact on the calculated tax income. The focus is on following modern methods to reach an accurate measurement of the accounting cost, in a form that helps improve both the calculated tax



income and the company's returns, and improve their competitive status in line with different environmental changes.

### ***The Importance of the Research***

The importance of the research comes from the importance of its variables represented in the accounting costs and the calculated tax income. The accounting costs need to follow modern and appropriate methods through which an accurate measurement of the cost of the product can be reached. The method of determining costs based on Activity Based Costing (ABC) is a modern method that meets this purpose, and is of great importance for calculated tax income as companies strive to undertake tax planning processes in order to legally reduce taxes.

### ***Research Hypothesis***

The research is based on a basic hypothesis that: The accurate measurement of accounting costs has a positive impact on the calculated tax income and increases the final net profit of the economic units.

### ***Research Sample***

One of the formations of the Iraqi Ministry of Industry and Minerals, General Redemption Company/ Tammuz Factory, was chosen for the sample.

## **The Second Topic: Theoretical Framework for the Research**

### ***The Concept of Accounting Costs and the Importance of Calculating Them***

Accounting costs are seen as a sacrifice of resources borne by the economic unit in exchange for expecting to obtain a service or benefit necessary to achieve its goals, and used in accordance with the established standards. They can be measured in the form of monetary and quantitative units, and therefore can be predicted and determined in advance; this sacrifice is made either in the form of cash spending or other assets, in order to obtain a future benefit (Dess, et.al. 2007: 6). The accounting cost of the Financial Accounting Standards Board (FASB) has been defined as the sacrifice resulting from carrying out economic activities, that is, what has been abandoned by consumption, savings or production in order to obtain goods or services. The American Institute of Certified Public Accountants has defined the cost as a price exchanging, sacrificing the benefit, which represents the amount that is measured by the cash spent or any paid property, issued shares, services rendered, or the creating of a debt in exchange for goods or services; this cost is a sacrificed resource to achieve a specific goal and the cost is often measured with financial values of duty to pay it to get services. For services the actual cost is the cost that occurred, to distinguish it from the planned cost according to

budget (Horngren, et.al, 2015: 30). There are several concepts of accounting cost, and they can be clarified through the following:

First, the actual cost and the standard cost: the actual cost is seen as the cost that was actually spent on the factors of production during a specific period, and is offset by the actual revenues achieved to determine the profit or loss; the standard cost is the cost determined in advance for all elements of production, which is determined on the basis of accumulated experience, studies and research conducted on these elements (Hammer, et.al., 1994: 8).

Second, the variable cost and the fixed cost: the variable cost is the cost that changes in its totals directly and with the same percentage change in the activity level, while the unit cost of these costs remains constant within the appropriate range; the fixed cost is the cost that remains in a fixed set that does not change within the appropriate range despite the change in the activity level, while the fixed cost per unit changes inversely with the change in the level of activity (Danny, 2018: 102).

Third, the direct cost and the indirect cost: the direct cost is the cost that can be allocated precisely on the cost goal easily and economically, and the share of the cost goal can be determined easily due to the presence of a direct relationship between them; the indirect cost is the cost that cannot be easily tracked on the cost target because it is a general or shared cost for each or a group of goals (Dess, et.al., 2007: 6).

Fourth, the total cost and the marginal cost: the total cost indicates that the cost of the product is represented by the cost of all cost components, including materials, wages and expenses, whether a variable, fixed, direct or indirect, while marginal cost refers to the increase in total cost due to an increase in the size or level of activity, and if the volume of production increases by one unit, then the marginal cost represents the increase in the total costs as a result of the increase in the volume of production (Potted, 2008: 33).

### ***Appropriate Methods for Measuring Accounting Costs***

1. The first step: allocating costs to the activity centres: After the costs are recorded in the general ledger record or sub-ledger records, the cost according to this method is collected in the activity centre which is a cost pool; the activity centre is any type of production process. The administration prepares a separate report on its costs, and to determine these activities, the administration must take into account the nature of the equipment and machinery, the cost and cost structure, the benefit and the centres with similar cost confrontations. A high accuracy in cost determination can be obtained by dividing the activities into four levels and then re-measuring what to the specific activities of the centres, which are as follows: (Kasey & Akan, 2015: 72)

- A. Unit-level activities: these are accomplished each time a unit is produced, such as by drilling, cutting, welding and work machinery activities, because they are determined on the basis of the size of the output.
- B. Batch level activities: these are those that are accomplished every time a batch of products is concerned, such as activities to prepare purchase orders, handle materials and prepare machines.
- C. Product-level activities: these are carried out to support the production of each type of product, such as production scheduling, quality inspection and product design.
- D. Activities at the level of equipment or plant: these provide facilities for the production process. These activities are of general assistance to the factory, such as administrative, financial and insurance activities.

