Is Tax Policy Responsible for Inclination in Practicing Earnings Management: A Case Study Analysis among Accountants in Non-listed Companies of Bangladesh

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Abstract

The study is attempted to show the relationship between progressive tax policy in Bangladesh and the intensity of the practice of earnings management. Discussion in this study includes two parts where we introduced the taxation system of Bangladesh along with the tax administration in the first part, and then a brief discussion has been made on earnings management with its techniques. We attempted to find a relation between tax policy and inclination for practicing earnings management in Bangladesh. This study is based on both qualitative and quantitative data. Different articles on earnings management have been studied, and primary statistics have been collected by placing questionnaires among business graduates, who are serving in accounts section of commercial firms. At the end, it has been concluded that the contemporary tax policy of Bangladesh, its multiplying tax burden, and its loopholes are the probable stimulus behind the practice of earnings management.

Keywords: Earnings Management; Progressive Tax; Tax Evasion

1. Introduction

Organizations need to prepare financial statements and to show financial result and financial position. Different types of stakeholders seek and use financial information for different purpose. The financial statements ought to show true and fair view of the organization’s financial result and financial position for the convenience in decision making. A professional body for accounting developed some rules and regulations to create uniformity in accounting practice and to prevent accounting fraud. Accountants worldwide need to follow those rules. But if there is a rule, there will have some loopholes in rule. In accounting, there are principles and at the same time there some modifications to principles which we call constraints.

Individuals or organizations need to divide up their earnings into different recipients. Say for example royalty to the landlord, part of profit to the partners, dividends to stockholders, part of profit to the franchisor, part of profit to the workers, tax to National Board of Revenue (NBR). Sometimes government gives subsidy to export-oriented industries at a percentage of their production cost. In both cases, individuals or organizations wants to get some unethical financial benefits by fabricating the financial statements, production cost report. This motive gives birth to the practice of earnings management. In organizations where the management attempts to alter and misrepresent the actual performance or the true income and assets for the purpose of showing a more favorable image of the organization, earnings management takes place.

But showing favorable position is not the only motive of earnings management practice. Frequently, the managers of companies or even individuals show worse financial result or financial position to the stakeholders. In perspective of Bangladesh, it is a very popular practice to show low income than the
real income for the purpose of making different entities aggrieved from their claim. It mostly happens in the case of income tax payment. Moreover, the tax policy of Bangladesh may be a reason behind this.

1.1. Tax

Tax is the compulsory payments to government without expecting a direct benefit or return by the tax payer. By paying tax, the tax payers cannot demand any direct benefit from the government. Rather they get the return in the form of common benefits, like public welfare services.

Tax rate can be regressive, proportional, or progressive. Here, we make difference on the basis of the marginal tax rate. For different levels of income tax rate can be different or same.

1.2. Tax policy

Policy is anything that guides any activity. Tax policy is the rule set by a government as to what taxes to levy, in what amounts or at what rate, and on whom or which sector.

1.3. Progressive tax policy

A progressive tax is a tax where lower-income entities pay a lower fraction of their income in taxes than do higher-income entities, or we can say progressive taxation is the tax structure whereby the marginal tax rate is higher than the average tax rate. In general, the governments of poor or developing countries impose progressive tax to collect greater amount of revenue and to redistribute the wealth. Tax rate for an individual is progressive in Bangladesh. In annual budget for 2015-2016, it can vary from 10% to 30% depending on income level.

1.4. Earnings management

Earnings management is the operating and discretionary accounting methods to adjust earnings to a desired outcome. As per matching principle expenses of a particular year are to be matched with the revenues of that year. Thus, we get profit or loss. However, some people or organizations fix profit first then set hypothetical revenues and expenses. According to Schipper (1989) “earnings management is the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain” Healy and Wahlen (1999) define earning management other ways. They say “earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers” Scott (2003) says that managers can choose accounting policies from a set of policies (for example, generally accepted accounting principles [GAAP]), it is natural to expect that they will choose policies so as to maximize their own utility and/or the market value of the firm. This is called earnings management. Roman (2009) in his article in AICPA journal says that “earnings management” is not a technical term in accounting or finance. However, it occurs when (1) firm management has the opportunity to make accounting decisions that change reported income and (2) exploits those opportunities.”

