



Customer concentration and corporate tax avoidance[☆]



Henry He Huang^{a,*}, Gerald J. Lobo^b, Chong Wang^c, Hong Xie^c

^a Sy Syms School of Business, Yeshiva University, New York, NY 10033, United States

^b C. T. Bauer College of Business, University of Houston, Houston, TX 77204-6021, United States

^c Von Allmen School of Accountancy, Gatton College of Business and Economics, University of Kentucky, Lexington, KY 40506, United States

ARTICLE INFO

Article history:

Received 1 December 2014

Accepted 11 July 2016

Available online 4 August 2016

JEL classification:

H20

G30

G38

M49

Keywords:

Customer concentration

Tax avoidance

Corporate major customer

Governmental major customer

ABSTRACT

Firms with a concentrated corporate customer base need to hold more cash and have a stronger incentive to manage earnings upwards. Since tax planning can increase both cash flow and accounting earnings, firms with a concentrated customer base may be more likely to engage in tax avoidance. We find evidence of a positive association between the level of corporate customer concentration and the extent of tax avoidance. In addition, we find that the positive relation between corporate customer concentration and tax avoidance is more pronounced when a firm has a lower Market Share in its industry, enjoys less revenue diversification, and engages less in real earnings management. In contrast to corporate major customers, governmental major customers provide stable cash flow to suppliers, which is likely to alleviate supplier firms' need for tax avoidance. We find that firms engage in lower levels of tax avoidance when they have a governmental major customer, and that this association is less pronounced under Democratic presidencies. Taken together, our findings indicate that a firm's customer concentration (i.e., corporate and governmental major customers) has a significant effect on the extent to which it avoids taxes.

© 2016 Elsevier B.V. All rights reserved.

1. Introduction

The significant variation in the level of tax avoidance among public firms has attracted much academic attention (e.g., [Dyreng et al., 2008](#)). Prior studies show that the level of corporate tax avoidance is affected by: (1) financial characteristics ([Gupta and Newberry, 1997](#); [Rego, 2003](#); [Graham and Tucker, 2006](#); [Lisowsky, 2010](#)), (2) governance and executive compensation ([Phillips, 2003](#); [Desai and Dharmapala, 2006](#); [Rego and Wilson, 2012](#)), (3) ownership structure ([Chen et al., 2010](#); [Cheng et al., 2012](#)), and (4) external stakeholders such as labor unions ([Chyz et al., 2013](#)), the Internal Revenue Service (IRS) ([Hoopes et al., 2012](#)), and independent auditors ([McGuire et al., 2012](#)). Surprisingly, there is little evidence on how a firm's customer concentration, an important feature of its business operation, relates to the extent of its tax avoidance.

In this study, we examine the differential effect of corporate and governmental customer concentration on tax avoidance.

Customer concentration measures how concentrated a supplier's customer base is, and is one of the most important characteristics of the supplier–customer relationship.¹ The extant literature finds a significant association between customer concentration and (1) supplier financial policy ([Titman and Wessels, 1988](#); [Banerjee et al., 2008](#); [Wang, 2012](#); [Cohen and Li, 2013](#); [Itzkowitz, 2013](#)), (2) supplier performance and risk ([Ravenscraft, 1983](#); [Kalwani and Narayandas, 1995](#); [Piercy and Lane, 2006](#); [Patatoukas, 2012](#); [Dhaliwal et al., 2013](#); [Dhaliwal et al., 2016](#); [Campello and Gao, 2014](#)), and (3) supplier financial reporting quality ([Raman and Shahrur, 2008](#); [Hui et al., 2012](#)). However, few studies have addressed how customer concentration affects the supplier's relationship with another important stakeholder, the government, through tax payment.²

[☆] We thank the editor Carol Alexander, two anonymous reviewers, and workshop participants at Beijing Jiaotong University, Fudan University, Shanghai University of Finance and Economics, Southwestern University of Finance and Economics, and Zhongnan University of Economics and Law for their very valuable comments. Chong Wang acknowledges financial support from Von Allmen School of Accountancy (Luckett Fellowship) and National Nature Science Foundation of China (funding #71332008).

