GLOBALIZATION AND ITS SOCIO-ECONOMIC CONSEQUENCES

Transfer pricing and controlled transactions in connection with earnings management and tax avoidance

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AIM OF THE PAPER

- To find out if controlled transactions are used in connection with earnings management and tax avoidance in the selected Slovak company using proxies, which may carry this detection capability (ratios of related party transactions, book-tax differences ratio, and discretionary accruals ratio).

- Backround for the research:
  - it is generally known that income tax is perceived by businesses as an unproductive withdrawal of own funds without obvious consideration, and therefore managing economic transactions at the level of related-party entities in order to minimize the tax liability is obvious and even expected.

METHODOLOGY OF THE PAPER

- The analytical part follows the Slovak transfer pricing legislation in force.
- We test hypothetical relationship between the indicators of earnings management, related party transactions and tax avoidance by applying correlation analysis.
- Publicly available data from financial statements and notes to financial statements from the Register of Income Statements of the Slovak Republic.
- Financial statements are in accordance with the Slovak Accounting Standards (SAS).

BACKROUND OF THE RESEARCH

- The general definition of earnings management defines it as a series of decisions taken by responsible managers in the field of accounting and reporting of economic transactions to signal financial information to external users to assist them to improve their understanding of company's current or upcoming performance. (Kaya, T., Turegun, N. (2017))

- In practice, earnings management is rather negative since activities of managers are of an opportunistic nature – they mostly act for other than enhancing truthful reporting (i.e. it is financial reporting aggressiveness), e.g. to fulfil bonus incentives, debt contracts, political costs (including tax burden) etc. (Park, S. (2018); Healy, P. M., Wahlen, J. M. (1999); Watts, L. R., Zimmerman, L. J. (1989))

- Earnings management disposes with a range of tools applicable to stakeholders´ interests, including tax management.

BACKROUND OF THE RESEARCH

- „Tax" is confined to compulsory, unrequited payments to general government. Generally, taxes are unrequited in the sense that benefits provided by government to a taxpayer are not normally in proportion to a taxpayer´s payments. (OECD (1996))

- Transfer pricing is one of the most discussed tax areas.

- Prices of intragroup transactions are a mean for allocating the profits between the various legal entities involved in related-party transactions of an economic nature. (Kramarova, K., Bartosova, V., Gajanova, L., Havelkova, A. (2019); Park, S. (2018))

- Transfer pricing manipulates the amount of accounting profit, thereby affecting the tax to be received by the government, dividends that will be received by shareholders and managerial bonuses for economic results.

- Opportunistic policies of management to manage earnings are motivated by the amount of tax that is borne by the company as a tax-payer, so that the tax burden owed becomes smaller due the fact that the accounting profit has been managed by the management. (Scott, W. R. (2015))

BACKROUND OF THE RESEARCH

- Beuselinck – Deloof (2014) confirmed that the extent of fraudulent financial reporting was larger in case of business groups than in case of non-business groups.

METHODOLOGY – USED PROXIES

- The amount of related-party transactions (RPT) we calculated as the ratio of their monetary value and the value of all transactions of a given type. We took into account all economic transactions with the direct impact on the economic results of the company. From the accounting point of view, these are transactions of a revenue and cost nature.

- To measure tax avoidance we used book- tax differences ratio, namely total book-tax differences ratio TBTDs).

- Financial aggressiveness as the action of earnings management we calculated through discretionary accruals (DA):

METHODOLOGY – USED PROXIES

$$\mathbf{DA_t = TA_t - NDA_t = (NI_t - CF\ operation_t)/A_{t\text{-}1} - (1/A_{t\text{-}1} + \Delta REV/A_{t\text{-}1} - \Delta REC/A_{t\text{-}1} + PPE_t/A_{t\text{-}1} + ROA_t}$$

- where:
  - DA_t – discretionary accruals
  - TA_t – total accruals
  - NDA_t – non-discretionary accruals
  - NI_t – net income (EAT)
  - $A_{t\text{-}1}$ – total assets in the year previous to analysis
  - ΔREV – year-on-year change in revenues
  - ΔREC – year-on-year change in account receivable
  - PPE_t – fixed assets
  - ROA_t – return on assets

RESULTS

- The legal framework of individual countries is created under the influence of various endogenous and exogenous factors.
- They determine the uniqueness of tax systems, which, on the one hand, are linked to the need to harmonize legal systems at the level of supranational entities and, on the other hand, to reflect specificities of national environments.
- The basic and transnationally accepted principle of transfer pricing – arm´s length principle – in case of Slovakia is enacted in the Section 18 (1) of the Act No. 595/2003 Coll. on Income Tax Act as amended.
- Given Act together with the Guidelines of the Ministry of Finance of the Slovak Republic MF/019153/2018-724 on Details Regarding the Content for Keeping Documentation for Transfer Pricing Method and Methodological Guideline on the Transfer Pricing Methods of the Financial Directorate of the Slovak Republic are the primary legislation governing the issue of transfer pricing in Slovakia.