2. Literature Review

Most of the previous studies recognized for years that firms use the freedom in accounting rules to manage their reported earnings in a wide variety of contexts. Those studies were mainly about the concepts, techniques, and motivations behind earnings management. Literature on progressive tax policy focused on merits and demerits of progressive tax policy and people’s response toward the progressive tax.

“Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the
underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” There are two methods that could be used for earnings management. First, one could use the flexibility allowed in GAAP to change reported earnings without changing the underlying (past) cash flows, which Healy and Wahlen (1999) describe as usage of managerial judgment in financial reporting. This is called accounting earnings management. Second, a manager may change operating decisions, such as delivery schedule or maintenance, to manage the underlying cash flows that will affect the reported income reports, which is being described as structuring of transactions by Healy and Wahlen (1999). This kind of management is usually referred to as economic earnings management. They conclude in their review article on this topic that the evidence is consistent with earnings management “to window dress financial statements before public securities offerings, to increase corporate managers’ compensation and job security, to avoid violating lending contracts, or to reduce regulatory costs or to increase regulatory benefits.”

Cohen et al. (2005) from their study find that earnings management increased steadily from 1997 until 2002, and options and stock-based compensation emerged as a particularly strong predictor of aggressive accounting behavior.

Ahadiat and Hefzi (2012) discussed earnings management in light of GAAP. GAAP includes principles and constraints. Constraints are the modifications to the principles where we cannot follow principles strictly. They say “although GAAP offer managers a great deal of discretion in the choices they may make in financial reporting, the expectation is that management will apply professional judgment and integrity in their selection of the standards that best fit the firm’s financial condition.”

In the version of Defond and Park (1997) and Greenfield et al., (2008) “earnings management is primarily accomplished through accounting transactions that are designed to achieve desired earnings level. Prior research suggests that managers have both personal and business motivations to display impressive or at the very least satisfactory performance in their reports on a consistent basis.”

According to Roman (2009), “Earnings management occurs when firm management has the opportunity to make accounting decisions that change reported income and exploit those opportunities.” He also stated that accounting for business operations requires judgment and estimates. For example, one cannot measure revenue without estimating when customers will pay, how many will not pay, how many will return goods for refund and costs to the seller for fulfillment of warranty or maintenance promises. According to Roman (2009), earnings can be also be managed by timing of the transaction. For example, management can decide to paint the office in December. All other things being equal, management will report lower earnings in that office painting period than in other periods. Management can choose when to paint and thereby, manage the earnings. In addition, the management of a company that uses a last-in, first-out cost flow assumption for inventories has an opportunity to manage earnings by timing end of year purchases. In times of rising prices, management can buy during this period which will increase the cost of goods sold and reducing income or delay purchases until the next period that will decrease this period’s cost of goods sold and increasing income. The management can choose when to buy and manage earnings. Management has the ability to choose a number from a reasonable price range and be confident no one can say some other number is better gives them the opportunity to manage earnings. When management’s number choice is made with an eye to its effect on net or comprehensive income, it is engaging in “earnings management.”