2. The second step: the costs of the activities are reassigned or allocated to the cost purposes using cost confrontations (second step guides), and thus the cost of the cost purpose is the sum of the costs that were consumed by the activities (Auras, 2014: 79).

The importance of the method of determining cost on the basis of activities is highlighted through the advantages they achieve, whether applied in industrial or service economic units. This importance can be illustrated by helping to calculate the cost of the unit produced accurately, as the method Activity Based Costing (ABC) is the entrance that provides accuracy in determining and allocating indirect costs. The method also supports the decision-making process, especially internal manufacturing or external purchase decisions, pricing decisions, and decisions to add or delete a specific line or product, and this method is a way to reduce costs by identifying activities that add value or do not add value, assisting management in the reduction or elimination of activities that do not add value. There are a set of main concepts used in the method of determining costs based on activities. These concepts are as follows: (Carbine & Parrish, 2017: 4)

- 1. Activities:** an activity is a business unit or task for a specific goal, and the set of processes or procedures forms the core of the work that is performed within the economic unit.
- 2. Cost complexes:** are the lowest level of detail at which costs are collected and distributed, and this complex may relate to one or a homogeneous group of activities in an economic unit.
- 3. Cost guides:** a measure that reflects the main reason for the emergence of the cost component within each cost complex in the economic unit. It represents the factor affecting the increase or decrease of cost.

### ***The Concept of Tax, Its Elements, Importance and Objectives***

**The First Definition:** The traditional definition of tax indicates that it is a monetary obligation that an individual is obligated to pay to the state in accordance with legislative rules, and ultimately for the purpose of covering public expenditures without charge to the state, treasury pays off its commitment without having any other goals (Jaeger, & Biafra, 2014: 15).

**The Second Definition:** Tax according to the modern concept is a cash deduction imposed by the public authorities on individuals and companies according to their mandatory capabilities in a final and free way with the intent to cover public burdens and to achieve income for the state in that year, and it is imposed in a predetermined way, to achieve various economic and social goals. There are several elements of the tax, as follows: (Washita & Sancho, 2014: 47)

- 1. Tax is a Monetary Obligation:** At the present time, most countries have imposed taxes and collected them in cash, contrary to what was prevalent in some previous eras, whereby the tax was collected from what was produced or dealt with by the citizen, companies and other units operating in the economy.
- 2. Taxation is imposed by the State:** Taxation in principle cannot be imposed, amended or cancelled except by legislature. The tax administration is implementing the provisions of the law, and it can only collect the amounts of taxes permitted by the competent government authorities.
- 3. Tax is imposed without charge:** The taxpayer who pays the tax does not receive a personal benefit, for the taxpayer pays the tax as a member of the community. This does not mean that the taxpayer does not benefit from it, but rather benefits as one of the members of society.

### **The Relationship between Accounting Costs and the Calculated Tax Income**

Accordingly, there is a relationship between the accounting costs and the calculated tax income, therefore companies seek to achieve the best possible returns, and this is done by reducing unnecessary costs so that the product does not negatively affect the performance and quality of the product, and in return, the increase in returns or profits will be offset by an increase in income calculated tax. The question that arises here: Does the use of new techniques and methods of calculation lead to an increase in accounting returns and profits despite the increase in the tax imposed on the company? Therefore, companies must: (Grundy, 2006: 212)

1. Plan to avoid paying the tax if possible legally by focusing on the necessary costs and avoiding costs that do not add value to both the customer and the company.
2. Take advantage of the costs that should be deducted from the tax base and use cost items that are deducted, instead of items that have not cost, such as borrowing financing instead of self-financing.

3. Take advantage of all exemptions established by tax law and related laws.

Consequently, the use of accounting costs to improve the calculated tax income and improve corporate returns is far from tax evasion, it depends on the development of procedures and policies that allow financial management to reduce or increase the amount of the tax liability to the maximum extent possible and to take advantage of the facilities and legal loopholes mentioned in the laws and regulations (Ming, et.al., 2005: 306).

