

Effect of Deferred Tax Accounting on Financial Performance of Manufacturing Companies in Nigeria

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Abstract

The study examined the effect of deferred tax accounting on financial performance of listed manufacturing companies in Nigeria using data from 19 out of 56 listed manufacturing companies that are selected based on judgmental sampling technique. In so doing, the study adopts the Vector Error Correction Model (VECM) to test two hypotheses stated in line with the specific objectives. Findings from the study reveal that, deferred tax asset and liability have a positive but insignificant effect on profitability of listed manufacturing companies in Nigeria. Following the study's findings, the study suggests that manufacturing enterprises in Nigeria investigate possible tax credits for specific assets and investigate the feasibility of utilizing such tax credits to minimize their tax burden through tax deferment. This may minimize the enterprise's tax burden and, as a result, boost the firm's profitability.

Keywords: *Deferred tax assets, Deferred tax liability, Ability to pay theory, and Profitability.*

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Background to the Study

Finding strategies to reduce a company's overall tax liability is one of the most pressing responsibilities of a corporate tax manager (Abiola, James, & Asiweh, 2012). According to theories, a firm's tax burden is proportionally tied to its profitability; achieving the firm's wealth maximization goal through various means of growing profitability imposes greater challenges on the firm's ability to lower its tax liability. Deferred tax, according to Savka and Radojko (2013), is a part of successful tax planning and methods that maximize the firm's predicted discounted after-tax cash flows. Aside from being well-versed in tax legislation, any company's tax advisors should have a thorough understanding of the company, its history, and how the organization operates to predict its deferred tax liability (John, Samuel & Holy, 2013). According to Chludik (2011), deferred tax temporary differences may also include both time gaps applied in the final accounting records and differences that have not passed through the comprehensive income statement because deferred tax is not actually in the true sense but a projection of what is likely to occur. This deferred tax forecast, as claimed by Nwaorgu, Abianhu, Tapang, and Iormbagah (2019), will limit the distribution of profit parts that were not subject to owing income tax to funds formed from profit or among shareholders in the present period. This is a significant issue that arises when firms account for deferred tax. There is no doubt in accounting theory about the necessity of deferred tax when formulating tax plans, the goal of which is to correct the impact of due income tax on company profitability (Citron, 2014).

According to Ogundajo and Onakoya (2016), the concept and content of deferred tax have a certain history, development, and experience in Nigeria; nonetheless, it cannot be argued that in its practicality it is a self-evident and cohesive part of current financial report. According to Ogundajo and Onakoya (2016), even though deferred tax first appeared in Nigerian firms' accounting reports in the early 1990s, it became more well-known to the professional accountant's audience when Nigeria adopted the International Accounting Standard Board's financial reporting standards (IASB). Since then, all accounting companies that are required to prepare financial statements in the full format have been required to account for deferred tax. This was the beginning of deferred tax accounting methodology in Nigeria, as deferred tax accounting reduces accounting profit or loss distortions caused by the effect of deferring tax circumstances for the addition of accounting expenses or revenues to the income tax base (Ogundajo & Onakoya, 2016).

The theories and practices of implementing an all-deferred tax in a firm's tax plan cannot be overstated; hence, additional research on the topic of deferred tax, including deferred tax assets and their effect on company profitability, particularly from a Nigerian viewpoint, is required. The goal of this study is to emphasize the complexities, as well as the larger context, surrounding the requirement of corporations using deferred tax procedures. Therefore, this study will examine the effect of deferred tax on the financial performance of manufacturing companies in Nigeria. The specific objectives of the study are to:

- i. Assess the effect of deferred tax assets on the profitability of listed manufacturing companies in Nigeria.
- ii. Ascertain the effect of deferred tax liability on the profitability of listed manufacturing companies in Nigeria.

