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### **FIRM CHARACTERISTICS AND CORPORATE TAX AVOIDANCE OF DEPOSIT MONEY BANKS IN NIGERIA**

**Aisha Nuhu Mohammed**

Department of Accounting,  
Ahmadu Bello University, Zaria, Nigeria

**Lawal Mohammed**

Department of Accounting,  
Ahmadu Bello University, Zaria, Nigeria

#### **Abstract**

*Corporate tax avoidance has, especially since 2001 received vast empirical examination in Western academe. The same can however not be said in respect of tax avoidance by corporate entities in Nigeria. This study therefore examined the effect of firm characteristics such as firm size, financial leverage, profitability and capital intensity on corporate tax avoidance among deposit money banks (DMBs) in Nigeria over the period 2006 to 2014. Data was gathered purely from secondary sources in the form of annual proxy financial statements. Using a fixed effect model estimation technique, and a sample of 126 firm-year observations, the study found that among the studied characteristics only firm size significantly affects banks' tax avoidance. A significant inverse association was found between firm size and tax avoidance among the studied DMBs which supports the political power hypothesis. Overall, however the study concluded that firm characteristics explain only a modicum of tax avoidance among the studied DMBs. There is therefore much need to broaden the scope of investigation to embrace other potential explanatory factors such as board of directors-related corporate governance mechanisms and internal control systems.*

**Keywords:** Tax avoidance, firm characteristics, deposit money banks, political costs, political power.

## **1. Introduction**

The issue of corporate tax avoidance has emerged to be an item of both public discourse and empirical examination. In particular much of the empirical examination found its impetus, in part, to a call by Shackelford and Shevlin (2001) on the need to examine for corporations what determines their tax avoidance levels. Prior to the call researches had hitherto tacitly assumed that motivations for corporate tax avoidance were similar to that of individuals. Slemrod (2004) therefore further stressed for researches the fact that the separation of ownership and control within corporate bodies meant that it was incorrect to assume that motivations for tax avoidance by corporations would be the same as that of individuals.

Debate has therefore since then focused on trying to unravel what factors explain corporate tax avoidance. The searchlight naturally initially beamed on firm-level characteristics. Prominent past researches such as Gupta & Newberry (1997), Richardson and Lanis (2007) and more recently Hsieh (2012) all therefore proceeded to empirically examine whether various firm characteristics played a significant role in determining corporate tax avoidance. As usual, however there is no consensus in the findings of these previous studies. Furthermore, as a research issue corporate tax avoidance is only very recently receiving academic interest in Nigeria with studies such as James and Igbeng (2014) and Ekoja and Jim-Suleiman (2014). The James and Igbeng (2014) study however merely succeeded in rendering a theoretical exposition of the matter which is to a large extent a re-echo of Desai and Dharmapala (2007) while Ekoja and Jim-Suleiman (2014) only examine one external monitoring mechanism in the form of competition without actually looking at firm-level characteristics. The lack of consensus in former studies coupled with the preponderance of studies focusing solely on Western corporate entities therefore serve as motivations for the current effort at examining the effect of firm characteristics on corporate tax avoidance in a developing country like Nigeria.

Our work is closely related to Ekoja and Jim-Suleiman (2014) who studied the effect of competition on tax avoidance by Nigerian deposit money banks (DMBs). However, our contribution differs in that our study categorically examined firm-level characteristics of the said banks.

The focus of this study was solely on deposit money banks (DMBs) in Nigeria. The focus on DMBs is because banks are thought to play a pivotal role in the structuring and executing of tax avoidance activities; both for themselves and their customers (OECD, 2012). The study covered the period 2006 to 2014. The year 2006 was chosen as a base year in order to avoid any distortions to our studied variables arising from the banking sector consolidation exercise of 2005 while 2014 represents the latest year for which we are able to access complete financial statements for the DMBs being studied. The period overlaps with the 2001-2010 previously noted by a Global Financial Integrity, GFI (2012) report which chronicled the period as one in which Nigeria lost substantial revenue through tax avoidance activities.

For researchers interested in understanding determinants of corporate tax avoidance, the study serves to add to the overall existing literature on the determinants of corporate tax avoidance. In particular it serves to fill the gaps on corporate tax avoidance research in the developing world as well as in relation to documenting results from banks. Furthermore, the study is also important for shareholders; both existing and potential, who wish to know which firm-level characteristics they should pay more attention to in their desire to achieve more effective tax outcomes such as avoidance.

