

The Effect of Financial Distress and Accounting Conservatism on Tax Avoidance with Special Reference to the Manufacturing Companies in Sri Lanka

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Abstract

Introduction: Tax avoidance is the activity of managing the company's finances to avoid the larger amount of tax burden legally without violating the prevailing laws. Tax avoidance practices are common and legal for companies. The study aims to examine the effect of financial distress and accounting conservatism on tax avoidance.

Methodology: This study aims to analyze the effect of financial distress (Altman Z-score) and accounting conservatism (conservative accruals) on tax avoidance (book-tax differences) with firm size and audit quality as moderating variables and year of tax rate changed as a control variable. Secondary data used to collect the data from annual financial statements of 20 manufacturing companies listed in the Colombo Stock Exchange during the period of 2011 to 2021. Descriptive statistics, correlation and panel data regression used to analyze the data.

Findings: The study found that financial distress has a significant negative effect on tax avoidance and accounting conservatism has a significant positive effect on tax avoidance, while firm size moderates the effect of financial distress on tax avoidance, and audit quality does not moderate the effect of accounting conservatism on tax avoidance. The study shows that manufacturing companies had a high level of financial distress from 2011 to 2021, thus there were certainly concerns from the creditors and investors that manifested in the supervision of the company's operational activities. Therefore, managers of manufacturing companies try to avoid high-risk policies such as tax avoidance.

Conclusion: Initially, the primary focus for the Sri Lankan tax authority should be on effectively overseeing, closing legal gaps, overseeing tax evasion, and implementing stringent measures in cases of tax avoidance. Additionally, the government needs to establish and strengthen trust, showcasing tangible outcomes to illustrate the efficiency of utilizing tax revenue. Secondly, corporate entities must comprehend and acknowledge their rights and responsibilities concerning tax obligations. These businesses should strive to enhance management capabilities and governance skills to prevent financial strain that could potentially lead to bankruptcy.

Keywords: Financial distress, Accounting conservatism, Tax avoidance