Review of Related Literature

Concept of Deferred Tax

The value of the deferred tax, as defined by International Accounting Standard (IAS) 12, is the amount of income tax due for payment in a future period in connection with taxable transitory differences. According to Halim, Veysel, and Baykut (2015), the deferred tax might include both deferred tax assets and liabilities. According to David (2003), the liability part of deferred tax is the money generated for accounting purposes rather than tax ones. According to David (2003), deferred tax obligation identifies future taxes owed when generated income is later recorded for tax reasons. One of the primary reasons a company lists deferred income taxes as a liability on its statement of financial position is the use of accelerated depreciation for filing to the Revenue authorities and straight-line depreciation for reporting to stockholders (Goh, Lee, Lim & Shevlin, 2013). Deferred tax is a tax that a corporation will owe on its income but has not yet been assessed in its financial statements (Halim et al., 2015). According to Chang, Herbohn, and Tutticci (2009), deferred tax is a financial reporting construct.

According to Burgstahler, Elliott, and Hanlon (2002), a deferred tax asset is a projected future tax saving tied to book income that represents temporary changes in cash flow timing. Burgstahler, Elliott, and Hanlon (2002) went on to say that a deferred tax asset is created when an expense is deductible for calculating book income in the current period but not for tax reasons until some future period when income is includible in present taxable income but not in book income until some future period, or when carry forwards exist. Compensation-related expenses (e.g., retiree health insurance, stock options, and defined benefit), other accrued expenses (e.g., guarantee expenses), asset impairments (e.g., intangible assets, inventory write-offs), and the company's net loss and tax credit carryforwards are examples of deferred tax items. Deferred tax liability is the projected future tax rise on book income (Nwaorgu et al., 2019). When an expense is deductible for tax reasons in the present period but not for book income till some future date, or when revenue is includible for accounting purposes yet does not constitute taxable income until some future period, a deferred tax liability is established (Bauman & Shaw, 2016). According to Barth, Beaver, and Landsman, (1998), a common deferred tax liability component includes book-tax depreciation differences (accelerated for tax purposes), instalment sales, and undistributed or reinvested earnings.

On the statement of financial status, most companies declare simply the net deferred tax assets as well as deferred tax liabilities (Nwaorgu et al., 2019). If the net deferred tax assets exceed the net deferred tax obligation, the firm reports a net deferred tax asset; if it exceeds the net deferred tax liability, the firm reports a net deferred tax liability. Because of this opinionated accounting for deferred tax, the report of deferred tax components

varies greatly across enterprises subject to managerial judgment (Haskins & Simko, 2011). To keep the statement of financial position current, Statement of Financial Accounting Standard 109 requires a yearly calculation of the deferred tax assets (including the valuation allowance) and deferred tax obligation. The valuation allowance must be created if it is more likely than not that some portion or all of the deferred tax assets will not be realized (FASB 109).

Deferred tax expense is generally affected by the reporting of and changes in deferred taxes. Nonetheless, changes in deferred taxes are directly reflected in equity, implying that they are income neutral. If the underlying transaction or event that results in the book-tax difference is reported as a separate profit or loss (IAS 12.58). Deferred tax obligations often result from financially recorded income that has not yet been taxed, such as in the instance of accelerated tax depreciation, in which tax liability is deferred into the future by accelerated depreciation rates that exceed book depreciation values. Deferred tax assets, on the other hand, often originate as a result of earlier expensing for financial accounting purposes than for tax purposes (Weber, 2009). In his assessment of IAS 12, Rohaya, Nor'Azam, and Bardai (2010), argued that deferred tax components can indicate book-tax differences that occur naturally due to differences in tax legislation vs accounting standards, as well as book-tax differences that inform about book-tax choices. Deferred tax assets, on the other hand, coming from book-tax discrepancies in pension provisions, for example, imply that corporations often employ a lower discount rate in calculating the pension provision for book reasons than for tax purposes (Purina, 2016). However, because the presence of unused tax losses and tax credits, as well as a recent history of losses, may indicate that future taxable profit is not accessible (IAS 12), IAS 12 provides additional guidance on the reporting of deferred tax assets for tax loss and tax credit carryforwards. When calculating the likely utilizable share of unused tax losses and tax credits, an entity should take into account the availability of reversing deferred tax liabilities, projected future taxable income, the sources of the unutilized tax losses, and available tax planning strategies, according to IAS 12. Deferred taxes are measured at the tax rates that are projected to apply when the underlying asset or liability is realized or settled since they represent future tax consequences. However, because future tax rates are unknown, current tax rates, i.e., tax rates and tax legislation implemented or substantively enacted by the end of the reporting period, are used for measurement (IAS 12).

