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Tax Avoidance and Evasion as a Factor Influencing 'Creative Accounting Practice' Among Companies in Kenya

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Abstract
Creative accounting is carried out with an objective of making the company appear to be financially stronger or weaker depending on the management's aspirations. This practice is considered professionally unethical in Kenya even though in some countries it's permitted by law. This study singled out Tax avoidance and evasion as one of the major factors influencing creative accounting practice in Kenya. The researcher randomly collected and analyzed data from thirty six accountants working for various companies in Kenya. The results of the study established that tax avoidance and evasion is indeed one of the major factors contributing to practice of creative accounting among companies in private sector in Kenya.

Key Words: Creative Accounting, Tax avoidance, Tax evasion.

INTRODUCTION

1.1 Background

Creative accounting explains a set of technically legal accounting activities and practices that are not conventionally accepted or practiced. These practices are preformed with the objective of making the company appear to be financially stronger or weaker depending on the management's aspirations. Creative accounting is also known as cooking the books, window dressing or earnings management. According to Gosh (2010), Creative accounting is the transformation of accounting figures from what they actually are to what perpetrators desire by taking advantage of the existing rules and/or ignoring some or all of them. It involves those techniques which are openly displayed such as window dressing as well as those which are sophisticated ones such as off-balance sheet financing. The difference between creative accounting and fraud is that creative accounting is working within the regulatory framework but fraud involves breaking the law or violating regulatory framework (Jones, 2011).

There are four main forms of creative accounting which includes: earnings management, income smoothing, aggressive accounting and big bath accounting (Büsra and Ömer). Techniques, effects and detection of creative accounting has been identified and researched on by various scholars.

Simser (2008) elucidates that taxpayers are required to pay taxes based on accounting and legal advice provided which should be aligned to the firm's financial reports and the existing tax rules. Taxation is complex and exploring the tax system requires the guidance of skilled lawyers, accountants and other advisors. Tax evasion is unacceptable and/or illegal while tax avoidance is perfectly acceptable however there is no clear line between the two. This is the dilemma that is faced by the advisors. Tax evasion is perpetrated through acts such as presenting incorrect statement of accounts, making false entries or alterations, or false books or records, destruction of books or records, concealment of assets or covering up sources of income constitute tax evasion (Malkawi, and Haloush, 2008).

The Kenya government relies on revenue from taxes for both recurrent and development expenditure. Kenya Revenue Authority (KRA) is the body that is charged with responsibility of tax administration in Kenya. Its functions include providing advice on matters pertaining to the administration and collection of revenue; enhancing efficiency and eliminating tax evasion; facilitating economic stability and controlling exit and entry points to the country (Parliamentary Budget Office, 2010)

Amat, O. and Gowthorpe, C. (2010) highlights tax as one of the major motivators of creative accounting since it's based on the business income. Niskanen and Keloharju (2000) explain that tax is a major motivator of creative accounting in Finland also Herrmann and Inoue (1996) describes taxes a motivator of creative accounting in Japan.

Balaciu and Pop (2008) highlighted the various motivations behind practice of creative accounting more so in Bangladesh. One of the motivations highlighted in his research was tax avoidance and evasion. This study narrows down to tax avoidance and evasion as a factor influencing creative accounting practice in Kenya. Accountants working for various organizations responded to this study.

1.2 Problem statement

For many years, people have debated about creative accounting which is widely used to describe accepted accounting techniques which permit corporations to report financial results that may not accurately portray the substance of their business activities. Creative accounting has been controversial because in some countries such as Greece it is backed by law (Baralexis, 2004) while in some other countries it is considered illegal (Healy and Wahlen, 1999). Likewise some scholars argue that creative accounting is legitimate and ethical while others consider it illegitimate and unethical (Healy and Wahlen, 1999).

Regulators of accounting profession in Kenya seem to be silent on the issue of creative accounting yet it is widely practiced among many companies in the country (Mbaire, 2012). Further users of accounting information seem not to have perceived this practice of creative accounting which has led to collapse of many major companies globally such as Enron and world com (Ayala and Giancarlo, 2006) and locally such as Nyaga stock brokers and Discount Securities (Bonyop, 2009).

With increasing hard economic times, companies may be motivated to practice creative accounting for diverse reasons. Players in the accounting profession may not fully understand the operations of creative accounting because different companies practice creative accounting for different reasons. Carrying out research on factors contributing to creative accounting in Kenya will help the players in accounting profession to empirically understand the motivations behind practice of creative accounting in Kenya. This research singled out Tax avoidance and evasion as one of the major factors influencing creative accounting practice in Kenya.

1.3 Study Objective

The objective of this study was to establish whether Tax avoidance and evasion influences creative accounting practice among companies in Kenya.

1.4 Hypothesis

Tax avoidance and evasion does not influence creative accounting practice among companies in Kenya

1.5 Justification

This research will help the players in accounting profession to understand tax avoidance and evasion as a factor that contribute to practice of creative accounting. This may be instrumental to the regulators of accounting profession in their bid to curb the vice. The users of financial statements especially governments may also be made aware of the motivations behind creative accounting such as tax evasion and avoidance and hence the knowledge may help them perceive or suspect possibility of creative accounting in financial reports.

