

# The Effect of Earnings Management and Taxable Profit of Listed Industrial Goods Firms in Nigeria

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## **Abstract**

*In this study, we made efforts to examine the effect of earnings management (EMan) practice (discretionary accruals) on taxable profits (TP) of listed industrial goods firms in Nigeria. The population of the study involves seventeen (17) listed firms in the Nigeria Stock Exchange (NSE) as at 31<sup>st</sup> December, 2017. Secondary source of data was used from the annual reports and accounts published by the firms between 2010 and 2017. The study focused on reported earnings of seventeen (17) listed industrial goods firms in Nigeria between the periods 2010 and 2017. Panel data of 164 firm observations were used and analyzed with the use of ordinary least square regression technique. Findings from the study indicated that earnings management (EMan) has a significant effect on taxable profits (TP) of listed industrial goods firms in Nigeria. Hence, this study as a wakeup call for auditors, stakeholders and tax policy makers to be alert, with kin interest to reported profits and tax planning while performing their duties in; analyzing, monitoring and policy making of corporate organizations.*

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**Keywords:** stock price, taxable profit, earnings, industrial goods, listed firms

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## **Introduction**

Earnings Management (EMan) as a concept has come to be in the accounting and finance literature over the years. But the opposite practices of EMan has not been fully explored; 1) EMan to reduce profits (conservative accounting) for tax purposes. 2) EMan to increase profits

(aggressive accounting) for higher stock prices and to satisfy the earnings benchmark. Earnings Management is the process of deviating from standard accounting processes and adjusting reported income (Roychowdhury 2006). The business environment has recorded some business failures due to some fraudulent accounting practices. One of which is the manipulation of financial figures in the presentation of financial statements. The likes of Enron, WorldCom and Xerox are good examples (Okolie, 2014). This is because some firms purposefully manipulate financial statements to look good in the eyes of the public and influence major decisions based on accrued earnings per share results which are often called the shareholder's profits (Healy & Wahlen, 1999; Scott, 2014).

In Nigeria, tax is levied on the authority of the Federal Government Income Tax Management Act 1961 (Nworji, 2004). And it is imposed by the government against the income, profit or wealth of an individual, partnerships and corporate organizations (Ojo, 2009). Why do corporate organizations, in presenting their profits to be assessed by the tax authority, choose to present a manipulated figure, and how it affects the sustainability of the business by paying extra tax liability from the real earnings, which may subsequently lead to business collapse?

The profits of a firm are called earnings (Scott, 2014). Stock analysts and investors are often attracted to a particular stock by considering the earnings of the firm. When firms have poor earnings results, their share prices will be low, and those with good results have higher share prices with a better prospect that tells of the ability of the firm to make profits in the future (Badertscher, 2011). In order to attract investors, some firms make their earnings look good by deliberately inflating their earnings and, when tax is assessed based on the inflated figure; it may affect the firm's real earnings and may lead to business failure, especially, when subsequent manipulations are no longer sustainable in the long run. The practice involves moving earnings from one reporting period to another in order to paint a better picture or manipulating the balance sheet to hid liabilities and inflate earnings (Ojo, 2009).

The main aim of this study is to examine the effect of earnings management on taxable profits of listed industrial goods firms in Nigeria. Specific objectives are;

1. To examine the significant effect of manipulated earnings and taxable profits on the sustainability of listed industrial goods firms in Nigeria.
2. To examine the relationship between earnings management and taxable profit of listed industrial goods firms in Nigeria.

This paper will consider the following sections; next to the introductory aspect of the study, is the second section which is review of literature, third and fourth sections will be for empirical analysis, results and discussions, leading to the conclusion in the fifth section.

## **Review of literature**

### **Conceptual review**

Tax is the levy, but taxation is the process involved in identifying, assessing and collecting of the tax (Sun, Salama, Husainey, & Habbash 2010). It is one of the main sources of generating

revenue for the government for developmental purposes. A tax is a fee levied or charged by the government on product, income or activity. There are various types of tax. If tax is levied or charged directly on personal or corporate income, it is regarded as a direct tax, that is, where taxation is levied on the income of individuals or profit of corporations. But if it is levied on the price of a good or service, it is called indirect tax (Ayers, John & Stacie, 2009).

An authorized legislation is usually responsible to impose such tax, otherwise, it is illegal (Okafor, 2012; Nworji, 2004). It is enforced contributions of money to aid government achieve its desired goals, through a defined and authorized legislation as defined by the Institute of Chartered Accountants of Nigeria (2006) and Chartered Institute of Taxation of Nigeria (2002). If business corporations fail to pay tax, it means the economy of the country is not doing well (Soludo, 2009). Some of the Legislations that allowed the Nigerian government tax its citizens are the Personal Income Tax Amendment Act 2007, Petroleum Profit Tax Amendment Act 2004, Capital Gains Tax Amendment Act 2004, Value Added Tax Amendment Act 2007 and the Education Tax Amendment Act 2004 (Ojo, 2009).

