

TAX SHIELD DEPRECIATION AND EARNINGS MANAGEMENT OF NIGERIAN COMMERCIAL BANKS

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Abstract

This study determines the effect of depreciation on Earnings Management in Nigerian commercial banks. Ex Post Facto research design was adopted for the study. A sample size of thirteen (13) was used from a population of twenty two (22) commercial banks listed on the Nigerian Stock Exchange from 2010-2019. Data were extracted from audited accounts of the sampled banks. regression analysis was employed to test the hypothesis. The result showed that depreciation has a positive significant effect on Earnings Management of Commercial Banks in Nigeria. Based on the findings of the study, the researchers recommended that tax authorities should ensure that depreciation to be deducted must be associated with an asset used in a business or income-generating activity, and have an expected lifespan of more than one year.

Keywords: Tax shield, Depreciation and Earnings management

Introduction

Banking activity is subject to general taxation in most nations, including Nigeria (personal and corporate income taxes). Bank taxation is of particular interest for a variety of reasons: banks are financial intermediaries that perform unique and critical functions, despite increased competition from investment funds and security markets in many countries; they are heavily regulated and monitored, which reduces the administrative costs of some forms of taxation; and they are subsidized through low-cost deposit insurance and bailouts of insolvent banks. Furthermore, especially in the family and small company sectors, banks frequently have a monopoly of power. Banks have been characterized as intermediaries that are able to perform three main functions: asset transformation, provision of transaction services and monitoring. Banks can monitor entrepreneurs, which reduces agency costs in the credit market; they provide transaction services to investors (routine payments, check writing); and they offer investors liquidity insurance (Caminal & Xavier, 2004).

Banks demonstrate that taxes play a significant role in determining the capital structure of banks across the globe. Tax avoidance, often known as tax shielding, is a method of tax planning in which individuals and businesses limit the amount of money they pay to the government each year by using tax loopholes (VanDenburgh, 2012). A technicality permits banks or other business firms to circumvent the scope of regulatory restrictions without outright breaking the law. It is frequently used in tax avoidance, and it allows individuals and commercial banks to move income or assets from taxable situations to ones with lower or no taxes. Loopholes are most prevalent in complex business deals involving tax issues, political issues and legal statutes (Hayes, 2020).

According to Albertazzi and Gembacorta (2006), corporate income tax distorts the capital structure and raises the average cost of capital. In the case of commercial banks, the effects of corporate taxes are quite different since banks are subject to regulations that influence their liability structure. For example, in the presence of a minimum capital requirement, substitution effects between equity and other forms of financing are very limited for a bank (Gembacorta & Mistrulli, 2004). Thus, tax shield, involves deliberate but legally acceptable way of attempting not to pay tax. This has enhanced entities involvement in earnings management towards achieving undue regulation of profit to reflect the goals of management, or stakeholders or special purpose income settings of the entity (Pohan, 2009). Martani and Persada, (2009) concur to this stressing that one of the motivations for earnings management is taxation; raising income to reduce tax expenses in the following year. In other words, the phenomenon of effective tax rate increases the occurrence tendencies of earnings management and the quality of corporate profits disclosed by entities.

Studies linking earnings management and corporate tax shield have explained the relationship relying heavily on the agency theory (Desai & Dharmaphala, 2008, 2009b). They argue that due to the conflict of interest between managers and shareholders, opportunistic managers seeking to maximize their self-interest resort to tax shield practices to divert rent to themselves through earnings management. Managers opportunistically adjust earnings to expropriate wealth from shareholders to themselves which has the tendency of affecting equity value negatively (Hunt, Moyer & Shevlin, 2000).

Christensen and Murphy (2004) argued that corporate tax shield is values accruing to shareholders hence managers are encouraged to employ their best effort to minimizing taxes. Corporate tax shield is favoured by shareholders; it has been described as a transfer of value from the state to shareholders. However, tax shield techniques like interest payment, debt payment and differed tax liability pave way for opportunistic management to manage earnings in a way that is beneficial to managers instead of the owners (Desai & Dharmapala, 2007). Hence managers managing earnings are more likely to insulate themselves by avoiding more taxes as avoidance offers them shield from shareholder scrutiny. This is possible because corporate tax shield techniques are secretive in nature and require obfuscation of transactions to guarantee tax benefits whilst shielding such actions from tax authorities (Goncharov & Zimmermann, 2006a). Such mystification of transactions and its consequent shielding from the tax authorities reduces the ability of shareholders to monitor managers' behaviour.

