Moderating Effects of Board of Directors on the Relationship between Tax Planning and Bank Performance: Evidence from Tunisia

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Abstract

This paper contributes to the banking literature by investigating the moderating effects of two sources of the monitoring board (board size and independent outside directors) on the relationship between tax planning and bank performance. We propose that these monitors can affect either the *form* or the *strength* of the relationship between tax planning and performance. Our empirical investigation uses a sample of 18 Tunisian banks during the period 2000-2011 and various statistical tools including panel data techniques. Results showed that while board size moderate the *form* of the tax planning-performance relationship, independent outside directors influence the *strength* of that relationship. Its findings have direct policy relevance for investors and tax administrations in monitoring and controlling banks' tax planning activities.

Keywords: tax planning, bank performance, board of directors, moderating variables

1. Introduction

Previous research works have explained the variations in tax burdens in terms of firm level characteristics (Gupta & Newberry 1997; Holland 1998). It has only been recently that their attention has turned to understanding the underlying motivations for these variations and any potential equity valuation consequences (Abdul Wahab & Holland 2012). Tax planning is considered one of the means of motivations for these variations. It is defined as the downward management of taxable income through tax planning activities (Frank *et al.* 2009; Chen *et al.* 2010). Tax planning represents a significant cost to the firm and shareholders. Although, the tax reduction can entail an increase of after-tax profits. There are actual and potential costs that inhibit firms from maximizing after-tax profits through tax planning. However, non-tax costs can be generated and accompanied by tax planning activities, particularly those arising from agency problems. Thus, the shareholders have to control the managers on the decision taken in fiscal subject. In fact, Swenson (1999) provides evidence of a negative relationship between the Effective Tax Rates (ETRs) and the share price. In the same context, Slemrod (2004) suggests linking manager's compensation to desirable outcomes such as ETR.

Governance can play the role of mediator between tax planning and banking performance. In particular, internal governance considers the board of directors as the main vehicle to exercise an actual control over the management, such as the rules which require a board dominated by external directors. Therefore, the board becomes a key mechanism to monitor managers' behavior and to advise them on the identification and the implementation of the strategy. In this context, Andres & Vallelado (2008) examined the effect of board of directors on banking performance. They found that bank board composition and size are related to directors' ability to monitor and advise management. Thus, the inclusion of more directors should benefit the monitoring and advisory functions, improve governance, and raise returns.

Similarly, Pathan & Skully (2010) examine the trends and endogenous determinants of boards of directors: board size, composition and Chief Executive Officer (CEO) duality. They found that the costs and benefits of boards' monitoring and advising roles could explain bank board structures with caveats. They also found that in contrast to non-bank evidence, for instance, board size was discovered to decrease over the sample period for large and medium-sized banks, while board size remained relatively stable for small banks.

In the same context, Belkhir (2009) investigated the relationship between board size and performance. Contrary to theories predicting that smaller boards of directors are more effective, increasing the number of directors in banking firms does not undermine performance. In contrast, the evidence is in favor of a positive relationship between board size and performance, as measured by Tobin's Q and the Return on Assets. He found that the number of directors leaving the board and the number of those joining the board for the first time increase following a poor performance, but the net change in board size is not affected by past performance.

In the same spirit, Pathan & Faff (2013) found that both board size and independent directors decrease bank performance. They show that board structure is particularly relevant for banks with low market power. The diversity of board of directors can affect banking performance. Pathan & Faff (2013) found that although gender diversity improves the performance of the bank for the pre-Sarbanes-Oxley (1997-2002), the positive effect of

sex decreases both after the introduction of the Sarbanes-Oxley (2003-2006) and during periods of crisis (2007-2011).

