Shareholders motives and corporate tax avoidance: a literature study

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Abstract.

There are many studies have been done to formulate models that are useful for shareholders and stakeholders to detect fraud or manipulation of published financial statements. Some of them are Beneish mathematical model and Dechow F score model . Similarly, there are also many studies have been done in purpose to find the model in detecting tax avoidance. Some of them are Book-tax gap (differences) analysis, Long run Cash Effective tax rate analysis and Tax-gap Analysis. On the contrary, there are very few studies that investigate the relationship between management and shareholder motive and corporate tax avoidance. In this paper, I perform a literature study to explore There are many studies have been done to formulate models that are useful for shareholders and stakeholders to detect fraud or manipulation of published financial statements. Some of them are Beneish mathematical model and Dechow F score model . Similarly, there are also many studies have been done in purpose to find the model in detecting tax avoidance. Some of them are Book-tax gap (differences) analysis, Long run Cash Effective tax rate analysis and Tax-gap Analysis. On the contrary, there are very few studies that investigate the relationship between management and shareholder motive and corporate tax avoidance. In this paper, I perform a literature study to explore the possibility of employing such existing models and analysis to investigate the relationship between shareholder's motive and corporate tax avoidance within the Agency Theory framework .

Keywords: earning management, tax avoidance, shareholders motive, agency theory

1. Introduction

Avoidance to pay the tax means the legal exploitation of the companies from the tax system in their own interest which lead to the reduction of the legal payable amount to the government. One of the result of self-determined tax system is the tax non-compliance .It is believed that this is the main factor in reducing the tax earnings of one country. The beginning of the tax avoidance is when the tax payer does not desire to pay some parts of his income to the government as the tax. There are various ways and methods which the companies and institutes can use in order to decrease their tax liabilities including the report of the income less than the real amount and using different tax tricks due to different tax rates. The tax avoidance can be considered as the measures which encounter the tax system of the company with problem which resulted in non-payment of the tax liabilities to the government (Fouest and Raidel, 2009).The company's tax tricks change to the considerable tools for reducing the tax load of many companies (Wilson,2007).

The noteworthy point is that there is a common view between the shareholders and tax authorities on the financial operation of the companies since both parties try to company can achieve the higher profit level. According to the shareholders' view, the earned profit is a safe criteria for describing their investments in order to increase their wealth and predicting of the future cash flows. Meanwhile, according to the tax authorities' view, with the increase of the profit of the companies, the more taxes will be earned for the government's expenses.

The mangers of those companies who refuse to pay the real amount of tax, may take the measures in the profit management individually or together with the shareholders in order to achieve to their expected profit level. Although some of this proceedings lead to pay more taxes but according to the previous studies, there are many of these proceedings which do not need to pay more taxes necessarily. Therefore, in the recent years, the accuracy and reliability of the companies' financial statements have been questioned. The users of the financial statements believe that the manipulation of the management in financial statements may cause the low quality of the financial reports.

The necessary factor for investigating the reliability of the financial statements is the model or analysis of the deception discovery. The researchers attempt to perform more comprehensive researches in this field and present some models for discovering the deception, manipulation, profit management and companies tax avoidance, assist the tax system in order to receive the taxes according to the tax laws and regulations. There are many studies in investigating the deception in financial statements which submitted by the companies. Also, there are many studies in investigating the tax avoidance of the companies based on the models of “analysis of the difference between the office revenue and taxable income”, “analysis of the effective long term rates of taxes” and “analysis of the tax gap”. In addition, there are some studies for approving the relationship between the taxable income and the future income of the company and the relationship between the motivations of the managements and tax avoidance. But in previous studies, the relationship between the motivations of the managers, shareholders and tax avoidance has not been investigated based on the agency theory, therefore in this present study, it has been tried to remove the gap in this field.

