

# Tax Avoidance and Financial Performance of Quoted Firms in Nigeria

Adeduro Adesola Ogunmakin\*, Micah Juwon Akinleye\*\*, Oluwafemi Dele Anifowose\*\*\*, Adesodun Isaac Adebayo\*\*\*\*

## Abstract

The study examined the relationship between tax avoidance and financial performance of selected quoted firms in Nigeria. Secondary method of data collection was adopted. Simple random sampling technique was used in selecting five out of 17 quoted industries in Nigeria and two firms each from the sampled industries. Variables tested for tax avoidance are tax cost savings (COS); profit before tax (PBT) and debt equity ratio (DER). Earnings per share (EPS) were proxy for profitability. Data were subjected to pretest analyses including correlation test, panel unit root test and panel co-integration test, followed by panel estimation including pooled OLS, fixed effect, random effect estimation, alongside post estimation tests such as restricted f-test, Hausman test, heteroscedasticity test, cross-sectional dependence test, and autocorrelation test. Results showed that profit before tax and debt equity ratio exert a significant positive impact on earnings per share while tax cost savings exert an insignificant negative impact. The study concluded that earning per share is substantial with all the tax avoidance variables showing statistically significant, with the impact of tax cost saving specifically contributing to increase in earnings per share. This study therefore recommends that management should device a model that can help evaluate the appropriate leverage ratio fit for the implementation of tax avoidance strategies to ensure that strategies are adopted without posing threat to the going concern of the firm.

**Keywords:** Tax Avoidance, Earnings Per Share, Profit Before Tax, Debt Equity Ratio, Tax Cost Savings, Panel Regression

## Introduction

Tax avoidance is usually regarded as a technique of selecting the technicality in the overall tax legislations to take this technicality to cut back the overall tax payable (Ojo, 2003 cited by Abata, 2014). Tax avoidance is not always regarded as an associate offence. Tax avoidance

systems cash in spectacular public purse at powerful personal expense of the overall state. The key technicality within the tax legislation would be the waistline where firms take advantage of capital allowances as to their hedged capital expenditure. Capital allowance could be espoused on expenditure that are employed for the businesses. Replacing depreciation with capital allowance is a way of avoiding tax that is fumed as inappropriate trade expenses for the reason of taxation. The tax benefits assist the businesses to maintain finances in the system to grow their firms.

Corporate organisations operate based on agency relationship between the shareholders, management and the managers (driver of the firm). Management is required to behave with maximum honesty along with purposeful discharge of tasks in a manner the shareholders could have done with a view to heighten the market worth of the overall firms (Bariyima & Cletus, 2014). Based on the aforementioned, concerning the processes of the company, which included business performance, should be disclosed timely and accurately by the management. Shareholders should employ proper monitoring of their investment in order to promote fairness, transparency and accountability. Financial feedback, as far as corporate tax, covers activities to transfer source of revenue to some flippantly taxed location. Real responses to international tax credit cover repositioning of assets, employment in addition to economic output in low-pitched revenue enhancing countries. Kimberly (2009) also stated that multinational firms have many methods for shifting profits across locations. For example, it may be advantageous for multinational firms to alter the debt/equity ratios of affiliated firms in high- and low-tax countries in order to maximise interest deductions in high-tax countries and

\* Department of Accounting, Ekiti State University, Ado Ekiti, Ekiti State. Email: adeduro.ogunmakin@eksu.edu.ng

\*\* Department of Accounting, Ekiti State University, Ado Ekiti, Ekiti State. Email: micah.akinleye @eksu.edu.ng

\*\*\* Department of Accounting, Ekiti State University, Ado Ekiti, Ekiti State. Email: oluwafemi.anifowose@eksu.edu.ng