Shareholders will want a board of directors that will advise managers to undertake risky investments. The composition of the board of directors should be a reliable proxy of how well the board can process information provided by insiders and advise as well as monitor the bank's risk taking practices in the best interests of its shareholders. Minton *et al.* (2011) examined how board independence and the percentage of financial experts among independent directors relate to risk taking and performance of commercial banks during the period from 2003 to 2008, which includes the most recent financial crisis. They found that larger and more independent boards are associated with lower levels of risk taking. Thus the level of financial expertise among independent directors is positively related to risk taking both before and during the financial crisis. They show that during the crisis both stock performance and changes in firm value are worse for large banks with more financial expertise among its independent directors.

Furthermore, board of directors affects tax planning. Lanis & Richardson (2011) show that the inclusion of a higher proportion of outside members on the board of directors reduces the likelihood of tax aggressiveness. They also found a negative and statistically significant association between outside board of director membership and tax aggressiveness. Thus, more independent boards appear to deter tax aggressiveness through better governance. In the same framework, Lanis & Richardson (2012) examined the association between Corporate Social Responsibility (CSR) and corporate tax aggressiveness. They found a negative and statistically significant association between CSR disclosure and tax aggressiveness which holds across a number of different regression model specifications, thus most socially responsible corporations are likely to be less tax aggressive in nature. They also found that the social investment commitment and corporate and CSR strategy (including the ethics and business conduct) of a corporation are important elements of CSR activities that have a negative impact on tax aggressiveness. Recently, Lanis *et al.* (2013) have shown that the interaction between the composition of the board and the establishment of an effective system of risk management effect and internal controls can jointly reduce tax aggressiveness.

Based on the foregoing, we note firstly that the research works mentioned above have examined the effect of corporate governance on the tax planning (Desai & Dharmapala 2006; Hanlon & Slemrod 2009). Secondly, other studies have examined only the effect of governance on bank performance. So governance can play the role of moderator between tax planning and bank performance. Knowing that no study has been made in this direction, then our hypothesis is: governance (board of directors) may moderate the relationship between tax planning and bank performance.

This study makes several important contributions. Firstly, against a backdrop of increased attention on Tunisian bank's tax planning, it provides the first evidence concerning the potential moderating effects of corporate governance factors on the relationship between tax planning and bank performance. Secondly, the analysis is conducted by using a longitudinal period of twelve years thereby recognizing that the tax planning activities may vary over time.

The next section of the paper discusses the sample and data source and is followed by sections on variables for research design, models specification, results and finally the conclusion.

2. Sample and Data

The paper employs a panel dataset of financial firms listed on the Tunisian Stock Exchange in the beginning of 2013, during the period 2000-2011. As the nature of tax planning activities may depend on firm's consistently profitable (Mills *et al.* 1998), the sample is limited to firms that were profitable in all reporting years. This restriction resulted in the exclusion of 5 non-persistent firms. To provide a more representative analysis, a filter is used to exclude firms with extreme ETRs. Outlying observations were defined with an ETR>1 (Abdul Wahab & Holland 2012). In order to maintain a balanced panel by necessity 45 year end observations were excluded. Table 1 presents the sample selection process which resulted in 18 financial firms to give a balanced panel of 216 year end observations overs the reporting period.

Table 1. Sample Selection Process

Details	Numbers of observations	Numbers of companies
Finance listed companies in the beginning of 2013		24
Companies not exist throughout the period		(1)
	276	23
Negative pre-tax profit	(14)	
Extreme value of effective tax rates (ETR>1)	(1)	
Unbalance data	(45)	
Sample	216	18

The data have been collected with reference to the financial statement obtained from the Tunisian Financial Market Council. Board of director's data was obtained from stock guides published by the Tunisian Stock Exchange with supplemental data collected from firm's websites.

3. Variables for Research Design

3.1 Measurement of Variables

The empirical analysis in this paper is based on models that explain bank performance as a function of tax planning, board structures and a series of control variables. Bank performance, the dependent variable that we are examining, is measured by the Return on Assets ratio (ROA). It is calculated as the net income divided by the total assets. This ratio is the most used ratio to integrate accounting based performance as proxies for firm performance (Lam & Lee 2008; Abdullah 2004).

