Business and Finance
Society for the Study

International Journal of Finance & Banking Studies *IJFBS*
Vol.3 No.3, 2014 ISSN: 2147-4486
available online at www.ssbfnet.com

Examining Corporate Governance and Corporate Tax Management

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Abstract

Taxation play an essential role both in a country and in a corporation. For a country it is one of the primary income source, while for the corporation taxes will reduce corporate net income. To minimize the tax payment, corporation conduct a corporate tax management. According to some of previous research, there is a correlation between corporate governance and corporate tax management. While there are many corporate governance proxies could be used in corporate governance research, in this research we are focusing on three: number of board, number of independent board and board compensation. We measure corporate tax management by using effective tax rate (GAAP ETR and current ETR are used in this research). By using several other control variables, we run the regression and conduct the statistical analysis to examine the correlation between corporate governance and corporate tax management. Our result show that corporate governance have a significant correlation to corporate tax management.

Keywords: Corporate governance; corporate tax management; number of board; independent board; board compensation.

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1. Introduction

Taxation have an essential role in a country, as one of primary income source for the country. As for Indonesia, according to the latest data, almost 70% of the budget is funded from taxation. For a corporation, the tax obligation will create a tax expenses which will significantly reduce corporate net income. Many efforts have been done to minimize the tax payment, one of which is applying a tax management.

There are some factors affecting tax management application in a corporation. Among those factors is corporate governance. Minnick and Noga (2010) have conducted the research on corporate governance and tax management. From their research, they concluded that compensation give a long-term incentives for board to reduce tax in short and long-term. According to them, examining relationship between corporate governance and tax management is interesting as tax management is really complex. Therefore, management sometimes are really opportunistic to conduct tax management to significantly reduce their net income and taxes. Understading nature of corporate governance in tax management will create a better understanding of the effect of corporate governance.

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This research will study the relationship between corporate governance and tax management in Indonesian listed corporation. We use number of board, number of independent board and board compensation as a corporate governance proxy. While effective tax rate is used as a variable of corporate tax management.

2. Literature Review

2.1. Tax rate and tax management

According to Walby (2010), there are four tax rate: statutory tax rate, average tax rate, marginal tax rate and effective tax rate. Tax rate use in this research is effective tax rate, which is actual tax rate paid by corporation compare to corporate net income. Statutory tax rate should equal with effective tax rate if there are no tax shields and tax credits. These factors are also known as tax incentives. Factors affecting difference of effective tax rate between corporations are: interest expense, research and development expense, foreign ownership, stock market listing and number of subsidiaries.

Tax management is a process to organize a corporation so its tax liabilities stay in the minimum position according to tax code. Tax management is integral process with corporate strategic planning, and also increase bottom line performance measurement. However, it has also costs such as: opportunity cost and political cost (Scholes et al., 2009; Hanlon and Slemrod, 2009).

2.2.Accounting report

Shackelford et al. (2011) develop a general model how tax affecting corporate decision making based on cash and accountancy. Accounting report is a management tool to communicate with external parties. It will also reduce information asymmetries, therefore, reducing cost of capital. They conclude two main reasons why accounting report is essential for management: (1) contractual arrangements which based on accounting report; and (2) accounting report users could not distinguish the quality of net income (low income due to low profitability, or low income due to tax management). In this case, tax management will reduce net income and improve cash flows in the same time.

2.3. Corporate governance

Corporate governance arises due to principle-agent problem. The problem between principal and agent will create costs. Some of researchers divide agency cost by two: monitoring cost and bonding cost. Corporate governance could reduce monitoring cost by creating a higher level of control and transparency.

According to OECD, there are four corporate governance principles: fairness, transparency, accountability and responsibility. By applying all principles of corporate governance, the principle-agent problem will be minimized. Brown and Caylor (2004) also found corporation with better corporate governance will have a better performance compare to corporation with worse corporate governance.

To research corporate governance, as have been mentioned in the introduction, three proxies were used in this research namely: number of board, number of independent board and board compensation. Indonesia uses two board systems, in which both board have responsibility for corporate strategic planning and oversight function. The existence of

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independent board will provide a continuity and necessary objectivity needed by a corporation to grow. In their research, Hermalin and Weisbach (1998) conclude that outside director provide a very high level of oversight function in the board.

As for compensation, it has three basic objectives: attracting, retaining and motivating key employees. Moreover, individuals tend to be motivated by compensation. Motivation will be weaker once an individual consider an objective is too easy to reached, or in contrary could not be reached. In a corporation, board compensation could be in various forms ie: salary, bonus, stock option plans, performance share plans and retirement pension.

2.5. Previous research and hypotheses development

Erickson et al. (2006) found that 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 tax management.

In relation to number of independent board, 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 has a high degree of positive correlation in determining corporation performance. Rego and Wilson (2012) also found negative correlation between compensation and tax management.

Based on the above previous research, we have developed three hypotheses to be tested in this research: the relation of (1) number of board, (2) number of independent board and (3) board compensation to tax management.

