# CHAPTER I
# INTRODUCTION

## 1.1 BACKGROUND OF THE STUDY

Tax is the primary source to obtain state revenue of a country in which may affect the national economy significantly. It is used to defray all government's expenditures including expenditures of national development. Indonesia's state revenue is also primarily obtained through tax realization revenue. According to Law No. 16 year 2009 Article 1 (1) on General Provisions and Tax Procedures, tax is defined as a mandatory contribution for the country which is withheld by individuals or entities and enforceable under the law, without any special benefit conferred and used for state purposes. In accordance with the data from year 2012 to 2017 (see figure 1.1), state budgeting of Indonesia has shown that Indonesia earns revenue from tax sector for approximately 79.38% of total state revenue. It means almost 80% of state revenue is obtained through tax sector which is a great potentially income in respect of continuing its national development plans and executing other state purposes. Considering the huge potential revenue given by tax sector, government of Indonesia should optimize tax revenue for maximizing the state revenue.

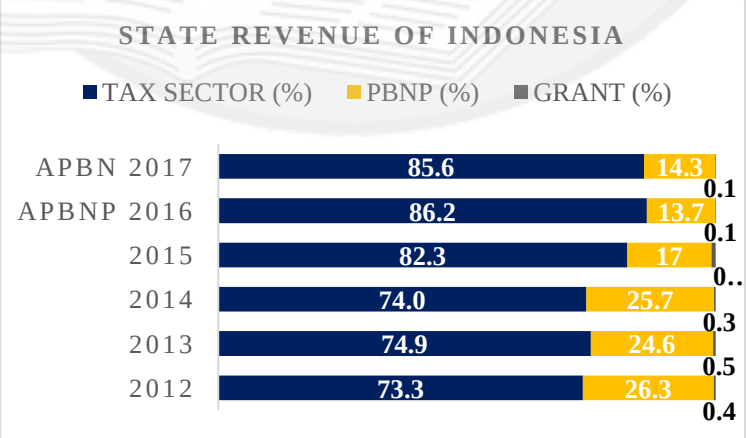


**Figure 1.1. Tax Revenues of Indonesia Year 2012 – 2017**
Source: *Kementerian Keuangan Republik Indonesia* (2017)

In implementing the practice of tax realization revenue, entity taxpayer is one of the tax subject which gives great contribution. However, purpose of government to collect tax revenue maximally are contradicting with the main purposes of entity taxpayer in earning profits. For instance, the information retrieved from CNN Indonesia (2016) which said about the issue of Panama Papers which offered big opportunities for the rich to establish companies in the state of tax haven to manage their own personal finance in respect of minimizing tax burden. It is a huge potential evidence of tax avoidance that happened globally, including in Indonesia. Company assumes tax as a burden towards their developing activities. The contradiction leads to difference of interests between government and entity, where government has purpose to maximize the tax realization revenue and entity as taxpayer desires to minimalize the tax burden to the state. This situation can be seen through low amount of state tax revenue realization in accordance with OECD Economic Surveys for Indonesia (2016). It gives direct impact to constrained Indonesia development.

In the world of business, Otley (1999) mentioned that profit is a substantial indicator to assess the financial performance of company in which becomes the primary objective of a business organization to notice the company's achievement. Profit is the primary information which is used to estimate the company's financial performance. Rahman, Moniruzzaman, and Sharif (2013) stated in his research that company with high profit outlook possesses stock price over company with low profit outlook. Fundamentally, profit is a crucial indicator to attract investors in investing the company. This statement can be supported by the 'Clientele Effect' theory which explains the movement of company's stock price is influenced by the purpose of investors in reaction to profits usage, dividends, policy and procedure changes. Greater profits will allow the company to have greater opportunities from investors to support their operational activities. However, profit is

a tax imposition basis of the entity taxpayer in accordance with statement from Belkaoui (2005). This is the primary reason why company always try to manipulate the profits, which is to avoid paying taxes. Higher profits earned by the company will result in higher tax obligations that should be imposed by the company.

Due to the situation exists, manager of company is driven to manipulate the information of profit at a certain level for certain purposes. The manipulation activity is also referred as earning management in which mostly implemented by abusing the gap of accounting principle. Earning management is managing profit at the level which is not appropriate to the real circumstances that may disadvantage stakeholders of the company. The statement is appropriate with the research statement from Scott (2006) and Subramanyam (2008) stated that earning management is an activity to polish company's profit which is not accordance with the actual condition.

