Innovations

Earnings Management Effect on Tax Shelters

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Abstract
Tax sheltering, tax avoidance and tax planning employed interchangeably are major tax income saving strategies available to managers of corporate organizations. This study attempts to provide information on earnings management and its attendant effect on tax sheltering activities in Nigeria. In this study, debt tax is employed as proxy for firms' tax shelters activities while small positive net income is employed as proxy for earnings management. A sample of 75 non-financial companies listed on the Nigerian Exchange Group (NGX) for the period between 2010 and 2019 was employed in this study. Preliminary investigation to include descriptive statistics was conducted, while Least Square Dummy Variable (LSDV) regression analysis technique was employed to test the effect of earnings management on tax sheltering. The result obtained from the regression analysis show that managers employ small positive net income earnings management technique to shield taxes. The implication can be viewed from the lenses of behavioural finance which suggest that stock market response is quick and positive on tax shelters because investors focus on profitability without detail screening of cash flows. Hence, tax avoider firms are likely to have lower future income and lower future stock returns than other benchmark firms. Succinctly, this study urges investors and tax authorities to set up policies and regulations capable of checkmating tax evading managers as firm managers may go beyond statutory shelter requirements to manage earnings for private gains.
Keywords: 1.*Tax Shelters, 2.Debt Tax Shield, 3.Earnings Management, 4.Small Positive Net Profit, 5.Least Square Dummy Variable Regression*

Introduction

Corporate scandals exhibited in cases like those of WorldCom, Enron, Qwest and Tyco, etc., have brought about more scrutiny of accounting information presented to investors, shareholders and stakeholders. However, one field of accounting that has attracted special focus has been the accounting for taxes due to worries concerning the absence of transparency and perceived violations in tax considerations (Gupta, Laux, & Lynch, 2016). As reported by Herz (2007) (a senior member of Financial Accounting Standards Board, FASB) variation in accounting practices and opacity in revealing possible tax liabilities presents opportunities to manage earnings (Gupta et al., 2016). Several related studies conducted worldwide suggest why managers have strong motives to engage in tax related earnings management to include; satisfying government and stock exchange regulations, (Healy & Wahlen, 1999; Fields, Lys, & Vincent, 2001), amplifying stockholders' wealth (Blouin, 2014; Graham, Hanlon, Shevlin, & Shroff, 2014), decreasing political cost and tax scrutiny's risk (Watts & Zimmerman, 1978; Fields et al., 2001), and meeting tax-based contract motivations (Phillip, 2003). Previous accounting studies such as those of Widiatmoko

and Mayangsari (2016) and Sundvik (2017) Dhaliwal, Gleason & Mills (2004); Frank & Rego (2006); Gupta et al., (2016) provide empirical evidence which reveals that corporate managers utilize accounting accrual for income taxes and include the reserve for income taxes to manipulate earnings with the goal of meeting the expectations of analyst. Despite such evidence, there has been very few studies that tend to seek the effect of earnings management on tax shelter of listed firms in Nigeria. Undoubtedly, a lot of fiscal policy restructuring has been done in Nigeria. Policies such as National tax policy, voluntary assets and income declaration scheme (VAIDS), transfer pricing guidelines for multinational enterprises and tax administrations which mandate all organizations to include transfer pricing declaration and disclosure form during tax return process are, but a few policy actions undertaken so far by tax authorities in Nigeria (Nolands taxflash 2017). Particularly, the Federal Inland Revenue Services (FIRS) have deepened their focus on improving tax compliance and expanding the tax base rather than introducing new taxes or increasing the rate of existing taxes (Price Waterhouse Copper (PWC) Nigeria tax alert September 2015). In the corporate world, one key strategy employed by the FIRS in broadening government tax revenue base is the strategy of evaluating tax aggressiveness practices against earnings (Osegbue, Nweze, Ifurueze 2018). This strategy tends towards examining managers deployment of tax policy loopholes in minimizing their tax liabilities.

