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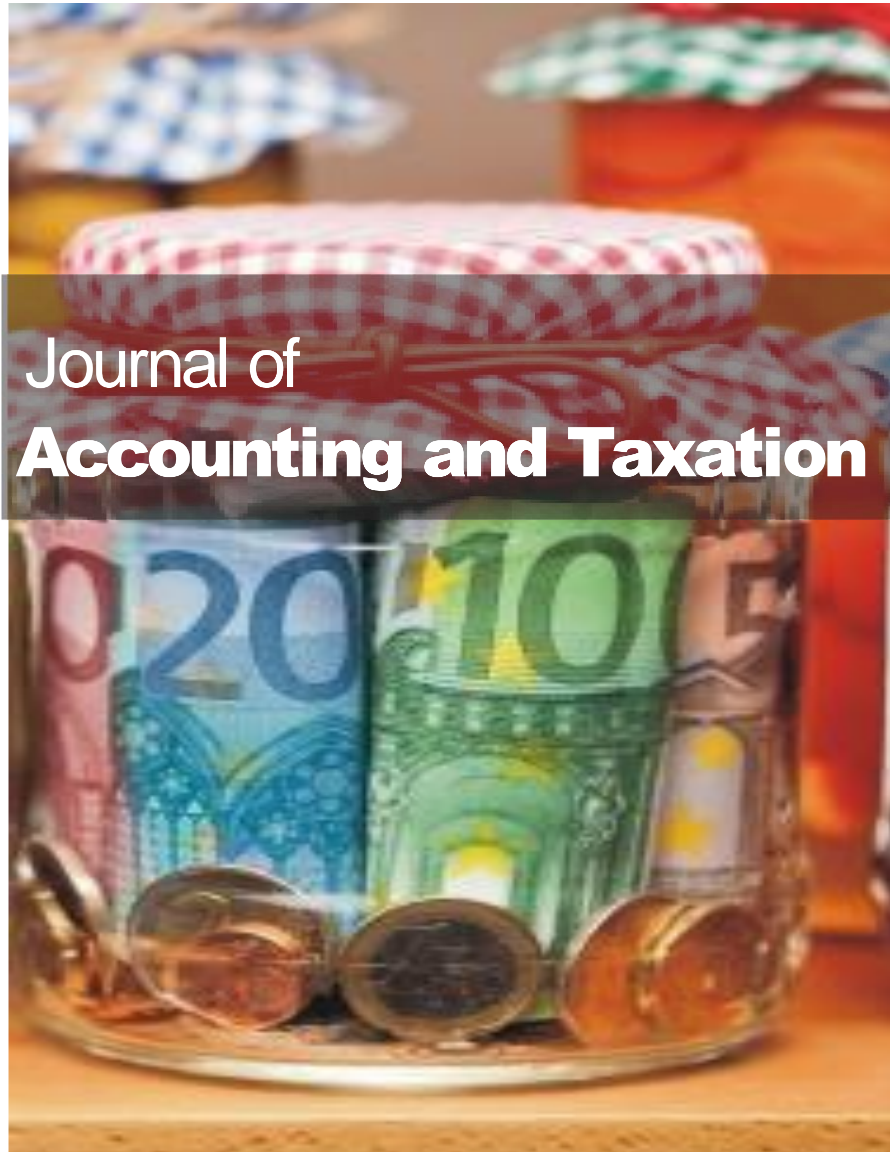

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Influencing factors of accounting practices: a case study of New Zealand

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Accounting practices in different countries influenced by several factors. This study has identified some factors those have a great impact on accounting practices in different countries. This study also explains the accounting practices in a specific country: New Zealand, which is one of the developed counties in the South Pacific Ocean close to Australia and a member of commonwealth countries. However, this study is a desk-based research that analyses the existing knowledge on factors influencing accounting practices from different published academic articles, reports, periodicals and webpages. This study found that accounting policies and standards in New Zealand came from Australia and the United Kingdom, and International Financial Reporting Standards (IFRS) and the External Reporting Board (XRB) are the most influential body of New Zealand for setting up standards for its local demand. Moreover, New Zealand ensures good accounting practices because of having political stability, economic growth, and transparent systems in all public and private sectors. However, this study would be an excellent addition of knowledge on factors affecting accounting practices.

Keywords: International financial reporting standards (IFRSs), external reporting board (XRB), accounting practices, factors, New Zealand.

INTRODUCTION

International Accounting Standard Board (IASB) has issued International Financial Reporting Standards (IFRSs) for providing world recognised accounting standards for transparency, accountability and efficiency of financial market. The latest Conceptual Framework for Financial Reporting 2018 has provided a comprehensive guideline for preparing and presenting financial information by the preparers. However, the practices of accounting standards may not be same in every country, and the different aspects of the respective country influence the accounting practices. Surprisingly, IFRS adopted countries have the influence of US GAAP (Lourenco et al., 2018). Therefore, researchers argued for different influencing factors (Iqbal, 2002; Walton et al., 2003; Doupnik and Perara, 2007; Roberts et al., 2008; Nobes and Parker, 2010) those play an influential role in accounting practices. However, there is extremely limited research on influencing factors of accounting practices in a specific country. Therefore, this study is designed to identify factors that influence the accounting practices in

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New Zealand. This study chooses New Zealand because it is one of the developed countries in Oceania that is culturally and politically close to Australia and was a colonial country of British Emperor. This study would identify the major influencing factors of accounting practices and in a case study of New Zealand how accounting practices are influenced.

The objectives of this study are to find out the factors that influence the accounting practices in different countries and to analyse the influencing factors of accounting practices in New Zealand. Therefore, the research questions of this study would be what are the influencing factors of accounting practices and what factors influence the accounting practices in New Zealand? Therefore, to find out the answer of the above mentioned research questions, this study has been designed as a desk study where available previous literature on influencing factors of accounting practices and existing relevant documents published by different relevant professional bodies in New Zealand and around the world as well as relevant webpages for accounting practices have been analysed. Therefore, this study would be an excellent addition of knowledge in accounting practices and disseminate interesting information to different stakeholders on relevant field.

INFLUENCING FACTORS OF ACCOUNTING PRACTICES

Over the century, different scholars have been trying to classify accounting systems in different groups of countries and they identified reasons behind their classification. In the early of 20th century, Hatfield (1966) took four sample countries' accounting systems and identified three-group classification. Later, a group of researchers classified accounting systems of different countries (Mueller, 1967, 1968; Seidler, 1967; Previtas, 1975; Buckley and Buckley, 1974; Frank, 1979; Nair and Frank, 1980; Nobes, 1998 and 2011). Nair and Frank (1980) critically analysed the classification of countries of various researchers on measurement and disclosure aspect of accounting practices. In 1973 analysis they summarised four groups (Table 1) of countries after considering 147 measurement practices in 38 countries but after analysing 86 observations on disclosure practices in the same 38 countries for 1973 they finally identified seven country group (Table 2). Nobes (1998) classified accounting systems of fourteen countries in two major classes, but Nobes (2011) first classified accounting systems of same fourteen countries based on practices and in the context of IFRS by using the large number of companies on most recent data. The recent study of Lourenco et al. (2018) analysed accounting practices of 27 countries where IFRS is widely adopted and the result from their cluster analysis identified three group of countries: Australia and New Zealand; USA-influenced countries; and South Africa, Oman and other European countries.

However, Radebaugh et al. (2006), Riahi-Belkaoui (1995), Nobes and Parker (1995) focused on some reasons for differences of accounting practices in different countries but they are failed to develop any theory for those reasons. Gray (1988) and Doupnik and Salter (1995) developed a similar type of theoretical models regarding reasons for accounting differences. Later, Nobes (1998) clearly explained the theory of Doupnik and Salter (1995) that is shown in Figure 1. Nobes (1998) also summarized different reasons for international accounting differences proposed by various scholars (Table 3). However, by analysing the concept of some authors like Iqbal (2002), Walton et al. (2003), Doupnik and Perara (2007), Roberts et al. (2008), Nobes and Parker (2010) the relevant factors to international differences in accounting are Culture, Legal Systems, Taxation, Accounting Profession, Providers of Financing, Political and Economic Systems, Accounting Regulations. However, recent studies also found that management accounting practices of a country is influenced by a group of factors. Wu and Boateng (2010) found that firm size, foreign partnership and intellectual ability of managers and employees influence the Chinese management accounting practices. Similarly, Nair and Nian (2017) argued that firm size, market competition, qualification of preparers and advanced technology have an impact on management accounting practices.

ACCOUNTING PRACTICES IN NEW ZEALAND

The country

New Zealand is a sovereign island country in the southern Pacific Ocean. It is one of the wealthiest countries and agriculture is the economic mainstay. New Zealand is the top list country on easy of doing business index, political freedom, GDP per capita, human development index, income equality, literacy rate, global peace index, economic freedom and sustainable state. Some important key facts regarding New Zealand is shown in Appendix 1.

History of New Zealand IFRS

Since early 1960s New Zealand has been passing in historical events for standard setting in New Zealand (Cordery and Simpkins, 2016). At first, New Zealand adopted English standards and later Bradbury (1999) suggested changing it in accordance with the local needs. The New Zealand Society of Accountants (NZSA), the first professional body for financial reporting in New Zealand, was established in 1946 (Zijl and Bradbury, 2005) and until the introduction of Financial Reporting

Table 1. Measurement classification of Nair and Frank (1980).

Group I	Group II	Group III	Group IV
Australia			
Bahamas			
Fiji	Argentina	Belgium	
Jamaica	Bolivia	France	
Kenya	Brazil	Germany	Canada
Netherlands	Chile	Italy	Japan
New Zealand	Colombia	Spain	Mexico
Pakistan	Ethiopia	Sweden	Panama
Republic of Ireland	India	Switzerland	Philippines
Rhodesia	Paraguay	Venezuela	United States
Singapore	Peru		
South Africa	Uruguay		
Trinidad and Tobago			
United Kingdom			

Table 2. Measurement classification of Nair and Frank (1980).

Group I	Group II	Group III	Group IV	Group V	Group VI	Group VII
Australia						
Bahamas						
Fiji		Belgium				
Jamaica	Bolivia	Brazil	Canada			
Kenya	Germany	Colombia	Mexico	Argentina		
New Zealand	India	France	Netherlands	Chile	Sweden	Switzerland
Republic of Ireland	Japan	Italy	Panama	Ethiopia		
Rhodesia	Pakistan	Paraguay	Philippines	Uruguay		
Singapore	Peru	Spain	United States			
South Africa		Venezuela				
Trinidad & Tobago						
United Kingdom						

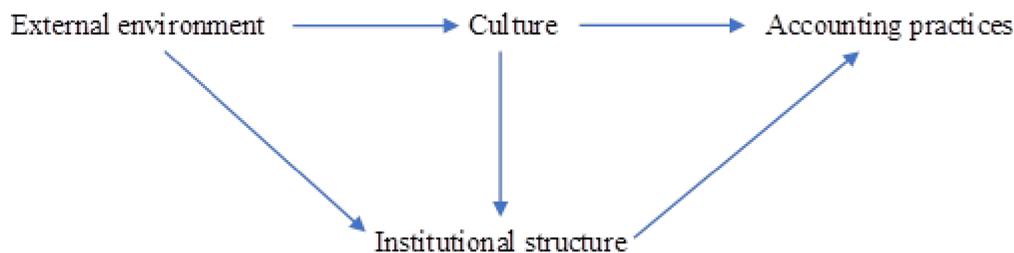

Figure 1. Simplification of Doupnik and Salyer's model of development by Nobes (1998).

Act. 1993 it was the only standards setting body in New Zealand (Cordery and Simpkins, 2016). Despite some having limitations in 1974 NZSA got associate membership of the International Accounting Standards Committee (IASC) (Cordery and Simpkins, 2016) that is now known as International Accounting Standards Board (IASB). In 1974, NZSA first issued Statement of Standards Accounting Practice (SSAP) and later in 1980, Accounting Research and Standards Board (ARSB) were formed by NZSA for developing accounting standards

Table 3. Reasons for international accounting differences by Nobes (1998).

International Accounting Differences	
1.	Nature of business ownership and financial systems
2.	Colonial inheritance
3.	Invasions
4.	Taxation
5.	Inflation
6.	Level of education
7.	Age and size of accountancy profession
8.	Stage of economic development
9.	Legal systems
10.	Culture
11.	History
12.	Geography
13.	Language
14.	Influence of theory
15.	Political systems, social climate
16.	Religion
17.	Accidents

(Nguyen, 2010; Cordery and Simpkins, 2016). Although, few years later this body was split into two separate body namely The Professional Practices Board and the Financial Reporting Standard Board (FRSB) in November 1992 (Nguyen, 2010). In 1996, the NZSA was renamed as the Institute of Chartered Accountants of New Zealand (ICANZ) (Nguyen, 2010) and ARSB was renamed as External Reporting Board (XRB) in 1 July, 2011 (Cordery and Simpkins, 2016).

Accounting standard setter and professional bodies in New Zealand

New Zealand adopted International Financial Reporting Standards (IFRS) as New Zealand equivalent and it is relatively similar to IFRS standards issued by IASB with three additional New Zealand specific standards (IFRS, 2016). The External Reporting Board (XRB) is the independent Crown Entity that issues and monitors accounting and auditing and assurance standards in New Zealand and it was established under section 22 of the Financial Reporting Act 1993 and started its operation under section 12 of the Financial Reporting Act 2004 (The External Reporting Board, 2021). This organization consists of three important boards: The XRB Board itself (XRB Board), The New Zealand Accounting Standards Board (NZASB) and The New Zealand Auditing and Assurance Standards Board (NZAuASB). The accounting professional body in New Zealand is the Institute of Chartered Accountants Australia and New Zealand (ICANZ, 2019) that is affiliated with renowned accounting alliances and member bodies such as, Global Accounting Alliance (GAA), Chartered Accountants Worldwide, Association of Chartered Certified Accountants(ACCA), International Federation of Accountants (IFAC), International Accounting Standard Board (IASB), Australian Accounting Standards Board (AUASB), Accounting and Finance Association of Australia and New Zealand (AFAANZ), International Public Sector Accounting Standards Setting Board (IPSASB), etc.

New Zealand's political and regulatory system

Political interference (such as colonial inheritance) has a great impact on financial reporting (Nobes, 1998) and the impact of this factor goes to the political history and the accounting system of colonised country (Cerne, 2009). This not only influences on politics and accounting systems but also influences in legal systems and cultural factors (Parker, 1989). New Zealand has constitutional monarchy and parliamentary democracy headed by Queen Elizabeth II as the Governor-General of the country (The Commonwealth, 2019). So, the legal and accounting environment is largely influenced by history and culture of United Kingdom (UK). For analysing and evaluating the performance of public sector organization, such as government, budgetary transparency is highly acceptable tool (Cimpoeru and Cimpoeru, 2015). Fiscal transparency of government that linked with political polarization and government debt and deficit is also important and increased transparency index shows lower level of government debt (Alt and Lassen, 2006).

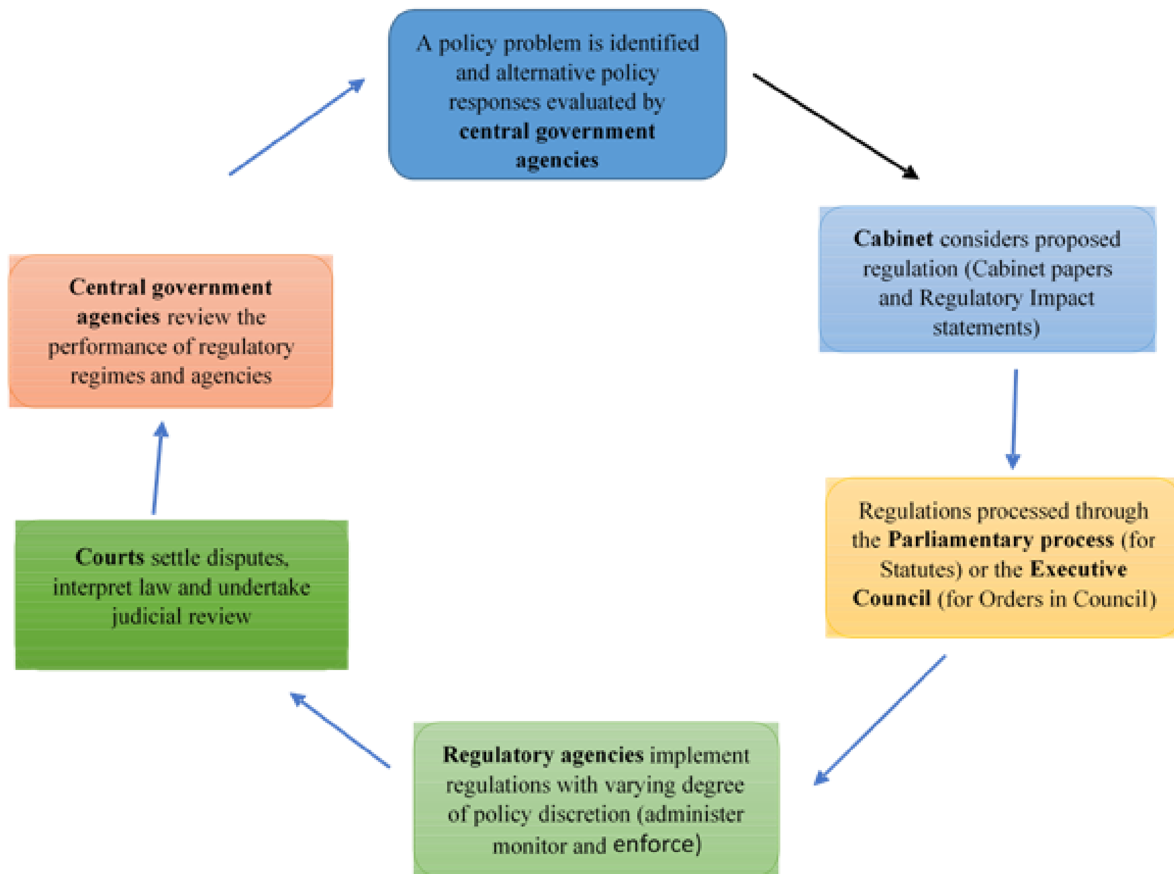

Figure 2. The regulatory system of New Zealand.
Source. New Zealand productivity commission.

However, New Zealand ensures a transparent regulatory system among the entire department of the government and other institutions. It focuses on the improvement of the overall policy guidelines by improving and maintaining the capability needed for enforcement of the regulations and by overseeing and managing the whole system. It includes all three organs of the government- the Executive, Parliament and the Judiciary that is shown in the Figure 2 (New Zealand Productivity Commission, 2014). New Zealand continuously ensure transparency on budget and in 2017 New Zealand's open budget index score was 89 out of 100 (International Budget Partnership, 2019).

Cultural factors in New Zealand

Hofstede (1980) defines culture as "the collective programming of the mind which distinguishes the members of one group or category of people from another". Nobes (1998) developed a simplified model of cultural influence on accounting based on Doupnik and Salter's model that explains how culture influence on accounting practices. The influence of culture on accounting practices can also be identified from the research work of a large number of authors (such as, Da Costa et al. (1978), Frank (1979), Nair and Frank (1980), MacArthur (1996), Nobes (1998), Perera et al. (2012), Drnevich and Stuebs (2013). New Zealand has a close cultural relation with Australia (Gray, 1988). CPA Australia and Institute of Chartered Accounts in Australia and New Zealand, two prominent accounting professional bodies, operate their activities both in Australia and New Zealand. Both countries are in Anglo-American group and they are closely influenced by factors developed by Hofstede's analysis (Fechner and Kilgore, 1994). From the analysis of Nair and Frank, 1980 of different countries it is found that Australia and New Zealand was in same country group. However, the accounting standards in New Zealand are highly influenced by the standards issued by International Financial Reporting Board (IFRS, 2016).

New Zealand financial reporting framework

In the past, the UK and Australian standards were

Table 4. Re-formed tax rate in New Zealand.

Type of income	Re-formed tax
Personal Income	33% on income above NZ $70,000 30% on income from NZ$48,001 to NZ$70,000 17.5% on income from NZ$14,001 to NZ$48,000 10.5% on income from NZ$0 to NZ$14,000
Company Income	28%
Goods and service tax	15%

Source: New Zealand Immigration.

responsible for setting up the standards for New Zealand and some legislations were fully adopted by those of that countries (Keenan, 2000); and the controlling authority of those countries rather than the professional bodies of New Zealand dominated in standard setting (Cordery and Simpkins, 2016). However, at present, financial reporting systems in New Zealand is influenced by IFRS and XRB. All the companies in New Zealand use NZ IFRS for preparing their financial statements and it has been mandatory from 1 January 2007 (IFRS, 2016). On the other hand, public sector organisations report their financial statements in accordance with International Public Sector Accounting Standards (IPSAS) (Cordery and Simpkins, 2016). However, financial reporting framework in New Zealand is divided into four important tiers such as Tiers 1, 2, 3 and 4 and the criteria for these tiers are defined by the XRB and this framework normally influenced by two important parts, such as the statutory financial reporting framework and the accounting standards framework (KPMG, 2014).

Taxation systems in New Zealand

Accounting systems in some countries can be highly influenced by taxation and some countries are not (Nobes 1998). In some countries tax accounting and financial accounting are different (Doupnik and Salter (1995). With having some exception, tax regulations set by the government dominate the accounting and the taxable profit of the corporations that is important for the government (Lamb et al., 1995). Alley and James (2005) suggest that rules and regulations regarding the tax should be reviewed and updated with the needs of business activities and the principles in tax systems itself. In New Zealand, the adoption of IFRS have a tax consequence and government's recommendation is normally included in discussion documents for standards setters and New Zealand tax legislators also adopt relevant financial reporting standards (Alley and James, 2005). Inland Revenue Department (IRD) is the sole controlling authority for collecting and maintaining tax related activities in New Zealand as a department of Government of New Zealand. Among the developed countries New Zealand was ranked second for overall tax system and first for its personal taxes by the US-based Tax Foundation (New Zealand Immigration, 2019). IRD impose tax on personal and business income, and on the supply of goods and services. But there is no inheritance tax, general capital gains tax (with some exception), local or state tax, payroll tax, social security tax (with some exception) and healthcare tax (New Zealand Immigration, 2019). New Zealand has flat transparent tax rate (Table 4) on company's income that attracts new business and the revenue from taxes are more efficiently collected by New Zealand compared with other OECD countries by imposing broad base low rate (Inland Revenue, 2017) and the collection of crown tax revenue is increasing year by year (The Treasury, 2017) that is shown in Figures 3 and 4.

Auditing and assurance standards framework in New Zealand

Assurance practitioners in New Zealand must comply with the specific standards developed and issued by New Zealand Auditing and Assurance Standard Board (NZAuASB) which is performed by the section 12(b) of the Financial Reporting Act 2013. NZAuASB also provide guidance statements, practice statements, consultation documents and exploratory documents for interpretation and application of auditing and assurance standards (XRB). XRB *Au1: Application of Auditing and Assurance Standards* has developed five important suites of standards and provide guidelines regarding which suit of standards will be applicable in what type of assurance engagement. This is summarized in Table 5.

One the other hand, public entities are audited by Auditor-General with relevant professional accounting and auditing standards or the Auditor-General's own specific standards. Moreover, Auditor-general has to publish Auditing Standards, by the way of a report to the House of Representative, at least once in every three years (Controller and Auditor-General, 2019).

Financing systems

Financial system plays a dominant role in financial

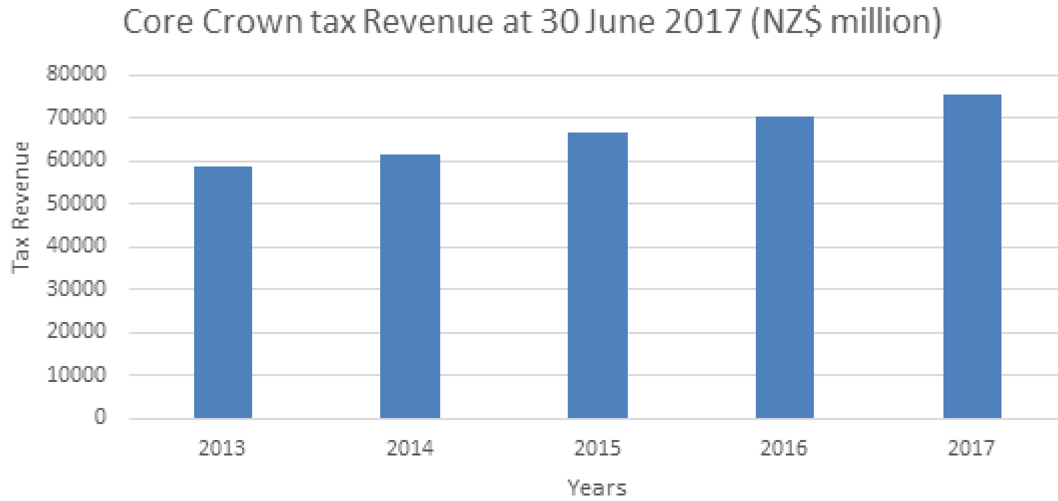

Figure 3. Tax Revenue of New Zealand.
Source: The Treasury.

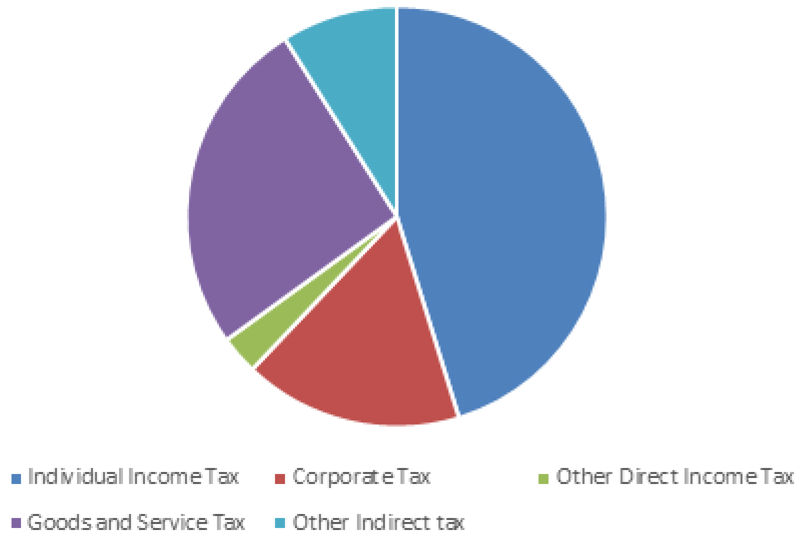

Figure 4. Sources of tax revenue in New Zealand.
Source: The Treasury

reporting of a country. Zysman (1983) identified three types of financing systems such as: capital market based; credit based systems: government; credit based systems: financial institutions. Nobes (1998) showed two dominant groups of financial systems: insiders dominant and outsiders dominant. In New Zealand firms largely depend on debt finance instead of equity finance and the banks are the single largest providers of debt (Reserve Bank of New Zealand, 2021).

Accidents of history

In New Zealand there is a considerable impact of financial accidents from its own making and from international market. Chiang and Prescott (2010) identified 50 finance companies as at May 2010 those were failed and the main reason for that failure was poor corporate governance. Reserve Bank of New Zealand (2009) was documented some banks for financial crisis because of

Table 5. Suits of assurance standards and their applicable engagement.

Suits of Standards	Applicable Assurance Engagement
Professional and Ethical Standards	For all assurance engagement
International Standards on Auditing (New Zealand)	In case of historical financial information
Review Engagement Standards including International Standards of Assurance Engagement (New Zealand) and New Zealand Standard on Review Engagement	For conducting a review of historical financial information
Other Assurance Engagement Standards including Standards on Assurance Engagement and International Standards on Assurance Engagements (New Zealand)	Other than audits or reviews of historical financial information
Related Service Standards including International Standard on Related Service (New Zealand)	Agreed-upon procedures to information and other related services engagements as specified by the NZAuASB

Source. External Reporting Board.

the significant erosion of the banking system capital and for the credit-driven asset price boom. Consequently, all the evidence influenced accounting systems in New Zealand.

CONCLUSION AND RECOMMENDATION

The overall environment of accounting systems and policies are greatly influenced by a group of factors over different countries, even the same accounting standards are followed. This study is contributing to identify those factors and how accounting practices of an individual country is influenced by those factors. Therefore, this study has found the influencing factors of accounting and made a linkage up of these factors to New Zealand. New Zealand is one of the developed countries with small area and ensure transparent and accountability in its accounting practices. But some key facts affect the overall environment of accounting systems. Though it was a British colonised country and politically and is regionally close to Australia, most of the accounting policies and standards came from these two countries. However, IFRS and XRB are the most influential body of New Zealand for setting up standards for its local demand. Therefore, having been political stability, economic growth and transparent systems in all public and private sectors New Zealand ensure good accounting practices.

However, this study has some limitations. The study has been conducted by analysing secondary data only, thus the practical situation of accounting practices in New Zealand would not be present. Therefore, the analysis of practical phenomena by developing some hypothesis based on literature and a set of interviews with key accounting professional bodies in New Zealand or other major stakeholders would provide more interesting data. However, this study would provide a clear understanding of the factors those influence the accounting practices. Moreover, this study would provide an overview of accounting practices of New Zealand and how it is influenced by different factors.

CONFLICT OF INTERESTS

The author has not declared any conflict of interests.

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APPENDIX

Appendix 1. Key Facts of New Zealand.

Population (Total)	4.79 million
Population Growth (annual %)	2.1
Surface Area (sq. km), (thousands)	267.7
Major Language	English, Maori
Currency	New Zealand dollar
GDP (US$ in billions)	205.85 (2017)
GDP Growth (annual %)	3.0 (2017
Inflation, GDP deflator (annual %)	3.4 (2017)
GNI, Atlas method (US$ in billions)	186.84 (2017)
GNI per capita, Atlas method (US$)	38,970 (2017)
Net lending 9% of GDP)	1.6
Domestic credit provided by financial sector (% of GDP)	160.5
Tax revenue (% of GDP)	27.3
Personal remittance received (US$ in millions)	465
Foreign direct investment, net inflow (US$ in millions)	2,144
Energy use (kg of oil equivalent per capita)	4,445 (2017)
CO2 emission (metric tons per capita)	7.69 (2017)

Source: World development indicators database, World Bank Group.

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The development of a scale to measure SMEs tax compliance in Nigeria: An adaptation of Fischer's model

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This study aims to investigate the reliability and validity of a new version of the tax compliance scale. The new scale extended the Fischer's et al model of tax compliance by drawing more constructs and question items from the theoretical literature review, empirical results of the previous studies and similar questionnaires from different countries. There were 39 question items refined through the process of the pilot study (n = 53) for initial reliability. Finally, a complete questionnaire comprising 37 question items classified into seven main constructs (tax system complexity, tax noncompliance opportunity, tax deterrence sanction, tax rate, tax attitude and fairness perception, tax compliance cost, and tax information) were administered to 392 SMEs owners across all six geopolitical zones that make up Nigeria. All seven constructs demonstrated an acceptable level of internal consistency and intra-class reliability. The principal component analysis, correlational analysis and communality showed that the tax compliance scale fits the theoretical expectations and is well aligned with the prior empirical perspectives. The findings provide enough evidence that the new scale is reliable and valid and will be a useful instrument to the tax authority, policymakers and academics willing to gauge tax compliance amongst SMEs in Nigeria and beyond

Key words: Tax compliance scale, principal component analysis, Fischer's model, reliability, validity, SMEs.

INTRODUCTION

McBarnett (2003) defined tax compliance from three dimensions: first is committed compliance which sees tax compliance as ethical duty discharged without complaint, second is capitulating compliance where tax compliance is enforced on reluctant taxpayers while the third is creative compliance which taxpayers carry out by taking advantage of the tax loophole in the system. Tax compliance has a broad determinant base ranging from economic, behavioural, psychological and sociological determinants. Many authors have conducted studies into determinants of tax compliance in sub-Saharan African countries but without an all-encompassing instrument for

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capturing the determinants of tax compliance (Fagbemi et al., 2010; Otusanya, 2011; Atawodi and Ojeka, 2012; Alabede et al., 2011; Mansor and Gurama, 2016; Aladejebi, 2018, Vincent, 2021).

Most of the prior studies on tax compliance relied on the works of Allingham and Sandmo (1972), Yitzhaki (1974), and Fischer et al. (1992). Allingham and Sandmo (1972) and Yitzhaki (1974) models highlighted crucial variables in the measure of tax compliance to include tax audit probability, tax rate, penalty rate and gross income. Fischer et al. (1992) categorised the determinant of tax compliance into four construct-groups, including tax system structure (tax rate, penalty and probability of detection, tax system complexity); noncompliance opportunity (income level, income sources and occupation); attitude and perception (fairness, ethics, and peer influence); and demographic factors (age, gender and education). The focus of this study is to extend Fischer's model by incorporating more items and variables derived from the empirical literature review for creating a more robust scale for measuring the tax compliance behaviour of SMEs entrepreneur in Nigeria.

Many efforts of the government to bring SMEs into the tax net in Nigeria have proved abortive. The SMEs sector is too economically strategic to be left out of the national tax net. SMEs in Nigeria account for 96 per cent of business enterprises and 84 per cent of employment opportunities with a total number of about 17.4 million (IMF, 2019; PwC, 2019). They account for over 50 per cent of the industrial employment, 90 per cent of the manufacturing sector, in terms of the number of enterprises and dominance in agriculture (IMF, 2019). In contrast to the contributions of SMEs to the national GDP, the same SMEs account for the increasing level of tax evasion and non-compliance in Nigeria (Aladejebi, 2018). The problem of tax evasion and poor tax compliance attitude might have contributed to the abysmal tax-to-GDP ratio of 5%, trailing far below 34.1% and 20% in Organization for Economic Cooperation and Development (OECD) and emerging markets respectively (World Bank, 2015; Amaeshi et al, 2020). Therefore, a modification of Fischer’s tax compliance model (which is a synthesis of contemporary tax issues and Nigerian tax system idiosyncrasies) has become imperative in addressing the problem of tax noncompliance amongst SMEs entrepreneurs in Nigeria.

LITERATURE REVIEW

Theoretical review

The extant literature establishes the combination of both economic and behavioural variables as factors responsible for tax compliance behaviour. The economic approach has its root in expected utility (EU) theory and deterrence theory. The EU theory of individual tax evasion establishes a positive correlation between underreporting opportunity and the actual act (Allingham and Sandmo, 1972; Yitzaki, 1974). The theory perceives taxpayers as immoral utility maximizers who elect to evade taxes when the estimated gains outweigh the cost of evasion (Allingham and Sandmo, 1972; Sapiei et al., 2014). The deterrence theory focuses on the sanction threat and sanction effect, the punishment or sanction determined by taxpayer compliance behaviour. The more the severity of sanction and probability of detection, the lower the tax noncompliance tendencies is (Musimenta, 2020; Sapiei et al., 2014). The economic approach has been expanded to include all factors that put a taxpayer in a position of economic advantage or disadvantage. For this study, the economic factors are grouped into three: tax system structure, tax non-compliance opportunity and tax compliance cost.

The behavioural components of the behavioural economics theory assume that individuals have their differing opinion about tax compliance according to their attitudes, culture, peer influence, beliefs, values, ethics, demographic characteristics, norms and roles (Sebele-Mpofu, 2020; Onu and Oat, 2018; Elffers et al., 1992; Lewis, 1982; Warneryd and Walerud, 1982). The behavioural aspect of the model considers what Weber et al. (2014) called social effects, which are influenced by the socio-cultural environment of a taxpayer. The socio-cultural factors include prestige, social norms, psychological factors, fairness, and group effect. Beyond the fines, the psychological factors (e.g. shame) associated with tax evasion may discourage a taxpayer from cheating (Weber et al., 2014). The psychological factors arise because people fear being detected or openly shamed (Hashmizade et al., 2012). Hashmizade et al. (2012) opined that tax fairness can be classified into two, fairness towards government and fairness towards other taxpayers. In a situation where government renders poor services and poor quality public goods, the taxpayers might see tax payment as unfair. Conversely, if tax payment is not progressive or of unjustifiable difference from one taxpayer to another;, the high tax-paying party might perceive the system as unfair.

Empirical review

McBarnett (2003) postulated three types of tax compliance behaviour: committed compliance, capitulated compliance and creative compliance. The committed compliance sees tax compliance from an ethical prism, the discharge of tax obligations without complaining. Capitulating compliance is a discharge of tax obligation

with some level of reluctance under the regulatory influence and creative compliance is an act of tax avoidance through legitimate loopholes which ultimately reduces tax liability legitimately.

The tax system structure has been found to have a great influence on tax compliance. The tax system structure could be grouped into tax deterrence sanction, tax system complexity and tax rate structure. Fischer et al. (1992) opined that the tax rate, the probability of detection and the penalty structure are determinants of the monetary cost of tax compliance; these conversely determine tax compliance behaviour (Fischer et al. 1992). Several similar empirical studies in different countries subsequently tested hypotheses based on these factors (Alm, 1999, Chan et al., 2000; Devos, 2008; Sapiei, 2014; Musimenta, 2020) and results confirmed the influences of these factors as significant determinants of tax compliance behaviour. Tran-Nam and Evans (2014) defined tax complexity from different perspectives. To a tax professional it refers to the time it takes to carry out tax planning, give tax advice and prepare tax returns. A lawyer considers complexity as difficulty in reading, interpreting and application while a taxpayer views it from difficulty in understanding. In general, tax complexity may be procedural complexity, computational complexity; low level of readability, compliance complexity, form complexity and rule complexity ((Pau et al., 2007; Saad, 2014; Saw and Sawyer, 2010). The complexity in a tax system primarily arises from a lack of understanding by laypersons that constitute the bulky of the taxpayers (Kirchler, 2007; Musimenta, 2020). A weak tax deterrence sanction breeds corruption. Joulfaian (2009) established a correlation between tax evasion and corruption. Business noncompliance increases with corruption; substituting corruption cost for tax payment might yield positive results because such acts of tax evasion offset expenses or financial loss. Tax noncompliance thrives when inducements or bribes to tax officials is pervasive (Joulfaian, 2009). The previous works that specifically explored the relationship between corrupt tax officials and tax evasion established a positive relationship (Whait et al., 2018; Crequeti and Coppier, 2009; Escobari, 2005; Gupta, 2008; Hindriks et al., 1999; Imam and Jacobs, 2007; Sanyal, 2000). There are divergent opinions on the effect of the tax rate on tax compliance behaviour (Onu and Oats, 2018; Jackson and Milliron, 1986; Clotfelter, 1983). The tax rate is an important variable in determining tax compliance behaviour despite its exact effect remains elusive (Kirchler, 2007). An increase in tax rates may encourage tax evasion (Witte and Woodbury, 1985), while a reduction in tax rate may not certainly improve tax compliance (Kirchler, 2007; Trivedi et al., 2003). Allingham and Sandmo (1972) attempted to consider independent variables such as actual income, tax rates, penalty and audit rates as determinants of tax (non)compliance using statistical modeling. In conclusion, tax rates were statistically insignificant. Porcano (1988) concluded that the tax rate does not affect tax compliance.

Tax noncompliance opportunities are prospects for tax evasion which sometimes may be created by inequality and lack of means of earning a decent living. Witte and Woodbury (1985) found higher tax compliance behaviour in regions that have low unemployment rates and poverty. From the study of tax return data for small companies, Rice (1992) reported that firms that have profit margins below their industry average revealed higher rates of tax noncompliance than firms with above-average returns. The study, however, suggested that certain individuals with limited resources have a higher tendency to evade tax due to their susceptibility to financial strain. Such companies' need for money in the present outweighs the expected future costs of detection and punishment. Personal financial constraints have been found to positively impact tax noncompliance (Alabede et al., 2011; Abdul, 2001). The financial problems confronting a taxpayer might embolden him to focus more on his financial burden rather than tax liability settlement. Abdul (2001) argued that individuals facing financial problems are more likely to evade tax. Sometimes persons without financial burden may also dodge tax and their level of evasion might be higher than those with a financial problem (Vogel, 1974; Warneryd and Walerud, 1982).

Tax compliance costs are expenses incurred by taxpayers arising from their obligations to comply with applicable tax laws. The tax compliance costs refer to the value of resources spent by taxpayers in complying with tax laws (Tran-Nam and Glover, 2002, Sapiei et al, 2014). These costs include external costs (fees paid to external tax professionals), internal costs (value of time spent by staff on tax matters) and incidental costs (telephone and communication, litigation, computer and stationeries). Certain empirical studies found tax compliance costs as a likely determinant of tax compliance behaviour (Slemrod, 2004; Tran-Nam, 2003). The level of tax compliance costs could be one of the factors affecting the compliance decisions of SMEs.

The perception of equity or fairness strongly correlates with tax compliance behaviour (Jackson and Milliron 1986, Sebele-Mpofu, 2020). Spicer and Lundstedt (1976) established a negative correlation between fairness and tax evasion. Spicer and Becker (1980) asserted that tax noncompliance increases when taxpayers perceive fiscal inequity because they feel ill-treated by unfair income redistributions. Etzioni (1986) opined that an unfair tax system has a higher propensity for tax noncompliance than an increased tax rate. The taxpayers are more likely to evade tax anytime they perceive the tax to be unfair,

even when the tax rate remains stable. Hite and Roberts (1992) concluded that fairness is significantly correlated to the perception of an enhanced tax system, thereby discouraging tax noncompliance. Fischer et al. (1992)'s study on detection probability and tax compliance found tax attitude and perception to greatly influence taxpayer compliance behaviour. The tax attitudinal and perception factors include fairness and equity in the distribution of tax proceeds, trustworthiness and accountability for taxes collected by the government, the peer influence of other taxpayers and the moral obligation of the taxpayer to render complete tax returns (Fischer et al., 1992; Sapiei, 2014). Torgler (2012) established an association between trust and tax compliance morale. The extent of tax compliance depends on the trust a taxpayer has for the constituted authority or government. Therefore, relationships between taxpayers and their government are crucial in determining tax compliance. There is empirical evidence that citizenry tax compliance depends on efficient government spending (Ali et al., 2014; Alm et al., 1992b). Individual tax morale is influenced by the magnitude of government spending on public goods, specifically; taxpayers' perception of benefits in return for their tax contribution motivates tax compliance behaviour. Barone and Mocetti (2011) argued that tax compliance improves when there is an efficient allocation of resources by the government. However, if taxpayers notice that the government indulges in wasteful habits; taxpayers might feel disappointed and seek retaliation in the form of tax evasion (Bodea and Lebas, 2016; Nurkholis et al., 2020). This study extended Fischer's view of attitude and perception by adding more factors that depict the peculiarities of Nigeria tax environment.