2. Managers’ motivations for tax avoidance and some discussions in ownership theory.

Tax avoidance not only helps the cash flow of the company but also improves the liquidity situation of the management of the company and shareholders. When we talk about the tax non-compliance, we cannot ignore the submission of the artificial financial statements which presented with the tax purposes by the management since the mentioned financial statements are different with the submitted financial statements in the capital market. Basically, the method of preparation of these two financial statements is not different but the difference is in the motivation of the management in preparing them. Despite of the company’s economic advantages of tax avoidance, it can cause some risks in company. The management of the company is responsible for preparing the financial statements and the consequences of the probable non-accordance of financial statements with the financial laws and regulations. Sometimes, the managers avoid to pay the tax individually and without the agreement of the shareholders and just consider their own economic interests but sometimes this action is performed by the managers and the agreement of the shareholders. In this case both groups are concerned. From the traditional point of view, the partnership in tax avoidance defiantly lead to increase the profit after the reduction of the tax of shareholders, therefore, they have enough motivation for doing that but in this case the managers just receive their given salaries and certainly they are not encouraged to perform that action. Thus, if the mentioned action needs a few attempt, the managers prefer to avoid that. But motivating the managers by paying them whether in reward or bonus shares can encourage them for cooperating in tax avoidance and this lead to increase the profits of the shareholders. The relationship between the shareholder and the manager of the company is the base of formation the relationship between owner and agent in the agency theory. The agency theory is a contract in which a group of owners select a person or a group as the steward or agent (Nikoomaram and Bani Mohammad). Yensen and Macling believe that according to the contractual relationship, one or more persons (owner(s)) employ another person (agent) for performing some services and granted him some part of decision making power of the company. If both parties of the relationship seek his maximum profit, therefore, it is possible that the agent does not attempt in the direction of owner’s profits. In contrary, the owner can create the necessary motivation for the agent and pays the monitoring expenditures from his own profits in order to be assured from the non-diversion of the agent from the intended purposes. In addition, sometimes the owner pay the expenses called “bonding expenditures” in order to be assured that there is no action against his interests. Dipken and his colleagues used the advertisement expenditure criteria of the company in order to determine and measure the bonding expenditures. They increased the advertisements, shareholders and other active factors of the market in order to precise investigation of the company’s activities with the purpose of decreasing the risk of manipulation in financial statements.

The unwillingness of the managers for cooperating in the tax avoidance can be interpreted based on the agency theory as problem between the owner and the agent which cause the non-avoidance to pay the taxes since the agents are not interested in performing action in order to promote the interests of the shareholders. Therefore, the owners should pay some expenses of the agents in order to achieve their intended purposes. In most of the agency relationship, the owner and the agent pay some expenses for monitoring and monetary and non-monetary bonding but still there are a few difference between the decisions of the agent and the decisions which lead to maximum welfare of the owner. This difference causes the reduction of the owner’s welfare and considered as one of the expense of the agency relationship which called residual loss. Generally, Yensen and Macling define the expense of agency as a combination of the following factors:

A-Monitoring expenditures paid by owner

B-Bonding expenditures paid by agent

C- Residual loss

3. Effective steps in determining the tax avoidance.

According to the mentioned discussions, the investigation of the shareholders’ motivation and companies’ tax avoidance should be performed in 3 phases based on the investigated analyses and models. The first step includes the distributed financial statements by the company with the purpose of discovering any deception and manipulation. Second step includes the investigation of the distributed financial statements by the company with the purpose of discovering the tax avoidance. Third step includes the investigation of the relationship between shareholders' motivation and tax avoidance based on the agency theory.

The first step should be performed due to high correlation between the deceptive financial statements and tax avoidance. Some of the researchers believe that usage of the taxable income is appropriate and useful for measuring the stability and reliability of the financial statements and predicting the future profits. Therefore, according to this argument, the deception in the financial statements can be used for determining the tax avoidance by the companies. The analytical model of Spatis which includes the ratios of inventory to sale, debt to total asset, net profit to total asset, working capital to total asset and z-score can be used for clarifying the probable deception in financial statements. Another models such as Beneish and Indicator models (F-score) can be used for investigations in this field.

The second step relates to ensuring the willingness of the company to tax avoidance. The result of this step forms the third step. In ideal conditions, the investigation of the tax avoidance can be performed by the comparison between published financial statements by the company and the tax return in order to find the difference between the real income and taxable income. Also, the comparison between the tax debts before and after auditing can be used for finding the tax gap. According to the confidentiality of the tax returns and other tax information under the authority of the tax authorities, therefore, only accessible data for investigation of this step is the amount of mentioned tax in the financial statements. In investigating the difference between the office income and taxable income, the source of this difference should be considered in order to find whether the difference resulted from the time difference or temporary difference which is not illegal or it resulted from the different conclusions from the tax regulations or probable deception. In order to improve and enrich the analyses in this step, the analysis of the effective long term rates of taxes which introduced by Daireng can be used.

