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TAX AVOIDANCE, EARNINGS MANAGEMENT, AND CORPORATE GOVERNANCE MECHANISM (AN EVIDENCE FROM INDONESIA)

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Abstract: *The aim of this study is to determine whether tax avoidance can be used as an instrument for companies doing earnings management in Indonesia. The study also investigates the role of corporate governance mechanism in influencing the relation between tax avoidance and earnings management. The research proved that the manufacturing company in Indonesia applies tax avoidance in earning management. These results also showed that among the three indicators of the corporate governance mechanism used only institutional ownership is capable of reducing the effect of tax avoidance on earnings management; while, the board of commissioners and the independent commissioner are not.*

Keyword*: earnings management, tax avoidance, effective tax rate, corporate governance mechanism*

JEL classification codes G39

I. BACKGROUND

The view that the tax paid by a company is the transfer of wealth from the company to the shareholders (Watts and Zimmerman 1978; Stolowy 2004) causes shareholders encourage the management to be more aggressive to the tax which could lead to tax avoidance practices. Tax avoidance practices may increase the company's cash flow and the wealth of the company that lead to increase the wealth of the shareholder. This action is supported by financial literature-based assumption about the effects of tax on financial decision making of a company, which states that tax avoidance conducted by a company resulted in a transfer of wealth from the government to the shareholders (Desai and Dharmapala 2009).

The shareholders expect the manager's actions on their behalf to focus on income maximization, which includes the pursuit of opportunities to reduce tax liabilities as

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long as the benefits is greater than the costs incurred. Desai and Dharmapala (2009) propose two opinions to be taken into consideration to determine whether the tax avoidance activities undertaken by the company are valuable to the company. The first opinion is that there are costs that occur when companies engage in tax avoidance activities and the second one is based on agency theory.

Based on the first opinion, a company doing tax avoidance might deal with risk and uncertainty as that activity might be detected by tax authority that leads to company's loss. In this case, Desai and Dharmapala (2009) stated that the cost incurred for the tax avoidance activities compels manager to ensure that those activities conducted by the company are not detected as an illegal activity (unacceptable tax avoidance) by tax authority. If it is detected, sanctions to be received can take the form of additional tax payments, interest, penalties, and other additional payments that can reduce the cash flow and the wealth of the shareholder, and the total number of the sanctions might exceed the benefits that have accrued to the enterprise (Desai et al. 2007). Therefore, the consequence to be afraid of most is the reputation damage of the company whenever public realizes it (Hanlon and Slemrod 2009).

Furthermore, Desai and Dharmapala (2009) report their second view which is based on agency theory. According Slemrod (2004), Chen and Chu (2005), and Crocker and Slemrod (2005), the relationship of tax avoidance activity and agency problems is inherent in the companies owned by public. Tax avoidance activities undertaken by the company can be used by managers to do earnings management. Earnings management that reflects the opportunistic nature of management is an action suffering the company. The existence of the agency problem might raise questions whether the tax avoidance actions undertaken by the company promotes the interests of shareholders. The application of various schemes, methods, scenarios, and tactics in the activities of tax avoidance instead is being used as a way for management to achieve personal interest which is not aligned with the corporate goals.

According to Desai *et al.* (2007) opportunistic manager prepares corporate activities in a complex mode in order to reduce corporate taxes as well as an attempt to divert company resources for personal purposes (including manipulate earnings for personal gain). Desai *et al.* (2007) stated that following this scenario the strong tax authorities and the qualified corporate governance can provide additional monitoring to managers; so that, tax authorities can reduce the diversion of resources by corporate managers.

The linkage between corporate governance and tax avoidance is due to the agency problem that affects tax avoidance activities carried out by the company. The structure and the transactions of tax avoidance are usually very complex and secret involving managers in such activities that might harm shareholders. The asymmetry of information between the two led to a high chance of misuse of power of the managerial positions in performing methods and schemes of tax avoidance. Control mechanisms of corporate governance (corporate governance mechanisms) can be used to assist companies in aligning the interests of the owners and the management (Hart 1995).