RESULTS

- As far as the analysed company is concerned, the company is identified for the purposes of transfer pricing only as a domestic dependent person.
- The connections with other persons and entities are of an economic and personnel nature (apparent involvement of the company in the assets, control and management of another company).
- All controlled transactions are of a significant nature, i.e. the company is obliged to keep transfer documentation about all kinds of controlled transactions (extra-simplified transfer documentation since January 2015).
- The transactions have the character of purchased services, including rental of properties and received financial loans (other than bank loans). From an accounting point of view, these are the transactions of a cost nature, which reduce the company´s earnings.
- The company does not carry out control transactions of a revenue nature except the year 2013. However, their monetary value in comparison with total revenues exceeding 19 mil. EUR did not reach even 0.01%.

RESULTS

- The average value of income tax payable from 2010 to 2019 was EUR 267,299; the average value of net profit was EUR 869,822.
- The company was profitable in all analysed years, with the exception of 2019 (accounting loss of EUR 782,701).
- The average effective tax rate was 20.1%, and thus 4.26% lower than the statutory average tax rate for individual years.
- CF from operating activities reached an average value of EUR 3,099,340.
- The average ROA_{EAT} was 5%.

RESULTS

- The value of the RPT ratio for all years is 0.02879, i.e. controlled transactions of the cost nature accounted for 2.88% of all cost transactions. After the introduction of the obligation to keep transfer pricing documentation on domestic controlled transactions (since 2015), the average value of the indicator decreased to 0.02090.

- DA as a proxy in measuring financial statements aggressiveness indicates that the analysed company managed earnings rather downwards, since the values of DA were negative in all years; the exception is 2018. This may indicate the company´s effort to minimize its tax duties. The average value of the DA ratio accounted for (-) 0.75330. If we consider only the years after the introduction of the obligation to keep transfer pricing documentation on domestic controlled transactions, the average value of DA dropped to (-) 0.66250.

- TBTDs as a proxy in measuring tax avoidance shows fluctuations over the analysed years. Its average value accounted for (-) 0.00701. If we consider only the years after the introduction of the obligation to keep transfer pricing documentation on domestic controlled transactions, the value of TBTDs lower, namely (-) 0.01001.

RESULTS – HYPOTHETICAL RELATIONSHIPS BETWEEN THE DA RATIO AND RPT INDICATOR

- According the analysis of hypothetical relationships between the proxies, the results indicate an indirect relationship of moderate intensity.
- Coefficient of correlation r = (-) 0.55505).

- I.e. in the case of a decrease in the share of considered controlled transactions in the total volume of transactions of a given type, the value of the indicator indicating the degree of propensity to earnings management and aggressiveness financial reporting would increase (from negative values it would “shift” to zero). I.e. the rate at which profits are reduced, it would decrease.

- In the case of an increase in the share of controlled transactions, the DA ratio would develop ad versa.

- From a statistical point of view, the linear dependence of the indicators is statistically significant.

RESULTS – HYPOTHETICAL RELATIONSHIPS BETWEEN THE DA RATIO AND TBTDS RATIO

- From the analysis of the impact of earnings management on tax avoidance is obvious that:

  - earnings management could be implemented for the purpose of tax avoidance, however the linear dependence is low (coefficient of correlation $r = 0.10785$) and statistically it was not confirmed as significant.

  - we deduce that tax management was not the only reason why opportunistic earnings management occurred in the company.

RESULTS – HYPOTHETICAL RELATIONSHIPS BETWEEN THE RPT RATIO AND TBTDS RATIO

- In analysing the potential relationship of controlled transactions and transfer pricing on tax avoidance, we have concluded:
  - RPT indicator had a positive effect on tax avoidance of a medium strength (coefficient of correlation $r = 0.33895$).
  - The result suggests that in the case of a decrease in the share of controlled transactions in the total volume of transactions of a given type, the value of TBTDs would decrease.
  - At the same time, the result suggests that controlled transactions were not the only proxies that contributed to a potential disproportion between accounting and tax profits.

CONCLUSION

- The results of the analysis indicate the potential relationship between the indicators, which point out:
  - ad 1) the importance of controlled transactions and transfer pricing in connection with earnings management,
  - ad 2) the link between earnings management and tax avoidance,
  - and ad 3) the potential relationship between controlled transactions and tax avoidance.

CONCLUSION AND FUTHER DIRECTION

- We consider the analysis performed and the obtained results as an input analysis of potential relationships between the observed variables.

- To do analysis that is more comprehensive and to get results, which are more valuable it would be appropriate to implement mediation analysis that can contribute to better understanding the relationship between variables when these variables do not have an obvious direct connection.

Thank you very much for your attention.