According to Rahman, et.al (2013), one of the reasons to do earning management is to minimalize tax liability. Company assumes tax as the burden for the company in maximizing profits. Therefore, management of the company does implement earning management in respect of minimizing tax burden. Company should implement the strategy of earning management safely and legally. One of the ways to implement it is by doing tax avoidance. Mortenson (1959) defined tax avoidance as the method to reduce, avoid, as well as minimize the tax burden through every possible 'loopholes' which are legal according to tax regulations and also analyzing the impact of taxation that may happened due to the implementation. The practice of tax avoidance differs from tax evasion, Mortenson (1959) stated tax evasion is an illegal practice by an organization that intentionally avoids paying its true tax liability.

Although tax avoidance is a legal practice, government seems to be not satisfied. Practically, tax avoidance allows entity taxpayer

unintentionally breaking the law but it is inappropriate towards taxation law purposes. Prakosa (2014) explained that tax avoidance is a legal method to avoid tax due to its compliance level which does not violate the applicable law and principle. However, the implementation will disadvantage government in respect of minimizing the state budgeting. Tax avoidance practice is a contradictive between the company and the government. Both have their own purposes to advantage themselves. Therefore, tax avoidance is a practice conducted by corporate that disadvantages government.

A good corporate governance should be implemented due to the irrelevance practice of earning management. The implementation of good corporate governance is used to control and maintain compliance of management towards the tax liability. It gives protection for the company's stakeholders on the level of compliance, defined by Indonesia Institute for Corporate Governance (IICG, 2009). In addition, Maher and Andersson (1999) wrote on OECD that corporate governance is also used to minimize agency problems which are the conflicts happened due to interest differences between manager and owner of the company. In accordance with Fadhilah (2014), a good corporate governance has two mechanisms which purposely to create a value added for investors by controlling and maintaining the internal as well as external factors of the company.

Earning management are interesting to be investigated because there are several cases of manipulating profits within Indonesia or foreign country as well. For instance, the case of Asian Agri Group (AAG), published on ekonomi.kompas.com (2014), which underpaid its tax obligation for 2002-2005 period with amount of IDR 1,25 trillion in accordance with the Supreme Court. Armstrong, Blouin, Jagolinzer, and Larcker (2013) stated that earning management on tax avoidance mostly happened at advanced development country in accordance with their research "Corporate Governance, Incentives, and Tax

Avoidance". In addition, Directorate General of Tax ever stated that 4,000 companies in Indonesia were reporting nil tax liability at 2012 as it is retrieved from kompasiana.com (2013).

Not only in Indonesia, earning management is widely used by multinational companies to fulfill their own purposes. Jamaludin, Sanusi, and Kamaluddin; researchers from Mara Technology Malaysia University (UiTM); did research about the 'Board Structure and Earnings Management in Malaysian Linked Companies' (2015) which discuss there is a positive relationship between the board structure offered by corporate governance towards the earning management. Another UiTM researchers; Kazemian and Sanusi (2015) concluded that earning management is influenced by the institutional ownership structure in their research 'Earnings Management and Ownership Structure'.

Country such as India also does research about earning management. Researchers from Indian Institute of Technology; Kaur, Sharma, Khanna (2014); found out that majority of companies on their findings are included in the implementation of earning management. One of the most well-known companies in Japan, Toshiba Corporation, was reported manipulating financial statements of the company. In accordance with the news from CNN Indonesia (2015), Chief Executive Officer of Toshiba Corp, Hisao Tanaka, had resigned due to accountancy scandal in the recent years. The results of investigation showed that Tanaka is proven manipulating financial report by marking-up profits of the company for US$1,2 billion.

In addition, the awareness of earning management activities also generate many interests from researchers over the world. González and García-Meca (2013) stated that high level ownership of the firm which exists in Latin American companies, listed on the primary stock markets of Latin American during the period 2006–2009, has negatively affected the quality as well as transparency of its financial information

issued to the market. The institutional ownership influences the manipulative practices in which they suggested the practices will be restricted, only if the proportion of shares owned by internal committees is low. Moreover, earning management implementation is examined in Nigeria as well. Uwuigbe, Peter, Oyeniyi (2014) found out the impact of independent parties give an effective as well as positive solution on the practice of earning management. As they did research on the 40 corporate that listed in the Nigerian stock market for the period 2007-2011, they concluded that independence level of board of commissioners will generally improve the efficiency ability in monitoring the top management activities which relate to earning management. Therefore, researcher is interesting to investigate the relationship among earning management, tax avoidance, and corporate governance applied by Indonesia's property sector.