Tax information has a limited mention in both theoretical and empirical literature (Vincent, 2021). In recent tax practices in Nigeria, the tax officials strongly believe that tax enlightenment and knowledge are necessary for bringing more individuals and businesses into the tax net. As such, a huge amount of resources is now committed to tax campaigns, tax news and tax information. The influence of tax information on tax compliance still lacks clear empirical evidence although Vincent (2021) opined that there is a significant relationship between tax information and tax compliance behaviour

METHODS

The objective of this study is to develop a new tax compliance scale by extending the Fischer (1992)'s model of tax compliance. The research method is a survey design and the tool of analysis is principal component analysis (PCA). The PCA is used extensively by researchers concerned with the development and evaluation of tests and scales (Pallant, 2010; Tabachnick and Fidell, 2001).

Review of the Fischer's model of tax compliance

Fischer's model provided one of the most viable and popular conceptual frameworks for understanding tax compliance behaviour (Chan et al., 2000). Fischer et al. (1992) classified tax compliance determinants into four-group constructs which include tax system structure (tax rate, penalty, probability of detection and complexity of tax system); attitude and perception (fairness, ethics, and peer influence); noncompliance opportunity (income level, income sources, and occupation) and demographic factors (age, gender, and education). Alm (1999) opined that no single model can account for all the factors responsible for tax compliance decision and other factors may as well be relevant in explaining tax compliance behaviour. The factors such as perceived tax service quality, public governance quality, risk preference and personal financial condition have been found to influence tax compliance behaviour (Chan et al., 2000; Chau and Leung, 2009; Manaf, 2004; Mustafa, 1997; Tayib, 1998).

New scale: Constructs definitions and sources

The new tax compliance scale made up of 37 question items (grouped into seven constructs) are products of Fischer's model and empirical reviews of literature on tax compliance behaviour, tax morale and tax evasion. The seven constructs include tax rate, tax system complexity, tax deterrence sanction, tax attitude and perception, tax noncompliance opportunity, tax compliance cost and tax information (Allingham and Sandmo, 1972; Yitzaki, 1974; Fischer et al., 1992; Christensen et al., 1994; Kirchler, 2007; Am and Gomez, 2008; Joulfaian, 2009; Alabede et al., 2011; Alm, 2012; Sapiei, 2014; Musimenta, 2020; Vincent, 2021). Table 1 provides the operational definitions of the new scale constructs.

Sampling procedure

The total population of SMEs in Nigeria is estimated at 17.4million (IMF, 2019; PwC, 2019), constituting 96% of business enterprises in Nigeria. The Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) defined a small business as an enterprise that employs 10-49 persons and has capital in the region of N5 to N50million (excluding land and building); while the medium enterprises are those that employ between 50 -199 employees, and have a capital range of N50 million to N500million (excluding land and buildings). For this study, SMEDEN provides the sampling frame from where SMEs that are properly incorporated under Corporate Affairs Commission (CAC) as "Limited Liability" and render tax returns to the Federal Inland Revenue Service (FIRS) are pre-qualified as participants.

The research instrument was administered with the combination of online, electronic mail (email) and face-to-face medium. A total number of 3,568 SMEs were sent questionnaire and a response rate of 11% was recorded, which translates to 392 completed questionnaires from the participating companies. A set of questionnaires was administered to each company from whom the questionnaire was filled by any of business owner, CEOs, finance manager, accountant or tax managers who have knowledge and experience in handling tax matters of their respective companies. Table 2 provides corporate characteristics of the sample:

Pilot survey

The questionnaire was subjected to a pilot survey of 53

Table 1. Description of variables and measurement sources.

	Variable	Full meaning	Definition	Source of measurement
1	TR	Tax rate	It is the applicable rate used to determine tax liability. It is one of the monetary cost of tax compliance.	Sapiei et al., 2014; Christensen et al. 1994; Fischer et al., 1992
2	TSC	Tax system complexity	Difficulty in understanding a tax system.	Musimenta, 2020; Kirchler, 2007; Fischer et al 1992
3	TDS	Tax deterrence sanction	This is the degree of severity of sanctions for tax noncompliance and evasion	Sapiei, 2014; Christensen and Hite, 1997; Fischer et al., 1992
4	TAP	Tax attitude and perception	This is the taxpayer's perception of fairness, equity and accountability in the spending of tax proceeds by the government	Torgler et al. 2010; Joulfaian, 2009; Alm and Gomez, 2008; Christensen et al. 1994; Robert 1994
5	TNO	Tax noncompliance opportunity	These are excuses for tax noncompliance as a result of adverse conditions like underemployment, lack of means of livelihood, and poverty.	Witte and Woodbury, 1985; Rice 1992; Fischer et al. 1993, Abdul, 2001
6	TCC	Tax compliance costs	These are expenses incurred by taxpayers arising from their obligations to comply with applicable tax laws	Sapiei 2014; Tran-Nam and Glover, 2003; Ritchie et al 1997;
7	TI	Tax information	The extent of taxpayer's clarity, enlightenment and knowledge about the tax system	Vincent, 2021
*8	Corporate demo	Corporate demographics	These are corporate charactereistics of the participating SMEs defined in Table 2	Sapiei 2014; Vincent, 2021

*The respondents are companies from whom the questionnaires were filled by any business owner, CEOs, finance manager, accountant or tax manager. The scale will not be subjected to reliability and validity procedure but the current study agrees that socio-demographic (in case of individual taxpayer) or company characteristics influence tax compliance behaviour (Fischer et al., 1992, Sapiei, 2014). Source: Author.

respondents for reliability and validity assurances. The pilot survey showed that two items from the initial 7 items that make up the tax deterrence sanction (TDS) Scale have correlation coefficients below the 0.3 benchmark (Leech et al., 2008). These items were later removed from the scale, and as a consequence, Cronbach's alpha improved to 0.797. Also, one item with a correlation coefficient below 0.3 was removed from the tax attitude and fairness perception (TAP) scale and subsequently Cronbach's alpha statistic improved to 0.837 (Table 3).

Treatment of measuring scales biases

In a study conducted by use of a paper-and-pencil questionnaire for measuring the study constructs, the challenges of common method variance or measuring scale biases are unavoidable (Buchanan and Bryman, 2011). The biases associated with the use of questionnaires do emanate from response styles, social desirability, halo, acquiescence, survey design biases, leniency, negative affectivity, environment, general instructions, mood and so on. They are extraneous variables with abilities to interfere with the reliability and validity of the measuring scales and in the end distort the relationship between focal variables under investigation (Podsakoff et al., 2016).

In addressing the problem posed by the measuring scale bias in this study, certain statistical and procedural designs advocated by Buchanan and Bryman (2011) and Podsakoff f et al. (2016) were conducted. In terms of procedure, the study sub-scales were sampled at different time intervals (but same respondents) by first obtaining respondents' responses on three of the scales, and afterwards the remaining four scales; this was to control the halo effect and response style effect (Okereke et al., 2018). The acquiescence effects and social desirability bias (SDB) were moderated by reverse coding of certain question items in the questionnaire. More importantly, the respondents were kept anonymous by making sure that questions and expressions capable of divulging the identity of a respondent were not stated in the survey instrument. The statistical remedies include reliability test by using Cronbach's alpha statistic to establish the internal consistency of the study questionnaire, validity test by factor analysis and rotation method reported in Table 3 and Table 5.

RESULTS AND DISCUSSION

The descriptive statistics compare the mean standard deviation and skewness of the study constructs as reported in Table 4. The third and fourth rows show mean and standard deviation statistics respectively. The normality of the data, set is measured by skewness on the fifth row and reveals that all the variables have skewness

Table 2. Summary of the sample.

Variable	Value label	Freq. (%)	Total
Respondent designation	CEO	22(6)	392(100%)
	Accountant/finance manager	324(82)	
	Tax manager	46(12)	
Business size	Size 1 = Turnover ≤ N25M	85(22)	392(100%)
	Size 2 = Turnover = N25M-N50M	154(39)	
	Size 3 = Turnover = N50M-N75M	121(31)	
	Size 4 = Turnover = N75M-N100M	32(8)	
	Size 5 = Turnover ≥ N100M	0	
Business age	1-5 years	62(16)	392(100%)
	6-10 years	155(40)	
	11-15 years	100(25)	
	16-20 years	49(12)	
	More than 20 years	26(7)	
Business sector	Oil, gas, mining and metal	11(3)	392(100%)
	Manufacturing	31(8)	
	Agriculture and livestock	63(16)	
	Property and Construction	23(6)	
	Transport, trade and services	102(26)	
	Finance and Banking	21(5)	
	Entertainment and hospitality	38(10)	
	Technology and Telecoms	44(11)	
	Educational services	59(15)	
Tax professional services provider	Internal	289(74)	392(100%)
	External	43(11)	
	Internal and external	60(15)	
companies by the geographical spread	North East	16(4)	392(100%)
	North West	22(6)	
	North Central	32(8)	
	South East	69(18)	
	South-South	52(13)	
	South West	201(51)	
Income tax Liability in 2019	Less than N1M	158(40)	392(100%)
	N1M – N5M	138(35)	
	N6M-N10M	49(13)	
	N11M-N15M	32(8)	
	N15M and above	15(4)	

Source: Author.

below the recognized threshold of 3 (Gujarati, 2006). There are correlations between certain variables but at an acceptable level considering inter-correlation between the variables at less than 0.7 and tolerable statistics close to 1.

The study relies on principal component analysis (PCA) for the new scale development and evaluation. This is in line with the existing tradition in scale development and

Table 3. Scales reliability.

Section A: Tax deterrence sanctions		Abbreviation	Correlation	Cronbach's alpha
1	If there was a discrepancy in the annual tax return, how likely would that be audited?	TDS1	0.596	
2	If your company was to be chosen for a compulsory audit, how likely would a discrepancy be identified?	TDS2	0.492	
3	If discrepancies were discovered during an audit, how severe are the penalties?	TDS3	0.512	0.797
4	If there was a discrepancy that led to a penalty, it can place criminal charges on the management of the company	TDS4	0.687	
5	Detection of an act of bribery of tax officials can possibly attract the attention of the Economic and Financial Crimes Commission	TDS5	0.758	
Section B: Tax system complexity				
1	The preparation of the company's income tax return is difficult.	TSC1	0.789	
2	Company's income tax computation is full of ambiguity	TSC2	0.687	
3	Complexity in tax law is necessary so that companies are treated fairly.	TSC3	0.451	0.763
4	Corporate income tax law is relatively simple to understand.	TSC4	0.426	
5	The tax office provides enough guidelines and procedure for seeking clarity	TSC5	0.875	
Section C: Tax Rate				
1	A 'fair' tax rate should be the same for every company regardless of their size (small, medium or large).	TR1	0.689	
2	A fair tax rate should be made proportional to the level of business performance	TR2	0.528	
3	It is fair that high-profit companies should pay a higher rate of tax than low-profit companies.	TR3	0.824	0.789
4	The company income tax rate is high in comparison to SME profit earnings potentials and activities	TR4	0.789	
5	The current tax rate paid by SME can impede the sector's growth	TR5	0.852	
Section D. Tax non-compliance opportunity				
1	I believe that if my company's profit reporting is below the industry average I may not likely pay the correct amount of tax liability	TNO1	0.699	0.790
2	If my company has a cash flow crisis, tax obligation may not be a priority in that period	TNO2	0.608	
3	The company's present need for money outweighs the expected future cost of tax non-compliance	TNO3	0.727	
4	I believe that certain small businesses are easily traceable for tax compliance than others (e.g. small businesses like microfinance bank regulated by the Central Bank of Nigeria- CBN)	TNO4	0.545	
5	If the country slides into recession, it is an opportunity to pay a lesser tax than my company should have paid	TNO5	0.607	
Section E. Tax compliance cost				
1	To successfully render complete tax returns my company requires the services of external consultants	TCC1	0.557	
2	The length of time necessarily spent by the accounts department for tax purposes is material enough to achieve better business performance	TCC2	0.523	0.790

Table 3. Contd.

3	How significant are other additional non-staff costs in meeting requirements of filing tax returns (e.g. travelling, stationeries and courier service)	TCC3	0.545	
Section F. Tax attitude and fairness perception				
1	I believe that each company's officers have a moral obligation to report all of their company's income and pay the correct amount of company income tax	TAP1	0.617	
2	Do you believe that self-assessment made company tax laws more or less fair?	TAP2	0.777	
3	Do you believe that the tax system is fair to small, medium and large businesses in Nigeria?	TAP3	0.812	0.837
4	The government uses revenue generated from tax to provide public goods and services	TAP4	0.825	
5	I believe that judicious use of revenue from taxes implies taxpayer commitment	TAP5	0.811	
6	The taxpayer is encouraged when tax revenue is spent more on the geopolitical zone where the tax is paid	TAP6	0.689	
7	I believe that government renders quality services from various taxes collected from companies	TAP7	0.736	
8	To a large extent, my company believes that the government is trustworthy and accountable for all collections.	TAP8	0.567	
9	We are committed to paying because other small businesses pay	TAP9	0.567	
Section G. Tax information				
1	Do you believe that availability of necessary information and guidelines would necessarily aid the payment of taxes?	TI1	0.799	
2	How easily assessed is tax information for small businesses?	TI2	0.608	
3	How adequate is tax information and guidelines available online?	TI3	0.727	0.789
4	The amount of information available is simple enough to render self-assessment returns without the services of an external consultant.	TI4	0.764	
5	Do you believe that prior tax knowledge does not affect tax compliance?	TI5	0.819	

Source: Sapiei 2014; Ritchie et al 1997; Pope, 1993; Sapiei et al. 2014; Christensen et al. 1994; Fischer et al 1992; Torgler et al. 2010; Joulfaian, 2009; Alm and Gomez, 2008; Christensen et al. 1994; Robert 1994;Vincent, 2021.

validation (Bobek et al., 2011; Bryant et al., 2004; Shukla and Srivastava, 2016). The results in Table 5 show that the Kaiser-Meyer-Olkin (KMO) value of 0.76 exceeds the recommended value of 0.6, suggesting that there are adequate question itemsfor each scale (Pallant, 2010). Bartlett's Test of Sphericity (measuring factor analysis appropriateness) attains statistical significance ($p < 0.05$). The test of scale validity reveals that all question items forming the scale for each of the seven constructs record factor loading greater than 0.6; suggesting that all question items are highly correlated with the seven constructs (Pallant, 2010).

The 37 items of the tax compliance scale are subjected to principal component analysis (PCA) with the aid of SPSS. The PCA reveals the existence of seven factors with eigenvalues greater than 1, explaining 25% (tax system complexity), 19% (tax noncompliance opportunity), 17% (Tax deterrence cost), 11% (tax attitude and fairness perspective), 8% (tax information), 6% (tax rate) and 5% (tax compliance cost) of the variance, respectively. In other words, over 90% of the variance in the tax compliance scale is accounted for by the seven factors that form the scale. Therefore, the new tax compliance scale

Table 4. Mean, standard deviation, and inter-correlations (n = 392).

Variable	TR	TSC	TDS	TNO	TCC	TAP	TI	BSize	BSector	BAge	BTaxLiab
TR	1										
TSC	0.137	1									
TDS	0.346(**)	-0.152	1								
TNO	0.237(*)	0.065	-0.094	1							
TCC	0.072	0.016	-0.153	0.197	1						
TAP	-0.123	0.118	-0.232(*)	0.072	0.072	1					
TI	0.162	0.081	-0.127	-0.123	-0.123	0.086	1				
BSize	0.173	-0.015	0.059	0.192	0.328(**)	-0.063	0.312(**)	1			
BSector	0.124	0.096	0.131	0.162	0.173	0.152	0.221(*)	0.142	1		
BAge	0.093	0.219(*)	0.215(*)	0.104	0.124	0.056	0.036	0.304**	0.041	1	
BTaxLiab	0.149	0..038	0.119	0.093	0.093	-0.115	0.348(**)	0.218(*)	0.333(**)	0.053	1
Mean	3.211	3.731	2.872	3.154	2.302	3.952	4.101	2.775	5	12.5	2.6
Standard deviation	1.263	1.299	1.020	1.534	0.923	0.961	1.267	0.961	2.100	4.511	3.211
Skewness	-0.674	-1.405	0.389	0.593	1.003	0.122	0.865	-1.622	0.940	1.367	2.019

** $p < 0.01$; *$p < 0.05$. TR = tax rate; TSC = tax system complexity; TDS = tax deterrence sanction; TAP = tax attitude and perception; TNO = tax noncompliance opportunity, TCC = tax compliance cost, TI = tax information; BSize = business size; BSector = business sector; BAge = business age and BTaxLiab = business tax liabilities

Table 5. Result of principal component analysis for 37 new tax compliance scale with varimax rotation.

Item	Cronbach's alpha	Tax deterrence cost	Tax system complexity	Tax rate	Tax noncompl. opportunity	Tax compliance cost	Tax attitude and fairness perception	Tax info	Communality
		Factor loading	Factor loading	Factor loading	Factor loading	Factor loading	Factor loading	Factor loading	
TDS2	0.797	0.874							0.521
TDS5		0.810							0.658
TDS3		0.785							0.451
TDS1		0.736							0.598
TDS4		0.732							0.529
TSC1	0.763		0.821						0.402
TSC2			0.819						0.569
TSC4			0.786						0.609
TSC5			0.751						0.874

Table 5. Contd.

TSC3			0.708						0.721
TR2	0.789			0.869					0.772
TR5				0.825					0.598
TR1				0.822					0.479
TR4				0.791					0.591
TR3				0.734					0.607
TNO2	0.790				0.878				0.372
TNO5					0.846				0.593
TNO1					0.782				0.382
TNO3					0.745				0.533
TNO4					0.719				0.429
TCC1	0.589					0.701			0.714
TCC2						0.697			0.532
TCC3						0.687			0.499
TAP3	0.837						0.891		0.661
TAP5							0.855		0.543
TAP4							0.827		0.561
TAP8							0.784		0.609
TAP1							0.767		0.523
TAP6							0.765		0.489
TAP9							0.763		0.756
TAP7							0.745		0.484
TAP2							0.734		0.473
TI2	0.789							0.814	0.774
TI4								0.794	0.597
TI3								0.792	0.631
TI1								0.788	0.453
TI5								0.746	0.619
Eigenevalues		2.76	3.02	1.78	2.89	1.57	2.32	1.96	
% of variance		17	25	6	19	5	11	8	

Extraction Method: Principal Component Analysis, Rotation Method: Oblimin with Kaiser Normalisation.

which benefitted immensely from Fischer's model, contemporary literature and empirical studies in tax compliance is reliable and valid having satisfied the rigor of reliability and validity tests. There is no doubt that the new scale is an extended or modification of Fischer's model.

Conclusion

The purpose of this study was to develop a theoretically valid scale for measuring tax compliance behaviour of SMEs in Nigeria. The development of a new scale by extending Fischer's model would enhance literature in tax evasion, tax morale and tax compliance in Nigeria and SSA countries that currently need a good understanding of how the informal sector and SMEs can effectively be brought into the tax system. The study will be of immense benefits to the tax authorities, fiscal managers and policymakers when formulating strategies for improving tax compliance, tax collection and tax-to-GDP ratio in SSA.

The study has both practical and theoretical implications. There is a practical implication for a country like Nigeria where over 70% of contributors to the national GDP are SMEs whose activities are difficult to bring into the national tax net. As much as SMEs contribute to the national GDP, it is equally the biggest evader of taxes because the economic and behavioural dynamics of the sector players have not been properly dimensioned in tax administration. The new tax compliance scale (that is extension of Fischer's model) is expected to effectively aid in understanding the dynamics of tax compliance and noncompliance in Nigerian SMEs. The scale has the potential to help tax regulators understand the nature of tax compliance beyond SMEs in Nigeria and bring about a new lease of life in tax revenue generation in Nigeria and Sub-Saharan African countries. Theoretically, the reliability and validity of the new scale confirm the relevance of the existing theory and empirical evidence in the literature. All the seven constructs of the new scale are products of the behavioural and economic approach to tax compliance (Allingham and Sandmo, 1972; Yitzhaki, 1974; Fischer et al., 1992; Frey and Torgler, 2007; Alm, 2012; Sapiei, 2014; Musimenta et al., 2017; Nurkholis et al., 2020; Vincent, 2021).

The current study might have suffered biases despite deliberate efforts to minimize social desirability bias (SDB). The tax compliance was measured from individuals' (business owner, accountants, tax managers, CEOs and heads of finance) standpoint. The views of the individuals representing the participating companies might not necessarily represent the behaviours of the companies. In addition to this limitation, the study did not focus on how each construct is related; rather it focused on developing distinctive measure of each construct.

CONFLICT OF INTERESTS

The author has not declared any conflict of interests.

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Does the importance of relevance and faithful representation differ between GAAP and tax reporting? A discussion of the trade-offs between cash-basis, accrual-basis, and fair value accounting methods

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This paper explains the trade-offs between the relevance and faithful representation of accounting information analyzed in the contexts of the cash-basis, accrual-basis, and fair value accounting methods used to prepare financial statements for Generally Accepted Accounting Principles (GAAP) and tax reporting. Discussion of the role of the relevance and faithful representation of accounting information is generally separate from any discussion of the trade-offs between cash-basis, accrual-basis, and fair value accounting methods, and the different needs and priorities of the users of GAAP and tax reporting information. The study contributes to the literature by suggesting how the importance of relevance and faithful representation differs between GAAP reporting and tax reporting, and how the allowable accounting methods for GAAP and tax reporting align with the differing emphasis on relevance and faithful representation. We review the reporting requirements established by regulators in light of these trade-offs and discuss how the needs of external users of the reporting information shape the allowable accounting methods for GAAP and tax reporting.

Key words: Relevance, faithful representation, cash-basis, accrual-basis, fair value, GAAP, tax reporting.

INTRODUCTION

The purpose of this paper is to discuss the trade-offs inherent in three competing financial reporting systems - cash-basis accounting, accrual-basis accounting, and fair value accounting - and the implications of the trade-offs in light of the requirements established for GAAP (financial) and tax reporting. To the researchers' knowledge, this study is the first to demonstrate how the importance of relevance and faithful representation differs between GAAP and tax reporting, and how the allowable accounting methods emphasize the different needs and priorities of the users of accounting information.

The conceptual framework developed by the Financial

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Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) states that the primary objective of financial reporting is to provide financial information that is useful to investors and creditors for making investment and lending decisions. According to the FASB, useful information has two fundamental qualities - relevance and faithful representation. Accounting information is considered relevant if it would make a difference in a business decision. For such information to be relevant, it must possess predictive value (providing accurate expectations about the future) or confirmatory value (confirming or correcting prior expectations). Consequently, accounting information is deemed relevant if it provides helpful information about past events or potential future events. Furthermore, accounting information has faithful representation if it accurately depicts the actual events that occurred, including providing information that is complete (without important omissions), neutral (not biased), free from error, and verifiable.

Under cash-basis accounting, companies record revenue and expenses at the time money is received or paid out (related to their operating activities). Cash-basis is largely appealing due to its simplicity, but it can result in misleading financial statements, as it does not record business activities (such as sales) as they happen – the activity is only recorded as cash changes hands. Cash-basis accounting is considered to be low in relevance, but high in faithful representation. Using fair value accounting, companies measure and report the value of assets and liabilities using the actual or estimated fair market price of the assets and liabilities. Changes in asset or liability values are recorded as unrealized gains or losses, increasing or reducing net income, comprehensive income, and/or equity. Fair value accounting is considered high in relevance, and low in faithful representation. Using accrual-basis accounting, transactions are recorded in the periods in which the events occur, even if cash is not exchanged, following the revenue and expense recognition principles. Accrual-basis accounting is considered to be a middle ground for both relevance and faithful representation; as it is more relevant than cash-basis accounting (but less than fair value), and has more faithful representation than fair value (but less than cash-basis accounting).

The qualitative characteristics of accounting information, relevancy and faithful representation, allow those who analyze and use this information to make well informed decisions. We suggest that financial reporting emphasizes relevance: under current GAAP, companies are allowed to report (with few exceptions) using accrual-basis accounting and fair value methods, which are ranked as high and medium in relevance. The external users benefit from the increase in information that is useful for decision making and relies on auditors to verify that the information presented in the financial statements is accurate and free from errors. The focus for financial reporting is on allowing companies to use accounting methods that provide external users with the information they need to make decisions. We also suggest that tax reporting emphasizes faithful representation. Under current tax regulations, companies are allowed to report (with few exceptions) using cash and accrual accounting methods, which are ranked as high and medium in faithful representation. The primary external user for tax reporting is the Internal Revenue Service (IRS). The IRS likely believes there is no benefit to allowing taxpayers increased subjectivity (bias and errors) in their tax reporting. Instead, the focus is on allowing companies to use verifiable, accurate, and easy to audit accounting methods for this reporting.

Table 1 illustrates the trade-offs between the relevance and faithful representation of accounting information in the context of the three competing financial reporting systems and importance for GAAP and tax reporting. The information suggests that accrual accounting avoids the extremes, providing users with information that is neither low in relevance nor low in faithful representation and is therefore a frequently used method for both GAAP and tax reporting.

ACCOUNTING METHODS AND RELATED LITERATURE

Cash basis

With cash-basis accounting, revenues are recorded when cash is received from customers in the ordinary course of business, whether it’s after the sale of a product or after a service is provided. Cash flows received from parties other than customers (such as, money borrowed from a bank) would not be considered revenue under a cash-basis system since these cash flows are helping finance the business rather than resulting from day-to-day operations. Expenses under a cash-basis system are recorded when there are cash outflows (that help to generate cash inflows from customers). For example, a manufacturing facility’s cash purchase of equipment would be recorded as an expense under a cash-basis system. The focus of cash accounting is on cash flows; cash receipts, cash payments, and cash surpluses or deficits (Tickell, 2010).

Accrual basis

Using accrual-basis accounting, revenues are recorded only when they are earned, when the goods or services have been provided to customers, and not when cash is

Table 1. Trade-offs between Relevance and Faithful Representation across Cash-Basis, Accrual-Basis and Fair Value Accounting Systems.

Qualitative Characteristics	Cash-Basis	Accrual-Basis	Fair Value
Relevance (usefulness for decision-making)	Low	Medium Focus for GAAP (financial) reporting	High
Faithful Representation (accurate, complete, neutral, can be verified)	High Focus for tax reporting	Medium	Low

received from customers.

Therefore, accrual accounting can provide information on the impact of transactions where cash has not yet been received or paid (Public Sector Committee, 2002). Expenses are recorded under an accrual accounting model only when they are incurred and not when cash has been paid (to employees, vendors, etc.). Under accrual accounting, the transaction is recognized on the date the income is earned or the expense is incurred (Tickell, 2010). For example, monthly rent expense would be recorded at the end of each month, and not when the rent payment is actually made. The historical cost principle is used in accrual accounting, and fixed assets are recorded at their original cost on the balance sheet, and generally depreciated (and subject to impairment). Accrual accounting focuses on revenues, expenses and profits or losses, and enables informed decision making (Tickell, 2010).

Fair value

Fair value accounting is focused on the balance sheet and uses current market values as the basis for reporting certain assets and liabilities. Therefore, fair value accounting modifies the historical cost of assets and liabilities and adjusts them upwards or downwards to their current market values. Fair value is the estimated price at which an asset can be sold, or a liability settled in an orderly transaction to a third party under current market conditions and focuses on the exit price (the price at which an asset can be sold, not the price at which the asset can be purchased; Corporate Finance Institute, 2020).

Under SFAS 157, companies classify their fair-valued assets into three categories: Levels 1, 2, and 3, based on the asset's liquidity and/or valuation input reliability, and determine the values of the assets accordingly (AICPA; Bragg, 2020). Under fair value accounting, gains or losses from any changes in the value of assets or liabilities are reported in the period in which they occur. An increase in asset value or a decrease in liability value adds to net income or other comprehensive income, and a decrease in asset value or an increase in liability value reduces net income or other comprehensive income.

The usefulness of accounting information, and the use of various accounting methods, has developed into several streams of accounting literature. The seminal article by Ball and Brown (1968) demonstrated the relation between stock returns and earnings. Building on this idea, other studies have examined the faithful representation (or reliability) of accounting information in the context of the ability of current earnings to predict future earnings (Bandyopadhyay, et al., 2010; Kirschenheiter, 1997; Richardson et al., 2005), and whether a high degree of conservatism indicates high quality financial statements (Basu, 1997; Ball et al., 2000; Ball and Shivakumar, 2005; Barth et al., 2008; Chen et al., 2010).

Other studies have shown the links between financial reporting and firm value. For example, researchers have examined whether value relevance, the ability of information that is presented by financial statements to capture and summarize firm value, has increased or decreased over time, examining differences between countries, before and after the adoption of new accounting standards (such as IFRS) and changes in regulations (such as the Sarbanes-Oxley Act), and whether firm characteristics that mediate the relation (Khanagha, 2011; Perera and Thrikawala, 2010; Core et al., 2003; Marquardt and Wiedman, 2004; Kargin, 2013; Iatridis, 2010; Papadatos and Bellas, 2011). Other research streams have studied the historical development of accounting methods. For example, Georgiou and Jack (2011) examine the historical roots of fair value accounting and conclude that no accounting basis has become fully institutionalized to the exclusion of others, resulting in an acceptance of mixed measurements in financial reporting.

This study builds upon these studies and shows that the importance of relevance and faithful representation for GAAP and tax reporting differs, and describe how cash-basis, accrual-basis and fair value accounting methods allowed under each reporting system reinforce the differences.

CASH-BASIS AND ACCRUAL-BASIS ACCOUNTING

The benefits of accrual-basis accounting

Accrual accounting generally results in more relevant income statements, providing information that is better for decision making, compared with a cash-basis system, as expenses are better matched with the revenues that these expenses helped to generate with the accrual accounting method. In Appendix A we provide a numerical example. Without this matching, the net income of companies using cash-basis accounting generally has a larger variance, making it more difficult for investors and lenders to forecast future income or cash flows. Financial statement users may be concerned to see large losses in years when fixed assets are purchased.

Following these “big bath” years, the company is likely to report artificially high book income, which may be very attractive to investors and lenders and may generate unrealistic expectations for future profitability. For tax purposes, a net loss reported in asset purchase years would create a net operating loss (NOL), and that would eliminate taxes due in that year, and could be used to reduce taxable income in future years. Although not ideal for highly relevant financial reporting, cash-basis accounting may be ideal from a tax perspective as it alleviates some pressure on the business cash-flow, which can be a crucial factor in the initial years of an entity.

Just as accrual-basis income statements will generally provide more relevant information to financial statement users than cash-basis income statements, the same thing can be said for the superiority of accrual-basis balance sheets relative to cash-basis balance sheets. For example, significant resources (or claims on resources) are not reflected on a cash-basis balance sheet. Examples include accounts receivable, accounts payable, and fixed assets. Without reflecting receivables and payables and other significant resources and claims on resources, a cash-basis balance sheet may not be very relevant for financial statement users’ decision making.

Accrual-basis balance sheets, which show company resources and claims on those resources, provide more relevant information. For example, a bank would have less difficulty making a good lending decision using an accrual-basis balance sheet that contains information concerning receivables and payables. Interestingly, for small companies (companies with under $250,000 in assets), the IRS does not require balance sheet information to be reported with a company’s tax return. It is likely that the IRS knows many of these small companies are using cash-basis accounting, and the balance sheet would not be very informative.

The benefits of cash-basis accounting

In order to obtain the more relevant income statements with accrual accounting (that match expenses with the revenues generated by those expenses), faithful representation is oftentimes sacrificed with the use of estimates. For example, the annual allocated cost of equipment (depreciation expense) depends on two estimates: useful life and salvage value. If and when either of the estimates are adjusted, (for example, as new information is obtained), the company will change the future depreciation charges. This loss of faithful representation (or reliability) with respect to estimates inherent to the accrual accounting method is a stark contrast to the cash-basis model in which estimates are not needed to complete the financial statements. The lack of estimates makes cash-basis information very easy to verify, and the most faithfully represented of all three accounting methods.

Cash-basis may be potentially advantageous for tax reporting, as companies have some flexibility regarding the exact timing of the cash receipts and disbursements. For example, companies can reduce taxable income in the current year by waiting to send out invoices for goods delivered or services rendered until the start of the following year. Alternately, companies can increase current-year deductions by prepaying certain expenses, like insurance or rent. Using the “12-Month Rule,” a substantial amount of those prepaid expenses can be reported on the current year tax return in order to increase deductions, and reduce taxable income reported to the IRS.

Summary

While the cash-basis method has higher faithful representation than the accrual-basis method, most users of financial statements would agree that the increase in relevance from the use of accrual accounting is worth the sacrifice in faithful representation. The accrual method generally provides a better “report card” of how well a company is doing because of better matching of revenues and expenses, lower variance in net income, and more complete balance sheets (reflecting receivables and payables, etc.) compared with a cash-basis accounting system.

ACCRUAL ACCOUNTING AND FAIR VALUE ACCOUNTING

The benefits of fair value accounting

Fair value income statements provide more relevant

information for decision makers compared with accrual-basis income statements, and in Appendix B, the study provides a numerical example. The example demonstrates that with rising replacement costs, fair value income statements provide more conservative net income figures compared with accrual accounting income statements. However, just because the fair value income statements are more conservative (than the accrual accounting statements) does not always mean they help users to make well informed decisions.

The fair value method also provides more relevant data on the balance sheet, compared with the cash and accrual-basis methods. For example, the fair value method would report land on a company's balance sheet each year based on the appraised value of the land, whereas with accrual-basis, a company's balance sheet would reflect the original (historical) cost of this land (even if this cost was incurred many years ago).

The study provides an example in Appendix C illustrating the high relevance of fair value balance sheets, compared to accrual-basis balance sheets. In our example in Appendix C, the ending retained earnings using fair value is equal to the cash balance available to either grow the business or pay dividends. Thus, the fair value method yields retained earnings that more accurately portrays how much "better off" the Company is in terms its "true economic profit". By showing a "true economic profit," the fair value income statement and balance sheet is highly relevant. Accrual-basis balance sheets, on the other hand, result in a mismatch between retained earnings and cash. Since the cumulative earnings under the accrual model does not agree with the incremental assets available to grow the business and/or pay dividends, the relevance of accrual accounting income statements is said to only be "moderate". Indeed, the accrual accounting method seems to overstate earnings relative to the "true" economic profit that is reflected in the fair value method.

The benefits of accrual accounting

One drawback of the fair value method is that it can be highly subjective when measuring financial statement accounts. This is especially concerning when active markets do not exist for company assets and liabilities (Level 2 and 3 assets), and the fair value is estimated, opening up the possibility of intentional or unintentional errors in accounting estimates. Due to the subjective nature of fair value accounting and the estimates often involved, fair value accounting is considered to have the lowest level of faithful representation.

In other words, shifting to more relevant fair value data in the balance sheet can oftentimes only be attained by sacrificing faithful representation. Faithful representation is reduced any time a company is not able to perfectly forecast the factors used in determining its estimates. For example, in fair value accounting, the increased purchase price of a replacement asset needs to be accurately allocated to changes in technology, inflation, and/or supply/demand considerations. With these unknowns, the estimation process for the replacement cost depreciation determinations can be quite subjective, and determining which assumptions are correct and how to make the assumptions is very challenging. For example, it can be very subjective determining how much of the increase in an asset's replacement price is due to improved technology and how much is due to inflationary pressures.

Additionally, it can be quite subjective determining how much more effective (or productive) a replacement asset will be, and whether there will be a related reduction in annual repairs and maintenance. It could turn out that part of the increase in the purchase price of a replacement asset would not be inflationary in nature but would instead reflect expected product improvements. The complexity of making estimates for replacement cost depreciation is just one area that requires a significant number of estimates.

Both GAAP and IFRS are increasing the use of the fair value method to report balance sheet assets (at this point the IFRS has adopted it more broadly).

One example is revaluation, where GAAP and IFRS allow the value of a fixed asset that was originally recorded using historical cost, to be adjusted downward to reflect the fair market value. However, only IFRS permits assets that have been written down to be reversed, where the value is restored to the historical cost or above, and in some cases IFRS allows depreciation based on revaluation of assets, which is not permitted under GAAP. The main advantage of fair value accounting is that if done at regular intervals and without management bias, fair market balance sheets show assets at their true market value, providing highly relevant information to users, and a more accurate financial picture of a company than either the cash or accrual-basis methods.

The IRS allows only a few items to be reported at fair value for tax purposes, likely to prevent the temptation to report biased estimates on the tax return in order to reduce a company's tax liability. For example, businesses may report the fair value of charitable contributions as a deduction on their tax returns (this depends on the type of property donated, and for qualifying donations; many require an independent appraisal of the fair value). Further, depending on the type of entity and financial reporting requirements, the balance sheet reported on the tax return may include fair value amounts (for example, when reporting investments).

Summary

The fair value method is closely linked with estimations. If performed on a regular basis and without management bias, the estimations result in financial statements that are highly relevant. Unfortunately, the extent and subjectivity of estimations suggest that fair value financial statements have the lowest level of faithful representation out of the three methods.

CONCLUSION

To the authors' knowledge, they are the first to demonstrate how the importance of relevance and faithful representation differs between GAAP and tax reporting, and how the allowable accounting methods emphasize the different needs and priorities of the users of accounting information. We highlight trade-offs between the two fundamental qualities of useful accounting information in the context of the fair value, accrual-basis, and cash basis accounting methods. The accounting information prepared for GAAP and tax reporting is presumed to be useful for external users. "To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent" (Conceptual Framework, 2010, A34). Publically traded companies are required to follow U.S. GAAP, suggesting that regulators view highly relevant financial statements as essential for external users, and therefore allow (with few exceptions) companies to report using accrual-basis and fair value methods. Fair values have played a role in U.S. GAAP for more than 50 years; however, accounting standards that require or permit fair value accounting have increased considerably in the last two decades (Ryan, 2008). A recent publication from KPMG states "The use of fair value measurement for financial reporting continues on an upward trajectory and presents significant challenges, requiring judgment and interpretation" (KPMG, 2017, page 3). Fair value accounting has been blamed for multiple stock market crises, including the Wall Street crash of 1929 and the 2008 financial crisis (Ramanna, 2013). However, relying on the idea that financial markets are efficient and that prevailing prices are reliable measures of value most relevant to financial statement users, regulators continue to allow companies to use fair value accounting for reporting a specific set of assets, including certain financial assets and liabilities, asset retirement obligations, derivatives and intangible assets acquired in a business combination (Chung et al., 2016). It appears that regulators believe that allowing accounting methods that increase relevance (accrual-basis and fair value) for external users is the priority, as potential decreases in faithful representation may be mitigated with a high-quality audit.

Tax reporting has few external users – with the IRS being the most significant. As the primary user of tax reporting, the IRS requirements concerning accounting methods are likely focused on limiting the subjectivity (bias and errors) allowed in tax reporting, and allowing companies to use verifiable, accurate, and easy to audit accounting methods. According to Fellow and Kelaher (1991), although the accrual accounting concept is simple to understand, it can be difficult to implement. Therefore, allowing cash-basis accounting (appealing due to simplicity) may lessen the burden of accrual accounting for small taxpayers. As tax information is generally used exclusively for the purposes of collecting tax revenue, and is generally not used by outside parties for lending and investment decisions, it appears that the IRS is willing to sacrifice relevance in order to prioritize obtaining tax reporting information that is high in faithful representation. As tax law is ultimately established by US Presidents and Congress, the study concludes that these branches of the US government have also more highly valued faithful representation compared with relevance.

Regulators have undoubtedly considered the trade-offs between accounting methods when establishing both financial and tax reporting requirements for companies in the U.S. As we suggest, the importance of relevance and faithful representation differs between GAAP and tax reporting, as a result of the different needs and priorities of the external users of this information. However, these needs are not static, and in recent decades regulators have modified the reporting requirements to allow, and in some cases even require, components of the cash-basis, accrual-basis, and fair value accounting methods for both GAAP and tax reporting.

Future research in this area can continue to analyze the trade-offs between fair value, accrual-basis, and cash-basis accounting for financial and tax reporting, in light of changing regulations and reporting environments. For example, recent news articles suggest that the Biden administration may eliminate the basis step-up rule (The New York Times, 2021). Currently, when an individual inherits property, their basis in the property is "stepped-up" to the current fair market value, so an immediate sale of that property would not be subject to capital gains tax. Eliminating the step-up could increase taxes for individuals inheriting property that had appreciated in value and would require information regarding the original owners cost basis in the property. In addition, future studies could also examine how the increase in digital information available to individuals and regulators impacts reporting requirements for financial statement and tax purposes, and how the ease with which fair market value and cost basis information can be gathered affects the relevance and faithful representation of fair value, accrual-basis, and cash-basis accounting methods.

These intriguing ideas are left for future studies.

CONFLICT OF INTERESTS

The authors have not declared any conflict of interest.

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APPENDIX A: CASH AND ACCRUAL-BASIS INCOME STATEMENTS

The following example illustrates the differences between cash-basis and accrual-basis income statements for a fictitious entity. On January 1, Year 1 ABC Company pays $1,800 cash for equipment, with an estimated three-year useful life and no salvage value. ABC will earn $1,000 in revenues each year (and will receive $1,000 in cash inflows each year), and ABC will have no expenses across this three-year period except for the equipment purchase. Based on these facts, ABC would have the following income statements for Year 1 through Year 3 using cash-basis accounting.

ABC Company Example:

Cash-Basis Income Statements.

Variance	Year 1	Year 2	Year 3
Revenues	$1,000	$1,000	$1,000
Equipment Expense	(1,800)	(0)	(0)
Net Income (Loss)	$ (800)	$1,000	$1,000

The company will report a net loss of $800 for Year 1 (as the full cost of the equipment is recorded as an expense this year even though this equipment will benefit the company for three years) and net income of $1,000 in Years 2 and 3. Using the accrual-basis method, the cost of the equipment is spread over the three-year life of the equipment (using straight-line depreciation). Based on the above facts, the company would have the following income statements for Year 1 through Year 3 using the accrual method and would report net income of $400 each year.