\*\*\*\* Department of Accounting, Ekiti State University, Ado Ekiti, Ekiti State. Email: micah.akinleye @eksu.edu.ng

taxable profits in rock-bottom tax countries. He further explained that multinational firms have a tax incentive to distort the prices on intra-firm transactions. For example, firms can follow a strategy of under-pricing intrafirm turnover to rock-bottom tax countries as well as over-pricing intrafirm purchases from rock-bottom tax countries, trailing the alternative scheme parallel to high regressive countries. One will also find various different prospects through the source of revenue tax credits that influences global firm behaviour, which includes the placement of intangible holdings, disbursement of royalties along with the timing and planning of recovery choices. Tax avoidance is an essential component containing financial planning and the area of financial structure decision offers a tax manager and the company an opportunity to alleviate the company's tax liability and improve on the financial performance of the firm. Although previous empirical studies such as Bariyima and Cletus (2014); Kimberly (2009) and Ogundajo and Onakoya (2016) have established that tax avoidance has a significant influence on corporate governance by increasing the value of the firm, most of the previous studies concentrated more on financial institutions. Therefore, this research work covered both financial and non-financial institutions. This study overcomes this weakness by extending the scope across industries to determine how industries' specific approach towards tax avoidance enhances firms' performance.

The specific objective is to examine the impact of tax cost savings; profit before tax and debt equity ratio on earning per share.

## Literature Review

Companies interested in tax avoidance use the tenacity of scaling down their taxes knowing that tax expenditure can cut down their net profit (Khaoula, Amor & Ahmed, 2010). Tax avoidance is considered as an important investment for organisations because of the reduction of the tax burden.

## Tax Rate and Avoidance

Raymond (2004) and Abdirahman, Mary and Ondabu (2005) explained that tax rates have been widely accepted as a primary determinant of income tax avoidance. In fact, one argument in support of cutting marginal tax rates

has been that by tempting greater income, lower rates will broaden the tax base. While this claim has not been confirmed by traditional micro theoretic analyses which have generally found the consequences of a tax rate, latest efforts to analyse this issue have even resulted in negative relationship between tax rates and tax avoidance. Empirical analyses have also been unable to determine the avoidance. Some studies ignore the theme all together by omitting tax rates (Witte & Diane, 1985).

The typical approach to analysing the firm's avoidance decision has been to use a portfolio-choice framework in which the optimal level of avoidance is obtained from maximising expected utility of income after taxes and penalties (Allingham & Sandmo, 1972). Using this approach, four factors have been commonly found to affect the decision in avoiding taxes. These are the firm's true income, the tax rate, the probability that the tax avoider is detected and the penalty rate to which detected avoiders are subjected. In most cases, a positive relationship between the level of avoidance and the firm's actual income, and negative relations with both of the compliance policy tools are obtained. With respect to the tax rate, however, most models have been unable to resolve this unclear relationship. The increase in tax rate brings excessive tax avoidance. It has two perspectives; first, the disposable income goes down. Second, this change discourages the accumulation of capital, which will drive the marginal productivity of human capital. This brought greater number of income and taxes to be unpaid (Yitzhaki, 2000). The important issue to understand is the connection enclosed by tax rates and tax avoidance. A number of theories have evolved to incorporate tax avoidance, but they failed to provide any prediction concerning the uniform impact of tax rates on avoidance.

This study derived its theoretical framework directly from theory of optimal taxation, and general theory of tax planning.

The traditional scientific theory consisting of optimal taxation opines that a tax process ought to be selected to maximise a social welfare programme contingent upon a set of limitations. The overall articles as to optimal tax income usually treat the social group as a utilitarian: that is, the spectacular welfare routine revolves around the services of people in the environment. In very general interpretations, the present articles provide a welfare routine that is a deterministic function of individual services. A deterministic function consists of a social

group, which allows for an additional equal spread of utility. However, some studies posit that social groups are concerned exclusively on average utility, postulating a social welfare function that may be one-dimensional in individual utilities.