Duncan and Peter (2012) explained progressive tax from fiscal perspective. They says that progressive taxes are often designed to collect a greater proportion of income from the rich relative to the poor, thus reducing the inequality of disposable income compared to taxable income. However, as the government increases structural progressivity or tax rates facing the rich relative to the poor, individuals may respond by taking steps to reduce their taxable income. Reducing taxable income is achieved by either working less (productivity response) or simply reporting a smaller share of true income (tax evasion/avoidance response). While both behavioral responses are likely to reduce observed income inequality, they can have a differential effect on true income inequality. Although we expect the productivity response from more progressive taxes to reduce actual inequality, the evasion response may increase the actual disposable income of the rich (since no taxes are paid on the hidden income), and thus, increase inequality in actual net income.
Bangladesh Economic Update (2011) states that both tax evasion and avoidance in Bangladesh have reached alarming proportions and its victim is revenue. Although the tax and gross domestic product ratio is still very low in Bangladesh as compared to that of different neighboring countries, many taxpayers do not want to pay their taxes or try to avoid the payable income taxes. Therefore, the NBR reveals that tax evasion and incentives cost Tk. 40,000 crore a year. Even, tax evasion and avoidance lead to a parallel black economy of about Tk. 9,000 to 11,000 crore.

In the study of Clotfelter (1983); Slemrod (1985); Gorodnichenko et al. (2009), it is focused on the relation between progressive tax and tax evasion. They concluded that from their empirical studies; they had found the evidence of a positive relationship between tax rates and tax evasion.

3. Objectives of the Study

The study is attempted to show the relationship between progressive tax policy in Bangladesh and the intensity of the practice of earnings management.

4. Theoretical Framework and Hypothesis

This study identified earnings management practice as dependent variable and the dimensions of progressive tax policy as independent variables. Those are, tax policy of Bangladesh, tax rate for individual, double taxation, higher income, tax rate for private limited company, tax rate for public limited company, tax officials behavior, harassment in tax payment, tax rate for banking company, and effect of political affiliation. This study also aimed at construct the regression model using multiple regression analysis. The model is as follows:

\[ Y = a + b_1 x_1 + b_2 x_2 + b_3 x_3 + \ldots + b_n x_n \]

Where,

- \( Y \) = Practice of earnings management
- \( x_1, x_2, x_3, \ldots, x_n \) = The dimensions of progressive tax policy
- \( a \) = constant
- \( b_1, b_2, b_3, \ldots, b_n \) = The coefficient

Therefore, the outline of the model of the study is shown in Figure 1.

4.1. Hypothesis

This study drew the following hypotheses to show whether there is any relationship between (the dimensions of) progressive tax policy and earnings management practice:

- \( H_0 \): There is no significant relationship between progressive tax policy and earnings management practice.
- \( H_1 \): There is a significant relationship between progressive tax policy and earnings management practice.

Figure 1: The earnings management practice model caused by progressive tax policy. Dimension 1, 2, 3, 4, N refers to the independent variables of the study.
5. Methodology

5.1. Sampling area and sample selection

This research was based on a fieldwork conducted in two largest cities of Bangladesh: Dhaka and Chittagong. For the convenience of our study, we purposively selected 105 employees who are doing jobs in accounts sections of different non-listed companies and are individual tax payers. We selected accountants because they are aware of contemporary tax issues, and they are familiar with the concept of earnings management. We conducted a questionnaire survey from August 2015 to January 2016.

The survey covered 105 employees of different organization who are doing jobs in accounts sections. Purposive sampling was used to choose the respondents. Among the questionnaire, 103 responses were received. Off them, 5 unusable responses were found. Eliminating those 98 respondents responses were used for this study. The sample size was selected using convenient sampling method. The areas of sampling were mainly Dhaka and Chittagong: Two large cities in Bangladesh.

5.2. Sources of data

Both the primary and secondary data were used in this study. The secondary data and information were collected from the existing literature in the said field and the primary data and were collected through the questionnaire survey.

5.3. Questionnaire design and tools used

A structured questionnaire with both closed and open-ended questions was used for collecting primary data. For the closed-ended questions, we use 5-point Likert scale, where 5 = strongly agree, 4 = agree, 3 = neutral (neither agree nor disagree), 2 = disagree, and 1 = strongly disagree. The questionnaire included four parts. Part - I says about the demographics of the respondents. Part-II provides little information for the convenience of the respondents. It includes tax slabs as per the annual budget 2015-16 so that the respondents will have updated data while filling up the questionnaire. Part - III includes 6 questions to assess the concept of the respondents on earnings management. Part - IV includes 21 questions about tax policy and earnings management. Finally, the respondents were asked to response on the questions. Finally, Statistical Package for Social Science (SPSS) was used to analyze and interpret the data.