Many studies on tax avoidance and Earnings Management have been conducted; studies like Amidu and Yorke (2017) and Yorke (2016) indicated a positive significance association between tax avoidance, debt/leverage, and a firm's Earnings Management.

Despite these findings, other research has revealed that debt has a negative impact on earnings management. Although the results of prior research were inconsistent, they were conducted primarily in foreign nations such as Bahrain, Egypt, Jordan, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, United Arab Emirates, and the United States. Given this scenario, the research is therefore envisaged to determine whether depreciation have significant effect on Earnings Management in the Nigerian corporate setting with specific emphasis on commercial banks.

Review of Related Literature

Every country in the world with a strong belief in the right to private property engages in a variety of activities for the common good, and the government extracts varied percentage of individuals' wealth for this purpose. Taxation connotes a notion of rights and duty in this sense, rights owing to people and duties owed by individuals to society (Jim-Suleiman, 2015). Taxation is a method of acquiring funds for government expenditures by collecting payments from individuals or corporations (Soyode & Kajola, 2006). They claimed that taxes is a system in which the government imposes a set amount of money on individuals, businesses, and government organizations in order to make cash available for her to accomplish. Similarly, Osita (2004) stated that taxation is a compulsory levy by government through its various agencies on the income, capital or consumption of its subjects. These levies are made on personal income such as salaries, business profit, interests, dividends, commissions, royalties and rent. It may also be levied on capital gains and petroleum profits.

When the government's and customers' preferences disagree, according to Kotakorpi (2009), the government may wish to influence consumer choice through public policy. Excessive consumption of items with harmful health consequences is one example (such as unhealthy food, cigarettes and alcohol). The government utilizes taxation to discourage the consumption of such commodities in this country. Government should explore taxation in this context to discourage certain practices (O'Donoghue, 2003; Gruber, & Koszegi, 2004; Rabin, 2006). As a result, taxing may be a useful instrument for lowering harmful consumption (Koszegi, 2005). Taxation is a highly significant instrument for the government to generate money for its operations and also as a deterrent from some detrimental behaviours, according to this study. After studying the definition of taxation, tax classification, and tax types.

A tax is a sum of money paid to the government that is usually calculated as a proportion of personal income or corporate earnings. According to Appah (2004), a tax is a mandatory levy imposed by the government on a subject or his property in order for the government to provide security, social amenities, and establish circumstances for the society's economic well-being. A tax is a monetary deduction made by a government agency for public purposes (Soyode, & Kajola, 2006). It is also a tax imposed by the government on an individual's, partnership's, or corporation's income, profit, or wealth. All Nigerian commercial banks are obligated by law to pay their taxes to the Federal Government in order to boost the country's overall revenue. Taxes are divided into two categories. It could be classified as Direct or Indirect Taxes (Osita, 2004; & Ojo, 2009).

Corporate Tax Rate and Earnings Management

The term corporate tax refers to a compulsory levy imposed by the government on the income of companies and corporate entities. Corporate tax is a tax on the taxable profits of limited companies and some organisations including clubs, societies, associations, co-operatives, charities and other unincorporated bodies. According to Adegbite (2015), this corporate income tax generally only applies to corporations and treated as taxable entities separate from their shareholders. That is, corporate income is taxed once at the corporate level according to the corporate income tax system. When corporate dividend payments are made or capital gains are realized income is taxed again at the individual-shareholder level according to the individual tax system.

In conducting earnings management, a company is not only influenced by tax incentive but also by non-tax incentive. Non-tax incentive is an incentive which is performed by the company itself. The implementation of incentive is expected to improve employees' performance and to maintain their achievement so that they will stay in the company (Harnovinsah & Lisya, 2014). Each company, either profit firm or loss firm, has its own way to implement the non-tax incentive. It will determine the management policy to respond to tax rate changes by earnings management. Yin and Cheng (2004) mentioned in their research that non-tax incentive can be measured by earnings pressure, debt level, earnings baths, firm size, and managerial ownership. The Nigerian Tax Law No. 36 year 2008 issued by the government regarding tax rate changes, which previously applied progressive rate and now becomes single rate, provides incentives to management to perform earnings management. Scott (2012) explained taxation motivation as one of motivations in earnings management which means that the company would prefer an accounting method that can earn lower reported profit than it should be, so that the payable tax will be lower as well.