(Stiglitz, 1986) propounded the overall scientific theory of tax planning. In his theory, he stated that ‘in a perfect capital market, the principles of tax planning are so powerful that they can enable the astute taxpayer to eliminate all taxation on capital income, and possibly all taxation on wage income as well’. He observed specifically that more of general equilibrium received because of tax planning stems from variations in tax rates, throughout firms and people through categories of revenue instead of postponement. Stiglitz (1986) stated that ‘the tax laws constantly change the opportunities for tax avoidance but underneath, there remain three basic principles of tax planning within an income tax are postponement of taxes, tax arbitrage across’.

The study reviewed some empirical studies in relation to organisational tax avoidance and firms’ financial performance. Wang (2010) examines the relationship between tax avoidance, corporate transparency and firm value. The researcher exploited cash effective rates and permanent book-tax difference to proxy tax avoidance, using 1,500 firms in the period 1994 to 2001. The study found a positive significant relationship between tax avoidance and firm value.

Jens and Schweltnus (2008) examined the effects of corporate income taxes on two of the main drivers of growth, profitability and investment of firms in European OECD member countries over the time of 1996–2004. The outcome suggests that corporate income taxes reduce investment through an increase in the user cost of capital. This may be partly explained by the negative profitability effects of corporate income taxes, if there is an increase in the corporate tax rate.

Ogundajo and Onakoya (2016) examined the influence of corporate tax planning on the financial performance of quoted manufacturing firms in Nigeria using annual reports and accounts of 10 selected firms out of 28 firms listed under consumer goods sector. The study employed generalised least square (GLS) method of regression based on the outcome of Hausman’s model estimation test. The study established that aggressive tax planning – such as thin capitalisation, tax law incentives and other

benefits of loopholes in Nigerian tax laws – has not been fully utilised by the Nigerian firms.

## Research Methods

### Model Specification

This study adopted the model of Ogundajo and Onakoya, (2016) with modifications. Hence, the model of the study is specified in functional and linear forms as follows:

$$EPS = f(COS, PBT, DER, U)$$

The model can as well be specified in linear form as:

$$EPS_{it} = \alpha_0 + \alpha_1 COS_{it} + \alpha_2 PBT_{it} + \alpha_3 DER_{it} + \mu_i + \varepsilon_{it}$$

Where:

*EPS* = Earnings per share

*COS* = Tax cost savings by the firm

*PBT* = Firm profit before tax

*DER* = Debt equity ratio

*i* = cross-sectional variable from 1, 2

*t* = time series variable form 1, 2, 3, ... 10

$\alpha_0, \alpha_1, \alpha_2, \alpha_3$  are parameter estimates corresponding to the explanatory variable and the constant term,  $\mu_i$  is the cross-sectional unit effect, while  $\varepsilon_{it}$  is the idiosyncratic error term.

### Sources of Data and Methods of Estimation

The study covered periods from 2006 to 2014. The choice of the period was derived from the observation that these listed firms have gradually become prominent according to the Nigerian stock exchange performance indicator. However, data used for this study covered those collated from the financial reported of selected quoted firms in Nigeria [Brewing: Guinness and Nigerian Brewery; Consumers: PZ and Glaxo; Cement: Wapco/Larfage and Dangote; Banking: Zenith and Guarantee Trust Bank; Agric: Presco and Okomu]. These firms were selected using simple random sampling techniques.

In the quest to attain the objectives predetermined in the research work and to provide answers to those research questions raised, the research employed panel data analysis starting with the Pooled OLS estimation, fixed effect estimation as well as random effect estimations in an attempt to arrive at the most consistent and efficient estimator.

