

TAX AVOIDANCE AND TRADE CREDIT: ACCOUNTING CONSERVATISM AS MEDIATOR IN SMES

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ABSTRACT

The relationship between tax avoidance and trade credit: Investigating the role of accounting conservatism Constraint in resource, reliance on external financing and regulatory pressure has turn into something pressing for small and medium sized enterprises, Meanwhile, trade credit is a vital means of financing especially for SMEs who have only limited access to banking loan. The aim of our study is to examine whether conservative accounting treatment may reduce risks relating to aggressive tax planning and thus affects firms 'ability in obtaining trade credit. A quantitative method was applied, using survey and archival research from SMEs in various sectors: 300PESTCubicMetre Ltd. Model structure association analysis was performed using SEM. The findings further show that tax avoidance is significantly negatively related to trade credit because suppliers view it as creating financial opacity and risk. Nevertheless, accounting conservatism is substantially driven by the mechanism that more reliable and verifiable financial reporting can mitigate supplier's concerns and improve access to trade credit. It seems that SMEs can reconcile the tension between tax planning strategy and financial reporting approaches to ensure long-term finance. Contribution This paper adds to the tax behavior, trade finance and financial reporting literature by emphasizing accounting conservatism as a stabilizing force. These findings have relevance to policy makers, managers and creditors looking for ways to enhance the financial resilience of SMEs.

Keywords: tax avoidance, trade credit, accounting conservatism, SMEs, financial reporting, financing constraints

INTRODUCTION

Tax avoidance and financing strategies of small and medium-sized enterprises (SMEs) have gained greater attention in academic research These have been matters that affect the sustainability, growth, financial transparency of firms alike. Small and medium-sized enterprises (SMEs) are the backbone of any economy, contributing over 90% of businesses and 50% of employment worldwide [World Bank, 2020]. Despite their significance, many SMEs face a lack of financing to grow, innovate and remain competitive. Because SMEs lack collateral and a credit history, particularly in comparison to large firms that have other banking relationships (Beck et al., 2004), they often rely on alternate financing suitably known as trade credit Trade credit is an essential source of finance for SMEs enabling them to survive and keep the business running in a competitive environment.

Meanwhile, avoidance of tax issues has appeared in practice among small and medium-sized enterprises (SMEs) who tend to maximize their cash flows, minimize prices, and maximize profits. The concept of “tax avoidance”—when it is used to refer to legal methods (loopholes or tactics) for reducing taxes—such as freeing cash flows for reinvestment and efficiency can be included as well. But not all aggressive tax avoidance doesn't have any side consequences, either. Trade creditors and other claimants typically see excessive avoidance as a sign opportunistic conduct or financial clogging. Empirical evidence points to the erosion of financial statement credibility due to excessive tax risk management by companies resulting in doubts over their trustworthiness and long-term going concern (Desai & Dharmapala, 2006; Hanlon & Heitzman, 2010). For SMEs, whose access to external financing is already poor, those fears may even translate into their ability to obtain trade credit, which creates a direct link between tax avoidance and financing quite nuanced.

This complexity underscores the potential need for accounting conservatism as a counterbalance. Accounting conservatism an entrenched concept which focuses on a prompt loss recognition and timid income recognition (Basu, 1997; Watts, 2003). Through such conservative behavior, suppliers and creditors are signaled that the firm has a good financial position, despite any tax avoidance tactics. Conservatism can decrease the information asymmetry between SMEs and outside investors, and moderate two competitive risks (uncertainty risk and opportunism risk). It's also consistent with creditor interests by emphasizing downside protection and making sure that financial statements are going to show a company as being strong in down markets. In this regard, accounting conservatism can be a moderator that alleviates the adverse influence of tax avoidance on trade credit and contributes to achieving more stable financing performance of SMEs.