The Federal Inland Revenue Service (FIRS) is the agency of the Federal government responsible for the administration & collection of these taxes (Ofuegbu, Akwu & Oliver, 2016; Nworji, 2004). Nigerian government is kin and very serious in her duty regarding taxation because it is one of the main sources of government revenue. The FIRS recorded an increase in tax revenue above the target every year. For example, tax revenue increased from ₦2.83 trillion to ₦4.71 trillion between 2010 to 2014 (Ofuegbu et al., 2016).

Taxable profit is the income declared by corporations after the necessary adjustments have been made. It is usually called assessable profit or profit before tax (Sun et al., 2010). At the end of the financial year, every corporation is expected to give the financial report which includes statements as to the financial position, comprehensive income, cash flow and equity.

There are various definitions of Earnings Management (EMan). Some defined it as a purposeful intervention in the process of financial reporting with the aim of achieving certain goals set by the management of the firm (Roychowdhury, 2006; Scott, 2014; Budi, 2016).

Holland & Jackson (2004); Healy & Wahlen (1999), see (EMan) as the alteration of financial statements through the use of judgment in structuring transactions either to achieve some contractual benefits contingent on accounting figures or, to mislead the firm's stakeholders about the true economic picture of the enterprise. This is to say EMan involves the use of accounting choices and methods to misrepresent financial reports in order to achieve some objectives that do not agree with the underlying economic realities of the firm (Badertscher, 2011; Holland & Jackson, 2004; Sun et al. 2010).

### **Theoretical framework**

Schipper (1989), described retribution organization, and mentioning it as a focused interference in the peripheral financial journalism procedure as effort aimed at obtaining individual achievement.

Aggressive accounting, no doubt, promotes analysts/investors by way of higher reported performance. This happens through dealings with figures in the balance sheet and revenue reports, however, these variations may be done according to the requirements, but can still mislead some investors. Even if retribution management is viewed as an income to fetch significance to stakeholders, managers must not forget that tax may still have to be paid out of it.

### Empirical review

The Board of Directors and its committees are saddled with the responsibility of ensuring the credibility of financial reports. Such committees involve Managers and Audit Committees and Stakeholders who take care of monitoring the business activities and preparation of financial statements with a view of ensuring integrity of financial reports (Ofuegbu et al., 2016). The stakeholders to the corporation are also involved because whatever happens to the firm may also affect them either directly or indirectly. Major economic decisions with great economic consequences are taken care of through business research, analysis development and implementation strategies by such committees. Other research studies have given serious attention to the committee as the main agent in ensuring integrity of financial information (Abbott, Parker & Peters, 2004; Budi, 2016).

Worlu & Nkoro, (2012) examined the impact of tax revenue on the economic growth of Nigeria, using infrastructural development & GDP as proxies for economic development, with data of 1980-2007 and ordinary and using least square regression as the tool of analysis. It was revealed that tax revenue stimulates economic growth through infrastructural development. The study recommends that tax revenue can only impact on economic development when offenders are checkmated so as to reduce the level of corruption, evasion and tax avoidance so that tax revenue base for increased growth can be increased (Frank, Lynch & Rego, 2009; Abbott et al., 2004). This is to say government will always be excited to collect high tax revenues, without considering whether the firm inflated its financial report or not.

The study proposed two main hypothesis, that;

Ho<sub>1</sub>: EMan has no significant effect on taxable profits of listed industrial goods firms in Nigeria.

Ho<sub>2</sub>: EMan & taxable profit has no significant relationship on the sustainability of listed industrial goods firms in Nigeria.

### Methodology

The population of the study involved the 164 firms listed with the Nigeria Stock Exchange (2017). Listed firms are companies whose stock trades on a stock exchange, and meets the requirements to be listed (Cretchen & Campbell, 2012). Seventeen (17) industrial goods firms were considered, secondary data was extracted from the published audited annual reports & accounts of the firms as published by the Nigeria Stock Exchange. The choice of industrial goods was because of the important role they play in the development of the Nigerian economy. These are goods that are bought and used for industrial and business use, which includes machinery, manufacturing plants, raw materials etc. They used for the production of other goods such as consumer goods (Soludo, 2009).

The regression research design is adopted for the study and the model used is as follows:

$$EMan_{it} = a_0 + a_1(TP_{it}) + a_2(AY_{it}) + a_3(LV_{it}) + a_4(SH_{it}) + e_{it}$$

Where:

EMan<sub>it</sub> = discretionary accruals of earnings management for each company (i) per year (t).

TP<sub>it</sub> = taxable profit for each company per year.