The paper proceeds as follows: section 2 reviews relevant and related literature in respect of conceptualization, previous empirically documented associations and theoretical underpinnings; section 3 describes the methodology adopted for the research, section 4 provides a discussion of the descriptive statistics of the studied variables, their correlations and the empirical results of the study while section 5 puts forth the study's conclusions and recommendations.

## **2. Review of Related Literature**

Lending a definition to tax avoidance in particular is a dicey affair; leading The UK Tax Law Review Committee (1997) to assert that defining the expression 'tax avoidance' in any truly satisfactory manner is an impossible affair. The reason for this perceived inability to appropriately conceptualize and define tax avoidance may lie in the fact that tax avoidance as a concept draws its meaning from several fields; Law, Accounting & Finance, Sociology and even Psychology all have perspectives. The Law perspective however seems to resonate with most (Bello, Mohammed & Dahiru, 2013). This is because under the law perspective, a distinction is drawn between two similar acts; one thought to be criminal (tax evasion) and the other thought of as allowable (tax avoidance) and therefore not criminal. However, in the Accounting and Finance perspective, aside the

acceptance of the legal position of criminal v allowable, the use of so many other related terms such as tax mitigation, planning, minimization and aggressiveness have served to further complicate conceptualization of the phenomena. Having therefore looked at some of the various existing expositions such as Osuegbu (2007), Adegbe and Fakile (2011) as well as Hanlon and Heitzman (2010), this study finds it appropriate to settle for a broad-based definition. Therefore the Hanlon and Heitzman (2010: 137) definition of tax avoidance, “broadly as the reduction of explicit taxes” was adopted.

Firm-level characteristics have been argued and found to play a pivotal role in determining varied corporate outcomes. For instance previous literature allude to effects of various firm characteristics, among others, on outcomes such as earnings management (Kim & Yoon, 2009; Hassan & Bello, 2013), financing decisions (Wald, 1999) as well as empirical asset pricing models (Kogan & Tian, 2012). Therefore as a point of initial investigation into any outcome, investigating whether firm characteristics play a role is quite apt.

Amongst the multitude firm characteristics, firm size in particular has been argued to influence corporate tax avoidance. The argument is pre-supposed on two diametrically opposite hypotheses; political cost and political power. Under the political cost hypothesis, as postulated by Watts and Zimmerman (1978) and Zimmerman (1983), it is argued that larger firms, due to their greater visibility are likely to bear more regulation and by juxtaposition will therefore pay more taxes. The association, therefore, given the said high visibility, between firm size and corporate tax avoidance, according to proponents of the political cost hypothesis is that larger firms pay more taxes and by doing so thus avoid/ evade less than their smaller counterparts. Conversely, the alternative hypothesis- that of political power argues that larger firms have more financial muscle to manipulate tax payments to their advantage. Thus, under the political power hypothesis, larger firms are more likely to avoid greater taxes.

Our review reveals that most previous empirical studies have measured firm size as the natural logarithm of total assets and that studies such as Gupta and Newberry (1997), Philips (2003), and Wang (2012) have previously documented significant inverse associations between firm size and corporate tax avoidance while studies such as Richardson and Lanis (2007), Md Noor, Fadzillah and Matsuki (2010) as well as Hsieh (2012) have conversely documented significant positive associations. Yet other studies such as Armstrong, Blouin and Larcker (2012), Taylor and Richardson (2013), and Gaertner (2013) all found no significant association between firm size and tax avoidance. The empirical results

on the association between firm size and corporate tax avoidance are therefore mixed.

Profitability is assumed to be another firm characteristic that is likely to determine corporate tax avoidance. The expected direction of the association is however not clear. This is because profitability may be viewed from the premise that it signals more taxable earnings or conversely it may imply that the firm has more resources at its disposal to engage in greater tax avoidance. Consistent with the view that profitability means greater tax payments, studies such as Gupta and Newberry (1997), Rego (2003), Richardson and Lanis (2006), Frank, Lynch and Rego (2010), Wang (2012), Khaoula and Ali (2012), Rego and Wilson (2012), McGuire, Wang and Wilson (2012), and Gaertner (2013) all found that more profitable firms have higher Effective Tax Rates (ETRs), suggestive of lower levels of avoidance. On the other hand, other studies such as Edwards, Schwab and Shevlin (2013) and Taylor and Richardson (2013) found a negative but statistically not significant association between profitability and tax avoidance. Given the mixed empirical results on the association between profitability and corporate tax avoidance, there is still room for more examination into the matter.