Earnings Management

The concept of earnings management stems from the trade-off between relevance and reliability in financial reporting. Sundvik (2017) reported that highly reliable financial reports solely include realized cash flows, whereas highly relevant reports are concerned with the current value of expected future cash flows. Since accounting rules and legislation demand both relevance and reliability in proportion, financial reporting is therefore associated with certain elements of discretion and managerial judgment. Academic accounting literature provides many definitions of the term earnings management. Derived from the opportunistic use of discretion in financial reporting, early literature defined the notion of earnings management as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain" (Schipper, 1989). Here, earnings management is viewed through an opportunistic lens.

Several studies provide evidence that firms manage their earnings around events when there is a change in the CTR. In their studies, firms are observed to defer earnings from high to low tax rate periods. After a call by Hanlon and Heitzman (2010) for more work to help understand the reporting behavior of privately held firms overall and especially with respect to taxation, more recent studies observe that private firms act according to the proposed incentive around tax reforms, even more than publicly listed firms (Lin, Mills, & Zhang, 2014; Watrin, Pott & Ullmann 2012). Hanlon and Heitzman (2010) also encourage the use of private firms in research where they are used not just as a comparison group for

publicly held firms. The events of investigation are recognized as strong incentives for earnings management and reforms both in a single-country context and with an international perspective are analyzed (Sundvik, 2016).

Tax Shields for Depreciation

A tax shield is the deliberate use of taxable expenses to offset taxable income. Tax shield lowers tax bills, which is one of the major reason why taxpayers whether individuals or corporations spend a considerable amount of time determining which deduction to apply in their financial statement for each year. The tax shield strategy can be used to increase the value of a business, since it reduces the tax liability that would otherwise reduce the value of the entity's assets. The effects of the tax shield should be used in all cash flow analyses, since the amount of cash paid in taxes is impacted. Tax shield strategies are available for both business and individual tax returns. A tax shield is a reduction in taxable income for an individual or corporation achieved through claiming allowable deductions such as mortgage interests, medical expenses, charity donations, amortization, and depreciation. These deductions reduce a taxpayer's taxable income for a given year or defer income taxes into future years. Interest expense is, as opposed to dividends and capital gains, tax deductible; therefore the tax shield (being a benefit of debt financing over equity financing) is an important factor influencing the company's capital structure choice (Valaskova & Bakes, 2018).

Tax shields according to Murray (2019) involve investments and purchases that are tax deductible. Some common examples is businesses can take a depreciation expense on the purchase of business property, including equipment, furniture and fixtures, and vehicles (but not land). Depreciation is basically a way to spread out the expense of buying a business asset over the life of that asset. Accelerated depreciation allows you to depreciate more of the asset in the first year or two, and it's a great example of a tax shield. The two types of accelerated depreciation are Section 179 expenses and bonus depreciation.

The depreciation deduction allows taxpayers to recover certain losses associated with the depreciation of qualifying property. The deduction can apply to tangible property, such as vehicles and buildings, as well as to intangible assets, such as computer software and patents. In order to qualify, the depreciation must be associated with an asset used in a business or income-generating activity, and have an expected lifespan of more than one year. Other conditions may affect the ability for depreciation to be deductible, including, but not limited to, the duration of ownership of the asset and whether the asset was used to build capital improvements.