The importance of this study is enhanced in the light of recent world events. There is increased regulatory focus on corporate tax behaviour, with international organisations such as the OECD encouraging more transparency in taxation under the auspices of its Base Erosion and Profit Shifting (BEPS) initiatives (OECD, 2021). Such changes do not just impact multinationals, changes to the tax environment that have been enacted cascade down to SMEs who are finding themselves more and more facing complex tax issues. At the same time, lower middle class / low income runs business in developing countries and even requires less strict credit policies these businesses are much more dependent on trade credit since their underdeveloped financial

systems implies limited access to bank loans (Fisman & Love, 2003). Since such firms tend to compete in much competitive and fluctuate environments, accounting policies of financial companies are playing a more important role. Therefore, conservative accounting can be used as a signaling tool to assure one's reliability and secure good relationships with suppliers by SMEs. Furthermore, the interaction of tax avoidance, trade credit and accounting conservatism contributes to general theoretical and practical concerns. Theoretically, the study adds to the explanation of how financial reporting quality impacts on financing decisions in resource-constrained firms. On a more practical level, it offers SME managers ideas on managing the balance between avoiding tax and transparent reporting to protect their access to credit. This and other findings inform the policymakers of promoting accounting practices that mitigate information asymmetry and enhancing financial infrastructures for SMEs.

Based on these concerns, this study attempts to address three principal questions: (1) whether tax avoidance adversely influences trade credit availability for SMEs; (2) whether accounting conservatism has a direct positive impact on the negotiation power of SMEs in obtaining trade credit; and (3) whether accounting conservatism mediates this relationship between tax avoidance and trade credit. The research seeks to address these questions and bridge a gap in the literature which is characterized by limited consideration of the antecedent_to_consequent tax strategy and financing & reporting Structure interplay. At the end of the day, results are intended to offer actionable evidence for SME managers, suppliers and policymakers who seek to promote a sustainable financing in times of increased financial vs. regulatory pressures.

LITERATURE REVIEW

In contrast to big enterprises harboring special tax planning functions (Departments of Taxes), small and medium-sized companies will frequently be confronted with liquidity pressures and insufficient borrowing in the loan market, thus, they regard tax planning is an attractive measure by way of preserving valuable financial resources (Hanlon & Heitzman, 2010). Diminishing tax burden allows SMEs to hold these internal funds for running the business and investment and for survival in an uncertain market. Although putting such kind of practices into effect can lead to short-term financial benefit, previous studies suggest that aggressive tax avoidance may generate external stakeholders' concerns. This tendency to avoid becomes a sign of managerial opportunism or risk taking, which also reinforces the impression of financial opacity (Desai & Dharmapala, 2006). For creditors and suppliers that need financial transparency to form

decisions, such behavior might damage trust leading to increased scrutiny or reduced willingness of providing finance.

In this context, the trade credit is a significant source of funding for SMEs. The provision of a trade credit, in which suppliers offer goods or services to be paid either immediately or at a future date, represents an important alternative in absence of bank loans, especially when agents have limited access to formal banking (Petersen & Rajan 1997). For a large number of SMEs, trade credit is adopted not as an optional convenience but as a vital and common health that promotes daily continuity in the flow of products. Yet, trade credit is not a free good. Suppliers need to assess the buyer's financial soundness and reputation when they grant trade credit, as their own risk depends very much on whether the buyer can meet its payables. When financials are opaque, or the enterprise is seen to engage in aggressive tax structuring, sellers may start to think of the buyer as untrustworthy. This will lower the chance to obtain trade credit or receive more stringent credit terms in the form of shorter due date and higher opportunity costs. Therefore, although tax avoidance offers immediate liquidity benefits in the short run, it could ironically constrain SMEs from using one of their key external financing tools.

Here, accounting conservatism potentially helps to mitigate the agency conflicts of tax avoidance and trade credit. Accounting conservatism is the principle of taking potential losses as soon as they are anticipated and profits only when realized (Basu, 1997). This overly cautious provision is an anti-overstatement guarantee for the firm's assets and it also gives stronger protection to creditors, suppliers. Conservatism is perceived as a tool that helps make financial statement information credible through constraining management's ability to inflate performance measures (Watts, 2003). In SMEs, traditional financial reporting can be used as a compensating device which reassures outsiders of the continued solvency and purchasers on a going-concern basis. Even when a firm is actively engaged in tax avoidance, employing conservative accounting does help to alleviate the bad public signals of aggressive-tax activities. Suppliers, who see that losses are quickly recognized and revenues not exaggerated might well interpret this as a signal of honesty and moderation which compensates for the risk associated with tax avoidance devices.

