Corporate Governance, Earnings Management and Tax Avoidance: Indonesia Evidence

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Abstract. This study aims to investigate the empirical evidence on the impact of corporate governance on earnings management and tax evasion in public companies. The scope of this study is companies listed on the Indonesia Stock Exchange except those in financial, real estate, and telecommunication industries. Panel regression method was employed to run the data on samples for five-year-period (2012-2016). The results show that several corporate governance mechanisms play an important role in detecting earnings management, namely the institutional ownership, the percentage of independent commissioners, and percentage of audit committee members with finance/accounting background. For tax evasion, only the size of the board of commissioners that plays a role in detecting the practice. The results have practical implication on improving several corporate governance mechanisms to effectively tackle unethical practices such as earnings management and tax avoidance.

Keywords: Corporate Governance, Earnings Management, Tax Avoidance, Institutional Ownership, Independent Commissioners, Audit Committee

1. Introduction

One of the conflicts of interest between owners and management is represented in the manipulation of a company's financial statements; which can be in the form of earnings management. This can be detrimental to investors as the inappropriate financial statement information provided by management can bring difficulties to investors in making decisions.

Earnings management practices can also be used by companies to control their earnings that will impact taxes at the same time. Good corporate governance can play an important role in mitigating the problems of corporate earnings management and tax avoidance. This research discusses the issues of earnings management, tax evasion and corporate governance which is a development of previous research conducted by[1];[2];[3]. The objective of this research is to find empirical evidence using current data on the role of corporate governance mechanisms in mitigating earnings management and tax avoidance practices.

2. Method
3.1 Sample Selection
The samples taken in this research are public companies listed on the Indonesia Stock Exchange (BEI) from 2012-2016. To investigate earnings management, the companies in the banking industry, other financial services, telecommunications, and real estate are excluded as they have different regulations[4]. The other reason is that the Jones model to measure the earnings management cannot be applied to the financial industry. To investigate tax avoidance, companies in the banking industry and other financial services are excluded, as well as companies experiencing losses as it will bring different consequences on the applicable tax rate.

3.2 Research model
Model 1: To investigate the association between corporate governance mechanisms and earnings
management
where:

$$\text{ADA} = \beta_1\text{INST} + \beta_2\text{KOMITE} + \beta_3\text{RKOMITE} + \beta_4\text{PINDP} + \beta_5\text{DK} + \beta_6\text{PBKOMITE} + \beta_7\text{SIZE} + \beta_8\text{LEV} + \beta_9\text{BIG4} + \beta_{10}\text{CFFO} + \beta_{11}\text{LOSS} + \beta_{12}\text{ROA} + \beta_{13}\text{ROA}^2 + \varepsilon_{it} \quad \text{..(1)}$$

ADA	: The absolute value of discretionary accruals
INST	: Institutional Ownership
COMMITTEE	: Number of audit committees
RKOMITE	: Number of audit committee meetings
PBKOMITE	: Percentage of audit committees with a financial/accounting background
PINDP	: Percentage of the independent board of commissioners
DK	: Number of boards of commissioners
SIZE	: Control variable, measured by the natural logarithm of total sales.
LEV	: Control variable, measured by the ratio of total debt to total assets
BIG4	: Control variable, measured by dummy variables, 1 for Big 4 and 0 otherwise
CFFO	: Control variable, measured by the ratio of cash flow from operation to total assets
LOSS	: Control variable, measured by a dummy variable, 1 when the company suffered loss for two years and 0 otherwise
ROA	: Control variable, measured by the ratio of net income to total assets
ROA2	: Control variable, measured by the square of net income and total asset

Model 2: To investigate the association between corporate governance mechanisms and tax avoidance

$$\text{ETR} = \beta_1\text{INST} + \beta_2\text{KOMITE} + \beta_3\text{RKOMITE} + \beta_4\text{PINDP} + \beta_5\text{DK} + \beta_6\text{PBKOMITE} + \beta_7\text{ROA} + \beta_8\text{BM} + \varepsilon \quad \text{...(2)}$$

where:
ETR : Effective Tax Rate
SIZE : Control variable, measured by the natural logarithm of total sales.
ROA : Control variable, measured by the ratio of net income to total assets
BM : Control variable, measured by the ratio of book value and market value of the stock.

