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The Role of Earning Quality, Audit Quality and Independent Commissioner in Suppressing Tax Avoidance Practice

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Abstract:

Aggressive tax planning is a threaten government revenue in many countries, so tax avoidance has become an international political issue nowadays. The objectives of this study were to observe the trends in tax avoidance practices in manufacturing companies in Indonesia and to examine the influence of earnings management, proportion of independent commissioners, and audit quality toward the possibility of companies in reducing tax costs.

The practice of tax avoidance is measured by the Cash Effective Tax Rate (CETR) as it is not affected by changes in estimates such as valuation allowance or tax protection. Aggressive practices in minimizing the tax burden still occur in Indonesia, but this study showed encouraging evidence since the trend of tax avoidance practices is gradually decreasing. The result of testing factors which affect tax avoidance that the variable proportion of independent directors was proven to be able to reduce the action of reducing the tax burden, thus independent party supervision needed to be improved. The government needed to enforce regulations through increased transparency and disclosure, closing the loophole on taxation rules, and raising awareness for taxpayers through improving tax policies and increasing accountability for channeling tax funds.

Keywords: earning management; independent commissioners; audit quality; tax avoidance; cash effective tax rate (CETR).

JEL Classification: H26; H71; K34; M41.

Introduction

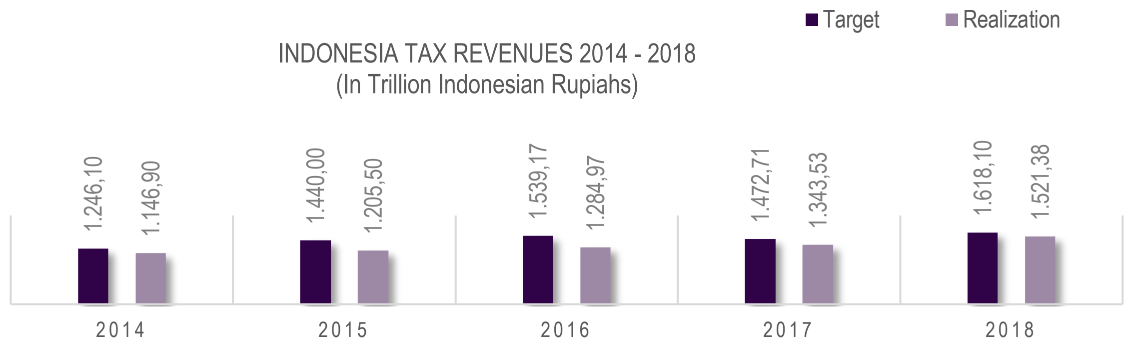
The Indonesian government authorizes taxpayers to calculate, pay, and report their taxable income which called a self-assessment system. However, taxpayers often misuse this authority and take advantage of opportunities by calculating the tax to a minimum as possible so that the tax burden becomes negligible. According to Brian and Martani (2014), companies can do two ways in reducing the amount of tax paid, that is, reducing the value of taxes by staying abreast of applicable tax regulations (tax avoidance) and/or reducing the value of taxes by contravening the tax laws (tax evasion). Nevertheless, tax avoidance is still legal as long as it does not violate the applicable tax legislation.

Tax avoidance is a public problem as it can weaken the government's capacity to invest in social infrastructure and redistribute income and wealth to ensure social stability. In tax avoidance, taxpayers look for loopholes to manage their taxes without having to violate taxation rules. However, when viewed in terms of state revenue, tax avoidance is very detrimental for it can make state revenues decrease. Whereas Jacob (2014) defined tax avoidance as an action to reduce or minimize tax obligations by carefully regulating in such a way as to take advantage of loopholes in the provisions of tax law.

1. Literature Review

In Indonesia, taxation is such as the country's biggest source of income, which has a very important role in sustainable development. Over the past 10 years, the largest source of revenue in the structure of the Indonesian State Budget comes from the taxation sector, which is around 70% to 80%. Tax revenue budget data from 2014 to 2018 in Figure 1 shows that the realization of tax revenue is always lower than the target set. This can be an indication of the ineffectiveness of the tax collection system in Indonesia. The Self-Assessment System implemented by the Indonesian government apparently has not been matched by an awareness of paying tax in an orderly manner by taxpayers. Taxpayers usually do tax planning so that they can pay taxes as little as possible. In general tax planning is the first step in tax management. This stage is carried out by collecting and researching tax regulations so that they can choose the type of tax-saving measures as what will be done.