ABC Company Example:

Accrual-Basis Income Statements

Variance	Year 1	Year 2	Year 3
Revenues	$1,000	$1,000	$1,000
Depreciation Expense	(600)	(600)	(600)
Net Income	$400	$400	$400

APPENDIX B: FAIR VALUE INCOME STATEMENTS

The following example extends Appendix A and presents fair value income statements for the fictitious company. We again assume ABC buys equipment for $1,800 on January 1, Year 1, and estimates that the equipment will have a three-year useful life (no salvage value), and that the company will earn $1,000 in revenues each year (and receive $1,000 in annual operating cash inflows). However, in this example, the company replaces the equipment on January 1, Year 4 and pays $2,100 (in cash) to buy new equipment. We assume that there have been no technological improvements with respect to the equipment in the last three years. The equipment is simply $300 more expensive at the beginning of Year 4 compared to the beginning of Year 1 (due to inflation, changes in the supply or demand for the equipment, etc.,) and not due to new and/or improved features.

Appendix A reports accrual-basis net income of $400 for each of the first three years of operations. For the fair value method, the annual revenues would be unchanged, but depreciation is calculated by dividing the $2,100 expected cost to replace the original equipment by three years of useful life or $700 of annual depreciation charges. Given the $2,100 replacement cost estimate, the fair value income statement information for the first three years of operations for ABC is shown below.

ABC Company Example

Fair Value Income Statements.

Variance	Year 1	Year 2	Year 3
Revenues	$1,000	$1,000	$1,000
Depreciation Expense	(700)	(700)	(700)
Net Income	$300	$300	$300

APPENDIX C: ACCRUAL-BASIS AND FAIR VALUE BALANCE SHEETS

The following example illustrates the differences between accrual-basis and fair value balance sheets for a fictitious entity. We extend our example of ABC Company and focus on the following transactions: ABC raised $1,800 on an initial public offering (IPO) of common stock on January 1, Year 1 and later that same day the company bought $1,800 of equipment with this cash. Using the accrual accounting method, the transactions would be recorded as shown in the table below (Note that Transactions 1 and 2 take place on January 1, Year 1, Transactions 3 and 4 occur over the first three years of operations, and Transactions 5 and 6 occur on January 1, Year 4).

ABC Company Example:

Accrual Accounting Transactions.

Variance	Cash	Equipment	Accum. Depr.	Common Stock	Retained Earnings
IPO	$1,800			$1,800	
Purchase Equipment	(1,800)	$1,800			
Sales	$3,000				$3,000
Depreciation Expense			(1,800)		(1,800)
Retire Old Equipment		(1,800)	$1,800		
Purchase New Equipment	(2,100)	$2,100			
Total	$900	$2,100	$0	$1,800	$1,200

In Appendix A, the accrual-basis income statement indicates annual income of $400 and retained earnings of $1,200 at the end of the first three years. In Appendix B, the Fair Value income statements (reflecting current replacement cost depreciation) result in annual income of $300 and retained earnings of $900 at the end of the first three years. Note that the $900 ending retained earnings under the fair value model equals the $900 cash balance available, whereas the accrual model ends up with cash of $900 and retained earnings of $1,200 (as seen in Appendix C). The $300 difference between cash and retained earnings in this example reflects the fact that part of the profits under the accrual model (that is, $300) are not real economic profits but merely reflect the fact that the company has had to buy more expensive equipment to stay in business.

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Taxing the informal sector through presumptive taxes in Zimbabwe: An avenue for a broadened tax base, stifling of the informal sector activities or both

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Domestic revenue generation occupies a central domain in most countries, leading to continuous mapping of strategies towards its enhancement. Taxation is a dependable and foreseeable avenue to generate revenue for governments to fulfil their key obligations of employment creation, economic growth and infrastructural development, poverty reduction and state security. Despite these plausible arguments, tax revenues are minimal and tax bases narrow in developing countries. Contemporary tax debates point out that informal sector represents a lucrative fountain of tax revenue for governments, yet opponents of taxing the sector suggest that taxation might cripple small firms. Zimbabwe introduced presumptive tax in 2005, further enforcing to expand the tax base by including the sector into the tax basket in 2011. Researchers have focused on tax evasion and non-tax compliance when studying this sector, this paper focuses on the stakeholders perceptions on the impact of informal sector taxation on revenue generation and growth. This study adopted a sequential exploratory mixed method approach, argued to be ideal for under-researched areas such as this one. Key findings were that the current one size fit all tax framework suffocates small firms. Governments have to strike a balance between revenue mobilisation and the sector's key economic contributions, without crippling informal firms.

Key words: Informal sector, taxation, growth, stifling, revenue mobilisation.

INTRODUCTION

In developing countries, the Informal Sector (IS) plays a central role, accounting for a projected share that is between 50-80% of GDP and a bigger share of employment between 60 to 80% and representing 90% of new jobs (Bhorat et al., 2017; Dickerson, 2014). Zimbabwe's informal sector is estimated to be the second largest in the world contributing 60.6% of GDP after Bolivia's 62.3% contribution (Medina and Schneider, 2018). Mangwana (2016) expresses that more than 75% of the labour force is employed by Small to Medium

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Enterprises (SMEs) and the IS and this accounts for an estimated 5.7million people. From the statistics shown on the sector's contribution to GDP, economic activity and employment, the exigency to bring this sector into the tax net in Zimbabwe is apparent. According to Joshi et al. (2013, 2014) and Rogan (2019), there seems to be a consensus amongst revenue authorities, governments, development organisations such as the World Bank, African Development Bank and the International Monetary Fund (IMF) that African governments would have to work industriously to bring the informal sector into the tax basket. Researchers concur that the IS occupies the most complex domain with regards to taxation, due to its characteristics such as the hidden nature, small scale, ease of tax evasion and mobility as well as diversity, yet they disagree on the impact of taxation on the viability of the sector's activities (Joshi et al., 2014; Ligomeka, 2019; Maina, 2017; Munjeyi, 2017). The sector represents an understudied yet promising group of potential taxpayers. The size of the sector and its socio-economic implications as well as the exogenous inhibitions to feasible taxation policies have generated extraordinary academic and policy interest by both developed and developing country governments especially SSA country governments. Efforts by these governments endeavour to help augment the tax base, increase tax revenues, enhance economic development and reduce the reliance on donor funding if the full revenue potential of this sector is exploited. Joshi et al. (2014) and Mbiliayi (2012) allude to the fact that revenue lost in SSA countries from not taxing the sector ranges between 35 to 55% of total revenues, implying that the losses could be even higher for Zimbabwe if the size of the sector and contribution to GDP are anything to go by. Developing countries introduced presumptive taxes to widen the tax base, bring the non-paying IS into the tax net and address equity consideration. These efforts have been argued to be unsuccessful and faced with considerable hindrances impeding effective taxation of this sector. Tax revenues from this sector are argued to be very inconsequential and worryingly low in comparison with the sector's magnitude and contribution to GDP (Ligomeka 2019; Maina, 2017). Researchers such as Prichard (2009) and Masarirambi (2013) are quick to point out that a large chunk of this sector continues to slip through the noose of tax authorities, even as governments continue to grapple with the problem of how to manage this or even to efficiently and effectively collect tax revenues from the sector. However, while the subject of informal sector taxation has goaded considerable attention, this has not been without controversy.

Contention has surrounded whether informal sector taxation should indeed be a policy priority for these fiscally constrained developing countries in view of the potentially low revenue yields, high administrative costs as well as huge costs of collection (Joshi et al., 2013, 2014). Debate has also surrounded the benefits to be derived from taxing this sector versus the costs and challenges associated with such a move. Researchers have called for taxation of the IS to broaden the tax base, boost revenue generation to fund economic development (Joshi et al., 2014; Rogan, 2019), yet others have queried the logic of taxing the IS in view of its small scale nature, minimal and erratic incomes, lucid nature, heterogeneity and difficulties tracking players, aggressive nature of operators in the sector and low tax morale (Kundt, 2017; Meagher, 2018; Sebele-Mpofu, 2021). Opponents of IS taxation have further argued against taxing it, suggesting it is a means of subsistence and its taxation might be regressive and lead to the closure of small firms, crippling the very activities that are essential for poverty alleviation, employment creation and the provision of a livelihood for the disadvantaged. Political, economic and administrative constraints have been tabled as formidable challenges that make taxation of the IS unattractive and if at all a feasible option. Meagher (2018) questions whether any meaningful revenues can be mobilised from the sector, arguing that the current efforts to tax the sector represent an increase in the tax burden, as the IS in Africa is already paying multiple formal and informal taxes to local authorities. Pimhidzai and Fox (2011) argue that any increased efforts towards taxing the sector are likely to be regressive to the growth of small firms. This casts doubt on whether taxation of this sector is indeed a way to attain an expansive tax base. On the contrary, it could be crippling the existence and survival of the informal firms. At the same time the tax gap, operational problems faced by governments due to huge budget deficits and the uneven distribution of the tax burden cannot be ignored (Dalu et al., 2013; Munjeyi et al., 2017; Masarirambi, 2013). The importance of raising tax revenues on a sustainable basis cannot be overemphasised. In view of this, it is essential for research to review and critically evaluate the implications of IS taxation through presumptive taxes on revenue mobilisation, economic growth as well the growth of small firms and to consider alternative strategies of taxing the IS. Is informal sector taxation an avenue for broadening the tax base, curtailing of IS activities and impeding growth of small firms or both? In light of the arguments above, this question begs for answers. It still remains incomprehensible whether government can collect any meaningful tax revenue from the sector without suffocating these small firms or adversely incorporating them into the formal sector as questioned by Meagher and Lindell (2013). Machemedze et al. (2018) raise thought provoking questions with regards to presumptive taxes used to tax the IS, asking, "is this a fair system of tax, we are assuming government is making certain presumptions about the earnings of these operators, is

this a good approach? What is the effect of the tax system on SMEs and the informal economy? Is the tax system designed to enhance SMEs growth? Does the system discourage growth of SMEs?" Submissions and conclusions remain inconclusive and paradoxical. Ojeka (2011) postulates that SMEs are bedrocks for employment generation, innovation and competition in developing economies which ultimately lead to poverty alleviation and national growth and contends that tax policy must not be an encumbrance to SME growth but foster voluntary compliance.

Zimbabwe is described by Ligomeka (2019) as one of the few countries that are slowly but increasingly taxing the IS. The country introduced presumptive taxes in 2005 and further enforced them in 2011 in terms of the Zimbabwe Income Tax Act, Chapter 23.06 (Government of Zimbabwe, 2005). Commenting on presumptive taxes, Mangwana (2016) alludes to the fact that the Zimbabwean government must balance the efforts to mobilise revenue from the sector and the sector's other irrefutable contributions such as providing survival income, employment and value creation, being a driver and source of novel technological advancements, centre piece of economic growth and poverty alleviation. Zimbabwe therefore, becomes an ideal platform to evaluate IS taxation hence the question whether IS taxation in Zimbabwe is a widening of the tax base, stifling of informal firms or both? The objectives of the study are therefore, to explore the design of the informal sector taxation system in Zimbabwe as well as to evaluate stakeholder perceptions on the impact of IS tax administration on revenue generation and on the survival and growth of informal firms. Since this study is an exploratory study that assessed perceptions of various stakeholders, it also sought to design a conceptual framework to guide future researchers in evaluating the impact of taxation on growth of small firms. Fulfilment of these objectives would lead to contributions to the body of knowledge on IS taxation and to policy and practice with regards to IS taxation which is contemporary topic among developing counties governments, policymakers and revenue authorities. Revenue generation appears to be the most emphasised motive and studies have focused on the motives of and the need for IS taxation, without paying attention on the impact of such tax administration on other taxation motives such as governance, growth and wealth distribution. The focus on the evaluation and the outcomes of this appraisal of the IS tax framework would assist policymakers in improving IS tax policy. Maina (2014, 2017) points to a dearth in research that evaluates the current presumptive taxes' appropriateness in mobilising tax revenues from the IS, provide justifications why they are performing below expectations and provide suggestions to ameliorate the handicaps. Joshi et al. (2014), suggests that, there is also a lacuna in literature that advances research in legal, regulatory and administrative reforms in informal sector taxation. Von Soest (2007) points to the insufficiency of studies concentrating on tax, its administration and impact in the African continent. Therefore, this research sought to contribute to the paucity in literature on IS taxation, especially its impact on the survival and growth of small firms. This paper evaluates perceptions on the impact of IS taxation in Zimbabwe in terms of revenue generation and survival and growth implications on these informal firms.

LITERATURE REVIEW

Informal sector background

The informal sector is undeniably a consequential component of developing economies and has been a part of the Zimbabwean economy since time immemorial. It has however been suggested that the sector has grown exponentially in recent years (Sikwila et al., 2016). Schneider et al. (2010) describe it as "all market based legal production of goods and services that are deliberately concealed from public authorities to avoid payment of income tax, value added tax and other taxes". Pimhidzai and Fox (2011) proclaim that the contribution of the IS in providing employment and income opportunities is very fundamental in reducing the extent and intensity of poverty in developing countries especially Sub-Saharan Africa (SSA). IS taxation is a turbulent topic with connotations on taxation, economic development and growth that has generated strong discussions in recent years in developing countries. The paradox is how to tax the IS without crippling the sector and frustrating poverty alleviation efforts and the majority of people's livelihoods especially in Zimbabwe where the economy is largely informal (Ayee, 2007; Moyi and Ronge, 2006).

Taxation in the informal sector

Resource mobilisation lies at the heart of economic development, if not the "blood life" of any economy, yet the "capability" to collect taxes continues to be a fundamental shortcoming of African nations (von Svoest, 2007). Fifty percent or more of potential tax revenue goes untapped in developing countries. In the wake of fiscal crises of the states in sub-Saharan Africa, designing tax systems that can provide incentives for growth, can ensure equity, stimulate economic growth as well as preserve the survival of firms and can increase revenue collection is central to state viability and effectiveness (Toye, 2000; Munjeyi, 2017; Munjeyi et al., 2017; Rogan, 2019). Revenue collection is said to be negatively

impeded by the existence of a large heterogeneous informal sector, corruption, low tax compliance and heightened tax evasion and feeble taxation administration in developing countries especially Sub-Saharan African countries (Joshi and Ayee, 2008; Ligomeka, 2019). The features of the IS makes it hard to tax the sector, as the actors are mostly unregistered, so mobile, not recorded in official statistics, small scale operators, deal mainly in cash transactions, unwilling to keep records and have little or no access to the formal markets. The sector is usually made up of small scale traders, small scale manufacturing operations, garage owners, restaurants, small scale miners and repair workshops among others. The current trend has leaned towards individual professionals such as lawyers, doctors, accountants, economists and engineers being players in this sector (Fajnzylber et al., 2009).

The statistics on the sector's contribution points to an urgent need to tax the IS. Controversy arises as to whether to tax or not to tax the IS as proponents against such taxation have attributed the growth of the IS to rising tax burden and strict labour market regulations coupled with a declining tax morality and loyalty towards government. Contention also surrounds the enormity of the potential "tax gap", which is the difference between tax potential and actual tax collected. Others allude to its vastness (Dube, 2014), yet others argue that erosion of the tax base is considerable, though not as huge as usually purported by governments (Pimhidzai and Fox, 2011). Amid the disputations, presumptive tax frameworks aimed at taxing the IS are slowly becoming an inescapable component of developing economies' tax systems and Zimbabwe is no exception having introduced the tax framework in 2005.

Informal sector taxation in Zimbabwe background

The Zimbabwean system adopted presumptive tax rates depending on the industry (http://www.zimra.co.zw) in an attempt to magnify the tax base and increase revenues in 2005 as shown in Tables 2 and 3. Hairdressing salons and cross-border traders were added in 2008, and cottage industry and bottle-store operators in 2009.

Should the IS be tax or not taxed?

Tax bases are narrow in SSA as they rely on few taxpayers. The large taxpayers, who make less than 1% of the potential taxpayers, contribute more than 70% or more of the total revenue whereas small and medium taxpayers contribute as little as between 0-25% (Gerxhani, 2004; Gordon and Li, 2009; Udoh, 2015). Taxation of the sector could also be a solution to reduce government-donor budget overreliance. Millin and Coetzee (2007) citing Xaba et al. (2002) suggest that formal employment and output growth have been stagnant in most African countries, while informal employment and its share of GDP have been steadily increasing. With the informal sector growing more rapidly than the formal sector, if not taxed then how would government increase revenue from a slowly dwindling formal sector especially in countries like Ghana, Kenya, Uganda, Nigeria and Zimbabwe? Various scholars focusing on tax policy regard IS taxation as challenging, hence less attention and interest is given to it. They argue that the mismatch between the formidable efforts required taxing the sector versus the paltry revenue realised as the major reason (Joshi and Ayee, 2008). Di John (2009) laments the paucity of literature that provides a clear guide on how to tax the IS, presumably because the sector is heterogeneous. Pimhidzai and Fox (2011) have questioned the logic of taxing the informal sector, querying whether such a move is local economic development or taking from the poor and stifling growth of small firms. Their argument is premised on the view that microenterprises in the informal sector are a major source of livelihoods in developing countries. The researchers argue that policy recommendations pushing for formalisation of the sector in order to increase government revenue through taxes could be misconceived.

A view shared by Rogan (2019) who argues that perhaps for large informal firms, formalisation might be beneficial but on the contrary for smaller firms it might have adverse effects. Using the case of Uganda Pimhidzai and Fox (2011) show that contrary to the widely held misconceptions that view the IS as tax evaders, the IS pays taxes- albeit not to central government but to local governments in the various fee payments. The single-minded focus on tax collection towards the IS, regardless of size or profitability ignores the role played by these enterprises in local economic development (Fox and Pimhidzai, 2011). Proponents for taxation of the sector (McKenzie and Sakho, 2010; Perry et al., 2007; Schneider and Enste, 2013; Torgler and Schneider, 2009), have pointed to potential benefits of increased revenue, growth and governance gains as resultant products of IS taxation.

Rutasitara (2014) questions whether informal sector taxation is a feasible exercise that can be sustainable in the future by these developing country cash strapped governments. Taxing the IS raises equity, efficiency and administrative issues (Dube, 2014). Taxes skew economic judgements as they create welfare loss over and above the revenues collections (Pimhidzai and Fox, 2011). It is therefore indisputable that the question whether IS taxation is indeed a route for widening the tax and thus should a policy priority still adjures for answers.

The question whether informal sector taxation increases revenue collections or destroys the growth of informal firms which is key to economic growth and sustainable development also remains unanswered. An evaluative review of the myriad factor by factor arguments aimed at unpacking this contentious subject is synthesised below.

Informal sector taxation and revenue mobilisation

Di John (2009) portends that domestic revenue mobilisation has not moved with the same strides with the rising public government expenditure. Therefore, there is greater need to take into account what governments should do or know better in order to raise revenue from the IS. Sharing the same view, Ebeke and Ehrhart (2012) assert that the ever ballooning public expenditure needs and budget deficits signal that revenue from the formal sector and foreign aid are not sufficient, making the IS a competing option for expanding domestic revenue. The argument is that the expansion of the non–tax paying IS undermines domestic revenue mobilisation and equity. Moyi and Ronge (2006) concur by pointing out that to enlarge the tax base and enhance equity, it is necessary to bring the IS into the tax net.

As underscored by Bhattacharya and Akbar (2014), steps towards expanding the tax base and enhancing revenue mobilisation should thoughtfully consider taxing the burgeoning IS. Benjamin and Mbaye (2012) assert that, despite the importance of the IS in African economies, it only contributes 3% of overall tax revenue collections. The size and magnitude of the informal sector, implies the need to tax it if developing country governments are to remain afloat and be able to collect enough revenue to finance public expenditure (Munjeyi et al., 2017; Van den Boogaard et al., 2018). De Mel et al. (2013) and Bruhn and McKenzie (2014) adduce that it is unlikely that taxing the informal sector would bring in noteworthy revenues at least in the short and medium term. The researchers observe that formalisation and registering for tax can facilitate opportunities to get credit or funding, offer possibilities to engage with larger firms and government, reduce harassment by police and government officials. In addition, the steps can heighten chances to access to training and support programmes availed to the formal sector. These benefits in the long run will foster increased productivity and improved profits, ultimately resulting in a surge in tax revenues. Fox (2009) and Fox and Pimhidzai (2011) question the taxable capacity of the informal sector in developing country conditions. They point to the measly direct revenue possibilities from the IS. IS activities are characteristically constrained by their small scale operation and hence minimal levels of profits. Since tax revenues, are a product of profits, the lower the profits simply implies diminished tax revenues.

Therefore direct revenue benefits of IS taxation are likely to be relatively modest or comparatively low (Joshi et al., 2014), and implications of equity prospectively adverse (Leoprick, 2009). From a distance, taxation of the IS appears to be a promising source of government revenue considering its size and growing share of GDP (Schneider, 2002; Schneider and Enste, 2013; Buehn and Schneider, 2012). However, in practice, the cost and benefit analysis tells a different story. Individual incomes within the sector are meagre, tax rates correspondingly low, while the costs of collection are substantial owing to the heterogeneity of the firms operating in this sector as well as the large number of individual firms and the difficulty in monitoring them (Ayee, 2007). Bird and Wallace (2003) state that the ease of tax evasion and hiding from other regulations by the IS makes tax collection from this sector on a sustainable basis a pressing task. Consequently, many tax experts are sceptical of whether any meaningful value can be derived from committing significant scarce resources in developing countries on IS taxation, given the inconsequential revenue yields, huge administrative costs and the questionable value of taxing low income individuals (Joshi et al, 2014; Kanbur and Keen, 2014; Keen, 2012). Fox and Pimhidzai (2011) observe that formalisation for tax purposes might not lead to higher revenue generation in some economies as the IS already pays some forms of tax anyway through licence fees and other local authority charges. They argue that the majority of enterprises will remain too small to pay central government taxes such as VAT, even if registered for taxes.

In order for governments in developing countries to reap any meaningful enlarged revenues from this sector, they have to equally invest into it and nurture it. There is a great potential to grow the contribution of the informal sector to revenue mobilisation and economic growth if necessary institutional support is availed to them to foster their productive capacity (Bruhn and Loeprick, 2014; Bruhn and McKenzie, 2014). An enhanced tax base can only become a reality when governments start supporting the productive capabilities of IS activities through innovative formalisation activities that also address the growth constraints faced by the sector (Arosanyin et al., 2009; Gerxhani, 2004). It is argued that Governments of developing countries only want to tax this sector and not invest first in it in order to boost its productivity and profitability and then tax later. Pimhidzai and Fox (2011) suggest that to address the dilemma of informal sector taxation, government policy should thus aim to raise revenues through local economic development rather than pursue the short term strategies that only focus on revenue collection through tax, risking the failure of small firms.

Informal sector taxation, poverty reduction and equity concerns

The contributions by Smith (1776) to economic theory on taxation are still regarded highly in economics and taxation. His propagation of the canons of taxation can be hardly exceeded in clarity and simplicity. The four canons of "Equity, Certainty, Convenience and Economy", are still regarded as yardsticks of a good tax system. IS taxation raises equity concerns. Equity issues have to do with fairness. Horizontal equity is treating people on the same economic level equally for tax purposes and vertical equity is when those at different levels are treated differently (Dube, 2014). Players in the IS are said to have low incomes as well as low profits. Taxation of such firms is tantamount to disproportionately burdening the poor and is potentially regressive (Pimhidzai and Fox, 2011; Rogan, 2019). Fox (2009) argues that the single minded drive towards collecting more tax revenue from the sector could be counterproductive and at the same time worsen the vulnerability of the IS firms and individuals. Opportunities of poverty reduction would be lost in the process and the growth of small firms suppressed. Joshi et al. (2014) suggest that efforts to tax the IS also exacerbate the risk of coercive and corrupt behaviour by tax officials. Arguments have been raised in favour of IS taxation, basing on the fact that if IS players are willing to pay bribes to tax officials and endure the inconvenience of harassment, why not pay taxes and operate freely (Pimhidzai and Fox, 2011; Prichard, 2009).

According to Pimhidzai and Fox (2011), SSA governments as well as the body of knowledge on economic development hold an "ambivalent" perspective towards the IS. The behaviour of the IS players and their role in economic development is often misunderstood, their actual and potential contribution to poverty reduction and provision of employment often overlooked (Biles, 2008; Evans et al., 2006; Fjeldstad et al., 2006; Fox and Pimhidzai, 2011). It is a fact that this sector is an indispensable part of people's means of subsistence on the continent and a major driver for poverty reduction (Wafula Wanyama, 2013). Employment creation and poverty reduction are some of the major macro-economic objectives of government yet this contribution made by the sector to governments' responsibilities are often ignored. From an equity point of view there have been suggestions for almost total exemption of the informal sector from paying direct taxes (Prichard, 2009). Pimhidzai and Fox (2011) contend that non- formal enterprises including those above the tax thresholds pay taxes at local level and their compliance is high. They are an important tax base, but for local governments. It is therefore unfair to view them as tax evaders. Their contribution should be acknowledged and reciprocated in better institutional and tax policy environment if equity can be achieved.

With regards to equity also, taxation of this sector is said to be a step towards ensuring equity. According to Smith (1776), equity is defined as the situation when the subjects of every state contribute towards the support of government as nearly as possible in proportion to their respective abilities. That is in proportion to the revenue which they enjoy under the protection of the state. Basing on the statistics presented by Bhorat et al. (2017) who put the IS sector in African countries between the ranges of 20% for South Africa and above 50% of economic activity for countries such as Lesotho, Liberia, Zimbabwe, Tanzania and Zambia, not taxing such a significant chunk of the economy will equally violate the equity principles. Despite that taxation of the IS would yield little revenue in the short to medium term, it will serve to bring the IS into the tax net in the long term, thus ensuring equity (Joshi et al, 2014; Terkper, 2003; Torgler and Schneider, 2009). The IS would be equally contributing (no matter however negligible the contributions might be) to government coffers in order to finance the public utilities, infrastructure and protection which enables the sector to function and make profits. Formal firms are financing the above through payment of taxes, therefore the troubling question would be, is there equity if the IS players become free riders? The playing field is arguably not level as the firms in the formal sector would have their goods expensive because of the VAT tax fraction yet the informal firms will have their goods affordable less the same fraction. The tax fraction would in turn make the formal goods less competitive hence tilting the scale towards the IS, giving the IS undue competitive advantage over the formal (Torgler, 2005; Rogan, 2019). As a result, the market share of registered operators would be lost due to pricing issues and the registered operator sales reduction would ultimately culminate in reduced VAT collections denying government the much needed revenue.

As observed by Benjamin and Mbaye (2012), systematic studies on the IS in Africa are lacking as some important dimensions are misapprehended and misread. According to these researchers these studies overlook the existence of "large informal firms" with sales and profits that rival those of formal firms yet these operate in ways that are similar to small informal firms. They "appear formal" in all dimensions but do not pay taxes. For these large firms for which formalisation is feasible, regulations and taxation should be systematically applied and enforced. For the smaller ones, improvements in support services and easing of burdensome regulations are in order (Benjamin and Mbaye, 2012; Maloney, 2004). Failure to tax the IS may be viewed by formal firms as unfair and as a breach of the canons of taxation. To exhibit the hallmarks of a sound tax system (equity,

fairness and neutrality), taxation regimes must ensure compliance from both the formal and IS (Mpapale, 2014). Tax burden should not be shifted to the formal sector only when the two sectors benefit from social infrastructure, service provision and related investments funded by taxes collected. Taxing formal employed individuals and not taxing the informally employed ones, creates inequalities and perpetuates tax injustice. Redistributive taxation may be seen as the best alternative to lower the inequality and provide tax justice as well as fairness. IS taxation is therefore not only a matter of revenue mobilisation but also tax justice.

Joshi et al. (2014) portend that formalisation for tax purposes might offer small firms a measure of predictability and protection. The researchers are quick to point out that the power inequities between the state and the IS may equally make the small firms vulnerable to unequal treatment and exploitation by state authorities as they will be now more visible, thus leading to their collapse. Overall potential equity benefits of IS taxation can be pictured, but the pitfalls of such a move are visible too, especially the concerns of disrupting precarious livelihoods, increased vulnerability and stifling growth of small firms as previously argued by Pimhidzai and Fox (2011). Restrictive institutions impose barriers to formality that reduce growth rate of small firms and sometimes impose inequalities. Redistributive taxation lowers inequalities but blunts the incentives to accumulate capital, lowering growth (Davis, 2007). Examined through purely revenue and equity lens, justification for amplifying the base by taxing the IS rests to a greater degree on implicit and incidental connections such as tax compliance gains, growth and governance gains. These potential advantages remain only weakly studied and documented empirically as alluded to by Joshi et al (2014).

Informal sector taxation and growth exposition

Growth is viewed as the major target for businesses and also a fundamental yardstick for businesses and also a fundamental yardstick for business viability as well as a pivotal determinant of wealth creation, employment and economic development (Neneh and Vanzyl, 2014). The insinuations of a broadened tax base for growth of small firms are as prominent to the argument of IS taxation as the immediate revenue implications (Joshi et al., 2013, 2014). Neneh and Vanzyl (2014) and Douglas (2013) explain growth from the entrepreneur's angles as referring to increase in the sales, number of employees, profits, assets, firm value and general internal development. Penrose and Penrose (2009) define growth in the view of geographical expansion, diversification into new products and markets, acquisitions and increase in branches. Irrespective of how growth is defined, along with the growth arguments comes into play the need to cogitate about issues of employment creation and poverty reduction among lower income earners and the unemployed (Pimhidzai and Fox, 2011),long term economic development and the development of a larger tax base over time. The connections between these vital vectors are often misconstrued. The major issue of consideration by tax experts is that, a rise in the tax rates or tax burden could hinder growth, threaten viability of the small firms and push people into poverty ultimately reducing the tax revenue even further. The costs may be far greater than the tax collections in the sector. The argument is instinctively compelling (Keen, 2012; Pimhidzai and Fox, 2011). Borrowing from the literature, the dualist view sees the IS as purely marginal, subsistence and a safety net for the poor (Sabot, 1973), arguing for an empowerment approach before any taxation can be considered (Fox, 2009). In support of the argument against taxing the IS, the notion that informality is actually driven by the burdensome regulations and bureaucracies of regulatory authorities takes centre stage. Informal firms are informal because they are trying to survive by cutting loose the suffocating burdens of formality (exiting) as proposed by the legalist/exit view. However, despite these cogent arguments, a growing body of research knowledge expostulates otherwise, proclaiming that, formalisation, which entails being captured into the tax net as the central component may bring about significant growth gains contrary to hindering growth.

While informality helps firms avoid certain costs, it also comes with a variety of costs for example, it precludes access to certain opportunities available to formal firms, including greater access to credit and financing. Benefits such as increased opportunities to engage with large formal firms, access to government contracts, reduced harassment by government officials and municipal officers and access to training and other support programmes might be lost (Prichard, 2009). Formalisation alone will not yield any purposeful perquisites to attract the IS. Therefore developing country governments have to partner SME organisations through stakeholder consultations as well as show palpable benefits from formalisation.

Informal firms are often viewed as “parasites”. This school of thought considers informal firms as a threat to formal firms and as a stumbling block to economic growth. Impediments to growth are viewed from two angles: firstly, the small scale nature of informal operations leads to inefficient and uneconomic production coupled with the incentive to remain in the “shadows” to avoid detection by public authorities (Ordóñez, 2014; Woodruff, 2013). As a result the inability to fund technological changes and capital expenditure confines

informal firms to an “informality low productivity trap” which adversely affect the overall productivity growth of a country (Kenyon and Kapaz, 2005). Low revenues from the IS may lead to over taxing the formal firms hence fuelling more informality and tax evasion. La Porta and Shleifer (2014), table that the lower productivity has nothing to do with formality but has a lot to do with the proportionately small size, poor education levels, scarcity of economies of scale and shortage of avenues to export which characterise the IS. Secondly, tax evasion and regulatory non-compliance enjoyed by the informal firms allows them to impinge on the market share of their formal counterparts. The unfair competition that the formal firms are subjected to reduces their incentive to invest, expand and improve productivity. This line of thought might hold water for larger informal firms competing with comparable formal firms with like incomes and characteristics (Benjamin and Mbaye, 2012; Dube and Casale, 2016); otherwise, La Porta and Shleifer (2014) contradict the argument, adducing that informal firms are too inefficacious and non-identical to formal ones to constitute a possible challenge to the formal firms. Interestingly, Perry et al (2007) submit that informal firms are cognisant of their inhibitions with regards to scale, capital, skills and distribution channels; thus, they tend to ply sectors where they operate efficiently on a limited scale. The reasoning is why not find a means of taxing them without forcing them to formalise and risk asphyxiating them. There is need to support them rather than view them as harmful to the existence of formal firms.

Despite the fact that the IS plays an predominant role by significantly contributing to employment and output in developing countries, in addition to providing a livelihood for millions, there are mixed views on its impact on whether it enhances economic growth (Fourie, 2018). On the contrary, it may obstruct and slow economic growth. Proponents for this view propose the need for stronger fiscal and regulatory enforcements, while opponents to the view argue that firm level surveys do not find enough evidence to support the suffocating of economic growth logic (Fajnzylber et al., 2009; Maloney, 2004). Opponents to the argument suggest that the provision of low cost goods and services to the public can be reckoned as enhancing household savings which ultimately results in physical and human capital accumulations. Positive implications for growth may follow (Fajnzylber et al., 2009; Fox and Pimhidzai, 2011). Maybe results mask variations across countries and firms or they depend on the institutional and regulatory variations across nations. This could be evident as argued by Munjeyi (2017) citing Gurtoo (2009) who attribute the divergent perspectives to developing and developed country context where the informal sector is adjudged differently. Developed countries perceive the sector as a “resource” to be harnessed, supported and nurtured through policy prescriptions in order to graduate into the formal sector. On the contrary for developing countries it is viewed as an evil to be extinguished yet it remains a fact that this sector contributes immensely to employment creation and poverty alleviation efforts (World Bank, 2011).

According to Mpapale (2014) and the IEA’s Budget Focus (2011), tax reforms are by no means strategies aimed at stifling growth or suffocating the very existence of informal firms, but reforms targeted at unlocking the ultimate potential of the sector, create new avenues for the poor to realise their potential and raise national competitiveness. These differing frames of reference open room for more debate especially on the causal relationship between formalisation, firm growth, profitability, taxation and firm survival. Another area of interest is the question, why is it that, despite these supposed benefits the informal sector is rapidly growing in developing countries and Zimbabwe in particular? Could it be because these costs and benefits vary across firms and across countries or is it a question of the legal, political and regulatory environments that are disparate across countries? Could it be the tax rates are too high and stifle the growth of small firms forcing them to operate informally to evade them?

Empirical findings on formalisation for tax purposes, taxation and growth

A variety of studies have explored the causal relationship between formalisation and growth with varying conclusions. Fajnzylber et al. (2009) provide evidence that in Mexico formalisation in the form of access to credit, training, tax payments and participation in business associations had positive effects on firm growth, survival and profits. De Mel et al. (2013) exhibit benefits that have to do largely with greater legitimacy and freedom of operation by informal firm owners in Sri Lanka as by-products of formalisation. The researchers found significant growth benefits for a small group of firms, while most firm incomes were largely unaffected. In Bolivia, McKenzie and Sakho (2010) conclude that formalisation, especially registration with tax authorities increase firm profitability, but only for medium enterprises. In Uganda, Pimhidzai and Fox (2011) come to the conclusion that, any tax increases or additional taxes will hurt smaller firms and increase their risk of failure. Analogously, Ocheni and Gemade (2015) pronounce the negative impact of multiplicity of taxes on the survival of SMEs noting that the size of the firm also has an impact on its propensity to honour its tax obligations. The smaller the firm, the higher the risk of failure to pay taxes and the risk of failure. This would increase the vulnerability of households surviving through

the IS (basically killing the goose that lays the egg). The increased risk of failure would see the same strategy aimed at growing small firms and increasing the prospects of tax revenues, resulting in their failure and reduced revenues respectively. The prominent argument coming out here is that growth benefits indeed exist but they are meagre for small firms. McCulloch and Grover (2010) point that in Indonesia, the impact of formalisation for tax purposes was heterogeneous across firms, with medium sized ones gaining remarkable profits increase and the small firms indeed citing exposure and pronounced harassment from tax officials. De Mel et al. (2009) argue that the benefits of formalisation though real are too sketchy to convince firms to formalise. They are not appreciable enough or exclusive enough to argue a case towards formalisation as concurred by Bruhn and McKenzie (2014). While studying how tax incentives influence SME growth in Rwanda, Twesige and Gasheja (2019), concluded that that there is a strong positive relationship between tax incentives and firm growth in SMEs. Notable from the different findings is that probably the impact of informal sector taxation on the growth of informal firms is heterogeneous across firm types and nations.

The inconsistencies in findings might be because preferences differ for small and larger informal firms. The latter might be operated by individuals who are still job hunting or just operating them to supplement employment income. These might not have a motivation for formalising and deem it an unnecessary costly exercise (Bruhn, 2013; Maloney, 2004). Fajnzylber et al. (2009) state that the dynamics of “inclusion or exclusion” might privilege other firms while disadvantaging some. Literature evidence has produced controversial and contradictory findings, while broader economic gains seem plausible, whether small firms are likely to benefit still remains haze. Equally uncertain is the best strategy to tax the informal sector firms without compromising their economic survival. Solutions to the challenges of IS taxation and its impact to economic growth will differ across nations and should be tailored to fit the local context (Heggstad et al., 2011). Conclusively, it is imperative to recognise that the actual benefits of improved profits, predictability, access to credit and training and support are likely to vary across firms and across countries. This is because power relations and political networks that link the state and individual firms dissimilar across nations and also vary in particular contexts.

Impact of IS on tax compliance

Compliance is perception based, linked to expectations and attitudes ordered differently by taxpayers. It depends on how taxpayers judge fairness, trust in political situations, governance, institutional quality and delivery of public services, together these influence tax morale (Martinez-Vazquez and Bird, 2014; Torgler and Schneider, 2009). Despite the tax revenue potential of the IS being small, equity and growth benefits being questionable, it is highly possible that IS taxation might ensure high tax compliance overtime. Paying little or no attention towards IS activities lowers tax morale and increases the risk of non- compliance in the formal firms (Ayee, 2007; Joshi and Ayee, 2008; Terkper, 2003; Joshi et al., 2014). More simply, it is a matter of establishing tax compliance among the firms in IS. According to Joshi et al. (2014), the moment tax is viewed as a source of unfairness; this will lower the morale and reduce tax compliance among formal firms leading to a reduction in government revenues. Several researchers share this view and document this by providing evidence that tax morale is lower in countries with a large IS (Benjamin and Mbaye, 2012; De Paula and Scheinkman, 2011; Torgler and Schneider, 2009). Mutsapha et al. (2015), while studying tax compliance in Nigeria, concluded that fairness has an impact on tax compliance. Perry et al. (2007) provide extensive evidence that failure to tax the IS builds up a “pervasive culture of noncompliance” where large informal firms use “fixers” to manage their relationship with the state for a fee ensuring these firms do not pay taxes but remain camouflaged from tax authorities. In Latin America, evidence pointed to the fact that tax compliance is inversely related to the size of the IS (Perry et al., 2007). In Tanzania, Rutasitara (2014) found out that the reason why people work informally is because they want to avoid taxation and other regulatory costs. In West Africa, Benjamin and Mbaye (2012) document the presence of large firms which are “formal” in all dimensions (registered, have a fixed location and are able to access financing in the form of bank loans) but do not pay taxes. This has negative impacts on tax compliance. In Uganda, Pimhidzai and Fox (2011) found no evidence on whether the size or persistence of informal sector has an impact on tax compliance or drives tax evasion. These connections remain largely unexplored.

The impact of taxation on the survival and growth of small firms/informal firms

IS growth is curtailed by a myriad of challenges such as lack of technology, poor managerial skills, inadequate financial resources to fund expansion, capital constraints, low productivity and above all unfavourable taxation policies that are argued to compromise the growth of these small firms (Ocheni and Gemade, 2015). Alluding to the performance of presumptive taxes in Zimbabwe,

Mangwana (2016) expressed that “very few fiscal benefits have been received by the government of Zimbabwe from the current SMEs because many do not pay taxes. Those that pay taxes are not happy as they find ZIMRA to be a big boulder on their necks pushing them under water”. The presumed nature of presumptive taxes or basing on assumed baseline results in a mismatch of the fixed presumptive tax amounts and incomes; hence this is seen as retrogressive and suffocating to small firms. Taxation has continually been cited as a major constraint to the survival and expansion of small businesses. High SMEs’ mortality rates have been attributed to tax matters, ranging from the huge tax burden to the multiplicity of taxes. Tax policy greatly impacts on the business fraternity. The more supportive and progressive the tax laws, the higher the opportunities of breeding stable and expanding businesses. This in turn steers economic growth. There is an interdependent relationship between business growth, survival and tax policy (Atawadi and Ojeka, 2012b; Ocheni and Gemade, 2015). Taxation is a vital tool for government to exploit for development, government funding, control the supply of money in the economy and resource distribution. On the one hand government seeks to broaden the tax base by incorporating the IS into the tax, yet on the other this same move increases the financial burden for the small firms.

According to Atawadi and Ojeka (2012b), the size and nature of small firms distinguish them from formal ones, therefore policy makers especially with regards to tax policy need to pay close attention to this distinction. These small firms are often viewed as minute and contributing very little in terms of both economic growth and tax revenues, but their great potential is overlooked. Tax policy should carefully consider a balance between the need for survival and the need to collect tax income, hence to tax and still “leave” adequate profits to foster business expansion. Charema (2014) submits that high levels of tax rates, penalties and the rigid licensing requirements were a huge stumbling block hindering SMEs growth in Zimbabwe. Tax policy should be aimed at minimising tax evasion and fostering compliance without leaving the taxpayer worse off (economy principle). These arguments call for the evaluation of the relationship between tax policy and the growth of small firms. Shahrodi (2010) suggests that for tax policy to be able to achieve its objective of maximising tax revenues without crippling the activities of small firms, it must be effective. The researcher expostulates that an efficient and effective tax system is one with appropriate and logical tax rates, easy to administer, has lower exemption amounts, is not overly burdensome to taxpayers and above all strengthens efforts to curb corruption and tax evasion.