3.2.1 Dependent Variables
a. Earnings management
Earnings management is measured by the modified Jones model:
$$TA_{i.t} = NI_{i.t} - CFO_{i.t}$$
....(3)
where:
$TA_{i.t}$: total accruals
$NI_{i.t}$: net income before extraordinary item
$CFO_{i.t}$: cash flow from operation

$$\frac{TA_{i.t}}{A_{i.t-1}} = \alpha_1 \left(\frac{1}{A_{i.t-1}}\right) + \alpha_2 \left(\frac{\Delta REV_{i.t} + \Delta REC_{i.t}}{A_{i.t-1}}\right) + \alpha_3 \left(\frac{PPE_{i.t}}{A_{i.t-1}}\right) + \alpha_4 ROA_{i.t-1} + \varepsilon_{i.t}$$
.....................................(4)
where:
$\Delta REV_{i.t}$: income changes
$\Delta REC_{i.t}$: change of receivables
$A_{i.t-1}$: total assets
$PPE_{i.t}$: net property, plant and equipment
$ROA_{i.t-1}$: Return on Assets

    Non-discretionary accrual (NDAC) is the fitted value of the above equations while the discretionary accrual (DAC) is the residual value. In accordance with [5], in this study, we use a cross-sectional model, where each model is estimated separately for each combination of years and industrial group of companies.

b. Tax evasion
The next dependent variable is tax evasion measured by ETR or effective tax rate calculated using the formula below:

$$\frac{Current\ Tax}{Profit\ Before\ Interest\ and\ Tax}$$
.....................................(5)

3.2.2 Independent Variables
a. Institutional ownership
    Institutional ownership is defined as financial institutions such as insurance company, bank, pension fund, and investment banking[4].
b. Audit Committee
    Audit committee consists of at least a chairman who is also an independent commissioner and two independent external members.
c. Number of audit committee meetings
    The frequency of meetings between members of the audit committee is measured by the number of audit meetings within one year.

d. Percentage of audit committees with a financial/accounting background
   The proportion of an audit committee with a financial/accounting background is calculated by dividing the total number of audit committees with a financial background to the total members of the audit committee.
e. Size of boards of commissioners
   The size of the board of commissioners is defined as the number of board of commissioners member in a company.
f. Percentage of the independent board of commissioners
   Based on the regulations of the Indonesia Stock Exchange (BEI) Number Kep305 / BEJ / 07 2004 any company that has an independent commissioner of at least 30% (thirty percent) of the total members of the board of commissioners has fulfilled the corporate governance guidelines. Information on the number of independent board of commissioners obtained from annual reports of each company.

3. Result
3.1 Descriptive statistics

Descriptive statistics are used to look at the characteristics of each variable in the research model which is s presented in the following table.

Table 1. Descriptive Statistics of Earnings Management Samples

Variable	N	Min	Max	Mean	Std. Dev
ADA	635	0.0006	0.7651	0.0769797	0.0842453
INST	635	0	0.8104	0.1262	0.19766
KOMITE	635	1	6	3.143307	0.5444864
RKOMITE	635	0	59	8.124409	8.03101
PINDP	635	0	0.8	0.3839802	0.1055993
DK	635	2	13	4.618898	1.737403
PBKOMITE	635	0	1	0.6586089	0.2262564
SIZE (LN)	635	24.81756	33.19881	29.04166	1.538987
SIZE (Rp '000.000.000)	635	59.99677	261855	12198.34	24984.82
LEV	635	0.0010116	0.7415355	0.2578602	0.1593993
BIG4	635	"1" = 49.375% & "0" = 50.625%			
CFFO	635	-0.1037274	0.162899	0.0093942	0.0279947
LOSS	635	"1" = 2.97% & "0" = 97.03%			
ROA	635	-0.0656	0.1261	0.0180446	0.0236261
ROA2	635	-0.2788	0.2691	0.0086457	0.0354059

Table 2. Descriptive Statistics of Tax Evasion Samples

Variable	N	Min	Max	Mean	Std. Dev
ETR	950	0.00000	0.9743	0.19521	0.1412516
INST	950	0	0.9201	0.134786	0.2255474
KOMITE	950	0	4	3.013684	0.4668371
RKOMITE	950	0	59	6.809474	7.6344650
PINDP	950	0.0000	0.8333	0.392533	0.1057107
DK	950	0	9	4.382105	1.7986930
PBKOMITE	950	0	1	0.665694	0.2370283
ROA	950	-1.322	0.9804	0.027387	0.0670897
BM	950	-3.8014	36.0007	2.654757	4.0531780

3.2 Regression results

Prior to conducting the regression test, the data has been checked for the classical assumptions and no multicollinearity and heteroscedasticity problems found.