The independent variable of main interest is the tax planning. The measure used is defined as the percentage of total tax expense to pretax income. This measure reflects aggressive tax planning through permanent book-tax differences. Examples of such tax planning are investments in tax havens with lower foreign tax rates (provided that foreign source earnings are classified as permanently reinvested), investment in tax exempt or tax favored assets, and participation in tax shelters that gives rise to losses for tax purposes but not for book purposes (Wilson 2009). We draw on ETR in this study for two important reasons. Firstly, recent empirical tax research has found that ETR encapsulate tax planning (Armstrong *et al.* 2012). Secondly, ETRs also denote the proxy measure of tax planning most frequently used by many academic researchers (Robinson *et al.* 2010; Dyreng *et al.* 2008).

The two measures considered of board structures represent board size (BS) and independent outside directors (INDEP). BS is the number of directors on the board. INDEP is the percentage of total directors that are outside. An independent outside director is one whose only business relationship with the bank is his or her directorship. An independent outside director is not an existing or former employee of the bank and does not have any significant business/ familial ties with the bank (Charreaux 1997).

In line with literature on bank risk and performance, this paper controls for several firm specific characteristics. Firstly, the natural logarithm of the book value of total assets is used as a measure of bank size (SIZE). Anderson & Fraser (2000) showed that larger banks are more capable of diversifying risk, both geographically and by industry, than small banks. Moreover, larger banks have greater access to capital markets and thus more ability to adjust to unexpected liquidity and capital shortfalls. Secondly, the bank capital ratio (CAPITAL) is measured as bank total equity as a percentage of the bank's total assets. Cornett *et al.* (2009) found that capital is negatively related to earnings management. Thus, banks with high levels of income and capital record more loan losses and fewer securities gains. Pathan & Faff (2013) stipulate that statistically significant and positive coefficients on CAPITAL indicate that highly capitalized banks perform better. Thirdly, net interest margin (NIM) is calculated as net interest income as a percentage of average earnings assets. Net interest income is the difference between interest income and interest expense. Angbazo (1997) showed that the NIMs of money-center banks are affected by default risk, but not by interest-rate risk, which is consistent with their greater concentration in short-term assets and Off-balance Sheet (OBS) hedging instruments. By contrast, (super-) regional banking firms are sensitive to interest-rate risk but not to default risk. The data show that OBS activities promote a more diversified, margins-generating asset base than deposit- or equity-financing, and that cross-sectional differences in interest-rate risk and liquidity risk are related to differences in OBS exposure.

3.2 Descriptive statistics

Table 2 displays a summary of definition of variables and descriptive statistics for the sample firms.

Table 2. Variables, Definitions, and Descriptive Statistics

Variable	Symbol	Measurement	Mean	SD
Bank performance	ROA (%)	Percentage of net income to total assets	3.5256	5.2793
Effective tax rate	ETR (%)	Percentage of tax charge to profit before tax	15.6204	9.6009
Bank size	SIZE	Natural logarithm of the total assets at the end of each fiscal year	12.9633	1.9751
Net interest margin	NIM (%)	Percentage of net interest income to average earnings assets	3.0299	1.5233
Bank capital	CAPITAL (%)	Percentage of total equity to total assets	29.4748	31.8152
Board size	BS	Number of directors serving the board	10.5972	1.8172
Independent directors	INDEP (%)	Percentage of independent directors to total number of directors on the board	42.9802	20.6383

As regards the main variables of interest, the mean value of ETR indicates a mean tax charge of 15.62% for the

sample of 216 year ends observations. This rate is lower than the statutory rate applied which is equal to 35%. The average ETR of Tunisian banks indicates that statutory tax rates displayed by the government do not adequately reflect the nature of payment of taxes on Tunisian banks. Equally, we might note that ETR standard deviation is about 9.6% which highlights the dynamic nature of tax planning.

The corporate governance related characteristics of the sample can be summarized as follows: the mean board size (BS) is ten directors with 43% being independent directors (INDEP). These values are similar to those reported in a recent Tunisian corporate governance study (Trabelsi 2010) with the exception of INDEP which was higher at 80%.