5.4. Reliability and validity of data

The initial reliability of the items was verified by computing the Cronbach’s alpha. The Cronbach’s alpha suggests that a minimum alpha of 0.6 is sufficed for the early stage of research. The Cronbach’s alpha estimated for all of the variables was 0.815 (Table 1). As the Cronbach’s alpha was much higher than 0.6 the constructs were therefore deemed to have adequate reliability.

6. Analysis and Findings

Major dimensions of tax policy of Bangladesh along with some related dimensions about people’s devotion and responsibility to their country.

The Table 2 shows the major dimensions through which tax policy of Bangladesh, people’s devotion and responsibility to their country can be expressed. From Table 2, we get the mean and standard deviation of the dimensions of tax policy of Bangladesh, People’s devotion and responsibility.

<table>
<thead>
<tr>
<th>Table 1: Reliability statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cronbach’s alpha</td>
</tr>
<tr>
<td>0.815</td>
</tr>
</tbody>
</table>

95
Considering the means the most important factors, we can say that the people of Bangladesh are devoted to their country (3.94), they are aware about their responsibility (3.20) and even they want to pay tax for the betterment of the country (3.35). But they think that the prevailing tax policy is not so suitable (2.81) that they are looking for. Moreover, the tax official’s treatment is not satisfactory (2.05). The people are frequently harassed in tax payment (1.92). People think that political affiliation can give some extra benefit while paying tax (1.50).

6.1. How tax policy leads to earnings management practice

This study used the multiple regression analysis to test the hypothesis. The output and the interpretation are as follows.

From Table 3, it is found that the value of R is 0.658 and it indicates that the relations between the dependent variable and the independent variables are strong enough to represent the model. It is also seen that the value of adjusted $R^2$ is 0.368, i.e., the dependent variable is nearly about 37% explained by the independent variable that is included in the model.

Table 4 shows that the value of F is 6.639 at 0.05 level of significance, which is higher than the critical value of F from the F distribution (3.13) and it indicates that the study can reject the null hypothesis. That means, there is a significant relationship between prevailing tax policy and earnings management practice.
Table 3: Model summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>Standard error of the estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.658&lt;sup&gt;a&lt;/sup&gt;</td>
<td>0.433</td>
<td>0.368</td>
<td>0.54157</td>
</tr>
</tbody>
</table>

<sup>a</sup>Predictors: (Constant), politically affiliated persons don’t get any extra benefit in tax payment, tax payers have no headache about double taxation, tax rate for public limited company is rational, tax officials are friendly to the tax payers, tax rate for individual tax payer is rational, individual tax payers with higher income don’t hide income to avoid tax, tax rate for private limited company is rational, tax rate for banking company is rational, tax policy of Bangladesh is suitable to the tax payers, tax payers are not harassed in tax paying process.

Table 4: ANOVA<sup>b</sup>

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of squares</th>
<th>df</th>
<th>Mean square</th>
<th>F</th>
<th>Significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>19.473</td>
<td>10</td>
<td>1.947</td>
<td>6.639</td>
<td>0.000&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Residual</td>
<td>25.517</td>
<td>87</td>
<td>0.293</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>44.990</td>
<td>97</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup>Predictors: (Constant), politically affiliated persons don’t get any extra benefit in tax payment, tax payers have no headache about double taxation, tax rate for public limited company is rational, tax officials are friendly to the tax payers, tax rate for individual tax payer is rational, individual tax payers with higher income don’t hide income to avoid tax, tax rate for private limited company is rational, tax rate for banking company is rational, tax policy of Bangladesh is suitable to the tax payers, tax payers are not harassed in tax paying process. <sup>b</sup>Dependent variable: On the basis of above responses we can say that earnings management practice is not dependent on progressive tax policy.

