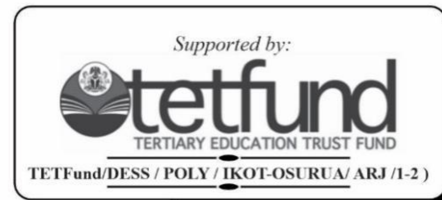
THE ROLE OF EARNINGS MANAGEMENT AND TAXATION IN FINANCIAL REPORTING QUALITY



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ABSTRACT

When a company faces pressure to manipulate its earnings to meet predetermined targets, it may resort to earnings management practices. Depending on the company's size and financial circumstances, earnings management can take various forms, including accrual accounting, capitalization constraints, and the establishment of reserves. Employing earnings management techniques enables companies to present more consistent profits on a monthly, quarterly, or annual basis by mitigating fluctuations in earnings. This study investigated the interplay between Earnings Management and Taxation in Financial Reporting Quality. Through an exploratory research design, the findings suggest that while companies may utilize earnings management to optimize tax liabilities, these practices can negatively affect financial reporting quality. And upholding the integrity and accuracy of financial reporting is paramount for a

company's long-term success, reputation, and stakeholder relationships. The paper noted that although tax avoidance through earnings management is generally permissible, it can raise ethical and corporate governance concerns, becoming a topic of debate and scrutiny. Regulators and tax authorities consistently aim to close loopholes and establish regulations to deter excessive earnings management that could erode tax revenues or mislead investors. Thus, the paper recommends that companies prioritize transparency and adhere to accounting standards to ensure the precision of their financial statements and tax filings, thereby averting the adverse consequences of earnings management.

Keywords: *earnings, management, taxation. financial report, transparancy*

INTRODUCTION

Earnings management and taxation are interconnected concepts that involve manipulating a company's financial statements and reporting practices to minimize tax liabilities or achieve other economic objectives. Earnings management refers to using accounting techniques to present an excessively optimistic view of a company's financial position, inflating earnings (Tuovila & Kelly, 2023). Earnings management is a broader concept encompassing various strategies and tactics businesses employ to present their financial performance in a way that may not accurately reflect their economic reality. There are two basic approaches to earnings management: accruals-based and actual activities management. The most common method of manipulation is via accruals (Healy & Wahlen, 1999).

Accruals generate the difference between income and cash flows. Although their primary purpose is to provide information, it has been observed that the accruals are used by management for earnings management (Gikas et al., 2010). Total accruals-based earnings management are divided into nondiscretionary and discretionary accruals.

The former are accruals from implementing generally accepted

accounting policies, while the latter result from management's accounting choices (Eftychia et al., 2015). Earnings management can also be achieved through actual activities management, including the acceleration of sales, the adopted inventory policies, and an increase in production to reduce the cost of goods sold, which can influence accounting figures (Roychowhury, 2006). However, taxes play a big part in earnings management since businesses frequently use tax avoidance to maximize their reported earnings to lower their tax obligations. According to Dyreng and Maydew (2018), tax avoidance is commonly described as any decrease in a company's taxes compared to its pretax accounting income, while some studies look into more specialized types of avoidance, like aggressive tax avoidance, tax sheltering, or tax risk.

Taxation and earnings management are related, as companies may use earnings management to reduce their tax payments (Delgado et al., 2023; Nguyen et al., (2022). Therefore, taxation plays a significant role in earnings management, as companies may use various strategies to reduce their tax liabilities while maintaining a positive financial image. This can be done through both legal and sometimes questionable means. However, the gap between accounting and taxation seems unaffected mainly by earnings management (Delgado et al., 2023). When a business is pressured to manipulate earnings to meet a predetermined objective, earnings management may occur. According to the size of the business and its financial situation, there are numerous forms of earnings management, such as accrual accounting, capitalization limitations, and cookie jar reserves (Swaminathan &Vaidya, 2023). Employing earnings management helps businesses present more consistent profits every month, quarter, or year by mitigating earnings swings (Tuovila & Kelly, 2023).

It is important to note that while some of these strategies are legal and widely used for tax planning, others may cross ethical and legal boundaries, leading to potential regulatory and legal consequences. This paper aims to broadly examine earnings management and taxation while

specifically exploring the connection between earnings management to optimize their tax liabilities and how this affects their financial reporting quality.

LITERATURES REVIEW

CONNECTION BETWEEN EARNINGS MANAGEMENT AND TAX LIABILITY OPTIMIZATION

Earnings management is often connected to optimizing tax liabilities, as companies seek to minimize their tax expenses while maintaining a positive financial image. This connection involves various strategies aimed at achieving the balance between legal tax planning and potentially aggressive tactics.

1. **Tax Planning**: Companies plan to minimize their tax liabilities legally. This includes taking advantage of available tax deductions, credits, and incentives. For instance, a company might invest in research and development to claim the R&D tax credit (IRS, 2021) or set up operations in a location with a favorable tax regime.

2. **Income Shifting**: Multinational corporations may strategically allocate income between subsidiaries or entities to take advantage of lower tax rates in certain jurisdictions. Transfer pricing is a common legal technique used to shift income (Hines, 2010). This allows companies to optimize their overall tax liabilities.