Tax planning related to accounting cost management involves the implementation of various strategies in order to reduce the value of taxes of companies paid for a specific period, taking into account reducing tax obligations to provide more money to cover expenses, as this contributes to finding sources of working capital. There are two basic rules that apply on tax planning, as follows: (Paradises, 2004: 156)

1. Charge the financial year with the expenses of extinction when purchasing machines, equipment, or any other fixed assets before the end of the fiscal year, which reduces the tax base for the same fiscal year.
2. The company shall postpone taxes when possible, so postponing the payment of the tax enables the company to use this money by conducting its business without interest until the tax is due.

### **The Third Topic: The Applied Side of the Research**

#### ***An Introductory Profile of Al-Fedaa State Company / Tammuz Factory***

The costing system applied in the case study factory is the actual cost system. Chapters (5) to (9) are assigned to cost accounts under the unified accounting system, as the cost accounts are organised by the cost department in light of the financial data provided by the Financial Affairs Department in the factory. The cost department then prepares cost lists in order to determine the cost of the unit produced, then submits these lists to the department, which diverts them to pricing committees in the factory in order to determine the appropriate prices for selling each product.

#### ***Using the Appropriate Methods to Measure the Accounting Costs in Al-Fedaa General Company/ Tammuz Factory***

The aforementioned company manufactures two types of products, namely dampers and pistons. The company manufactures 5000 units of dampers and 2000 units of pistons. Manufacturing one unit of dampers requires twenty (20) hours, while manufacturing one unit of pistons requires ten (10) hours of direct work. The cost of direct materials per unit of dampers was 15,000 dinars, while the cost of a piston is 10,000 dinars; the cost of wages (the cost of

one hour of direct work) was 1500 dinars per hour. The indirect costs amount was 90 million dinars during the year, in total for all units, and requires applying the method of costing on the basis of Activity Based Costing (ABC), extracting the average of indirect costs as well as knowing the number of times the cost engine is used per unit from the mentioned products as follows:

**Table 1:** Indirect Cost Rate

Indirect Cost Rate	Total Expected Use of the Cost Engine	Expected Total of Indirect Costs	Cost Engine	For Activity
25000 Dinar	1000	25000 000 Dinar	Number of plays	Preparing machines for operation
10 000 Dinar	4600	46000 000 Dinar	Hours of operation	Operation of machines
9500 Dinar	2000	19000 000 Dinar	The number of times the products are checked	Check the products

**Source:** Preparing the research based on the data available in the company.

For the purpose of knowing the number of times the cost engine is used for both products with respect to both the number of times the machines are running, the operating hours of the machines and the number of times the manufacturers of dampers and pistons are inspected in the research company during the fiscal year ending December 31, 2017, the following schedule has been organised:

**Table 2:** Number of Times the Cost Engine Used

Total use	Piston product	Dampers product	Cost engine
1000	450	550	The number of times machines are run
4600	2200	2400	The number of hours for machines
2000	1000	1000	The number of times the products are checked

**Source:** Preparing the research based on the data available in the company

The total number of direct working hours for both products was extracted as follows:  
 Direct working hours = (the number of direct working hours for the dampers x the number of units produced during the year) + (the number of direct working hours for the dampers x the number of units produced during the year).

Direct working hours =  $(5000 \times 20) + (2000 \times 10) = 120,000$  hours.

The rate of indirect costs per hour of work was extracted using the following formula:

Hourly rate of indirect costs = annual indirect costs  $\div$  direct hours.

Average hourly costs =  $90,000,000 \div 120,000 = 750$  dinars per hour.

Depending on the previous two tables, a table that includes the implementation of the ABC method can be organised as follows:

**Table 3:** Applying the (ABC) Method in the Research Sample Company

Total indirect costs	Piston product		Dampers product		Activity
	Costs	the number	Costs	Number	
25000 000	11250 000	450	13750 000	550	Preparing machines for operation
46000 000	22000 000	2200	24000 000	2400	Operation of machines
19000 000	9500 000	1000	9500 000	1000	Check the products
90 000 000	42750 000	-	47250 000	-	Total costs allocated
-	2000	-	5000	-	Number of units produced
-	21375	-	9450	-	Indirect costs per unit

**Source:** prepared by the researcher.

**Table 4:** Calculating the cost per unit if ABC method is not applied

Piston product	Dampers product	Libya
10 000	15000	Direct articles
15000	30 000	Direct wages Dampers product = $(1500 \times 20)$ Piston product = $(1500 \times 10)$
7500	15000	Indirect costs Dampers product = $(750 \times 20)$ Product of presses = $(750 \times 10)$
32500	60 000	Total cost per unit