4. Models Specification

The initial regression incorporating the predictor variable (ETR) and related control variables is set out below with variables as defined in Table 2:

$$ROA_{it} = \beta_0 + \beta_1\,ETR_{it} + \beta_2\,SIZE_{it} + \beta_3\,NIM_{it} + \beta_4\,CAPITAL_{it} + \varepsilon_{it} \tag{1}$$

To assess the potentially impact of board structures on the tax planning performance the above regression is extended by including the two board related variables BS and INDEP.

$$ROA_{it} = \beta_0 + \beta_1\,ETR_{it} + \beta_2\,BS_{it} + \beta_3\,INDEP_{it} + \beta_4\,SIZE_{it} + \beta_5\,NIM_{it} + \beta_6\,CAPITAL_{it} + \varepsilon_{it} \tag{2}$$

A third regression tests whether the relationship between tax planning and bank performance is moderated by the banks' board structures. In view of that, two moderating variables, ETR*BS and ETR*INDEP are constructed by multiplying tax planning measure by BS and INDEP variables respectively.

$$ROA_{it} = \beta_0 + \beta_1\,ETR_{it} + \beta_2\,BS_{it} + \beta_3\,INDEP_{it} + \beta_4\,ETR_{it}*BS_{it} + \beta_5\,ETR_{it}*INDEP_{it} + \beta_6\,SIZE_{it} + \beta_7\,NIM_{it}$$
$$+ \beta_8\,CAPITAL_{it} + \varepsilon_{it} \tag{3}$$

To perform the study, we followed the method for identification of moderators proposed by Sharma *et al.* (1981). Specifically, we used a Moderated Regression Analysis (MRA) to examine whether the monitoring board affects the *form* of the relationship, and we used Subgroup Analysis to examine whether they influenced the *strength* (degree) of the relationship. The proposed framework consists of four steps discussed below:

Step 1: Determine whether the hypothesized moderator variable interacts with the predictor using the MRA procedure (see equations 1, 2, 3). If there is a significant interaction, then proceed to step 2. Otherwise, go to step 3.

Step 2: Determine whether the moderator variable is a quasi or pure moderator by testing whether it is significantly correlated with the criterion variable (ROA). If it is, then it is a quasi moderator variable. If not, it is a pure moderator variable. Both quasi and pure moderators influence the *form* of the predictor-criterion relationship.

Step 3: Determine if the hypothesized moderator is related to the criterion or predictor variable. If it is, it is not a moderator. If it is not related to either the predictor or criterion variable, proceed to step 4.

Step 4: Split the total sample into subgroups on the basis of the suspected moderator and test of significance for differences in predictive validity across subgroups. If significant differences exist, the variable is a homologizer. Otherwise, it is not a moderator and the analysis is concluded.

5. Results

As described earlier, a series of regression models are intended to test for moderators of the *form* of the relationship between tax planning and bank performance. Before doing so, in our subsequent analysis we test the level of multicollinearity by using condition indices (Belsley *et al.* 1980). None of these indices exceeds the critical value of 30, the level at which multicollinearity may be a problem.

The results reported in Table 3 are estimated with a fixed effects model which assumes that uncontrolled heterogeneity in firm specific factors are correlated with the included independent variables. We remedied this assumption through the use of a *robust* option for estimating the standard errors using the Huber-White sandwich estimators which control for heteroscedasticity (Petersen 2009).

