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NEXUS BETWEEN TAX SHELTERING AND EARNINGS MANAGEMENT OF LISTED NON-FINANCIAL FIRMS IN NIGERIA

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Abstract

This study aims to assess the effect of tax sheltering on earnings management of listed non-financial firms in Nigeria. Non-Debt Tax Shield (NDTS) and Debt Tax Shield (DTS) are used as proxies for tax sheltering. Discretionary Accrual (DA), which was measured by the Larcker and Richardson Model, was employed as a proxy for earnings management. The study employs purposive sampling technique and Generalized Method of Moments (GMM) estimator was used to analyze the data collected. The findings shows that NDTS and DTS have positive and significant effect on DA. Also, asset structure, firm performance, and working capital reveals positive and significant effect on DA. The study concludes that tax sheltering has a significant influence on aggressive earnings management. Hence, the study recommends that tax authorities verify available non-current assets that companies charge depreciation on and confirm the firm's servicing of debt to confirm both NDTS and DTS. This would stop managers from going beyond acceptable statutory shelter requirements for their own private gain.

Keywords: non-debt tax shield, debt tax shield, earnings management, listed non-financial firms, Nigeria

Introduction

Taxes are important sources of revenue for most governments, which are used to fund infrastructure, health, education, and other public services. Tax sheltering is one of the major tax income-saving strategies available to managers of corporate organizations in Nigeria. Tax sheltering practices are usually used to reduce the tax burden to achieve greater after-tax earnings per share and cash available for shareholders. Tax sheltering can be carried out in the form of Non-Debt Tax Sheltering (NDTS) as well as Debt Tax Shields (DTS). NDTS is a way for an individual or a corporate entity to lower their taxable income by claiming allowable deductions that will reduce a taxpayer's taxable income for a given year or defer income taxes to a later year. For instance, interest expenses, medical expenses, amortization, or depreciation may be deducted before arrived at taxable income. DTS is a technique adopted by organizations to reduce the tax to be paid by deducting interest on debt from income realized before arriving at the taxable income. These deductions

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Tax shields lower the total amount of taxes that a person or business has to pay. The more aggressively a company tries to manage its profits, the more likely it is trying to avoid paying taxes. This is called a "high sign of tax sheltering." Most of the time, tax-sheltering practices are used to reduce taxes so in order to increase cash available to shareholders and after-tax earnings per share. Tax shields vary from country to country, and the extent of benefits depends on the taxpayer's overall tax due and cash flows for the given tax year (Aditama & Purwaningsih, 2014; Hayes, 2020; Robin *et al.,* 2021). According to Awuye (2022), loopholes are most prevalent in complex business deals that involve tax issues, political issues, and legal statutes. Companies that have the potential to save taxes tend to use earnings management (EM) to accelerate discretionary spending because it can reduce profits for certain purposes. EM is a method of announcing profit and loss information to the public that has been pre-adjusted to management's interests and with the goal of assisting the company by increasing or decreasing profits (Ofurum *et al.,* 2021; Kong, 2021; Shittu *et al.,* 2022). EM is a managerial activity that companies use to save money on taxes. This is because EM can reduce profits for certain purposes. One reason why companies do EM is to avoid paying taxes (Scott, 2012; Putri *et al.,* 2016).

From relevant studies reviewed on tax sheltering and EM, the findings in majority of these studies shows consistent results that have a significant effect. For example, Amidu and Yorke (2017), Teja (2019), Nadhifah *et al*. (2020) and Robin *et al.* (2021) consistently concludes that tax sheltering has a significant effect on EM. However, some researchers, such as Nico and Silvy, (2017), concluded that it had no significant effect. The majority of studies carried out in Nigeria that were reviewed, considered non-debt tax shield to proxy tax sheltering in their studies and used Modified Jones model (1995) to measure EM (Osegbue *et al.*, 2018; Ofurum *et al*., 2021). Currently, to the best of the researchers' knowledge, no previous study in Nigeria has been found in the literature, to have examined tax sheltering on EM among non-financial listed firms and using non-debt tax shield and debt tax shield to proxy tax sheltering with Generalized Method of Moments (GMM) estimator as analytical tool. Likewise, none of the studies in Nigeria reviewed, employed Larcker and Richardson model (2004) to measure EM. Thus, there is paucity of similar researches on tax sheltering on earnings management practices in Nigeria. Therefore, this study fills the aforementioned gaps by conducting an empirical study on the effect of tax sheltering on EM of listed non-financial firms in Nigeria, using non-debt tax shield and debt tax shield to proxy tax sheltering. Also, this study employed Larcker and Richardson model (2004) to measure EM.