**Source:** prepared by the researcher.

For the purpose of comparing the cost per unit of dampers and pistons produced in the case of applying the Activity Based Costing (ABC) method and in the case of not applying it to the research sample company, the following schedule has been organised:

**Table 5:** One-unit cost in case ABC method is applied and in case of not applying

Calculating the unit cost in the case of ABC method		Calculating the unit cost in case the ABC method is not applied		Statement
Piston product	Dampers product	Piston product	Dampers product	
10 000	15000	10 000	15000	Direct articles
15000	30000	15000	30000	Direct wages
21375	9450	7500	15000	Indirect costs
46375	54450	32500	60000	Total cost per unit

**Source:** prepared by the researcher.

The pre- and post-variance analysis of the indirect costs of dampers and pistons produced was used to find out the amount of change in costs in the case of applying the method of costing on the basis of Activity Based Costing (ABC) and in the case of not applying it, and the two direct materials and direct wages components were not introduced because they did not change whether this method was applied or not, and this can be illustrated by the following schedule:

**Table 7:** Pre and Post Variance of Indirect Costs

D <sup>2</sup>	D	Y	X	Statement
30802500	5550	54450	60000	Indirect costs per unit of dampers product
192515625	13875	46375	32500	Indirect costs per unit of the compressor product
223318125	19425	100825	92500	Total

**Source:** prepared by the researcher.

It is noted from the above table that there are four variables in the table which are (X, Y, D, D<sup>2</sup>), where (X) indicates the amount of indirect costs before using the ABC method, (Y) indicates the amount of indirect costs after using the Activity Based Costing (ABC) method, while (D) indicates the difference in indirect costs between (X, Y) for the two products, and (D<sup>2</sup>) indicates the square of the difference between the mentioned indirect costs. The results of the aforementioned schedule can be clarified through the following:

$$(\text{£ d}) \frac{2}{n} = (19425) \frac{2}{2} = 188665312.5$$

$$SSd = 223318125 - 188665312.5 = 34652812.5$$

$$DF = 1$$

$$S2d = SSd / DF = 34652812.5$$

$$Sd = S2d = 5886.7$$

$$Sdx = Sd / n = 5886.7 / 1.14 = 4174.96$$

$$X = 46250, Y = 50412.5$$

$$t = 50412.5 - 46250 / 4174.96 = 0.0997.$$

When comparing the calculated (t) with the tabular under the degree of freedom (1) and the probability level (0.05), we find that the tabular (t) is (6.314), which means that the calculated (t) is less than the tabular, and therefore we can say that following modern methods of measuring cost will help to provide appropriate and accurate information on the cost of products.

***Measuring the Effect of Accounting Costs on the Tax Income Calculated in Al-Fidaa General Company / Tammuz Factory***

Total product costs = number of units produced x cost per unit.

Total costs of dampers product before applying Activity Based Costing (ABC) = 5000 x 60,000 = 300,000,000 dinars.

Total costs of dampers product after applying (ABC) = 5000 x 54 450 = 272 250,000 dinars.

Total costs of the piston product before applying (ABC) = 2000 x 32500 = 65,000,000 dinars.

Total costs of pistons product after applying (ABC) = 2000 x 46375 = 92750000 dinars.

After determining the total accounting costs for the dampers and piston products before and after applying the (ABC) method, the sales revenue of these two products must be determined, as the number of units sold of the dampers and piston products reached (5000) and (2000) units respectively, and sales revenue can be calculated according to the following formula: -

Product sales revenue = number of units sold x sale price per unit.

Sales revenue of dampers product = 5000 x 75,000 = 375,000,000 dinars. Revenue from piston product sales = 2000 x 55,000 = 110,000,000 dinars during the research year.

After calculating both sales revenue and total accounting costs for dampers and piston producers, net profit before tax can be calculated if ABC is applied and if it is not applied, as shown in the following table:

**Table 8:** Net profit before tax if ABC method is applied and if not

Calculation of net profit before tax in case of ABC method		Calculating the net profit before tax in case the ABC method is not applied		Statement
Piston product	Dampers product	Piston product	Dampers product	
110000000	375000000	110000000	375000000	Revenue from sales
(92750000)	(272250000)	(65000000)	(300000000)	Total accounting costs
17250000	102750000	45000000	75000000	= Net profit before tax

**Source:** Prepared by the researcher

After calculating the net profit before tax for the dampers and piston producers, the amount of tax on these two products can be calculated before and after applying the ABC method, as shown in the following formula: (Tax amount = net profit before tax x tax rate), and the amount of tax and net profit can be explained, after tax, in the case of applying the (ABC) method and in the case of not applying it through the following schedule:

**Table 9:** The amount of tax and net profit after tax if ABC method is applied and if it is not applied

Calculate the amount of tax and net profit after tax in case of application (ABC)		Calculating the amount of tax and net profit after tax in case of non-application (ABC)		Statements
Piston product	Dampers product	Piston product	Dampers product	
17250000 (2587500)	102750000 (15412500)	45000000 (6750000)	75000000 (11250000)	Net profit before tax Tax amount (15%)
14662500	87337500	38250000	63750000	= Net profit after tax

**Source:** Prepared by the researcher.

It is clear from the above table, that the amount of tax on the dampers product in the case of non-application (ABC) was at the amount of 11,250,000 dinars and in the case of its application it became at 15,412,500 dinars, while for the piston product, the amount of tax before applying the (ABC) method was the amount of 6,750,000 dinars and become, after application, an amount of 2,587,500 dinars, and the pre and post variation of the amount of the tax can be explained as follows:

**Table 10:** Pre and post variance of the tax amount for dampers and piston products

D <sup>2</sup>	D	Y	X	Statements
17326406250000	(4162500)	15412500	11250000	The tax amount of the dampers product
17326406250000	4162500	2587500	6750000	The tax amount of the piston product
34652812500000	0	18000000	18000000	Total

**Source:** Prepared by the researcher.

It is noted from the above table that there are four variables in the table, which are (X, Y, D, D<sup>2</sup>), where (X) indicates the amount of tax before using the ABC method, (Y) indicates the tax amount after using the ABC method, (D) indicates the amount of the difference in the amount of tax between (X, Y) for the two products, and (D<sup>2</sup>) indicates the square of the difference between the amount of tax mentioned. The results of the aforementioned schedule can be clarified through the following:

$$\begin{aligned}(\text{£ d}) 2 / n &= (38850) 2/2 = 754661250 \\ SSd &= 754661250 - 377330624 = 377330626 \\ DF &= 1 \\ S2d &= SSd / DF = 377330626 \\ Sd &= \sqrt{S2d} = 11773.4 \\ Sdx &= Sd / n = 11773.4 / 2.28 = 5163.78 \\ X &= 69375, Y = 75618.75 \\ t &= 50412.5 - 46250 / 4174.96 = 0.0997.\end{aligned}$$

When comparing the calculated (t) with the tabular under the degree of freedom (1) and the probability level (0.05), we find that the tabular (t) is (6.314), which means that the calculated (t) is less than the tabular, and therefore it can be said that the accurate measurement of the accounting costs has a positive effect on the estimated tax income and increases the final net profit.

## **The Fourth Topic: Conclusions and Recommendations**

### *Conclusions*

Through this research a set of conclusions were reached, as follows:

1. Accounting costs are a sacrifice of resources borne by the economic unit in exchange for expecting to obtain a service or benefit necessary to achieve its goals and used in accordance with the established standards, and that this sacrifice is made either in the form of cash spending or other assets in order to obtain a future benefit.
2. An appropriate method for measuring accounting costs is the Activity Based Costing (ABC) method, which is defined as the method of allocating costs to activities that consume resources and then allocating the costs of these activities to products that consume activities by the extent that the product benefits from them.
3. Tax is a cash deduction that the public authorities impose on individuals and companies according to their mandatory capabilities in a final and free way with the intention of covering public burdens and in order to achieve income for the state.
4. The use of accounting costs to improve calculated tax income and improve returns is far from tax evasion, as it depends on the development of procedures and policies that allow financial management to reduce or increase the amount of the tax liability to the maximum extent possible and to benefit from legal facilities.



## **Recommendations**

Based on the conclusions reached, the research recommends the following:

1. The need to pay attention to accounting costs and analyse them appropriately in order to arrive at unnecessary costs associated with activities that do not add value to the company, in order to exclude them.
2. The use of modern methods to measure accounting costs by relying on scientific and sound foundations in all units that use cost accounting in their activity, with the need to convince officials in the company of the importance of their application, and one of these methods is the ABC method.
3. Companies should stay away from the topic of tax evasion and focus on tax planning issues in order to take advantage of allowances and exemptions determined by law, with the need to pay taxes to the tax authority at the time legally specified in order to avoid payment of late fines.
4. Companies need to pay attention to both the accounting costs and taxes and work to improve them through reducing costs and increasing revenues and thus improving the calculated tax income.



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