After justifiability investigation in the second step and assuring of the willingness of the company to tax avoidance, the third step will be performed. In this step the relationship between the shareholders' motivations and tax avoidance will be investigated based on the agency theory. In this step, some of the variables such as the relationship of the shareholder and manger, ratio of shareholder's ownership, position of the shareholder in the Board of Directors, rewards and payments alternatively according to the change of management can be used as some indicators.

4. Management or income smoothing.

Management of the profit is one of the important factor in the discussion of the tax avoidance of the management. The companies are obliged in order to present the annual financial reports to the external users. The annual financial statements may be prepared and delivered based on the purposes and motivations of the management. In the other hand, the management of the companies may apply their subjective purposes and opinions in financial statements which delivered to the outside users. Asfer (2005) believes that in the ideal situation, the management uses its own knowledge of the current situation of the company and the conditions of the business for presenting the financial statements which considered as the useful information source for investors, lenders, government authorities, customers, suppliers and employees in order to make the decision about the investment, tax and etc.

There are many reasons for justifying the profit manipulation by the management. Some of them include the achievement of the income purposes, reward, motivational programs of the management, higher salary, awards, increasing the capital through the public presentation, attempt to reduction of the tax and distribution the income fluctuations between different periods for stabilization the profit. The motivation of the management of the company for reducing the income fluctuations or in other word the profit management is that based on the opinion of the managers, the unstable income with high fluctuations result in reduction the market value of the company. Some of the researchers believe that the profit management is legal totally and it is different with the deception since it is performed based on the acceptable standards of the accountancy. But another researchers believe that there is a little boundary between the income management and deception and consider that as an illegal action which needs the investigation of the independent accountants. The most prevalent methods and techniques for profit manipulation can be categorized in three groups including the changes in accountancy methods, reliance on to management estimations and transmission of the expenses and incomes of (a) period (s) to another period (s). Pikasovich believes that the common methods for unreal improvement of financial statements include the artificial presentation of the prices through consideration of the future expected sales and less presentation of real expenses through the consideration of the operation expenses as investment, increasing the net value of the assets based on the intentional usage of appropriate time scheduling for depreciation and hiding some commitments in the balance sheet of the company and wrong disclosure of the structured financial transactions.

Another alternative method for deception in financial statements is the reparative reserve accountancy method. In this method, the company announces its income for the period less than real one and save the remainder as the reserve for the future periods which may have the weaker performance. According to Magarat and Vold, the common methods for presenting the artificial and spurious incomes are as follows: reparative reserve accountancy, misuse of accountancy principals, registration of the non-achieved incomes and accountancy of creative ownership.

Despite of the identification of the management's motivation for deception, many of researchers attempt to discover some models and formulas as the warning deception indicators based on the elements of the financial statements. Therefore, according to the obtained information from the financial statement of a company, the probable deceptive manipulation of the numbers and figures of the financial statements can be justified.

5. Deception discovery models in financial statements.

5.1. Spatis Model.

Spatis (2002) suggested a model for identification of the signs of a correct financial statement by using the logistic regression and 10 financial ratios obtained from the financial statement. In this model, he represented some of the variables as the indicators of the artificial financial statements: ratio of the inventory to sale, ratio of the total debt to total asset, ratio of working capital to total asset, ratio of the net profit to total asset and the indicator of the financial distress (z-score). He concluded that according to the results of logistic regression, those companies with high ratio of the inventory to sale, high ratio of debt to asset, low ratio of the net profit to total asset, low ratio of the working capital to total asst and low level of the z-score indicator, have more probability for representing the wrong financial statements. Analysis of the comparative ratio permits the analysts, accountants and shareholders in order to identify the differences in the financial statements of the company.