According to Ocheni and Gemade (2015), developing countries should actually come up with favourable tax policies that aid the growth of small firms. Tax policy must be enabling with provisions such as tax holidays and exemptions. The researchers give references to SME tax policies in China which they argue have been crafted to be favourable to SMEs, encouraging their financing by granting tax exemptions from business tax for financial corporations that provide guarantee for loans to SMEs. The tax policy in China also award tax deductions to the tune of 70% of the investment amount to market entities and venture capitalists that invest in high tech SMEs (Ocheni and Gemade, 2015).

A positive relationship between taxation and economic development has been alluded to (Twesige, Gasheja, and Barayendema, 2020), yet on the other hand, studies point to the negative relationship between payment of taxes and survival and growth of informal businesses (Evans, Hansford, Hasseldine, Lignier, Smulders, and Vaillancourt, 2014; Adebisi and Gbegi, 2013). Those that point to a favourable relationship argue that as SMEs take advantage of tax incentives, it reduces their tax liability and in the process frees funds for expansion and growth (Feyitimi et al., 2016; Twesige and Gasheja, 2019). Problems brought by taxation for example complexity of tax laws, high rates of tax, multiple taxes and dearth in tax education and awareness have compounded the negative relationship (Ocheni and Gemade, 2015; Ojeka, 2011). Affirming this concern, Ocheni and Gemade discussing the impact of multiplicity of taxes in Nigeria describe multiple taxes as a “worm that eats deeply on the large chunk of revenues generated by SMEs for their growth and survival”. Multiplicity of taxes impedes the survival and growth of small businesses. Discussing the negative impact of taxes on SME growth, Machira (2007) advances that tax policy has unfavourable influence on the viability of the sector, as it reduces sales, capital, profits and employment levels. Atawadi and Ojeka (2012a) propose simplification of informal sector taxation frameworks, filing of returns and tax payment procedures in order to reduce compliance costs. They also recommend that developing countries must deal with multiple taxes on one income challenge, increase tax education and training for taxpayers to appreciate the incomes, deductions, exemptions and incentives they are eligible for if they register for tax purposes.

Omare and Erickson (2015) present the inability to purchase assets after committing the bulky of the resources to tax payments as a major hindrance to small business expansion, yet asset accumulation is an imperative measure firm growth and performance. Masato (2009) points out that an overly complicated tax system or “opaque administration” breeds undue burden on its taxpayers, especially informal firms and this distorts economic decisions made by these taxpayers. This has

a distortionary impact on the development of these firms. Farzbod (2000) suggests that a poorly administered tax framework brings inefficiencies, increased collection costs, non-optimal allocation of resources and ultimately results in lower tax revenues. Reiterating the above concerns, Mungaya et al. (2012) opine that tax payments constitute a tax cash outflow, resulting in the reduction in the purchasing power of a company as more cash is channelled to the tax obligations instead of using it for business expansion efforts. Empirical evidence points to a negative relationship between payment of taxes, the costs of compliance and growth of small firms. Giving evidence of the negative impact of taxation, Tee et al. (2016) establish that taxation has an adverse impact on growth of SMEs and recommended the need for tax policy review and its alignment to the growth needs of SMEs. Resources committed to tax compliance could otherwise have been channelled to investment, reinvestment as well growth opportunities (Ocheni and Gemade, 2015; Tomlin, 2008). Observing a disproportionate burden as a result of tax compliance costs, Tomlin (2008) opines that the costs of complying with taxes for smaller firms are comparatively higher than those of larger formal firms. Ojeka (2011) further suggests a reduction in taxes and improved revenue authorities support services through tax education, training and awareness programs. Ocheni and Gemade (2015) posit the need for developing country governments to come with tax initiatives such as tax rebate for SMEs that locally acquire their inputs, add value to commodities and those that export. Ameyaw et al. (2016) submit that tax policy reforms should be aimed at bringing an alignment of the incomes made by SMEs to their tax obligations.

Holban (2007) interestingly views the negative impact of taxes on informal firms from the tax planning angle, bringing to light that informal firms may fail to leverage on tax planning advantages to avoid taxes or minimise their liability within the confines of the law due to lack of tax knowledge or professional expertise. Therefore when confronted by multiple taxes as well as high tax rates, the failure to exploit this key vector affects the growth and survival of small firms. Ocheni and Gemade (2015), exhibit a negative impact of taxation on the survival of SMEs, using ANOVA analysis and Ebere et al. (2016) affirm the negative impact of taxes on profitability, turnover and liquidity, ultimately affecting survival and growth. According to Atawadi and Ojeka (2012b), taxes impact on a business' propensity to survive and enlarge its operations. The researchers point to a negative correlation between tax and the small business's propensity to grow and even augment its activities. Higher tax rates swallow funds earmarked for business growth and lack of investment funds results in curtailed business expansion. On the other hand lower taxes allow for higher retained earnings and working capital resources to sustain a business' going concern ability (Atawadi and Ojeka, 2012b). Affirming the negative impact of taxes, (Engelschalk, 2007; Engelschalk and Loeprick, 2016), notes that taxes reduced the rate at which the rate of growing for small firms as most businesses choose to forego their contemplated capital budgeting projects because after evaluation they find the possible after tax gain not worth the risk of undertaking the projects. Liu (2011) expresses that tax payments led to a reduction in working capital and deferring tax payments to reserve money to finance working capital results in accumulated tax debt and penalties that eventually makes it harder for small firms to survive leading closures or collapse (Nanthuru et al., 2018). To enhance the growth of small firms, tax policy has to be apt and not a hindrance to the growth of small firms.

In addition to the tax rates and penalties discussed above constituting significant outflows that affect the survival, profitability and growth of the business, compliance costs are another issue that cannot be ignored. Due the complexity of most developing country systems the informal sector is often faced with huge compliance burdens. Compliance costs refer to expenditure incurred in adhering to government regulations and tax legislation. These include planning, costs for keeping accounting records, preparation of returns, filing of returns and paying of taxes. These compliance costs come in the form of monetary costs (payment to tax professional, accountants and experts who help with tax matters or even expenses on tax legislation material such as books and study guides) and time costs (time dedicated to record keeping, preparation of tax returns or dealing with tax professionals and tax authorities. They also include psychological costs such as anxiety, harassment by tax authorities and dealing with the demands for bribes (Sandford et al., 1989). These compliance costs, along with the fines and penalties as well as the potential risks of being inspected and extortionist demands of revenue authority officers and politicians often demotivated companies from wanting to grow and instead encourages them to hide from tax authorities as much as possible (Meagher, 2018; Sebele-Mpofu and Msipa, 2011). These costs in a way diminish competiveness of businesses and even the attractiveness of the country's investment climate.

RESEARCH METHODOLOGY

The study employed a pragmatic research philosophy and used a mixed method research (MMR) design that was dominant qualitative. The study adopted a sequential exploratory mixed method research design combining qualitative (literature review, document analysis and semi structured interviews) and quantitative research approaches (questionnaires). MMR designs are

increasingly being articulated in tax research (Mckerchar, 2008), though researchers need to be careful of three things as advanced by Creswell (2016). These are: establishing when the MMR design choice is appropriate, anticipating the challenges linked to MMR and to critically assess its appropriateness (weight, sequence and integration). Sequential exploratory MMR designs are argued to be suitable for probing understudied research areas as in these areas it is difficult to identify what to measure, how to measure it, what variables or concepts to focus on or apply as well as what questions to ask (Creswell et al., 2009). In this case qualitative approach is employed in the first stage to inform the second stage quantitative part to gain a complete comprehension of the subject under study by combining the two approaches, together with integrating the results. Such is the case with IS taxation which is argued to be an under-researched phenomenon in developing countries and in Zimbabwe, with minimal available literature (Ligomeka, 2019; Maina 2014, 2017; Sebele-Mpofu, 2020). Creswell and Clark (2018) recommend the use of MMR for researching on understudied subject areas. The researchers state that the results of the initial qualitative first can be used to deduce variables and themes that can be further investigated on a much larger sample using questionnaires crafted from these results and enhanced by findings from literature review. MMR is also ideal when one wants to ensure generalisability of the study to a wider population and in circumstances where the phenomenon under study is complex. Therefore tapping into different constructs from different research approaches builds a more complementary picture as combining the two approaches permits the use of results from one approach or method to corroborate, supplement and give a context of the results (Creswell et al., 2009; Zohrabi, 2013). Taxation in general is a complex and sensitive phenomenon, with IS taxation even more complicated, hence the pragmatic philosophy through the application of the MMR approach was found to be more relevant to evaluate IS taxation. The MMR was such that it was first phase, qualitative and second phase quantitative as shown in Figure 1.

Semi structured interviews were held with 10 tax experts selected through purposive sampling using their tax expertise and experience (20 years or more) as the guiding criteria and these were identified through Institute of Certified Tax Accountants, Zimbabwe (ICTAZ) and 10 ZIMRA tax officers (from small claims office dealing with smaller taxpayers like the IS) as well 5 members of informal sector associations. The tax expert interviewees were made up of tax directors in accounting firms, tax consultants and advisers running their own consultants as well as members of tax departments in accounting firms. These were from Harare and Bulawayo. ZIMRA officers were selected from the small claims office that deals with taxation of small businesses and those from the audit section. These were sampled through snowballing from ZIMRA offices across Zimbabwe. The IS association members were selected from the transport associations, informal traders associations and cross-border traders associations in Bulawayo. The interviews sought to understand the IS taxation framework and how it impacts on tax base expansion, revenues mobilisation and growth. The interviews were carried out between 2019 and 2020. The three groups were targeted for the relevance to the study. The tax experts have information that is appropriate in evaluating IS taxation in relation to the main research question from their experience in interacting with both ZIMRA and the IS. The revenue officers on the other hand being tax administrators could help in assessing whether there is tax base expansion, its further destruction of the impediment of the growth and survival of small firms. The informal association members on the other hand would be very vital in expressing the views of the taxpayers from their lived experiences, thus practical appraising the IS tax system from what they have seen and experienced. The interviews were pivotal for the preliminary qualitative phase of the MMR adopted by the study. Interviews are allowed for deeper exploration and probing on issues thus giving a complete picture of a phenomenon (McKerchar, 2008). These interviews held were viewed as adequate as between 3-10 interviewees are argued to be good enough in qualitative research as suggested by Creswell (2014). The findings from the qualitative analysis were used to develop the questionnaire instrument. The questionnaires were then distributed to a larger population with 73 target respondents (64 actual responded) drawn from the different categories of IS operators who are targeted for tax purposes as given in the Income Tax Act (ITA) and the ZIMRA extract in Table 1 and 2. Table 3 gives a snapshot of the questionnaire respondents and interviewees for the study. The respondents were drawn from the IS in Bulawayo. These were identified through referrals and with the help of members of the different ARE associations interviewed. This was because people are generally apprehensive of tax researchers so it would have been difficult to get the respondents to co-operate. The questionnaire respondents and interviewees' educational qualifications are presented in Table 4. The qualifications were important for informed consent as well as for the reliability of findings.

Data validity, reliability and ethical considerations

The interview guides and questionnaires were given to a tax expert who was a Tax Director in an Accounting firm to assess the relevance of the instruments, point out areas of ambiguity to be addressed and to advise on the appropriateness of the questions. After effecting the expert's suggestions the instruments were piloted on a small group of the target population and further refined. The questionnaires refinement was also refined with reference to the tape recordings and transcribed interviews as well as NVIVO outputs. The methodological triangulation enhances research validity and credibility of findings (Zohrabi, 2013:259). Member check was also used to enhance the validity of findings. Interview transcripts were sent to some interviewees to confirm the discussions were properly transcribed and to add clarifications where they were misunderstood. In terms of ethical considerations, informed consent was sought and granted by all participants. Of importance to note is that all ZIMRA officers are bound by the oath of confidentiality, hence before undertaking the research the researcher sought authority and approval from ZIMRA, this was accordingly granted through a written approval letter. This approval letter was produced in arranging for interviews with the ZIMRA officers. The privacy and confidential of respondents was respected all identifying data coded and securely kept throughout the research process.

Accordingly the participants were made aware that the anticipated benefits of the research were to accrue to policy making and improvements that would have an impact on the IS, the government and economy at large. Informed consent was then sought to tape record the interviews. All interviews granted the researcher permission to record the interviewees except for three ZIMRA officers who only granted consent to participate in the study without being tape-recorded. The researcher had to take notes during the interviews. In order to maintain anonymity of the respondents during data analysis and discussion, the participants were given code names. ZIMRA officers were coded ZIMRAOs, Informal Sector Association members were described as ISAMs and Tax Experts as TEXs. The questionnaires collected from the IS operators were analysed through SPSS.

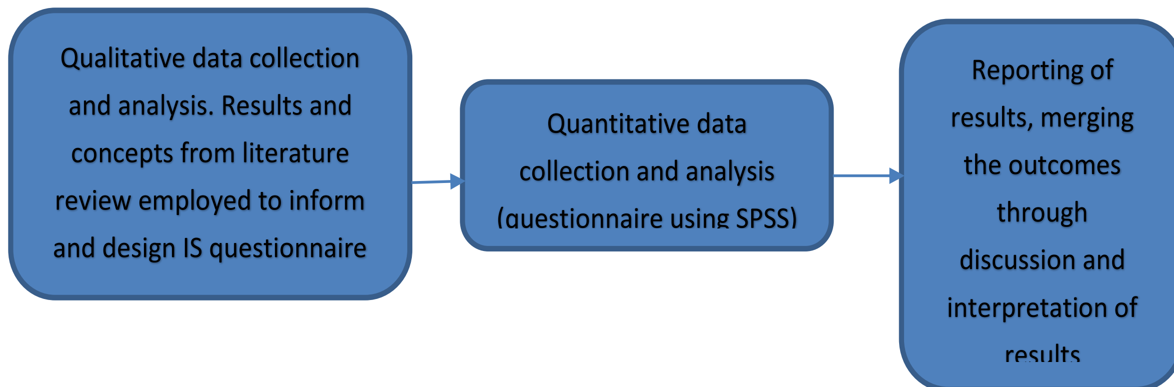

Figure 1. Sequential exploratory MMR.
Own Compilation from Creswell and Clark (2018).

Table 1. Transport operators presumptive tax rates.

Operators of:	Description	Presumptive Tax (US$/ quarter for each vehicle)	Presumptive (US$/month with effect from 1/1/2017
Omnibuses	8 to 14 passengers	150	40
	15 to 24 passengers	175	45
	25 to 36 passengers	300	70
	37 passengers and above	450	100
Taxi-cabs	All	100	25
Driving schools	Class 4 vehicles	500	100
	Class 1 and 2 vehicles	600	130
Goods vehicles	More than 10 tonnes but less than 20 tonnes	1000	200
	More than 20 tonnes	2500	500
	10 tonnes or less but with combination of truck and trailers of more than 15 but less than 20 tonnes	2500	500

Source: Zimbabwe Revenue Authority (ZIMRA) (2018).

Table 2. Other presumptive tax rates.

Category	Presumptive tax
Hairdressing salon operators	US$10.00 per chair per month.
Informal traders	10% of Rental
Cross border trader	10% of the value for duty purposes (VDP)
Operators of restaurants or bottle-stores	US$70 per month
Cottage industry operators	US$70 per month

Source: ZIMRA (2018).

Data analysis

Data analysis of the exploratory qualitative interviews was done through the use of NVIVO 12. The data was analysed through the use of themes and the transcripts were analysed until saturation was reached; this being the point where no new themes, codes and information emerged from the data (Fusch and Ness, 2015; Guest, Namey and Chen, 2020). The deducing themes were used to

Table 3. Summary of respondents and interviewees.

Target	IS Category	Questionnaire responses		Interviews held
		Target	Actual	
1. ZIMRA officers				10
Tax exports				10
Informal sector association members				8
2. Informal sector	Transport Operators:			
	•Minibuses	8	7	
	•Taxis	10	8	
	•Driving Schools	10	9	
	2.Hairdressing and salon operators	15	13	
	3.Operators of restaurants or bottle stores	10	8	
	4. Cross border traders and informal traders	10	9	
	5.Cottage Industries	10	10	
Total/ Overall		**73**	**64**	**28**

Source: Primary Data.

Table 4. Educational Qualifications of Informal sector participants.

Instrument	Group	None	O Level	A Level	Diploma	Degrees	Total
Questionnaires	IS	3	10	14	20	17	64
Interviewees	Tax experts	-				10	10
	ZIMRA officers				2	8	10
	IS association members			2	4	2	8

Source: Primary data.

design the questionnaire for the IS and the modelling of a conceptual framework. The codes generated from NVIVO were used to construct the statements that were used to elicit the responses such as 'agree' and 'disagree' on the questionnaire. The data collected through questionnaires was analysed through the use of SPSS. Data was presented in narrative form, word search queries (qualitative findings) and tables and graphs (quantitative results). The discussion of findings integrated both qualitative and quantitative results to enjoy the confirmatory, diversity and elaboration advantages of MMR.

FINDINGS AND DISCUSSION

The study found out that Zimbabwe adopted a fixed presumptive tax system whereby various informal taxpayers were grouped into stratas and different quarterly fixed presumptive tax rates levied as shown in Table 1 and 2. It was also evident from participants that they considered that increasing government revenues through more tax collections as the major reason behind the implementation of the presumptive tax policy. Despite taxation being administered with several objectives such as to reduce market externalities, help government and citizens engage, stimulate economic growth and support the growth of firms, participants highlighted that these were not prioritised by government (the majority of IS associations members and tax experts). The study found out that creating a conducive environment for the survival and growth of SMEs through inclusive tax policy at the same time compelling tax compliance was an arduous task facing many nations especially Zimbabwe. The informal sector was described by the majority of participants as a fountainhead for economic entrepreneurship, economic growth, modernisation, competition and employment creation hence the need to try and balance the revenue collection needs and the importance of this sector in the economy. The key findings were explicated in detail below.

Table 5. Contribution of informal sector to total national tax revenues.

Year	2011	2012	2013	2014	2015	2016	2017	2018
Other Taxes (including presumptive tax)	3%	4%	6%	2%	1%	1.7%	2%	1.37%

Source: ZIMRA Revenue Performance Reports (2011 -2018) and Sebele-Mpofu and Msipa (2011).

Design of presumptive tax systems

It was established from literature and from the findings that Zimbabwe used a fixed presumptive tax system. The structure of the presumptive tax framework was presented in Table 1 and 2 in the literature review section. According to the ZIMRA officers and Tax Experts, the tax rates were designed based on a study done in the early 2000s on the transport sector and that no further study was done. There was consensus among the IS associations members, ZIMRA officers and Tax Experts that the tax rates were not considering the actual profitability of these operators, thus being advantageous to those who were more profitable and unfair to those whose incomes could not sustain the tax rates. This resonates with arguments by Machemedze et al. (2018) and Dube (2014) who called for the need to consider the ability to pay principle.

Perceptions on the impact of IS taxation on revenue generation, survival and growth of small firms

Low tax revenue contributions from the sector

The revenue mobilised from the sector in comparison to its magnitude in terms of economic activity and more than 60% of the GDP in Zimbabwe as suggested by Medina and Schneider (2018) was found to be relatively minimal. According to Sebele-Mpofu and Msipa (2011), "If GDP contribution could be translated into revenue contribution, largely through tax compliance, the government would witness a significant revenue appreciation". Information from the ZIMRA reports and Sebele-Mpofu and Msipa (2011) show that the sector's contribution to total national tax revenues. ZIMRA officers explained the fact that the effort and costs associated with tracing players in the IS to tax them is not commensurate with the little revenues collected, hence they concentrate on the easy to tax formal sector which yields worthwhile tax revenues. ZIMRAO1 argues that *"the informal sector is difficult to capture in the tax net, they are too mobile and can easily hide from tax authorities, sometimes looking at the cost and a benefit assessment it is not sensible to commit our small resources and time chasing the elusive players*". This appears to be placing the burden unfairly on the formal sector. TEX1 expressed a contradictory opinion on the low tax revenues pointing out that *"the general feeling among tax officials is that the informal sector evades tax, but I don't think this is wholly correct. The incomes in the sector are just very low to collect any substantial taxes"*. The two opinions may possibly explain the low tax revenue collections displayed in Table 5. The views also resonates with submissions by Cheeseman and Griffiths (2005) who advance that the scope for realising significant tax revenue increases by taxing the IS in the short term is less likely due to the high levels of poverty and the elusiveness of the IS.

An obvious irregularity in these Revenue Performance figures is the miniature share of "Other Taxes" (including presumptive tax) to the overall taxes. There is no proportion indicatively linked to presumptive tax in the presentations as extracted from ZIMRA reports, it is aggregated under other taxes. This demonstrates the fact that due to the inconsequential nature of the contribution, ZIMRA saw it fit to group it with other taxes. TEX2 asseverated that the fact that the presumptive taxes are lumped together with other taxes might possibly suggest the little attention that tax authorities attach to presumptive tax administration due to the likely high costs of collections for low tax revenues. Tax authorities tend to pay more attention to the large taxpayers, who are few, organised and easy to tax and yield substantial tax revenues. This was considered to be unfair on the formal sector and the few informal operators that are tax compliant lowered. TEX5 avowed that *"this lack of prioritisation of the informal for tax purpose diminished tax morale among those who religiously pay their tax obligation. It is indeed seen as a source of unfairness and unequal treatment*". The minute tax revenues collected as displayed in Table 5 could be connected to the fact that the IS operators make low incomes or that the majority of them are not registered for tax purposes as shown in Figure 2.

Reasons for registering/not registering for tax purposes

The researcher further explored the reasons for registering and those for registering for tax who were registered and not registered respectively. For those who

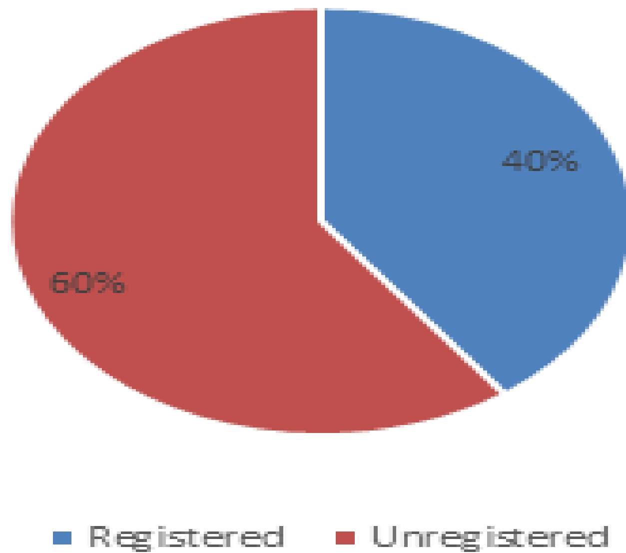

Figure 2. Registration Status of IS businesses sampled.
Source: Own Compilation

Table 6. Justifications for not registering for presumptive tax.

Justification	Strongly agree (%)	Agree (%)	Strongly disagree (%)	Disagree (%)	Not sure (%)
Small scale operation and low incomes	31	69	-	-	-
Heavy tax compliance costs	75	22	-	-	3
Burdensome formal regulations	81	8	-	11	-
High tax rates and penalties	92	8	-	-	-
Poor government service delivery	81	16	3	-	-
Complexity of the tax system	60	10	-	20	10
High handedness of tax officials	69	21	-	-	10

Source: Own Compilation.

were registered, the reasons offered include: access to government tenders and trading with large formal companies who ask for tax clearance certificates, access to financing and government tenders, fear of penalties and garnishes, fulfilling a moral obligation and religiosity. The reasons proffered by the registered informal operators were also echoed during the discussions by participants from the three interviewee groups as some of the benefits that ultimately contributed to the growth of informal firms. The benefits were noted as access to finance and government tenders as well as trading with big companies which leads to the growth of the turnover base and profits. The sentiments were mixed on these advantages. Very few firms were said to have been able access funding from the banks. According to TEX6 the general feeling shows the loss of confidence on the Zimbabwe bank sector by not only the IS but the formal one as well, due to policy inconsistencies, erratic currency and monetary policy changes. For those that were not registered, the reasons that were given were as follows: low incomes and small scale nature of the operations, excessive compliance burden and formal regulations, high tax rates and penalties, unhappiness with service delivery, complicated tax system as well as the high. The responses were presented in Table 6. High tax rates and penalties were the highly ranked, with all respondents agreeing to them as a rationale (92% strongly agreed and 8% agreed). 81% strongly concurred on burdensome formal regulations and poor service delivery. Results for other factors are as presented in Table 6. The prominence of the high tax rates and penalties was also pointed out by the majority of tax

experts and ISAMs during interviews. They linked the burdensome nature of tax to the high failure rates of informal businesses. Similarly literature alluded to this pervasive impact (Atawadi and Ojeka, 2012a; Ojeka, 2011, Ocheni and Gemade, 2015).

Relationship between business growth, survival and tax policy

There were mixed perception on the relationship between tax payment and growth and survival of small firms. Others pointed to a positive impact and the majority of participants referred to negative ramifications. Taxation of the IS was found to negatively affect the operations of informal firms. Overly onerous tax regimes abrade the profitability of IS firms, compounding the failure rates and essentially reducing tax yields. According to ISAM2 *"most of our members own small and medium enterprise, the majority of these enterprises cannot afford to pay tax and survive. Several of them have collapsed due to taxes and garnishees from ZIMRA"*. 80% of the tax expert participants argued that tax rates and tax policy have an undesirable impact on the growth of firms. The majority of IS association members suggested that tax is a cost that eats into profits so in most cases small firms are forced to either increase the costs of their products or reduce the number of employees in order to reserve cash flows to pay taxes. The former strategy makes IS business products pricey and less competitive reducing their sales, paralysing their survival and the after effects are reduced tax revenues. The view was also shared by TEX5 who expressed that *"competition is very stiff in the IS and among SMEs because of ease of entry and exit in the market, so any increases in the prices to take care of the tax component will lead to a loss of customers"*; the latter leads to loss of employment and compromising poverty alleviation efforts. Similar findings were tabled by Ojeka (2011) in Nigeria where he established a negative relationship between SMEs growth and Tax policy. The other 20% of tax experts (TEX 6 and 7), proclaimed that some of the informal firms were now able to tender for government contracts and trade with big companies due to the visibility brought about by tax registration and them holding valid tax clearances certificates which are often a pre-requisite.

They also suggested that those SME who registered for tax purposes could now access financing in the form of loans from the banks as their properly kept books of accounts could show the viability and performance of their businesses. ISA members on the contrary argued that the demand for collateral still made access to financing difficult even for taxpaying SMEs. The ISA members further expressed that even government support in the form of services, work spaces and funding was still inaccessible even for the tax compliant small firms. Similar concerns were expressed by Pimhidzai and Fox, 2011 in Uganda and Meagher (2018) in Nigeria. ZIMRAO 6, 8, 9 and 10 despite agreeing that tax rates are high in relation to incomes earned by the IS and that the fixed presumptive tax system was not ideal, they officers contended that it was rather unfair to solely attribute the collapse of IS firms to tax and ZIMRA garnishees as there are other factors that have nothing to do with tax that can explain their high mortality rates such as poor accounting and risk management skills, high competition, economic challenges, misuse of funds and lack of capital among others. The discussion on the impact of taxes on the growth and survival of small firms crystallised itself in the word tree extract from NVIVO analysis as shown in Figure 3. From the top left of the word tree, verbatim extracts of conversations from the study participants show mixed perceptions on the impact of IS taxation on the survival and growth of small informal businesses. The visible conversations are: "*it boosts the growth and the survival*", "*positive attributes to growth and survival*", "*might stifles the growth and survival*", "*to suffocate the growth and survival*", "*little earnings to use for survival and growth of small firms*". From the bottom left others apparent statements are: "*not detrimental to the sector's survival and growth of small businesses*", "*positive and negative impact on the survival prospects of small businesses*", "and *impact negatively on the survival and growth of small businesses*" and "*constructive impact on the survival aspects of the business*". The views on the unfavourable consequences of tax administration on the IS expressed in the discussions in the word tree are analogous to the advancements by Charema (2014) quoting the president of SMEs Chamber Daniel Chiremba who pointed out that "Presumptive taxes demanded by ZIMRA are too high for most of the growing SMEs. Almost 10 SMEs in Zvishavane alone have collapsed after failing to pay presumptive taxes and many more countrywide are collapsing".

Negative impact on the survival and growth of small firms

High tax rates and tax laws were fingered as one of the major contributors of high SME mortality rates in Zimbabwe, in addition to lack of funding. The fixed presumptive tax rates were described by tax experts and 50% of ZIMRA officials as overburdening the IS. The fact that these rates are fixed does not take into consideration actual sales made (incomes), the cost incurred in making the income (allowable deductions) and ultimately the taxable income. Hence it becomes unfair to taxpayers who are assumed to have made income and hence a tax obligation arises. Failure to pay the taxes and accruing

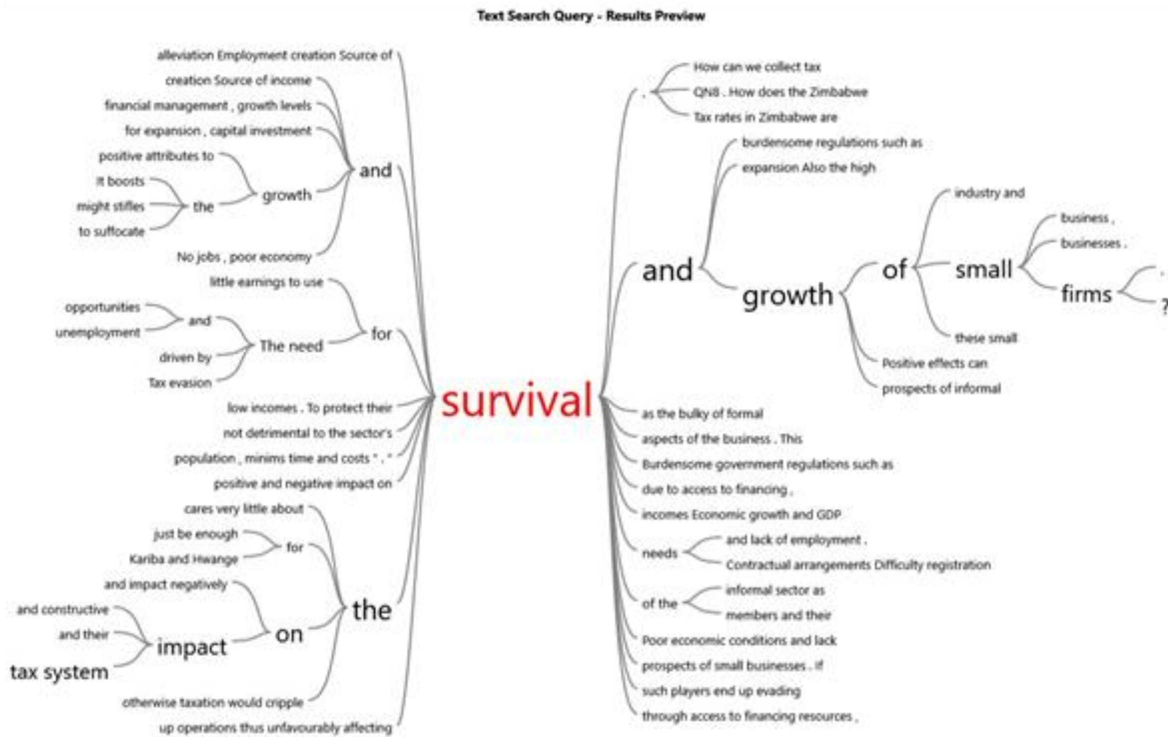

Figure 3. Survival word tree.

penalties has seen many small firms closing shop. The high tax rates are pointed to be inhibiting the growth of SMEs because as they focus on building cash flow reserves to meet tax obligations, they fail to reserve funds to finance business development, growth and survival. This signals an interrelationship between tax policy and capital investments. A relationship affirmed by Manyani et al. (2014) who used the transport sector in Bindura to evaluate the "Effectiveness of Presumptive and its impact on profitability of SMEs in Zimbabwe" and established a negative relationship. Presumptive tax was found to ambivalently affect the viability of SMEs. A similar view was expressed by SMEs Minister, Sithembiso Nyoni who laid the blame for decreased SMEs growth and increased failure rates on exorbitant taxes and penalties levied by ZIMRA. TC 2 expressed that *"the unfavourable impact of taxes on the growth and continued survival of SMEs is worsened further by the liquidity crunch, high cost of money and short term lending costs due to the volatile economic environment, the inconsistent monetary and currency and exchange risk issues".* In spite of their acknowledgement of the negative ramifications of IS taxation on the growth and survival of small firms tax experts (TEX3, 6, 7 and 10) pointed to some advantages that could accrue to informal firms that are properly registered as SMEs for tax purposes. TEX3 advanced that the ITA, Zimbabwe has a provision that the Commissioner General of Taxes may "on application of a taxpayer who qualifies as a small and medium enterprise" permit such a taxpayer to pay provisional income tax on a monthly basis, that is one month in advance". Income tax refers to corporate tax in this context. This is as opposed to the general provision in respect of corporate tax that that requires taxpayers to tax provisional tax in advance quarterly in relation to the quarterly payments dates (QPDs)at instalments of 10, 25, 30 and 35% for the first to the last quarter in ascending dates. If taxpayers were to take advantages of this provision and accordingly apply and be granted reprieve, it can be good for capital working management. TEXs 6 and 7 tabled that registered SMEs were eligible for the Special Initial Allowance tax depreciation on assets (constructed immovable and purchased movable assets) at a rate of 50% on the first year of use, 25% on the second year and 25% on the third year. This allows the taxpayer to write off an eligible capital asset in three years as opposed to the 25% for four years awarded to big companies. TEX10 on the other hand, pointed out that the small scale miners' payments for gold proceeds were subject to 3% mining royalty deduction, which is generally 2% lower than the general rate of 5% applicable to other enterprises. Some of these benefits

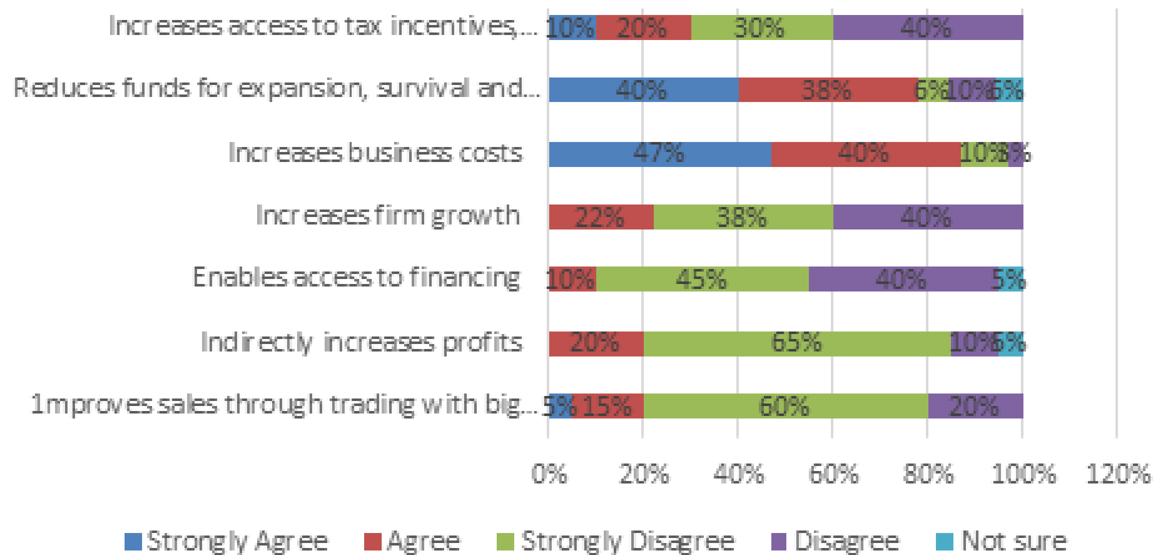

Figure 4. Impact of taxation on informal firms.
Source: Own Compilation

for formalisation for tax purposes were highlighted by Tax Matrix (2019). Notwithstanding these notable advantages the IS associations members and some the ZIMRA officers and tax experts felt that formalisation requirements and tax payments suffocated informal firms. ISAM5 argued that *"the IS firms do not have enough working capital not to even talk about purchasing any assets to enjoy the capital allowances. Sometimes the IS operators have no knowledge of these tax advantages or even how to claim them*". The negative influence of tax policy on firm growth, survival, performance and expansion was also highlighted by IS questionnaire respondents as presented in Figure 4.

Multiplicity of taxes unfavourably affecting informal operators

The multiplicity of taxes was raised as another source of controversy on the IS taxation and firm growth puzzle. Tax experts pointed out that the taxes faced by the IS were multiple on the same income for example presumptive tax, VAT withholding taxes on transactions that exceed $250 with a registered operator, the recently introduced 2% transaction tax and this is compounded by licences fees and other fees that they pay to the local authorities and their associations. ISAM2 expressed this fact by saying "*the taxes faced by businesses in Zimbabwe are generally too many and for our members there is presumptive tax, the 2% intermediary monetary transaction tax (IMTT) that is charged on money transfers, income tax on employment and VAT for those meeting the thresholds. The incomes made by our members cannot sustain these many taxes."* In light of all this IS taxation was found to be regressive to the growth of small firms, a view shared by Pimhidzai and Fox (2011) in Uganda. TEX5 asseverate that "*the impact of the 2%IMTT is impacting badly not only on companies but on disposable incomes of individuals especially in an environment whether there are significant cash shortages as Zimbabwe. Assume you make a transfer of $500 000, the 2% IMTT is $10 000. That's a lot of money for small firms*". Despite acknowledging the multiple taxes badly affecting the performance of small firms and taking money for investment and expansion needs, other tax experts were quick to point out that for those small firms who managed to register for VAT, even voluntarily, they are able to claim VAT input tax and also avoid the 10% withholding tax on tenders deducted for not having a valid clearance certificate. This thus positively affects small firms' cash flows and ultimately their profitability levels. *"Theoretically that is the case but practically it's a different story altogether as ZIMRA takes for ever to process VAT refunds or worse still your refund claim can be an "invitation" to come and scrutinise your transactions"* said TEX3. A view affirmed by the majority of the tax experts and all IS association members. ZIMRA officers on the other hand acknowledged the multiplicity of taxes but argued that those taxes must be viewed differently as income tax on employment was tax on employees' incomes and VAT was merely a transmission of tax collected to consumers to ZIMRA. ZIMRAO5

asseverated that *"perhaps presumptive taxes and the 2% transaction tax can be argued to be from the same income but VAT is paid by consumers of products and employment income is in principle being paid by the employees as it is part of their gross income anywhere."* In light of the discussion it was apparent that the multiplicity of taxes is burdensome on the informal firms this crippling their operations and leaving little or no funds for working capital, growth and continuity needs. This observation is similar to submissions by Cheeseman and Griffiths (2005) who expressed the negative impact of formalisation and tax administration on the IS positing that informal firms exist because if they were to be formalised, they would fail to achieve profitability and collapse resulting in the loss of "informal jobs". TEX5 insisted that despite the heavy burden imposed by the 2% IMTT, if registered for tax purposes and formalised, an informal firm's payment of remuneration of are exempt from the 2% tax. Considering the informal firms are very small and pay very low incomes the exemption would still be very minimal amounts.

Disincentive to investment

It was established that the current IS taxation framework acted as a disincentive to investment. Taxes were attested to have an effect of reducing the return on investment (ROI). It was also considered unfair to informal firms who do not enjoy benefits that go hand in hand with capital investments such as special initial allowance or wear and tear awarded to their formal counterparts as allowable deductions and in the case of miners the capital redemption allowance (CRA) in terms of the Income Tax Act, Zimbabwe (Chapter 23:06). This discourages the IS from investing and having fixed abodes. One IS sector association member expressed that "*our sector is not given the same privileges of tax holidays, incentives, tax deductions and given to the formal sector; hence it is difficult for our members to invest or even acquire fixed assets. Government should consider that our businesses are small and enable us instead of killing the businesses through heavy taxes*". This resonates with submissions in relation to SME growth by Machira (2007) who advances that tax policy has an unfavourable influence on the growth and going concern of the small businesses, as it reduces sales, capital, profits and thus affecting investment decisions

Garnishees lead to the collapse of small firms

The other notable findings from TEXs were that registration for tax purposes and tax compliance minimised the unnecessary garnishees and penalties by ZIMRA which often compromised the survival of the IS firms. It also helped in the avoidance of "greasing the palms" of tax officers as way to cover up for non-tax compliance. The IS association members expressed views to the contrary arguing that registering for taxes actually opened crevices for the ZIMRA garnishees as due to the instability of incomes in the IS, the informal firms always struggle to pay their tax obligations and penalties. This leads to ZIMRA garnishing them as the tax collectors just want tax money even when cash flows are low, on the basis that income has been received or accrued s defined by Income Tax Act. ISAM4 raised the following concern, *"imagine you are expecting to receive a payment and you have made plans to purchase raw materials, settle creditors and other operational costs and suddenly ZIMRA garnishes you through your bank and all that income is gone. The impact that such a move will have on your business and plans is just bad, especially for small businesses such as ours.*" The challenge was not only viewed from the garnishees side by the IS associations, but also increased extortions highlighted as one factor that crippled the operation of the IS in Zimbabwe. 90% of the tax experts strongly agreed that registration for tax purposes on the contrary exposed registered small companies to harassment and predatory behaviour of revenue officers. *"These corrupt ZIMRA officers often exploit the lack of tax knowledge by these taxpayers and in their calculations of liabilities and penalties, they often show huge figures so as to convince the taxpayers that they will save by paying bribes as the debt would be reduced or concealed"* said a TEX7. The majority of tax experts equally shared similar opinions. Most revenue officers had a different view of things though acknowledging them maybe bad apples in the system, they argued that corruption does exist but in most cases the general public is against the coercive nature of tax collection, yet this is should be expected.

Development of a conceptual framework

A schematic portrayal of the relationship between IS taxation and growth which is measured in terms of vectors profitability, capital investment and asset growth is presented in Figure 5 in a conceptual framework to guide derived the study. Tax policy should aim to balance the need to mobilise revenue and other reasons for taxation. To do so, policy makers can use the following framework in guiding policy formulation as well as evaluating the impact of tax policy.