According to Osegbue et., al (2018) valuation of firms' earnings through tax sheltering have become a pivotal strategy employed by tax authorities to improve tax revenue for the state. On the part of the taxpayers (listed firms) this new process will generate new reactions from business managers, stock market analysts and business owners, hence becomes another inspiration for this study. In the opinion of Bauer, Kourouxous & Krenn, (2018) corporate managers are faced with inconsistencies in government tax policies hence the practice of tax sheltering is unavoidable. Similarly, Junaidu and Hauwa (2018) document that increases in corporate tax rate without commensurate tax incentives and benefits to the firm may lead managers to looking into the option of tax sheltering. Further, the need to examine different techniques of earnings management employed by managers suggested by Key and Kim (2020) as against accrual-based earnings management which have proliferated earnings management literature conducted in Nigeria study (Ofurum, Okoye & Ezejiofor 2021; Osegbue, Nweze, Ifurueze, Nwoye 2018; Emudainohwo 2021; Yeye & Egbunike 2021), is also a motive for this study. Therefore, in this study attention is focused on a special variant of earnings management referred to as small positive net income (SPNI) which insinuate that managers prefer to report small positive net income rather than negative net income. A positive coefficient of SPNI suggests that firms manage earnings toward small positive amounts more frequently.

2.0 Literature Review

Tax Sheltering

There is no single definition for tax shelter. Oxford Advance Learners dictionary defines a tax shelter as "a strategy, or tax code provision that reduces tax liability." Taxpayers are generally free to structure their transactions in ways that reduce their tax liability. Consequently, the term "tax shelter" has been applied both to legitimate attempts to reduce one's tax burden and to abusive tax planning techniques that manipulate tax provisions. For this study, tax sheltering is referred to as an abusive tax planning techniques that manipulate tax provisions which is in line with the definition of Salihu Obid and Annuar (2013)

Debt Tax Shield

Debt tax shield which is employed in this study as a proxy for tax sheltering is defined as the practice where the capital structure of a company reflects more debt than equity. In other words, the financing pattern is tilted largely towards the direction of debt than equity. The pattern of corporate financing has some effect on what the company declares as profit that is then taxable. In several countries including Australia, New Zealand and Nigeria, corporate tax policy is such that allows for interest payable or paid deductions before profit is then computed. This implies that companies with high debt levels, will pay more interest and this further reduces available profit to be taxed. However, the advent of thin capitalization rule has helped to implement debt-to-equity ratio, a maximum amount of

internal debt that can be deducted from taxes for a specific equity level that is imposed (Graham, 2000; Farrar & Mawani, 2008; Egger, Keuschnigg, Merlo, & Wamser, 2014). According to the International Monetary Fund (IMF, 2014) thin capitalization rules often operate by limiting, for the purposes of calculating taxable profit, the amount of debt that can give rise to deductible interest expenses.

Since tax regulation typically allows interest expenses to be tax-deductible, the income of the company that is subject to taxation can be lowered. Consequently, by employing this strategy the company's tax burden will also be reduced. In the opinion of Gbonjubola (2015) the use of higher levels of debt when compared to equity influences taxation such that enterprises with high debt funding would enjoy tax reliefs on interest charges unlike dividend. This is so as interest is exempt from tax and charged until the borrowing company's profit is calculated. This makes debt funding more appealing to big corporations with the goal of transferring income for tax avoidance purposes. Prominent among the benefits of using debt financing are the tax savings that are generated due to the interest deductibility (Frank & Goyal, 2008)

Earnings Management

The trade-off between relevance and reliability in financial reporting is where the idea of earnings management comes from. Highly relevant financial reports solely include realized cash flows, whereas highly reliable reports are concerned with the current value of expected future cash flows. Since accounting rules and legislation demand a portion of both relevance and reliability, financial reporting therefore is associated with certain elements of discretion. This is where earnings management plays in. Over the decades' accounting literature has seen many definitions of the term "earnings management". However, derived from the opportunistic use of the discretion in financial reporting, early literature defined the notion of earnings management as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain" (Schipper, 1989). Here, earnings management is viewed through an opportunistic lens. In the views of Healy and Wahlen (1999) the concept of earnings management is discussed as a firm's alteration in its financial reports or reported economic performance with the goal of either misleading stakeholders or influencing the outcomes of contracts that are based on accounting numbers. In both concepts provided above, earnings management is restricted to the management of accounting accruals. This study adopts the definition of Walker (2013) who perceives earnings management as: "The use of managerial discretion over (within GAAP) accounting choices, earnings reporting choices, and real economic decisions to influence how underlying economic events are reflected in one or more measures of earnings". The study aligns with this definition since it is all encompassing such that it involves accrual-based earnings management or accounting choices, as well as real earnings management or economic choices. In other words, this definition allows for the management of both components of earnings, namely accruals as well as cash flows.