Financial Performance

According to Berger and Patti (2002), business performance is typically measured by ratios derived from income statements or stock market prices, also including industry-adjusted operating profits or stock market returns. This is consistent with Pandey's (1995) argument that profit maximization results in the optimum allocation of resources in a market that is competitive, and profit is seen as the most relevant measure of a firm's performance. Hill and Jones (2009) and Girish, Harsh, and Nidhi (2014) agree that profitability is the most important indicator of a company's financial performance. Hence, financial performance ratios in this context focus on the link between profit and

sales as well as profit and assets utilized (Ilaboya, Izevbekhai & Ohiokha, 2016). Return on assets is calculated by dividing earnings after tax by total assets. Companies with more steady cash flows are more profitable, and they prefer to use debt since they have greater debt servicing capacity and higher tax profit (Myers, 2001). Similarly, profitable enterprises with free cash flows should benefit from loans to meet their needs and should not misuse free cash flow to preserve firm liquidity (Modigliani & Miller, 1963). Jens and Schweltnus (2008) empirically demonstrated a negative association between write-offs and profitability, however, the introduction of deferred tax assets has changed this assumption.

The Ability to Pay Theory

This research is based on Adams Smith's ability to pay theory, which he proposed in 1776. According to Adams Smith's (1776) ability-to-pay approach, taxes are levied depending on taxpayers' ability to pay. Taxes are viewed as a sacrifice by taxpayers (individuals and businesses), raising the question of what each taxpayer's sacrifice should be and how it should be quantified. The ability to pay hypothesis is argued to stem from the premise that corporations in forming their tax plans take into account the available firm resources, which range from the profit made, asset structure, and tax incentives/ credits. With due consideration to these resources, firms determine the most effective tax rates pay at the moment and the taxes to be deferred. Nwaorgu et al., (2019) argued that it posits the firms' resources and consequently ability to pay taxes.

Empirical Review

Quite several investigations had been conducted on the interrelationship between deferred tax and the financial performance of firms in developed and developing countries in recent times. Nwaorgu et al., (2019); Uwuigbe, (2016); Mayeenda, (2013); Ogundajo and Onakoya, (2016); Gatsi, Gadzo and Kportorgbi, (2013); Akinyomi and Tasi, (2011) all studied an aspect of deferred tax and how it affects the financial performance of companies. They mostly focused on deferred tax liability. The various arguments by authors and application of standards have created a source for the future application of effective tax planning in the form of a deferred tax considering only deferred tax liabilities. These studies from Africa do not take into account the deferred tax asset that is exceptionally accounted for provided that there is a sufficiently high tax base in the future against which this asset could be applied. Meiryani, Fernando, Hendratno, Dewiyanti, and Yanny (2021) researched the impact of deferred tax charges on earnings management in banking firms. This study makes use of secondary data derived from financial reports or annual reports of companies registered on the Indonesia Stock Exchange. Their data analysis method is linear regression analysis. Their findings indicated that deferred tax expenditure had an impact on earnings management.

Mear, Bradbury, and Hooks (2020) evaluated the value relevance of recognized deferred tax elements under International Accounting Standard 12 (IAS 12): Income Taxes (balance sheet method) to taxes payable (flow-through). They also look into the worthiness of IAS 12 deferred tax disclosures. Their analysis employed typical valuation

models to investigate the relationship between share price and IAS 12 recognized amounts and footnote disclosures. The Vuong (1989) test is then applied to determine which information set is more valuable. The sample comprises 440 firm years from 2008 to 2012. The findings reveal that deferred tax amounts recognized using the balance sheet technique give no more information to investors than deferred tax amounts recognized using the taxes payable approach (TPM). Deferred tax footnote disclosures, however, are more relevant than the amounts recognised under the balance sheet method.