AY<sub>it</sub> = asset yield for each company per year.

LV<sub>it</sub> = financial leverage of each company per year, calculated as the ratio of total debt to equity (attributed to ordinary shares). Debt-To-Equity is calculated from the variables Total Debt and common Equity from the data stream.

$SH_{it}$  = dummy variable which represents the type of stakeholder that benefits from manipulated income. Those that benefited from the manipulated income takes the value 0, and those that do not benefit takes the value 1.

$a_0$  = the constant term,

$a_1, \dots, a_4$  = the coefficients the independent variables

$e_{it}$  = the regression residuals.

The variables  $AY_{it}$ ,  $LV_{it}$  and  $SH_{it}$  are employed as control variables.

### Measurement of variables and results

The dependent variable of the study is EMan using discretionary accruals in determining abnormal cash flow from operating activities as a proxy, while the independent variable is taxable profit.

Observations:164	Mean	Median	Standard deviation	Minimum	Maximum
Accounts receivable	30105.31	11712.5	64754.2	141	573600
Variation of accounts receivable	225.812	239	15940.17	-146721	165237
Fixed assets	182142.4	210382.5	606187	302	570000
Total assets	233235.6	42662.5	532650	1532	500000
Sales	192145.6	32345	407306	611	306000
Variation of sales	19480.53	1511	67105.2	-643575	582821
Earnings (loss) before taxes	10338.64	848	4381.7	-135634	403000
Net income	7763.22	632	3128.33	-116768	246000
Cash flows (operating activities)	11403.31	734	59788.9	-88203	631200
Total accruals	-2043.668	8.5	44232.7	-572700	16324
Total accruals/ Total assets	0.0015345	0.000232	0.506204	-1.046283	0.554871

**Table (1)** Source: *Researchers' stats.*

Observations:164	Non discretionary accruals (model 1)	Discretionary accruals (modell)	Non-discretionary accruals (model 2)	Discretionary accruals (model2)
Mean	0.0007725	0.0007004	0.0005846	0.0003388
Median	0.0008232	-0.0006685	0.0009264	-0.0007317
Standard deviation	0.0080234	0.0571554	0.0071166	0.0578436
Minimum	-0.0310531	-0.871068	-0.0335767	-0.854735
Maximum	0.1344518	0.176102	0.0913063	0.452232

**Table (2)** Source: *Researchers' stats.*

$$EMan_{it} = a_0 + a_1(TP_{it}) + a_2(AY_{it}) + a_3(LV_{it}) + a_4(SH_{it}) + e_{it}$$

EMan	Coefficients	Std. Err	t	P>t	95% coef.	Interval
TP	0.233***	0.044	3.120	0.000	0.150	0.371
AY	0.001**	0.000	5.210	0.000	0.001	0.001
LV	-0.0004*	0.000	-0.610	0.022	0.000	0.000
SH	0.0052**	0.003	0.720	0.012	0.000	0.013
CONSTANT	-0.014***	0.001	-1.250	0.000	-0.015	-0.006

\*\*\*significant at the 0.01 level (2-tailed)

\*\*significant at the 0.05 level (2-tailed)

\*significant at the 0.1 level (2-tailed)

**Table (3)** Source: *Researchers' Stats.*

Table 1 presents the pooled data of the assets of the firms.

Using model 1 and 2 with discretionary and non-discretionary accruals (table 2), an increase in taxable profit tends to increase discretionary accruals and as a result the possibility of earnings management increased. Table 3 shows that taxable profit is significant at 0.01 levels. On the basis of these outcomes, the null hypothesis can be rejected and the alternative hypothesis is accepted. EMan has a significant relationship with taxable profit, and EMan and taxable profit affects the sustainability of listed industrial goods firms in Nigeria. These findings are not far from the findings of previous research. Management tends to manipulate earnings to increase profits in order to look good in the eyes of the public without considering the implication of tax liability in the long-run (deferred tax) (Healy & Wahlen, 1999; Sun et al., 2010).

### Conclusion

Based on the findings of the study, the following conclusions are drawn that; EMan has a significant effect on taxable profits of industrial goods firms in Nigeria. This means increase in EMan will lead to higher tax liability. Again, EMan and taxable profit is significantly related to the sustainability of the industrial goods firms in Nigeria. This is true in the sense that when taxable profit is increased as a result of EMan, more of the real income of the firm is collected through tax and the firm may not be able to sustain such payments in the long run, thereby leading to business collapse (Frank, et al., 2009; Ayers, et al., 2009). Therefore the study opines that; financial managers, stakeholders and policy makers should recede from EMan without a corresponding tax policy in the industrial goods firms in Nigeria. Other studies could focus on conservative accounting for tax purposes (Budi, 2016; Badertscher, 2011).

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