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By Luk Luk Fuadah



The Effect of Corporate Governance Mechanism on Tax Aggressiveness With Earnings Management as Intervening Variable

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Jel Classification

G30, G32, H26.

Abstract

This study aims to analyze the effect of corporate governance mechanism on tax aggressiveness with earnings management as intervening variable. In this study, corporate governance is measured by institutional ownership and the proportion of independent board of commissioners. The sample used in this study is 43 manufacturing companies taken using purposive sampling technique. The type of data used is panel data while the data analysis used is path analysis model. The results of the study found that institutional ownership and the proportion of independent board of commissioners had a significant negative effect on earnings management and institutional ownership with significant negative impact on tax aggressiveness. The proportion of independent board of commissioners and earnings management are found to have significant positive effect on tax aggressiveness. The Sobel Test results show that earnings management variables are able to mediate the relationship of institutional ownership and proportion of independent board of commissioners to tax aggressiveness.

1. Introduction

Taxes are an important phenomenon and the focus of government. The government creates tax-related programs and regulations aimed at maximizing state revenues from the tax sector. However, in recent years the realization of tax revenue in Indonesia has not yet reached the target set by the government. The government's inability to achieve tax revenue target can be caused by various factors, one of which is the company's aggressive attitude toward taxes.

According to the Ministry of Finance, of a total of 12 million corporate taxpayers only 11% routinely report annual tax returns. This is evidenced by the low tax ratio of Indonesia which is only 10.3% compared to other countries such as Malaysia over 13%, and Vietnam and Singapore which has reached 16%. According to Suyanto & Supramono (2012), the company is considered more aggressive against taxes if more and more gaps are used. Companies tend to tax aggressiveness in order to minimize the tax burden to increase the company's net income (Chen *et al.*, 2010).

Corporate governance within the company is necessary to reduce the existence of tax aggressiveness so that it can have a positive impact on tax compliance. The Company implements corporate governance to create effective corporate performance and impact on decisions to be effective in determining policies related to the effective corporate tax rate (Pranoto & Widagdo, 2015). This research refers to research conducted by Nugroho & Firmansyah (2017), Prawira (2017), Hanna & Haryanto (2016), Cahyono *et al.*, (2016), Fadli (2016), Wulansari (2015), Pranoto & Widagdo (2015), Embree (2012), Suyanto & Supramono (2012), Khurana & Moser (2009), Badertscher *et al.*, (2009) that uses corporate governance, which is measured using institutional ownership and independent board of commissioners, have an impact on tax aggressiveness.

This study differs from the previous study as it uses institutional ownership and the proportion of independent board of commissioners in measuring corporate governance. These two corporate governance mechanisms are expected to make the management of the company better so that it will improve the company's performance and become an added value for the company. In addition, this study uses earnings management as an intervening variable. The act of tax aggressiveness that occurred closely related to the behavior of the

management who tend to practice earnings management in order to minimize the tax burden of the company. Kim *et al.*, (2010) finds evidence that earnings management can be used as a tool for tax aggressiveness in order to reduce the tax burden.

1. Literature Review

1.1. Agency Theory

Jensen & Meckling (1976) describes the agency relationship in agency theory that the firm is a collection of contracts between the owner of the economic resources (principal) and the manager (agent) that takes care of the use and control of the resource. Differences of interests that occur between the management of the company as taxpayers with tax authorities as tax collectors to cause conflict between the two.

1.2. Positive Accounting Theory

Positive accounting theory was proposed by Watts & Zimmerman (1986). Positive accounting theory explains the factors that make the management has a motivation in choosing methods and accounting principles that can improve the welfare of the company. Watts & Zimmerman (1986) reveals three main hypotheses in positive accounting theory, namely: (1) Bonus Plan Hypothesis, (2) Debt Covenant Hypothesis, (3) Political Cost Hypothesis.

1.3. Hypothesis Development

1.3.1. The Effect of Institutional Ownership on Management Earnings

Institutional parties are considered sophisticated investors because the institutional can monitor the behavior and actions of management that will reduce the behavior of management to make earnings management (Midiastuty & Mahfoedz, 2003). This is in line with agency theory, which states that the ownership of shares by other institutions can reduce the conflicts of interest that occur and opportunistic behavior of management so as to reduce the potential likelihood of profit management practices (Jensen dan Meckling, 1976). This is also in accordance with the results of research Jao & Pagalung (2011) which shows that institutional ownership affects earnings management. Based on the description above, the proposed hypothesis is as follows:

H₁ : Institutional ownership has negative effect on the earnings management

1.3.2. The Effect of Proportion of Independent Board of Commissioners on Earnings Management

The independent board of commissioner is responsible for overseeing the activities of the company conducted by independent management who work for the company's interest in overseeing the process of preparing the financial statements. Therefore, the greater the proportion of independent board of commissioners the higher the supervision and expected to minimize opportunistic management behavior in the form of earnings management practices. Research conducted by Rahmawati (2013), Prastiti & Meiranto (2013), Jao & Pagalung (2011) indicate that independent board of commissioners have an influence on earnings management. Based on the description above, the proposed hypothesis is as follows:

H₂ : The proportion of independent board of commissioners has negative effect on earnings management

1.3.3. The Effect of Institutional Ownership on Tax Aggressiveness

It is believed that, the greater the ownership of shares owned by other institutions then they will have the ability to effectively control and supervise management and have the ability to influence the decisions and policies made by management (Easterbrook, 1984). Based on the agency theory, which states that by enlarging the ownership of shares by institutions outside the company can reduce the conflict of interest that occurred and opportunistic behavior of management so as to reduce the potential possibility of tax aggressiveness action. Research conducted by Nugroho & Firmansyah (2017), Cahyono *et al.*, (2016), Hanna & Haryanto (2016), Mahulae *et al.*, (2016), Prakosa (2014), Embree (2012), Badertscher *et al.*, (2009), Khurana & Moser (2009) show that institutional ownership has an influence on tax aggressiveness. Based on the description above, the proposed hypothesis is as follows:

H₃ : Institutional ownership has negative effect on tax aggressiveness

1.3.4. The Effect of Proportion of Independent Board of commissioners on Tax Aggressiveness

Independent commissioners in the board of commissioners contribute to supervising managers to not take tax aggressiveness. The greater the ratio of independent commissioners in the composition of the board of commissioners will minimize the possibility of corporate tax aggressiveness. Supervision of independent commissioners makes management more transparent in disclosing corporate information so that tax aggressiveness activities can be minimized and even eliminated. Research conducted by Nugroho & Firmansyah (2017), Prawira (2017), Fadli (2016), Wulansari (2015), Pranoto & Widagdo (2015), Richardson *et al.*, (2014), Fadli (2013), Armstrong *et al.*, (2012), Suyanto & Supramono (2012) indicate that independent board of commissioners influence tax aggressiveness. Based on the description above, the proposed hypothesis is as follows:

H₄ : The proportion of Independent board of commissioners has negative effect on tax aggressiveness

1.3.5. The Effect of Earnings Management on Tax Aggressiveness

Tax is believed to be the problem for the companies because paying taxes will lower their net profit. Therefore, the company will make earnings management to reduce the tax burden (Scott, 2009). Based on the political cost hypothesis in positive accounting theory, management tend to manipulate profits in order to avoid government regulation. One of the government regulations that directly relates to corporate profits is corporate income tax. Research conducted by Hashim *et al.*, (2016), Sari *et al.*, (2016), Tiaras & Wijaya (2015), Kamila (2014), Ohnuma (2013), Suyanto & Supramono (2012), Frank *et al.*, (2009) shows that earnings management has an influence on tax aggressiveness. Based on the description above, the proposed hypothesis is as follows:

H₅ : Earnings management has positive effect on tax aggressiveness

1.3.6. The Effect of Institutional Ownership on Tax Aggressiveness through Earnings Management as Intervening Variable

Ownership of shares of companies by other institutions is one part of corporate governance that allegedly can solve conflicts of interest between shareholders and management and can reduce opportunistic management behavior in the form of earnings management practices because ownership of shares of companies owned by other institutions can align the various interests between the interests of holders shares with the interests of the management (Jensen & Meckling, 1976). With decreasing opportunistic management behavior in the form of earnings management practice, it is assumed that it can reduce the potential of tax aggressiveness. Based on the description above, the proposed hypothesis is as follows:

H₆ : Institutional ownership has positive effect on tax aggressiveness with earnings management as intervening variable

1.3.7. The Effect of Proportion of Independent Board of Commissioners on Tax Aggressiveness through Earnings Management as Intervening Variable

Independent board of commissioners is one part of corporate governance. Supervision of independent commissioners makes management more transparent in disclosure of company information and is expected to minimize opportunistic behavior of management in the form of earnings management so the profits presented will be in accordance with actual company conditions so that the tax burden of the company will also be in accordance with the existing reality (Jao & Pagalung, 2011). Based on the description above, the proposed hypothesis is as follows:

H₇ : The proportion Independent board of commissioners has an impact on tax aggressiveness with earnings management as intervening variable