The corporate governance mechanism is rules, procedures, and a clear relationship between the parties that make decisions and the parties that control/supervise the decision taken (Walsh and Seward 1990). Corporate governance mechanism is used to manage, monitor, control, and reward. Corporate governance mechanism is a form of monitoring conducted by principal to an agent in order to reduce earnings management actions (Hart 1995).

This research focuses on the mechanisms of corporate governance related to the owner of the company consisted of the board of commissioners, independent commissioner, and institutional ownership as the tax paid by the company illustrates the magnitude of the transfer from the company to the government that is directly related to the shareholder (Desai and Dharmapala 2008). The board of commissioners and the shareholders are responsible as they have full authority to make decisions about how to carry out, control, and supervise upon the resources following the corporate goals (Syakhroza 2003). The mechanism quality of the corporate governance in general is associated with the better performance of the corporate (Aman and Nguyen 2008). Oversight by the board of commissioners, independent commissioner, and institutional ownership is a very important mechanism in aligning the interests of the shareholders and the management.

The aim of this study was to test whether tax avoidance is a way used by companies to do earnings management in manufacturing companies in Indonesia. Although the aim of this study is in line with (Burgstahler and Dichev 1997; Phillips et al. 2003; Holland and Jackson 2009) whose aim is to determine whether tax-related disclosures can be used as a way to detect earnings management of a company, previous studies have not tested yet the effect of the tax avoidance on earnings management.

Unlike previous studies, this study do not use tax account that its value is directly stated in the financial statements as in deferred tax expense or benefit but use deferred tax asset or deferred tax liability. This study measures the tax avoidance using the effective tax rate which is calculated by dividing the total cost of the tax to the earnings before tax. The study also investigates the role of the corporate governance on the relationship between tax avoidance and earnings management.

Further discussion of this paper is organized as follows: Section II addresses Literature review and hypothesis development. Section III discusses the methodology. Part IV discusses the research results. Section V concludes with a conclusion.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Tax avoidance and Earnings Management

According to Scott (2009), earnings management can be predicted as a management behavior in selecting accounting policies with specific purposes. There are two viewpoints in understanding management earnings. First, earnings management is seen as a form of opportunistic behavior of managers to maximize their interests.

Second, earnings management can be understood from the perspective of efficient contract. This study examines earnings management as a form of opportunistic behavior of the management as one of the assumptions of agency theory.

The relationship between tax avoidance and the agency theory related to the problems within public-owned companies was introduced by Slemrod (2004), Chen and Chu (2005), and Crocker and Slemrod (2005). The structure and the transactions of tax avoidance are usually very complex and secret that might lead managers to get involved in activities that insecure the shareholders. The asymmetry information between the two cause high opportunities of managers to do malfeasance represented in the choices of accounting methods or policies to make tax avoidance schemes. The act of the tax avoidance conducted by a company is used as a shield by the management performing earnings management.

Moreover, previous studies have shown that earnings management in the perspective of tax can use account deferred tax expense (Burgstahler et al. 2002; Phillips *et al.* 2003; Holland and Jackson 2009), deferred tax assets (Bauman et al. 2001; Schrand and Wong 2003; Frank and Rego 2006). Based on the elaboration, the hypothesis proposed is:

H1: Tax avoidance positively affects the earnings management.

Tax avoidance, Earnings Management, and Corporate Governance Mechanism

Agency theory is used to understand the basic issues of corporate governance and earnings management. In a organization, the separation of ownership by the principal through agents controlling tend to cause agency conflict between principal and agent. In the perspective of agency theory, the agent is the risk adverse that tend to be self-centered; so that, the company's value will rise if the owner of the company can control the behavior of the management not to waste the resources of the company, either in the form of unfeasible investment or in the form of shirking.

Meanwhile, Corporate Governance is a system that regulates and controls the company expected to provide and enhance the company's value to the shareholders (Walsh and Seward 1990). The relationship between corporate governance and tax avoidance is caused by tax avoidance transaction which is usually a very complex process that allows managers to get involved in any activities that harm the shareholders. The asymmetry information between the two cause high opportunities of managers to do malfeasance represented in the choices of accounting methods. The corporate governance mechanism can be used to assist a company in aligning the interests between owners and management (Hart 1995). The corporate governance mechanism is rules, procedures, and a clear relationship between the parties that make decisions and the parties that control/supervise the decision taken.