CONCLUSIONS AND LIMITATIONS

The answers to the question, if an avenue for an

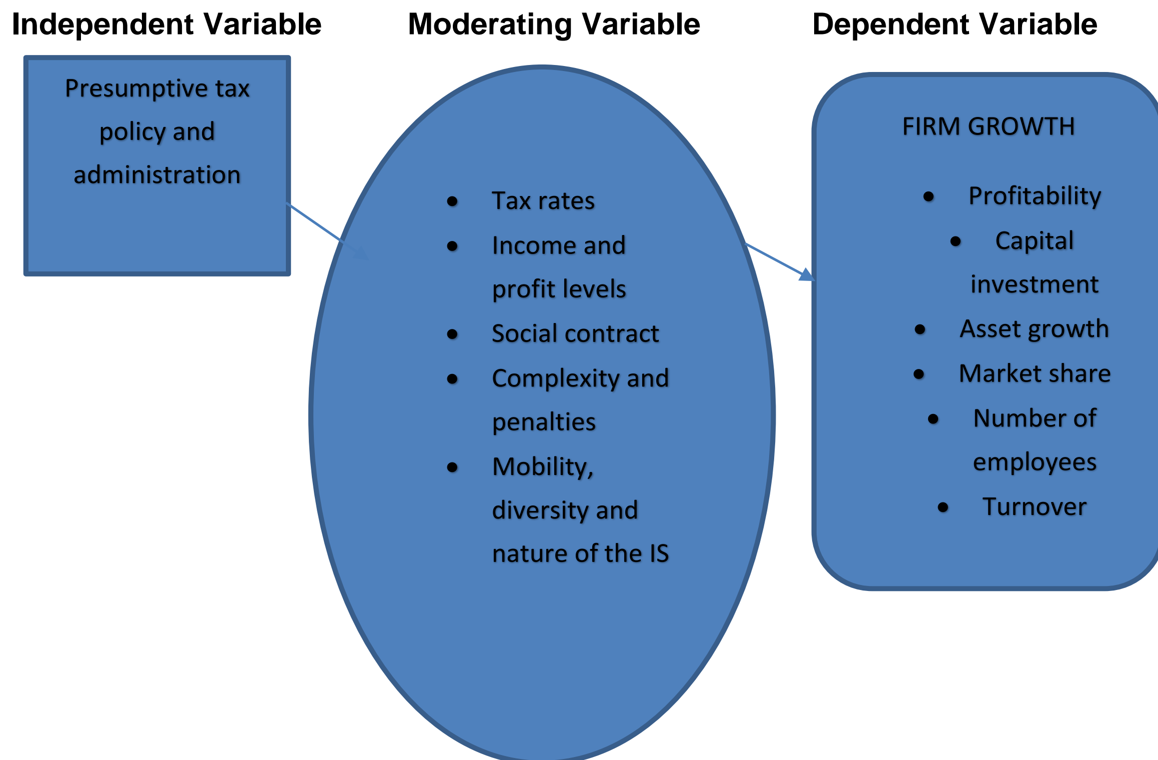

Figure 5. Conceptual framework.

expansive tax base or hindering the growth of small firms or both? could be disparate depending on the contextual environments. For instance one could argue for both, depending on tax policy, the structure and design of the IS taxation framework, its administration and implementation (how burdensome it is, in terms of the tax rates, compliance costs versus the incomes/profit from the sector). Secondly, how incentivising is the taxation framework (tax incentives, exemptions and allowable deductions; chances of business development, training programmes and access to financing). Lastly the economic, political and social realities in the country will provide contextual answers to the question. In Zimbabwe, this study concludes that the IS taxation framework in its current state has not resulted in a meaningful expanded tax base but instead it could be crippling the IS operations, increasing tax evasions and compounding SMEs' mortality rates, as expressed in the opinions of stakeholders interviewed. This conclusion though has a limitation that the failure of small firms can be linked to many other factors such poor accounting skills and financial management as well as lack of adequate capital. Expansion of the IS absorbs unemployment to a large extent, to the relief of policy makers, the same IS creates a "fiscal gap" that undermines policy makers' objective of widening the tax base. Tax policy should focus on revenue generation and its relationship with the construction of productive capacities of small firms. The argument albeit, does not infer that formalisation will automatically expand the tax base; therefore efforts have to be made into building a tax compliance culture. To reduce the fiscal gap and excessive foreign financing that often lead to the problem of debt sustainability, domestic revenue mobilisation has to be improved by taxing the IS. Non-payment of taxes by the IS kills the tax morale of compliant firms in the formal sector. Lower tax compliance morale leads to a rise in tax evasion and avoidance as well as a fall in tax revenue. On the other hand, excessive tax and the one size fits all kind of taxation cripples the growth, survival and profitability of IS firms. The absence of tax exemptions and tax holidays for the IS in most developing countries hampers enlargement of IS firms. On equity grounds, low incomes, large IS, poor tax administration and unproductive businesses have potentially resulted in the formal sector being burdened through VAT, corporate tax and excise duties. The pertinent question is, how then do developing country governments expand the tax base without obstructing the survival and growth of the IS? A keen appreciation of the imperatives entailed in the different

perspectives in favour of and against IS taxation is vital for any reconciliation of the divergent policy prescriptions towards IS taxation. According to Oviedo et al. (2009), policy packages need to be adapted to the characteristics of informality in a country. In some countries regulatory reform might be more appropriate, while in others regulator enforcement or IS tax framework restructure might be more relevant. The common denominator of the various policy prescriptions is the realisation that the IS cannot be dismissed out of hand, it has grown to the extent that it warrants serious attention and consideration for both taxation and economic growth. The challenge remains how to balance the revenue mobilisation agenda with the need to promote growth and survival in the sector in Zimbabwe considering the current unfavourable impact.

RECOMMENDATIONS

The findings of the study acknowledge the role played by the IS in the economy and that unfavourable tax policies can have a detrimental effect on the on the sector's growth and its development and the economy at large. If taxes are responsible for the high SMEs mortality rates, then it are essential for government-stakeholder consultation on the impact of presumptive taxes on the growth and survival of IS operators. The study makes the following contributions:

1. Revisit the current design of IS tax policy (assess whether it is optimal or there are other alternatives). There is need for reforms on the current IS taxation framework in Zimbabwe, it is essential to consider the ability to pay when designing tax policy. Setting a level of growth limit or turnover which can be viewed as adequate to sustain payment of taxes, payment of tax obligations in instalments is another angle to address the problem. In relation to designing of IS tax policy, Deloitte (2015) suggested the need for stratification of IS operators in order to ensure appropriate focus and strategies are employed towards taxing the sector arguing that in most developing countries profit margins earned by firms in the sector are not matching the relatively high tax rates levied in the sector.
2. Stakeholder consultations and discussion on IS tax policy design and impact. Inclusivity of tax policy, understanding and acceptance can be best fostered through government, tax administrators and IS consultative engagement which is key to inclusive tax policy.
3. Reduce multiplicity of taxes. There is need for the Zimbabwe government to revisit it taxation structures especially on the multiplicity of taxes. The 2% IMTT transaction tax recently implemented has compounded the impact of taxes on the survival of small firms. Despite the benefits of formalisation and registering for tax purposes that were highlighted especially by tax experts in the study, these are difficult for the IS to access due to several reasons such as tax education inadequacies and low incomes that cannot sustain formal requirements and multiple taxes. It is therefore important for policymakers to consider designing tax incentives that are targeting the informal firms in their informal state without forcing them to formalise. Cheeseman and Griffiths (2005) cautioned against forcing informal firms to formalise adducing that some of them are only viable, operational and profitable because they are informal otherwise forced formalisation would suffocate them.
4. Nurture the IS. Government to desist from a single minded focus on revenue collections but nurture the IS firms through incentives, skills empowerment programmes on record keeping, financial management, cost and management accounting as well as tax technical knowledge, access to credit and other financing programs. Nanthuru et al (2018) highlight the need for developing countries' government to offer training programs of risk management and accounting to equip SMEs to mitigate business risks and risks such as tax. Developing countries could borrow from emerging economies like China where tax policies are designed with the objective to enhance growth of small firms. For example their tax policy awards allowable tax deductions to institutions and venture who invest in SMEs up to a maximum of 70% of the invested amount (Ocheni and Gemade, 2015; Ameyaw et al., 2016). This view of supporting and nurturing informal firms was affirmed by Cheeseman and Griffiths (2005) who argued that in highlighting the failure to pay taxes by the IS policy makers tend to ignore the dichotomy of denied finance and services as well as proper infrastructure that results in low productivity and low incomes, hence the failure to pay tax. The researchers suggest that the equation should start from government support in the form of financing and infrastructure to aid in the transition from informal to formal in order to preserve the survival of informal firms.
5. Consider tax holidays, tax exemptions and incentives for the IS. Considering the submissions by researchers such as La Porta and Shliefer (2014) that the informal firms are too inefficient to operate under formal platforms without being enfeebled by the formalisation costs, developing country governments should try to give the informal firms access to some of the tax concessions rendered to the formal sector for example the allowable deductions, tax holidays and tax incentives. While others view informality with the eyes of inefficiency others argue the informal firms are productive enough and efficient enough for their size, all they need is for tax policy to be accommodative and also give them access to social

security platforms.
6. Conduct more research on IS tax policy and continuously evaluates it. There is need for more research on the tax rates and their impact on the IS. The introduction of presumptive taxes, in 2005, was informed by research carried out by the Zimbabwe Revenue Authority (ZIMRA) on informal urban transport operators as opined by Dube and Casale (2016). However, indications are that subsequently, no research was done by ZIMRA on the profitability of the other sub-sectors that were later added to the presumptive tax. Bearing in mind that the economic environment and business world is dynamic it would be noble to revisit the policy and assess it for suitability, effectiveness and impact. There is also need for more research on how to formulate an optimal informal sector policy as well as the nature of the tax incentives that can be awarded to the IS in order to boost both the growth of informal firms and tax compliance. Future researchers could also focus on the best way to tax the IS, whether to do it through direct or indirect taxation.

CONFLICT OF INTERESTS

The author has not declared any conflict of interests.

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Board size and firm performance in developing counties: Case of East Africa

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The main objective of this study was to examine the influence of board size on the financial performance of listed companies within the East African Community (EAC) and make recommendations on the board size that can enhance company financial performance within the EAC. The research adopted a positivist paradigm in a quantitative analysis using non-probability sampling to select forty-two listed companies listed on the EACs stock markets between 2008 and 2014. We developed our hypothesis based on secondary data from databases, company's published annual reports, and websites. We used Microsoft excel and SPSS to generate, manage and analyses data used in the descriptive statistics, correlation, and regression outputs. Results from our regression analysis were inconclusive and hence we were unable to generalize the relationship between board size and company performance moderated by total assets and market capitalization. The descriptive statistics result suggests that the optimal board size in EAC lies between nine and ten members. We thus recommend to EAC-listed companies to adopt board size of nine directors to avoid the drawback of large boards such as limited members' participation, lack cohesion and consensus due to widespread opinions which may deter the board from carrying out its advisory and monitoring functions.

Key words: Board size, East African Community (EAC) stock markets, financial performance.

INTRODUCTION

Board size is defined as total number of directors (both outside and executive directors) at a specified time (Lipton and Lorsch, 1992; Yermack, 1996). The board of directors plays two broad functions: Company monitoring and advisory services to the management (Nguyen et al., 2016). According to Dalton et al. (1999), large boards often offers wide and rich levels of monitoring and advisory than a small board especially where the board is not well diversified. Goodstein et al. (1994) posit that board size reflects the company's ability to attract resources from its environment, this is consistent with the resource dependency theory which states that companies always aim to attract a diversity of directors as a means of attracting resources (human capital, network, and financial) to the company (Johnson et al., 1996). So what is the optimal board size? According to Lipton and Lorsch (1992), an optimal board size is composed of eight to nine directors while Jensen (1993) suggested an optimal board to be comprised by seven to eight directors. At any point when number goes above or below an optimal size,

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the board's insufficiencies outweigh its benefits and hence poor company performance (Jensen, 1993; Lipton and Lorsch, 1992). It is believed that both big or small board sizes have some merits and demerits, for instance a large and complex company will require a large board to provide a wide range advice and monitoring than small ones (Coles et al., 2008). Board size depends on company characteristics; Small and Medium Enterprises (SMEs) or family businesses tend to have fewer directors than multinational organizations (Gabrielsson, 2007). However, Jensen (1993) suggests that both large and small board sizes have some risks and benefits, hence companies should aim at having an optimal board that minimizes the risks while maximizing the benefits associated with the board size. According to Bonn et al. (2004), a large board is often more skeptical when making strategic decisions than an optimal one, which will inhibit the company's value maximization. This makes large boards more symbolic in nature but less competent in facilitating good management practices (Hermalin and Weisbach, 1991). The establishment of the EAC-Common Market in 2010 led to the regional harmonization of trade, taxation regimes, accounting systems, and security market listings rules within the region (Yabara, 2012). The EAC has four securities exchange markets (SEM's) domiciled within the four EAC member states each with different codes of governance and good practices that regulate their listed companies and issuers of bond instruments. These codes provide codes of conduct addressing the minimum board size, roles and responsibilities of the CEO, board committees, shareholders' rights to mention but a few. These codes are neither compulsory nor legally binding to listed companies (CMA, 2002). The codes simply provide guidance to stock market participants on corporate ethical practices and self-regulation protocols (CMA, 2002). One of the fundamental changes brought about by the operationalization of the EAC- Common Market in 2010 was the free movement of capital and labor among the member states which would affect the firm characteristics such as the most optimal board size for EAC listed companies. This study thus examined the board size in 2008/2009 before the operationalization of the EAC common market in 2010 and 2013/2014. This was three years after the operationalization of the EAC common market.

The main objective of this study was thus to examine the influence of board size on the financial performance of listed companies within the East African Community (EAC) and make recommendations on the board size that can enhance company financial performance within the EAC. According to Dalton et al. (1999), unlike small boards, bigger boards tend to lack cohesion which limits their ability to connect with all directors. This makes it difficult for the board to reach a consensus due to the wide ranging differences in opinions (Lipton and Lorsch 1992). Muth and Donaldson (1998) posits that a large board makes it extremely hard for an organization to take quick decisions, because it takes the executive management more time and effort to achieve a consensus decision. This can exacerbate by poor coordination, which is typical of larger boards (Cheng 2008). According to Cheng (2008) a large number of directors increases the agency cost. Lipton and Lorsch (1992) identified dysfunctional behavioral norms and higher monitoring costs associated with a large board. Goodstein et al. (1994) acquiesced that a big board often face problems of poor group cohesion and higher levels of internal power struggles and bickering, which may hinder the board in carrying out its advisory and monitoring functions (Nguyen et al.,2016). On the other hand, Mwanzia Mulili (2014) identified the large board to be associated with many benefits; a larger board brings to the company wider knowledge, skills, experience and economic networks of the individual directors, which can be used to create synergy between the board of directors and management, thereby increasing company financial performance.

LITERATURE REVIEW

We adopted the agency theory to explain the relationship between board size on company performance as commonly used in accounting and finance research (Alagha, 2016; Heenetigala, 2011; Tshipa, 2015).

Agency theory

The need to separate organizational ownership and control creates an agency relationship, whereby principals (shareholders) contract agents (managers) to run their company on their behalf (Bhaduri and Selarka, 2016; Fama, 1980). An agency relationship is established because of an organization's need to ensure independence of organizational control from ownership. Jensen and Meckling (1976) distinguish a company as a nexus between different types of stakeholders, with the principal at one end and an agent on the other with diverse rights and responsibilities, which theoretically should complement each other for the good of the company. However, due to management's lack of altruism, they tend to focus more on their personal gains when making strategic decisions, which create the principal–agent conflicts (Fama, 1980). The agency theory hence seeks to resolve such conflicts through strict monitoring and controls to restrain the management prejudices in decision-making. The principal–agent conflict is further worsened by information asymmetry where an agent tends to have more information than the principal, thus creating a moral dilemma that motivates an agent to pursue personal interests at the expense of the principal (Bhaduri and Selarka, 2016). Consequently, the principal is forced to incur agency costs (such as

audit fees) to make the agents responsible for any wrong decisions while mitigating any risks associated with the agent's extravagances (Jensen and Meckling,,1976). We adopted the agency theory to explain the importance of board size in reducing the agent's extravagances; an optimal board size improves its ability to monitor and control management decisions thereby reducing agency costs (Bhaduri and Selarka 2016; Fama, 1980).

Company performance

According to Shleifer and Vishny (1997), company performance depends on its governance; a company with poor governance such as incongruous board size is less likely to invest in profitable projects that can generate superior cash flows for the benefit of the shareholders and vice versa. Performance is measured in different ways using varying performance matrices. The commonly used matrix include Return on Assets (ROA), Return on Equity (ROE), Tobin's Q ratio (TBQ) and Price Earnings ratio (PER). These are commonly used in finance and accounting research to evaluate the extent to which a company has achieved its overall objective (Richard et al., 2009). Performance measurements thus help managers to assess the effectiveness of company strategies and identify opportunities for strategic changes to achieve the targeted performance objectives (Porter, 2008). There are two broad categories of performance measurements; market-based (measuring performance using marketing information) and accounting based (measuring performance using accounting information). The accounting-based measures have been criticized for using historical information as a measure of company's present performance (Hall and Brummer, 1999); while market-based performance measurements are faulted for being too simplistic due to their inherent assumptions like the efficient market hypothesis (EMH) used in determining share prices as a measure of company performance (Tobin, 1984). To avoid the weaknesses of accounting or market-based performance measurements, we adopted a mix of accounting (ROE and ROA) and market-based (TBQ and PER) as our measures of performance.

We adopted return on assets, Tobin's q ratio, return on equity, and price earnings ratio as our performance measurement as commonly used in business, finance, accounting and corporate governance research (Alagha, 2016; Heenetigala, 2011; Tshipa, 2015)

Return on assets (ROA)

The RoA ratio is a measure of company efficiency in generating income from its total assets (Lesakova, 2007). It is one of the commonly used accounting measure of performance when evaluating companies' economic health and the proficiency of investment portfolios (Lesakova, 2007). According to Ingram and Albright (2006), the RoA ratio provides a links between company's annual operations and investment activities. The RoA ratio hence measures the efficiency management in using company assets (Lesakova, 2007).

The RoA is calculated as:

$$\text{RoA (\%)} = \frac{\text{Annual Profits after Interest and Tax}}{\text{Total assets at the year-end}}$$

A higher RoA ratio is an indication of management efficiency in utilizing company assets to generate a higher value for the investors (Lesakova, 2007).

Return on equity (ROE)

RoE was calculated as:

$$\text{RoE (\%)} = \frac{\text{Annual Profits after Interest and Tax}}{\text{Total equity at the Year-end}}$$

A higher RoE ratio is an indicator of management's ability to generate extra income to the owners/shareholders

Tobin's Q ratio (TBQ)

According to Gross (2007), TBQ ratio is a hybrid measure of performance, that is based on both accounting and market-based data. TBQ was calculated as:

$$\text{TBQ} = \frac{\text{Year-end market capitalization}}{\text{Total assets at the Year-end}}$$

The TBQ ratio measures the firm's growth prospects using the company's assets (Leng, 2004). A TBQ value of one indicates that the company's market value is equal to the total book value of its assets. If the ratio is higher than one, the company's market value is higher than its asset's book value, and hence management is deemed to have created more value for owner.

Price earnings ratio (PER)

This study calculated PeR using the following formula:

$$\text{PER} = \frac{\text{Company's year-end share price}}{\text{Earnings per share (EPS)}}$$

The PER depends on finance risk, which affects the company's bottom line and EPS.

Control variables

This study adopted total assets and market capitalization as the control variables as often used in accounting and finance research (Lins, 2003). According to Bowerman et al. (2003), a control variable is a variable which is held constant during the course of an experiment, in order to assess or clarify changes in other independent variables. The use of control variables in regression models helps to determine their explanatory power exclusive of the independent variables (Tabachnick and Fidell, 2006). Total assets in this study are represented by book value of all company assets at the year-end. Prior studies in accounting, corporate governance, finance, and company performance have used total assets as the control variable (Alagha, 2016; Heenetigala, 2011). We computed Market Capitalization by multiplying the year-end market price per share by the total number of outstanding shares at the financial year-end (Heenetigala, 2011). Market capitalization represents the value of a company based on its perceived future economic prospects, and it has commonly been used in many corporate performance studies as a control variable (Alagha 2016 and Heenetigala, 2011).

The EAC stock markets

The EAC has four securities exchange markets (SEM's) domiciled in the four EAC member states. These are the Nairobi Securities Exchange (NSE) in Kenya, the Dares Salaam Stock Exchange (DSE) in Tanzania, Uganda Securities Exchange (USE) in Uganda, and the Rwanda Stock Exchange (RSE) in Rwanda. Burundi and South Sudan do not have operational stock exchange markets. The stock markets are a major source of information and capital to listed companies, which helps them to better their financial performance. According to Yartey and Adjasi (2007), stock markets exist to facilitate low-cost information flow between international and domestic market players, thus enhancing the company's return on investment. Hence, a country without a stock market is more likely to lag behind economically (Baier et al., 2004). Stock market hitherto promotes the adoption of international financial reporting standards which promotes transparency between management and investors hence improved financial performance (Ilmolelian 2005). In the mid-1990s, EAC member countries formed Capital Market Authorities to regulate the activities of the East African Community Security Markets and in 1997, a joint regulatory body known as the East African Securities Regulatory Authorities (EASRA) was formed and mandated with regulating the EAC Security Markets' activities, fast-tracking the EAC Security Markets' integration, harmonizing the legal frameworks and market infrastructure as well as developing policy guidelines for the capital markets' growth incentives within the EAC (Yabara 2012).

Meanwhile, in 2005, the EAC's economic integration had changed from a free trade zone to the East African Community Customs Union, which later became the East African Common Market (EAC- Common Market) in 2010. This transformation led to the advent of corporate governance in the early 2000s among all the EAC countries. Kenya was the first country to introduce a code of corporate governance in 2002 followed by Uganda and Tanzania in 2003 (CMA, 2002). Rwanda introduced their code of corporate governance in 2010 (RSE, 2015).

The EAC code of governance does not recommend any specific number of directors for the listed companies' boards. However, it advises companies to have an optimal board (that are neither too small nor too large) for the benefit of the company shareholders (CMA, 2002). We adopted an optimal board definition from Lipton and Lorsch (1992) where an optimal board is seen to have between eight and nine board members, making any board membership over nine or below eight classified as big and small respectively. Based on the above arguments, we hypothesized as follows:

H[1:] There is a significant relationship between board size and company performance.

METHODOLOGY

We adopted a quantitative research design and positivist paradigm approach using a deductive technique to examine the relationship between board size and company performance (Veal 2005). Our study adopted a multiple regression in the ordinary least squares (OLS) method to examine the relationship between board size and company performance. A paradigm is defined as "a shared framework of assumptions held within a discipline, sub discipline or school of thought within a discipline" This has an influence on researcher's choice of methodology to achieve specific research objectives (Veal, 2005, p. 24). There are two types of research paradigms in social science, namely the positivist and the critical or interpretive paradigms. Under the critical paradigm, a researcher is perceived to be independent from a research study, and behavior of the person (s) or group(s) used in the study is explained using only facts and observations (Veal, 2005). The positivist paradigm depends on three principal assumptions, namely: that the cause and effect must be identified to explain phenomena or test a theory, that knowledge is based on what can be tested by observing tangible evidence; and that a researcher must use a scientific method that emphasizes control, standardization and objectivity (Veal, 2005). We adopted these assumptions to clarify the research structure using quantitative statistical data analysis tools. We used the positivist paradigm which is usually applicable in quantitative research where theories and hypotheses are developed prior to the empirical study (Veal, 2005).

Sample selection and Data collection

We adopted non-probability sampling to select the forty-two listed companies used in this study. Initially, we intended to use as a population all the listed companies on the EAC Security Markets in 2008/2009 and 2013/2014. A total of 108 companies were listed on the EAC Security Markets as at 31st June 2016. Regrettably, not all the listed companies qualified to be included in the sample because

they were either not listed on the EAC stock market for the full financial years 2008/2009 and 2013/2014, and their annual reports were not available from DataStream, Eikon and Mint Global Bureau Van Dijk databases. We used secondary data from company annual reports and databases, which are consistent with other accounting, finance, and corporate governance research studies where it was justified by the fact that secondary data sources save time and money for data collection (Heenetigala, 2011; Okiro, 2014). Secondary data was obtained from journal articles, e-books, websites and press releases. We also obtained financial data from databases (Orbis Bureau Van Dijk, DataStream, Eikon and Mint Global Bureau Van Dijk). Additional data was obtained from published companies' annual reports on their websites. Microsoft Excel and Statistical Package for the Social Science (SPSS) version 23 was used for data analysis. We used SPSS to carry out the preliminary diagnostic tests, descriptive statistics, correlation, and regression analyses and Microsoft excel was used to manage and format data before exporting it into SPSS for statistical analysis.

Independent and dependent variable

This study seeks to examine the influence of board size on company financial performance in the EAC listed companies. We thus adopted board size as the study's independent variable. Company board size influences its performance (Jensen, 1993; Lipton and Lorsch, 1992; Yermack, 1996). Coles et al. (2008) submit that larger boards are more effective in driving company performance because they bring together a pool of expertise from diverse directors, which helps the company to improve its monitoring capacity and enhance its financial performance. The wider knowledge of a larger board can also be utilised by the company in making some strategic decisions, which can drive company performance (Dalton et al*.,* 1999). However, some schools of thought view larger boards as less effective in enhancing company performance. They hence conclude that board size is negatively associated with company performance (Cheng, 2008; Yermack, 1996). It is believed that a bigger board faces problems of social loafing and high coordination costs that affect company value (Jensen, 1993; Lipton and Lorsch, 1992; Yermack, 1996). Moreover, Cheng (2008) suggests that larger boards reduce company value and are not necessary for all categories of companies and industries. On the other hand, we used company performance (represented by return on assets, Tobin's q ratio, return on equity, and price earnings ratio) as our dependent variable. This is consistently used measure of performance measurement commonly used in business, finance, and accounting research (Alagha, 2016; Heenetigala, 2011; Tshipa, 2015).

Ordinary least squares (OLS) regression

We adopted OLS regression which is considered a straightforward method of statistical analysis (Bryman and Bell, 2015). We adopted our model using the following equation:

$$Yi = \beta o + \beta 1\ X + \mathcal{E} \quad (1)$$

Where: Yi = the dependent variable, X = the independent variable, $\beta 0$ = intercept, $\beta 1$ = slope and $\mathcal{E}$ = error term. The above equation was used to derive equation 2 and the subsequent 4 equations that were used in this study.

$$Yt = \beta o + \beta 1BS + \beta 2TA + \beta 3MC + \mathcal{E}t \quad (2)$$

Where: $\beta 0$ = intercept, βi = slope, Yt represents dependent variable (PER, TBQ, ROE or ROA) at time't', BS = Board size, TA = total assets MC = market capitalization, and $\mathcal{E}t$ represents the margin of error due to other factors outside the model that may influence Yt. We thus derived four model equations used to test the study hypotheses in SPSS.

$$ROAt = \beta o + \beta 1BS + \beta 2TA + \beta 3MC + \mathcal{E}t \quad (3)$$

$$ROEt = \beta o + \beta 1BS + \beta 2TA + \beta 3MC + \mathcal{E}t \quad (4)$$

$$TBQt = \beta o + \beta 1BS + \beta 2TA + \beta 3MC + \mathcal{E}t \quad (5)$$

$$PERt = \beta o + \beta 1BS + \beta 2TA + \beta 3MC + \mathcal{E}t \quad (6)$$

We used the above equations to test the hypotheses for the study period. Data analyses were carried out using the SPSS version 23 and the macro on HCSE estimators developed by Hayes and Cai (2007) which is known to provide heteroscedasticity-consistent regression results (Hayes and Cai, 2007).

OLS's diagnostic tests

We carried out diagnostic statistics tests to ensure our data conforms to OLS regression assumptions of normality distribution, multicollinearity and homoscedasticity. Shapiro-Wilk test was used to test normality distribution. According to Baty et al. (2015), Shapiro-Wilk test is the best statistical means for detecting any deviations from normality distribution due to skewness or kurtosis. Using Shapiro-Wilk test, the null hypothesis states that there is no difference between the observed distribution of surveyed scores and a normally distributed sample error. Hence, if the critical alpha is larger than the obtained p-value, the null-hypothesis is rejected (Shapiro and Wilk, 1965). We also tested our data for multicollinearity using the variance inflation factor (VIF) in which multicollinearity problem is assumed to be present when the predictor variables have a VIF above 10.0 (Field, 2009). Our test revealed no multicollinearity problem with VIF less than 10.0. Finally, we tested our study data for homoscedasticity. According to Hayes and Cai (2007), the absence of homoscedasticity undermines statistical significance tests by making the estimator of the regression factor inconsistent and biased. We tested the presence of homoscedasticity using the Koenke tests in the SPSS macro developed by Watson and Teelucksingh (2002) posits that Koenker test is simple to comprehend and can be done on a small data sample like the case with this study. The null hypothesis of the heteroscedasticity test implies that there is no conditional heteroscedasticity and thus the individual-specific or time-specific variance error components are equal to zero (Park, 2011). The homoscedasticity assumption was met and hence we adopted the retrogression analysis to test the study's hypothesis.

RESULTS AND DISCUSSION

This study revealed the following statistical results on OLS diagnostic test, descriptive statistics (mean, median, standard deviation, maximum and minimum), correlation and regression results obtaining from testing the impact of board size on company financial performance.

OLS Assumption's diagnostics test results

Table 1 presents the test results of the normality, heteroscedasticity, and multicollinearity. As indicated in Table 1, the p values for the Shapiro-Wilk tests for

Table 1. OLS assumption's diagnostics test results.

Threshold assumption	Normality test	Heteroscedasticity test	Multicollinearity test	Normality test	Heteroscedasticity test	Multicollinearity test
	p > 0.05	p > 0.05	10 max	p > 0.05	p > 0.05	10 max
	Shap.Wilk	Koenker	VIF	Shap.Wilk	Koenker	VIF
	2013/2014			2008/2009		
ROA	0.08	0.01		0.12	0.04	
BS			2.42			2.13
TA			3.25			4.95
MC			3.07			3.30
ROE	0.93	0.01		0.78	0.04	
BS			2.42			2.13
TA			3.25			4.95
MC			3.07			3.30
TBQ	0.33	0.01		0.16	0.04	
BS			2.42			2.13
TA			3.25			4.95
MC			3.07			3.30
PER	0.44	0.01		0.85	0.04	
BS			2.42			2.13
TA			3.25			4.95
MC			3.07			3.30

ROA= Return on assets, ROE= Return on equity, TBQ= Tobin's Q ratio, PER= Price Earnings Ratio, BS = Board size, TA = Total assets, MC = Market capitalization.

2008/2009 were as follows: ROA =0.12, ROE = 0.780 TBQ = 0.16, and PER = 0.85, while in 2013/2014 ROA = 0.08, ROE = 0.930, TBQ = 0.33 and PER = 0.44. All these values are higher than 0.05 (the significance value) which confirms the presence of normality distribution of data (Shapiro and Wilk, 1965). Additionally, we tested multicollinearity using the Variance Inflation Factors (VIF). Using Field (2009) maximum VIF threshold value of 10.0, we discovered no multicollinearity problem since the VIF for the predictor variables in 2008/2009 and 2013/2014 were below the recommended VIF threshold of 10 (Field 2009). Also, as indicated in Table 1, we used Koenker tests to certify existence of homoscedasticity The results show that the p values of the Koenker tests results for 2013/2014 was 0.01 while in 2008/2009 it was 0.04 which are below homoscedastic threshold ($p<0.05$) which implies that the data used in this study was not homoscedastic ($p<0.05$).

Descriptive statistics

We used the mean, median, maximum, minimum and standard deviation to identify the statistical characteristics of the study's dependent (PER TBQ, ROA, ROE) and independent variable (Board size). Table 2 presents the descriptive statistics.

Return on assets (ROA)

The descriptive statistics analysis in Table 2 indicated positive mean value in both periods, which indicates that the EAC-listed companies on averagely generated a similar positive return of about 40% on assets for their shareholders in 2008/2009 and 2013/2014. The degree of volatility in ROA increased by more than 50% in 2008/2009, as compared to 2013/2014. Comparatively, ROA was less volatile before the operationalization of the EAC Common market in 2010 (Table 2).

Return on Equity (ROE)

We calculated ROE as a percent of profits after interest and tax, divided by the company's total shareholder equity. Analysis of 2008/2009 descriptive statistics on ROE in Table 2 indicated a mean of 40.79%, median of 41.74%, standard deviation of 10.01, minimum of 19.34%, and the maximum of 63.40%. The ROE mean and median values for both 2008/2009 and 2013/2014 indicate that the EAC-listed companies in this study generated a similar average positive return of about 40% for their shareholders before (2008/2009) and after (2013/2014) the establishment of the EAC-Common Market.

Table 2. Descriptive statistics.

Variable	No.	Mean	Median	Std. Dev.	Minimum	Maximum	Years
ROA (%)	C	40.58	40.11	263	32.76	50.57	
ROE (%)	42	40.79	41.74	10.01	19.34	62.40	
TBQ	42	0.43	0.39	1.91	0.17	2.04	
PER	42	9.74	9.81	1.88	2.72	37.34	**2008/2009**
BS	42	8.62	9.00	2.42	4.00	13.00	
TA	42	185,946	226,493.2	5.5	5,590.6	3,387,087.0	
MC	42	51,200	68,000	5.0	3,000	747,000	
ROA (%)	42	40.01	39.083	9.09	19.105	63.86	
ROE (%)	42	39.23	41.32	11.497	7.09	6121	
TBQ	42	0.47	0.44	3.11	0.06	6.94	
PER	42	11.056	11.36	2.06	1.77	52.38	**2013/2014**
BS	42	9.262	9.00	2.78	5.000	15.00	
TA	42	182,816.7	205,616.1	6.4	5,280.8	4,877,776.9	
MC	42	85,500	85,700	5.3	24,000	2,474,100	

ROA= Return on assets, ROE= Return on equity, TBQ= Tobin's Q ratio, PER= Price Earnings Ratio, BS = Board size, TA = Total assets, MC = Market capitalization.

Tobin's q ratio (TBQ)

The TBQ was calculated as a company's market capitalization at the year-end, divided by its total assets. The TBQ descriptive statistics results in Table 2 show that for 2008/2009, TBQ had a mean of 0.4251, median of 0.390, standard deviation 1.913, minimum of 0.165, and maximum of 2.038. For 2013/2014, the TBQ descriptive statistic results included a mean of -0.466, median of 0.441, standard deviation of 3.107, minimum of 0.056 and maximum of 6.936. The descriptive statistics indicates that TBQ experienced higher volatility in 2013/2014, with an increased by 62% in 2013/2014 as compared to 2008/2009 (Table 2).

Price earnings ratio (PER)

The PER ratio in Table 2, was calculated as the year-end market price per share, divided by earnings per share (EPS), where market price per share is the year-end share price i.e. the price at which shares were bought or sold, based on the forces of demand and supply. The descriptive statistics results for 2008/2009 indicate an PER mean of 9.743, median of 9.812, standard deviation of 1.884, minimum of 2.719, and maximum of 37.341. On the other hand, in 2013/2014, the descriptive statistic results showed a mean of 11.056, median of 11.364, standard deviation of 2.058, minimum of 1.766, and maximum 52.375. There were no significant differences between the mean and median in PER for 2008/2009 and 2013/2014. The PER's positive means and medians for both 2008/2009 and 2013/2014 are an indication that the EAC-listed companies continued to create value for their shareholders after the operationalization of the EAC–Common Market in 2010.

Board size (BS)

We measured BS as the total number of directors on the board of a company. The descriptive statistics (Table 2) demonstrate that in 2008/2009, the mean and median board size was 8.62 and 9.0 respectively, the standard deviation was 2.42, the minimum was 4.0 and the maximum was 13.0. In 2013/2014, the mean board size was 9.26, the median was 9.00, the standard deviation was 2.78, the minimum was 5.0 and the maximum was 15.0. Overall, after the operationalization of the EAC–Common market, the mean, minimum and maximum board sizes increased by 7, 25 and 15% respectively. Available data also indicates that the listed companies in the EAC had an average board size of 9 directors, which is consistent with the optimal board size recommended by Lipton and Lorsch (1992).

Total assets (TA) as a control variable

We used total assets and market capitalization as control variables, the company's total assets were measured the total book value of all assets at the year-end. The descriptive statistics (Table 2) for 2008/2009 show mean total assets of US$ 185, 944, median of US$ 226, 493, and standard deviation of 5.5. The minimum was US$ 5, 591 with a maximum of US$ 3, 387, 087. In 2013/2014, the mean total assets were US$ 182, 817, the median of US$ 205, 616, the standard deviation was 6, the minimum was US$ 5, 281 and the maximum was US$ 4, 877,777. Table 2 shows a reduction in mean, median and minimum values by 0.1, 0.8 and 0.7% respectively. There was also a 2.4% increase in the maximum after the operationalization of the EAC Common Market.

Table 3. Pearson's Correlation Coefficient analysis.

		PER	TBQ	ROA	ROE	BS	TA	MC
2008/2009	**PER**	1						
	TBQ	0.571*	1					
	ROA	-0.325**	0.156	1				
	ROE	-0.393**	0.065	0.662** *	1			
	BS	-0.354**	0.050	0.123	0.245	1		
	TA	-0.237	-0.119	-0.193	0.204	0.664***	1	
	MC	-0.046	0.074	-0.003	0.230	0.576***	0.818***	1.
2013/2014	**PER**	1						
	TBQ	0.409***	1					
	ROA	-0.239	0.603***	1				
	ROE	-0.121	0.430***	0.687***	1			
	BS	-0.143	-0.186	0.018	0.260*	1		
	TA	-0.526***	-0.436** *	0.017	0.352**	0.598***	1	
	MC	-0.284*	0.078	0.427***	0.637***	0.539***	0.764***	1

***,**,and * Significant at 1, 5 and 10% level respectively. BS = Board size, TA=Total assets, MC = Market capitalization, PER = Price Earnings ratio, TBQ =Tobin's Q ratio, ROA = Return on asset, ROE = Return on equity.

Market capitalization (MC)

Market capitalization was calculated as the company's total number of outstanding shares, multiplied by the market price per share (Yermack, 1996). The descriptive statistics results in Table 2 demonstrate the following statistics for 2008/2009: a mean market capitalization of US$ 51,200, a median of US$ 68,000, a standard deviation of 1.54, a minimum of US$ 3,000 and a maximum of US$ 747,000. Similarly, in 2014, the mean market capitalization was US$ 85,500 and the median was US$ 85,700, while the standard deviation, minimum, and maximum values were 1.68, US$ 2,400, and US$ 2,47100 respectively. Overall, between 2008/2009 and 2013/2014, the mean increased by 13%, the median by 5.5% and the maximum values of the market capitalization was 18.1%. However, the minimum value of the market capitalization fell by 5.6% after the operationalization of the EAC Common Market in 2010.

Pearson's correlation results

Table 3 shows the results of Spearman's correlation analysis which was used to examine the relationship between the board size control variables (TA and MC) and company financial performance variables (ROE, ROA, TBQ and PER)

According to the correlation results in Table 3 the following pair of variables exhibited significant correlation at 1% significance in 2008/2009, ROA and ROE with a coefficient of 0.66, PER and TBQ with correlation coefficient of 0.57, board size and total assets with correlation coefficient of 0.66, board size and total assets with correlation coefficient of 0.58. The pair of variables that displayed significant correlation at 5% significance were PER and ROA with correlation coefficient of -0.33, PER and ROE with correlation coefficient of -0.39, PER and board size with correlation coefficient of -0.35, and total assets and market capitalization with correlation coefficient of 0 82. From the results for 2013/2014 in Table 3, the following variables exhibited significant correlation at 1% significance: PER and TBQ with correlation coefficient of 0.41, PER and total assets with correlation coefficient of -0.53, PER and total assets with correlation coefficient of -0.28, TBQ and ROA with correlation coefficient of 0.60, TBQ and ROE with correlation coefficient of -0.43, TBQ and total assets with correlation coefficient of -0.44, ROA and ROE with correlation coefficient of 0.69, ROA and market capitalization with correlation coefficient of 0.43, ROE and board size with correlation coefficient of 0.26, ROE and total assets with correlation coefficient of 0.35, ROE and market capitalization with correlation coefficient of 0.64, board size and total assets with correlation coefficient of 0.60, board size and market capitalization with correlation coefficient of 0.54, and total assets and market capitalization with correlation coefficient of 0.76. The above correlation figures indicate lower correlations between the dependent and independent variables and some lacked significant correlations.

Regression results

This study adopted OLS regression analysis which is considered a straightforward method of statistical analysis (Bryman and Bell, 2015). The OLS regression analysis results are discussed below.

Table 4. Regression analysis of BS, Control variables and ROA.

Dependent variable: ROA	2008/2009			2013/2014		
	Model fit: R^2 = 0.3960; P = 0.1601; F = 1.6809			Model fit: R^2 = 0.5426; P = 0.0003; F = 5.8543		
Variable	**Coeff**	**T**	**P**	**Coeff**	**T**	**P**
Constant	60.843	6.091	0.000	52.834	3.713	0.001
BS	0.855	1.771	0.077*	-0.409	-0.613	0.544
TA	-2.291	-2.294	0.029**	-3.284	-2.718	0.101
MC	1.723	1.737	0.093*	6.360	4.954	0.000***

***,**, and * Significant at 1, 5 and 10% level respectively. BS = Board size, TA =Total assets, MC =Market capitalization.

Table 5. Regression analysis of BS, control variables and ROE.

Dependent variable: ROE	2008/2009			2013/2014		
	Model fit: R^2 = 0.4121; P = 0.0997; F = 1.9820			Model fit: R^2 = 0.5168; P = 0.0001; F = 6.3576		
Variable	**Coeff**	**T**	**P**	**Coeff**	**T**	**P**
Constant	62.223	2.924	0.007	26.876	1.411	0.167
BS	1.467	1.598	0.120	-0.578	-0.709	0.483
TA	-1.931	-0.929	0.360	-1.530	-0.986	0.331
MC	1.947	1.082	0.288	6.471	239	0.000***

***,** and * Significant at 1, 5 and 10% level respectively. BS = Board size, TA =Total assets and MC =Market capitalization.