## Results and Discussion

**Table 1: Pooled OLS Estimation**

*Series:* EPS COS PBT DER

Variable	Coefficient	Std Error	T-Test Values	Probability
C	319.4196	44.68772	7.15	0.000
COS	3.396518	2.060584	1.65	0.103
PBT	.0019252	.0006616	2.91	0.004*
DER	-49.98297	15.9221	-3.14	0.002*

R-square = 0.5755, Adjusted R-square = 0.5498, F-statistics = 6.81, Prob(F-stat) = 0.0003 (\*) connotes significance at 5% level of significance

Table 1 reports coefficient estimates for tax cost saving (COS), profit before tax (PBT) and debt-equity ratio (DER) to be 3.396518, .0019252 and -49.98297 alongside corresponding probability values of 0.103, 0.004 and 0.002, respectively. Reported estimates revealed that tax cost saving has an insignificant positive impact on earnings per share, with a percent increase in tax cost saving culminating into only 3.4 naira increase in the earning per share of firms annually. Influence of profit before tax as reflected in the reported estimate is positive and significant with a billion naira decline in profit before tax due to tax planning leading to about 1.9 naira reduction in earnings per share. Debt equity ratio exerts a significant negative impact on earnings per share with a unit increase in debt-equity ratio leading to about 49.98 naira fall in earnings per share. Table 1 reported R-square value of 0.5755, meaning about 58% of the systematic variation in earnings per share could be explained by variation in tax planning variables used in the study. F-statistics and probability values of 6.81 and 0.0003 confirm the joint significant impact of the explanatory variables on earnings per share thus affirming the fitness of the model.

### Fixed Effect Estimation

**Table 2: Fixed Effect Cross-Sectional Specific Estimation Result**

*Series:* EPS COS PBT DER

Variable	Coefficient	Std Error	T-Test Values	Probability
C	294.8683	56.43684	5.22	0.000
COS	4.902516	1.292411	3.79	0.000*

Variable	Coefficient	Std Error	T-Test Values	Probability
PBT	.0034457	.0004823	7.14	0.000*
DER	-38.9224	16.99761	-2.29	0.024*
<b>Cross-Sectional Effects</b>				
DANGOTE	24.58474	72.68941	0.34	0.736
GLAXO	-116.4343	71.1922	-1.64	0.106
GTBANK	-161.3843	85.3374	-1.89	0.062*
WAPCO	509.3982	65.90173	7.73	0.000*
GUINNESS	-25.64139	76.98564	-0.33	0.740
OKOMU	-152.7383	69.6206	-2.19	0.031*
PRESCO	-551.6318	68.57282	-8.04	0.000*
PZ CUS-SION	34.85012	69.67069	0.50	0.618
ZENITH	-148.0861	81.96313	-1.81	0.074*

R-square = 0.7968, Adjusted R-square = 0.7688, F-statistics = 28.43, Prob(F-stat) = 0.0000 (\*) connotes significance at 5% level of significance

Table 2 reports result of fixed effect estimation conducted in bit to examine the effect of tax planning variables on earnings per share taking into account the possible heterogeneity effect that may exist amidst firms sampled for the study. The table reported coefficient estimates of 4.902516, .0034457 and -38.9224 for tax cost saving, profit before tax and debt-equity ratio, respectively. Probability values reported for the corresponding estimates stood at 0.000, 0.000 and 0.024, respectively, which revealed all the tax planning variables exert a significant impact on earnings per share.

Specifically, an increase in tax cost saving by a percent leads to about 4.9 naira increase in earnings per share; similarly, for profit before tax, a billion naira decline due to tax planning culminates into about 3.4 naira decrease in earnings per share. Debt-equity ratio exerts a significant negative effect on earnings per share with every one unit increase in debt-equity ratio leading to about 38.9 naira decline in earnings per share. Table 2 also reported differential intercept terms for each of the firms sampled in the study from the intercept term of the reference firm (Breweries). Specifically, intercept term for the reference firm stood at 294.8683, while deviation from the reference intercept stood at 24.58474 for Dangote, -116.4343 for Glaxo, -161.3843 for Gtbank, 509.3982 for Wapco, -25.64139 for Guinness, -152.7383 for Okomu, -551.6318 for Presco, 34.85012 for PZ cusson and -148.0861 for Zenith.