Capital intensity, mostly measured by researchers as the proportion of property, plant and equipment (PPE) in relation to total assets is also another firm characteristic touted to be associated with variations in at least two measures of corporate tax avoidance; ETRs and of book-tax differences. The argument draws its strength from the fact that having large amounts of PPE allow for higher depreciation charges on one hand and/ higher qualifying capital allowances on the other. Given the likelihood that firms with such large amounts of PPE will have lower ETRs or greater book-tax differences, studies using one or both of these measures of tax avoidance usually control for capital intensity. Typically, the firm-specific determinants studies (Gupta & Newberry, 1997; Richardson & Lanis, 2007; as well as Md Noor, Fadzillah & Matsuki, 2010) found statistically inverse associations, all through their models, between capital intensity and tax avoidance as measured by ETR. In specifically studying determinants of thinly capitalized avoidance, Taylor and Richardson (2013) however found a significant positive association between capital intensity and thin capitalization in their ordinary least squares estimate but found a positive but statistically not significant association using their logit estimate. Edwards, Schwab and Shevlin (2013) and Ding, Duan, Hou and Zhang (2013) found statistically not significant negative associations between their measures of capital intensity and tax avoidance. The results for capital intensity and tax avoidance are therefore also mixed.

Leverage is another variable frequently emphasized on by studies in relation to corporate tax avoidance. The rationale is that since interest payments for debt are tax deductible, debt capital serves as a definite tax shield for firms. Although strictly speaking the tax shield, unless aggressively exploited, does not constitute an act that is thought to be on the other side of the moralistic argument on tax avoidance. However, in addition to the tax shield, highly levered firms may likely be financially constrained and as such have a motivation to engage in more tax avoidance. Consistent with this argument, Harrington and Smith (2011) found that firms that pursue tax avoidance activities issue more long-term debt as a form of financing and thus have higher average leverage after a re-financing. Conversely, Graham and Tucker (2006) who examined forty-four tax shelter cases found that firms in their sample use proportionally less debt when they engage in tax sheltering implying that shelters (their measure of actual tax avoidance) are non-debt tax shields that substitute for the use of interest deductions. Other empirical studies that found a negative and significant association between leverage and GAAP ETR include Gupta and Newberry (1997), Richardson and Lanis (2007) and Md Noor, Fadzillah and Mtsuki (2010), Gaetner (2013) and Edwards *et al* (2013).

Other firm-specific characteristics thought to constitute determinants of tax avoidance include intangibles intensity- specifically research and development (R&D) intensity; extent of a firms' foreign operations or income, extent of a firms' cash holdings and inventory intensity. The association between R&D intensity and tax avoidance in particular has come under close scrutiny. Studies that found positive associations between R&D intensity and tax avoidance include Philips (2003), and Taylor and Richardson (2013). On the other hand, Dyreng *et al* (2010) and Edwards *et al* (2013) found inverse associations. However the results of Dyereng *et al* are not significant. The effect of foreign income and/ operations on corporate tax avoidance is also mixed with studies such as Rego (2003), Boone *et al* (2013) and Edwards *et al* (2013) all documenting positive associations and studies such as Philips (2003) and Ding *et al* (2013) documenting inverse associations. Dyreng *et al* (2010) and Armstrong *et al* (2012) have however documented positive but statistically not significant associations between foreign income and tax avoidance. A study by Wang (2010) found evidence that suggest that growth firms avoid less in three out of the nine models of the study while the remaining six show that growth firms avoid more. A negative but insignificant effect of growth on firms' tax avoidance is also documented by Harrington and Smith (2012). Chen *et al* (2010) attribute tax sophistication to interactions between firm size and age and find that firm size and age are indeed significant in determining tax sophistication. By virtue of the said tax

sophistication, therefore, firm size and age have an overall positive association with corporate tax avoidance. This positive association between firm size and age is corroborated by Harrington and Smith (2012).

For reasons of brevity we limit our review of associations between firm characteristics and corporate tax avoidance to what has been presented. In further modelling the association, of the aforementioned and reviewed characteristics, we invoke Occam's razor (Blumer, Ehrenfeucht, Haussler & Warmuth, 1987) to only examine four firm characteristics in relation to corporate tax avoidance. These are profitability, capital intensity, financial leverage and firm size.

### **3. Methodology**

A quantitative framework was adopted for this study because quantitative research deals with data that lends itself to defined measurement in numerical terms. Within the quantitative framework, the study utilized a correlational research design. We considered such a design apt for this research because the study's major aim was to examine the association between firm characteristics and corporate tax avoidance. The data used in this study was collected from secondary source only. Specifically, data was sourced from the published financial statements of the DMBs for the period under study. The research method was therefore archival; involving data being hand collected by the researchers from the said financial statements.