* Corresponding author.

E-mail addresses: henry.huang@yu.edu (H.H. Huang), gjlobo@uh.edu (G.J. Lobo), chongwang85@uky.edu (C. Wang), hongxie98@uky.edu (H. Xie).

¹ We use the terms firm, supplier, and supplier firm interchangeably in this paper.

² A concurrent paper by [Cen et al. \(2014\)](#) also shows that firms with major customers have higher levels of tax avoidance. Our study differs from theirs in at least the following four ways. First, we differentiate between corporate and governmental major customers and find that these two types of major customers have opposite effects on tax avoidance. Second, we contend that firms with major corporate customers have incentives to engage in tax avoidance because of the cash flow risk inherent in their business model; furthermore, we show that the level of tax avoidance is associated with the level of cash flow risk (e.g., when the customer

Firms with concentrated corporate customers have incentives to hold additional cash for at least three reasons. First, reliance on major customers entails higher cash flow risk because the loss of a major customer could lead to a sizable drop in the supplier's cash flow (Hertzel et al., 2008; Dhaliwal et al., 2013; Dhaliwal et al., 2016; Campello and Gao, 2014). Second, Wang (2012) and Itzkowitz (2013) suggest that suppliers with major customers may need to invest in relationship-specific assets as a commitment to their customers. Third, Ravenscraft (1983), Balakrishnan et al. (1996), Gosman and Kohlbeck (2009), and Piercy and Lane (2006) argue that major customers tend to use their bargaining power to obtain favorable terms from their suppliers, resulting in lower profitability and higher earnings and cash volatility for suppliers. For all the above reasons, suppliers with concentrated customers need to hold more cash. Because tax avoidance can reduce cash outflow (Desai and Dharmapala, 2009; Badertscher et al., 2010; Hanlon and Heitzman, 2010), firms with concentrated customers may have incentives to engage in more tax avoidance activities.

Firms can increase cash using various means other than tax avoidance such as share and debt issuance, cutting dividends, and reducing discretionary spending. For example, Wang (2012) and Itzkowitz (2013) suggest that firms with high customer concentration use lower dividend levels and share issuance, respectively, to keep their cash holding high, suggesting that firms with concentrated customers may not rely on tax avoidance to increase cash. We argue that whether firms rely on tax avoidance or other means to increase cash depends on the relative cost of each method and that tax avoidance is a relatively low cost means for firms with concentrated customers to generate cash internally.³ First, other ways of generating cash may not be available or may lead to adverse consequences for firms relying on major customers. For example, unfavorable macroeconomic conditions and the high cost of capital associated with firms that rely on major customers could make it very costly to raise cash externally (McLean, 2011; Dhaliwal et al., 2016), cutting dividends could signal a firm's poor future prospects and damage its relationships with major customers (Titman, 1984), and engaging in real earnings management (e.g., reducing discretionary spending) could hurt a firm's operations and future cash flow (Roychowdhury, 2006; Cohen et al., 2008), making it more difficult for firms with a concentrated customer base to keep their cash holding high in the future. Second, firms with a higher probability of financial distress tend to use tax avoidance to save cash (Mills and Newberry, 2001; Noga and Schnader, 2013). Firms with heavy customer concentration have a higher probability of experiencing financial distress (Ravenscraft, 1983; Balakrishnan et al., 1996; Gosman et al., 2004; Piercy and Lane, 2006), and thus are more likely to engage in tax avoidance to conserve cash. Third, the low debt ratio associated with firms with high customer concentration (Titman and Wessels, 1988; Shantanu et al., 2008) provides incentives for tax avoidance because these firms have a small debt tax shield.