This research focuses on the mechanisms of corporate governance related to the owner of the company consisted of the board of commissioners, independent commissioner, and institutional ownership as the tax paid by the company illustrates the magnitude of the transfer from the company to the government that is directly related to the shareholder (Desai and Dharmapala 2008). Oversight by the board of commissioners and shareholders is a very important factor in harmonizing the interests of shareholders and management.

Board of commissioners

The board of commissioners as the organization's top leadership has the responsibility to direct, to control, and to monitor the use of resources in order to parallelize the organization determined goal. In terms of corporate governance, the focus of the discussion will always be the board of commissioners, because they have the responsibility and full authority to make a decision about how to direct, control, and supervision of the resource management in accordance with the company's goals (Fama 1980; Fama and Jensen 1983). Therefore, if the company has a good board of commissioners, the company will have a good performance. This quality of this function is the determinant to the effectiveness of the corporate governance. The Committee of Governance Policy stated that the board of commissioners has the responsibility and authority to control management action, and Gives suggestion to management as necessary. The hypothesis proposed is:

> H2A: The board of commissioners negatively moderates the effect of tax avoidance on earnings management.

Independent commissioner

The effectiveness of the Board of commissioners in balancing the power of the CEO is strongly influenced by the level of independence of the board of commissioners (Mizruchi 1983; Zahra and Pearce 1989; Lorsch and Young 1990). Therefore, the independent commissioner might act as a moderator in solving the dispute Among the internal managers, to control the management policy, and to give an advice to the management (Fama and Jensen 1983). Given that situation, the independent commissionaire is the best position to do Controlling function in order to create good corporate governance. In addition research conducted by Dechow *et al.* (1995), Chtourou *et al.* (2001), Klein (2002), and Xie *et al.* (2003) concluded that a company with a balanced proportion of outsider commissioner that act as an independent side in doing the management control might influence the earnings management act. The hypothesis proposed is:

> H2B: Independent commissioner negatively moderates the relationship between tax avoidance and earnings management.

Institutional ownership

The institutional ownership has the capability to control management by effectively controlling the process to reduce earnings management. This capability is needed because the institutional investors are mostly the ones who are not sophisticated easily to be fooled by the management. Therefore, the institutional investors will make-analyzes of Reviews their investment and do an assessment of information Gathered in order to effectively control the process. McConnel and Servaes (1990), Smith (1996), Hartzell and Starks (2003), and Cornett *et al.* (2006) found the evidence that the controlling conducted by the company and institutional investors can constrain the manager's behavior. The hypothesis proposed is:

H2C: Institutional ownership is negatively moderates the relationship between tax avoidance and earnings management

Empirical research model can be seen in Figure 1.

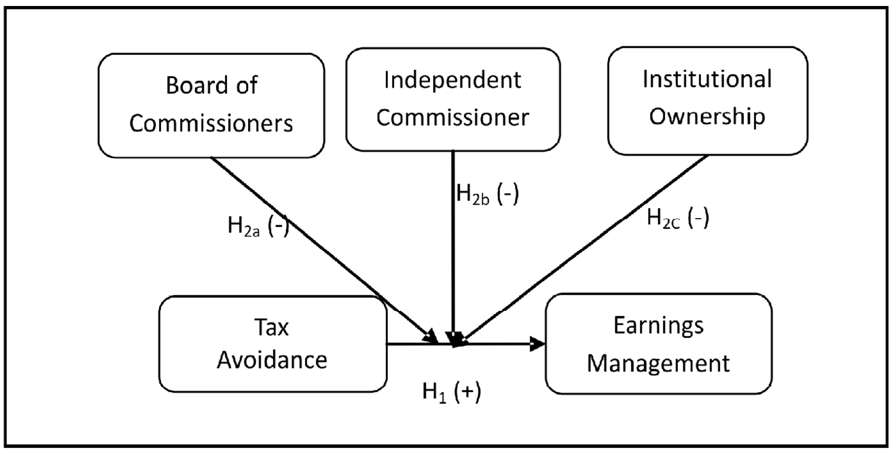

Figure 1: Empirical Research Model

III. METHODOLOGY

Data

The population of the study was all manufacturing companies listed in the Indonesian Stock Exchange from 2009 to 2012. The samples chosen were manufacturing companies assumed to do tax avoidance. In this study, the word allegedly doing tax avoidance is used because Indonesia has no tax avoidance act to be issued yet that results in undetermined criteria whether a company doing tax avoidance or not. The criteria used for companies doing tax avoidance are referred to the research of Putri and Tanno (2015) in which the company considered doing tax avoidance is the company whose its ETR (Effective Tax Rate) value is under the statutory tax rates.

