The Effect of Corporate Governance, Ownership and Tax Aggressiveness on Earnings Management

Nico Alexander¹, Silvy Christina²*
Trisakti School of Management, Kyai tapa No. 20, 11440, Jakarta, Indonesia

ABSTRACT

Objective – The purpose of this research is to empirically examine the effect of corporate governance, ownership and tax aggressiveness on earnings management.
Methodology/Technique – The population of this research consists of non-financial companies listed on the Indonesian Stock Exchange (IDX) between 2013 and 2015. This research uses 3 recent years and utilizes different variable that have not been used in prior research. The 67 samples were choose using a purposive sampling method. The hypotheses are tested using multiple regression analysis with the SPSS program, to investigate the influence of each independent variable on earnings management.
Findings – The results show that the board of director have a positive influence on earnings management, while board independence, audit quality, managerial ownership, and tax aggressiveness have no influence on earnings management.
Novelty – This research add value in the existing literature and empirically study the effect of the board of directors, independence of the board, audit quality, managerial ownership, and tax aggressiveness on earnings management.
Type of Paper: Empirical

Keywords: Earnings Management; Corporate Governance; Ownership; Tax Aggressiveness.
JEL Classification: M40, M41, M49.

1. Introduction

Companies listed on the Stock Exchange have an obligation to issue financial statements each year. These financial statements are required to be audited by an independent auditor, so that the information contained within them is reliable to enable investors to make savvy decisions, as well as creditors who may provide loans to various companies. Information generated from these financial statements becomes a signal to investors to invest in the company. The more relevant the information, the more positive a signal is given by the investor to the company and vice versa. If the information is increasingly irrelevant, then a negative

¹ Paper info: Revised: August, 3, 2017
² Accepted: December, 21, 2017
* Corresponding author: Silvy Christina
E-mail: nico@stietrisakti.ac.id
Affiliation: Trisakti School of Management, Kyai tapa No. 20, 11440, Jakarta, Indonesia
signal will be given by the investor to the company. The use of information in financial statements is what encourages management to engage in earnings management, resulting in more favorable financial reports being produced, which are typically less transparent and have a reduced level of reliability. Tax aggressiveness activities undertaken by the company may be used by the manager or managers to conduct earnings management, to reduce taxes as well as an to divert company resources for personal purposes (Putri, Abdul and Anis, 2016). To prevent earnings management within a company, the implementation of Good Corporate Governance (GCG) is designed to accommodate parties associated with the company, such as creditors, suppliers, governments, investors and the public. Quality Good Corporate Governance leads to greater protection for parties related to the company, by reducing the possibility of earnings management practices within the company.

According to Putri, Abdul and Anis (2016), the link between corporate governance and tax aggressiveness refers to the structure; tax aggressive transactions are usually complex and involve the manager acting not in accordance with the shareholders’ interests. To protect the shareholders, control mechanism such as corporate governance can be used to assist a company in aligning the interests of the owners and management. This research aims to examine variables that might contribute to the decision of management to engage in earnings management amongst Indonesian companies. The purpose of this research is to study the effect that the variables (the board of directors, board independence, audit quality, managerial ownership, tax aggressiveness) have on earnings management practices.

2. Literature Review

2.1 Agency Theory

The parties involved in agency theory include the management of a company, acting as agents, and the investors, acting as principals. The agent and the principals typically have different interests, and the principal relies on the agent to protect those interests (Godfrey et al., 2010). This can sometimes be a source of distrust between the parties. Jensen and Meckling (1976) state that the separation between the owners and managers of a company may cause agency problems or conflicts. Jensen dan Meckling (1976) also comment on the costs of agency, including: (1) the monitoring expenses incurred by the principal to supervise the behavior of agents, (2) the bonding expenses incurred by the agent to ensure that the agent will not act in a way that harms the principals interests, and (3) the residual loss in the form of decreased levels of well-being, for both parties.

2.2 Corporate Governance

According to the IICG (Indonesia Institute of Corporate Governance) “Good Corporate Governance (GCG) is the structure, system, and process used by corporate organs as an effort to add value to the company continuously in the long term, while maintaining the interests of other stakeholders, based on morals, ethics, culture and rules apply other”. Based on KNKG (2004), there are 5 GCG principles: transparency, accountability, responsibility, independence and fairness and equity, all of which are needed to achieve sustainability of a company, by accounting for and protecting the interests of the shareholders.

2.3 Board of Director and Earnings Management

In this research, the board of director refers to the board of commissioners, as Indonesia embraces the two-tier system, in which the monitoring and the managing levels are distinct from one another. The board of commissioners is an organ of the company tasked with general and/or specific surveillance in accordance with the articles of association and advises the board of directors. Each member of the board of
commissioners shall act in good faith, be prudent and are responsible for carrying out supervisory and advisory duties to the board of directors in accordance with the purposes and objectives of the company. According to Mansor et al. (2013) the board of directors is the central oversight of management, so that the more effective a board of directors is, the more limitation there is on earnings management behaviors. Based on this, the following hypothesis is proposed:

H1: The board of director has a negative effect on earnings management.

2.4 Independence of the Board and Earnings Management

According to KNKG (2004), independent commissioners refers to those parties with no business or family relationships with the controlling shareholders, members of the board of directors and other board of commissioners, as well as with the company itself. According to Jao and Pagulung (2011), the presence of independent directors will reduce earnings management practices within the company, as the independent director has no interest in the company. On this backdrop, the following hypothesis is proposed:

H2: An independent board has a negative effect on earnings management.