## 1.2 PROBLEM LIMITATION

To fulfill the criteria of focus and profound research, the writer limits the scope of research. The researcher limits the problems that only related to the earning management, tax avoidance, and corporate governance.

## 1.3 PROBLEM FORMULATION

Referring to the background of study which has been described previously, the problems can be described as follows:

1. Do size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance have relations towards earning management?
2. What are the relationship's effect of size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of

managerial ownership, and tax avoidance on earning management?

3. How robust are the impact of size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance on earning management?
4. How much do size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance determine earning management?

## 1.4 OBJECTIVE OF THE RESEARCH

The purpose of this study is:

1. To identify whether size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance affect earning management.
2. To analyze the relationship's effect of size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance towards earning management.
3. To investigate how robust the impact of size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance on earning management.
4. To determine how much size of board of commissioners, proportion of independent board of commissioners, amount of audit committee, proportion of managerial ownership, and tax avoidance affect earning management.

## 1.5 BENEFIT OF THE RESEARCH

### 1.5.1 THEORETICAL BENEFIT

1. For the writer, this research is used to enhance the knowledge of how significant corporate governance and tax avoidance affect the earning management.
2. For the company, this research will give insights and knowledge about the importance of corporate governance towards tax avoidance and earning management.
3. For the government, this research is used to analyze the appropriate percentage of how significant the relationship among corporate governance, tax avoidance, and earning management.

### 1.5.2 PRACTICAL BENEFIT

For the company, this research will give knowledge about the impact of corporate governance and tax avoidance on earning management.

## 1.6. SYSTEM OF WRITING

As the result of data collection as well as to simplify the discussion and understanding of this research, the writer had divided the research into five chapters which are elaborated into its sections. These are the following systems of writing:

**CHAPTER 1. INTRODUCTION**

This chapter explains the information about the research such background of the study, problem limitation, problem formulation, objective of the research, significance of the research, and systems of writing. Problem limitation only consists related information and data of corporate governance, tax avoidance, and earning management. And,

objective of the study is to find out the relationships, relationship's effects, how robust are the relationships, and how much determination of corporate governance elements as well as tax avoidance on earning management applied by property sector in Indonesia for 2013 – 2016.

**CHAPTER 2. LITERATURE REVIEW**

This chapter explains the review towards the information and statements that are given by experts, government, as well as trusted sources on theoretical background, prior research, and framework of thinking. The theoretical background is including the definition as well as the explanation of Effective Tax Rate, Tax Avoidance, and Corporate Governance.

**CHAPTER 3. RESEARCH METHODOLOGY**

This chapter shows the concept and methods that are used by the writer to do the research such as research design, research object, data collection method, and data analysis method. Data analysis method consists of multiple regression linear model, classical assumption test, and hypothesis testing. Classical assumption test is including normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test. Furthermore, hypothesis test consists of coefficient of determination, F – Test, and T – Test.

**CHAPTER 4. DATA ANALYSIS AND DISCUSSION**

This chapter describes the general description of research object and data analysis. In this case, the research discusses the impact of corporate governance and tax avoidance on earning management by implementing double linear regression model. There are 4 independent variables within the corporate governance: size of Board of Commissioners, proportion of Independent Board of Commissioners, size of Audit Committee, and proportion of Managerial Ownership. In addition, Earning Tax Rate (ETR) is used as the proxy in measuring the independent variable of Tax Avoidance.

## CHAPTER 5. CONCLUSION

This is the last chapter of doing the research which consists of conclusion and recommendation. The research outcome is that Board of Commissioners, Independent Commissioners, Audit Committee, Managerial Ownership, and Tax Avoidance are simultaneously influencing the Earning Management. Moreover, Tax Avoidance is the only independent variables which has impact and negative impact towards the implementation of earning management. The other 4 independent variables do no have any impact on earning management. Size of Board of Commissioners, proportion of Independent Board of Commissioners, size of Audit Committee, proportion of Managerial Ownership, and Tax Avoidance are able to determine Earning Management for 15.2%.