Table 5 shows the value of the coefficients to construct the model. Since the beta value of standardized coefficients is 0, we will use the unstandardized coefficients. Hence, the regression line will be:

Earnings management practice = 0.075 – 0.064 (Tax policy of Bangladesh) + 0.026 (Tax rate for individual tax payer) + 0.107 (Double taxation) + … + 0.370 (Political affiliation).

7. Conclusion

Perhaps earnings management as a concept is unknown in Bangladesh. But practically, it is widely practiced at all levels of tax payers. In our study, we have tried to identify the real motivation behind the practice of earnings management. We tried to identify the real relation between prevailing tax policy of Bangladesh and the practice of earnings management, whether the tax policy is the motivation behind the earnings management practice. We can conclude that by nature the people of Bangladesh are devoted to their country and they want to pay tax for the betterment of their country, but they seek the ways of avoiding tax because of some reasons. The reasons are the tax policy, progressivity of tax rates, unsuitable treatment by tax officials, and harassment in tax payment. In addition with this people use political affiliation to avoid taxes.

8. Recommendation

Government imposes a progressive tax to reduce inequality and to distribute income. But when the rich people see progressive tax, they try to hide income using the loopholes available in tax laws and accounting. Few countries of Eastern Europe already using flat tax policy. As a developing a country Bangladesh cannot go beyond progressive tax policy but we can reform our tax policy to a limited extent. We can reduce the progressivity. Tax slabs must be convenient to the tax payers and taxpaying process need to be easy. In perspective of Bangladesh, we can introduce Forensic Audit System in grass root level to ensure quality information in financial statements.
Table 5: Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized coefficients</th>
<th>Standardized coefficients</th>
<th>t</th>
<th>Significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.075</td>
<td>0.546</td>
<td>0.138</td>
<td>0.891</td>
</tr>
<tr>
<td>Tax policy of Bangladesh is suitable to the tax payers</td>
<td>−0.064</td>
<td>0.077</td>
<td>−0.087</td>
<td>−0.832</td>
</tr>
<tr>
<td>Tax rate for individual tax payer is rational</td>
<td>0.026</td>
<td>0.083</td>
<td>0.028</td>
<td>0.316</td>
</tr>
<tr>
<td>Tax payers have no headache about double taxation</td>
<td>0.107</td>
<td>0.064</td>
<td>0.148</td>
<td>1.686</td>
</tr>
<tr>
<td>Individual tax payers with higher income don’t hide income to avoid tax</td>
<td>−0.113</td>
<td>0.071</td>
<td>−0.145</td>
<td>−1.581</td>
</tr>
<tr>
<td>Tax rate for private limited company is rational</td>
<td>0.240</td>
<td>0.074</td>
<td>0.319</td>
<td>3.252</td>
</tr>
<tr>
<td>Tax rate for public limited company is rational</td>
<td>0.048</td>
<td>0.084</td>
<td>0.055</td>
<td>0.572</td>
</tr>
<tr>
<td>Tax officials are friendly to the tax payers</td>
<td>0.409</td>
<td>0.087</td>
<td>0.425</td>
<td>4.677</td>
</tr>
<tr>
<td>Tax payers are not harassed in tax paying process</td>
<td>−0.206</td>
<td>0.106</td>
<td>−0.218</td>
<td>−1.948</td>
</tr>
<tr>
<td>Tax rate for banking company is rational</td>
<td>0.022</td>
<td>0.087</td>
<td>0.026</td>
<td>0.248</td>
</tr>
<tr>
<td>Politically affiliated persons don’t get any extra benefit in tax payment</td>
<td>0.370</td>
<td>0.099</td>
<td>0.359</td>
<td>3.740</td>
</tr>
</tbody>
</table>

*Dependent variable: On the basis of above responses, we can say that earnings management practice is not dependent on progressive tax policy.

References