2.5 Audit Quality and Earnings Management

Auditing is the process of gather and processing data to determine similarities and differences between different sources of data. Auditing is also used to reduce information asymmetry between the owners and the managers of a company. According to Guna and Herawaty (2010), the audit quality of the big four is capable of preventing the instance of earnings management. Based on this, the following hypothesis is proposed:

H3: Audit quality has a negative effect on earnings management.

2.6 Managerial Ownership and Earnings Management

Managerial ownership refers to the shares of the company that are owned by managers of the company. According to Ogbonnaya et al., (2016), Warfield et al., (1995) and Guna and Herawaty (2010), shares owned by the managerial practice may contribute to an increase in earnings management within a company. This is because managers that are shareholders will be motivated to practice earnings management in order to improve the quality of the company's shares, to obtain maximum benefit for managers and shareholders. Based on this discussion, the following hypothesis is proposed:

H4: Managerial ownership has a positive effect on earnings management.

2.7 Tax Aggressiveness and Earnings Management

Tax aggressiveness is the action of decreasing the tax paid by the company. Tax aggressiveness can be legal and illegal. Legal tax aggressiveness refers to taking advantage of loopholes in the tax regulatory scheme, whereas illegal tax aggressiveness occurs when a company does not pay its taxes. The main purpose of tax aggressiveness is to reduce the amount of tax payable by the company, therefore increasing the overall profit of the company. Tax aggressiveness activities can be used by management to engage in earnings management in order to reduce taxes, as well as to divert company resources for personal purposes (Putri, Abdul and Anis, 2016). Based on this, the following hypothesis is proposed:

H5: Industry has a positive effect on earnings management.
3. Research Methodology

The population used in this research includes non-financial companies listed on the Indonesian Stock Exchange between 2013 and 2015. The sample selection techniques used in this research is a purposive sampling method. This resulted in the use of 67 companies. Multiple regression analysis is used to test the above hypotheses.

3.1 Definition of Operation

Earnings management is measured using discretionary accruals that were developed by Kohtari (2005). The board of directors is measured by the total number of board members in the company; independence of the board is measured by the number of independent board members divided by the total number of board members in company; audit quality is measured by dummy (1 if the company is audited by one of the big four tax firms, and otherwise); managerial ownership is measured by the percentage of shares owned by managers; tax aggressiveness is measure by the effective tax rate. This research also uses firm size and leverage as control variables.

![Figure 1. Research Framework](image)

4. Results

The result of the descriptive statistic and hypothesis results are show in Table 1 and Table 2 below.

<table>
<thead>
<tr>
<th>Control Variables</th>
<th>Earnings Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Director</td>
<td></td>
</tr>
<tr>
<td>Independent Board</td>
<td></td>
</tr>
<tr>
<td>Audit Quality</td>
<td></td>
</tr>
<tr>
<td>Managerial Ownership</td>
<td></td>
</tr>
<tr>
<td>Tax Aggressiveness</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 1 Descriptive Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>EM</td>
</tr>
<tr>
<td>BOD</td>
</tr>
</tbody>
</table>
Table 2 Hypotheses Results

<table>
<thead>
<tr>
<th>Variable</th>
<th>B</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.151</td>
<td>1.728</td>
<td>0.086</td>
</tr>
<tr>
<td>BOD</td>
<td>0.004</td>
<td>2.818</td>
<td>0.005</td>
</tr>
<tr>
<td>BOI</td>
<td>0.053</td>
<td>1.249</td>
<td>0.213</td>
</tr>
<tr>
<td>AQ</td>
<td>0.015</td>
<td>1.509</td>
<td>0.133</td>
</tr>
<tr>
<td>MO</td>
<td>-0.020</td>
<td>-0.513</td>
<td>0.609</td>
</tr>
<tr>
<td>ETR</td>
<td>-0.035</td>
<td>-1.219</td>
<td>0.224</td>
</tr>
<tr>
<td>FS</td>
<td>-0.005</td>
<td>-1.483</td>
<td>0.140</td>
</tr>
<tr>
<td>LEV</td>
<td>0.005</td>
<td>1.108</td>
<td>0.269</td>
</tr>
</tbody>
</table>

5. Discussion

Table 2 shows that only the board of directors has an effect on earnings management, and all other variables have no effect on earnings management. The board of director has a positive effect on earnings management; this is consistent with studies conducted by Abdul and Ali (2006), Campos et al., (2002), Kao and Chen (2004), and Kouki et al., (2001). The larger a board of director is, the more earnings management occurs. This is because the commissioners in the company are not monitoring the management effectively (Siregar and Utama, 2005). Kao and Chen (2004) also found that board size should not be too large or too small, in order to avoid the instance of earnings management.

6. Conclusion

This research aims to empirically study the effect of the board of directors, independence of the board, audit quality, managerial ownership, and tax aggressiveness on earnings management. The sample used in this research consists of 201 data. The results show that from the 5 variables, only the board of directors has a positive effect on earnings management. Board independence, audit quality, managerial ownership and tax aggressiveness therefore do not have an effect on earnings management. This is because the commissioners in the company are not monitoring the management effectively, so they are unable to prevent management from engaging in earnings management. The larger the board of directors is, the less effective they are at monitoring the management team (Siregar and Utama, 2005). Kao and Chen (2004) believe that that board of directors should not be too large or too small, to avoid the the instance of earnings management within the company.

References
KNKG. 2004