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# DOES TAX AGGRESSIVENESS LEAD TO MORE EARNINGS MANAGEMENT: THE CASE OF TUNISIAN FIRMS

**Keywords:** tax aggressiveness, earnings management, discretionary accruals, emerging market.

**J E L Classification:** M42, L11, G38.

**Abstract:** The aim of this study is to determine whether a firm tax avoidance activity can be used as an instrument for corporate earnings management in an emerging market called Tunisia. The study also investigates the role of firm size, leverage and audit quality on earnings management. Evidence of earnings management is examined by focusing on accounting earnings management. From a sample of 20 Tunisian listed firms from 2017 to 2019, the results estimated from the linear regression model argue that tax aggressiveness has a positive effect on earnings management but not significant. Furthermore, the results show that larger Tunisian firms exhibit more earnings management. However, findings don't show any significant effects of leverage and audit quality on earnings management.

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## Introduction

Tax aggressiveness is an area that continues to attract considerable attention from both academics and policy makers. This may reflect the importance that managers place on taxes which affect their bottom line and financial condition. As stated by Shackelford and Shevlin (2001), the managers' decision reflects a trade-offs between tax and financial reporting benefits. On one hand, managers can disclose higher income to shareholders but at the same time incur tax costs. Managers, on the other hand, can report lower incur financial reporting costs thus disclose lower incomes to shareholders.

Tax aggressiveness presents an opportunity for managers to practice earnings management by minimizing income tax owed to realize profit target profits while directing firms' resources for personal needs. This happens because management may be able to select accounting procedures or policies that are advantageous to them personally when ownership and control are separated (Putri, Rohman & Chariri, 2016; Blaylock, Shevlin & Wilson, 2012). Given the opacity and complexity of tax aggressiveness activities, managers may hide bad news to achieve its opportunistic goals (Armstrong, Blouin & Lack, 2012).

Desai and Dharmapala (2009) argued that these characteristics may favor managerial opportunism. The majority of recent research in developing markets have been done to explain how earnings management principles relate to firm-level characteristics (e.g. profitability, size, and leverage) or corporate governance mechanisms (e.g. board size, independent directors, CEO duality, and audit quality) and largely ignore how tax aggressiveness impact earnings management decisions. Hence, it is intriguing to explore areas that earlier scholars mostly ignored in order to learn new insights about the relationship between aggressiveness tax avoidance and earnings management.

In this light, the current study's goal is to examine how aggressiveness tax avoidance and earnings management interact in Tunisian firms.

This study makes several contributions to the existing literature. First, we complete studies relating to the determinants of earnings management by identifying the tax avoidance incidence in the context of a developing country like Tunisia, which deepens our understandings about the determinants of firms' earnings information production. Second, the paucity of research on how company tax regulations impact earnings management in less developed nations is the primary impetus for studying the Tunisian market. It should be noted from an economic perspective that Tunisia is one of the nations with high debt capital markets and incentive tax regulations that support investment. Finally, these findings could have some practical and regulatory repercussions that alert regulators to the need for new restrictions to limit earnings management.

The remainder of this paper is structured as follows. In section 2, we give an overview of the relevant literature and derive our hypothesis. In section 3, we describe the research methodology. The results are provided and discussed in section 4. Section 5 concludes this paper.

## Literature Review

### Aggressiveness tax avoidance

Tax aggressiveness refers to the practices taken by a firm to reduce its tax burden through legal tax planning (tax avoidance) and illegal (tax evasion). According to Sunarto, Widjaja and Oktaviani (2021), this action is taken to minimize or reduce the tax costs. In an agency framework where managers frequently act in their own interests and do not prioritize shareholders' interests, the examination of a tax aggressiveness choice is embedded (Salehi, Mirzaee & Yazdani, 2017).

Tax literature argued that tax avoidance serves as one of the motivations for earnings management (Wang & Chen, 2012). Referring to Scott and Scott (2015) definition, earning management can be predicted as the managerial behavior of choosing accounting policies for specific purposes. Two perceptions of earnings management are proposed by Desai and Dharmapala (2009). On one hand, earnings management is regarded as an opportunistic behavior by managers to maximize their own interests. On the other hand, effective contracts may be used to explain earnings management.