Research Hypotheses

Ho_1: Non-debt tax shield has no significant influence on earnings management of listed non-financial firms in Nigeria.

Ho_2: Debt tax shield does not have a significant effect on earnings management of listed non-financial firms in Nigeria.

Literature Review

Non Debt Tax Shields and Earnings Management

Non-debt tax shields are methods used by managers to reduce their tax liability. Companies are allowed to lower their taxable income through non-debt tax shields such as medical allowances, depreciation, charitable donations, and an employee pension contribution plan, which is expected to make employees do a better job and keep doing a good job, so they will stay with the company

for a long time (Robin, *et al.,* 2021). However, managers could use the non-debt tax shield to manipulate earnings in order to make their companies appear to be doing well. Stakeholders may not know how well the company is really doing financially because of how earnings are managed (Gunawan & Surjandari, 2022). EM is the practice of taking actions that show up in a company's financial reports to give the impression of smooth quarterly or annual earnings; to show high profits in a given year in order to show lower profits in future years; or to show low profits in a given year in order to show higher profits in future years (Gills *et al.,* 2013). EM is done, in part, to show corporate boards that things are going well during a certain time period. Managers also tend to change earnings to surprise investors and boost share prices (Harnovinsah & Lisya, 2014; Ofurum *et al.,* 2021).

Debt Tax Shields and Earnings Management

Debt tax shields are an approach employed by organizations to lower their taxable income. Interest expenses are considered to be tax-deductible, so tax shields are very important, as firms can get benefits from the structuring of such arrangements. EM benefits the company by influencing financial statements through manipulating or selecting accounting methods (Aditama & Purwaningsih, 2014). Profit is the main indicator of management's success in running a company, but on the other hand, taxes are a financial burden for the company because paying them reduces profits. As a result, EM will be used to lower the company's tax burden (Putri *et al.,* 2016). It is a technique that the company adopted to lower its reported income and, in turn, it's taxable income. Hence, the company carries out EM to reduce reported income in order to reduce taxable income. However, if tax expense is smaller, the more aggressive the company will be in carrying out profit management, which could show that the sign of tax sheltering is high. One of the reasons companies do EM is through tax (Scott, 2012).

Theoretical Review

This study was based on Agency theory, Ross (1973) initiated the agency theory from an economic perspective. In a contractual arrangement involving an agent and his principal, the principal's challenge is to decide on a pay structure that will incentivize the agent to act in a manner that is in line with the principal's preferences. Later, this hypothesis was developed by Jensen & Meckling (1976). Among the parties involved in agency theory are the management of a corporation, serving as its agents, and the investors, acting as its principals. The principle depends on the agent to preserve their interests because they often have distinct interests from the agent (Wali, 2021). On occasion, this could lead to mistrust between the parties. According to Jensen and Meckling (1976), the division of a company's owners and management may result in agency problems or conflicts. The costs of agency are also discussed by Jensen and Meckling (1976), including the monitoring costs incurred by the principal to keep an eye on the behavior of agents; the bonding costs incurred by the agent to guarantee that the agent will not act in a way that is detrimental to the interests of the principal; and the residual loss in the form of decreased levels of wellbeing for both parties.