Methodology

The ex post facto research approach is used in this study. This study's population consists of 56 manufacturing companies that are listed on the Nigerian Exchange Group as of July 2021. The study used the judgmental sampling technique to choose 19 companies as the study's sample size. These are the companies that were listed throughout the study period and have complete data in their financial reports. Extracted data from the sampled firms audited financial statements are rigorously analyzed, and pertinent data from the period 2015-2020 is extracted for analysis. To investigate the relationship between the dependent and independent variables, the multiple regression methodology employing the ordinary least square regression (OLS) method is used.

This study formulates the following model to be used by the researcher in the investigation with some modifications of the model by Nwaorgu et al., (2019);

$$ROA_{it} = \alpha + \beta_1 LOGDTA_{it} + \beta_2 LOGDTL_{it} + U_{it} \dots \dots \dots \text{Model 4}$$

Where;

α = Constant

ROA = Return on assets

LOGDTA = Log of Deferred Tax Asset

LOGDTL = Log of Deferred Tax Liability

IT = Cross-section (i) at a time (t)

U = Error term used in the model.

β = beta coefficient of the independent variable.

Decision Rule: Accept the null hypothesis if the calculated value is greater than the significant level of 0.05.

Results and Discussions

Descriptive statistics

The descriptive statistics for both the dependent and independent variables are presented in Table 1.

Table 1: Descriptive Statistics

	LOGDTA	LOGDTL	ROA	LEV	EPS
Mean	5.577517	5.629476	0.085747	0.324172	1.626667
Maximum	7.807889	7.874419	0.459459	0.991418	9.760000
Minimum	3.710202	3.079904	0.002969	0.003143	0.020000
Std. Dev.	1.035834	1.003555	0.093432	0.251884	2.092950
Skewness	0.240609	-0.115852	1.875356	0.846643	2.022782
Observations	114	114	114	114	114

Source: E-View Output

Table 1 presents the descriptive statistics of all the variables. N represents the number of observations and therefore the number of observations for the study is 114. The result reveals that, deferred tax asset (LOGDTA) reflects a mean of 0.5.577517 with a deviation of 1.035834. LOGDTA also revealed a maximum value of 7.807889 and a minimum value of 3.710202. Also, deferred tax liability (LOGDTL) reflects a mean of 0.5.629476 with a deviation of 1.003555. LOGDTL also revealed a maximum value of 7.874419 and a minimum value of 3.079904. The return on asset (ROA) has a mean of 0.085747 with a deviation of 0.093432. Furthermore, ROA records a maximum and minimum value of 0.459459 and 0.002969. Result also reveals that, leverage (LEV) reflects a mean of 0.324172 with a deviation of 0.251884. LEV also revealed a maximum value of 0.991418 and a minimum value of 0.003143. Earnings per share (EPS) reveal a mean of 1.626667 with a deviation of 2.092950. EPS further revealed a maximum and minimum value of 9.760000 and 0.020000 respectively.

The Skewness statistic is used to test for data normalcy. The skewness to standard error ratio can be used to determine normalcy. The data set for all variables reveals skewness statistic values ranging between about -2 and +2. This suggests that the data are not too much out of whack from the mean to produce non-normality difficulties.

Diagnostic Test:

This section of the study presents in the multicollinearity test using correlation matrix and the test for stationarity using both the unit root and co-integration tests.

Table 2: Correlation matrix

	LOGDTA	LOGDTL
LOGDTA	1	
LOGDTL	0.6809	1

Source: E-View Output

Table 2 shows the correlation values of all the variables to ensure the test for multicollinearity of the independent variable since they consist of unranked data. The correlation matrix above shows the absence of multicollinearity among the explanatory variables as all the variables show a low correlation estimated at 0.6809 (LOGDTA & LOGDTL).