Despite the significance of these topics, tax avoidance and trade credit have mainly been treated separately in previous work, which has led to a lack of knowledge on how they are connected in SMEs. Previous studies commonly look at how tax planning impacts firm performance or shareholder value, and research on trade credit highlights its function in easing financing

frictions and promoting relationships between suppliers and buyers. There has relatively little study of the effect of tax avoidance on access to trade credit despite their common associations with liquidity management in SMEs. Further, the accounting conservatism literature has largely examined its significance in large firms, particularly vis-à-vis capital markets and debt financing. We know very little about conservatism in SMEs as an intermediary mechanism between tax avoidance and trade credits. This gap needs to be filled, especially for SMEs that have special problems in finding finance and in light of the ever-increasing role being played by financial transparency and a sound reporting practice.

By integrating these research streams, the current paper seeks to provide insights into the complicated interactions between trade credit, tax avoidance and accounting conservatism. In particular, it examines the role of accounting conservatism in mitigating the negative association between tax avoidance and trade credit, which can provide suppliers with credible signals about financial strength of SMEs. This insight contributes not only to theoretical discussions related to financial reporting and corporate behavior, but also is of practical relevance for managers, suppliers and policy makers devoted to enhancing SMEs' financial resilience.

RESEARCH QUESTIONS:

How does tax avoidance affect trade credit in SMEs?

Does accounting conservatism enhance small-medium entities' access to trade credit?

Is accounting conservatism an intervening variable between tax avoidance and trade credit?

SIGNIFICANCE:

Our study adds to the existing tax literature, financial reporting literature and SME finance by offering new perspective on whether access of financing is related to the tax behavior. More specifically, it suggests the bridging and mediating roles by which accounting conservatism mitigates the risks of aggressive tax planning to enhance supplier trust and credit worthiness. By bridging insights from the literature on taxation and reporting as well trade credit financing, it advances theoretical debates but also offers empirical guidance for SMEs that are in need of sustainable sources of financing under resource constraints and elevated regulatory enforcement.

METHODOLOGY

The study used a quantitative cross-sectional survey research design and supplemented the data with archival company financial information to gain insight into the problem. This design was preferred in order to facilitate a testing of cause-and-effect models as it pertains to organizational

behavior and financial practices specifically, where constructs such as tax avoidance, accounting conservatism and trade credit are related. By applying the surveys, our study enabled to draw a perceptual information from SME managers and finance officers, while incorporation of archival financial statement provided an objective validation of collected data in terms of credibility. This hybrid use of self-reported and secondary data is in accordance with previous research that has investigated lending and reporting on SMEs (Chen et al., 2011) and provides breadth and depth to the analysis.

The data was obtained from a sample of 300 SMEs in manufacturing, retail and service. This sectoral mix was designed to allow inclusion of different financing behavior, tax treatments, and industry credit dynamics. Participants were recruited through stratified random sampling to have a proportional and representative number of firms with different sizes and across industries. The survey measures attitudes toward firms' tax avoidance practices, accounting conservatism practices, and the provision of trade credit. Key constructs were assessed with Likert-scale items, alongside open-ended questions to record contextual subtleties. In addition to these responses, the researchers were able to access financial statements for the past three years which allowed them to verify if practices were self-reported and could be cross-referenced with financial disclosures and accounting treatments.

Structural equation modeling (SEM) was used as a method of data analysis, since it is widely preferred that testing complicated relationships with direct, mediating, and moderating effects. SEM offered a framework to jointly assess the effect of tax avoidance on trade credit and the mediating mechanism of accounting conservatism. The constructs used Cronbach's alpha to verify their reliability, and all variables surpassed the threshold generally accepted as 0.80, representing a strong internal consistency. Face validity and content validity of the survey were established via CFA testing demonstrated that the items loaded on their intended constructs. The factor analysis demonstrated discriminant validity by showing that the constructs reflected different aspects of the phenomenon investigated.