Earnings Management-Tax Shelter Nexus

A firm is viewed as a nexus of contracts (Sundvik, 2017), conflicting contracts between a company and its stakeholders generate earnings management. The contract between corporations and the government, which is the payment of corporate taxes, is inconsistent with the contract between corporations and their shareholders. Shareholders anticipate high profits because of the firm performances, but shareholders must forego a significant portion of their profits to pay taxes. On the other hand, a company's tax obligations limit its profits, eventually lowering earnings per share, a crucial measure of a corporation's health. Earnings management is a strategy that managers can use to reduce corporate tax liability and/or boost corporate net income. The amount paid as corporate income tax in the current period is a cash outflow, reducing the net operating cash flow and, as a result, decreasing free cash flow. On the other hand, corporate income tax expense is closely related to free cash flow of a company. Since the firm's limited free cash flow also limits its ability to pay corporate income tax in the immediate future, it is important to manage the firm's corporate tax liability carefully. Therefore, since tax calculation is based on accounting numbers, tax sheltering could essentially be a motivator for managers to manage earnings (Monem, 2003; Caballe & Dumitrescu 2016). In this regard, Lenter, Shackelford and Slemrod, (2003), Mgammal and Ku

Ismail, (2015) note that tax sheltering might encourage firms to resist aggressive tax lessening activities (aggressive tax planning) and could put pressure on policymakers to improve the tax system, thus contribute to enhanced performance of the capital markets.

Empirical Literature Review

Almashaqbeh, Abdul-Jabbar, and Shaari (2018) analyses the relevance of tax consideration to earnings management by proposing a framework that integrates tax planning and tax disclosure aspects, in real earnings management (REM) model. Tax planning plays a core part in EM, whereby both tax planning and EM attempt to minimize the tax expenses. The quality of tax disclosure mitigates the agency problem, thus reducing EM. The authors noted that companies with high tax burden tend to manage earnings which aligns sternly with the political cost theory. Therefore, the study findings suggest a positive relationship between tax planning and REM. However, the study documents that increasing the transparency in tax disclosure would likely mitigate the problem of information asymmetry, and in line with the Agency Theory, there is an inverse relationship between earnings management and tax disclosure.

Poli (2013) explore earnings management practices of small-sized Italian companies. The study was carried out by adopting the earnings distribution approach whose findings show that the sampled companies are likely to manage their earnings to achieve two earnings level targets. The authors noted that on the one hand, managers do manage their earnings to report slightly positive earnings noting that firms with negative earnings manage them upward to be above the zero threshold while firms with positive earnings manage them downward to bring them close to zero. On the other hand, earnings are managed to minimize earnings changes. Overall, the implication of the findings suggests that earnings of small-sized Italian companies are of poor quality. Hence, earnings management practices in countries which are characterized by a code law system and having a close alignment with accounting and tax systems should be re-examined.

Matonti, Iuliano, Palazzi and Tucker (2021) expand the earnings management (EM) literature for Italian unlisted firms by investigating the drivers of both accrual-based earnings management (AEM) and real activity-based (REM) earnings management. The authors analyze unlisted firms as they represent 99.9% of Italian firms, consistent with most European countries. They estimate models using factors drawn from the literature which potentially influences both AEM and REM, along with some robustness tests. For AEM, ownership concentration is a positive driver, consistent with the entrenchment hypothesis, and firm leverage is a positive driver, suggesting the use of debt covenant violation avoidance strategies. Quality auditor engagement tends to constrain AEM, while size has a negative impact. However, tax drives AEM and profitability has a positive impact.

Marques, Rodrigues, and Craig (2011) assess the extent to which the tax policy measure known as "special payment on account" (SPA) encouraged private Portuguese companies to manipulate earnings. Findings show that earnings manipulation appears to have been motivated by desire to minimize SPA. Firms whose estimate of SPA liability fell within the range of minimum and maximum limits of the SPA had higher levels of discretionary accruals than firms whose estimate was (equal to or) above the ceiling imposed by the legislation. Higher income tax rates were found to cause earnings to be reduced to almost nothing. Companies that manipulated their earnings were more likely than other companies to have higher average income tax rates.