Figure 1. Target and Realization of Tax Revenues in 2014 – 2018



Source: Suandy (2017, 6).www.kemenkeu.go.id

Dewinta and Setiawan (2016) suggested that tax avoidance is mostly done by companies, either major European companies or even companies established in Indonesia themselves. Based on the publication of The Organization for Economic Cooperation and Development (OECD), the US senate estimates that revenue losses from tax avoidance by US-based companies and individuals are around 100 billion dollars per year. In many other countries, the number of losses reached billions of Euro. Even in 2016, based on a report by Ernesto Crivelli, an investigator from IMF which was then analyzed by the United Nations using the International Center for Taxation and Development (ICTD) database, showing that Indonesia ranked 11th largest tax avoidance from 30 countries surveyed with an estimated value of 6.48 billion US dollars corporate taxes were not paid to the Indonesian Tax Office (Susilo 2017).

According to Mulyani *et al.* (2017), corporate taxpayers in Indonesia (*i.e.* corporate taxpayers) have been avoiding taxes from time to time which is proven from the number of taxpayers who take advantage of the tax amnesty. The Indonesian government policy through tax amnesty was effect on July 1st, 2016 until March 31st, 2017. Tax amnesty is a tax write-off that should have been owed, but not subject to tax administration sanctions and criminal penalties in the taxation field, by uncovering assets and paying money ransom in smaller amounts.

This program is a national program from the government to increase tax revenues as well as to identify tax revenue opportunities in the future.

Tax for companies is such an expense that will reduce net income. Hence, companies always want to pay tax to a minimum (Hardika 2007, Kurniasih and Sari 2013). The company and its owner mind to pay the tax burden, therefore, they do an effort to avoid tax (Chen 2010). Companies use unclear regulations (loopholes) in the context of tax avoidance to obtain favorable tax outcomes (Dyreng *et al.* 2008). The issue of the erosion of tax base and profit shifting has become a major international political issue (International Monetary Fund 2013a, 2013b, United Nations Finance for Development 2014, Sikka 2018). Some researches concerning tax avoidance had been conducted in various countries to examine what factors influence tax avoidance. In Indonesia, some of the researches on tax avoidance were conducted by Dewi and Jati (2014), Maharani and Suardana (2014), Tiaras and Wijaya (2015), Wijayanti *et al.* (2016), Astuti and Aryani (2016), Praditasari and Setiawan (2017). Likewise, in other countries, research on tax avoidance were conducted by Dyreng *et al.* (2008), Wilson (2009), Deak (2009), Hanlon and Heitzman (2010), Chen *et al.* (2010), Lanis and Richardson (2013), Hashim *et al.* (2016), Amidu *et al.* (2016), Drake *et al.* (2019). Some researchers such as Atwood *et al.* (2012), Blaylock *et al.* (2012) even doing research in an international context.

The objective of this study was to examine the influence of earnings management, proportion of independent commissioners, and audit quality toward the possibility of companies in reducing tax costs. This research focused on manufacturing companies in Indonesia since the manufacturing sector is one of the sectors that experience the greatest growth compared to other sectors (www.idx.go.id). Based on the Financial Note along with the 2018 Draft State Budget, the manufacturing sector is still the biggest contributor of the national economy with a contribution that reaches 20% of the total national Gross Domestic Product (GDP) (www.kemenkeu.go.id).

Tax Avoidance

Hanlon and Heitzman (2010) suggested that tax avoidance is an activity that aims to reduce tax liability. Epifantseva and Hashimzade (2017) considered tax avoidance as an arrangement of transactions to obtain profits, benefits, or tax reduction by utilizing the applicable tax rules and regulations. According to Maharani and Suardana (2014), tax avoidance is such a complicated and unique problem, since on the one hand it is permissible, but on the other hand, it is not expected by the government.

Picciotto (2018) suggested that tax avoidance is not 'perfectly legal' as it can be opposed by tax authorities and can be considered unlawful. Furthermore, Picciotto (2018) stated that currently the perception of tax avoidance has changed, there has been a strengthening of law enforcement and greater efforts to reform and improve the rule of law. Often, tax avoidance is used to describe avoidance achieved by engineering the business, whether in personal or business matters to take advantage of loopholes, ambiguities, anomalies, or other tax law deficiencies. Laws designed to fight avoidance have become commonplace and often involve very complex provisions.