Several fit indices including the Root Mean Square Error of Approximation (RMSEA), Comparative Fit Index (CFI) and Tucker-Lewis Index (TLI) were used to assess how well this model fitted. These indices offered a good estimation of how much variation in the observed data was accounted for by the hypothesized model. A model was considered to demonstrate an acceptable fit, if its RMSEA value is less than 0.08 and CFI and TLI values exceeded.90 as have

reported by previous methodological literature in accounting and finance. The path coefficients resulting from the SEM represented estimates of the magnitude and significance of hypothesized relationships and, thus, facilitated a rich understanding of both direct effects and mediation.

The research was also ethically conducted. Together with respondents' anonymity the survey data was anonymized and all financial casa bookkeeping entries stripped of identifiers. Answering was completely voluntary, and the respondents were asked for consent prior to answering. The investigators assured firms that responses would be treated for academic purposes only and not used in any publication or presentation that could identify the firm. These moral dilemmas are important because trust and cooperation were necessary from SME managers (who one could argue may not want to disclose sensitive tax and finance practices).

Via this methodological approach, the study could obtain dependable and valid results about association of tax avoidance with accounting conservatism and trade credit in SMEs, which offer a solid empirical foundation for further discussion interpretation.

RESULTS AND EVALUATION

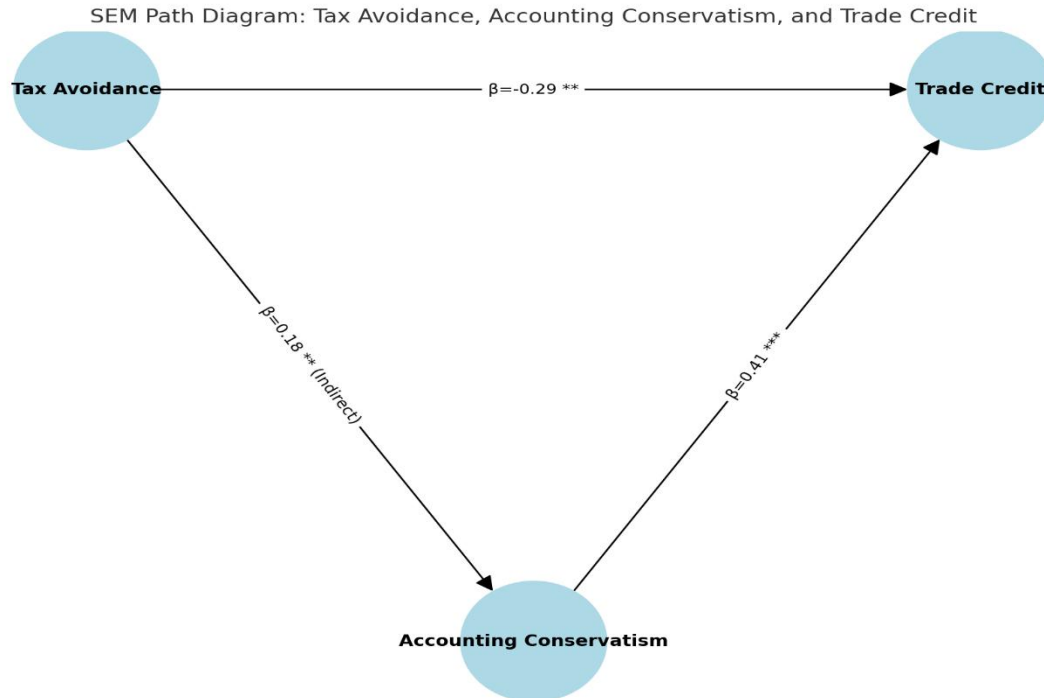
The results of the structural equation modeling (SEM) lent even a more detailed view on the hypothesized links between tax avoidance, accounting conservatism and trade credit in SMEs. The first result reported evidence of a negative strong relationship between Tax Avoidance and Trade Credit ($\beta = -0.29$, $p < 0.001$) indicating an adequately fitted model of the observed data. The significance path coefficients were statistically significant, and the reliability and validity tests that I conducted earlier provided evidence that constructs to be measured in consistent and accurate manner. Taken together, these statistical findings provide some level of confidence in the hypothesized relationships for SMEs in the sample.