Review of Empirical Studies

Atu, Atu, Enegbe and Atu (2016) carried out a study on determinants of earnings management in Nigerian quoted companies. The study made use of Ordinary Least Squares (OLS) regression analysis as the data analysis method. In the study they adopted OLS regression techniques to examine how the explanatory variables (Corporate governance, firm size, audit firm type and financial performance) impact on earnings management using discretionary accruals measure. The study finding indicates the existence of negative significant relationship between board size, audit firm type and earnings management In addition, the study also found the existence of a non-significant relationship between firm size and earnings management. Gasteratos, Karamalis,

Koutoupis and Filos (2016) studied Earnings Management in Greece: A Case Study in Construction Sector Using Jones Model. The sample covered 12 companies of the Greek construction sector during the period 2008-2014 and data was taken from income statements as well as balance sheets. The findings showed that in the Greek construction sector discretionary accruals in practice affect negligibly the percentage of shadow economy in GDP, secondly in the Greek construction sector discretionary accruals (showing lower profits) increase in periods of higher capital tax rate and thirdly in the Greek construction sector usually large companies resort to earnings management more than the small ones. Ubesie and Inyama's (2019) research examined the effects, magnitude and strength of the relationships between corporate governance and earning management of commercial banks in Nigeria from year 2007 to 2017. Correlation Analysis was performed to test the strength of the relationship between selected variables. Earnings Per Share was found to be negatively and significantly influenced by Board Size (BDSIZE) while Ownership concentration has a positive and insignificant effect on Earnings Per Share. Board meeting has a positive and significant effect on Earnings per Share. Kamel and Elbanna (2010) assessed respondents' perceptions of the quality of reported earnings in Egypt. The descriptive analysis using questionnaire surveys for accounting academics, external auditors, and financial managers. They found that firms make inadequate provisions, capital rather than expense expenditures, and overestimate inventory value as techniques of engaging in earnings manipulation. According to the study, accruals-based earnings management can be used to overstate earnings, understate expenses, overstate asset values, and understate liability values. Hamadi and Faten (2012) ascertained the determinants of earnings managements for a sample of French companies during the period 1998-2008. Earnings management is measured by discretionary accruals. A pool regression analysis was employed to test the data. The results show that the relative size of the operation and accounting criteria and earning management are positively related in the acquiring firms. Alves (2012) examined the relationship between corporate ownership structure in Portugal and earnings management. Using a sample of 34 non-financial listed Portuguese firms for years from 2002 to 2007, it was discovered that discretionary accruals as a proxy for earnings management is negatively related both to managerial ownership and to ownership concentration. The study's results suggested that both managerial ownership and ownership concentration improve the quality of annual earnings by reducing the levels of earnings management. Amidu and Yorke (2017) investigated tax avoidance and earnings management of firms in Ghana: does the funding strategy matter? This paper sought to evaluate how the firm's financial policy affects the relationship between corporate tax avoidance (CTA) and earnings management (EM) using a sample of 119 firms from emerging and developing countries over a four-year period 2010–2013. The results imply that monitoring managerial diversionary behaviour by relying on external monitoring mechanism provided by debt holders does not lead to a reduction in EM associated with increased tax avoidance activities. Jim-Suleiman's (2015) study examined the impact of competition on tax avoidance activities among Nigerian Deposit Money Banks. The objective of the study was to examine the effects of competition on tax avoidance and also determine the impact managerial efficiency and non-performing loans on tax avoidance has on the Nigerian Deposit Money Banks. To achieve the objective, this study used panel regression model to analyze the data obtained from the financial statement of 15 banks operating on the Nigerian Stock Exchange for a