Stationarity Test

To further prove the normality of data and to ensure that the data set are stationary in order not to run a spurious regression, unit root test is carried out to ensure that the variables employed in this study are stationary at same unit before further analysis.

Table 3: Unit Root

Variable	LLC (Common P-value)	ADF (Individual P-Value)	Order	Difference
LOGDTA	0.0000	0.0115	I(0)	LEVEL
LOGDTL	0.0000	0.0023	I(0)	LEVEL
ROA	0.0000	0.0024	I(1)	1 st

Null: There is serial Unit Root in the data

Source: E-view Output

The table above shows the result of the first test required to know the common and individual stationarity of the variables. For the common stationarity test, the Levin Lin Chu (LLC) test for common stationarity is used which considers lags in data series. Result for the study model (ROA= f (LOGDTA & LOGDTL) revealed a unit root result for LLC and ADF P-values of less than 0.05 for LOGDTA and LOGDTL which depicts common and individual stationarity at level, while ROA has common and individual unit root after 1st differencing. This means that, there is need for cointegration test in order to determine whether the study will adopt an error correction model for long run adjustment.

Co-integration test

H₀: There is no co-integration

Table 4: Co-integration

S/N	Statistic	Model ROA
1	Panel v-Statistic Within Dimension	4/11

Source: E_views Output

In the ROA model, there are eleven test statistics. Out of the 11 cointegration test statistics, 4 of the statistics have probability values of <0.05; that is less than 6 statistics. Therefore, the model reveals that, there is no cointegration of data in the long run. Therefore, the error correction model is adopted for further analysis.

Estimated Model Summary

Table 5 presents the results produced by the five model summaries for further analysis;

Table 5: Error correction model

Long run equilibrium	Coefficient	Short run equilibrium	Coefficient
ROA (-1)	1.0000	ROA (-1)	-0.025574
LOGDTA (-1)	0.145372	LOGDTA (-1)	0.010945
LOGDTL (-1)	-0.127751	LOGDTL (-1)	0.000779
ConET	-0.149439	Const	-0.174068

Source: E-View Output

Table 5 present result of the Vector Error Correction Model (VECM) for LOGDTA, LOGDTL and ROA to test for long run and short run shocks correction because of non-cointegration of the data set in the model. The various coefficient values of the short run equilibrium are compared against the long run equilibrium to ascertain the level of bounce backs in addressing non long run cointegration issues of the model. After differencing, the adjustment coefficient (ConET) value of -0.149439 shows that, the previous period deviation from long run equilibrium is corrected in the short run at an adjustment speed of 0.149439. For ROA coefficient, a unit change in ROA is associated with a -0.025574 unit decrease in ROA in the short run *Ceteris Paribus* against the long run coefficient of 1.0000. For LOGDTA coefficient, a unit change in LOGDTA is associated with a 0.010945 unit increase in LOGDTA in the short run *Ceteris Paribus* against the long run coefficient of 0.145372. For LOGDTL coefficient, a unit change in LOGDTL is associated with a 0.000779 unit increase in LOGDTL in the short run *Ceteris Paribus* against the long run coefficient of -0.127751.

Table 6: Panel error correction model regression

VAR Variable	Coefficient	Probability	Statistic	Value
ROA (C2)	-0.025574		R ²	0.059
LOGDTA (C3)	0.010945	0.6521	R ² Adjusted	0.006
LOGDTL (C4)	0.000779	0.9786	Fisher Statistic	1.120133
			F Probability	0.353925
Constant (C5)	0.003667	0.6578	DW	1.779404

Source: E-View Output

To ensure that the set of data was free from serial auto-correlation the Durbin Watson statistic for the model specified is computed. The Durbin Watson statistics for the model specified is estimated at 1.779404. The Durbin Watson statistics for the series data is within the standard of 2 indicating the absence of auto-correlation. The Durbin Watson statistics ensures that the residuals of the proceeding and succeeding sets of data do not affect each other to cause the problem of auto-correlation. Thus, this model exhibit low risk of potential autocorrelation problem as the model shows a DW statistics of approximately 2.