One of the assumptions of agency theory is that management of earnings is an opportunistic management practice. According to a stand of literature (Slemrod, 2004; Chen & Chu, 2005; Crocker & Slemrod, 2005), the link between tax avoidance activities and agency problems is inherent in the context of owned-public firms. Corporate tax avoidance can be used by managers to manage earnings. Earnings management, which reflects the opportunistic nature of management, is a practice that is harmful to firms. The existence of agency problems may call into question whether the tax avoidance measures adopted by the firms are in the interests of shareholders. Instead, management applies various schemes and methods to tax avoidance activities as a means of safeguarding personal interests that are inconsistent with corporate goals.

Therefore, firms with aggressiveness tax avoidance are more likely to practice opportunistic earnings management. We expect that aggressiveness tax avoidance to be positively related to earnings management. Therefore, formulate the following hypothesis:

H1: For Tunisian firms, highly tax aggressiveness are more likely to undergo earnings management.

## Firm size

Early studies based on positive accounting theory used firm size as an indicator of the firm's political visibility. According to Watts and Zimmerman (1978), large firms are more sensitive to political cost pressures than small firms and are consequently subject to greater transfer of wealth through mechanisms as taxes and insurance. As a result, managers of large firms seek to escape political pressures by choosing accounting policies that will lower earnings, which aims to reduce the political costs and therefore avoid other government regulations that reduce firm income (Cormier, Magnan & Morard, 1998). This condition indicates that firm size can motivate management to practice earnings management.

Building on this framework, empirical research documents a positive relation between firm size and earnings management (Ali, Noor, Khurshid & Mahmood, 2015; Türegün, 2016). For example, Jones (1991) supported the idea that managers are more likely to manipulate accruals during import-relief investigation in order to reduce earnings. Similarly, Türegün (2016), using data from 179 firms listed on the Turkey stock exchange, investigates the effect of borrowing costs, firm size and characteristics of board of directors on earnings management and finds that large firms are more likely to practice earnings management.

Charfeddine, Riahi and Omri (2013) reach a similar conclusion in Tunisian context. Using a sample of 19 listed companies over the period 2003-2009, they investigate the factors that determine earnings management and show how managers choose practices that minimize earnings in order to pay less in taxes.

Therefore, large firms are more likely to practice opportunistic earnings management. We expect that firm size to be positively related to earnings management.

H2: For Tunisian firms, larger firms are more likely to undergo earnings management.

### Leverage

A review of literature on earnings management highlights that firms use leverage for smooth operations. To protect their private control benefits and to conceal from outsiders, Leuz, Nanda and Wysocki (2003) provide evidence that insiders are motivated to use earnings management in countries with weak shareholders protection. Several studies have been conducted on earnings management explain usually the firms' leverage development by the trade-off theory, suggesting that firms choose their optimal leverage that balances the benefits and the cost of using debt (Kraus & Litzenberger, 1973; Lazzem & Jilani, 2018).

Benefits include reduced agency conflicts between firm agents and owners, while costs include the possibility of bankruptcy. By damping asymmetric information issue that present a major source of earnings management practices, agency problems can be reduced. Moreover, according to positive accounting theory, the most common incentives for earnings management are bonus plan, political costs, and debt covenants (Watts & Zimmerman, 1990). Consistent with this theory, several previous studies (Beatty & Weber, 2003; Dichev & Skinner, 2002) have provided evidence that mangers use voluntary accounting changes in leveraged firms in order to increase earnings and to avoid debt covenant violations.

Consistent with the argument above, a large part of studies have documented the positive impact of leverage on earnings management practices. For example, Abbadi, Hijazi and Al-Rahahleh (2016) investigate the effect of corporate governance quality on earnings management in Jordanian context and provide evidence that higher leveraged firms are more interested in managing their earnings. Likewise, Sercu, Vander-Bauwhede and Willekens (2006) reach similar conclusion in Belgian context. Analyzing a sample of 583 non-listed Belgian firms, they show that earnings management is more significantly related to bank debts. Recently, Tulcanaza-Prieto, Lee and Koo (2020) investigate nonfinancial firms listed on the Korea market, and also find a positive relationship between leverage and earnings management.

In accordance to debt covenants hypothesis, Lazzem and Jilani (2018) find for French firms that managers of highly indebted firms engage in earnings management activities to avoid debt covenants violation. Charfeddine et al. (2013) reach similar conclusion in Tunisian context. On the other hand, there is some empirical evidence to support the opposite view (Qin, 2020; Zamri, Rahman & Isa, 2013). Lazzem and Jilani (2018) argued that these different conclusions can result from the differences in countries' legal systems.