period of 10 years. The Hausman test result of 1.30 revealed that the random effect is more consistent for this research than the fixed effects. The result of the random effect revealed that competition has a positive and an insignificant impact on tax avoidance, implying that competition exists among the Nigerian Deposit Money Banks and this competitive tendency does not influence tax avoidance. Masri and Martani (2014) studied Tax avoidance behaviour towards the cost of debt. The aim of the research was to analyse tax avoidance behaviour to cost of debt (COD) moderated by tax rate changes and family ownership structure. Analysis techniques used in this research are descriptive quantitative and regression analysis on panel data to examine the effect of tax avoidance to the COD. The study found that tax avoidance has positive influence on COD. Tax avoidance creates a risk thereby increasing the COD. Prabowo, Winarna, Aryani, Falikhatun and Gantjowati (2020) studied Debt and earnings management in Indonesia: An issue of free cash-flow or covenant? Analysis was based on a sample set consisting of 497 firms engaging in manufacturing operations listed in Indonesia Stock Exchange during the period of 2009 to 2014. The results revealed that corporate debt is an important determinant of earnings management statistically and economically. Further tests revealed that the interaction between liquidity and specification of corporate debt shapes different pattern of the directions of earnings management. The study of Tjondro and Pemeta (2019) aimed to prove the effect of total debt and long-term debt on the company's management decisions regarding preference to focus on accounting or tax reporting. The results showed that there was a non-linear relationship between debt ratios and management decisions. The companies lean to focus on accounting reporting when debt ratios are below a certain threshold and choose to focus on tax reporting above threshold. Regarding long term debt, it was discovered that long-term debts do not have a significant effect on preferences to focus on accounting or tax reporting cost. Gao (2016) studied the influence of non-debt tax shield on the choice of corporate debt levels based on the tax preference. Data from A- share listed corporations in China from 2008 to 2013 were deployed, using ratio of the sum of fixed assets, depreciation and intangible assets amortization and R&D expenses plus deduction to total assets as substitute variables of NDTs. This study found a negative and significant relationship between NDTs and corporate debt levels, which is consistent with the NDTs's effect theory of capital structure. In addition, it was further found that the effect of the non-debt tax shields has ownership nature and industry characteristics. Peter and Isiya (2019) examined the effect of corporate tax on the performance of selected indicators of money deposit banks in Nigeria. Drawing from the theoretical model of Caminal (2003), the impact of corporate tax on demand deposits and loans of money deposit banks was examined. The study used secondary data covering from 1990-2017. It also used the Vector Auto regression (VAR) model and the variance decomposition test was utilized to estimate the relationship amongst the variables. The result of the VAR estimates revealed the impact of corporate tax on total demand deposits and loans of money deposit banks. However, the variance decomposition test revealed that innovations in corporate taxation will trigger some level of variations in total demand deposits and loans of money deposit bank. Abubakar and Oladele (2018) studied firm size and audit quality on earnings management of eight (8) quoted Oil and Gas Marketing Companies in Nigeria, over the period of seven (7) years (2010-2016). Data were extracted from the Firms' audited annual reports and accounts. The study adopted the use of both descriptive statistics and correlation matrix using the

NDTAC = Value of non-discretionary accruals

DTAC = Discretionary accrual

Under the cash flow approach, total accruals are measured as follows:

$$TACC_{it} = EBX_{Tit} - OCF_{it} \quad (1)$$

Where:

EBX_{Tit} = Earnings before extraordinary items and discontinued operations period t

OCF_{it} = Operating cash flow for period t

Decision rule:

Using SPSS, 5% is considered a normal significance level. The accept/reject criterion was based on the p-value, alternative hypothesis will be accepted. If p-value > 0.05 otherwise reject and accept the null hypothesis.

Data Analysis

Table 1: Descriptive Statistics

	TACC	DEP
Mean	-1.36E+09	8506727.
Median	-1.08E+09	7440611.
Maximum	3.04E+09	17113619
Minimum	-5.50E+09	5008921.
Std. Dev.	2.44E+09	3517112.
Skewness	0.107520	1.576648
Kurtosis	2.564141	4.667506
Jarque-Bera	0.098423	5.301608
Probability	0.951980	0.070594
Sum	-1.36E+10	85067272
Sum Sq. Dev.	5.35E+19	1.11E+14
Observations	10	10

Source: Researcher’s computation (2021)

Table 1 shows the mean (average) for each of the variables, their maximum values, minimum values, standard deviation and Jarque-Bera (JB) statistics (normality test). The result in Table 1 provided some insight into the nature of the selected Nigeria quoted banks that were used in this study.

It was observed that on the average over the ten (10) year period (2010-2019), the sampled quoted banks in Nigeria were characterized by negative average TACC (-1.36). In Table 1, the Jarque-Bera (JB) which test for normality or the existence of outlier or extreme values among the variables shows that all our variables are normally distributed and significant at 5% level and the result could be generalized. This also implies that a least square regression can be used to estimate the pooled regression models.

Hypothesis Testing

H₀₁: Depreciation has not significantly affected Earnings Management of Commercial Banks in Nigeria.