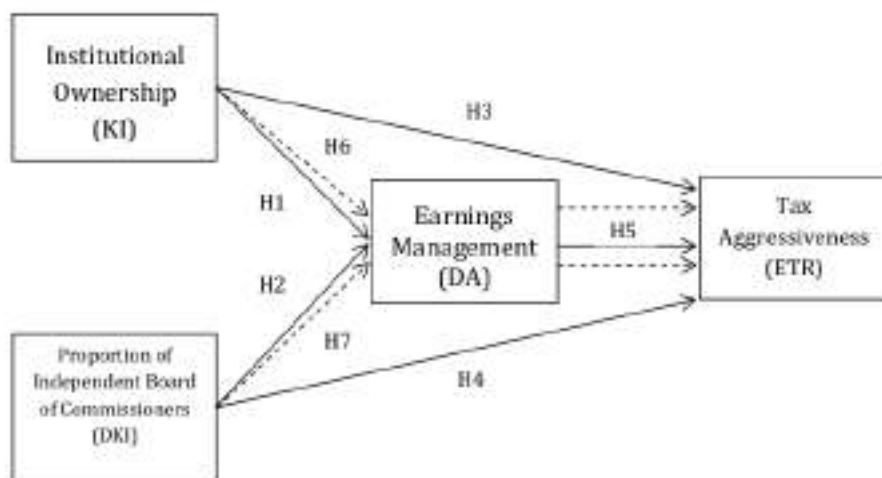


Figure 1. Research Framework

Notes:

————> : The effect of KI, DKI, DA, and ETR

- - - - -> : Mediating effect of KI, DKI and ETR

2. Methodology

2.1. Population and Sample

Population in this study is manufacturing companies listed in Indonesia Stock Exchange from 2012-2016 with the total of 152 companies. The sample selection used is purposive sampling method using the following criteria: (1) Not delisting during the observation periods, 2012-2016, (2) Using rupiah as the currency during the observation, (3) Earned profits successively during the study period.

2.2. Analytical Method

Regression method used in this research is panel data regression by using path analysis model. The structural equation in this research is as follows:

$$DA = \alpha + \beta_1 KI_{it} + \beta_2 DKI_{it} + \varepsilon_1 \quad \dots (1)$$

$$ETR = \alpha + \beta_3 KI_{it} + \beta_4 DKI_{it} + \beta_5 DA_{it} + \varepsilon_2 \quad \dots (2)$$

Notes:

DA = Earnings Management

ETR = Tax Agressiveness

KI = Institutional Ownership

DKI = Independent Board of Commissioners

i = Company - 1

t = Time - t

$\beta_1 - \beta_5$ = Regression coefficient

$\varepsilon_1 - \varepsilon_2$ = error

3. Result and Discussion

Data were analyzed by using panel data regression with path analysis model and to test the effect of mediation used sobel test. The following is the result of testing in this study by using EViews 9.

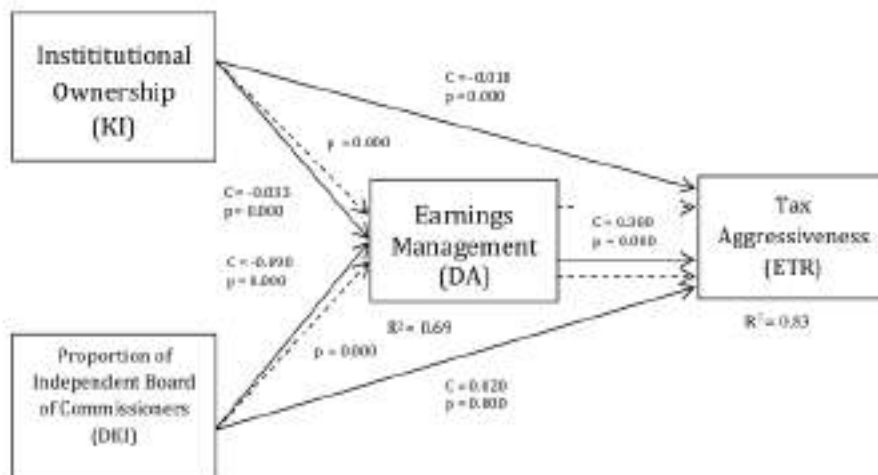


Figure 1. The Test Result

3.1. The Effect of Institutional Ownership on Management Earnings

Test results show that institutional ownership has a negative and significant impact on earnings management. This can be seen from the regression coefficient of institutional ownership showing the negative direction of -0.033 and the level of significance of institutional ownership of 0.000 smaller than 0.05 ($\alpha = 5\%$), which means H_1 accepted. The coefficient of institutional ownership has a negative sign which means that the greater the shares owned by the institutional then they will have the ability to control and supervise the management effectively and have the ability to influence the decisions and policies made by the management to reduce the possibility of occurrence profit management practices (Midiastuty & Mahfoedz, 2003). The results of this study in accordance with the theory of the agency, namely by enlarging the ownership of shares by the institutional then it can reduce the conflicts of interest that occur and opportunistic behavior management that can reduce the practice of earnings management. The results of this study are consistent with the Jao & Pagalung (2011) study indicating that institutional ownership affects earnings management.