The target population of this study was all the Deposit Money Banks (DMBs) quoted on the Nigeria Stock Exchange (NSE) as at 31<sup>st</sup> December 2014. Going by records extracted from the NSE website the number of listed DMBs as at that date was 15 (NSE Fact book 2014). Given that the sector being studied does not consist of many elements, a census approach would have been employed. However, Eco Bank Nigeria Plc. was not included in the final analysis because for several years of the study period there are no local financial reports on the bank. The final sample therefore constituted of 14 DMBs which yielded 126 firm-year observations on the dependent variable.

The basic econometric form of the model tested by this study is as follows:

$$ETR_{it} = \alpha_{it} + \beta_1 ROA_{it} + \beta_2 CAPINT_{it} + \beta_3 LEV_{it} + \beta_4 FSIZE_{it} + \mu_{it}$$

Where:

$ETR_{it}$  = effective tax rate of bank  $i$  at time  $t$ ; measured as current tax expense divided by earnings before interest and tax (EBIT) which is our chosen proxy for banks' tax avoidance. The measure with its attendant

modification is consistent with Gupta and Newberry (1997), Richardson and Lanis (2007) as well as several other researchers.

ROA<sub>it</sub>= profitability of bank *i* at time *t*; measured as pre-tax accounting profits as a fraction or percentage of total assets. This is also consistent with Gupta and Newberry (1997), Richardson and Lanis (2007), Edwards *et al* (2013) as well as several other researchers.

CAPINT<sub>it</sub> = capital intensity of bank *i* at time *t*; measured as the beginning of period balance of property, plant and equipment divided by book value of total assets. This measure is consistent with Gupta and Newberry (1997), Richardson and Lanis (2007), Edwards *et al* (2013) as well as several other researchers.

FLEV<sub>it</sub> = financial leverage of bank *i* at time *t*; measured as the amount of total liabilities divided by total assets (both @ book value). This measure is consistent with Hsieh (2012), Edwards *et al* (2013).

FSIZE<sub>it</sub>= firm size of bank *i* at time *t*; measured as the natural logarithm of the book value of total assets at the beginning of the period. This is consistent with Gupta and Newberry (1997), Richardson and Lanis (2007), Lanis and Richardson (2011), Edwards *et al* (2013) as well as several other researchers.

#### 4. Results and Discussions

Table 1 presents the descriptive statistics of the variables being examined.

Table 1: Descriptive Statistics

Variable	N	Mean	Std. Dev.	Min	Max
ETR	126	0.1316	0.2035	0	1
ROA	125	0.0473	0.0346	-0.171	0.115
CAPINT	124	0.0323	0.0162	0	0.091
FLEV	126	0.8442	0.074	0.548	1
TASSETS	126	9.71E+08	8.34E+08	8.04E+07	4.13E+09

From the table it can be seen that the independent variable, ETR has a minimum value of 0.000 and a maximum value of 1.000. The minimum and maximum values derive from adjustments advocated by Gupta and Newberry (1997) that stipulate that any ETR computed based on a book loss (negative denominator) and a tax refund (negative numerator) which tends to give a positive figure even though taxes were not paid in that year by the entity should be assigned 0.000 while any ETR of entities that reported a book loss (negative denominator) but paid taxes (positive numerator) should be assigned a value of 1.000. Mean ETR

for the period was 13.16% with standard deviation of 0.5604. The mean ETR is well below the statutory corporate income tax rate of 30% and is therefore indicative of extensive tax planning in the DMBs. ROA for the period ranged from a minimum of -17.1% to a maximum of 11%. Mean ROA was 4.73% with standard deviation of 0.3456. Overall therefore there is some degree of wide variation in profitability among the studied DMBs. Capital intensity for the period ranged from 0.00% to 9.10% with a mean of 3.23%. On average therefore Nigerian DMBs are not highly capital intensive. Financial leverage for the DMBs over the study period ranged from 54.8% to 100% indicative of high variation in the sector and high debt capacity that may be exploited for tax planning purposes. The mean value was 84.3% with standard deviation of 0.0729. The high average financial leverage values are not surprising given the peculiarities of banks that characterize them as highly levered institutions. Total assets for the studied banks over the period was a minimum of N80million with a maximum of N4.13billion. This is indicative of significant increase in size over the studied period. Mean total assets was N971million with a standard deviation of 8.34e+08.