Empirical Review

Some studies have been conducted in Asia, Europe, Africa, and the Pacific to find out what effect tax sheltering has on EM. Some researchers found that tax sheltering had a negative effect on EM,

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while others found positive effect. Hanlon (2005) observed negative influence of tax aggressiveness on EM in a study conducted among United State large firms. Similarly, in a study conducted by Hanlon and Slemrod (2008), the study used regression analysis and revealed a significant negative effect of tax aggressiveness signal on earning quality. Likewise, Frank *et al.* (2009) carried out a study on the tax reporting aggressiveness on its relation to financial reporting of firm's earnings. Their result shows negative influence of tax aggressive policy on financial reporting. More so, Brad *et al.* (2010) observed negative and significant effect on how tax aggressiveness of firms influence earning quality. Furthermore, Waluyo (2016) revealed negative influence of book-tax gap and earnings quality among Indonesian manufacturing firms.

On the basis of studies that found positive effect, Blaylock *et al*. (2012) did a study on how book-tax conformity and earnings management are related. The results show that book tax conformity has a positive and significant effect on the quality of earnings. In a study carried out by Filho *et al.* (2013), the relationship between the parts of book tax differences and annual changes in earnings and tax expenses among firms listed on the Brazilian Stock Exchange was examined. The results show that permanent tax differences have a positive and significant effect on earnings quality. Also, Amidu and Yorke (2017) carried out a study among 119 firms in Ghana. The results showed that tax avoidance has a positive and significant effect on EM. Similarly, Osegbue *et al.* (2018); Ofurum, *et al.* (2021) did research on how tax sheltering affects EM in Nigeria. Their results showed that tax sheltering have positive and significant effect on EM.

Most of these studies reviewed were done in developed countries like the US and Europe, as well as in countries with emerging economies like Indonesia and Ghana. Osegbue *et al.* (2018), for example, used cash tax sheltering as a proxy for the long-term effective tax rate and temporary and permanent differences, while the Modified Jones model (1995) was used to measure EM. Likewise, Ofurum *et al.* (2021), which is based on financial companies, used Modified Jones model to measure EM, while tax sheltering was proxied with only NDTS. Based on the reviewed research works on tax sheltering and EM, it is revealed that none of the research work carried out in Nigeria measured EM with the Larcker and Richardson model (2004). Also, none of the research measured the effect of DTS and NDTS on EM of non-financial listed firms in Nigeria using the GMM estimator as an analytical tool. These among others forms research gaps the current study filled.

Methodology

The study used quantitative research design because the data for the study is historically extracted from 58 firms purposively selected from 113 non-financial listed firms on the Nigerian Stock Exchange (NSE) for ten years (2010–2019) as compiled by Machameratio. The Generalized Method of Moments (GMM) estimator was adopted for the panel data analysis to examine the effects of explanatory variables on the dependent variable.

Table 1. Listed Non-Financial Firms in Nigeria

Sectors	Population	Sample	Percentage %
Conglomerates	5	5	100
Natural Resources	4	3	75
Oil & gas	11	8	73
Agriculture	5	3	60

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Consumer goods	20	12	60
Healthcare	10	5	50
Industrial goods	15	7	47
Services	25	11	44
Construction & Real Estate	9	2	22
ICT	9	2	22
Total	**113**	**58**	**51**

Source: Authors Compilation, 2023

Measurement of Variables

Dependent Variable: Larcker and Richardson model (2004) was employed to measure Discretionary accruals

DA= TA- NDA (3.1)

Where

DAi,t = Total discretionary accruals firms i in year t, TAi.t = Total accruals of firm i in year t., NDAi,t = Total accruals of non-discretionary firms i in year t.,

$$NDA_t = \alpha_1\left(\frac{1}{A_{t-1}}\right) + \alpha_2\left(\frac{\Delta REV_t - \Delta REC_t}{A_{t-1}}\right) + \alpha_3\left(\frac{PPE_t}{A_{t-1}}\right) + \alpha_4\left(\frac{BMt}{A_{t-1}}\right) + \alpha_5\left(\frac{CFO_t}{A_{t-1}}\right) \quad (3.2)$$

Where,

ΔREVi,t = Changes in firm income i in year t. ΔRECi,t = Change in Receivable i in year t. More so, PPEit = firm Non-current asset in year t., MBit= Market Book Value, CFOit= Cash flow from operation, while Ai,t-1 represent Total assets of firm i in year t_{-1}, and εi,t = Error term.