Board size, control variables and ROA

Table 4 presents a summary of the regression results on the relationship between ROA, Board size and control variables in 2008/2009 and 2013/2014. The 2008/2009 results showed an adjusted R-squared value of 0.40, which indicates that about 40% of the total variability in ROA can be explained by board size, total assets and market capitalization. Board size had a statistically significant positive influence on ROA (p=0.08<0.10), hence an increase in board size by one member would results in an increase in the ROA by 86%, holding all other factors constant. The F test result indicates that all variables in aggregate are not statistically significant in influencing ROA (F = 1.68, p = 0.16>0.10). On the other hand, the 2013/2014 results (Table 4), show an adjusted R-squared value of 0.54, which indicates a better model fit than in 2008/2009. This means that, about 54% of the total variability in ROA is explained by Board size, total assets and market capitalization. The F test result for the regression model in 2013/2014 indicates that all variables in aggregate have a statistically significant influence on ROA (F= 5.85, p = 0.00<0.01). This suggests that board size together with the control variables is more relevant to ROA in 2013/2014 than in 2008/2009. The OLS regression results (Table 4.) indicates that board size had a statistically significant positive influence on ROA in 2008/2009 but no statistically significant influence in 2013/2014. The estimated coefficient for board size in 2008/2009 suggests that an additional director on the board contributes 86% to ROA, holding other variables constant. On the contrary, the contribution from an additional director on the board in 2013/2014 diminishes ROA by 41%, although this impact was not statistically significant.

Board size, control variables and ROE

Table 5 presents a summary of regression results on the relationship between ROE, as the dependent variable, board size and control variables in 2008/2009 and 2013/2014. As shown in Table 5 in 2008/2009, the OLS regression results showed an adjusted R-squared value of 0.41, which suggests that about 41% of the total variability in ROE is explained by Board size, total assets and market capitalization. The F test result indicated that all variables jointly influence ROE (F = 1.98, p = 0.09<0.10). Board independence had a statistically significant negative influence on ROE (p=0.05<0.10), hence, an increase in Board size by one percent would result in a decrease in the ROE of 25%, holding other

Table 6. Regression analysis of BS, control variables and TBQ.

Dependent variable: TBQ	2008/2009 Model fit: R^2 = 0.3088; P = 0.2719; F = 1.3368			2013/2014 Model fit; R^2 = 0.7368; P = 0.0000; F = 8.6757		
Independent variable	**Coeff**	**T**	**P**	**Coeff**	**T**	**P**
Constant	2.129	1.347	0.188	5.751	4.840	0.000
BS	0.098	1.218	0.233	0.007	0.126	0.901
TA	-0.332	-2.294	0.029**	-0.842	-6.749	0.000***
MC	0.268	1.526	0.138	0.827	6.801	0.000***

***,**,and * Significant at 1, 5 and 10% level respectively . BS = Board size, TA =Total assets and MC =Market capitalization.

Table 7. Regression analysis of BS, control variables and PER.

Dependent variable: PER	2009 Model fit: R^2 = 0.1834; P = 0.2402; F = 1.4186			2014 Model fit; R^2 = 0.4099; P = 0.0038; F = 3.9907		
Independent variable	**Coeff**	**T**	**P**	**Coeff**	**T**	**P**
Constant	3.921	3.312	0.002	52.824	3.713	0.000
BS	-0.096	-1.258	0.218	-0.409	-0.613	0.032**
TA	-0.161	-1.437	0.161	-0.284	-2.718	0.002***
MC	0.199	1.711	0.097*	6.360	4.954	0.500

***,**, and * Significant at 1, 5 and 10% level respectively. BS = Board size, TA =Total assets and MC =Market capitalization.

independent and control variables constant. On the other hand, the results for 2013/2014 (Table 5) presented an adjusted R-squared value of 0.52, which shows a better model fit than 2008/2009. The adjusted R-squared results indicate that during 2013/2014, about 52% of the total variability in ROE could be attributed to Board size, total assets and market capitalization. The F test result also indicated that all variables jointly influenced ROE (F= 6.34, p = 0.00<0.01). Although the market capitalization (a control variable) is the only variable that had a statistically significant positive influence on ROE (p=0.00<0.01) in 2013/2014, the adjusted R-squared suggests that the board size, together with the control variables, have more relevance in explaining ROE in 2013/2014 than in 2008/2009.

Board size, control variables and TBQ

Table 6 presents a summary of regression results on TBQ, Board size, total assets and market capitalization in 2008/2009 and 2013/2014. According to the OLS regression results in Table 6 the adjusted R-squared value in 2008/2009 was 0.31, which suggests that about 31% of the total variability in TBQ can be explained by Board size, total assets and market capitalization. The F test result indicated that all variables in aggregate do not have a statistically significant influence on TBQ in 2008/2009 (F = 1.34, p = 0.27>0.10). The 2013/2014 results, shows an adjusted R-squared value of 0.74, which demonstrates a better model fit, than 2008/2009. In other words, in 2013/2014 about 74% of the total variability in TBQ can be explained by Board size, total assets and market capitalization. The F test result also indicated that all variables in aggregate have a statistically significant influence on TBQ (F= 8.68, p = 0.00<0.01). This improvement in the model fit and model significance suggests that Board size, total assets and market capitalization have more relevance in explaining TBQ in 2013/2014 than in 2008/2009.

Board size, control variables and PER

Table 7 presents a summary of regression results on the relationship between PER as the dependent variable, board size and control variables in 2008/2009 and 2013/2014. The 2008/2009 results (Table 7.) show an adjusted R-squared value of 0.18, which means that during 2008/2009, about 18% of the total variability in PER is explained by board size, total assets and market capitalization. The F test result indicates that all variables in aggregate do not have a statistically significant influence on PER (F= 1.42, p = 0.24>0.10). According to

the 2013/2014 results, the adjusted R-squared value was 0.41, which indicates a better model fit than 2008/2009. This shows that about 41% of the total variability in PER in 2013/2014 can be explained by Board size, total assets and market capitalization. The F test results also indicates that all variables in aggregate have a statistically significant influence on PER (F= 3.99, p = 0.00). Board size had a statistically significant negative influence on PER (p=0.03<0.05) suggesting that an increase in board size by one member would result in a decrease in PER by 40.9%, holding other independent and control variables constant. The composite of PER (price per share and earning per share) offers two possible explanations for this negative relationship between PER and board size; either earning per share increases as board size increases, or price per share deceases as board size increases. This implies that the EAC markets in 2013/2014 tended to react positively to smaller board size and negatively to larger board size.

Control variables

As mentioned above, we used total assets and market capitalization as control variables in the regression models to statistically adjust their effects on company financial performance and thereby estimate the effects of board size on the study variables. We observed some significant relationships between the control variables and companies' financial performance indicators. For example, in 2008/2009 (Table 4.), the total assets had a statistically significant negative influence on ROA (p=0.03<0.05) while the market capitalization had a statistically significant positive influence on ROA (p=0.09<0.10). However, in 2013/2014 (Table 4), only the market capitalization had a statistically significant positive influence on ROA (p=0.00<0.01). Furthermore, no control variable significantly influenced ROE in 2008/2009. However, in 2013/2014 (Table 5), the market capitalization had a statistically significant positive influence on ROE (p=0.00<0.01). In 2008/2009 (Table 6), the total assets had a statistically significant negative influence on TBQ (p=0.03<0.05). However, in 2013/2014 (Table 6), the market capitalization had a statistically significant positive influence on TBQ (p=0.00<0.01) while the total assets had a statistically significant negative influence on TBQ (p=0.00<0.01). Furthermore, according to the results in Table 7 the market capitalization had a statistically significant positive influence on PER (p=0.09<0.10). The total assets also had a statistically significant negative influence on PER (p=0.00<0.01).

Conclusion

The main objective of this study was to examine the influence of board size on the financial performance of listed companies within the EAC and make recommendations on the board size that can enhance company financial performance within the EAC. Results from the regression analysis (Tables 4 to 7) indicated some significant relationships between board size and ROA, and board size and PER in 2013/2014 but no significant relationship between board size and ROE and TBQ in 2008/2009 and 2013/2014. The estimated coefficients in the series of regression models (Tables 4 to 7) appear to indicate that company financial performance deteriorated in 2013/2014 when the average board size increased to 9.2 directors. The regression results (Tables 4 to 7) suggest that larger board size has a negative impact on company financial performance. The descriptive statistics (Table 2) appear to suggest that the optimal board size in EAC-listed companies is no more than nine members. This thus supports the recommendation by Firstenberg and Malkiel (1994), who suggests an optimal board size of 9 members to encourage board participation, focus, interaction and effective debate. Furthermore, Dalton et al. (1999) posits that an optimal board is often cohesion, which creates a good working relationship between directors. This makes is less difficult for the directors to reach a consensus (Lipton and Lorsch, 1992). Moreover, an optimal board makes it easy to make quick decisions due to shorter time required achieve board agreement (Muth and Donaldson, 1998). Lipton and Lorsch (1992) identified dysfunctional behavioral norms and higher monitoring costs associated with a large board, while Goodstein et al. (1994) submitted that a big board faces problems of internal power struggle and bickering that hinders board business about advisory and monitoring functions (Nguyen et al*.,* 2016). Our findings are also consistent with Lipton and Lorsch (1992) who recommended optimum board size of eight to nine directors and Jensen (1993) recommended optimum board size of seven or eight directors.

Limitations of the study

A number of limitations were identified in this study. Firstly, we used a sample of forty-two listed companies from the EAC stock markets during the study period. Nevertheless, most companies in Tanzania, Rwanda, and Uganda were never listed on their respective stock market until after 2010 and hence were left out of this sample. Again, the current study used financial data from only listed companies, we excluded private companies and other small and medium enterprises which are also effected by board size. Moreover, the financial data used in this study was extracted from private databases (DataStream and Eikon) hence most companies whose data was missing out from these databases were left out of this study. Finally, the study used some accounting-based and market-based performance measures. The selection of these measures was based on previous

research. Using different performance measures could possibly result in different results. We thus recommend that future studies consider using data from un-listed companies, SME's, or adopt different financial and non-financial performance indicators to test the influence of board size on company performance. The findings from this study will help in improving the existing codes of governance and to enhance the firm's financial performance in Africa in general and the EAC in particular. However, the study's findings revealed a lack of consistently significant relationships between the dependent and independent variables, which can be attributed to the fact that some EAC countries had not adequately adapted to the EAC common market at the time of the study, hence their respective listed companies were not in a position to align their organizational structure and enhance their financial performance. Nevertheless, this study provides new knowledge about board size in the EAC countries before and after the operationalization of the EAC common market in 2010.

CONFLICT OF INTEREST

The authors have not declared any conflict of interest.

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An empirical investigation of the audit expectation gap: Evidence from Cameroon

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Although the audit expectation gap has been subject to substantial research over the past two decades, it remains a controversial issue for the audit profession. This study, therefore, examines the existence of an audit expectation gap in Cameroon between auditors and users (accountants, bankers, and investors), assesses the dimensions of the gap, and relates the findings to prior findings on the expectation gap. A survey questionnaire capturing fifteen semantic different belief statements on a five-point Likert scale was filled by respondents (n=365). The questionnaire addressed issues concerning auditors' duties, and the consistency and usefulness of audits and audited statements of account. The results indicate significant evidence (α = 0.05) of an audit expectation gap concerning auditors' accountability to prevent as well as detect fraud and to maintain the soundness of internal control systems, and issues related to auditors' objectivity and impartiality. An expectation gap was equally observed regarding auditors' trustworthiness and whether audited statements of accounts obviously articulated the degree of guarantee and the work performed by auditors. We mainly recommend the establishment of an informative and educational platform aimed at keeping users abreast of auditors' responsibilities. These findings serve as a critical reference point for policymakers and regulators interested in enhancing audit quality and audit reliability in Cameroon and other developing economies exhibiting similar audit regulatory and socio-economic characteristics as Cameroon.

Key words: Auditing, auditors, cameroon, expectation, perception, users.

INTRODUCTION

The expectation gap is a contentious issue in the audit profession (Stevenson, 2019), which has been subject to substantial research over the last two decades, especially following the increasing wave of accounting scandals and corporate failures (Dennis, 2010; Gold et al., 2012; Hassink et al., 2009; Pourheydari and Abousaiedi, 2011). The expectation gap is generally considered as the variance amid what the career considers an audit to be and what shareholders consider it to be. Nevertheless, the gap in belief is diverse for all actor-control, the audit team, supervisors, as well as the investment community (Stevenson, 2019). In numerous nations, both developed

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and developing, audit expectation gap (AEG) has been considered comprehensively and established to be in actuality. Examples abound, however herein is a sample: in the UK (Humphrey et al., 1993; Dewing and Russel 2002), Australia (Gay and Schelluch, 1993; Schelluch and Gay, 2006), US (Schelluch, 1996; Frank et al., 2001; Almer and Brody, 2002; McEnroe and Martens, 2001), Netherlands (Hassink et al., 2009), South Africa (Gloeck and De Jager, 1993), China (Lin and Chen, 2004), UK/New Zealand (Porter et al., 2012), Egypt (Dixon et al., 2006), Malta (Desira and Baldacchino, 2005), Singapore (Best et al., 2001), Ghana (Onumah et al., 2009), Iran (Pourheydari and Abousaiedi, 2011), Malaysia (Fadzly and Ahmad, 2004), Bangladesh (Chowdhury and Innes, 1998; Chowdhury et al., 2005; Siddiqui et al., 2009), Saudi Arabia (Haniffa and Hudaib, 2007), Lebanon (Sidani, 2007), Libya (Masoud, 2017), Nigeria (Adeyemi and Uadiale, 2011; Olojede et al., 2020), and Barbados (Alleyne and Howard, 2005).

A familiar feature among the results of these studies is that recorded gap mostly manifests in matters associated with subsequent areas: auditors' accountability for preventing and detecting fraud (Alleyne and Howard, 2005; Best et al., 2001; Desira and Baldacchino, 2005; Dixon et al., 2006; Fadzly and Ahmad, 2004; Gloeck and De Jager, 1993; Hassink et al., 2009; Lin and Chen, 2004; McEnroe and Martens, 2001; Pourheydari and Abousaiedi, 2011; Onumah et al., 2009; Olojede et al., 2020; Porter et al., 2012; Sidani, 2007; Siddiqui et al., 2009), auditors' responsibility to maintain internal controls (Best et al., 2001; Desira and Baldacchino, 2005; Dixon et al., 2006; Fadzly and Ahmad, 2004; McEnroe and Martens, 2001; Pourheydari and Abousaiedi, 2011; Onumah et al., 2009; Olojede et al., 2020; Siddiqui et al., 2009), auditors' responsibility to maintain accounting records (Best et al., 2001; Desira and Baldacchino, 2005; Dixon et al., 2006; Frank et al., 2001; Olojede et al., 2020; Pourheydari and Abousaiedi, 2011), auditors' responsibility to exercise judgment in selecting audit procedures (Best et al., 2001; Chowdhury and Innes, 1998; Chowdhury et al., 2005; Dixon et al., 2006; Olojede et al., 2020; Siddiqui et al., 2009), and issues related to auditors' independence (Gloeck and De Jager, 1993; Humphrey et al., 1993; Schelluch, 1996; Dewing and Russel, 2002; Hassink et al., 2009). Notwithstanding significant variations in auditing standards as well as improvements of the format of audit reports, subsequent to new conspicuous catastrophes of massive establishments like BT group, Tesco, Telkom Rolls-Royce, Barclays Africa, etc., there is obvious sign signifying the continuous existence of an expectation gap (Sidani, 2007; Noghondari and Foong, 2013). This might be accredited to customers' great hopes of auditors remaining unaffected (Fadzly and Ahmad, 2004). We believe that it is vital to recognize the aspects in which users have the uppermost prospects as an essential first phase in the direction of narrowing the gap.

The continuous existence of the expectation gap is detrimental to the credibility of auditors and severely tarnishes the trust in and perception of the audit profession (Fadzly and Ahmad, 2004; Porter, 1993; Ruhnke and Schmidt, 2014). Mainstream research into the audit expectation gap has mostly been done in the established world, and despite considerable differences in the audit services market between developed and developing economies few studies exist for developing economies (Taylor and Simon, 2003). It is worth noting that, the results and suggested recommendations proposed for the business environment of a particular society concerning the nature, objective, opportunities, and limitations of auditing, may not be applicable to another (Haniffa and Hudaib, 2007) due to variances in the state and development of the audit profession, the style of instruction, and the authorised location (Siddiqui et al., 2009).

This study, therefore, aims at examining the existence of an audit expectation gap in Cameroon between auditors and users, assessing the dimensions of the gap, and relating these findings to prior findings on this issue. This study principally investigates the expectancy gap in Cameroon from three perspectives; auditors' accountability, dependability of audited statements of account, and choice efficacy of audited statements of account.

To achieve the objectives of this study, we pose the following research questions:

1. Does an audit expectation gap exist between auditors and users in Cameroon?
2. In what areas is the expectation gap prominent in Cameroon?

This study focuses on Cameroon because very little is known about the impact of the audit regulatory and economic environments on auditing practice in the country. The audit regulatory environment is characterised by multiple legal frameworks while the economic environment has been shaped by the freedom of the monetary market with the establishment of the Douala Stock Exchange (DSX) and the amplified private sector involvement over the privatization wave that categorized the late 90's and the first part of the era. The subsequent effect of these growths is an improved concern among statement of finance operators concerning the degree of financial statement releases by companies. Therefore, the specificity of the audit regulatory and socio-economic environment of Cameroon makes it appropriate for this study. The findings of this study may, thus, function as a serious reference theme for policymakers and regulators interested in enhancing audit quality and the reliability of auditing practice in Cameroon and other developing economies exhibiting similar audit regulatory and socio-

economic environment characteristics as Cameroon. Furthermore, the results of this study may be of interest to academics and stakeholders with an interest in emerging economies, as this study attempts to bridge the gap in extant accounting literature by examining the expectation gap from the unique perpective of Cameroon, whose auditing profession is currently under-investigated.

ACCOUNTING AND AUDITING PRACTICES IN CAMEROON

The general business environment of Cameroon and sixteen other countries is regulated by the Organisation for the Harmonisation of Business Law in Africa (OHADA) (Dickerson, 2005). While the revised Uniform Act on commercial companies and economic interest groups (UACCEIG) provides a regulatory framework for commercial companies and economic interest groups, the Central African Banking Commission (COBAC) regulates banks and other financial institutions, and the Inter-African Conference on Insurance Markets (CIMA) regulates insurance companies. Also, the revised OHADA Act on Accounting and Financial Reporting (2017) provides a general framework for accounting, the UACCEIG details, within the framework of commercial companies, the functioning of auditors. It is worth noting that COBAC's accounting chart significantly differs from that of OHADA.

OHADA (2014) prescribes rules and regulations on the appointment of auditors (Art 289-1, 376, 694); obligations of the auditor (Art 710-717), the rights of the auditor (Art 718-724) and the responsibility of the auditor (Art 725-727). These regulations are meant to constitute a framework for the functioning of the auditor vis-a-vis their stakeholders and to set out the expected outcomes from an external audit engagement contract within the OHADA sub-region.

The OHADA accounting system is a three-tier system that provides a basic legal accounting framework and compels business entities to prepare complete or condensed financial reports depending on their sizes. Companies eligible for the condensed financial report (minimal cash system) are those with turnover below the following threshold; 60 million FCFA (for commercial companies), 40 million FCFA (for handicrafts businesses) and 30 million FCFA (for professional service companies). All other companies shall prepare complete financial statements (standard system). In its recent revision, the OHADA Uniform Act on Accounting and Financial Reporting converged, to a greater extent with the International Financial Reporting Standards (IFRS), especially the IFRS for Small and Medium Size Enterprises. As of 1 January 2019, all listed companies are expected to comply with IFRS.

Based on the provisions of the revised UACCEIG, statutory audits are mandatory for all limited liability companies and public companies which meet two of the following thresholds: (i) Share capital exceeding 10 million FCFA; (ii) sales volume surpassing 250 million FCFA; and (iii) with more than 50 permanent employees. Furthermore, based on the stipulations of article 695 of the OHADA No. Act 4/1997, financial institutions, banks, and insurance companies are expected to perform mandatory audits, although COBAC does not mandate banks to publicly disclose their financial statements.

There are multiple legal frameworks prevailing over the practice of auditing in Cameroon, like; the 2011 legislative law prevailing over the audit profession, the Uniform Act on Commercial Companies and Economic Interest Groups (UACCEIG), CEMAC Regulation No 11/01-UEAC-027-CM-07 of 5 December 2001, the French translation of International Standards on Auditing (ISAs), guides and directives from the Institute of Chartered Accountants in Cameroon (ONECCA), and regulations by the Ministry of Finance. These different regulatory frameworks have the potential to influence users' perception of the duties of auditors, especially when they infringe on each other's duty, thus forming an expectation gap. ONECCA is not involved in the training and certification of certified/ chartered accountants due to the absence of an examination body as is the case with other bodies. ONECCA relies on foreign-trained accountants, usually with various abilities, to execute constitutional audits in Cameroon. Although the parliamentary law of 2011 established a requirement for foreign-trained accountants to pass an examination on the business regulatory framework of Cameroon (conversion papers), this prescription is not yet operational. Besides, auditors often rely on their institutes of origin for practice guidance, resulting in the absence of de facto harmonisation of practice and performance on audits, which possibly generates or increases the audit expectation-performance gap.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Background and prior studies on the audit expectation gap

It is worth mentioning that the expectation gap has been in existence long before the term was first used (Sidani, 2007), and it is still debated to date (Lee et al., 2010). Thus, the audit expectation gap is not a new topic nor limited geographically (Porter et al., 2012). Humphrey and Turley (1992) trace the origin of the expectation gap back to the nineteenth century with the start of company auditing. The gap has been defined differently by various researchers. We, however, define the expectation gap as the differences in beliefs and desires between auditors

and users of financial statements resulting from unreasonable expectations, deficient standards, and the inadequate performance of auditors.

Preliminary studies on the audit expectation gap (Liggio, 1974; The Cohen Commission, 1978) focused on establishing its foundation and rationale. These early studies all confirmed the existence of the expectation gap, especially on issues relating to the nature of auditing, auditors' duties and responsibilities, auditors' independence, and the provision of non-audit services (Dixon et al., 2006). Humphrey et al. (1993) highlight that the expectation gap has customarily focused on continual issues such as the duties and responsibilities of auditors, the quality of the audit functions, the nature and meaning of the messages communicated in audit reports, the regulation and structure of the audit profession, and the provision of evidence of the expectation gap (Noghondari and Foong, 2013). Contemporary studies on the expectation gap have shifted from addressing the causes of the expectation gap to addressing the extent of its existence, the areas most affected, and possible measures to narrow the expectation gap (Sidani, 2007; Noghondari and Foong 2013).

Humphrey et al. (1993) categorise the discourse of the audit expectation gap into four main issues: the duties and responsibilities of auditors; the structure and regulation of the audit profession; the quality of the audit function; and the nature and meaning of the information communicated in audit reports. Conversely, Monroe and Woodliff (1993) categorise the expectation gap into three principal issues: auditors' responsibilities, the reliability of the financial statements, and the prospects of the entity being audited. On a similar note, Schelluch (1996) and Best et al. (2001) add decision-usefulness as an essential aspect of the expectation gap debate. A similar grouping has been adopted by other scholars (Fadzly and Ahmad, 2004; Desira and Baldacchino, 2005; Dixon et al., 2006; Pourheydari and Abousaiedi, 2011) who categorise the expectation areas into auditors' responsibilities, reliability, and decision usefulness of audited financial statements.

Porter (1993) categorises the expectation-performance gap into two major components: the reasonableness gap and the performance gap. The reasonableness gap is the gap between what financial statement users expect auditors to accomplish, and what auditors can reasonably be expected to achieve, whereas, the performance gap is the gap between what financial statement users can reasonably expect auditors to perform and what auditors are perceived to accomplish. The performance gap is further divided into the deficient performance gap and the deficient standard gap. The deficient performance gap is the gap between the expected performance of auditors as required by law and as expected and perceived by the public. In addition, the deficient performance gap is the gap between the duties and responsibilities which financial statement users can reasonably expect auditors to perform and the existing duties of auditors as defined by legislative statutes and professional promulgations. Porter et al. (2012) have similarly observed that 43 percent of the expectation gap is attributable to deficient standards, while 50 percent results from the unreasonable expectations of the public, and 7 percent results from auditors' sub-standard performance.

In examining the determinants of the expectation gap, Fossung et al. (2020) observed that audits and audited financial statements and auditors' skills are strong indicators of the expectation gap. On the other hand, gender, occupation, and years of experience are weak indicators of the expectation gap. Furthermore, they observed that an increase in regulation and the duties of auditors concerning the reliability and usefulness of audits only exacerbates the expectation. Furthermore, the contemporary discourse of the expectation gap seems to be shifting from the traditional audit perspective to the digital auditing perspective, as Fotoh and Lorentzon (2020) provide an added impetus on the expectation gap by studying how the ongoing digitalisation of the audit process could potentially impact the expectation gap.

Causes of and remedies for the expectation gap

The accounting profession contends that a major reason for the expectation gap is the inability of the public to recognise the nature and limitation of an audit (Frank et al., 2001), the failure of the public in assessing auditors' performance, and the underperformance of auditors (Ruhnke and Schmidt, 2014) which has further exacerbated the legal liability facing the audit profession (Maccarrone, 1993). Gold et al. (2012) equally note that users often assume that audits have a broader scope and often expect more from auditors than is possible. The public lacks the relevant knowledge of the level of inspection necessary for auditors to detect all fraud. As a result, they perceive the detection of fraud as the auditor's primary responsibility (Porter et al., 2012). Thus, the objectives of auditing are not as clear to financial statement users as they are to auditors (Masoud, 2017). Almer and Brody (2002) further attribute the expectation gap to the linguistic ambiguity in auditor communications and how these communications are understood by users.

Current enforced measures to narrow the expectation gap generally include the standardisation of the wording and structure of audit reports; the standardisation of audit opinions text; the addition of text stipulating the responsibilities of management and auditors in the audit report. Enes et al. (2016) contend that the lack of information results in an enormous misunderstanding of the audit profession. Therefore, providing more information through the audit or the audit report is a necessary step towards reducing the public's misunderstanding of the audit (Enes et al., 2016; Ruhnke

and Schmidt, 2014). In another study, Hatherly et al. (1991) observe that adopting the expanded audit report form changed users' perception of the audit as well as providing a sense of well-being, especially on the issue of freedom of fraud in the entity. However, Litjens et al. (2015) contradict this position by noting that the provision of more information does not necessarily narrow the expectation gap. Meanwhile, Schelluch and Gay (2006) and Asare and Wright (2012) recommend changing the language in which information is communicated as a vital measure of narrowing the information gap. Similarly, Vanstraelen et al. (2012) propose four information items necessary to narrow the expectation gap; audit scope, audit findings, discussion and analysis of auditors, and information on the auditor.

Vanstraelen et al. (2012) underscore the importance of changing the content of the audit report rather than changing the format of the audit process as imperative to narrowing the expectation gap. Additionally, prior and contemporary studies all emphasise the vital role of audit education in narrowing the expectation gap (Monroe and Woodliff, 1993; Sidani, 2007; Siddiqui et al., 2009; Hassink et al., 2009; Noghondari and Foong, 2013; Fulop et al., 2019). However, Ruhnke and Schmidt (2014) emphasise that currently enforced strategies to mitigate the expectation gap may not yield the desired results due to the ever-changing financial statements, thus, necessitating audit change. Similarly, after comparing previous and recent studies on the expectation gap, Porter et al. (2012) contend that the public's understanding has not improved over the years. Therefore, the audit expectation gap will continue to be an issue for the accounting profession.

From the review of literature, the findings on the expectation gap may be categorised into three main perspectives: auditors' responsibilities, the reliability of audits and audited financial statements, the usefulness of audits and audited financial statements, and other aspects of the expectation gap. Table 1 summarizes the findings from global studies from these perspectives.

Hypotheses

Based on the contextual environment of Cameroon and the review of the extant literature on the expectation gap, we formulated three principal hypotheses. The hypotheses were extracted from the categorisation in the prior section, that is: financial statement users' and auditors' perceptions of critical issues of auditors' duties, the reliability of audits and audited financial statements, and the usefulness of and audited financial statements. The underlying assumption was that if significant differences in perception existed between financial statement users and auditors, then there existed an audit expectation gap.

The following hypotheses were proposed:

H1. There are no significant differences in perception between financial statement users and auditors regarding auditors' responsibilities.
H2. There exists no significant differences in perception between financial statement users and auditors regarding the reliability of audits and audited financial statements.
H3. No significant differences exist between the perception of financial statement users and auditors regarding the usefulness of audits and audited financial statements.

METHODOLOGY

To examine the existence of an audit expectation gap in Cameroon, this study adopted a research method and research design significantly similar to those adopted in Schelluch (1996), Best et al. (2001), Fadzly and Ahmad (2004), Desira and Baldacchino (2005), Dixon et al. (2006), and Olojede et al. (2020). Schelluch (1996) was the first to use a semantic differential instrument to measure the messages conveyed through audited reports. This instrument was subsequently adopted by other researchers (Best et al., 2001; Fadzly and Ahmad, 2004; Desira and Baldacchino, 2005; Dixon et al., 2006; Olojede et al., 2020) to investigate the existence of the audit expectation gap. Using a similar method is useful in providing a reliable assessment of the expectation gap in Cameroon and further facilitates comparisons between the findings of this study and those of previous studies. This study makes use of the same semantic differential statements with minor adjustments to measure the audit expectation gap in Cameroon. Due to the large population involved, the questionnaire approach was deemed the most efficient method of collecting primary data for this study. The questionnaire method is consistent with prior studies on the audit expectation gap (Porter, 1993; Monroe and Woodliff, 1993; Best et al., 2001; Fadzly and Ahmad, 2004; Desira and Baldacchino, 2005; Dixon et al., 2006; Siddiqui et al., 2009; Olojede et al., 2020). The questionnaire was designed and modelled to ensure that the data needed were collected from relevant respondents to achieve the objectives of this study. The validity of the questionnaire was deemed appropriate considering that prior studies on the expectation gap have tested and validated all the questions used in this survey instrument.

Each semantic differential belief statement was evaluated using the five-point Likert scale with participants being asked to choose a number from the range which corresponded to their level of agreement with each of the statements. As Bell (2010) notes, the Likert scale is of significant importance in evaluating perceptions. The objective of this study can only be achieved by comparing and evaluating the perceptions of auditors and users; thus the Likert scale is suitable. Furthermore, we chose the five-point Likert scale over the seven-point Likert scale because it is less demotivating and frustrating to participants, as noted by Preston and Colman (2000). The questionnaire was divided into two sections. The first section gathered demographic information from respondents related to their occupation, experience, and qualifications, while the second section contained 15 semantic belief statements categorised into three factors:

1. Responsibility
2. Reliability
3. Decision usefulness

Table 1. Major studies uncovering the expectation gap in relation to issues regarding Auditor's responsibility, reliability and usefulness of audits.

Author(s)/Year	Country	Auditors' responsibilities						Reliability of audits and audited financial statements						Usefulness of audits and audited financial statements		
		Fraud prevention and detection	Soundness of internal controls	Maintaining accounting records	Maintaining accounting records (Management)	Exercising judgment in selecting audit procedures	Unbiased and objective	FS free from material misstatements	Auditors agree with accounting policies used in FS	FS give a true and fair view	Extent of assurance clearly communicated in the audit report	Extent of work performed by auditors is clearly communicated	Entity is free from fraud	Monitoring performance	Decision making	An indication an entity is well managed
McEnroe and Martens, 2001	USA	X	X					X								
Frank et al., 2001	USA	X		X												
Hassink et al., 2009		X														
Gloeck and De Jager, 1993	South Africa	X					X									
Lin and Chen, 2004	China	X														
Dixon et al., 2006	Egypt	X	X	XS		X	X	XM	XM	XM			XS	XS	XS	
Desira and Baldacchino, 2005	Malta	X	X	X				X		XS		X	X			X
Best at al., 2001	Singapore	X	XM	XS		XS			XS				X	XS		
Onumah et al., 2009	Ghana	X	XS	XS				X				X	X			
Pourheydari and Abousaiedi, 2011	Iran	X	X		XS			XM						X		XS
Fadzly and Ahmad, 2004	Malaysia	X	X	XS	X					XS		XM	XM	X		XM
Siddique et al., 2009	Bangladesh	XS	X	X		X	X		X				X		X	
Haniffa and Hudaib, 2007	Saudi Arabia	X														
Sidani, 2007	Lebanon	X			XS											
Adeyemi and Uadiale, 2011	Nigeria	X														
Olojede et al. 2020	Nigeria	X	X	X		X	X	XM		XM	X					X
Alleyne and Howard, 2005	Barbados	X														

S= Same line of opinion, but differences agreement level between auditors and respondents, M= Mild expectation gap mainly between auditors and one of the respondent groups, X= Significance expectation gap in opposite direction.

Table 2. Distribution of respondent groups.

Profession	Number	Percentage
Auditors	63	17
Accountants	186	51
Bankers	97	27
Investors	19	5
TOTAL	365	100

Table 3. Occupational experience of respondents.

Years of experience	Number	Percentage
Less than 1 year	34	9
1-5 years	149	41
5-10 years	76	21
10-15 years	71	20
Over 15 years	33	9
Total	**365**	**100**

Statements 1-6 related to auditors' responsibilities, statements 7-12 related to the reliability of audits and audited financial statements, while statements 13-15 related to the decision usefulness of audited financial statements.

Participants

The survey participants were drawn from four groups: auditors, accountants, investors, and bankers. These participants are relevant for this study because they are often perceived as knowledgeable and abreast on auditing issues. For this study, auditors refer to chartered accountants registered with ONECCA and currently practising audit. Meanwhile, accountants refer to those with an undergraduate or graduate degree in accounting with no prior audit experience currently working as an accountant for an entity. Investors are those shareholders and proprietors of those entities where the accountants work, while bankers are senior officers of commercial banks that provide savings and credit facilities to the companies of investors. The auditors were selected from the ONECCA database which includes 218 registered members, while the accountants, bankers, and investors were chosen randomly. It is worth noting that not all ONECCA members are active auditors; however, the study was limited to active auditors. All participants were selected using systematic random sampling. The participants included 63 auditors, 186 accountants, 97 bankers, and 19 investors. The choice of accountants, bankers, and investors as representatives of users stems from the fact that these professions are the most prominent consumers of audited financial statements. Furthermore, these user groups are believed to be representative of the user population. The same questionnaire was sent electronically to both auditors and users (accountants, investors, and bankers) with a promise of anonymity and confidentiality of responses. The underlying purpose of sending out the same questionnaire to both groups was to facilitate the comparison of responses between auditors and users. The survey was conducted in 2019 between 15 January and 15 March.

The data obtained for this study were analysed using descriptive statistics and T-test. Statistical information, such as the mean scores, standard deviations, and P values, was obtained for both auditors and users (accountants, bankers, and investors) after running an independent sample T-tests. The independent sample T-test was most appropriate for this study as it measures statistically significant differences (at $p \leq 0.05$) for both auditors and users based on the fifteen semantic differential belief statements.

RESULTS AND DISCUSSION

A total of 400 questionnaires were administered through a random selection process of users(accountants, bankers, and investors), while the total population of active auditors received the questionnaire as part of the data collection process, of which 365 were returned representing a response rate of 91.25%, comprising 157 (43%) females and 209 (57%) males. The demographic information of respondents was collected as part of the questionnaire. Table 2 shows the distribution of each respondent group. The majority of respondents were accountants (51%), while bankers constituted 27% of the respondents, auditors 17%, and investors 5%. Table 3 contains information about the occupational experience of respondents based on the classification of their current fields (auditing, banking, investing, and accounting). The results indicate that 9% of respondents had less than one year of work experience, while 41% had between one and five years, 21% between five and ten years, 20% between ten and fifteen years, and 9% had over fifteen years of work experience. The experience levels of the respondents of this study were generally high, lending credibility to the outcome of this study as respondents were likely to be informed about the importance of audited financial statements and the audit process.

Auditors' responsibilities

Table 4 presents the results of the mean scores and standard deviations for auditors and users of financial statements (accountants, bankers, and investors). The six statements in Table 4 address issues related to auditors' duties in relation to the following aspects: fraud prevention and detection; ensuring the soundness of the internal control structures of an entity; maintaining accounting records; exercising judgment in selecting auditing procedures; and finally, auditors' objectivity. Results show significant differences (an audit expectation gap) for all issues of auditors' responsibility except for the issue of whether auditors exercise judgment in selecting accounting procedures (statement 5).

The results indicate that auditors maintained a neutral position regarding their fraud detection responsibility, whereas accountants and bankers agreed, and investors somewhat agreed that auditors were responsible for detecting all fraud. It is fascinating to observe that the auditors' mean score was 3.08 (midpoint), which highlights an uncertainty among auditors as to whether

they are responsible for detecting all fraud. Such uncertainty may stem from increasing public pressure on auditors to provide absolute assurance that financial statements are free from fraud especially following prominent corporate wrecks in Cameroon such as; SODECOTON, SONARA, FIFA (First Investment and Financial Assurance), CONFINEST, and more recently BICEC has , which have largely shaped the perceptions of both users and auditors regarding auditors' fraud detection responsibilities. Furthermore, auditors were undecided as to whether they were responsible for ensuring the soundness of the internal control structures of an entity, while bankers and investors agreed, and accountants somewhat agreed that auditors were responsible for ensuring the soundness and the control structures of an entity. This finding is in line with prior findings (Best et al., 2001; Dixon et al., 2006; Fadzly and Ahmad, 2004; McEnroe and Martens, 2001; Olojede et al., 2020; Onumah et al., 2009; Pourheydari and Abousaiedi, 2011; Siddique et al., 2009) which observed an expectation gap on the issue of auditors being responsible for the soundness and the control structures of an entity. On the issue of whether auditors were responsible for preventing fraud, auditors slightly disagreed to this statement, while accountants and bankers somewhat agreed, and investors agreed that auditors were responsible for preventing fraud in an entity.

Table 1 highlights all 17 studies in this area, which uncovered an expectation gap as regards auditors' fraud prevention and detection responsibilities. In a nutshell, the endemic nature of corruption in Cameroon plagues both the private and the public sectors. For example, private entities in Cameroon spend almost 10% of their turnover on bribes and unofficial payments (Ondoa, 2014) while in 2015, over 146 companies were banned from accessing any process bid for procurement contracts due to fraud, corruption, swindling and misappropriation of funds. This corporate malfeasance has largely shaped financial statement users' perception in believing that auditors should prevent and detect fraud as well as maintain the internal control structures of an entity. In line with prior studies (Gloeck and De Jager, 1993; Dixon et al., 2006; Siddique et al. 2009; Olojede et al., 2020), there was a significant difference in response between auditors and users about the issue of auditors being unbiased and objective. While auditors strongly agreed they were impartial and objective, accountants and bankers agreed, while investors somewhat agreed to this statement. The results of this study further confirm the longstanding positive reputation that the audit profession accords to itself.

Additionally, there were significant differences observed between auditors, bankers, and investors regarding auditors' responsibility for maintaining the accounting records of an entity. While auditors disagreed, bankers fairly disagreed, and investors maintained a neutral position on the issue. On the other hand, no significant difference was observed between auditors and accountants on the subject as both groups believed that auditors are not responsible for maintaining the accounting records of an entity. The results of this study thus indicate that accountants take full responsibility for the preparation of accounting records. The neutral position of investors indicates uncertainty and possibly a wish for auditors to be involved in preparing financial statements. The findings of this study are consistent with prior studies (Best et al., 2001; Desira and Baldacchino, 2005; Dixon et al., 2006; Fadzly and Ahmad, 2004; Frank et al., 2001; Olojede et al., 2020; Onumah et al., 2009; Siddique et al., 2009) which uncovered an expectation gap as regards auditors' responsibility in maintaining accounting records. Although significant differences existed between auditors and users pertaining to auditors' accounting responsibility and auditors being unbiased and objective, these differences did not reflect contrasting opinions, but rather variations in agreement levels. Lastly, there was no significant difference in response between auditors and users pertaining to whether auditors exercised judgment in selecting audit procedures contrasting prior findings (Best et al. 2001; Dixon et al. 2006; Siddiqui et al. 2009; Olojede et al., 2020), as both groups of respondents agreed that auditors exercised discretion in selecting audit procedures.

Reliability of audits and audited financial statements

Table 5 presents the results of the mean scores and standard deviations for auditors and users of financial statements (accountants, bankers, and investors) on issues concerning the reliability of audits and audited financial statements. The six statements on the reliability of audits and audited financial statements centre on issues concerning the following aspects: the level of assurance financial statement users perceive in audited financial statements; whether auditors agreed with the accounting policies used in preparing the financial statements; whether audited financial statements present a true and fair view; whether the extent of assurance and the extent of the work performed by auditors are clearly communicated to users; and whether auditors were considered trustworthy. Results reveal a significant expectation gap regarding issues related to auditors' trustworthiness and whether auditors explicitly communicated the extent of assurance and the work performed in the audit report. However, no significant differences were found in relation to issues involving the level of assurance that audited financial statements were free from material misstatements, on auditors agreeing with the accounting policies of an entity, and whether audited financial statements present a true and fair view of the financial performance and operations of an entity.

Table 4. Results of issues related to auditors´ responsibilities.

Statements	Respondent group	N	Mean	Standard deviation
The auditor is responsible for detecting all fraud	Auditors	63	3.08	1.579
	Accountants	186	4.18*	1.073
	Bankers	97	4.18*	1.118
	Investors	19	3.79*	1.084
Auditors are responsible for the soundness of the internal control structures of an entity	Auditors	63	3.14	1.490
	Accountants	186	3.78*	1.089
	Bankers	97	4.08*	.773
	Investors	19	4.26*	.806
It is the auditor's responsibility to maintain accounting records	Auditors	63	1.79	1.346
	Accountants	186	2.16	1.362
	Bankers	97	2.65*	1.521
	Investors	19	3.21*	1.512
Auditors are responsible for preventing fraud	Auditors	63	2.71	1.475
	Accountants	186	3.67*	1.117
	Bankers	97	3.65*	1.100
	Investors	19	4.05*	1.268
Auditors exercise judgment in selecting audit procedures	Auditors	63	4.29	.941
	Accountants	186	4.23	.966
	Bankers	97	4.30	.806
	Investors	19	3.79	1.475
Auditors are unbiased and objective	Auditors	63	4.52	.800
	Accountants	186	4.07*	1.024
	Bankers	97	4.00*	.924
	Investors	19	3.53*	1.577

*Significantly different from auditors at $p \leq 0.05$. Five-point Likert scale was used where 1 means strongly disagree and 5 strongly agree.