Notably, the reported probability values for the deviation terms revealed that deviation from the reference intercept is significant for firms including Wapco, Okomu and Presco, which is a circumstantial evidence of the presence of heterogeneity effect amidst firms sampled in the study. R-square statistics reported in Table 2 stood at 0.7968 while f-statistics and probability values stood at 28.43 and 0.0000, respectively.

**Table 3: Fixed Effect (Period Specific Estimation) Result**

*Series:* EPS COS PBT DER

Variable	Coefficient	Std Error	T-Test Values	Probability
C	222.9379	91.09728	2.45	0.016
COS	3.012201	2.10191	1.43	0.155
PBT	.0012431	.0007306	1.70	0.092
DER	-50.64223	16.16262	-3.13	0.002*
<b>Period Effects</b>				
2006	23.36869	125.4674	0.19	0.853
2007	64.13305	125.6473	0.51	0.611
2008	93.88273	126.172	0.74	0.459
2009	106.0911	126.0962	0.84	0.402
2010	95.52316	126.7552	0.75	0.453
2011	230.5153	127.7365	1.80	0.075
2012	240.2451	128.2309	1.87	0.064
2013	230.0582	130.8622	1.76	0.082
2014	160.1267	132.7744	1.21	0.231

R-square = 0.2413, Adjusted R-square = 0.1367, F-statistics = 2.31, Prob (F-stat) = 0.0132 (\*) connotes significance at 5% level of significance

Reported in Table 3 are coefficient estimates reflecting the impact of tax planning variables (tax cost saving, profit before tax, debt-equity ratio) on earnings per share, taking into account the period specific effect. Specifically, Table 3 reported coefficient estimates of 3.012201, 0.0012431 and -50.64223 alongside probability values of 0.155, 0.092 and 0.002 for tax cost saving (COS), profit before tax and debt-equity ratio (DER), respectively. The result revealed that when period specific effect is incorporated in the model, impact of tax cost saving and profit before tax remains positive but insignificant, while the impact of debt-equity ratio is negative and significant. Deviation from the reference intercept terms (222.9379) representing 2005 stood at 23.36869 for 2006, 64.13305 for 2007,

93.88273 for 2008, 106.0911 for 2009, 95.52316 for 2010, 230.5153 for 2011, 240.2451 for 2012, 230.0582 for 2013 and 160.1267 for 2014. Observably probability values reported in Table 3 do not reflect significant deviation from the reference intercept term for any of the years. The table reported R-square statistics of 0.2413, alongside f-statistics and probability values of 2.31 and 0.0132, respectively.

## Random Effect Estimation

**Table 4: Random Estimation Result**

*Series:* EPS COS PBT DER

Variable	Coefficient	Standard Error	Z-Test Values	Probability
C	242.0614	96.35042	2.51	0.012
COS	4.862215	1.273381	3.82	0.000*
PBT	.0033652	.0004721	7.13	0.000*
DER	-40.51181	16.19972	-2.50	0.012*

R-square = 0.5544, Wald chi2 (5) = 80.35, Prob > chi2 = 0.0000 (\*) connotes significance at 5% level of significance

Table 4 reports the result of random effect estimation conducted in the bit to track the effects the impact of tax planning variables on earnings per share, while incorporating the heterogeneity effect that may exist amidst the sampled firms in the error term of the model. Specifically, Table 4 reported coefficient estimates of 4.862215, .0033652 and -40.51181 for tax cost saving (COS), profit before tax (PBT) and debt-equity ratio (DER), respectively. Reported probability values stood at 0.000, 0.000 0.012, respectively. Thus, the results revealed that when the heterogeneity effect is incorporated into the error terms the effect of tax cost saving and profit before tax remain positive and significant, while the effect of debt-equity ratio is negative and significant. The estimates revealed that for every one percent increase in the tax cost saving due to tax planning earnings per share increases by 4.9 naira. On the part of profit before tax, every one billion reduction in profit before tax due to tax planning culminates into 3.4 naira decline in earnings per share, while increase in debt-equity ratio due to tax planning culminates into about 40.51 naira decline in earnings per share. Reported R-square statistics stood at 0.5544 alongside while chi-square and probability values of 80.35 and 0.000 respectively.