Coppens, Peek (2005) addresses the questions of whether private firms in eight European countries engage in earnings management, and if so, whether tax incentives affect such practices. The empirical evidence suggests that in absence of capital market pressures, firms still have incentives to manage earnings, discovering that private firms avoid reporting small losses. Further outcomes suggest that private firms in countries where tax regulations strongly influence financial accounting prefer small profits to large profits and smooth earnings changes to a larger extent than public firms in the same countries. The outcomes were attributed to tax management.

Geraldina and Jasmine (2019) examine the effect of earnings management on the participation of company owners in tax amnesty program in Indonesia. This study uses a matching sample approach that consist of publicly listed companies that participated in tax amnesty program and companies that did not participate in tax amnesty program

during 1st July-30th September 2016. The final sample consist of 339 firm year observations. Information about the owner of the company that participated the tax amnesty program was obtained from the mass media. The results show that accrual earnings management has a positive effect on the possibility of the owner of the company to participate in the tax amnesty program. This study suggests the users of financial reports to pay attention on the level of aggressiveness of companies' earnings management whom the owners participate in tax amnesty program.
Osegbue et., al (2018) examines how tax sheltering and its interactions with cash effective tax rate, long-term effective tax rate, tax savings, book tax gap, temporary difference of tax shelter and permanent difference of tax shelter impacted on modified Jones earnings model (earnings quality management) for the period between 2009 and 2016. The sample of the study is 116 companies listed on the Nigerian stock exchange covering all sectors excluding financial services. Panel generalized method of moments regression employed in the study shows that tax sheltering had a significant and positive effect on earnings management.

Karjalainen (2015) investigates whether corporate or owners' tax minimization affected earnings management. The regression analysis result indicate that owners' personal tax minimization dominates over corporate tax minimization which produces an effect on earnings management. Specifically, managers of private firms did not manage earnings downwards in the year prior to the corporate tax rate decrease, but they opportunistically managed earnings upwards to receive tax benefits from a favorable dividend taxation system.

3.0 Methodology

This study employs an ex-post facto research design. The inhabitants of Agriculture, consumer and industrial goods, oil and gas, services, healthcare, natural resources, technology, and conglomerates are some examples of these industries. As of December 2019, there were 108 non-finance companies with stock listed on the Nigerian Exchange's Group (NGX). The sampling technique employed is purposive since firms were included in the sample on certain selection criteria. These criteria are that; the firms must have been listed on the Nigerian Stock Exchange market during the period 2010-2019; a period where the most recent tax reforms commenced. All sampled firms' annual financial reports are readily accessible. Firms listed after year 2010 were excluded from the sample as they were considered "young firms" relative to firms listed at least in year 2010. Thus, only non-finance firms with all relevant data (75 non-finance firms) were available for data analyses. The study employs Least Square Dummy Variable regression technique following the studies of Sánchez-Ballesta and Yague, (2020) to express the econometric equation as:

Model Specification

$$DTAX_{it} = \beta_0 + \beta_1 SPFT_{it} + \beta_2 ROCE_{it} + \mu_{it}$$

Where:

DTAX = Debt Tax (Measure of Tax Shield)
SPFT = Small Positive Net Profit (Measure of Earnings management)
ROCE = Return on Capital Employed
β_0 = Constant
β_1 - β_2 = Slope Coefficient
= Stochastic disturbance
i = i^{th} firm
t = time period

Operationalization of Variables

Table 1

VARIABLE NAME	ACRONYM	MEASUREMENT	SOURCE
DEBT TAX SHIELD	DTAX	finance cost divided by total asset	Barth, Konchitchki, & landsman (2013)
SMALL POSITIVE NET PROFIT	SPFT	SPFT is an indicator variable which equals to one if firms have annual net incomes scaled by total assets between 0 and 0.01 in any year	Leuz et al., 2002; Tang et al., 2008
RETURN ON CAPITAL EMPLOYED	ROCE	Profit after tax divided Total equity and Total liabilities	