RESEARCH DESIGN AND METHODOLOGY

2.1 Research Design

Research design guides the researcher in collecting, analyzing and interpreting data. It assists the researcher to determine the objectives of research, subjects of research, the sample size, the data to be collected, the procedures of collecting and recording that data, the procedures for analyzing that data and how the data will be interpreted and presented (Nachmias, 1996). This research employed a survey research design along with descriptive and hypothesis testing designs. Survey design entails selecting a few respondents from a population with an aim of generalizing the results to the entire population while descriptive statistics describes a phenomena and hypothesis testing uses inferential statistics to evaluate a proposition.

2.2 Sample

The research population was accountants working in private sector in Kenya. There numerous companies in Kenya with accountants working for them. Since the research design employed was a survey, the researcher circulated the questions to online accountant groups such as facebook and linkedin where random members responded. The researcher employed random sampling technique in this study.

2.3 Data Collection

The data was collected from accountants working in the private sector in Kenya. The research questions regarding practice of creative accounting for the purpose of tax evasion and avoidance were in form of 4 point likert scale measured as follows: Strongly Disagree (1), Disagree (2), Agree (3) and Strongly agree (4). Data was collected on all the variables with an aim of testing the hypotheses indicated in section 3.3 of this research.

2.4 Data analysis

The analysis involved both descriptive and inferential statistics. The hypothesis in this study was developed along with the study objective. A single mean hypothesis testing was carried out to establish any significant practice of creative accounting for the purpose of evading and/or avoiding tax.

DATA PRESENTATION AND ANALYSIS

3.1 Research Findings

Thirty six accountants contributed to the research by responding to the research question floated online. The results of this research were presented using both descriptive and inferential statistics as follows.

3.2 Creative Accounting Practice

The respondents were required to react to the statement that "Creative accounting is being practiced in Kenya for the purpose of avoiding and evading tax". The respondents were to Strongly Disagree (1), Disagree (2), Agree (3) or Strongly agree (4) with the proposed statement. A frequency distribution curve was plotted from the sample responses obtained and it appeared as follows:

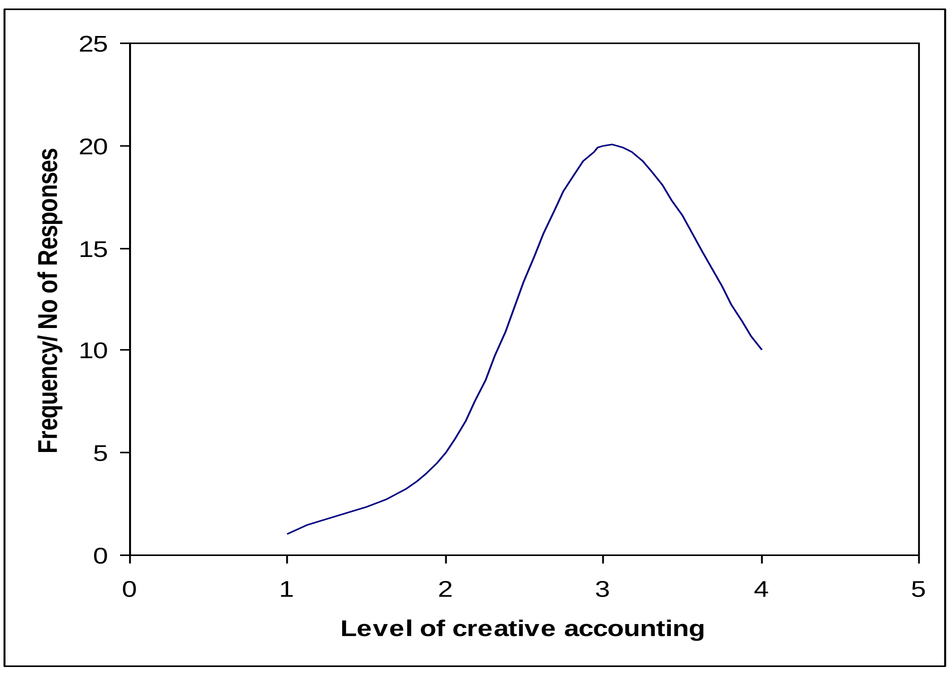

Figure 1 – Frequency of Creative accounting Practice

The graph shows that data is slightly skewed towards strongly agree that creative accounting is practiced in Kenya for the purpose of tax avoidance and evasion. This is confirmed by the coefficient of skewness calculated and indicated on table 1. Coefficient of Skewness was found to be -0.5947 which indicated that the data was actually skewed to words one side.

The descriptive statistics for the data analyzed was presented in the following summary table.