The fiscal affairs committee of the Organization for Economic Cooperation and Development (OECD) states that there are three characteristics of tax avoidance, including:

- there is an artificial element in which various arrangements appear to exist, but actually they do not, and this is done because of the absence of tax factors;
- such schemes often utilize loopholes from the law or apply legal provisions for various purposes, even though that is not what the legislator actually intended;
- confidentiality is also a form of this scheme because consultants generally show tools or ways to avoid tax on the condition that taxpayers keep as confidential as possible.

The amount of tax avoidance by companies can be measured using: Effective Tax Rate (ETR), GAAP Effective Tax Rate, Current ETR, Long-run Cash ETR, Book Tax Difference (BTD) and Tax Sheltering Activity. In this study, tax avoidance is proxied by the Cash Effective Tax Rate (CETR) which describes the amount of cash incurred by companies for tax costs divided by profit before tax. The greater the CETR indicates that the lower the level of tax avoidance by companies (Suryani *et al.* 2018). Cash ETR is best used to describe the tax avoidance by companies since it can see the amount of tax actually paid by the company from the cash flow statement (Chen *et al.* 2010). Meanwhile, according to Dyreng *et al.* (2008), the use of Cash ETR is good for describing tax avoidance, since cash ETR is not affected by changes in estimates such as valuation allowance or tax protection. In addition, tax measurement using Cash ETR can answer the problems and limitations of tax avoidance measurement based on the GAAP ETR model (Herawati and Ekawati 2016).

Hypothesis Development. The Effect of Earning Management on Tax Avoidance

Earnings management is done to report earnings that maximize personal or company profits by using accounting policies (Scott 2015 in Surahman and Firmansyah 2018). Earnings management does not have to be associated with efforts to manipulate accounting data or information, but can also be associated with efforts to choose accounting methods to regulate profits that can be done in accordance with accounting regulations (Suryani *et al.* 2018). In line with agency theory, earnings manipulation can be done as there is an information asymmetry between the preparer (management) and the user (principal) of financial statements. Concerning tax avoidance, management has an interest in manipulating corporate profits which in turn will reduce the tax debt borne by the company and usually these manipulations are not known by the principal or company owner (Suyanto and Supramono 2012).

Based on Surahman and Firmansyah (2018), accrual earnings management calculated using discretionary accruals has a significant positive effect on tax aggressiveness. Tiaras and Wijaya (2015) stated that manufacturing companies during the observation period did not consistently tend to increase profits. Income increasing is done by companies to maintain company performance indicators and to reduce tax rates. According to the laws of taxation, the greater the net income before tax, the greater the tax burden that must be paid by the company. Therefore, the management will report earnings adjusted for the purpose of using accounting options that reduce earnings as a form of tax avoidance. So we argued:

H1: Earning management has a positive effect on tax avoidance

The Effect of Proportion of Independent Commissioners on Tax Avoidance

According to Indonesian Law No 40/2007 regarding to Limited Liability Companies, that an Independent commissioner is a part of a company that has no relationship or as an unaffiliated party with members of the board of directors of the company, other members of the board of commissioners, and majority shareholders of the company. Based on the agency theory, the greater the number of independent boards of commissioners, the better in supervising and controlling the actions of directors and directors, including the opportunistic behavior of management. Increasing supervision can encourage management to comply with applicable tax regulations in preparing high-grade and more objective financial statements. Prakosa (2014) proved that the existence of an independent commissioner in a company has negative implications for tax avoidance. Maharani and Suardana (2014) stated that the existence of an independent board of commissioners is effective to prevent tax avoidance. So the second hypothesis is stated as follows:

H2: The proportion of independent commissioners has a negative impact on tax avoidance

The Effect of Audit Quality on Tax Avoidance

In the context of agency, quality auditing activities will address information asymmetry problems that occur between management and shareholders, including tax avoidance. In general, large Public Accounting firms have strong intensive to complete audit tasks faster, have more experience and high flexibility in scheduling audits and are perceived to do higher-quality audits (Sundari and Aprilina 2017). Annisa and Kurniasih (2012) described that the financial statements audited by Big Four Public Accounting Firm auditors have lower levels of fraud in taxation activities compared to companies audited by non-Big Four Public Accounting Firm. Then the third hypothesis is proposed as follows:

H3: Companies that are audited by Big Four Public Accounting Firm have a smaller chance of doing tax avoidance compared to companies that are audited by smaller Public Accounting Firm

2. Methodology

This study employed manufacturing companies listed on the Indonesia Stock Exchange as the population. The manufacturing sector was chosen since this sector was the largest contributor of the national economy with a contribution reaching 20% of the total Gross Domestic Product (GDP) and absorbing the most labor (www.kemenkeu.go.id). Then the sample was selected by purposive sampling technique based on predetermined criteria (see Table 1).

