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Corporate Governance, Earnings Management and Tax Management

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Abstract

Tax is undeniably essential for a country and also a corporation. Both parties have a similar interest of tax. For a country it is its source of income, while for a corporation tax will reduce its net income. Therefore, sometimes corporation use earnings management practice to control its income which will impacted tax in the same time. Previous research suggested that there is significant impact of corporate governance to corporate earnings management and corporate tax management. In this research we are focusing on number of board, number of independent board and board compensation disclosure as corporate governance proxy. We use discretionary accrual to measure earnings management, and effective tax rate as tas management measurement. Our finding show that there is significant impact of corporate governance to earnings management and tax management.
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Keywords: Corporate governance; earnings management; tax management; discretionary accrual; effective tax rate

1. Introduction

To measure performance of a corporation, one can use a financial statement for a particular accounting period. It is the primary communicator of corporate performance to all interested stakeholders. In this research, we highlight two stakeholders that put its interest to corporate financial statement namely: management and government.

Most of the time, management intends to pay lower tax obligation as it will significantly reduce corporate net income –usually a primary indicator of corporate performance. Earnings management is usually applied to minimize

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corporate tax obligation. In the same time, government wants to levy tax as high as possible; as it is one of primary income source for the country. This is the conflicting situation exist in a corporation.

Potential conflict of interest, however, could be minimized by an allignment of external and internal stakeholders interest mechanism. This mechanism is better known as corporate governance. It is a mechanism that control a corporation so it can run effectively in meeting both interest of external and internal stakeholders (ie. government and management).

2. Literature review

2.1. Corporate governance

Corporate governance arises due to principle-agent problem. Corporate governance could reduce monitoring cost by creating a higher level of control and transparency. It is a system that influence how a corporation directed and controlled (Turnbull, 1997; Cadbury, 2000). Brown and Caylor (2004) found corporation with better corporate governance will have a better performance compare to corporation with worse corporate governance.

2.2. Earnings management

Earnings management occur when management make an accounting decisions that change bottom line of corporation and distorting the application of generally accepted accounting principles. According to Matsumoto (2002), corporation with better growth prospects are tend to be more motivated to do the earnings management.

2.3. Tax management

Tax management is a process to organize a corporation so its tax liabilities stay in the minimum position according to tax code with opportunity cost and political cost (Scholes et al., 2009; Hanlon and Slemrod, 2009).

2.4. Previous research

Erickson et al. (2006) found that earnings management and tax management is affected by corporate governance. The optimal number of board in a corporation differs according to characteristic of each corporation (Coles et al., 2008). In the contrary, Bhagat and Black (1999) and Minnick and Noga (2010) found that less number of board will create better oversight function which will be more focused to convince management for conducting a earnings management and tax management.

Furthermore, Bhagat and Black (1999) conclude that more independent board will be resulted in better oversight function. Minnick and Noga (2010) also conclude that with the existence of independent board, corporation will be focus on overall performance where effective tax rate plays an essential role.

Yermack (2004) in his research conclude that the main objective of board is to maximizing shareholders wealth by using an effective tax management in the corporation. Jensen and Murphy (1990) and Brown and Caylor (2004) also found board compensation and its disclosure has a high degree of positive correlation in determining corporation performance. Rego and Wilson (2012) also found negative correlation between compensation and tax management.

3. Research Methodology

The following research methodology is used in this research, and data panel regression is applied.

$$ETR_{i,t} = \alpha_1 + \alpha_2 ETR_{i,t-1} + \alpha_3 BR + \alpha_4 IN + \alpha_5 CM + \alpha_6 SZ + \alpha_7 RA + \alpha_8 LV + \alpha_9 EV + \varepsilon \quad (1)$$

$$DA_{i,t} = \beta_1 + \beta_2 DA_{i,t-1} + \beta_3 BR + \beta_4 IN + \beta_5 CM + \beta_6 SZ + \beta_7 RA + \beta_8 LV + \beta_9 EV + \varepsilon \quad (2)$$

where:

ETRi,t	=	effective tax rate of i-corporation at t-time;
DAi,t	=	discretionary accrual of i-corporation at t-time (Modified Jones model);
GAAP ETR	=	tax expense based on GAAP-based accounting report$_{i,t}$/pretax income$_{i,t}$;
Current ETR	=	current tax expense$_{i,t}$/pretax income$_{i,t}$;
BR	=	number of board;
IN	=	number of independent board;
CM	=	board compensation;
SZ	=	control variable (log of total assets);
RA	=	control variable (net income to total assets);
LV	=	control variable (debt to equity);
EV	=	control variable (enterprise value based on Rosenbaum, 2009).

4. Discussion and analysis

For the first test using GAAP ETR, we have found that all variables significantly affected tax management in 1% and it is only board compensation and enterprise value which have significant influence to earnings management (board compensation is significant in 5%, and enterprise value is significant in 1%). Number of board has a positive coefficient. Our result support Bhagat and Black (1999) and Minnick and Noga (2010) findings. We also found a negative coefficient of number of independent board which is supported by Bhagat and Black (1999) and Minnick and Noga (2010). The last one is board compensation. From our research, we have a negative coefficient of compensation. Our result is supported by Jensen and Murphy (1990), Brown and Caylor (2004) and Rego and Wilson (2012).

When we use current ETR as our dependent variable, the only difference we found with the GAAP ETR is in number of board. The negative coefficient in number of board in the second study means higher number of board will result in lower current effective tax rate. This result could be explained by Coles et al. (2008) which found higher number of board in a big corporation will result in better corporate performance. From the research of corporate governance using GAAP effective tax rate and current effective tax rate, we conclude that there is a different result using different tax rate.

5. Conclusion

From our research, we can conclude that some part of (if not all) corporate governance significantly affected both tax management and earnings management. We have found evidence of mixed correlation to tax management. Independent board and board compensation consistently (both in GAAP ETR and current ETR) show a negative correlation to tax management. While for number of board, we found a positive correlation to tax management by using GAAP ETR and a negative correlation to tax management by using current ETR. Given this evidence, we suggest all corporation to pay a serious attention to its corporate governance practice as it is proved corporate governance has a significant impact to corporate tax management. While it appears it is only board compensation that has significant influence to earnings management.

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