3. Research Methodology

The following research methodology is used in this research, and data panel regression is applied to test the three hypotheses.

$$ETR_{i,t} = \beta_1 + \beta_2 ETR_{i,t-1} + \beta_3 BOARD + \beta_4 INDEP + \beta_5 COMP + \beta_6 SIZE + \beta_7 ROA + \beta_8 LEV + \varepsilon$$

where:

$ETR_{i,t}$	=	effective tax rate of i-corporation at t-time (GAAP ETR and Current ETR is used in this research);
GAAP ETR	=	tax expense based on GAAP-based accounting $report_{i,t}$/pretax $income_{i,t}$;
Current ETR	=	current tax $expense_{i,t}$/pretax $income_{i,t}$;
BOARD	=	number of board;
INDEP	=	number of independent board (in percentage);
COMP	=	board compensation to total sales;
SIZE	=	control variable (log of total assets);
ROA	=	control variable (net income to total assets);
LEV	=	control variable (debt to equity).

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The sample used in this research is listed corporation in Indonesia stock exchange which has positive earning before taxes and have positive and less than 1 of GAAP ETR and current ETR.

4. Discussion and analysis

Table 1 provide regression result using GAAP ETR as dependent variable, while the regression result using current ETR as dependent variable is available in table 2.

Table 1. Regression result, GAAP ETR as dependent variable

Variable	ETR_{t-1}	BOARD	INDEP	COMP	SIZE	ROA	LEV
Coefficient	-37.6418*	2.5958*	-2.2130*	-21.4996*	-56.8234*	-4.7257*	2.0624*

** Significant in 1%*

Table 2. Regression result, Current ETR as dependent variable

Variable	ETR_{t-1}	BOARD	INDEP	COMP	SIZE	ROA	LEV
Coefficient	6.3462*	-3.8669*	-2.4318*	-44.8743*	-5.4749*	-350.3876*	15.3743*

** Significant in 1%*

In the first regression (table 1), we conclude that all variables have significant relation to tax management which are significant in 1%. BOARD (number of board) has a positive coefficient which means higher number of board will result in higher GAAP effective tax rate. Our result support Bhagat and Black (1999) and Minnick and Noga (2010) which conclude that less number of board will create better oversight function which will be more focused to convince management for conducting a tax management.

The second corporate governance proxy we research in this first regression is INDEP (number of independent board). We found a negative coefficient of INDEP, which means higher number of independent board will result in lower GAAP effective tax rate. This finding is also inline with Bhagat and Black (1999) and Minnick and Noga (2010). In their research, they found more independent board will result in better oversight function, especially in this case oversight function of taxation (tax management).

The last corporate governance proxy in the first regression is COMP (board compensation). From our research, we have a negative coefficient of COMP which meas the higher amount of board compensation will result in lower effective tax rate. Our result is supported by Jensen and Murphy (1990), Brown and Caylor (2004) and Rego and Wilson (2012). In their research (Jensen and Murphy, 1990 and Brown and Robinson, 2004) found there is a positive correlation between board remuneration to corporate performance. The most common benchmark to measure corporate performance is its net income, which is affected by taxes. Rego and Wilson (2012) also concluded there is a negative correlation between compensation and tax management.

In the second regression (table 2), the only difference we found with the first regression is in number of board. While in the first regression we have a positive coefficient, in the second regression we found a negative coefficient. The

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negative coefficient in number of board in the second regression 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.

For number of independent board and board compensation shows the same result as we found in the first regression, which is higher number of independent board and higher amount of board compensation will result in lower current effective tax rate.

From the research of three proxies of corporate governance using GAAP effective tax rate and current effective tax rate, we could conclude that there is a different result using different tax rate. This difference due to the difference between GAAP-based effective tax rate (amount of tax expense should be paid based on accounting report which is prepared in accordance to GAAP) and current effective tax rate (the real amount paid to tax authority). As we have known, some tax authority in the world (one of it is Indonesia) have different requirement for income statement preparation to GAAP. Even in this IFRS-era (the usage of single accounting standard that is used in most of countries in this world), this difference (different between accounting-income statement and tax-income statement) is still exist (Mulyadi, Soepriyanto and Anwar, 2012).

Even though we found difference in one of corporate governance proxy in our research, for the three control variables we found the same result (in terms of positive/negative correlation). Corporate size has a negative correlation to effective tax rate. We found the same result as suggested by Dyreng et al. (2007) and Richardson and Lanis (2007) as the bigger the size of one corporation, it will has more resource to create an effective tax management. Return on assets also has a negative correlation to effective tax rate from our research, which means a corporation which operated efficiently will receive a lower effective tax rate. Derashid and Zhang (2003) also found the same evidence on this. While for leverage, it has a positive correlation to effective tax rate. This result is also supported by Gupta and Newberry (1997).

5. Conclusion

From our research, we can conclude that corporate governance have a mixed correlation to tax management. From all three proxies we used in this research, we found all the three proxies are significant in 1%. 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 can 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.

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