The results in Table 5 show no evidence of an expectation gap in Cameroon between auditors and users as regards issues concerning the extent of assurance that audited financial statements were free from material mis-statements (statement 7). Both auditors and users were of the opinion that audited financial statements were free from material misstatements. Similarly, Table 5 indicates no expectation gap between auditors and users regarding auditors' agreement with the accounting policies of an entity (statement 8). Auditors, as well as users, generally agreed that in making an unqualified audit opinion, auditors agreed with the accounting policies of the entity. Also, no expectation gap was revealed as to whether audited financial statements present a true and fair view of the financial performance and position of an entity (statement 9). Both auditors and users were of the opinion that audited financial statements without any qualification present a true and fair view of the financial performance and position of an entity.

Consistent with the findings of Olojede et al. (2020), there was evidence of an expectation gap between auditors and users regarding the extent of assurance communicated in the audit report (statement 10). Auditors strongly believed that audit reports explicitly highlight the extent of assurance given by the auditor compared to users. Additionally, an expectation gap was revealed in relation to the clarity with which the extent of the work performed by auditors is communicated in the audit report (statement 11). This finding is consistent with the findings of Desira and Baldacchino (2005), Fadzly and Ahmad (2004), and Onumah et al. (2009) who uncovered an expectation gap on whether the extent of work performed in audits is clearly communicated. Auditors fully believed that the extent of the work performed in audits is clearly communicated compared to accountants and investors. However, no expectation gap was discovered between auditors and bankers on this issue. Moreover, a significant difference was observed on the issue of whether auditors are trustworthy (statement 12). The results of this study reveal that auditors firmly

Table 5. Results concerning reliability of the audits and audited financial statements.

Statements	Respondent group	N	Mean	Standard deviation
Users can have absolute assurance that financial statements are free from material misstatements	Auditors	63	4.05	1.170
	Accountants	186	3.95	1.136
	Bankers	97	4.28	1.058
	Investors	19	3.79	1.357
Auditors agree with the accounting policies used in the financial statement	Auditors	63	4.16	.865
	Accountants	186	4.24	.991
	Bankers	97	4.41	.826
	Investors	19	4.05	1.129
Financial statements give a true and fair view	Auditors	63	4.21	.901
	Accountants	186	4.37	1.017
	Bankers	97	4.44	1.000
	Investors	19	4.21	1.134
The extent of assurance given by auditors is clearly indicated in the audit report	Auditors	63	4.71	.551
	Accountants	186	4.41*	.933
	Bankers	97	4.43*	.802
	Investors	19	3.74*	1.447
The extent of the work performed by auditors is clearly communicated	Auditors	63	4.52	.692
	Accountants	186	4.26*	.987
	Bankers	97	4.34	.967
	Investors	19	3.89*	1.286
Auditors are trustworthy	Auditors	63	4.57	.712
	Accountants	186	4.08*	1.122
	Bankers	97	4.13*	1.187
	Investors	19	3.74*	1.368

*Significantly different from auditors at $p \leq 0.05$. Five-point Likert scale was used where 1 means strongly disagree and 5 strongly agree.

believed themselves to be trustworthy compared with the less convinced users. It is worth underscoring that the mean score of investors regarding auditors' trustworthiness is the lowest on this issue as they only somewhat agreed that auditors are trustworthy. The sceptical position of investors possibly results from the corporate malfeasance and corruption which have plagued Cameroon. Similarly, an expectation gap was uncovered as regards whether the extent of assurance given by auditors was clearly communicated.

In addition, the findings of this study underscore that bankers held a firm conviction that auditors were in agreement with the accounting policies of an entity and that audited financial statements present a true and fair view of the financial performance and position of an entity.

These findings reflect bankers' views on the importance of audited financial statements for lending decisions. Similarly, auditors took a strong position that the scope of the work they do is clearly communicated in audit reports, which reflects a long-standing view held by the audit profession. It is worth underscoring that regarding the three issues in relation to which an expectation gap was observed, the differences do not indicate contrasting views; instead, the two groups had the same opinions, though with some variation in agreement levels, with investors having the least agreement level. Additionally, the positive view of financial statement users regarding the reliability of audits and audited financial statements could be attributed to the changes in the audit regulatory environment in Cameroon with the adoption of ISQ1, the 2009 IESBA code of ethics, and the creation of a disciplinary and trial committee by ONECCA. The ISQ1 and the 2009 IESBA code of ethics generally enhance

Table 6. Results concerning usefulness of audited financial statements.

Statements	Respondent group	N	Mean	Standard deviation
Audited financial statements are useful for monitoring an entity's performance	Auditors	63	4.56	.757
	Accountants	186	4.56	.704
	Bankers	97	4.52	.980
	Investors	19	4.42	1.261
Audited financial statements are useful for decision making	Auditors	63	4.62	.705
	Accountants	186	4.44	.784
	Bankers	97	4.55	.842
	Investors	19	4.53	.964
Audited financial statements indicate whether an entity is well managed	Auditors	63	4.25	.897
	Accountants	186	4.39	.901
	Bankers	97	4.56*	.790
	Investors	19	4.37	1.257

*Significantly different from auditors at $p \leq 0.05$. Five-point Likert scale was used where 1 means strongly disagree and 5 strongly agree.

audit quality resulting in reliable audits, while the disciplinary and trial committee serves as a punitive and deterrence body that typically dissuades auditors from engaging in unethical and fraudulent practices.

The usefulness of audited financial statements

The three statements on usefulness relate to the importance of audited financial statements in performance monitoring, decision usefulness, and evaluating whether an entity is well managed. Table 6 contains the mean scores and standard deviations regarding this issue. Results show no evidence of an expectation gap in Cameroon regarding the three statements, except for the importance of audited financial statements in evaluating whether an entity is well managed where there were significant differences between auditors and bankers. Bankers had a significantly higher level of agreement compared to auditors on the usefulness of audited financial statements for indicating how well an entity is managed. The best explanation for this view is that bankers pay a great deal of attention to audited financial statements in making lending decisions, and the effectiveness of management is critical in making lending decisions. The difference in mean score between auditors and bankers on this issue is not a result of contrasting views but a result of variations in agreement levels. It is worth highlighting that the mean scores of the decision usefulness statements were generally the highest of this study. The results show that auditors and users of financial statements believe audited financial statements are generally useful for performance monitoring, decision making, and assessing how well an entity is well managed. The result concurs with the findings of Olojede et al. (2020), who observed an expectation solely on the issue of whether audited financial statements were an indication of whether an entity was well managed and not on the other two decision-usefulness aspects. The result of this study corresponds with the findings of Schelluch (1996) and Olojede et al. (2020) and contrast with Fadzly and Ahmad (2004), Dixon et al. (2006), Desira and Baldacchino (2005), Siddique et al. 2009, and others, who uncovered an expectation gap regarding the usefulness of audited financial statements for performance monitoring. Furthermore, the findings of this study support the conclusion of Best et al. (2001), Fadzly and Ahmad (2004), and Olojede et al. (2020) who observed no expectation gap concerning the usefulness of audited financial statements in decision making.

Evaluation of hypotheses

The hypotheses are evaluated using the result of the T-test statistics. The assumption is that in cases where no differences in statistical significance exist, there is no expectation gap.

Hypothesis 1

H1. There are no significant differences in perception between financial statement users and auditors regarding auditors' responsibilities.

This hypothesis evaluated the mean responses between

auditors and financial statement users on issues related to auditors' responsibilities. The T-test output obtained highlights statistically significant differences (at $P \leq 0.05$) in mean scores between auditors and users for all issues of auditors' responsibilities, except for the issue of whether auditors exercise judgment in selecting auditing procedures. On the basis of statistical evidence, it can be deduced that there exists significant evidence of differences in perception between financial statement users and auditors regarding auditors' responsibilities, and therefore, we reject H1. The implication of these findings is that what auditors perceive as their responsibilities significantly differs from users' perception of auditors' responsibilities, except for the issue of whether auditors exercise judgment in selecting auditing procedures.

Hypothesis 2

H2. There exists no significant differences in perception between financial statement users and auditors regarding the reliability of audits and audited financial statements.

This hypothesis examined the mean responses between auditors and financial statement users regarding issues related to the reliability of audits and audited financial statements. Based on the T-test results, the result once again highlights statistically significant differences (at $P \leq 0.05$) in mean scores between auditors and financial statement users on issues pertaining to auditors' trustworthiness, and whether auditors explicitly communicated the extent of assurance and the work performed in the audit report. It is worth mentioning that these differences do not indicate contrasting views; instead the two groups had the same opinions, though with some variation in agreement levels, with investors having the least agreement level. However, no statistically significant differences (at $P \leq 0.05$) were uncovered on issues concerning the level of assurance that audited financial statements were free from material misstatements, on auditors agreeing with the accounting policies of an entity, and whether audited financial statements present a true and fair view of the financial performance and operations of an entity. These findings lead us to partially reject H2 since there is statistical significance in some aspects and no statistical significance in other aspects. The implication of these findings is that what auditors perceive about the reliability of audits and audited financial statements is more positive in some cases than financial statement users' perception, while in other cases there are no significant differences.

Hypothesis 3

H3. No significant differences exist between the perception of financial statement users and auditors regarding the usefulness of audits and audited financial statements.

The hypothesis compared the mean responses between auditors and financial statement users regarding the usefulness of audits and audited financial statements. There were insignificant statistical differences between auditors and users on all issues related to the usefulness of audits and audited financial statements. Hence, H3 is accepted, highlighting no difference in perception between both groups. Consequently, there is no expectation gap between the two groups as both groups appear to assert the usefulness of audits and audited financial statements in monitoring an entity's performance, in decision making, and as an indication that the entity is well managed.

Based on the analysis, H1 is rejected while H2 is partially rejected and H3 is retained. In a nutshell, the expectation gap was widest on issues concerning auditors' responsibilities, while there was a partial expectation gap on issues related to the reliability of audits and audited financial statements, and no expectation gap on issues related to the usefulness of audits and audited financial statements in Cameroon.

Conclusion

The aim of this study was to examine empirically whether an audit expectation gap exists between auditors and financial statement users in the Cameroon audit environment and economic context and to relate the results to the results of prior studies. Consistent with the findings of previous studies (Best et al., 2001; Desira and Baldacchino, 2005; Dixon et al., 2006; Fadzly and Ahmad, 2004; Frank et al., 2001; Haniffa and Hudaib, 2007; Lin and Chen, 2004; McEnroe and Martens, 2001; Onumah et al. 2009; Olojede et al., 2020; Pourheydari and Abousaiedi, 2011; Schelluch, 1996; Siddiqui et al., 2009), this study uncovered an expectation in Cameroon mainly on the responsibilities of auditors and the reliability of audits and audited financial statements. Concerning the responsibilities of auditors, financial statement users and auditors had different views on some fundamental auditing issues. The expectation gap was widest in relation to issues concerning auditors' fraud prevention and detection responsibilities, auditors' responsibility for the soundness of an entity's internal control system, and auditors' reputation for being objective and unbiased. Such findings are consistent with prior results of similar studies conducted globally. A slight expectation gap was also discovered between auditors and users, except for accountants, on the issue of auditors' responsibility for maintaining the accounting records of an entity. For the purpose of this study, a slight expectation gap is a gap between auditors and one of the respondent groups but not involving all of the respondent groups. Concerning

the reliability of audits and audited financial statements, an expectation gap was observed in relation to issues concerning auditors' trustworthiness and whether audited financial statements clearly articulated the extent of assurance and the work performed by auditors. Regarding the usefulness of audited financial statements, a slight expectation gap was uncovered between auditors and bankers regarding the importance of audited financial statements in evaluating how well an entity was managed. The different perceptions between financial statement users and auditors could be attributed to the unique auditing environment and economic context of Cameroon.

The results of this study are indicative of severe concerns for the audit profession in Cameroon, principally regarding fraud prevention and detection, and the maintenance of an entity's internal control systems. In the Cameroonian context, the Ministry of Finance and ONECCA should consider either stressing the limited role of auditors regarding fraud prevention and detection as well as auditors' responsibility for maintaining internal controls through communication and educational forums aimed to educate users or, consider introducing explicit legislation relating to auditors' responsibilities for fraud prevention and detection and the maintenance of internal controls. These measures could possibly be suitably implemented in Cameroon to narrow the expectation gap. Future studies could focus on testing the applicability of these recommended methods to narrow the expectation gap in Cameroon, particularly audit education, which has been widely recommended as an effective means of narrowing the expectation gap.

Limitations

The scope of this study is limited to the 400 potential respondents with the actual responses being unevenly distributed among the respondent categories. This limitation of scope resulted mainly from the fact that the survey was administered during the peak auditing season in Cameroon. Furthermore, the limitation in scope resulted from the electronic inaccessibility of some users. Furthermore, this study used a survey instrument similar to Best et al. (2001), Fadzly and Ahmad (2004), Dixon et al. (2006), and Olojede et al. (2020) who implemented the Mann-Whitney Test for analysis. However, this study used the independent sample T-test because it was deemed appropriate in relation to the purpose. Unlike aforementioned studies, which all implemented the seven-point Likert scale, we used the five-point scale for measuring the data, which may have an impact on the interpretation of the results. A further limitation of this study is the difference in audit regulatory and socio-economic conditions and outlook between Cameroon and the other countries where the above studies were conducted. Therefore, these limitations may affect the generalisability of the findings of this study.

CONFLICT OF INTERESTS

The authors have not declared any conflict of interest.

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Related party transactions and their association with earnings management – evidence of Hong Kong listed companies

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This study empirically investigates whether related party transactions play an important role in earnings management in Hong Kong Stock Exchange, by using manually collected data comprising 1,278 firms' yearly observations from all listed company on Hang Seng Composite Industry Indexes from 2016 to 2018. This study analyzes the three most frequent types of related party transactions, including related sales, related lending and related borrowing, and to examine their associations with earnings management. The findings suggest that companies did not have abnormally high level of related party transactions when they have earnings management incentives. Related party transactions are not used in income smoothing or to inflate earnings in Hong Kong Stock Exchange. This study may provide insights to investors on how companies use related party transactions to manipulate earnings.

Key words: Related party transactions, earnings manipulation.

INTRODUCTION

Over the past years, related party transactions have become extensively popular as firms can divert its earnings and cash to the other members within the group. The troubled firm could gain support from the other group members like receiving guarantees, selling goods and services, borrowing funds etc. On the other hand, related party transaction is an effective tool in income smoothing and can be used in spring loading, in which the company defers revenues and accelerates expenses until it is merged with the other company, resulting the company has a more favorable earnings trend after merger and acquisition. Related party transactions are strongly related to earnings management as a group-affiliated company which can be derived as subsidiaries with hundreds of related parties, where the larger the group's networks, the greater the opportunities to have transactions with related parties. Parties within the network can divert their free cash flows to the group with better terms and credits. This type of transaction has also aroused the need of academic research with close attention as it could affect the transparency of the financial statements and investors' decision-making. This paper aims to investigate the association between related party transactions and earnings management as well as the degree of usage of this type of transaction in Hong Kong Stock Exchange.

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Hong Kong is proposed as China's international finance center with a wide range of connections with Hong Kong and Mainland Chinese companies as well as the international companies. It has a diverse and global investor base with well-established legal system which makes it a compelling platform for fundraising and to stimulate business growth. The Stock Exchange of Hong Kong ranked the third largest Asian Stock Market by domestic market capitalization in 2018, behind the Tokyo Stock Exchange and Shanghai Stock Exchange. The unique characteristic of the Hong Kong Stock Exchange has provided an efficient and effective cross-border market connecting China with the world and has provided strong confidence to investors. In this circumstance, the disclosures of related party transactions are particularly crucial to enhance the credibility of the annual reports as well as to secure inventors' confidence and wealth.

Related party transactions can be in different forms. It could be a normal business transaction with related parties like selling or purchasing goods, providing services to or from, leasing etc. It could also be a fundraising activity like providing guarantees to or from, lending or borrowing agreements, asset transfers etc. With the various types of related party transactions and increasing incentives to manipulate earnings through related party transactions, the International Accounting Standards Board (IASB) issued IAS24 - Related Party Disclosures to address the importance of disclosing the transactions and outstanding balances with the company's related parties. All the companies listed on the Hong Kong Stock Exchange should also follow HKAS24 - Related Party Disclosures to disclose all the necessary and material information that will affect investors' decisions, in which it is generally disclosed at the notes to the financial statements.

IAS 24 - Related Party Disclosures defines a related party as a person or an entity that is related to the reporting entity, in which one party has control, joint control or significant influence over the other party. It could be a member of the entity's key management personnel, a close member of that person's family, controlling shareholders, ex-shareholders, non-controlling shareholders, parent, subsidiary, fellow subsidiary, associate, or joint venture etc. Many empirical evidences have shown that entities used related party transactions to manipulate earnings for financial reporting (Aharony et al., 2010; Jian and Wong, 2010; Lo et al., 2010; Wong et al., 2015). Meanwhile, Shan (2015) found that the abnormal related party transactions reduce the level of value relevance in which value relevance is the ability to generate valuable financial information that would affect stock price and stock return (Barth et al., 2001; Holthausen and Watts, 2001). All these researches have further testified the essential of related party disclosures as it could mislead investors in determining the value of the firm. From the growing importance of related party disclosures, the Hong Kong Institute of Certified Public Accountants (HKICPA) has been revising HKAS 24 - Related Party Disclosures to clarify the definition of related party and disclosure requirements in November 2014 and November 2016 respectively. Meanwhile, Chapter 14 - Notifiable Transactions of the Rules Governing the Listing of Securities in the Stock Exchange of Hong Kong states that companies should notify the connected transactions with connected parties to the public.

This study is motivated by the prevailing studies on earnings management and the unique characteristic of Hong Kong Stock Exchange. Related party transactions have also become a universal trend to perform earnings management. This intention may reduce the value relevance of the entity's financial statements and influence the entity's stock price. It could also lead to investors making unfavorable investment decisions and losing confidence in an entity's performance. A limited number of studies could be found in analyzing the relationship between related party transactions and earnings management in Hong Kong Stock Exchange, which also brings up the motivation and potential of this academic research.

LITERATURE REVIEW

IAS 24 - Related Party Disclosures was issued in July 1984 and was reissued in November 2009. The complexity of the related party transactions has brought investors' attention and it could greatly affect investors' decision-making as it tells whether the entity heavily relies on its related parties or third parties. Many studies argued that the transactions between member firms within the same group structure could reduce the transaction costs as well as the contract costs (Coase, 1937; Fisman and Khanna, 1998; Fan and Goyal, 2002; Khanna and Palepu, 1997; Shin and Park, 1999). The costs saved also bring an incentive for the entity to trade with its member firms with shorter negotiating time and better terms and conditions. With all these benefits, related party transactions have also become a popular means of earnings management.

Earnings management occurs when the entity uses its discretion in financial reporting and to present information with management's interests and benefits in order to mislead investors about its underlying financial performance or to influence the contractual outcomes (Healy and Wahlen, 1999; Jian and Wong, 2010; Lo and Wong, 2011; Shan, 2014). It is also a means to relocate resources within group. The corporate scandals like the Enron and Adelphia cases have brought attention to the use of related party transactions to manipulate earnings which had also led to a decline in perceived earnings quality (Ge et al., 2010). The quality of the financial statements is heavily relied on the full disclosure of the entity's transactions, in which firms with the intention to

manipulate earnings through related party transactions would deeply affect the quality of the firms' financial statements. Lang et al. (2006), Barth et al. (2008) and Pananen and Lin (2009) stated that the quality of the accounting information is correlated with value relevance and earnings management. Meanwhile, the quality of the information and value relevance are positively related, while earnings management would distort the value relevance of the financial statements (Nasution and Mita, 2017).

Even though the related party transactions are only disclosed at the end of the financial statements and they are easily to have missed or ignored, scholars including investors have boost their awareness on analyzing the related party transactions. Chien and Hsu (2010), Cheung et al. (2006), Gordon and Henry (2005) and Gordon et al. (2004) studied associations between related party transactions and earnings management, corporate governance, fraudulent financial reporting, and other phenomena. Jian and Wong (2010) mentioned that there are more frequent related party transactions under the environment of weak market development and heavy government intervention, which also gives rise to more opportunities for propping. Chang (2002) found companies using related party sales and purchases as a means to manipulate the accounting earnings in Korea. Jian (2003), Shan (2015) and Williams and Taylor (2013) studied on Chinese listed firms engaging in earnings management, propping and tunneling through related party transactions. Ye et al. (2002) investigated the effects of several corporate governance measures on related party transactions in Taiwan with the results showing that related party sales have a negative impact on firm's performance. However, Nasution and Mita (2017) suggested that there is a positive association between related party transactions and value relevance of earnings in Indonesia, while abnormal related party transactions are not an indicator of earnings management.

The prevalence of related party transactions has also led to firms' trade in internal financial markets as it might bring optimal economic transactions for all firms within the same group structure. However, it could also lead to agency problems with conflicting resources allocation (Cleassens and Fan, 2003). As the complex structure and ownership of the group-affiliated firms brings different controlling and minority shareholders together, their interests may be conflicted; while the management may not align their interests with the shareholders' interests. The information asymmetry could bring a huge problem to the group with rising agency costs and longer duration in decision-making (Jensen and Meckling, 1976; Rezaee, 2009; Shleifer and Vishny, 1997). Claessens et al. (2000) found that the separation of ownership and control is negatively related to firms' valuation in East Asia listed companies. In this regard, it is more likely to have minority shareholder expropriation and Cheung et al. (2006) supported this argument by stating that listed firms in Hong Kong Stock Exchange expropriate minority shareholders through connected transactions. Comparatively, Jian (2003) mentioned that group-controlled firms have greater ability to abuse related party transactions and inflate earnings than the non-group-controlled firms. The non-group-controlled firms are more independent and mainly depend on the external market with smaller level of related party transactions.

On the other hand, Hu et al. (2015) found that the larger the amount of related party loans, guarantees and capital transfers, it will generate the higher the audit fee as it requires the auditor to provide additional audit work on the related party transactions disclosures. However, surprisingly, Kohlbeck and Mayhew (2014) studied the relationship between related party transactions and audit fees, and argued that the audit assessments of related party transactions are easier than the third-party transactions, which leaded to auditor reducing the audit fees. The different empirical results have left a great potential and room to investigate on the topics regarding to related party transactions. As the related party transactions could bring many benefits to the entity, but at the same time, it could also destroy the group's value (Khanna and Palepu, 2000).

HYPOTHESIS DEVELOPMENT

There are two main situations that the company has incentives to inflate its earnings. First, the controlling shareholders may want to prop up earnings to avoid reporting losses. Jian and Wong (2010) mentioned that Chinese listed firms have stronger incentives to manipulate earnings, as reporting losses will lead to government scrutiny or even delisting. Article 157 of China's Company Law states company will be temporarily delisted if it has net loss for three consecutive years by the China Securities Regulatory Commission (CSRC). However Hong Kong Stock Exchange (HKEX) Main Board Rules Chapter 6 mentions listing may be suspended if the issuer fails to meet continued listing criteria for not maintaining sufficient assets or operations for listing. Second, the controlling shareholders may want to escalate earnings during rights issue offerings. Rights issue offerings are another source of funds that the listed companies can generate after the initial public offering. Bai et al. (2005) claimed that even the central government, which is also the ultimate controlling owner of the listed firms, has the incentives to help firms to maintain its listing status in order to qualify for rights issues. Meanwhile, previous studies provide evidence that listed companies managed to maintain 10% Return on Equity (ROE) as it is one of the requirements of rights issue offerings in China for achieving a ROE of at least 10% for three consecutive years prior (Chen and Yuan, 2001; Jiang and Wei, 1998; Chen, 1998; Haw et al., 1998; Chen et al., 2000). Li and Yu (2001) found that listed companies have a phenomenon to manipulate

ROE through related party transactions, while Lei and Song (2007) and Guan and Zhao (2014) stated that related party transactions is an important means to manage earnings whether the related party transactions are included above-the-line items or below-the-line items. Under the pressure of fulfilling continued listing requirements, listed companies have greater incentives to undertake earnings management in order to maintain favorable financial outcomes to stay in the financial market and obtain funds.

Prior studies investigate the use of related party transactions in earnings management in different dimensions. Berkman et al. (2009) examined the controlling shareholders issue loan guarantees to related parties to expropriate the wealth of minority shareholders in China. Jian and Wong (2010) found that Chinese listed firms use abnormal related sales to prop up their earnings. Jiang et al. (2010) suggested that controlling shareholders use corporate loans widely to extract funds from the entity in China from 1996 to 2006. Shan (2015) analyzed the relationship between earnings management, value relevance and corporate governance. The results show that abnormal related party transactions as a proxy of earnings management, reduces the value relevance of the financial information. However, good corporate governance could mitigate the level of earnings management. Therefore, the hypothesis is formed as follows:

H1: Firms inflate earnings through related party transactions.

The above hypothesis is further expanded in three most frequent types of transactions: related party sales, related party lending and related party borrowing.

Earnings management through related sales

Jian and Wong (2010) suggested that increasing number of firms using cash-based related sales to manage earnings. Khanna and Yafeh (2005) used related party sales to proxy for propping to manage earnings. While Jian (2003) indicated listed firms can sell more goods to its parent company in order to increase its overall sales level, in which the core earnings, income earned from operating activities, become higher when the profit margin is fixed. He further suggested that manipulating core or operating earnings and non-core or non-operating earnings could be two alternative means to meet earnings target. Management can easily conceal its earnings manipulation through core and non-core earnings as the details of earnings are disclosed separately in footnotes but not the income statement. Therefore, it is difficult for the investors to identity abnormal transactions for the manipulation purpose from the normal operating transactions. The following hypothesis is develop:

H1a: When firms have earnings management incentives, the level of related sales is abnormally high.

Earnings management through lending to related parties

Jensen (1986) brought up a free cash flow theory and argued that management tends to reinvest the free cash flow rather than distribute it to investors. Controlling shareholders prefer to divert companies' resources in their own benefits instead of distributing dividends to shareholders. This tunneling behavior brings up the agency problem that managerial decisions are mainly based on management's interests rather than the investor's interests (Shleifer and Vishny, 1997). Meanwhile, Jian and Wong (2010) stated that cash-based propping through related sales is associated with the cash transfers through related lending to the controlling owners. Listed companies may offer generous credits with longer credit periods to their related parties in order to divert resources and develop a long-term relationship with them. By doing so, companies may receive larger amounts of credits in trading and future fundraising activities from related parties in return. On one hand, internal borrowing and lending requires less procedures and shorter processing time than bank borrowing. Companies may provide interest-free or discount loans to their related parties so that related parties can generate more free cash flow with much profitable earnings. On the other hand, companies may charge significant front-end and loan origination fees to boost earnings (Ertan, 2017). Likewise, the interest income earned from related lending can contribute a huge part of the entity's revenue. Accordingly, the following hypothesis is formulated:

H1b: When firms have earnings management incentives, the level of related lending is abnormally high.

Earnings management through borrowing from related parties

The stable relationships that have been built within the group structure enable the entities to divert its resources and maximize group's overall benefits. Similar to related party lending, listed firms can receive better credits and longer loan period from their related parties in order to avoid the high interest expense from bank borrowing. Moreover, the free cash flow theory proposed by Jensen (1986) has further stated that the parent company could have access to the extra funds that the listed entity raised when the listed entity is the financial resources provider of the parent company, while entities are generally offering better credits to related parties than the non-related parties. Therefore, the internal borrowing could be a means to divert resources within group and at the same time, to manipulate earnings through financing activities.

Table 1. Data.

Variable	No. of observation
480 companies listed in Hang Seng Composite Industry Indexes from 2016 to 2018	1,332
Less:	
Observations of companies that are listed after 2016	(54)
Total firm-year observations	1,278

Frame et al. (2001) mentioned that borrower has a strong incentive to manage earnings in order to increase its borrowing capacity before a lending agreement is made. The large borrowing capacity could lead to lower interest rate and lower contracting costs. Mafrolla and D'Amico (2017) further stated that borrowers have incentives to improve their creditworthiness and consequent borrowing capacities through earnings management. Companies could use related party borrowing to build up satisfactory credit scores so that they could have an easier access to bank or third-party borrowing with lower interest rate in the future. At the same time, firms can enjoy interest-free or discount loans and avoid reporting interest expenses in its financial statements in order to inflate earnings. Therefore, the following hypothesis is built:

H1c: When firms have earnings management incentives, the level of related borrowing is abnormally high.

RESEARCH METHODS

Data collection

The sample contains all listed companies included in the Hang Seng Composite Industry Indexes from 2016 to 2018. The final sample composed of 426 companies after removing 54 companies that are listed after 2016, with a total of 1,278 firm-year observations from 2016 to 2018. The Hang Seng Composite Index is sub-divided into 12 industry indexes, including consumer discretionary, consumer staples, healthcare, conglomerates, information technology, properties and construction, financials, utilities, telecommunications, industrials, materials and energy. The data were sourced in two ways. Data of related party transactions, including related party sales, related party lending and related party borrowing, were manually collected from the annual reports disclosed on the Hong Kong Stock Exchange News. Other accounting data, such as leverage, firm size, market value of equity, book value of equity, firm age, ROE, industry median of ROE and ROA, were collected from Thomson Reuters Eikon and further verified by the information shown on the annual reports (Table 1).

Model specification

This study adopts Jian and Wong (2010) model to examine H1 and measure the degree of earnings management through related party transactions. This model had been used by Lo and Wong (2011) and Shan (2015) to employ abnormal related party transactions as a proxy of earnings management. The model is as follows:

$$RLPT_{i,t} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \varepsilon_{i,t} \quad (1)$$

Model (1) is then further expanded by adding two more independent variables shown as below:

$$RLPT_{i,t} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \beta_4 FIRMAGE_{i,t} + \beta_5 ROA_{i,t} + \varepsilon_{i,t} \quad (2)$$

Following Jian and Wong (2010)'s model, the residual values from Model (1) or Model (2) with the higher adjusted R^2 are proxied as the abnormal related party transactions and are regressed on the incentive dummy by the following model:

$$e_{i,t} = \beta_0 + \beta_1 INCENTIVE(V1)_{i,t} + \beta_2 INCENTIVE(V2)_{i,t} + \varepsilon_{i,t} \quad (3)$$

Dependent and explanatory variables

The dependent variable $RLPT_{i,t}$ represents the related party transactions of firm i in year t. $RLPT_{i,t}$ can be represented as either related party sales, related party lending or related party borrowing to testify H1a, H1b and H1c. The residual value $e_{i,t}$ is the abnormal related party transactions resulting from Model (1) or Model (2).

Prior studies found that companies have attempted to maintain their earnings at 10% ROE in order to be eligible for rights issues and continue listed on the stock exchange in China (Chen and Yuan, 2001; Jiang and Wei, 1998; Chen, 1998; Haw et al., 1998; Chen et al., 2000). Jian (2003) used ROE ranges from 0 to 10% as the indicator of high earnings manipulation intention in his research on earnings management. On the other hand, the Hong Kong Stock Exchange (HKEX) Main Board Listing Rules indicates one of the financial requirements for listing is to satisfy either profit test, market capitalization / revenue test or market capitalization / revenue / cash flow test, in which the company has to have 3-year aggregate profit more than HK$50 million and market capitalization greater than HK$500 million to satisfy the profit test. The profit test requirement is approximately the 10% ROE benchmark set in China. Meanwhile, due to the special characteristic of Hong Kong Stock Exchange, it attracts a lot of Mainland Chinese firms. Combining the above two factors, it is probable that the major constituents in Hong Kong Stock Exchange may also tempted to achieve a ROE of at least 10%. Therefore, an incentive dummy is used to testify companies' intention to enact earnings management.

Table 2. Descriptive statistics (n = 1,278).

Variable	Mean	Median	Std. Deviation
RLPT_SALES (HKD million)	15,523.34	316.74	129,060.25
RLPT_LENDING (HKD million)	17,122.31	515.95	116,411.57
RLPT_BORROWING (HKD million)	12,908.28	391.12	53,468.99
INCENTIVE(V1)	0.77	1.00	0.42
INCENTIVE(V2)	0.35	0.00	0.48
LEVERAGE	0.54	0.55	0.22
FIRMSIZE	24.83	24.74	1.86
MKVE	4.03	1.06	30.02
FIRMAGE	14.82	12	10.61
ROA	0.06	0.06	0.08

RLPT_SALES = related party sales disclosed in the firm's financial statements. RLPT_LENDING = firm's lending to related parties disclosed in the firm's financial statements. RLPT_BORROWING = firm's borrowing from related parties disclosed in the firm's financial statements. INCENTIVE(V1) = 1 if firm's ROE is higher than the industry median of the year; 0 otherwise. INCENTIVE(V2) = 1 if firm's ROE is between 0and 10%; 0 otherwise. LEVERAGE = debt-asset ratio, calculated by dividing total liabilities by total assets. FIRMSIZE = the natural logarithm of total assets, in which total assets represent the ability of the firm to generate more profit in the future. MKVE = growth of the firm, measured by the market-to-book equity ratio. FIRMAGE = firm's age, measured by the number of years since its initial listing. ROA = return on assets.

$INCENTIVE(V1)$ equals to 1 when the firm's ROE is higher than the industry median, equals to 0 otherwise, while $INCENTIVE(V2)$ equals to 1 when the firm's ROE is between 0 and 10%, equals to 0 otherwise.

Control variable

Control variables consist of $LEVERAGE$, which is measured by a firm's debt-asset ratio, $FIRMSIZE$, which is measured by the natural logarithm of a firm's total assets, and growth ($MKVE$), which is measured by the firm's market-to-book equity ratio.

Meanwhile, by taking reference to Shan (2015)'s earnings management equation model, two control variables are added in Model (2). $FIRMAGE$ is the firm's age represented by the number of years since initial listing in Hong Kong Stock Exchange. ROA is the return on assets.

RESULTS AND DISCUSSION

Descriptive statistics

Table 2 displays descriptive statistics of all 1,278 firm-year observations. During 2016-2018, the means (medians) of RLPT are 15,523.34 (316.74), 17,122.31 (515.95) and 12,908.28 (391.12) for related party sales, related party lending and related party borrowing respectively in HKD million. This finding indicates that sample firms are engaging more lending activities to its related parties than sales and borrowing, which also suggests the behavior of diverting resources to related parties. The huge gap between the mean and median also shows that some firms have extremely large amount of related party transactions than the others. On one hand, Table 2 indicates that 77% of sample firms had a ROE higher than the industry median. On the other hand, it shows that only 35% of sample firms had a ROE between 0and 10%. These results suggest that 65% of the sample firms had a negative ROE or a ROE greater than 10 and 77% of sample firms were performed better than the industry average in 2016-2018. While in terms of leverage, the mean value of debt-asset ratio is 54%. This finding tells that the sample firms had maintained a relatively good leverage ratio and had sufficient liquid assets to pay off its debts. The sample firms have a mean (median) of 14.82 (12) years listed on the Hong Kong Stock Exchange. The mean (median) values for firms' logarithmic total assets, market-to-book equity ratio and return on assets are 24.83 (24.74), 4.03 (1.06) and 0.06 (0.06) respectively.

Multicollinearity diagnostics

In order to test whether the multicollinearity problem exists, the correlation coefficients among the independent variables are found. Table 3 shows that none of them have an absolute value greater than 0.7. Therefore, there are no multicollinearity problems in the models.

Regression results

Table 4 to 9 show the results of regression analysis on the sample observations. The related party sales, related party lending and related party borrowing are regressed on various explanatory and control variables shown in Model (1) and (2) respectively. The residuals from either Model (1) or Model (2) with the higher adjusted $R^2$are then regressed on the incentive dummy shown in Model (3). As reported in Table 4 to 8, the F-statistics for both regression Model (1) and Model (2) are statistically significant at the 1 percent level; while Table 5, 7 and 9 also suggest that Model (3) is statistically significant at

Table 3. Pearson's correlation matrix.

Variable	Incentive(V1)	Incentive(V2)	Leverage	Firmsize	Mkve	Firmage	Roa
INCENTIVE(V1)	1						
INCENTIVE(V2)	-0.4481	1					
LEVERAGE	0.0465	-0.0230	1				
FIRMSIZE	0.0181	0.1137	0.5470	1			
MKVE	0.0344	-0.0161	0.0393	-0.0672	1		
FIRMAGE	-0.1426	0.1556	-0.1369	0.1024	0.0588	1	
ROA	0.4307	-0.2695	-0.3092	-0.2396	-0.0058	-0.0558	1

INCENTIVE(V1) = 1 if firm's ROE is higher than the industry median of the year; 0 otherwise. INCENTIVE(V2) = 1 if firm's ROE is between 0and 10%; 0 otherwise. LEVERAGE = debt-asset ratio, calculated by dividing total liabilities by total assets. FIRMSIZE = the natural logarithm of total assets, in which total assets represent the ability of the firm to generate more profit in the future. MKVE = growth of the firm, measured by the market-to-book equity ratio. FIRMAGE = firm's age, measured by the number of years since its initial listing. ROA = return on assets.

Table 4. Regression results on abnormal related party sales.

Variable	Predicted sign	Model 1		Model 2	
		Coeff.(S.E.)	Significance (*t*-statistics)	Coeff.(S.E.)	Significance (*t*-statistics)
Intercept		$-4.17 \times 10^{11}(5.15 \times 10^{10})$	0.0000(-8.0915) **	$-4.20 \times 10^{11}(5.27 \times 10^{10})$	0.0000(-7.9602) **
LEVERAGE	-	$-9.74 \times 10^{10}(1.90 \times 10^{10})$	0.0000(-5.1335) **	$-1.05 \times 10^{11}(2.01 \times 10^{10})$	0.0000(-5.2173) **
FIRMSIZE	+	$1.95 \times 10^{10}(2.27 \times 10^{9})$	0.0000(8.6155) **	$2.01 \times 10^{10}(2.33 \times 10^{9})$	0.0000(8.6266) **
MKVE	+	$5.51 \times 10^{7}(1.18 \times 10^{8})$	0.6403(0.4675)	$6.84 \times 10^{7}(1.18 \times 10^{8})$	0.5636(0.5777)
FIRMAGE				$-4.32 \times 10^{8}(3.45 \times 10^{8})$	0.2112(-1.2508)
ROA				$-1.70 \times 10^{10}(4.62 \times 10^{10})$	0.7135(-0.3672)
Observations		1278		1278	
Adj. R-Squared		0.0531		0.0529	
F-statistics		24.8857 **		15.2533 **	
S.E. of Estimates		1.26×10^{11}		1.26×10^{11}	

Model 1 : $RLPT_{SALES_{i,t}} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \varepsilon_{i,t}$;

Model 2 : $RLPT_{SALES_{i,t}} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \beta_4 FIRMAGE_{i,t} + \beta_5 ROA_{i,t} + \varepsilon_{i,t}$

where RLPT_SALES = related party sales disclosed in the firm's financial statements. LEVERAGE = debt-asset ratio, calculated by dividing total liabilities by total assets. FIRMSIZE = the natural logarithm of total assets, in which total assets represent the ability of the firm to generate more profit in the future. MKVE = growth of the firm, measured by the market-to-book equity ratio. FIRMAGE = firm's age, measured by the number of years since its initial listing. ROA = return on assets. The residuals are proxied as the abnormal related party transactions. * and ** represent statistical significance at 5 and 1% levels.

the 1 percent level, which indicate the models are overall significant. While FIRMSIZE is positively value-relevant and statistically significant in all three regression results on related party sales, related party lending and related party borrowing. On top of that, either INCENTIVE(V1) or INCENTIVE(V2) is negatively significant in each independent variable which is contrasting hypothesis H1.

Earnings management through related sales

As reported in Table 4, the adjusted R^2 decreases from 0.0531 to 0.0529 in Model (1) and (2). The coefficient on FIRMSIZE is positive and statistically significant, while the coefficient on LEVERAGE is negative and statistically significant. These results are consistent with the prediction. However, Table 5 shows a different result than the prediction. The coefficient on INCENTIVE(V1) is negative and statistically significant. It implies that companies with higher level of ROE than the industry median did not result in a higher level of abnormal related sales. This evidence does not support H1a that firms have a higher level of abnormal related sales when they have incentives to inflate earnings.

Table 5. Regression results on the association between earnings management and related party sales.

Variable	Predicted sign	Model 3	
		Coeff. (S.E.)	Significance (*t*-statistics)
Intercept		$2.88 \times 10^{10} (9.49 \times 10^{9})$	0.0024(3.0376) **
INCENTIVE(V1)	+	$-3.65 \times 10^{10} (9.28 \times 10^{9})$	0.0001(-3.9351) **
INCENTIVE(V2)	+	$-1.98 \times 10^{9} (8.15 \times 10^{9})$	0.8077(-0.2435)
Observations		1278	
Adj. R-Squared		0.0127	
F-statistics		9.1874 **	
S.E. of Estimates		1.25×10^{11}	

Model 3: $e_{model\ 1_{i,t}} = \beta_0 + \beta_1\ INCENTIVE(V1)_{i,t} + \beta_2\ INCENTIVE(V2)_{i,t} + \varepsilon_{i,t}$

where e = residual, which is proxied as the abnormal related party sales. INCENTIVE(V1) = 1 if firm's ROE is higher than the industry median of the year; 0 otherwise. INCENTIVE(V2) = 1 if firm's ROE is between 0 and 10%; 0 otherwise. *and ** represent statistical significance at 5 and 1% levels.

Table 6. Regression results on abnormal related party lending.