The sampling method applied in this study was purposive sampling method. The sampling process was carried out in two stages. The first stage was based on the following criteria: The Manufacturing companies that:

1. have periodically financial statements ended in December 31
2. publish the Audited Financial Statement consistently and completely from 2009 to 2012.

3. The financial statements do not use foreign currencies
4. do not have a negative earnings before tax.

After selecting the company following the first phase, the selection of the second stage of determining the company suspected of doing tax avoidance was conducted by comparing the value of ETR of the company with the statutory tax rate. In 2009, the statutory tax rate was 28%; therefore, the company suspected of doing tax avoidance was a company that its value of ETR was lower than 28%. In 2010 to 2012, the statutory tax rate was 25%; so the company suspected of doing tax avoidance was a company that its ETR value is below 25%.

Variables

Tax Avoidance (TA) as independent variable: Tax avoidance is the amount of tax paid compared with a earnings before tax value which is less than the statutory tax rate. Tax avoidance measured by ETR (effective tax rate) which calculating by dividing the total tax expense to income before taxes. In 2009, the statutory tax rate was 2%, while in 2010-2012 the statutory tax rate is 25%.

Earnings Management (EM) as dependent variable: Earnings management performed by manipulating the accruals numbers, namely discretionary accruals, which do not affect cash directly, through a wide choice of accounting methods that can be used in preparing financial reports. Earnings management measured by discretionary accruals. The step to calculate discretionary accruals follow Jones (1990) and Dechow et. al (1995):

1. Determine the total accruals:

   $$TAcc_{it} = NI_{it} - CFO_{it} \qquad (1)$$

2. Determining the value of the parameter α1, α2, α3 using the formula

   $$TAcc_{it}/A_{it-1} = \alpha_1 (1/ A_{it-1}) + \alpha_2(\Delta REV_{it}/A_{it-1}) + \alpha_3 (PPE_{it}/A_{it-1}) + \varepsilon_{i,t} \qquad (2)$$

3. Calculate the value of NDA (non discretionary accrual) with the formula:

   $$NDAcc_{it}/A_{it-1} = \alpha_1 (1/ A_{it-1}) + \alpha_2 [(\Delta REV_{it}/A_{it-1})-(\Delta REC_{it}/A_{it-1})] + \alpha_3 (PPE_{it}/A_{it-1}) + \varepsilon_{i,t} \qquad (3)$$

   Parameter values α_1, α_2, α_3 is the result of the calculation in step 2

4. Determining the value of accruals discretionary as an indicator of accrual earnings management using the formula:

   $$DAcc_{it} = TA_{it} - NDA_{it} \qquad (4)$$

   Where : $TAcc_{it}$ = total accrual of a company NDA_{it} = Non discretionary accrual

   $DAcc_{it}$ = Discretionary accrual NI_{it} = net income

   CFO_{it} = cash flow from operation A_{it-1} = total asset

   REV_t = total Revenue, $\Delta REV_{it} = REV_t - REV_{t-1}$

REC_{it} = receivable $\Delta REC_{it} = REC_t - REC_{t-1}$

PPE_{it} = property plan and equipmen

Corporate governance mechanism as moderating variable: The corporate governance mechanism used in this study is related to the owner of the company consisting of the board of commissioners, the independent commissioner, and the institutional ownership. The board of commissioners (BOC) is the number of commissioner that is owned by a company, measured by the total number of commissioner that is owned by a company (Lipton and Lorsch 1992; Jensen 1993; Yermack 1996). The independent commissioner (IC) is the member of board of commissioner from outside of the company, measured by the percentage of the member of the commissioner board from outside of the company from all of the company commissioner board member (Peasnell *et al.* 2000; Klein 2002). The institutional ownership (IO) is the number of share ownerships owned by institutional investor, measured by the percentage of share owned by institutions from all distributed company share capital (Beiner et al. 2004).