3.2. The Effect of Proportion of Independent Board of Commissioners on Earnings Management

The test results show that the proportion of independent board of commissioners has a negative and significant effect on earnings management. This can be seen from the regression coefficient of the proportion of independent board of commissioners showing the negative direction of -0.098 and the level of significance of institutional ownership of 0.000 smaller than 0.05 ($\alpha = 5\%$), which means H_2 is accepted. The coefficient of independent board's proportion has a negative sign which means that the increasing number of independent board of commissioners along with the improved role of the independent board of commissioners, is able to reduce the management's chance to practice earnings management. This is because the greater the composition of the board of independent commissioners, the higher the supervision in the company will be, thus, it will make the manager be more careful and transparent in running the company which will encourage the realization of Good Corporate Governance. The results of this study are consistent with the research of Rahmawati (2013), Prastiti & Meiranto (2013), Jao &

Pagalung (2011) which indicate that the proportion of independent board of commissioners influences earnings management.

3.3. The Effect of Institutional Ownership on Tax Aggressiveness

The results show that institutional ownership has a negative and significant effect on tax aggressiveness. This can be seen from the regression coefficient of institutional ownership showing the negative direction of -0.018 and the level of significance of institutional ownership of 0.000 smaller than 0.05 ($\alpha = 5\%$), which means H_2 accepted. Coefficient value of institutional ownership has a negative sign, which means that if there is an increase in institutional ownership of shares it will decrease the chance of management to act aggressively against taxes. This shows that the size of the shares owned by the institutional will affect the amount of tax burden that must be paid by the company. By increasing institutional ownership, the higher the control of the management will be, thus, it will help to reduce the behavior of management to act aggressively against taxes. The results of this test in accordance with the theory of the agency, namely by increasing the institutional ownership, it can reduce the opportunity to act aggressively against taxes. Companies with higher institutional ownership tend to lower tax aggressiveness than companies with low institutional ownership (Badertscher *et al.*, 2009). The results of this study are consistent with the research of Nugroho & Firmansyah (2017), Hanna & Haryanto (2016), Cahyono *et al.*, (2016), Fadli (2016), Embree (2012), Khurana & Moser (2009) that found an effect of institutional ownership on tax aggressiveness.

3.4. The Effect of Proportion of Independent Board of Commissioners on Tax Aggressiveness

The results show that the proportion of independent board of commissioners has a positive and significant effect on tax aggressiveness. This can be seen from the regression coefficient of the proportion of the board of commissioners showing the positive direction of 0.020 and the significance level of the proportion of independent board of 0.000 that is smaller than 0.05 ($\alpha = 5\%$), which means H_4 is rejected. This is because the result of the research shows that the proportion of independent board of commissioner has a positive effect on tax aggressiveness, meaning that the greater proportion of independent board of

commissioners will affect the amount of tax burden to be paid by the company. In this case, the independent board of commissioners has not been able to perform its role well since the independent board of commissioners actually increases the potential for tax aggressiveness due to the lack of oversight function of independent board members, it is assumed that the placement or addition of independent board members merely fulfills formal requirements, the granting of commissioners in Indonesia paid less attention to the competence and integrity of the commissioners, but tended as a tribute or reward only. This is also evidenced by the coefficient value of the proportion of independent board of commissioners that has a positive sign which means that the independent board of commissioners within a company can not dampen or reduce the management's behavior to act aggressively against taxes. The results of this study are consistent with Nugroho & Firmansyah (2017), Prawira (2017), Wulansari (2015), Pranoto & Widagdo (2015), Fadli (2013), Suyanto & Supramono (2012), which show that the proportion of independent board of commissioners influences tax aggressiveness.