3. **Earnings Smoothing**: Companies may engage in earnings smoothing to maintain a stable and predictable income stream, reducing the likelihood of fluctuating tax liabilities. This involves recognizing revenues or expenses in a way that evens out earnings over time. By avoiding significant fluctuations in income, companies can manage their tax liabilities more effectively (Healy & Wahlen, 1999).
4. **Deferred Tax Assets and Liabilities**: Deferred tax assets and liabilities can be manipulated by companies to manage earnings.

Companies can adjust their deferred tax positions to manage earnings. This can affect their reported tax expenses, leading to the optimization of tax liabilities (Graham, 1999).

5. **Income Recognition**: Accelerating or delaying the recognition of income can impact the timing of tax payments. Companies may defer income recognition to reduce the current tax liability, especially if they expect lower tax rates in the future (Guenther & Sansing, 2006).

6. **Tax Loss Carryforwards**: Earnings management can also involve the strategic use of loss carryforwards, which allows companies to offset current income with past losses, thereby reducing their taxable income. This practice can minimize tax obligations in profitable years (Dyreng et al., 2008).

7. **Effective Tax Rate Management**: Companies may disclose their effective tax rate in financial statements. By manipulating this rate, they can create the appearance of being more tax-efficient (Chen & Chu, 2005).

8. **Timing of Income Recognition**: The timing of recognizing income can be manipulated to align with tax planning objectives. Companies may defer income recognition to reduce their current tax liabilities, particularly if they anticipate lower tax rates (Guenther &Sansing, 2006). For example, a company might postpone recognizing income until a future period or prepay certain expenses to deduct them in the current period.

9. **Effective Tax Rate Management**: Companies may disclose their effective tax rates in financial statements. By manipulating this rate, they can create the appearance of being more tax-efficient (Chen & Chu, 2005). This can impact the way investors perceive the

company's tax management practices.

10. **Use of Tax Credits and Incentives:** Businesses often employ earnings management techniques to take advantage of government tax credits and incentives. By optimizing their financial statements and tax reporting, they can qualify for tax breaks, deductions, or credits that reduce their overall tax burden.

11. **Offshore Tax Havens:** Some companies engage in more aggressive tax planning by shifting profits to offshore tax havens with lower tax rates. This involves strategies like transfer pricing, where the company sets prices for transactions between its subsidiaries in a way that reduces taxable income in higher-tax jurisdictions.

12. **Financial Statement Manipulation:** Earnings management can also involve manipulating financial statements through accounting practices that may not accurately represent the economic reality of a company's operations. This can include revenue recognition, asset impairment, or using reserves and accruals to smooth earnings.

13. **Tax Avoidance vs. Tax Evasion:** It is essential to distinguish between tax avoidance, a legal practice of minimizing taxes through proper tax planning, and tax evasion, which is illegal and involves deliberately misrepresenting financial information to reduce tax liabilities. When done within the boundaries of the law, earnings management falls under tax avoidance.

The effect of tax liabilities optimization through earnings management on financial reporting quality

Tax liability optimization through earnings management is a common practice among corporations. This practice involves using accounting methods to reduce the reported taxable income of a company, thereby lowering its tax liability.

While earnings management can be used for legitimate purposes, such as reducing tax expenses, it can also be used to manipulate financial statements to make a company appear more profitable than it is. This can have a negative impact on financial reporting quality.
This can also influence a company's reported tax liabilities, potentially

affecting the accuracy and reliability of financial statements. While it is not always illegal, it can raise ethical concerns and impact the transparency and accuracy of financial reporting. Thus, there are several ways in which tax liability optimization through earnings management can impact financial reporting quality.

1. **Difficult for Investors to Assess the True Financial Health of a Company:** One way is by making it more difficult for investors to assess the proper financial health of a company. When a company manages its earnings to reduce its tax liability, it can make it difficult for investors to determine its true profitability. This can lead to investors making uninformed investment decisions.

2. **Eroding Investor Confidence**: Another way tax liability optimization can impact financial reporting quality is by eroding investor confidence. When investors believe that a company is manipulating its financial statements, they may become less confident in the company's management and the accuracy of its financial reporting. This can lead to a decrease in the company's stock price and make it more challenging to raise capital.

Reduced Transparency and Credibility: Earnings management can lead to financial statements that must accurately represent a company's financial performance. This can erode the transparency of financial reporting, making it difficult for investors, analysts, and other stakeholders to assess the company's financial health and make informed decisions. This reduced transparency can harm the

credibility of the financial statements and the organization.

Increased Risk of Financial Restatements: When companies engage in earnings management to reduce their tax liabilities, they may inadvertently or intentionally misstate financial information. This increases the risk of financial restatements, damaging the company's reputation and leading to legal consequences. Restatements are often triggered by external audits or regulatory investigations that uncover irregularities in financial reporting.

Impact on Valuation: Financial reporting quality is vital for investors and analysts when valuing a company. Earnings management can distort critical financial metrics, such as earnings per share (EPS), which can, in turn, affect a company's stock price and market valuation. Inaccurate financial reporting can mislead investors and lead to mispricing of a company's securities.