ANALYTICAL METHOD

The analytical methods used to test the hypothesis is path analysis by using WarpPLS program version 4.0. The equation for the regression model is described as follows:

$$EM=\beta_0 TA+ \beta_1 BOC+ \beta_2 IC+ \beta_3 IO+ \beta_4 TA^* \beta_5 BOC+ \beta_6 TA^* \beta_7 IC+ \beta_8 TA^* \beta_9 IO+\varepsilon \qquad (5)$$

Where:

EM= Earnings Management TA= Tax Avoidance

BOC = board of commissioners IC = independent commissioner

IO = institutional ownership

IV. RESEARCH RESULT

The Descriptive statistics of the sample data are shown in table 1.

Table 1
Descriptive Statistics

Keterangan	*N*	*Mean*				*Standard Deviation*			
		2009	*2010*	*2011*	*2012*	*2009*	*2010*	*2011*	*2012*
TA	80	0.17	0.20	0.21	0.19	0.09	0.05	0.03	0.08
EM	80	0.10	0.17	0.80	0.25	0.19	0.14	0.35	0.24
BOC	80	4.30	4.48	4.50	4.24	2.11	1.83	2.04	1.97
IC	80	0.36	0.37	0.35	0.38	0.08	0.09	0.08	0.10
IO	80	66.94	69.67	65.33	62.56	21.17	20.00	16.10	18.03

Source: Processed data used in this article

Note:

TA: Tax avoidance EM: Earnings management

IO: Institutional Ownership IC: Independent Commissioner

BOC: Board of Commissioners

The result of the full model test using WarpPLS 4.0 is presented in Table 2.

Table 2
Output WarpPLS 4.0

Model Fit and Quality Indices
Average path coefficient (APC) =0.171, ρ = 0.010
Average R-squared (ARS) =0.185, ρ =0.007
Average adjusted R-squared (AARS)=0.142, ρ =0.022
Average block VIF (AVIF)=1.394, *acceptable if* <= 5, ideally <= 3.3
Average full collinearity VIF (AFVIF)=1.316, *acceptable if* <= 5, ideally <= 3.3
Tenenhaus GoF (GoF)=0.431, *small* >= 0.1, *medium* >= 0.25, large >= 0.36

Jalur		*Coefficients*	*ρ-value*
TA → EM		0.284	<0.001***
BOC*TA → EM		-0.016	0.421
IC*TA → EM		0.110	0.093
IO*TA → EM		-0.274	<0.001***
R^2	**Q^2**	**Full Collin VIF**	
EM 0.185	0.185	1.102	
Total Effec		*Coefficients*	*ρ-value*
TA → EM		0.284	<0.001***
BOC*TA → EM		-0.016	0.421
IC*TA → EM		0.110	0.093*
IO*TA → EM		-0.274	<0.001***
Effect Size		*Coefficients*	
TA → EM		0.1	
BOC*TA → EM		0.003	
IC*TA → EM		0.014	
IO*TA → EM		0.096	

Source: Processed data used in this article
Note: ***, **, * indicate significant at a 1%, 5%, and 10% level
TA: Tax Avoidance
EM: Earnings management
BOC: Board of Commissioners
IC: Independent Commissioner
IC: Institutional Ownership
BOC * TA → EM: BOC moderates the relationship between TA and EM
KOMIND * TA → EM: IC moderates the relationship between TA and EM
INSTITUTIONS * TA → EM: IO moderates the relationship between TA and EM

The value of the output of the fit model and quality indices model is as follows; Average path coefficient (APC) = 0171, ρ = 0.010, Average R-squared (ARS) = 0185, ρ = 0.007, Average adjusted R-squared (AARS) = 0142, ρ = 0.022, Average block VIF (AVIF) = 1.394, (acceptable if <= 5, ideally <= 3.3), Average full collinearity VIF (AFVIF) = 1.316, (acceptable if <= 5, ideally <= 3.3), and Tenenhaus GoF (GoF) = 0431 (small> = 0.1, medium> = 0.25, large > = 0.36). The prerequisite of WarpPLS is that the value of ρ for APC and ARS should be less than 0.05 (significant). The value of AVIF and AFVIF as multicollinearity indicator must be smaller than 5, and the requirement value of GoF is small> = 0.1, medium> = 12:25, large> = 0:36. Referring to these provisions, it can be concluded that this research model is fit.