Table 1. Sample Selection Criteria

CRITERIA	TOTAL
Manufacturing companies listed on the Indonesia Stock Exchange in 2014-2018	164
Manufacturing companies were delisted during the 2014-2018 period	(3)
Manufacturing companies that did not publish annual reports or no longer accessible for the research period	(57)
Manufacturing companies that suffered losses and received tax compensation due to losses in previous years	(64)
Number of research samples	40
Total unit of analysis (40 x 5 years)	200

Data was collected using the documentation method from BEI's official website www.idx.co.id and respective official company websites. Measurement of research variables using the formula showed in Table 2.

Table 2. Measurement of Research Variables

No.	Variable	Measurement
1	Tax Avoidance	Cash Effective Tax Rate$_{it}$ = cash tax paid$_{it}$/ pretax income$_{it}$
2	Earning Management	DACC$_{it}$ = (TACC$_{it}$ / TA$_{it-1}$) –NDACC$_{it}$; DACC = Discretionary accrual perusahaan; TACC = Total accrual perusahaan; TA$_{it-1}$= Total asset perusahaan padaakhirtahun t-1; NDACC= Nondiscretionary accrual perusahaan .
3	Proportion of Independent Commissioners	INDEP = (number of independent commissioners$_{it}$/ total board of commissioners$_{it}$) x 100%
4	Audit Quality	Audit quality = Audit Firm size; 1= untukmewakilip erusahaan yang diauditoleh KAP Big-Four dan; 0= untukmewakili perusahaan yang diauditoleh KAP NonBig-Four.

This study applied descriptive statistical analysis, panel data regression analysis, and regression prerequisite tests for the best model selected using Eviews 8.0 to analyze the data. Descriptive statistics were used to find out the maximum, minimum, average, and standard deviation of each variable. Panel data regression analysis was done by estimating using the Common Effect, Fixed Effect, and Random Effect models first. Afterward, the best model with the chow test, the Hausman test, and the Lagrange Multiplier (LM) analysis was determined. The prerequisite regression test comprised a multicollinearity test and a heteroscedasticity test.

3. Case Studies

Descriptive Statistics Analysis Results

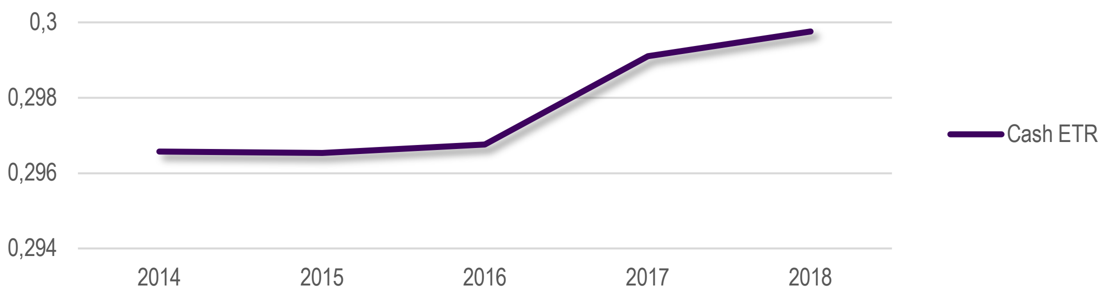
Table 3. Description of Research Variables

Variable	Mean	Median	Maksimum	Minimum	St. Dev
CETR	0.3036	0.2690	0.9140	0.0342	0.1365
DACC	0.0946	0.0891	0.4145	-0.1002	0.0835
INDEP	0.4094	0.3333	0.8000	0.2000	0.1173
Big4	0.4800	0.0000	1.0000	0.0000	0.5009