Regulatory Scrutiny: Earnings management practices that involve aggressive tax planning may attract the attention of regulatory bodies such as the Securities and Exchange Commission (SEC) or tax authorities.
These regulatory agencies may investigate and penalize companies for non-compliance with accounting and tax regulations, which can further damage the company's reputation and financial reporting quality.

Long-Term Consequences: Earnings management focused on reducing tax liabilities may provide short-term benefits, such as tax savings, but it can have adverse long-term consequences. It can undermine the company's financial stability, reduce investor trust, and limit access to capital markets. In the worst cases, it can lead to financial distress or even bankruptcy.

Impact on Stakeholder Trust: High-quality financial reporting is essential to maintaining trust with various stakeholders, including investors, creditors, employees, and customers. Earnings management practices can erode this trust, as stakeholders may question the accuracy and reliability of the company's financial statements.

External and Internal Audits: Earnings management can complicate the work of external auditors and internal control mechanisms. Auditors may need to perform more extensive procedures to detect potential manipulation, which can increase the cost of auditing and extend the audit timeline.

THEORETICAL CONSIDERATIONS

This paper discusses the agency theory and political cost theory as they relate earnings management and taxation.

a. Agency Theory

Jensen and Meckling developed the agency theory in 1976, grounded on the argument that separation of ownership and control in corporations creates a principal-agent problem, where managers (agents) may not always act in the best interests of shareholders (principals).

Avoiding taxes could contribute to higher profitability. Nevertheless, managers might also have the chance to act in other ways that are detrimental to shareholders in addition to shirking. According to conventional wisdom, regardless of the remuneration plan, tax avoidance increases after-tax shareholder value. However, since their compensation is independent of shareholder value, managers who are only paid salaries will not be motivated to use the tax evasion tactic.

According to the conventional wisdom, managers who engage in corporate tax evasion will see an increase in after-tax shareholder value. However, since managers receive no bonuses or additional income beyond their salary, there is no reason for them to utilize tax evasion techniques. In agency theory and earnings management, managers and shareholders will not be impacted by earnings management, specifically if the manager receives the company's wage. Manipulating earnings, however, allows managers to get incentives based on profits and encourages them to employ the tax shelter technique if they are faced with bonus earnings. This occurs even in situations where the cost of remuneration to shareholders surpasses the benefits of taxes—accordingly, tax evasion and

earnings management lower shareholder value (Desai & Dharmapala, 2009). The relationship between creditors and shareholders indicates that creditors' constant goal is to further their interests. Managers can use debt more frequently to benefit from the tax shield provided by debt, which will reduce income tax expenses. However, when debt financing is needed, managers representing shareholders will intervene in earnings, including income tax costs, so that financial capacity is optimal. The tax burden is carried forward to the following period, which may be tied to the loan's maturity rather than being lost due to this move. Consequently, stockholders and debtors seem to have a conflict of interest.

b. Political Cost Theory

The political cost theory was propounded by Watts and Zimmerman in 1986, which posits that firms' accounting choices are influenced by the desire to manage their political costs, which are the costs that arise from government regulation, taxation, and social pressures. As firms grow more prominent and more visible, they become more susceptible to public scrutiny and criticism, which can lead to higher political costs. To reduce these costs, firms may choose accounting methods that make their earnings appear lower, reducing their taxable income and regulatory scrutiny.

According to the Political Cost Theory, larger and more prosperous businesses have a higher vision that renders them "victims" of more lawsuits and asset transfers than smaller businesses (Watts & Zimmerman, 1986). Thus, larger organizations opt for lower-income accounting techniques more frequently than small enterprises (Zimmerman, 1983) or lower the transfer's capability or size (Cahan, 1992) to lower these political costs. According to Hong (2016), "political expenses are one of the company's most significant costs and payments and are regarded as non-contract expenses." As a result, businesses are constantly searching for methods to save costs. Political cost theory states that larger, more profitable corporations must pay CIT, a part of political expenses. They have a greater CIT due to a higher ETR. Discretionary accruals are used to measure earnings

management. Managers might manipulate these accruals to lower the reporting period's taxable income and the CIT expense.

The impact of firm size and profits management on corporate income tax evasion is explained by political cost theory. Larger companies will avoid CIT more than smaller companies, while companies that manage their earnings more will avoid CIT more than smaller companies.

Conclusion/Recommendation

In conclusion, while companies may manage earnings to optimize tax liabilities, these practices can harm financial reporting quality. Maintaining the integrity and accuracy of financial reporting is crucial for a company's
long-term success, reputation, and relationships with stakeholders. It is important to note that while tax avoidance through earnings management is generally legal, it can be a subject of debate and scrutiny, as it may raise ethical and corporate governance concerns. Regulators and tax authorities often strive to close loopholes and establish rules to prevent excessive earnings management that undermines tax revenues or misleads investors. Therefore, companies should prioritize transparency and adhere to accounting standards to ensure the accuracy of their financial statements and tax filings to avoid the negative consequences associated with earnings management.

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