Descriptive Statistic	Result
Mean	3.0833
Standard Error	0.1220
Standard Deviation	0.7319
Sample Variance	0.5357
Skewness	-0.5947
Sample size (n)	36.0000
Confidence Level (95.0%)	± 0.2476

Table 1 – Summary of Descriptive Statistics

Mean – The arithmetic mean of 3.08 for scores of 1 to 4 for Strongly Disagree to Strongly Agree respectively indicates clearly that on average, majority of the respondents agreed with the proposition that creative accounting is practiced in Kenya with an aim of evading or avoiding tax obligation.

Standard Deviation – It indicates that the variation of responses from the mean indicated above was not very high. In other words most of the responses were around the mean of 3.08 which represents agreement with the proposition that creative accounting is practiced in Kenya with an aim of evading or avoiding tax liability.

Confidence interval at 95% level
Confidence Interval = Point estimate ± Test statistic X Standard Error
Confidence Interval = $X \pm 1.645 (\sigma/\sqrt{n})$
Confidence Interval = 3.0833 ± 0.2476
Range of confidence interval is 2.8357 to 3.3309
The researchers were therefore 95% confident that the true mean of the population lies between 2.8357 and 3.3309. Since the lower limit is still above 2.5, the researcher concludes that creative accounting practice for the purpose of tax evasion and avoidance is high among companies in Kenya.

3.3 Hypothesis Testing

Hypothesis

Score of 2 implies that the mean of responses were equivalent to disagreement that creative accounting is practiced in Kenya to avoid and/or evade tax. The hypothesis of the study as indicated in section 1.4 was stated as follows:

H_0 – Tax avoidance and evasion does not influence creative accounting practice among companies in Kenya (Score, $\mu = 2$)

H_1 – Tax avoidance and evasion influence creative accounting practice among companies in Kenya (Score, $\mu > 2$)

Level of Significance

The test was carried out at 95% confidence interval therefore type I error ($\propto$) was 5%. ($\propto$ = 0.05)

Test statistic and decision rule

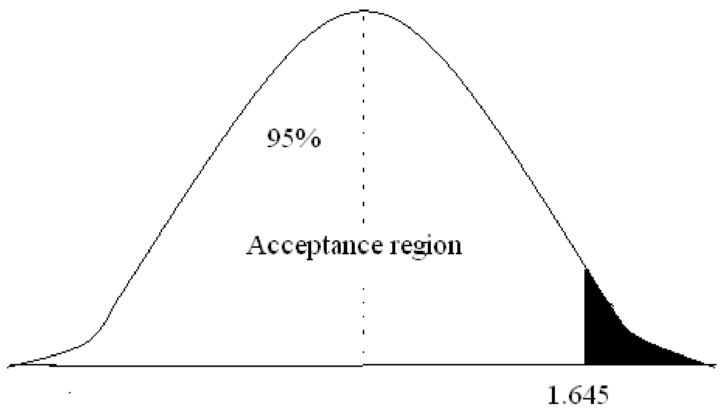

Figure 2 – One tailed Normal Distribution

The null hypothesis (H_0) is to be rejected if calculated t falls within the rejection region i.e. the calculated z > 1.645

Calculation

Descriptive statistics on the compliance with quality asurance standards were calculated using SPSS program.

$$z = \frac{x - \mu}{\sigma/\sqrt{n}} = \frac{3.08 - 2}{0.7319 \div \sqrt{36}} = 8.8537$$

The calculated z was 8.8537

Conclusion

Since calculated z (8.8537) is greater than the critical z (1.645), reject the null hypothesis (H_0) and accept the alternative hypothesis (H_1). Therefore the conclusion is that Tax avoidance and evasion significantly influences creative accounting practice among companies in Kenya

DISCUSSION AND CONCLUSION

4.1 Discussion

The aim of this study was to provide evidence of the practice of creative accounting for the purposes of evading and avoiding tax. This was to help the researcher assert that tax avoidance and evasion is one of the strong factors influencing creative accounting practice among companies in Kenya.

The results of this study found out that creative accounting is widely practiced among companies in Kenya. The study established that the tax avoidance and evasion is a major motivation that drives practice of creative accounting. The findings of this research concur with the findings of other researches as indicated in the introduction section of this study. This led to the conclusion that Kenya is not an exception i.e. just like countries such as Finland, Japan, Nigeria and others, tax avoidance and evasion are major contributors to practice of creative accounting. Since tax is calculated on the basis of income, it is highly likely that the companies may understate their income so as to reduce the tax burden.

These findings portrays a serious image for Kenya's professional accounting bodies, as they indicate that considerable potential value from the financial reporting process is being lost as a result of the creative accounting practice. These findings support the solutions provided by Amat and Gowthorpe (2010) especially on the issue of limiting judgment on choice of accounting methods to be applied.

4.2 Conclusion

The study ascertained that tax avoidance and evasion are some of the major factors contributing to practice of creative accounting among companies in private sector in Kenya. This therefore calls for accounting regulatory bodies to tighten the grip on financial reporting rules in a bid to curb creative accounting practice in Kenya.

Areas for further research could include other factors motivating practice of creative accounting, the research to expand on the solutions to the problem of creative accounting and detection of the same.

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