According to observation results of (n) 200 data, it was obtained that the mean of tax avoidance was 30.36%. This result infers that the average cash used to pay taxes made by manufacturing companies was 30.36% of the profit generated. The result shows that the average of observed manufacturing company practiced earnings management by increasing the profit of 9.46% of total assets in year *t-1*. The proportion of the board of commissioners' variable was 40.94% of the entire board of commissioners. This result indicates that most manufacturing companies on the Indonesia Stock Exchange have fulfilled the minimum 30% independent board of commissioners' regulations. This study signals that Big Four Public Accounting Firms have audited 96 companies in the amount of 48% and non-Big Four Public Accounting Firms have audited the remaining 104 companies or 52%.

Tax avoidance measured using cash effective tax rate, as shown in Figure 2, indicates that CETR continues to increase from year to year. In general, graph 2 suggested that the practice of tax avoidance in manufacturing companies in Indonesia continues to decline from time to time. The highest increase occurred in 2017, where CETR reached 29.91%, wherein that year, many companies in Indonesia participated in utilizing the tax amnesty program so that tax payments increased.

Figure 2. Tax Avoidance Trend in Indonesia



Panel Data Regression Test Results

Using the Chow test and the Hausman test that the Fixed Effect Model was the most appropriate choice of the regression model compared to the Common Effect model and the Random Effect model.

Table 4. Panel Data Regression Results of Model

Dependent Variable: CETR				
Method: Panel Least Squares				
Cross-sections included: 40				
Total panel (balanced) observations: 200				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.944108	0.240716	-3.922089	0.0001
DACC	-0.103052	0.404082	-0.255027	0.7990
INDEP	-1.314941	0.463857	-2.834800	0.0052
Big4	0.062951	0.207189	0.303836	0.7617
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.418148	Mean dependent var		-1.287588
Adjusted R-squared	0.257765	S.D. dependent var		0.449825
S.E. of regression	0.387538	Akaike info criterion		1.133533
Sum squared resid	23.42896	Schwarz criterion		1.859163
Log likelihood	-69.35327	Hannan-Quinn criter.		1.427184
F-statistic	2.607191	Durbin-Watson stat		2.418136
Prob(F-statistic)	0.000009			

The results of the panel data regression analysis test above can be written with the following regression equation:

$$CERT = -0.9441 - 0.1031_{DACC} - 1.3149_{INDEP} + 0.0630_{Big4} + e$$

where: CETR = Tax Avoidance; DACC = Earning Management; INDEP = Proportion of Independent Commissioners; Big4= Audit Quality.

The Effect of Earning Management on Tax Avoidance

The first hypothesis in this study examined the effect of earnings management on tax avoidance. Earning management is carried out by companies to obtain large profits or income following the desires and goals to be achieved by the company. This making is done through the actual activities of the company or utilizing the company's accrual accounts (Tiaras and Wijaya 2015). The results of the estimation test model showed that the earnings management regression coefficient had a negative value and was not significant to tax avoidance. This result indicates that the first hypothesis in this study, which stated that earning management has a significant positive effect on tax avoidance, is rejected.

It requires the company to carefully decide whether it will do earnings management to avoid taxation. On the one hand, the company wants to do earnings management by enlarging earnings that can serve as a positive image in front of investors. Nevertheless, the company also wants to minimize its profits so that the tax burden paid is reduced. Taxation Authority will be suspicious if there are significant differences between commercial profit and taxable income.

Hypothesis 1 is not accepted because management focused on providing sustainable commercial earnings information to shareholders over the purpose of short-term and unsustainable tax avoidance behavior. A similar result is supported by the findings of Hashim *et al.* (2016), who used a sample of going public companies in Malaysia. Their study proved that there was no effect between earnings management using accounting policies that were not under the standards of tax avoidance.

The Effect of Proportion of Independent Commissioners on Tax Avoidance

The second hypothesis in this study stated that the proportion of independent directors had a significant adverse effect on tax avoidance. Based on the test results in Table 4, the variable proportion of independent directors showed a negative relationship under the direction of the prediction and had a probability value that was smaller than the level of significance. It infers that the proportion of independent directors had a significant adverse effect on tax avoidance. Thus, the second hypothesis in this study is accepted.