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Table 2 Panel Least Regression analysis showing the relationship between TACC, and DEP

Dependent Variable: TACC
Method: Least Squares
Date: 10/18/21 Time: 13:12
Sample: 2010 2019
Included observations: 10

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-4.55E+09	1.88E+09	-2.413645	0.0423
DEP	374.5224	206.2394	1.815959	0.1069
R-squared	0.291892	Mean dependent var		-1.36E+09
Adjusted R-squared	0.203378	S.D. dependent var		2.44E+09
S.E. of regression	2.18E+09	Akaike info criterion		46.01633
Sum squared resid	3.79E+19	Schwarz criterion		46.07685
Log likelihood	-228.0817	Hannan-Quinn criter.		45.94995
F-statistic	3.297709	Durbin-Watson stat		2.074329
Prob(F-statistic)	0.106911			

Interpretation of Regression Result

In table 2, a panel least square regression analysis was conducted to test the relationship between depreciation and earnings management. Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the table 2, the value of adjusted R squared was 0.203, an indication that there was variation of 20% on earnings management due to changes in depreciation. This implies that only 20% changes in earnings management of banks could be accounted for by depreciation, while 80% was explained by unknown variables that were not included in the model. The probability of the slope coefficients indicate that; P-value = 0.107 > 0.05). The co-efficient value of; $\beta_1 = 374.5224$; $t = 1.815959$ for TACC implies that depreciation is positively related to earnings management, though not statistically significant at 5%.

The Durbin-Watson Statistic of 2.074329 suggests that the model does not contain serial correlation. The F-statistic of the DEP regression is equal to 3.297709 and the associated F-statistical probability is equal to 0.106911, so the null hypothesis was accepted and the alternative hypothesis was rejected

Decision

Since the Prob (F-statistic) of 0.106911 is greater than the critical value of 5% (0.05), then, it would be upheld that depreciation has not significantly affect Earnings Management of Commercial Banks in Nigeria. at 5% level of significance, thus, H_1 is preferred over H_0

Table 3: Pairwise Granger Causality Tests

Date: 10/18/21 Time: 13:26

Sample: 2010 2019

Lags: 2

Null Hypothesis:	Obs	F-Statistic	Prob.
DEP does not Granger Cause TACC	8	19.4667	0.0191
TACC does not Granger Cause DEP		0.22671	0.8097

Source: E-Views 9.0 Causality Output, 2021

Interpretation of Diagnostic Test

Table 3 indicates that there is a uni-directional causality between TACC and DEP, since the causality only runs from the independent variable to the dependent variable (TACC) at two (2) lags at p-values less than 5%; $DEP = 0.02 < 0.05$, thereby establishing the fact that depreciation affects significantly the earnings management of Nigerian banks.

Discussion and Recommendation

This study sought to ascertain the relationship between earnings management and tax shield (measured by depreciation) of listed Nigerian commercial banks. In this study, panel data were obtained from publications of Nigeria Stock Exchange, Annual reports and account, and Fact books of the sampled banks. This study covered ten-year period spanning from 2010-2019. This study has produced some insightful revelation based on the outcomes of the inferential statistics. The results of the hypothesis revealed that 0.203 of the total variation in dependent variable is explained by independent variable to the determination of earnings management (TACC) while the remaining 20% is caused by other explanatory factors outside this model and this is captured by the error term. The coefficient result shows that TACC ($\beta_1 = -374.5224$) is positively related with depreciation (DEP), The probability value of the slope coefficients indicate that $P(=0.107 > 0.05)$. This implies that DEP has insignificant positive related with TACC. The overall performance of the model is satisfactory as shown by Prob (F-statistics) = 0.106911. From the above factual information it is clearly obvious that there is a positive insignificant relationship between DEP and TACC. The result of this study is in congruence with Amidu and Yorke (2017); Amidu, Kwakye, Harvey and Yorke (2016); Tjondro and Pemeta (2019).

This study examined the effect of tax shield on earnings management using regression analysis, the study revealed that Depreciation have a positive significant effect on Earnings Management of Commercial Banks in Nigeria. However, net deferred tax liability has influence on earnings management in response to the corporate tax rate reduction. Besides that, earnings management done by banks is influenced by non-tax incentives as well, consisting of earnings pressure and debt level. Based on the findings of the study, the researchers recommended that tax authorities should ensure that depreciation to be deducted must be associated with an asset used in a business or income-generating activity, and have an expected lifespan of more than one year.

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