Table 3. Hypothesis Testing on Earnings Management

ADA = β1INST + β2KOMITE + β3RKOMITE + β4PINDP + β5DK + β6PBKOMITE+ β7SIZE + β8LEV+ β9BIG4 + β10CFFO + β11LOSS + β12ROA + β13ROA2 + εit				
Variables	**Sign Expectations**	**Coeff.**	**p-value**	**Sign.**
INST	+	0.0465948	0.025	**
KOMITE	—	-0.0092186	0.196	
RKOMITE	+	0.0003759	0.467	
PINDP	+	0.0975468	0.004	***
DK	—	-0.0032727	0.225	
PBKOMITE	—	-0.0458764	0.008	***
SIZE (LN)	—	-0.0406978	0.087	*
LEV	+	0.0406978	0.139	
BIG4	+	0.0034266	0.718	
CFFO	—	-0.0971696	0.410	
LOSS	—	-0.0345014	0.079	*
ROA	+	1.1007150	0.001	***
ROA2	—	-0.3223624	0.000	***
R Squared	0.1296			
Prob > F	0.0000			
*** Significant at level 1%; ** Significant at level 5%; * Significant at level 10%				
Description				
ADA	Absolute Discretionary accruals			
INST	Institutional ownership			
KOMITE	Audit committee size			
RKOMITE	Meeting frequency of audit committee			
PINDP	Percentage of independent commissioners			
DK	Board of commissioners size			
PBKOMITE	Percentage of audit committee member with finance/accounting			
SIZE(LN)	Natural log of total asset			
LEV	Total debt to total asset			
BIG4	A dummy variable, 1 for Big 4 and 0 otherwise			
CFFO	Cash flow from operation to total asset			

LOSS	A dummy variable, 1 for loss in 2 consecutive years and 0 otherwise
ROA	Net income to total asset
ROA2	Square of Net income to total asset

The institutional ownership has a positive effect on earnings who states that earnings management can be efficient, not always opportunistic[4]. The size of boards of commissioners has no significant impact on earnings management, which can be seen from the p-value of 0.225 with coefficient -0.0032. This reflects the irrelevance of board of commissioners size in detecting earnings management.

4. Discussion

The percentage of the independent board of commissioners has a positive effect on earnings management, as seen from the p-value of 0.004 at a significant level of 1% with a coefficient of 0.0975. This result is in line who examined the relationship between the composition of the board of commissioners and the fraudulent f financial reporting and found that the fraudulent company had a lower percentage of the independent board of commissioners than the non-fraudulent company[6].

The audit committee size negatively affects earnings management which is consistent [7].The audit committee meeting has no significant effect which is consistent stating that audit committee members who meet at least four times a year cannot reduce fraud in the financial reporting process[7]. This might be because the meeting is conducted for the regulatory purpose only and hence is not able to carry out its duties and responsibilities to the maximum which causes its function and role is not effective[8].

The number of audit committees with a financial/accounting background has a negative effect on earnings management, which is consistent stating that audit committees with expertise in finance/accounting effectively oversee the possibility of earnings management[9];[7].

Table 4. Tax Evasion Hypothesis Test

ETR = $\beta1$INST + $\beta2$KOMITE + $\beta3$RKOMITE + $\beta4$PINDP + $\beta5$DK + $\beta6$PBKOMITE+ $\beta7$ROA + $\beta8$BM + ε				
Variables	**Sign expectations**	**Coeff.**	**p-value**	**Sign.**
INST	—	-0.02207	0.439	
KOMITE	—	-0.00949	0.351	
RKOMITE	+	0.001226	0.174	
PINDP	+	0.069166	0.166	
DK	+	0.006657	0.063	**
PBKOMITE	—	-0.00715	0.246	
ROA	+	0.095766	0.113	
BM	+	0.001827	0.183	
R Squared		0.0349		
Prob > F		0.0397		

*** Significant at level 1%; ** Significant at level 5%; * Significant at level 10%	
Description:	
ETR	Effective Tax
INST	Institutional ownership
KOMITE	Audit committee size
RKOMITE	Meeting frequency of audit
PINDP	Percentage of independent
DK	Board of commissioners size
PBKOMITE	Percentage of audit committee member with finance/accounting background background
ROA	Net income to total asset
BM	Square of net income to total asset

The results show that only board of commissioner size that has a significant positive effect on tax evasion, reflecting that other corporate governance mechanisms are not able to prevent tax evasion.

5. Conclusion

This research is conducted with the aim to investigate the role of corporate governance on earnings management and tax evasion. Based on the result of the empirical test, several corporate governance mechanisms play an important role in detecting earnings management, namely the institutional ownership, the percentage of independent commissioners, and percentage of audit committee members with finance/accounting background. As for tax evasion, only the size of the board of commissioners that plays a role in detecting the practice. The results bring practical implications on the need to improve several corporate governance mechanisms to help resolve unethical practices in the form of earnings management and tax evasion.

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