Therefore, basing on Tunisian empirical outcomes (Charfeddine et al., 2013), we expect to observe a positive relationship between leverage and earnings management. Therefore, formulate the following hypothesis:

H3: For Tunisian firms, highly leveraged firms are more likely to undergo earnings management.

### Audit Quality

The recent corporate accounting scandals have triggered significant interest in the role of external auditor in ensuring the quality of corporate earnings, raising concerns about audit quality and its ability to limit earnings management (Velury, Reisch & O'Reilly, 2003). Varieties of research works have examined the effect of audit quality on earnings management, considering two input-based indicators of audit quality (audit size and audit fees).

According to Becker, DeFond, Jiambalvo and Subramanyam (1998) and Francis, Maydew and Sparks (1999), Big six auditors have higher tendency to identify and detect earnings management do to their greater knowledge, and act to curb opportunistic earnings management in order to protect their reputation. Given their larger client base, Krishnan (2003) argued that Big 6 auditors have greater incentive to protect their reputation that non-Big 6 auditors, and therefore higher risk to lose clients. Houqe, Ahmed and Zijl (2017) reach a similar conclusion in Indian context. Using a large sample of listed firms in India, they find that firms audited by high quality auditors exhibit lower levels of earnings management. Moreover, Rhee, Rhee and Li (2021) analyze, in China context, the difference from audit quality of big auditors and non-big auditors and they find that the big auditors provide higher audit service quality to prevent their clients' earning management than non-big auditors. As noted by Alzoubi (2018), audit quality can be viewed as a monitoring mechanism that prevents managers from manipulating firm earnings and argued that high audit quality reduce the information asymmetry that occurs between managers and stockholders. Using a sample of 72 Jordanian industrial firms for the period from 2006 to 2012, they report a negative effect of audit quality on discretionary accruals.

Considering these prior findings, the following hypothesis is tested accordingly:

H4: For Tunisian firms, highly audit quality are less likely to undergo earnings management.

## The Research Methodology and the Course of the Research Process

### Sample selection

To examine the importance of tax aggressiveness on earnings management decisions, we started with all the Tunisian firms listed on the Tunisian Stock Exchange publishing their financial reports in the period from 2017 to 2019. Data collection was halted in 2019 due to the COVID pandemic. The initial sample consisted of a total of 79 firms listed on 2017. We then removed 33 financial institutions which have specific characteristics. We also eliminated 20 totally exporting firms due to their exemptions from taxation and 6 firms with missing data. After restatement, our procedure results in a total number of 60 observations and 20 firms. We manually collected annual financial statements data available on the Tunisian Stock Exchange website (http://www.bvmt. com.tn).

**Table 1.** Sample Selection

| | Number of Firms | Number of Firm-Years |
|---|---|---|
| Observations with available Tunis Stock Exchange data (2017 to 2019) | 79 | 237 |
| Less: Observations of financial institutions | (33) | (99) |
| Less: exporting firms | (20) | (60) |
| Less: Observations missing accounting data | (6) | (18) |
| Final Sample | 20 | 60 |

Source: own study.

## Variable measurement

### Dependent variable: Discretionary accruals earnings management

For the purpose of this study, discretionary accruals were applied to proxy for earnings management. The modified Jones model as proposed by Dechow, Sloan and Sweeney (1995) was used. This is the most prevalent model in earnings management studies. The model is defined as follows:

$$\frac{TAi,t}{Ait-1} = \alpha_1 \frac{1}{Ait-1} + \alpha_2 \frac{(\triangle REVit - \triangle RECit)}{Ait-1} + \alpha_3 \frac{PPEit}{Ait-1} + \varepsilon_{it}$$

Where *TA* is the total accruals, *ΔREV* is the change in sales from year *t-1* to year *t*, $\Delta REC_{it}$ is the change in accounts receivable from year *t-1* to year *t*; *PPE* is the gross property, plant and equipment, *A* is the total assets, *ε* denotes the discretionary accruals, and the subscripts *i* and *t* denote firm and year respectively.

The residuals of Eq1 represent the discretionary accruals of companies through the modified Jones model that are determined as follows:

$$DA_{i,t} = \frac{TAi,t}{Ait-1} - \left( \hat{a}_1 \frac{1}{Ait-1} + \hat{a}_2 \frac{(\triangle REVit - \triangle RECit)}{Ait-1} + \hat{a}_3 \frac{PPE\ i,t}{A\ i,t-1} \right)$$

Obviously, the higher values of discretionary accruals suggest an upward accounting EM. In the following, EM = DA.