Table 2 shows the correlations between the independent variable and the dependent variables as well as between the co-variates themselves.

Table 2: Correlations

	ETR	ROA	CAPINT	FLEV	FSIZE
ETR	1				
ROA	-0.3699	1			
CAPINT	0.2416	0.0177	1		
FLEV	0.1469	-0.2808	0.0378	1	
FSIZE	-0.0571	0.0166	-0.0993	0.2311	1

The correlation matrix shows that all the independent variables are correlated with ETR but in different directions. ROA is negatively correlated with ETR (i.e. r of -0.3699), capital intensity is positively correlated with ETR (i.e. r of 0.2416), financial leverage is positively correlated with ETR (i.e. r of 0.1469) while firm size is negatively correlated with ETR (i.e. r of -0.0571). Of the explanatory variables, ROA has the highest correlation with ETR. None of the independent variables appear highly correlated with each other. This is evidenced by a maximum correlation coefficient of -0.2808 between financial leverage and ROA. Since none of the correlations exceeds or is equal to 0.8, the potential for harmful multi-collinearity is low (Kennedy, 2008). We however further test for the absence of harmful multi-collinearity by conducting more robust tests such as the

variance inflation factor (VIF) and corresponding Tolerance (TOL) values; the results of which are presented in table 3.

Table 3 presents the regression results together with results for the regression diagnostic tests

Table 3: Regression results

	OLS Model			Fixed-Effects Model	
	Coefficient	t-statistic		Coefficient	t-statistic
Intercept	0.2828	0.72		0.5441	1.55
ROA	-2.1668	-4.31	***	-2.0239	-1.48
CAPINT	3.0029	2.91	**	2.0662	1.25
FLEV	0.2154	0.88		0.4571	1.42
FSIZE	-0.0159	-0.83		-0.0376	-2.02 *
R-Sq	0.2144			0.1995	
Adj. R-Sq	0.188				
F-Statistic	8.12		***	7.2	**
Mean VIF	1.09				
Hettest	202.57		***		

\*\*\* Denotes significance at 1%.

\*\* Denotes significance at 5%.

\* Denotes significance at 10%.

We performed two regressions. The first is a standard OLS regression which is a necessary prelude to diagnostic testing with regards issues such as heteroskedasticity and multi-collinearity while the second is a panel data fixed effect model which we base our coefficient interpretations on. From the results in Table 3 it can be seen that the base OLS Model has an  $R^2$  of 21.44%. The F statistic for the model is 8.12 which is significant at 1% indicating overall that the model is well-fitted. The mean VIF of the co-variates included in the model is 1.09; which indicates the absence of harmful multi-collinearity. The Breusch-Pagan / Cook-Weisberg test for heteroskedasticity of the OLS model reported a value of 202.57 which is significant at 1%. This indicates that the model errors are not homoskedastic. In running our panel data fixed effect regression, we therefore try to correct for the heteroskedastic errors by using the robust option in STATA 13. The robust option uses Huber-White sandwich estimators to correct the standard errors of the estimated coefficients such that both heteroskedasticity and autocorrelation are minimized.

Our fixed effects regression model reported an  $R^2$  of 19.95% and F statistic of 7.20 which is significant at 5%. ROA has a negative coefficient of -2.0239 which is however not significant. The results for profitability (ROA) with regards both sign of coefficient and statistical significance are in tandem with those of Edwards *et al* (2013) and Taylor and Richardson (2013). Capital intensity has a positive

coefficient of 2.0662 which is also not significant. The positive association together with the not significant results are in harmony with results of the logit model in Taylor and Richardson (2013). Financial leverage also has a positive coefficient of 0.4571; also not significant. The positive results for financial leverage, with the exception of significance level, mirror those of Philips (2003) and Ding *et al* (2013). Firm size has a negative coefficient of -0.0376 which is statistically significant at 1%. The documented inverse association corroborates the political power hypothesis and is in tandem with the findings of Philips (2003), and Wang (2012).

## **5. Conclusions and Recommendations**

This study examined the effect of firm characteristics on corporate tax avoidance among DMBs in Nigeria. The study estimated a fixed effect model that found that out of four principal firm characteristics; profitability, capital intensity, firm size and financial leverage, only firm size significantly affects tax avoidance by the DMBs. The documented significant association is in tandem with theoretical expositions of the political power hypothesis. Thus Nigerian DMBs leverage on their size advantage to exploit tax avoidance opportunities.

Given the documented findings of the study, we recommend that

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