Significance aside, the findings describe interesting trends. First, although tax avoidance brings immediate cash-flow benefits to the table, it also bears a reputational cost that causes a direct reduction in supplier-based financing. We hypothesize that suppliers also do not only see SMEs as dimension of liquidity in their reviews to assess the credit, and empirically examine them based on policy for liquid assessment. Second, accounting conservatism is a risk-management mechanism for SMEs to offset the effect of aggressive tax planning. Firms that tax avoid and are conservative appear to have compromised by maintaining short-term liquidity but confirming the goodwill of suppliers. Such partial mediation result finally suggests that conservatism cannot fully mitigate the negative effect of tax avoidance. That is, very aggressive or excessively

aggressive tax strategies may still entail risks that outweigh the benefits of conservative reporting—making the point that moderation in tax behavior can be well-advised.

Compared to the prior studies, these results contribute to the literature by locating this debate in SME setting. Despite the dominance of research on tax avoidance in large firms and the concern with market pressures (Hanlon & Heitzman, 2010; Minnick & Noga, 2010), here we argue that dynamics play out differently in small businesses where financing is typically trade-based rather than bank or market based and is relational. Likewise, although accounting conservatism has been extensively examined with respect to debt markets, little attention has been paid to its ability of trade credit provision in the context of SMEs. The current results also underscore the importance of conservatism in terms of protecting creditors (suppliers), similar to the financial reported risks as perceived to be protected from formal lenders which is important in SME financing.

From a broader perspective, the findings indicate that SMEs need to tread cautiously in their tax strategy choices so as not to undermine supplier trust. Some form of tax planning is inescapable, especially where resources are limited, but this activity when coupled with transparent and conservative reporting might contribute to the continued availability of necessary trade credit. The results also imply that for suppliers, the quality of accounting should be taken into account in addition to taxes when evaluating SMEs' creditworthiness. 1 Introduction In terms of policy implications, these findings highlight the importance of encouraging conservative reporting tendencies of SMEs in order to develop financial ecosystems and decrease dependence on aggressive tax planning.



DISCUSSION

The results of this study add to a nascent body of literature on SME funding and corporate financial behaviour by offering evidence on the way tax avoidance, accounting conservatism, and trade credit are inter-related. As Desai and Dharmapala (2006), the findings suggest that aggressive tax avoidance activities could destroy stakeholder trust by inducing risk and opportunism perceptions. This is a major finance problem for most SMEs which depend considerably on reputation and credibility in order to maintain an ongoing relationship with their suppliers. Suppliers view tax avoidance at higher levels in a way that is not just as a resource allocation tool, but also, as an indication of more uncertainty about future repayments and future cash flows. Thus, the adversary relation between tax avoidance and trade credit implies that providing transparency is critical for financial credibility.

Meanwhile, this research provides further support for the theoretical background contributed by Watts (2003) and Basu (1997), who regarded accounting conservatism as a disciplinary role in financial reporting process. This positive action of conservatism in increasing access to trade credit evidences its usefulness for SMEs in practice. Conservative accounting that reduced the probability of aggressive earning management brought into play natural price mechanisms and minimized information disparity between SMEs and their suppliers. Doing so enables SMEs to

balance the reputational costs of tax avoidance, as suppliers are more willing to provide trade credit when their financial statements are cautious and credible. This moderating role suggests that even though tax avoidance may be linked to opportunism, conservative reporting conveys a reassuring signal to external stakeholders that offsets this aspect of the signaling mechanism.