### Independent variable: Tax avoidance

In this paper, we are interested by the firms' aggressiveness tax avoidance. Following the accounting and tax literature (Gaaya, Lakhal & Lakhal, 2017; Frey, 2018; Aronmwan & Okaiwele, 2020), the effective tax rate "ETR" is used as an appropriate measure for assessing aggressiveness tax avoidance as it covers both permanent and temporary aggressiveness tax avoidance strategies.

This measure represents the alternative measure of aggressiveness tax avoidance widely used in recent literature (Salhi, Riguen, Kachouri & Jarboui, 2019; Alkurdi & Mardini, 2020; Mouakhar, Kachouri, Riguen & Jarboui, 2020; Abdelfattah & Aboud, 2020). Then, the "ETR" is calculated as the tax expense for the year, scaled by the pre-tax income.

$$ETR = \frac{\text{Total tax expense}}{\text{Pre} - \text{tax income}}$$

### Control variables

The modeling includes three control variables that may influence earnings management. The first is the firm size (SIZE) measured by the logarithm of total assets (Taylor & Richardson, 2012; Khunkaew & Qingxiang, 2019). The leverage level (LEV) is the second variable. The Total liabilities-to-total equity ratio is a proxy for leverage (Nurdiniah & Herlina, 2015; Marchellina & Firnanti, 2020) that shows the total amount of debt a company has relatively to its assets. The last control variable is the audit quality (AUD). It is a binary variable denoting a BIG4 auditor is added, as high quality auditors provide a constraint on earnings management (Van Tendeloo & Vanstraelen, 2008; Richardson, Taylor & Lanis, 2013). 'AUD' takes the value 1 if the firm hires an auditor BIG4 and 0 if not.

Table 2 summarizes the definitions of the variables employed in this study.

**Table 2.** Summary of variable measurement

| Variable | Abbreviation | Definition |
|---|---|---|
| Earnings management | *DA* | The discretionary accruals estimated following the modified Jones model |
| Tax aggressiveness | *ETR* | The tax expense for the year, scaled by the pre-tax income |
| Firm size | *SIZE* | The natural logarithm of total assets |
| Firm leverage | *LEV* | Total liabilities-to-total equity ratio |
| Auditor size | *AUD* | Dummy variable which assumes the value of 1 if the firm is audited by a Big Four auditor and 0 otherwise |

Source: own elaboration.

### Model specification

To investigate the determinants of earnings management, the technique of linear regression is used to test the relationship between the dependent variable (earnings management) and a set of explanatory variables (aggressiveness tax avoidance, firm size, leverage level, and audit quality). Data were analyzed using STATA, a widely used and accepted panel data estimation model. This model is proposed to test our hypothesis in this study:

$$DA_{i,t} = \alpha + \beta 1ETR_{i,t} + \beta 2SIZE_{i,t} + \beta 3LEV_{i,t} + \beta 4AUD_{i,t} + \varepsilon_{i,t}$$

## The Outcome of the Research Process

### Empirical results and comments

#### Descriptive statistics

Table 3 reports the descriptive statistics for the regression variables considered in the study model for the period 2017 to 2019. The table is separated into two panels. The descriptive statistics for continuous and dichotomous variables for the full sample are summarized in panels A and B, respectively. Panel A in table 3 shows that the mean value of DA was -0.015, suggesting that Tunisian listed firms tend to be more conservative and more likely to be engaged with income-decreasing (negative change) earnings management. Over the period 2017-2019, ETR, the main explanatory variable, had a mean value 0.149 and the standard deviation is 0.265. This percentage was below the Tunisian statutory tax rate (35%). This suggests that tax aggressiveness represent an important mean to decrease tax due and increase in after-tax income of Tunisian listed firms. This result shows that due to the tax benefits given to business and regulatory loopholes which allow businesses to avoid tax, Tunisian firms generally pay less than half of the statutory rate.

Regarding firm size, the mean was 19 and the standard deviation of 1.449 suggests low variability in size. However, it is interesting to observe that financial debt is averagely -0,198 this means that the Tunisian firms have negative shareholder equity. Finally, we denoted that on average 40% of Tunisian firms are audited by at least one of the "BIG4".