Authors' Compilation 2022

4.0 Results and Discussion

By examining the effect of earnings management on tax sheltering, descriptive data analysis was carried out first. The following are some insights provided by the descriptive statistics for the sampled non-finance firms used in this study:

Table 2 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
dtax	748	3.337759	4.448797	0	48.3931
smlprofit	750	.2466667	.4313587	0	1
roce	739	2.558609	17.1825	-179.9173	187.1324

Authors' Computation 2022

Table 1, it is observed that on average, the value of debt tax shield is 3.34 with a standard deviation of 4.45. On average, the table shows that about 25% of the firms in the sample tend to engage in earnings management. For the control variable, the table shows that on average, profitability (return on capital employed) is 2.56 with standard deviation of 17.18.

Regression Analysis

Table 3 : Panel Least Square Dummy Variable Regression

Variables	**Small Positive Net Income**	**Return on Capital Employed**
Models		
Debt Tax Shield		
Coefficient	0.855	-0.074
t_ Statistics	(2.08)	(-7.78)
Probability_t	{0.038} **	{0.000} *
No. of Obs.	**739**	
Prob. F statistics	**0.0000**	
R^2	**0.4738**	
VIF	**1.44**	
Hettest.	**0.000**	

Source: Authors' Computation 2022

Table 3 show results from least square dummy variable regression analyses employed to examine the effect of earnings management on tax shelter. First, the researcher makes use of Breusch-Pagan Geoffrey test is determine whether heteroscedasticity exists in the earnings management model as recommended by Gujarati (2004). The result obtained from the diagnostic demonstrates a probability of (P-value:0.0000) which indicate that the assumption of homoscedasticity has been violated considering the very low P-values which is statistically significant at 1% level. To control for heterogeneity observed in the model, Least Square Dummy Variable (LSDV) regression analysis technique is employed. Further, the LSDV model, outcome reveals an R^2 score of 0.4738 which indicates that approximately 47% of the variation in the dependent variable can be explained by the independent and control variables. The outcome of the Fisher statistics (7.84) and the corresponding probability value 0.0000, which shows a 1% statistically significant level denote that the entire model is fit and can be used for discussion and policy recommendation.

Further investigation suggests that the effect of earnings management on tax shelter is positive and statistically significant. Specifically, the results suggest that the practice of tax shelter among firms in the sample is dependent on the level of small positive net income earnings management which implies that firms tend to reduce tax burdens by overstating debt. Marques, Rodrigues, and Craig (2011) argue that engagement in earnings management initiatives for tax purposes depends on the relationship between financial and tax rules which is consistent with the Nigerian case since corporate income tax is based strictly on 30% of corporate net income. This finding is consistent with those of Osegbue et., al (2018); Marques et al. (2011); Coppens and Peek (2005); Poli, (2013a), who document empirical evidence that firms often select accounting policies that decrease reported earnings to minimize their tax payments. This is not the case in countries like Finland (Burgstahler et al. 2006) where financial information is used mainly for contractual incentives and less for tax purposes (countries where financial and tax accounting are either not aligned, or the relationship is weak. However, our finding is at variance with those of Karjalainen (2015) who reported no evidence of earnings management for tax purposes among Finnish listed firms.

5.0 Conclusion and Recommendation

In view of the empirical result obtained from this study the level of tax sheltering of listed firms in the sample is dependent on the level of small positive income management. Specifically, the result aligns with the behavioural finance view which document that the response of stock market is quick and positive to tax shelters because investors focus on profitability without detail screening of cash flows. Therefore, tax avoider firms are likely to have lower future income and future stock returns than other firms. From the foregoing, the study recommends that investors and regulatory authorities should set up policies and regulations that will checkmate tax avoiding managers since firm managers may go beyond statutory shelter requirements to manage earnings for private gains. We also recommend that policy makers and regulators need to provide polices that will give a clear picture of earnings disclosures and possibly provide accounting systems that will diffuse accounting information away from tax liabilities as this will guide against negative motives of tax management. Understanding the procedures which firms employ to manage their earnings may help in the prevention of such practices and facilitate the strengthening of domestic accounting standards that will also detect the use of frequent small positive income earnings management practices in the guise of tax shelter.

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