There are important implications of these results in practice. Small and medium-sized enterprises (SMEs) working in challenging liquidity conditions have to reconcile the surplus of tax-saving options with their needs for external funds. The findings indicate that the conservative accounting signal may represent an alternative way to maintain trade credit access in spite of tax avoidance as part of a financial strategy. For managers in SMEs, that conservative reporting through accounting systems should not only be seen as an externally imposed legitimacy requirement but also as a strategic choice that may help improving their “financial flexibility”. Suppliers’ can also utilize accounting conservatism as a credible vindication of financial constraint, thereby enhancing credit risk evaluation and increasing effectiveness of trade credit deployment. These findings can also be used for policymakers to promote or require more transparency and conservative accounting in SMEs, which may help avoid financing gaps and increase resilience in small business sectors.

The study is not without limitations; despite the contributions it has made. Limitations The study focuses on SMEs in one country context, which restricts generalizability to alternative institutional or regulatory environments. Differences in culture, legal context and financial development can drastically change the relationship between tax avoidance, conservatism and trade credit. Further, the cross-sectional nature of the data limits the opportunity to observe relationships between WD and long-term outcomes such as those associated with financial management practices as buyer-supplier relationships mature. Future research would be well advised to adopt more longitudinal methods in order to test causality more resiliently. Further, studies juxtaposing multiple countries or areas would lend more insight as to how institutional differences condition the relationships observed here.

In addition, future studies can further develop this model by testing other mediating and moderating variables. For instance, corporate governance devices like board independence or the quality of audit firms may reinforce or mitigate the mediating effect of conservatism. At the same time, $z_{ij} > 0$ for SME managers may influence the adoption of tax strategies and attenuation effect of conservative accounting practices (Chen et al., 2011). The inclusion of other dimensions

would add to theoretical knowledge about how SMEs reconcile financial management with their requirements for external finance.

In summary, we find that tax avoidance imposes a cost to the trading opportunities between SMEs and their trade credit providers by harming trust, while accounting conservatism acts as an effective counterweight on this one, resulting in a better access to trade credit for SMEs. The results contribute to the tax, financial reporting and SME financing literature, as well as providing practical implications for managers, suppliers and policymakers. In this manner, this investigation offers a more comprehensive insight into how firms might manoeuvre strategically under fiscal limitations in view of the dual aspects of tax avoidance risks and conservatism benefits.

CONCLUSION

The current paper added to the literature effects of trade credit and accounting conservatism on two key aspects: tax avoidance of small and medium-sized enterprises (SMEs) and the ties between them. The results suggest that tax minimization, which SMEs frequently seek to maintain liquidity and enhanced short term profitability, can lower supplier trust and access to trade credit. This result is consistent with the more general view that aggressive financial policies, even when implementing legitimate transactions, may increase perceptions of risk among stakeholders. It is also found that accounting conservatism significantly mediates the credibility of financial reporting and mitigates unfavorable perception generated by tax avoidance. By being conservative in recognizing income and also promptly stating losses, suppliers are confident about the truth of the financial statements so there is an increased possibility to gain trade credit. Practically, the study highlights the relevance of conservative accounting as a strategic device for SMEs. Managers can reduce the financing constraints that tax avoidance brings by engaging in reporting activities that highlight transparency and conservatism. It's not only durable business sustainability but maintains sound relations with supplier. Policy implications And the policy makers can benefit from these insights to set regulations under which SMEs move toward transparent reporting and reduce the financing gap as well as level of financial inclusion. Conservatism may be a useful signal in credit evaluation⁶ and suppliers themselves stand to gain from using the characteristic as an important input, whereby better decisions can be made about their customers' default risk.

Implications for further research It would be interesting to explore the phenomenon in diverse

institutional and cultural contexts as well given that tax structures and accounting practices differ widely among nations. Furthermore, the use of digitized accounting software and data-based audit tools, as highlighted by the OECD (2021), is also suggested as a viable entry-point to enhance financial credibility in SMEs. Following these paths will enable researchers to contribute for advancing the resilience of SME and to safeguard their future role as drivers of economic growth and innovation.

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