**Tables 3.** Descriptive Statistics

| Panel A: Descriptive statistics of continuous variables (full sample N=60) | | | | |
|---|---|---|---|---|
| **Variable** | **Min.** | **Max.** | **Mean** | **Std .Dev.** |
| *DA* | -0.3096 | 0.2657 | -0.0151 | 0.1008 |
| *ETR* | -0.8997 | 1.0948 | 0.1495 | 0.2659 |
| *SIZE* | 16.2561 | 22.0244 | 19.0002 | 1.4497 |
| *LEV* | -60.653 | 27.2667 | -0.1984 | 8.8541 |
| **Panel B: Descriptive statistics – Dichotomous variables** | | | | |
| **Variable** | **Frequency of 1's (Yes)** | **Frequency of 0's (No)** | **Percentage of 1's (Yes)** | **Percentage of 0's (No)** |
| AUD | 24 | 36 | 40% | 60% |

Source: own elaboration.

## Multivariate results

Conducting linear regression analysis allowed us to estimate the association between earnings management and aggressiveness tax avoidance. According to table 4, the coefficient of the effective tax rate (*ETR*) of listed firms is positive but the relationship seems insignificant, partially supporting our first hypothesis ($H_1$), this is similar to the results of Abubakar, Mansor and Wan-Mohamad (2021) conducting a study on Nigerian listed firms. This means that firms with low tax rates often exhibit higher tax aggressiveness, which is possible through earnings management.

For the firm size (SIZE), the coefficient is positive and statistically significant; this validated our second hypothesis ($H_2$). The result supports previous research (Saleh & Ahmed, 2005; Wang, 2014), and shows that larger firms tend to have higher accruals. We also report a positive coefficient for financial leverage but not significant, partially supporting hypothesis 3. This result is consistent with Bassiouny, Soliman and Ragab (2016) who found that discretionary accruals are positively related to financial leverage for Egyptian firms.

The analysis results show that the coefficient corresponding to the audit quality variable (BIG4) is negative; however, it is statistically insignificant, partially supporting hypothesis 4 The results are in line with the findings of

Bassiouny et al. (2016), Gerayli, Yanesari and Ma'atoofi (2011) and Chan, Luo and Phyllis (2015), who found that auditor quality is negatively associated with the earnings management. According to this finding, firms who engage BIG4 auditor have lower discretionary accruals as compared to firms that hire non-Big 4 audit firms.

**Table 4.** Tax aggressiveness and earnings management

| Variables | Predicted sign | AD |
|---|---|---|
| ETR | + | 0.0394<br>(0.75) |
| SIZE | + | 0.0163*<br>(1.76) |
| LEV | + | 0.0007<br>(0.49) |
| AUD | - | -0.0324<br>(-1.15) |
| CONSTANT | | -0.3183*<br>(-1.82) |
| $R^2$ | | 0.07 |
| Observations | | 60 |

* Significant at the 0.1 level. ** Significant at the 0.05 level. *** Significant at the 0.01 level.
Note: t statistics in parentheses

Source: own elaboration.

## Conclusion

This paper attempted to analyze the impact of aggressiveness tax avoidance on earnings management in the Tunisian context. Specifically, we underlined the factors, which could be related intimately to aggressiveness tax avoidance and affected earnings management. We stressed the firm size, financial leverage and audit quality. To do so, we used a sample of Tunisian listed firms over the 2017- 2019 periods.

Based on linear regression analysis, the most significant finding of this research is that larger firms tend to have large value of accruals. Consistent with the findings of Saleh and Ahmed (2005) and Wang (2014), the coefficient corresponding to firm size variable is positive, implying that discretionary accruals are positively related to the firm size. In contrast, the result indicates that tax aggressiveness, inconsistent with our expectations, has a positive impact on earnings management. An alternative explanation for this finding is that firms with low tax rates are an indication of high tax aggressiveness, which is possible through earnings management. The findings show that some control variables such as the financial debt and the audit quality are inefficient in the studies context.

However, some limitations are highlighted in this study. First, the sample population is rather small, only 20 firms having been investigated. It may not be representative of the population of Tunisian firms. To increase the study's generalizability and robustness, future research could extend the sample by taking into account all the Tunisian firms-listed and unlisted firms.

Second, in this study the researchers only included executive characteristics (firm size, leverage) and an external corporate governance mechanism (audit quality) as control variables. Future research is suggested to include more control variables (such as internal corporate governance mechanisms, e.g. ownership structure, board directors) in the analysis that could likely product other interesting results. Finally, in this study the proxy used is the effective tax rate (ETR). Future research could examine the impact of tax aggressiveness on earnings management by using more proxy such as book-tax differences (BTD).

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