Variable	Predicted sign	Model 1		Model 2	
		Coeff. (S.E.)	Significance (*t*-statistics)	Coeff. (S.E.)	Significance (*t*-statistics)
Intercept		$-5.09 \times 10^{11} (4.51 \times 10^{10})$	0.0000(-11.2957) **	$-5.25 \times 10^{11} (4.60 \times 10^{10})$	0.0000(-11.4041) **
LEVERAGE	-	$-9.66 \times 10^{9} (1.66 \times 10^{10})$	0.5607(-0.5820)	$-2.10 \times 10^{10} (1.75 \times 10^{10})$	0.2307(-1.1992)
FIRMSIZE	+	$2.14 \times 10^{10} (1.99 \times 10^{9})$	0.0000(10.7845) **	$2.28 \times 10^{10} (2.04 \times 10^{9})$	0.0000(11.1949) **
MKVE	+	$3.08 \times 10^{7} (1.03 \times 10^{8})$	0.7650(0.2990)	$5.85 \times 10^{7} (1.03 \times 10^{8})$	0.5712(0.5665)
FIRMAGE				$-8.90 \times 10^{8} (3.01 \times 10^{8})$	0.0032(-2.9551) **
ROA				$8.03 \times 10^{9} (4.04 \times 10^{10})$	0.8423(0.1990)
Observations		1278		1278	
Adj. R-Squared		0.1082		0.1131	
F-statistics		52.6665 **		33.5609 **	
S.E. of Estimates		1.10×10^{11}		1.10×10^{11}	

Model 1: $RLPT_{LENDING_{i,t}} = \beta_0 + \beta_1\ LEVERAGE_{i,t} + \beta_2\ FIRMSIZE_{i,t} + \beta_3\ MKVE_{i,t} + \varepsilon_{i,t}$

Model 2: $RLPT_{LENDING_{i,t}} = \beta_0 + \beta_1\ LEVERAGE_{i,t} + \beta_2\ FIRMSIZE_{i,t} + \beta_3\ MKVE_{i,t} + \beta_4\ FIRMAGE_{i,t} + \beta_5\ ROA_{i,t} + \varepsilon_{i,t}$

where RLPT_LENDING is the firm's lending to related parties disclosed in the firm's financial statements. LEVERAGE = debt-asset ratio, calculated by dividing total liabilities by total assets. FIRMSIZE = the natural logarithm of total assets, in which total assets represent the ability of the firm to generate more profit in the future. MKVE = growth of the firm, measured by the market-to-book equity ratio. FIRMAGE = firm's age, measured by the number of years since its initial listing. ROA = return on assets. The residuals are proxied as the abnormal related party transactions.* and ** represent statistical significance at 5 and 1% levels.

Earnings management through lending to related parties

Table 6 shows that the adjusted R^2 increases from 0.1082 to 0.1131 in Model (1) and (2). Consistent with the prediction, the coefficient on FIRMSIZE is positive and statistically significant, while the coefficient on FIRMAGE is negative and statistically significant. An older firm tends to have less related lending than the younger firms listed on Hong Kong Stock Exchange. Contrast to the regression results on the association between earnings management and related party sales, Table 7 reports that the coefficient on INCENTIVE(V2) is negative and statistically significant. It indicates that firms with a ROE within the range of 0 to 10% did not have a higher level of abnormal related lending when they have earnings

Table 7. Regression results on the association between earnings management and related party lending.

Variable	Predicted sign	Model 3 Coeff. (S.E.)	Model 3 Significance (*t*-statistics)
Intercept		1.08×10^{10} (8.31×10^{9})	0.1943(1.2987)
INCENTIVE(V1)	+	-4.24×10^{9} (8.12×10^{9})	0.6017(-0.5221)
INCENTIVE(V2)	+	-2.12×10^{10} (7.14×10^{9})	0.0030(-2.9753) **
Observations		1278	
Adj. R-Squared		0.0060	
F-statistics		4.8378 **	
S.E. of Estimates		1.09×10^{11}	

Model 3: $e_{model\ 2_{i,t}} = \beta_0 + \beta_1\ INCENTIVE(V1)_{i,t} + \beta_2\ INCENTIVE(V2)_{i,t} + \varepsilon_{i,t}$
where e = residual, which is proxied as the abnormal related party lending. INCENTIVE(V1) = 1 if firm's ROE is higher than the industry median of the year; 0 otherwise. INCENTIVE(V2) = 1 if firm's ROE is between 0 and 10%; 0 otherwise.* and ** represent statistical significance at 5 and 1% levels.

management incentives, which did not support H1b.

Earnings management through borrowing from related parties

From Table 8, the adjusted R^2 increases from 0.2300 to 0.2416 in Model (1) and (2). Among all the dependent variables, the regression results on the association between earnings management and related borrowing have the highest adjusted R^2. Similar to the regression results on the association between earnings management and related lending, the coefficient on FIRMSIZE is positive and statistically significant, while the coefficient on FIRMAGE is negative and statistically significant. However, the results shown in Table 9 have once again differed from the prediction. It tells that firms with a ROE ranging between 0and 10% did not have a higher level of abnormal related borrowing as the coefficient on INCENTIVE(V2) is negative and statistically significant. Companies with these ROE ranges are likely to have financing activities with its related parties, including both lending and borrowing activities, but it does not necessarily mean that they have the incentive to inflate earnings through these related party transactions. This evidence also opposes H1c that firms did not have a higher level of abnormal related borrowing when they have incentives to manipulate earnings.

Robustness check

In order to ensure the relation between related party sales, related party lending and related party borrowing is not spurious, in which firms with higher level of related party transactions have a higher level of related party sales, related party lending and related party borrowing, and a robustness check is performed. Abnormal related party sales is regressed on the interaction between the three dependent variables, abnormal related party sales, abnormal related party lending and abnormal related party borrowing. The coefficient on the interaction between abnormal related party sales and abnormal related party borrowing is positively and statistically significant. This indicates that the relation is not driven by spurious correlations and when firms have earnings management incentives, the positive relation between abnormal related sales and abnormal related borrowing is much stronger. Meanwhile, the coefficient on the interaction between abnormal related party borrowing and abnormal related party lending is positive, but it is statistically significant at 7 percent level. The relation between these two dependent variables is weaker than the relation between abnormal related party sales and abnormal related party borrowing. Surprisingly, the coefficient on the interaction between abnormal related party sales and abnormal related party lending is negative and statistically significant, which explains that firms tend to have either abnormal related party sales or abnormal related party lending exclusively when they have incentives for earnings management (Table 10).

Conclusion

This study aims to examine the significant influence of related party transactions on earnings management in Hong Kong. Evidence is based on hand-collected data from annual reports disclosed on Hong Kong Stock Exchange News and accounting data collecting from Thomson Reuters Eikon comprising 426 listed companies on the Hang Seng Composite Industry Indexes from 2016

Table 8. Regression results on abnormal related party borrowing.

Variable	Predicted sign	Model 1		Model 2	
		Coeff.(S.E.)	Significance (*t*-statistics)	Coeff.(S.E.)	Significance (*t*-statistics)
Intercept		$-3.29 \times 10^{11} (1.92 \times 10^{10})$	0.0000(-17.1129) **	$-3.39 \times 10^{11} (1.95 \times 10^{10})$	0.0000(-17.3671) **
LEVERAGE	−	$1.34 \times 10^{9} (7.09 \times 10^{9})$	0.8500(0.1892)	$-6.15 \times 10^{9} (7.45 \times 10^{9})$	0.4089(-0.8261)
FIRMSIZE	+	$1.38 \times 10^{10} (8.47 \times 10^{8})$	0.0000(16.2311) **	$1.47 \times 10^{10} (8.65 \times 10^{8})$	0.0000(16.9535) **
MKVE	+	$1.08 \times 10^{7} (4.40 \times 10^{7})$	0.8069(0.2445)	$2.90 \times 10^{7} (4.39 \times 10^{7})$	0.5093(0.6600)
FIRMAGE				$-5.85 \times 10^{8} (1.28 \times 10^{8})$	0.0000(-4.5748) **
ROA				$5.05 \times 10^{9} (1.71 \times 10^{10})$	0.7682(0.2948)
Observations		1278		1278	
Adj. R-Squared		0.2300		0.2416	
F-statistics		128.1772 **		82.3619 **	
S.E. of Estimates		4.69×10^{10}		4.66×10^{10}	

Model 1: $RLPT_{BORROWING_{i,t}} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \varepsilon_{i,t}$

Model 2: $RLPT_{BORROWING_{i,t}} = \beta_0 + \beta_1 LEVERAGE_{i,t} + \beta_2 FIRMSIZE_{i,t} + \beta_3 MKVE_{i,t} + \beta_4 FIRMAGE_{i,t} + \beta_5 ROA_{i,t} + \varepsilon_{i,t}$

where RLPT_BORROWING is the firm's borrowing from related parties disclosed in the firm's financial statements. LEVERAGE = debt-asset ratio, calculated by dividing total liabilities by total assets. FIRMSIZE = the natural logarithm of total assets, in which total assets represent the ability of the firm to generate more profit in the future. MKVE = growth of the firm, measured by the market-to-book equity ratio. FIRMAGE = firm's age, measured by the number of years since its initial listing. ROA = return on assets. The residuals are proxied as the abnormal related party transactions.* and ** represent statistical significance at 5 and 1% levels.

Table 9. Regression results on the association between earnings management and related party borrowing.

Variable	Predicted sign	Model 3	
		Coeff. (S.E.)	Significance (*t*-statistics)
Intercept		$7.59 \times 10^{9} (3.51 \times 10^{9})$	0.0310(2.1594) *
INCENTIVE(V1)	+	$-3.61 \times 10^{9} (3.43 \times 10^{9})$	0.2930(-1.0519)
INCENTIVE(V2)	+	$-1.36 \times 10^{10} (3.02 \times 10^{9})$	0.0000(-4.4922) **
Observations		1278	
Adj. R-Squared		0.0149	
F-statistics		10.6673 **	
S.E. of Estimates		4.61×10^{10}	

Model 3: $e_{model\ 2_{i,t}} = \beta_0 + \beta_1 INCENTIVE(V1)_{i,t} + \beta_2 INCENTIVE(V2)_{i,t} + \varepsilon_{i,t}$

where e = residual, which is proxied as the abnormal related party borrowing. INCENTIVE(V1) = 1 if firm's ROE is higher than the industry median of the year; 0 otherwise. INCENTIVE(V2) = 1 if firm's ROE is between 0 and 10%; 0 otherwise.* and ** represent statistical significance at 5 and 1% levels.

to 2018. The primary results indicate that related party transactions are abnormally low when firms have incentive in engaging earnings management in Hong Kong, either through trading or financing activities. These results did not prove the strong association between related party transactions and earnings management for Hong Kong listed companies. Conflict with Jian and Wong's (2010) results which show that Chinese listed firms had incentive to inflate earnings through related sales and related party transactions is not an effective tool in earnings management in Hong Kong Stock Exchange. This phenomenon can be explained by the successful monitor on the related party disclosures by the securities regulators.

However, the empirical evidence is only based on past data; there is still a high possibility that firms will manipulate earnings through related party transactions in the future. As such, the independent auditors should keep on paying more attention on the firms' intention to manage earnings through related party transactions, in which firms may be less voluntarily disclosing the transactions with related parties when they have incentives to do so and affect the overall quality of the financial statements. The implications of these findings

Table 10. Regression results on the robustness check.

Variable	Model 4	
	Coeff.(S.E.)	Significance (*t*-statistics)
Intercept	$-7.50 \times 10^{9}(2.07 \times 10^{9})$	0.0003(-3.6185) **
ABNRLPT_S × ABNRLPT_B	$1.21 \times 10^{11}(2.41 \times 10^{13})$	0.0000(50.3430) **
ABNRLPT_S × ABNRLPT_L	$-3.42 \times 10^{12}(4.95 \times 10^{13})$	0.0000(-6.9164) **
ABNRLPT_B × ABNRLPT_L	$2.85 \times 10^{13}(1.53 \times 10^{13})$	0.0627(1.8630)
Observations	1278	
Adj. R-Squared	0.6661	
F-statistics	849.9812 **	
S.E. of Estimates	7.25×10^{10}	

Model 4. $ABNRLPT_S_{i,t} = \beta_0 + \beta_1 \times ABNRLPT_S_{i,t} \times ABNRLPT_B_{i,t} + \beta_2 \times ABNRLPT_S_{i,t} \times ABNRLPT_L_{i,t} + \beta_3 \times ABNRLPT_B_{i,t} \times ABNRLPT_L_{i,t} + \varepsilon_{i,t}$

where ABNRLPT_S = abnormal related party sales. ABNRLPT_B = abnormal related party borrowing. ABNRLPT_L = abnormal related party lending.*, ** represent statistical significance at 5 and 1% levels.

are as follow. First, this study enhances stakeholders' understanding of how firms manipulate earnings through related party transactions, as well as boosts their awareness on focusing notes disclosures but not just the bottom line of the financial statements. Second, it adds evidence to demonstrate that related party transactions may not be a tool in fraudulent reporting with successful guidance. Related party transactions could be used to transfer resources or profits to shareholders, subsidiaries, associates, joint ventures, management personnel and other group companies. This kind of practice can have profound implications for the economies and therefore requires closer monitor. It also further addresses the importance of voluntary disclosure of related party transactions to protect the public interests.

CONFLICT OF INTERESTS

The author has not declared any conflict of interest.

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Achieving competitive advantage and financial sustainability through acquisition and restructuring strategies

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Acquisition and restructuring strategies are some of the growth and retrenchment strategies that firms employ with the aim of achieving competitive advantage in form of superior financial sustainability position. In this study, we set out to provide a descriptive framework for acquisition and restructuring strategies as corporate level strategies and to investigate the ability of these strategies to help organizations improve their financial sustainability. Acquisition was recommended as an effective diversification strategy due to its benefit of increasing barriers to entry. Horizontal and vertical integration were particularly recommended as effective market development strategies by way of acquisition of unique resources and competitors' market share. However, few authors also discouraged acquisition strategy on the grounds of increase in external reliance for critical resources. Restructuring strategies were recommended as an effective part of a turnaround strategy as opposed to being implemented in isolation.

Key words: Acquisition strategy, restructuring strategy, competitive advantage, financial sustainability, diversification, market development, turnaround strategy.

INTRODUCTION

Strategic planning is one of the first stages of any strategic process in business. This stage often involves establishing the ultimate goals of the business and assessing one's position and capacity towards achieving such goals. The planning process involves an internal and external analysis of the business environment in order to assess the resources and capabilities as well as its opportunities and threats (Haque et al., 2021). These two stages have popularly been summarized with the following questions: where are we going (Establishment of goals) and where are we at the moment (Internal and external analysis)? Once these two questions have been adequately addressed, then the company will need to devise a strategy that will help them achieve the set goals

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(that is how do we get there?). Acquisition and restructuring strategies are some of those strategies that can help the company to achieve its goals. The major goal of any organization is to attain and sustain competitive advantage and this competitive advantage is reflected in the financial performance and sustainability position of such organizations (Haseeb et al., 2019). The ability of companies to achieve and sustain competitive advantage can be observed from their financial sustainability position. Financial sustainability relates to the ability of organizations to maintain above-average financial performance for a long period of time (Imhanzenobe, 2020). When a firm is able to maintain profits that are above the industry average for a long period of time, it indicates that the firm possesses resources and capabilities that are inimitable and help it to outperform its competitors.

Drawing from the above premises, this study tries to provide an answer to the question: to what extent can managers implement acquisition and restructuring strategies in achieving competitive advantage and financial sustainability? Most studies that address financial sustainability often focus on local governments and other government parastatals (Carmeli, 2008; Wallstedt et al., 2014), while ignoring the private sectors. Also, most of the previous studies do not consider or merge with the results of other authors. The review approach is used in this study to merge the findings of several authors that have investigated the subject. In this study, we look at the implementation of acquisition and restructuring strategies in achieving competitive advantage, either by acquiring critical resources or adjusting the existing business model respectively, and the effect of these strategies on the financial sustainability of the organization. To achieve this, the study provides a descriptive framework of acquisition and restructuring strategies as corporate level strategies. The study also discusses how these strategies can help to achieve competitive advantage and reviews existing empirical literature on the impact of the implementation of these strategies on the competitive advantage as well as the overall organizational financial performance and sustainability.

LITERATURE REVIEW

According to Porter (1996), a strategy is the creation of a unique and valuable position, through different set of activities, in order to help the organization achieve its specified short and long term goals. He differentiates strategy from operational effectiveness which is the ability of an organization to perform similar activities better than its competitors. Strategy involves performing different activities or similar activities in a different way from competitors (Zerfass et al., 2018). These activities are geared towards achieving competitive advantage (and superior financial performance in the long run) by creating a directional path for the overall organization, developing new products or enhancing existing products and services that serve a particular market and at the right price, and optimum allocation of the organization's resources and capabilities. Strategy implementation often involves opportunity costs (that is sacrificing something else) and these activities must align with the overall goals of the organization. There are three common levels of strategies; corporate level strategies, business level strategies and functional level strategies. Corporate level strategies provide direction to the overall organization, business level strategies provide ways of gaining competitive advantage for each of the organization's product or service in line with the selected corporate level strategies, while functional level strategies try to identify the optimum allocation of resources and capabilities within each department in supporting the corporate and business level strategies (Beard and Dess, 1981; Sage, 2019).

One of the earliest definitions of corporate strategy is that of Alfred Chandler Jr, who defined corporate level strategies as the determination of the basic long-term goals and objectives of an organization, adoption of courses of action, and the allocation of resources for carrying out the determined goals. His emphasis was on how organizations adapt their administrative structure to fit their chosen corporate strategies (Chandler, 1962; Heracleous, 2003). Corporate strategy has also been described as the identification of an organization's goals and the major policies for achieving them, stated in a way that clarifies what the business is and what it wants to become (Heracleous, 2003; Learned et al., 1965). This definition is closely linked with the concepts of corporate vision and mission statements and is quite similar with the definition of Andrews (1980) who defined corporate strategy as the determination of an organization's goals and objectives, the businesses it intends to pursue, the kind of human and financial organization it wants to be, and the nature of financial and non-financial contribution it intends to make to its stakeholders. This definition can be applied to corporate strategy even on a national level. Ansoff (1965) believed that corporate strategy addresses five perspectives of an organization (product-market scope, growth prospect, competitive advantage, and internally generated synergy and make or buy decisions) and these five perspectives are interrelated. When strategies are made at the corporate level, the organization is seen as a whole and strategic decisions are made that consider all of the firm's business activities in other to identify the best way to create value. According to Nickols (2016a), formulation and implementation of corporate strategy rests with the senior management ('the strategy wheel gets the executive grease') and other levels of strategy ought to align with the corporate strategy. One of the most popular corporate level strategies are the grand strategies.

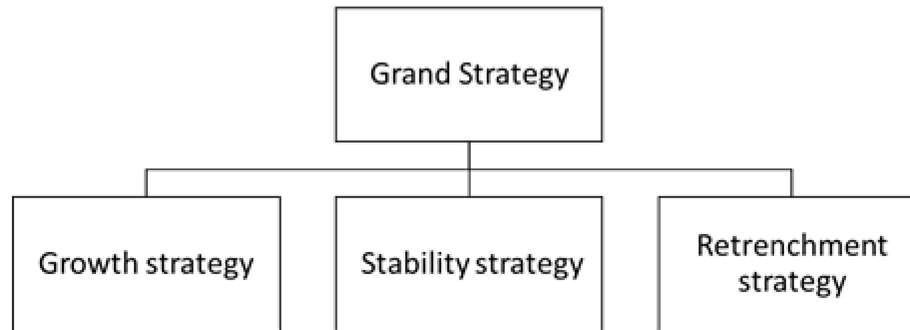

Figure 1. Types of grand strategies.

Grand strategies

The concept of 'grand strategy' originated from the British military and can be traced to Sir Basil Henry Liddell Hart (Nickols, 2016a). He described grand strategies from a war context as a nation's choices in matters of theaters of war, international alliances, distribution of resources among various military departments, and the kinds of ammunition to produce that will optimize the use of those resources. Other definitions of grand strategy include those of Paul Kennedy, who described grand strategy as consisting of policies and capacity of the nation's leaders to combine both military and non-military resources for the preservation and enhancement of the nation's long-term goals (Lissner, 2018). Some characteristics of grand strategies that can be deduced include the fact that they are targeted at the organization's long-term goals, and are holistic in their scope of influence (they affect the entire organization). The aspect of strategy implementation that involves allocation of resources constitutes the link between organization strategy and military strategy (Nickols, 2016b).

In business, grand strategies are corporate level strategies that reflect a firm's choice of actions with regards to the overall direction that it intends to follow in achieving its long-term goals. The concept of grand strategy has often been used interchangeably to refer to corporate level strategy. Grand strategy tries to provide answers to three main questions about an organization's strategic direction: how do we intend to grow? How do we intend to maintain/sustain our current position? How do we cut back if needed (Sage, 2019)? Consequently, we have three major types of grand strategies: growth/expansion strategy, stability strategy and retrenchment strategy (Figure 1) (Theintactone, 2018).

Acquisition and restructuring strategy are typical examples of growth and retrenchment strategies respectively that can help an organization to achieve its goals. The goal of every organization, often times, is to attain and sustain competitive advantage that will lead to superior financial performance in relation to competitors. Organizations can achieve this by acquiring critical resources or adjusting the existing business model. This could demand cutting off aspects of the business that are not beneficial to the overall organization.

Acquisition as a growth strategy

Growth strategy is a general term used to refer to a category of grand strategies that help a firm to expand its scale operations. In the famous Ansoff's growth strategy matrix, Igor Ansoff suggests that firms can grow either internally or externally (Figure 2). Acquisition is an example of an external growth strategy. An acquisition is a strategy through which one firm buys up all or a controlling interest in another firm with the intention of making the acquired firm a subsidiary business unit within its portfolio (Hitt et al., 2007). Unlike mergers, which are peaceful and solicited, acquisitions may be peaceful or not peaceful. Unsolicited acquisitions are often called takeovers.

Restructuring as a retrenchment strategy

Retrenchment strategy is another type of grand strategy that involves reductions in the scope or size of an organization (Boyne, 2004). The term retrenchment strategy also has a military origin. When armies were being attacked in an insurmountable manner, they would retreat back to the trenches from which they advanced, thus retrenchment refers to going back to the trench from which you came (Edwards, 2018). This strategy is often carried out as a response to a series of negative performance to ensure the overall survival of the company. Retrenchment strategies often involve reducing the overall cost of the organization or cutting off cancerous business units by making adjustments to the existing business model. There are three major types of retrenchment strategy; restructuring strategy, liquidation strategy and turnaround strategy (Figure 3). Turnaround strategies are strategies that are used to reverse the effects of a previously implemented strategy (often called

		Product: EXISTING	Product: NEW
EXISTING	Market	Market Penetration	New Product Development
NEW	Market	Market development	Diversification

Figure 2. Ansoff's growth strategy matrix (Ansoff, 1965).

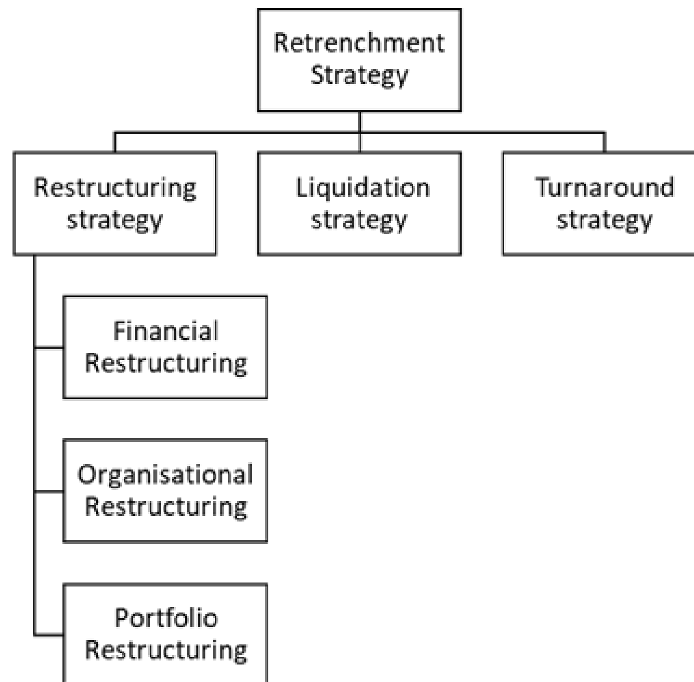

Figure 3. Types of retrenchment strategy.

an 'undo strategy'). Liquidation strategy involves the shutting down the operations of the entire organization and disposal of its assets at their realizable value. Liquidation is often considered only when all other strategies have failed.

Restructuring strategy is a strategy that involves making changes to the existing structures of the organization with the aim of improving its efficiency and effectiveness (Robbins and Pearce, 1992). Restructuring strategies may involve making changes to the financial structure (that is capital structure), organizational structure (that is operations, human resources, management hierarchy), or portfolio structure (that is strategic business units). Capital reconstruction is an example of a financial restructuring strategy that involves changing the mix of debt and equity with the aim of optimizing the overall cost of capital. Downsizing is a common organizational restructuring strategy that involves reducing the number of employees or other operating units with the aim of minimizing overhead costs and other administrative expenses. Similarly, downscoping is an example of a portfolio restructuring strategy in which an organization decides to stick strictly to its core business and sell off or shut down other product lines or strategic business units.

This strategy is quite similar with divestment in which an organization sells off business units that have been unprofitable for a subsequent period of time.

Competitive advantage and financial sustainability through acquisition and restructuring strategy

The ultimate aim of choosing and implementing a strategy is to achieve and sustain competitive advantage in view of future profits. Porter (1980) defined competitive advantage as the ability, gained through attributes and resources, to perform at a higher level than others in the same industry or market. According to Porter, sustainable competitive advantage is fundamental for above-average financial performance in the long run. This competitive advantage results from the ability of an organization to maximize their strengths and minimize their weaknesses (Hayes and Jaikumar, 1988). Several authors and theories have tried to identify the critical factors that create competitive advantage. Porter's theory of strategic groups attributes competitive advantage to industry structure and positioning. However, the ability to sustain competitive advantage often fades quickly because sustainable competitive advantage cannot be achieved merely by taking advantage of opportunistic deals and escaping threats in the business environment but from resources and capabilities that are under the control of the organization. Barney's resource-based view theory attributes competitive advantage to these unique and inimitable internal resources that are under the control of the organization (Hoskisson et al., 1999; Ployhart, 2021). A study by McKinsey Consultants discovered that out of 208 companies in various industries, only 3 could sustain their competitive advantage in terms of ability to earn above-average profits over a ten year period (Ghemawat, 2002).

Companies can obtain and sustain competitive advantage by implementing growth and retrenchment strategies and this can improve their financial performance and sustainability position. Both internal and external growth strategies can be used, however, the external growth strategies have to be such that the company has significant control over the targeted firm. This is often the case with an acquisition. Also, restructuring as a retrenchment strategy can be used to minimize weaknesses and thus create competitive advantage.

Competitive advantage through acquisition strategy

Acquisition is commonly used as a diversification strategy (Figure 2), in which case, a firm acquires another firm that offers a different product or service and to a different customer (for instance Amazon's acquisition of Whole Foods in 2017). However, acquisition can serve as a market penetration strategy when a company engages in acquisition solely to increase market share. The company can do this by acquiring a firm that is into a similar business and serves similar customers (for instance Access bank's acquisition of Intercontinental Bank plc. in 2011 and Diamond bank in 2018). This is common in monopolistic and oligopolistic industries. Similarly, acquisition can serve as a market development strategy when a company engages in acquisition solely to diversify its market. The company can do this by acquiring a firm that is into a similar business but serves different customers (for instance Access bank's acquisition of Kenya's Transnational Bank in 2020). Cross-border acquisitions can help to achieve competitive advantage and improve consolidated revenues by overcoming entry barriers to new markets. An acquisition can also serve as a product development strategy. In this case, instead of producing a new product, the company acquires an existing company that produces the new product or service (for instance Facebook's acquisition of WhatsApp in 2014). The product or service in this case is not too different from what the organization is already offering (more like an upgrade). Where the product is completely different, it would constitute a diversification strategy. This kind of acquisition can help create competitive advantage and improve financial performance by avoiding the costs, risks and delays associated with new product development (similar with a make or buy investment decision). When an acquisition involves companies in similar or related industry, it is often referred to as integration (He et al., 2017). Horizontal integration involves the acquisition of a firm by a competitor in the same industry. Horizontal integration is often done with the aim of increasing market share. Vertical integration refers to a case where a firm is acquired by a firm in a related industry (either a supplier or a customer). Forward integration is where a firm acquires another firm in its customer industry while backward vertical integration is when a firm acquires another firm in its supplier industry. Vertical integration is often done to take advantage of economies of scale (Koch et al., 2017).

Competitive advantage through restructuring strategy

Restructuring is often used as a retrenchment strategy (Figure 3). Capital reconstruction is a common financial restructuring strategy. It is often implemented to take advantage of cheaper costs of capital or when the leverage position of an organization is found to be alarmingly high. Debt refinancing is a capital reconstruction strategy that involves replacing a firm's existing debts with newer debts that have more favorable conditions (lower interest rate, longer maturity date etc.)

A debt-to-equity swap is another capital reconstruction strategy that involves converting debt into equity by getting bondholders and creditors to accept shares as settlement for the debt. Downsizing can be used as an organizational restructuring strategy for cost reduction. It

involves cutting off unnecessary infrastructures and employees (Kim et al., 2021). Although downsizing can help reduce the overall cost of the organization, some disadvantages have been identified. The learning curve effect may be lost when employees are fired since new employees will have to be retrained (Imhanzenobe, 2019). In the early 1990s, the advent of the new age banks caused the Nigerian banking sector to experience a period of rampant downsizing as older banks were forced to cut cost to be able to compete with the newer ones. Divestment tends to have more positive effect on firm performance in the long run. It is a portfolio restructuring strategy that involves selling off a cancerous business unit to save the overall company. This is often due to under performance of the divested unit for a reasonably long period of time. Coca-Cola recently had to shut down its operations in Lebanon due to its series of losses and the general economic downturn in the country (Arabnews, 2020). Downscoping is quite related to divestment. It refers to a case where a company streamlines its portfolio to its core businesses only (Fuhrmann and Madlener, 2020). Typical example of downscoping was Microsoft's announcement to stop developing new operating systems every few years but to adopt the Apple-like approach of only providing updates on the already existing Windows 10 version and focus more on producing computer hardware (Nguyen, 2015).

MATERIALS AND METHODS

The aim of this study was investigated by reviewing existing empirical literature. Several authors have carried out empirical investigation on the ability of acquisition and restructuring strategies to create competitive advantage and found mixed results. Most of the studies measured the ability of companies to achieve and sustain competitive advantage through their financial sustainability position (that is their ability to maintain above-average financial performance for a long period of time). When a firm is able to maintain profits that are above the industry average for a long period of time, it indicates that the firm possesses resources and capabilities that are inimitable and help it to outperform its competitors. Rhoades (1973) did a study on the effect of diversification on industry profit performance in 241 manufacturing industries. The author discovered that diversified firms enjoy competitive advantage in form of increased barriers to entry for potential competitors. These barriers to entry are of two kinds; ability to use profits from one business unit to subsidize low price strategy in another business unit, and ability to hide attractive returns in one of their product market using consolidated financial reporting. However, in a different study (Rhoades, 1974) the author discovered a slightly negative relationship between diversification and profitability. In this study, they measured diversification with the number of industries that the companies belonged to and the proportion of firm's sales outside their primary business compared to total sales. The author attributed the difference in results to the industrial aggregation rather than measures of diversification. Beard and Dess (1981), in their study discovered that the implementation of acquisition and restructuring as corporate level strategies can lead to sustainable profitability and competitive advantage in the long run. He attributed the success of the corporate strategies to the firm specific resources. This result is similar with those of Heracleous (2003), who supported the resource based view and suggested that competitive advantage can be obtained by acquiring firms that have unique resources which cannot be easily imitated. He also suggested that tangible resources are easier to imitate compared to intangible resources. Thus, firms can use acquisition strategies to obtain competitive advantage especially in services industries and other industries that thrive on intangible assets. Cording et al. (2008) did a study on the impact of integration acquisition and performance. They identified several factors that influence the success of such acquisition. Factors like integration depth and speed, market focus and internal reorganization tend to have positive effect on the successful implementation of integration strategy while factors like top management turnover have negative effect on the successful implementation of such acquisition strategy. Anderibom and Obute (2015) carried out an investigation on the effects of mergers and acquisition on the performance of Nigerian commercial banks using United Bank for Africa as a case study. They used a paired sample t-test to test for differences in the performance of the bank before and after its acquisition of Standard Trust Bank. The study showed that the performance of United Bank for Africa improved after the acquisition. A very similar result was discovered by Sujud and Hachem (2018) in their study on the effect of mergers and acquisition on the performance of commercial banks in Lebanon. A comparative analysis was done on the financial performance of Audi-Saradar Group before and after the acquisition (Bank Saradar signed a merger agreement with Bank Audi Sal, but Saradar was entitled to become the largest shareholders of the new Audi Saradar Group). The earnings per share improved significantly after the acquisition. The return on asset also increased but not significantly.

On the other hand, a study by Gort (1962) found that acquisition as a diversification strategy had no significant relationship on competitive advantage in terms of profitability. Christensen and Montgomery (1981) tried to test the relationship between the relatedness of business portfolios of conglomerate firms and economic performance as a way of evaluating the impact of diversified acquisition strategy on competitive advantage and financial sustainability. They discovered that there was a negative relationship between the unrelatedness of business portfolios and financial sustainability in terms of market share, thus discouraging acquisition as a diversification strategy. Hopkins (1987) carried out a study on acquisition strategy and market positioning of acquiring firms. In this study, the author evaluated the impact of the different forms of acquisition strategy (that is conglomerate acquisition, technology-related acquisition and market-related acquisition) on competitive advantage, in terms of market positioning of the acquirer after acquisition. The study suggested that unrelated diversification through acquisitions often resulted in unfavorable market positions. However, the results also showed that, while acquisitive growth is generally associated with a decline in market position, the market-related strategy (acquisition for market development) will often lead to superior market position for the acquiring firm and this will eventually improve revenues and profits. Hayes and Jaikumar (1988), in their study, suggested that acquisition and other strategies that create external linkages and dependencies can lead to autonomy-control tension (especially in cross-border acquisitions). Thus, they promoted the importance of building specific organizational competencies by encouraging companies to develop their own technologies and resources instead of depending on external intervention. This position is similar with that of Lanctot and Swan (2000). According to Lanctot and Swan (2000), external reliance on product and process technologies has a negative impact on firm success. They also identified geographical barriers as a hindrance to the effectiveness of technology acquisition strategies in achieving competitive global market position.

Some authors have also investigated the impact of restructuring strategies on the performance and competitive position of

organizations.A study by Robbins and Pearce (1992) analyzed the effectiveness of restructuring as a retrenchment strategy. The study investigated 32 textile manufacturers and showed that downsizing and divestment strategies resulted in the highest average level of turnaround performance. Chowdhury and Lang (1996) did a study on turnaround actions and firm profitability. They divided retrenchment strategy into cost-cutting (reduction in operational expenses) and asset reduction strategies (asset disposal and divestment). The results showed that profitability was more responsive to the efficiency strategies like asset divestment and employee productivity. Boyne (2004) did an investigation on the effectiveness of restructuring strategies (in terms of downsizing, downscoping, divestment and management reorganization) to effectively achieve a turnaround in failing public service organizations. They recommended that the highlighted strategies were crucial stages in the overall effectiveness of a turnaround strategy in public service organizations. They also emphasized that divestment in this case doesn't necessarily refer to exiting the market (since they are compelled to provide such services by law) but by partnering with other agencies and private sector organizations.

Some other authors have found negative or absence of relationship between some restructuring strategies and firm competitive advantage. Sudarsanam and Lai (2001) carried out a study on the effectiveness of restructuring strategies in achieving corporate recovery. They examined 166 potentially bankrupt UK firms drawn from 1985 to 1993 and observed their turnaround strategies (operational, asset, managerial and financial restructuring) for a period of three years from distress. The results showed that both recovery and non-recovery firms adopted very similar sets of restructuring strategies. The strategies of the non-recovery firms were more intensive than those of the recovery firms and yet did not help them recover. The major difference was that the recovery firms also adopted some growth-oriented strategies while the non-recovery firms had more of a fire-fighter approach. Marques et al. (2011) also did a study to investigate the effectiveness of downsizing strategy on boosting firm performance. They tested a sample of 1,357 Portuguese firms and concluded that firms that downsize largely maintain their underperformance compared to those that do not downsize. This result is similar with that of Imhanzenobe (2019) who discovered that changes in number of employees had no significant impact on the financial sustainability position of companies. Carriger (2018) also did a study that investigated the effectiveness of downsizing. They differentiated forced employee attrition (downsizing) from temporary or natural attrition. The found no significant relationship between forced attrition and financial performance. However, they suggested temporary attrition as a better alternative as it leads to positive immediate and long-term effect.

FINDING AND DISCUSSION

From the review of existing literature, we can identify mixed results on the ability of acquisition and restructuring strategies to achieve and sustain competitive advantage and improve financial sustainability. Some authors identified a positive impact of acquisition on firms' competitive advantage and overall financial performance (Rhoades, 1973; Beard and Dess, 1981; Heracleous, 2003; Cording et al, 2008; Anderibom and Obute, 2015; Sujud and Hachem, 2018) while others identified a negative impact (Rhoades, 1974; Christensen and Montgomery, 1981; Hopkins, 1987; Hayes and Jaikumar, 1988; Lanctot and Swan, 2000). Acquisition as a diversification strategy was supported on the basis that diversified businesses have the advantage of being able to conceal abnormal profits through consolidated financial reporting as well as charge low prices and subsidize such losses with profits from other businesses (Rhoades, 1973). Acquisition as a market development strategy (vertical and horizontal integration) was even more encouraged as it serves as an effective means of expanding market share and acquiring unique resources that cannot be internally generated (Beard and Dess, 1981; Heracleous, 2003; Anderibom and Obute, 2015; Sujud and Hachem, 2018). Although, several author identified positive effect of acquisition, some authors also acknowledged the fact that acquisitions create external reliance on other organizations for resources that are critical for their survival and this could harm the organization in the long run (Hayes and Jaikumar, 1988; Lanctot and Swan, 2000). Also, during the implementation process of acquisition and restructuring strategies, managers ought to consider how to deal with some of the challenges that come with it. Challenges like changes in organizational culture and value, lack of actualization of predicted synergy and top management turnover ought to be managed with caution as these could also have significant effects on the successful implementation of such strategies (Cording, Christmann and King, 2008).

Some authors identified a positive impact of restructuring strategies on firms' competitive advantage and overall financial performance (Robbins and Pearce, 1992; Chowdhury and Lang, 1996; Sudarsanam and Lai, 2001; Boyne, 2004) while some others identified a negative impact (Sudarsanam and Lai, 2001; Imhanzenobe, 2019). A potential explanation for this discrepancy is that some authors investigate restructuring as an isolated strategy, whereas others investigated it as the first stage in the process of a turnaround strategy (Arogyaswamy et al., 1995). Downsizing, downscoping and divestment were found to be significant determinants of the successful implementation of organizations' turnaround strategy (Robbins and Pearce, 1992; Chowdhury and Lang, 1996; Sudarsanam and Lai, 2001). However, when applied alone or as a fire-fighter approach, they were found to be insignificant (Sudarsanam and Lai, 2001; Imhanzenobe, 2019). The results of the reviewed studies are in line with the theory of grand strategies which suggests that acquisition and restructuring strategies, when implemented correctly can improve the competitive advantage and financial sustainability position of organizations.

Conclusion

This study sets out with the aim of providing a descriptive framework for acquisition and restructuring strategies as corporate level strategies and investigating the ability of these strategies to help organizations to achieve

competitive advantage and improved financial sustainability. The concept of acquisition and restructuring strategies where linked to the grand strategies of growth and retrenchment strategies respectively. The arguments on how these strategies can lead to competitive advantage and superior financial performance was also discussed and empirical studies on the subject were reviewed.

Some authors identified acquisition as an effective diversification strategy because it has the advantage of increasing barriers to entry through low price subsidization and concealing of abnormal profit through consolidated reporting. Several recommended horizontal and vertical integration as effective market development strategies with the argument that it helps the firm acquire unique resources and acquire competitors' market share. A few authors also discouraged acquisition strategy on the grounds that it increases external reliance on other organizations for critical resources.

Restructuring strategies have been recommended by several authors as an effective part of a turnaround strategy. However, when implemented alone may not be effective in improving the survival of organizations. Restructuring strategies ought to be implemented as part of a bigger picture and possibly accompanied with some growth strategies to produce positive and significant impact of firms' performance. The above findings have some practical implications for management research and practice. Managers who want to expand their businesses can carry out acquisition strategies. Although acquisition strategies are fairly effective for diversification purpose, they are even more effective for market development as they help in acquiring unique resources without having to build from scratch. Although the problem of relying on external organizations for acquiring unique resources exists, managers can reduce anticipate this problem by gaining substantial control over the acquired firm. During times of financial crisis, managers can also employ restructuring strategies in reviving the company. However, choices of restructuring techniques matter. Downsizing is a very common technique that managers are quick to use but which research has shown to be seldom effective. Restructuring strategies may not be very effective when applied in isolation. There ought to be a big picture for the overall turnaround of the firm which could comprise some restructuring strategies. Restructuring strategies cannot be used as a 'magic wand'. They ought to be used in combination with other growth and/or stability strategies to yield effective results.

Also, in the implementation of acquisition and restructuring strategies, some other factors like organizational culture, employee satisfaction, and management structure and style ought to be considered and managed properly to yield positive and significant results. Further empirical research could be carried out to investigate the impact of such mediating variables on the competitive advantage and financial sustainability of firms.

CONFLICT OF INTERESTS

The author has not declared any conflict of interest.

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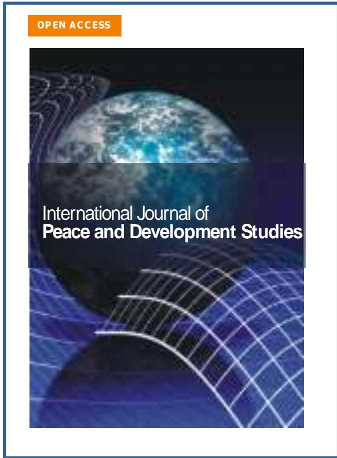

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