Table 2. Independent and Control Variables

Variable	Acronyms	Proxy	Sources
Independent Variables			
Non Debt Tax Shield	NDTS	Depreciation and amortization ÷ by total asset	Teja, (2019)
Debt Tax Shield	DTS	Different between net income and taxable income ÷ total asset	Kramorova, (2020)
Control Variables			
Asset Structure	AS	Intangible asset ÷ total asset	Amidu *et al.,* (2019)
Free Cash Flow	FCF	Cash flow to total debt	Onaolapo and Shittu, (2022)
Firm Performance	ROA	Net income ÷ total asset	Shittu *et al.,* (2023)
Working Capital	.WC	Trade receivable ÷ total revenue multiply by 365	Shittu and Amao (2022)

Source: Authors compilation (2023)

Research Model

This study model was adapted from the work of Ofurum *et al.,* (2021) as shown below.

$DA = \beta_0 + \beta_1 NDTSit + \beta_2 DTSit + \beta_3 ASit + \beta_4 FCFLit + \beta_5 ROAit + \beta_6 WCit + YEARit + \varepsilon$ (3.3)

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Results and Discussion

Descriptive Statistics

Table 3 shows the detail account of the descriptive statistics for the explained and explanatory variables respectively. The average earnings management as proxied by DA for non-financial listed firms in Nigeria during the study period is about 0.011 with standard deviation of 0.131. This suggests that there exists significant variation among the values of earnings management among non-financial listed firms in Nigeria during the period. In respect of NDTS of the firm, its average value shows 3.85 with standard deviation of 3.35. This implies that there is moderate variation among the values of NDTS due to its standard deviation. The analysis of DTS, Asset Structure (AS), Free Cash Flow (FCF), Firm Performance (FP) and Working Capital (WC) show mean of 3.74, 2.83, 0.17, 3.06 and 107.6 respectively while their standard deviation revealed 4.49, 7.24, 0.27, 14.32 and 242.6. These suggests that there are significant variation among the values of DTS, AS, FCF, FP and WC. The skewness of the study variables is from 0.39 to 17.06 while the kurtosis ranges for this study from 7.16 to 358.8 which depict the pointedness or flatness of the distribution compared with normal distribution.

Table 3. Summary of Descriptive Analysis

Variables	Min	Max	Mean	Std. Dev	Kurtosis	Skewness	Obs.
DA	-0.66	1.796	0.011	0.131	63.26	3.91	580
NDTS	0.001	26.37	3.85	3.35	11.54	2.34	580
DTS	0.00	48.39	3.74	4.49	28.38	3.90	580
AS	0.00	45.34	2.83	7.24	16.79	3.73	580
FCF	-1.10	1.61	0.17	0.27	7.16	0.39	580
FP	-71.35	17.62	3.06	14.32	42.95	2.23	580
WC	0.03	52.82	10.76	24.26	35.88	17.06	580

Source: Authors Computation (2023)

Correlation Coefficients

Table 4 shows that there was a negative correlation between NDTS and Debt Tax Shield DTS of the sampled non-financial listed firms in Nigeria during the study period, which was explained by -0.13 and -0.36 respectively. This implies that as NDTS and DTS increase, EM proxied by Discretionary Accrual (DA) decreases. For control variables, there is a strong and positive relationship between firm performance (FP) and DA with a value of 0.78, while a moderate and positive relationship exists between working capital (WC) and DA with a value of 0.44. Meanwhile, the table shows that there is a weak and positive relationship between asset structure (AS), free cash flow (FCF), and DA at a correlation coefficient of 0.02 and 0.01 respectively. Furthermore, the relationship between the study variables indicates that there is no evidence of multicollinearity since none of the relationships is up to 0.8.