For model fitness, the R^2 value is used to establish the level of overall fluctuation the study independent variables (LOGDTA & LOGDTL) can collectively cause ROA as the dependent variable to change. The R square value of approximately 0.059 shows that LOGDTA and LOGDTL cause ROA to fluctuate at approximately 5.9%; this means that 94.1% fluctuation of the return on assets of listed firms is caused by other factors not considered in this study like; actual tax paid. The R^2 adjusted value of approximately 0.006 revealed shows that, there will be a 0.053 (0.059 – 0.006) variation from the sampled result of R square if the other omitted factors are considered. This means that if the amount of tax paid for the firms are considered, there will be either 5.3% increase or decrease in the level of fluctuation deferred tax accounting can cause ROA to change. The Fisher statistic reveals a value of 1.120133 with a probability value of 0.353925 which prove that the overall model is statistically insignificant.

The constant value of 0.003667 revealed shows that, if all the independent variables are held constant; the ROA of the firms will increase by 0.003667 units. Furthermore, a unit change in LOGDTA will cause ROA to increase by 1.09%, also a unit change in LOGDTL will cause ROA to increase by 0.07%.

HO₁: Deferred tax asset has no significant effect on return on assets of listed manufacturing companies in Nigeria.

Since the calculated probability value for LOGDTA (0.6521) against ROA is greater than the accepted probability value of 0.05. The null hypothesis is accepted and the alternative rejected thus; deferred tax asset has no significant effect on return on assets of listed manufacturing firms in Nigeria.

HO₂: Deferred tax liability has no significant effect on return on assets of listed manufacturing companies in Nigeria.

Since the calculated probability value for LOGDTL (0.9786) against ROA is greater than the accepted probability value of 0.05. The null hypothesis is accepted and the alternative rejected thus; deferred tax liability has no significant effect on return on assets of listed manufacturing firms in Nigeria.

Discussion of Result

In terms of the two hypotheses investigated, the test from the first hypothesis demonstrated that deferred tax assets have no substantial effect on the return on assets of Nigerian-listed manufacturing companies. The study's findings contrast those of Uwuigbe, (2016) and Mayeenda, (2013) who in their study found out that deferred tax assets have a significant effect on financial performance of companies. The reason for the contradiction could be owing to the fact that, unlike the current study which is focused on deferred tax assets for manufacturing companies, the studies by Uwuigbe, (2016) and Mayeenda, (2013) were done in other sectors than the manufacturing sector which may be the reason for the varying evidence produce by both studies. The test from the second

hypothesis shows that, deferred tax liabilities have no significant effect on the return on assets of Nigerian-listed manufacturing companies. The study's finding does not conform to previous findings like that of Nwaorgu et al. (2019), who investigated the impact of deferred tax accounting on the financial performance of Nigerian-listed agricultural companies. They used information from four publicly traded agricultural corporations. They discovered that deferred tax accounting had a favourable and significant association with listed enterprises' profitability. The variation in the industry that both studies focused on, as well as the method utilized in determining deferred tax by both studies, is the source of this disagreement. While, Nwaorgu et al., (2019) focused on an agricultural firm that enjoys more tax credits that lead to huge net deferred tax assets, firms in other sectors are not given many tax credits compared to the agricultural sector; thus, the variation in finding is eminent.

Conclusion and Recommendation

Based on the findings of this study and the testing of the two research hypotheses earlier formulated in the study, the study concludes that deferred tax assets and liabilities have a positive but insignificant effect on the return on assets of listed manufacturing firms in Nigeria. Following the study's findings, the study suggests that manufacturing enterprises in Nigeria investigate possible tax credits for specific assets and investigate the feasibility of utilizing such tax credits to minimize their tax burden through tax deferral. This may minimize the enterprise's tax burden and, as a result, boost the firm's profitability.

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