5.2. Beneish Model.

Misood Beneish suggested a model (Beneish Model) for identifying the probability of the deception and manipulation in financial statements. In this model, 8 ratios have been calculated and investigated. These ratios include total committed items to total asset (TATA), general and sale administrative expenditures (SGAI), sale growth (SGI), daily sales in received accounts (DSRI),quality of the asset (AQI) ,depreciation (DEPI), gross profit margin (GMI) and levers(LVGI). Beneish used the samples of the deceptive financial statements from 1982 until 1988 in order to introduce a model for identifying the deception in profit. According to the evidences of his research, the probability of deception will be increased by (1) abnormal increase in received accounts (2) inappropriate gross profit margin (3) reduction the quality of the asset (4) sale growth and increase the committed items. the equation of the Beneish Model is a follows:

$$M=-4.84+(0.92*DSRI)+(0.528*GMI)+(0.404*AQI)+(0.892*SGI)+(0.115*DEPI)-(0.172*SGAI)+(4.679*TATA)-(0.327*LVGI)$$

The fixed number of the model is -4.84 which the coefficients of these 8 indicators are manifold to the fixed number.When the obtained result of the model be more than -2.22, the probability of the manipulation in financial statements will be increased.

5.3. F Score Model.

Decho and his colleagues studied the identification of the predictable factors of deception. They investigated 2191 deception cases between 1982 until 2005 published in the accountancy and auditing magazine. They identified those periods which manipulations were discovered in them and suggested one prediction model for probability of the deception with the factor of F-score. If the F-score indicator shows the number more than one, that company should be investigated precisely. The F-score test can be considered as the first phase in investigating the probability of the fraud and deception.

6. Identification and discovery of the tax avoidance from the accountancy income.

6.1. False or fraud tax return.

The taxes are described as the undesired payments which effect on financial and investment decisions. The tax information mentioned in financial statements give some information about the profit quality. In addition, Hanloon (2005) believed that the high difference between the office income and taxable income is the indication of low reliability of the profit. This difference or gap resulted from the difference between the reported incomes to the investment market and reported income to the tax administration. Measurement of the tax avoidance is very difficult, however, Manzon and Pelesco (2002) and Dosai (2003) used the difference between office income and taxable income as an indirect method for measuring the amount of tax avoidance. But there are two main problems. At the first, the tax information are confidential, therefore, the mentioned difference cannot be investigated by the researchers and investors. At the second, it is probable that the difference between two reported incomes be due to another factor except tax avoidance.

6.2. Applied methodology in the studies of the Kordom Palao and Karjio Rejoos.

According to the previous studies, the difference between the mentioned income in tax return and reported income to the investment market, does not mean the tax avoidance necessarily. Therefore, another researchers tried in order to suggest another methods in this direction. Kordom Palao and Karjio Rejoos (2011) estimated the amount of tax avoidance of the companies based on the data of the tax auditing of the accepted companies in the stock exchange of Athens. Firstly, the amount of tax reduction will be estimated by comparison between the determined tax of one financial year and the reported tax mentioned in tax auditing report. The second amount will be identified when the tax auditing be finished. The difference between the mentioned amounts is called tax gap and is calculated as follows:

Tax gap=tax after auditing- tax before auditing=(additional diagnostic tax+ reported tax)-reported tax= additional diagnostic tax (including taxes and fines)

The second method is used for estimating the tax compliance according to the ratio of the reported tax to real tax:

% tax compliance =(tax after auditing/ tax before auditing)*100%=(reported tax/(reported tax+ additional diagnostic tax)*100%

It is evident that in the second method, the amount of tax avoidance will be calculated as follows:

% tax avoidance =%100-% tax compliance

7. Conclusion.

Tax avoidance changes the competitive ability of the economic factors in favor of those who did not pay the tax. If there be no solution for preventing the tax avoidance, there is a possibility that other people be encouraged to perform this action in order to increase their financial ability. Also due to the effect of social behavior of people on each other and despite of the abstinence of some people, it is possible that the tax avoidance be extended and accepted at the public (Jahromi and colleagues, 2009).The expression of the “tax avoidance” is not a new concept. Many of Iranian companies avoid to pay the tax with different motivations. According to the discussion related to the agency theory and analyses of the relationship between owners and management, the companies are reluctant to pay the taxes to the governments. The tax officials and authorities who access to the most needed data for mentioned analytical models can investigate the available models and identify the appropriate models for early determination the signs of tax avoidances by companies. Therefore, the presented models in this article can be practical and useful in determining the manipulations in financial information of the companies which performed with the purpose of tax avoidance.

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