Diagnostic Tests

The Variance Inflation Factor (VIF) test was conducted to check for multicollinearity among the explanatory variables of the study. The results of VIF as shown in Table 4 show that the highest VIF

is 1.69 for FP and the least is 1.01 for AS, which is less than the threshold of 5 to 10. This indicates the absence of multicollinearity.

Table 4. Correlation Matrix and Variance Inflation Factor

Variables	DA	NDTS	DTS	AS	FCF	FP	WC	VIF
DA	1.00							
NDTS	-0.13	1.00						1.26
DTS	-0.36	-0.01	1.00					1.08
AS	0.02	-0.01	-0.04	1.00				1.01
FCF	0.01	0.23	-0.12	-0.05	1.00			1.34
FP	0.78	-0.02	-0.43	-0.02	0.33	1.00		1.69
WC	0.44	-0.12	0.01	-0.03	-0.19	0.33	1.00	1.32

Source: Authors Computation (2023)

Effect of Tax Sheltering on Earnings Management

Table 5 shows the results of the effect of tax sheltering on earnings management (EM) proxied by Discretionary Accrual (DA). NDTS and DTS had positive and significant effects on EM (= 7.52; 0.42; *P* > 0.05; 0.00 0.05, respectively). Asset Structure (AS), Firm Performance (FP), and Working Capital (WC) all had positive and significant effects on EM (= 9.28; 78.43; 5.80; *P* > 0.00; 0.00; 0.00 0.05), respectively. Free cash flow (=-32.31; *P* > t|=0.0000.05) had a significant negative and significant influence on EM. Diagnostic tests of Wald chi2 (2148.17; *P* =0.000) and Sargan statistic (34.45; *P*= 0.49) showed that the model has a good fit. More so, the Arellano-Bond test for zero autocorrelation shows that the Z-statistic of the second order autocorrelation test AR (2) is (1.109; *P*= 0.91) means that there is no problem with the model's autocorrelation. Thus, the diagnostic statistics revealed that the results were valid for policy inference.

Table 5. Effect of Tax Sheltering on Earnings Management

DA_{t-1}	**10.65 (0.00)**
NDTS	7.52 (0.00)
DTS	0.42 (0.00)
AS	9.28 (0.00)
FCF	-32.31 (0.00)
FP	78.43 (0.00)
WC	5.80 (0.00)
Constant	-5.34 (0.00)

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Wald chi2 Statistic	2148.17 (0.00)
Sargan Test	34.45 (0.49)
First order autocorrelation test	-3.65 (0.0003)
Second order autocorrelation test	-.1109 (0.91)
Firms	58
Observations	464

Source: Authors Computation (2023)

Discussion of Findings

This study examined the effect of tax sheltering, as measured by NDTS and DTS, on EM proxies by DA. The results showed that both NDTS and DTS had positive and significant effect on DA. The positive effect indicates that the sampled firms manipulate earnings through NDTS and DTS. The stock market responds quickly and positively to tax shelters because investors focus on profits and don't look closely at cash flows. This means that the study's hypotheses that NDTS and DTS have no significant effect on EM should be rejected. This finding supports what other studies have found (Osegbue *et al.,* 2018; Machdar & Nurdiniah, 2021; Enoch *et al.,* 2021; Ofurum *et al.,* 2021). But the results contradict the findings of the research work of Brad *et al.* (2010) and Waluyo (2016). Concerning the control variables, the positive effect of AS, FP, and WC shows that an increase in AS, FP, and WC increases the earnings management of the sampled firms. Even though FCF is negative, it shows that EM is going down as FCF goes up.

Conclusion and Recommendation

The study concluded non-debt tax shields and debt tax shields have positive and significant influence on earnings management among non-financial listed firms in Nigeria. Thus, the study suggested that tax authorities verify available non-current assets that companies charge depreciation on and confirm the firm's servicing of debt to confirm both non-debt and debt tax shields. This would stop managers from going beyond acceptable statutory shelter requirements for their own private gain.

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