Table 3. Regression Estimations

Dependent variable : ROA	Model (1)	Model (2)	Model (3)
ETR	-0.0343	-0.0281	-1.2471
	(-1.38)	(-1.23)	(-2.35)**
SIZE	0.5567	0.2145	0.8597
	(1.38)	(0.49)	(1.19)
NIM	0.8147	0.9191	1.1129
	(1.14)	(1.30)	(1.58)
CAPITAL	-0.0535	-0.0996	-0.0616
	(-0.52)	(-0.87)	(-0.75)
BS		-0.7282	-2.0584
		(-1.37)	(-2.33)**
INDEP		-0.0188	-0.0005
		(-0.89)	(-0.01)
ETR*BS			0.1082
			(2.48)**
ETR*INDEP			-0.0006
			(-0.35)
Cons	-4.0472	9.8579	14.1875
	(-0.70)	(1.04)	(0.93)
R^2 (within)	0.0365	0.1108	0.3084
N	216	216	216
F value	5.58***	6.07***	6.33***
Hausman	18.76***	28.29***	47.64***

Figures in parentheses represent t-statistics.

 ***, and ** indicate significance at 1% and 5% respectively.

The first two models show a negative but not statistically significant relationship between tax planning measure and bank performance, ETR is not significantly different from zero. The control variables have non-significant coefficients which are robust to controlling for board monitors in model (2). We conclude that the relationship between ROA and ETR appears to be proxying for omitted banks specific characteristics, such as risk management.

Though, caution should be exercised in interpreting these results. In model (3) the previously negative relationship between tax planning measure and bank performance holds, and now significant. In contrast to Abdul Wahab & Holland (2012), this result is not consistent with stakeholders concerns about risk in tax or other tax planning related risks, for example, the risk related to inspection or investigation by tax authorities. But it could be explained that banks are interested in tax planning in order to improve business performance (Minnick & Noga 2010). The negative significant coefficient with respect to BS is consistent with the Trabelsi (2010) finding within Tunisian banks suggesting that a high number of administrators results in a negative effect on performance.

The next set of results examines whether the board of directors is a moderator of either the *form* or the *strength* of the relationship between tax planning and bank performance. The first step is to test whether our various moderator variables interacts with the predictor variable. In column (3) of Table (3), results suggest that BS in fact moderate the *form* of the tax planning-performance relationship; that is, board of directors' size appears to involve itself directly in the tax planning activities. A comparison of the R^2 for model (3) (30.84%) with that of model (2) (11.08%) is consistent with the moderating variable ETR*BS contributing a lot in terms of additional explanatory power.

Interestingly, we do not find evidence that independent outside directors moderate the *form* of the tax planning-performance relationship; that is, they do not appear to involve themselves directly in the tax planning activities decision-making. Subsequently, we test the possibility that such board members moderate the *strength* of that relationship. In order to do so we split the sample into subgroups of "low" and "high" groups of outside board members (Le *et al.* 2006). Banks were assigned into subgroups by reference to the median value of independent outside directors, which was 42%. We then regressed ETR along with our control variables on ROA for each subgroup. The results from the pooled regressions are reported in Table 4.

Table 4. Subgroup Analysis

Dependent variable : ROA	Outside board members	
	"Low" group	"High" group
ETR	-0.0062	-0.1933
	(-0.63)	(-3.54)***
SIZE	-0.5296	1.3384
	(-5.08)***	(3.02)***
NIM	0.1346	1.5116
	(1.25)	(3.64)***
CAPITAL	0.0032	0.2018
	(0.20)	(7.69)***
Cons	8.4727	21.1317
	(4.74)***	(-3.32)***
N	114	102
F value	39.28***	27.70***
R^2	0.5116	0.6722
Difference in R^2	0.1606***	

Figures in parentheses represent t-statistics.

 *** indicate significance at 1%.

As chow in Table 4, the relationship between ETR and ROA proved to be statistically significantly negative for that subgroup consisting of banks with above-median independent outside board membership. For banks with low levels of outside board membership the ETR-ROA relationship was found to be insignificant. The ETR coefficients in the two subgroups do significantly differ from each other (result of test of significance is as follows: H_0 -0.0062 = -0.1933 F = 11.40 p = 0.0009).

A Chow test of the difference in R^2 between the two models proved to be significant. These results suggest that independent outside board members moderate the *strength*, rather than the *form* of the relationship between tax planning and resulting bank performance.

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