3.5. The Effect of Earnings Management on Tax Aggressiveness

The test results show that earnings management has a positive and significant effect on tax aggressiveness. This can be seen from the earnings regression coefficient of earnings shows the positive direction of 0.380 and the level of significance of profit management of 0.000 is smaller than 0.05 ($\alpha = 5\%$), which means H_0 accepted. Coefficient value of earnings management has a positive sign which means that if earnings management practices improve then there is likely to increase the chances of management to act aggressively against taxes. This indicates that the amount of tax burden to be paid by the company is influenced by earnings management practices conducted by the management. Profit management is done for the purpose of tax savings. Effect of earnings management in the form of income decreasing against corporate tax aggressiveness can be explained, as the profit becomes the benchmark to measure the amount of corporate tax burden. Therefore, management will report profits tailored to its objective, namely using accounting options that reduce the income or income decreasing as a form of tax evasion. The results of this study in accordance with the political cost hypothesis in positive accounting theory, i.e. the management tends to manipulate profit in order to avoid government regulation, one of

which is to avoid corporate income tax. The results of this study are consistent with Nugroho & Firmansyah (2017), Prawira (2017), Wulansari (2015), Pranoto & Widagdo (2015), Fadli (2013), Suyanto & Supramono (2012) which shows that earnings management has an effect on tax aggressiveness.

3.6. The Effect of Institutional Ownership on Tax Agressiveness through Earnings Management as Intervening Variable

The results of the sixth hypothesis testing (H_6) by using the test sobel show that earnings management is able to mediate the relationship between institutional ownership to tax aggressiveness. This can be seen from the results of the test sobel showing the significance value between the institutional ownership variable, tax aggressiveness, and earnings management, that is 0.000, which is smaller than 0.05 ($\alpha = 5\%$), which means H_6 is accepted. This suggests that the earnings management variable is able to mediate the relationship of institutional ownership to tax aggressiveness. The results of this study can be interpreted that the greater the shares owned by the institutional then it is able to reduce the opportunity of management to do earnings management practices so that if the practice of earnings management can be reduced it also can prevent the management behavior to be aggressive towards taxes.

3.7. The Effect of Proportion of Independent Board of Commissioners on Tax Agressiveness through Earnings Management as Intervening Variable

The results of the seventh hypothesis testing (H_7) show that earnings management is able to mediate the relationship between the proportion of independent board of commissioners to tax aggressiveness. This can be seen from the result of the test that shows the significance value between the independent proportion of board of commissioners, tax aggressiveness, and earnings management, that is 0.000, which is smaller than 0.05 ($\alpha = 5\%$), which means H_7 is accepted. This suggests that the earnings management variable is able to mediate the proportionate relationship of independent board of commissioners to tax aggressiveness. This can be interpreted that the increasing number of independent board of commissioners in a company will increase supervision on the management so that management makes more transparent in disclosure of company

information and expected to minimize opportunistic behavior of management in form of earnings management. By minimizing the opportunity to practice earnings management, the profits presented will be in accordance with the actual conditions of the company so that the tax burden of the company will also be in accordance with the existing reality, which means it can reduce tax aggressiveness.

4. Conclusion

The result of regression testing of panel data proves that corporate governance mechanism as measured by institutional ownership and the proportion of independent board of commissioner have a significant negative effect to earnings management. This means that the greater the institutional share of ownership and the increasing number of independent commissioners can reduce the behavior of management to practice earnings management. The result also proves that institutional ownership has a significant negative effect on tax aggressiveness, which means that the greater the institutional share of ownership the more likely it is to reduce aggressive action against taxes. Meanwhile, the proportion of independent board of commissioner has a positive effect on tax aggressiveness, meaning that an increasing number of independent board of commissioners are unable to reduce tax aggressiveness. This study also proves that earnings management has a positive effect on tax aggressiveness, which means that one of the objectives of earnings management practice is to minimize the corporate tax burden or in other words to act aggressively against taxes.

In testing the effect of mediation using a sobel test found that earnings management mediated the institutional ownership relationship and the proportion of independent board of commissioners against tax aggressiveness. The greater the shares owned by the institutional then it will be able to reduce the opportunity of management to make earnings management so that if earnings management practices can be reduced, it will also reduce the behavior of the management to be aggressive towards taxes. Meanwhile, the higher the number of independent board of commissioners, the supervision of the management will also be increased, making management more transparent in the disclosure of company information and expected to minimize the opportunity to make earnings management. By minimizing the opportunity for management to make earnings management then the

profits presented will be in accordance with the actual company conditions so that corporate tax burdens will also be in accordance with the existing reality, which means it can reduce to be aggressive towards taxes.

In addition, this study has several limitations and weaknesses, including the proxy of corporate governance used in this study is still limited to two variables, namely institutional ownership and the proportion of independent board of commissioners, and the independent variables used in this study only look in terms of non-financial factors that can affect the aggressiveness of taxes. Further research is expected to add other variables as a proxy of corporate governance mechanisms so as to further enrich the discussion of tax aggressiveness.

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