This result provides evidence that the higher the number of independent commissioners in a company, the lower the level of tax avoidance carried out by the company. The result indicates that the presence of independent directors will provide strict oversight on the management performance, so it encourages the management to comply with laws and regulations, including the present tax rules. Therefore, the presence of an independent commissioner can reduce the practice of tax avoidance (tax avoidance).

This result is in line with the research of Maraya and Yendrawati (2016), which showed that Good Corporate Governance (GCG) could serve as the bridge of the agency problem or optimize both the different benefits (managers and shareholders). GCG is considered as a rule that would generate trust between owners and management. Hence, good governance companies (including the sufficient number of independent directors) will likely do not want to take a risk, like tax avoidance.

Suyanto and Supramono (2012), Maharani, and Suardana (2014) also proved that the proportion of independent directors had a significant adverse effect on tax avoidance. In their observation periods, it was found that there was a growing tendency by the proportion of independent directors in reducing aggressive behavior towards corporate tax avoidance.

The Effect of Audit Quality on Tax Avoidance

The third hypothesis in this study examined the effect of audit quality on tax avoidance. The result of the regression estimation test showed that audit quality had no significant effect on tax avoidance, or H3 was rejected. Audit quality did not have a significant effect on tax avoidance. This result indicates that both the companies audited by the Big Four and non-Big Four KAPs have no significant differences in tackling tax avoidance practices. Audit quality is closely related to the probability of the examiner or auditor's accountant in finding misuse of a unit's accounting system. This finding then reported in the audit report, while the likelihood of finding such fraud requires the ability and high integrity of an auditor.

The result of this study finds a different phenomenon. Big Four Public Accountant Office should have a good reputation and performance as well as professional in auditing. Therefore, the anomalies related to financial statements, particularly fiscal reconciliation, would be tracked and followed up. This good reputation and performance will be considered in making an opinion. Seprini (2016) states that the Big Four KAP has high quality because it shows the real value of the company. Besides, it is more independent as it can withstand more pressure from managers not to report violations. The rejection of the third hypothesis is alleged because manufacturing companies in Indonesia are more audited by non-Big4 KAPs.

However, this result is consistent with research conducted by Winata (2014), Suryani *et al.* (2018) and Sundari and Aprilina (2017). Their investigations found that the company audited by the Big Four KAP with integrity was considered higher. Still, it did not guarantee a company would avoid fraud on financial statements. In connection with agency theory, when auditing, the essential thing in its implementation is transparency, which requires accurate disclosure of financial statements that have been audited by the KAP. If the company can provide benefits and prosperity to the reputable KAP, fraud can occur. This postulate is evidenced by the cases experienced by PT Kimia Farma in 2002. The overstated mark-up financial statements profit disclosure to inflate the net income in 2001 was a form of cheating.

This finding was also proven by two members of the Big Four KAP in 2011, namely KPMG and PwC, who had been fined millions of pounds in fines for failing their audit. KPMG was fined more than 6.2 US$ million or GBP 4.8 million by Securities and Exchanges Commissions (SEC) because of its auditing failure of Miller Energy Resources company. It significantly had increased the carrying value of its assets by 100 times its real value in the 2011 financial statements. KPMG had also issued an unqualified opinion on the financial statements. While, PwC was fined GBP 5.1 million and was condemned by the Financial Reporting Council in the UK after admitting wrongly in its audit of the Tenon Group RSM in fiscal year 2011 (Priantara 2017).

Conclusions

Tax Avoidance of manufacturing companies in Indonesia still occurs. The positive finding of this study is that the trend of tax avoidance gradually decreases from year to year. Testing factors affecting tax avoidance give the result that only the proportion of independent commissioners' variables is proven to be able to reduce the tax burden reduction. While other variables, namely earnings management and audit quality does not significantly affect tax avoidance. The practical implication of these findings is improving compliance with paying taxes, especially independent supervision need to be taken into account.

This study only used cash ETR to measure the level of corporate tax avoidance. Further research is expected to add another proxy to measure tax avoidance and can serve as a comparison to see trends in tax avoidance. The contribution of this research is expected to be beneficial for the government, especially tax policymakers. Moreover, the results of this study are expected to provide an overview of tax avoidance activities for manufacturing companies. The government needs to enforce taxation rules through increased transparency and disclosure (additional) as well as closing the loophole on taxation rules. It is more important to reduce the aggressiveness of the tax is to raise awareness for the taxpayer through improved tax policy and increased tax disbursements accountability.

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