## Post Estimation Test

**Table 5: Restricted F-Test of Heterogeneity (Cross-Sectional and Time Specific)**

	<i>F-statistics</i>	<i>Probability</i>
Cross-sectional	29.56	0.0000
Time specific	0.84	0.5830

Table 5 reported f-statistics values of 29.56 and 0.84 with probability values of 0.0000 and 0.5830, respectively. The result reveals that there is enough evidence to reject the null hypothesis that all differential intercepts corresponding to the cross-sectional specific units are equal to zero, but otherwise for the period-specific intercepts. Meaning there is substantial heterogeneity effect amidst firms sampled in the study, while the effect over the period covered is not significant. Hence, result of the restricted f-test presented above invalidates the potency of the pooled OLS estimation for investigating the effect of tax planning variables on earnings per share.

**Table 6: Hausman Test**

<i>Null Hypothesis</i>	<i>Chi-Square Stat</i>	<i>Probability</i>
Difference in estimates not systematic	60.18	0.0027

Table 6 reported chi-square statistics of 60.18 and probability value of 0.0027. The result shows that there is enough evidence to reject the null hypothesis of difference in the fixed effect and random effect estimates are not systematic in favour of the alternative hypothesis. Thus, among the three estimators (pooled regression estimator, fixed effect estimator and random effect estimator), in the analysis of the effect of tax planning variables, the most consistent and efficient estimation is fixed effect cross-sectional specific estimation presented.

**Table 7: Tests of Panel Model Assumptions**

<i>Wald Test</i>		
<b>Null Hypothesis</b>	<b>Statistics</b>	<b>Probability</b>
<i>Panel homoscedasticity</i>	2.0505	0.9230
<i>Pesaran Test</i>		
<b>Null Hypothesis</b>	<b>Statistics</b>	<b>Probability</b>
<i>No cross-sectional dependence</i>	-0.064	0.9493
<i>Wooldridge Test</i>		
<b>Null Hypothesis</b>	<b>Statistics</b>	<b>Probability</b>
<i>No AR(1)panel autocorrelation</i>	0.0131	0.9115

Table 7 reported the result of tests conducted with respect to standard assumptions of panel data model employed in the study. Test result reported in the table includes heteroscedasticity Wald test, Pesaran cross-sectional dependence test and Wooldridge autocorrelation test. From the table, it can be observed that there no enough evidence to reject the null hypothesis of panel homoscedasticity, null hypothesis of no cross-sectional dependence and null hypothesis of no AR(1) panel autocorrelation, respectively, given the reported probability of the corresponding statistics for Wald test, Pesaran test and Wooldridge test that is greater than 0.05.

## Conclusions and Recommendations

It is concluded that tax cost saving exerts a significant positive impact on return on earnings per share ( $\beta = 4.902516$ ,  $p = 0.000$ ). Profit before tax exerts a significant positive impact on earnings per share ( $\beta = .0034457$ ,  $p = 0.000$ ), while debt-equity ratio exerts a significant negative impact on earnings per share ( $\beta = .5765015$ ,  $p = 0.739$ ). Notably, the impact of tax avoidance variables on earning per share is substantial with all the tax planning variables showing statistically significant, with the impact of tax cost saving specifically contributing to increase in earnings per share.

The study therefore recommends that management should device a model that can help evaluate the appropriate leverage ratio fit for the implementation of tax avoidance strategies to ensure that strategies are adopted without posing threat to the going concern of the firm. Further study should focus more on accessing the determinants of tax avoidance strategies in firms, identifying key factors provoking effective tax avoidance practices, as this will reveal why some firms are better at tax avoidance than others are.

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