Firms with high corporate customer concentration may also have incentives to engage in tax avoidance in order to manage

their earnings upwards. Establishing a major supplier–customer relationship requires a long-term purchase commitment and relationship-specific investments that will lose value outside the relationship (Titman, 1984). A customer will therefore be hesitant to commit to such a relationship if the supplier is perceived to have poor future prospects. Therefore, suppliers have incentives to manage their earnings upwards to enhance the perception of their business prospects. Consistent with this proposition, Raman and Shahrur (2008) find that corporate customer concentration is positively related to the magnitude of discretionary accruals and the likelihood of reporting a large earnings increase. Furthermore, Dhaliwal et al. (2004) and Cook et al. (2008) show that firms can use tax accruals to manage their earnings upwards, leading to a lower effective tax rate. On the other hand, the close customer–supplier relationship enables major customers to better assess the supplier's business prospects and major customers are also able to use their bargaining power to demand conservative financial reporting from their suppliers. For example, Hui et al. (2012) show that, in response to major customers' demand for timely recognition of bad news, suppliers report more conservative accounting numbers, implying that suppliers with major customers are less likely to use tax avoidance to manage earnings upward. In summary, prior literature provides somewhat conflicting predictions regarding whether firms with greater corporate customer concentration are more likely to avoid taxes.

We also examine the effect of having a governmental major customer on tax avoidance. In contrast to corporate customers, governmental customers are less likely to default or go bankrupt, and also tend to sign long-term contracts with suppliers. Consequently, the presence of a governmental major customer reduces, rather than increases, a firm's cash flow risk, its need to hold additional cash, and its future financial distress risk (Cohen and Li, 2013; Dhaliwal et al., 2016). Similarly, Mills et al. (2013) show that firms that receive the most federal contract dollars pay higher levels of federal taxes. All these reasons suggest a lower need and incentive for tax avoidance. We therefore expect firms with governmental major customers to have lower levels of tax avoidance.

We define a major customer as a customer that accounts for at least 10% of a supplier firm's total sales.⁴ We employ the following three measures to capture the degree of a firm's customer concentration: (1) an indicator variable that reflects whether a firm has at least one corporate major customer, (2) the sales-based Herfindahl–Hirschman Index calculated as the sum of the squares of the ratio of a supplier's sales to corporate major customers over its total sales (Patatoukas, 2012), and (3) the percentage of a supplier's total sales to all corporate major customers. We also use three measures of tax avoidance following prior literature: (1) current effective tax rate (*Current ETR*), (2) cash effective tax rate (*Cash ETR*), and (3) Book-tax Difference factor (*BTDFactor*), which is the first principal component extracted from three different Book-tax Difference measures to capture the difference between a firm's accounting income and taxable income (Kim et al., 2011).

Based on a large sample of U.S. firms during 1988–2011, we find that a firm's corporate customer concentration is positively associated with the level of its tax avoidance after controlling for various determinants of firm-level tax avoidance documented in prior literature. That is, a firm with greater corporate customer concentration tends to engage in more tax avoidance activities. The results are robust to all three measures of customer concentration and all three measures of tax avoidance. For example, we find that

switching cost is low and the firm's revenue is not diversified). In contrast, Cen et al. (2014) focus on how supplier firms can obtain tax avoidance knowledge from their principal customers. Third, we find a substitution effect between tax avoidance and real earnings management for firms with corporate major customers. Fourth, we find that the effect of governmental major customers on tax avoidance is affected by the political/presidential cycle.

³ Wang (2012) and Itzkowitz (2013) do not examine whether tax avoidance is used by firms with concentrated customers to generate cash. Thus, their studies do not exclude the possibility that tax avoidance is an important means for these firms to keep their cash holding high. In Section 5.8, we show that high customer concentration firms can increase their cash holding especially when they also employ tax avoidance, suggesting that tax avoidance helps these firms increase their cash holding.

⁴ Following prior literature, we use the 10% cutoff because Statement of Financial Accounting Standards No. 14 (SFAS 14) requires a firm to disclose in its financial statements external customers that individually account for 10% or more of its total sales.

Download English Version:

<https://daneshyari.com/en/article/5088246>

Download Persian Version:

<https://daneshyari.com/article/5088246>

[Daneshyari.com](https://daneshyari.com)