The test result showed that the value of R^2 of the endogenous variables is 18.5% (EM). The research model has a predictive relevance for the value of Q^2 is above 0. As the value of the full collinearity of VIF is under 3.3, the multicollinearity in the research model does not exist.

Hypothesis 1 states that tax avoidance positively affect earnings management. The output WarpPLS as presented in Table 3 suggests that the values of the coefficient path of TA '! EM is 0.284 and significant with the value of ñ <0.001. It can be concluded that the tax avoidance positively affect the earnings management. The explanation suggests that the hypothesis 1 is accepted with the coefficient of determination of 0.185

Meanwhile, the hypothesis 2A states that the board of commissioners negatively moderates (weaken) the effect of tax avoidance on earnings management. The output of WarpPLS as presented in Table 3 suggests that the path of BOC * TA → EM has coefficient values of -0016 and is insignificant. Although this result has a negative coefficient path direction, the value of ñ is not significant. The analysis can be concluded that the hypothesis 2A is rejected; the board of commissioners do not moderate the negative relationship between tax avoidance and earnings management.

In hypothesis 2B, it is stated that the independent commissioner negatively moderates (weaken) the effect of tax avoidance on earnings management. The output of WarpPLS as presented in Table 3 indicates that the path of IC*TA → EM shows the coefficient value of 0.110 and is significance at $\rho = 0.093$. Although the result is significant to the value of $\rho = 0.093$, the coefficient is positive or moderate positively, which means that the independent commissioner negatively moderates (weaken) the effect of tax avoidance on earnings management. This finding does not support the proposed hypothesis. Therefore, it can be concluded that the hypothesis 2B is rejected; the independent commissioner does not negatively moderate (weaken) the effect of tax avoidance on earnings management.

Furthermore, the hypothesis 2C state that the institutional ownership negatively moderate (weaken) the effect of tax avoidance on earnings management. Based WarpPLS output as shown Table 3, it is known that the path of coefficient IO*TA → EM has the values of -0274 and is significant at $\rho = 0.093$. The result shows that the institutional ownership negatively moderates (weaken) the effect of tax avoidance on earnings management. Therefore, it can be concluded that hypothesis 3C is accepted with coefficient of determination of 0.185.

V. CONCLUSION

Based on the result and discussion presented in the previous chapters, a number of findings related to the research hypothesis are identified, among which are:

1. Tax avoidance positively affects earnings management. The separation of the ownership in public company can provide an opportunity for the management to make a method selection or accounting policy for personal gain. Researchers prove that the various methods used by the company to carry out tax avoidance has the main objective to do earnings management. This result supports the research findings of Burgstahler *et al.* (2002), Phillips (2003), Holland and Jackson (2009).
2. The Board of Commissioners does not negatively moderate the relationship between tax avoidance and earnings management. Although the results showed that the coefficient is negative, the result is not significant. The result of this study does not support the research findings conducted by Fama (1980) and Fama and Jensen (1983).
3. The Independent Commissioner does not negatively moderate the relationship between tax avoidance and earnings management. The result of this study does not support the research conducted by Dechow *et al.* (1995), Chtourou *et al.* (2001), Klein (2002), and Xie *et al.* (2003) concluding that the proportion of companies having board members coming from the outside of the company can influence the actions of earnings management because they act as an independent party to conduct supervision.
4. The institutions ownership negatively moderates (weaken) the relationship between tax avoidance and earnings management. The result of this study supports the research conducted by McConnel and Servaes (1990), Smith (1996), Hartzell and Starks (2003), and Cornett *et al.* (2006) proving that the control undertaken by a company and institutional investors can restrict the behavior of the manager. Institutional ownership has the ability to control the management through effective control to reduce earnings management as institutional investors are sophisticated ones so they are not easily to be manipulated by the company management. Institutional investors spend a lot of time to do investment analysis and they get expensive information access from other investors, so that they will do more effective control process.

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