ADLN-PERPUSTAKAAN UNIVERSITAS AIRLANGGA

CHAPTER 2

LITERATURE REVIEW

This chapter will explain the theory which consists of the theoretical review, previous research, hypothesis, and conceptual framework.

2.1 Theoretical Review

This part will explain about the agency theory as a grand theory for this research and some theoretical review came from previous research for tax avoidance as dependent variable and corporate governance that consist of independent commissioners, audit committee, institutional ownership, and audit quality as independent variables.

2.1.1 Agency Theory

Jensen and Meckling is the primarily developed of the agency theory and become a popular tenet in corporate governance today (Kulik, 2005:348). Agency theory is a foundation that used for understanding the corporate governance concept and this theory occur when a contract between the agent and the principal happened (Hanum and Zulaikha, 2013:2). This also proposed by Maijoor (2000:101) that claims corporate governance issues such as monitoring mechanisms are very much related to agency theory. The theory postulates that the separation of ownership and management functions lead to principal-agent conflicts as the managers may pursue their own interest at the expense of the

principals (Ugurlu, et al., 2000:566). As well as Bryant and Davis (2011:20) explained that agency theory broadly states, given that agents of an organization are responsible for conducting business in the interest of the organization, and given that an agent‟s own self interests will never align completely with the interests of the organization, agents of an organization will sometimes experience conflicts of interest when conducting business on behalf of the organization. This can be said that agency theory has enriched our understanding of transactions specific to the agency problem that the differences in goals and incentives of principals and agents and the risk preferences of these parties (Droege and Spiller, 2009:44).

Further for agency problem that can occur since the principal and the agent enter into a contract that defines the relationship. Henderson (2004:416) said while negotiating such a contract both the principal and the agent will recognize that the other party is a self-interested individual. An agency problem arises because the agent may not act in the best interest of the principal. Same with Kulik (2005:348) states that agency theory in a public corporation, there exist a central problem with regard to shareholders‟ interest: top management does not always act to maximize shareholders‟ return on investment. If the agent acts to use the wealth from principal to himself, it can be called as agency cost. Supported by Kulik (2005:349) agency costs is a divergence of interest that generates a divergence of managerial attention to his or her interest, and not to the interests of the shareholders. Thus, agency theory assumes that publicly held firms endure by finding ways to efficiently solve the agency problem by aligning their managers‟

behavior with shareholders" interests in such a way that agency costs are low enough to allow for the creation of corporate profits.

Agency theory can lead an agency conflict. As mentioned by Siallagan and Machfoedz (2006:2) the separation of ownership could lead to conflicts in controlling and managing the company, causing managers to act not in accordance with the wishes of the owner. Conflicts arise from the separation of ownership is called the agency conflict. This agency conflict can be solved with corporate governance mechanisms (Bernhart and Rosenstein 1998:2) such as the structure and board of directors in which there is an independent commissioner, audit committees, institutional ownership, and audit quality.

Tax policies are carried out in an enterprise is also influenced by the policies implemented by the manager in the tax report as the application of agency theory. Also as said by Minnick and Noga (2009:9) the implementation of corporate governance mechanism has varying relationships direction towards the payment of taxes. This depend on the management whether to use the tax incentives or other tax policy to minimize their tax including do the tax avoidance. This can be said that agency theory had a further effect to the company such as the implementation of the tax avoidance.

2.1.2 Tax Avoidance

Hanlon and Heitzman (2009:2) tax avoidance is defined as the reduction of explicit taxes per dollar of pre-tax accounting earnings. Desai and Dharmapala (2009:537) said that tax avoidance activity as a transfer of value from the state to

shareholders. Tax avoidance is the legal utilization of the tax regime to one‟s own advantage, to reduce the amount of tax that is payable by means that are within the law (Pasternak and Rico, 2008:33). This can be said that tax avoidance is a legal utilization of tax policy to reduce explicit taxes of pre-tax accounting income as a transfer value from the state to shareholder activity.

Tax avoidance is a kind of tax planning which is kind of tax management. Tax planning is a first step for tax management by doing collecting and researching for tax law to know the kind of thrift tax that will be done (Suandy, 2011:7). Also Wang (2010:2) said that tax avoidance as representative a continuum of tax planning strategies, encompassing activities that are perfectly legal and more aggressive transactions that fall into grey area. Generally, the purpose of tax planning is to reduce the tax obligation. As well as Suandy (2011:7) said tax planning is the systematic analysis of deferring tax options aimed at the minimization of tax liability in current and future tax periods. Also Lyons (1996:303) said that tax planning is arrangements of a person‟s business and/or private affairs in order to minimize tax liability.

Tax avoidance is a term used to describe the legal arrangements of tax payer‟s affairs so as to reduce his tax liability. It‟s often to pejorative overtones, for example it is use to describe avoidance achieved by artificial arrangements of personal or business affair to take advantage of loopholes, ambiguities, anomalies or other deficiencies of tax law. Legislation designed to counter avoidance has become more commonplace and often involves highly complex provision (Lyons, 1996:303). Suandy (2011:7) more explained if the objection of tax planning is

tricking tax burden as low as possible with using the available regulation but different objection with the law-makers, it can be called tax avoidance. In Essentially tax avoidance trying to maximize the after tax return because tax is a profit reducing for the investors or retained earnings. Most companies are involved in tax avoidance extensively with the purpose of reducing their income taxes since the income tax expenses will reduce their profits (Noor et al., 2010:189) the effect will be tax avoidance becoming the main concern of governments (Gravile, 2009:3).

Tax avoidance is engineered 'tax affairs' which still remain in the frame of tax provisions (lawful). Tax avoidance may occur in the sound or written provisions in legislation and are in the soul of the law or can also occur in the text of the law but contrary to the spirit of the law (Suandy, 2011:7). Fiscal affairs committee of Organization for Economic Cooperation and Development (OECD) says there are three characters following the tax avoidance that is the artificial element in which various settings as - if there is in it but it is not, and this is done in the absence of tax factors, often take advantage of loopholes legislation or implementing legal provisions for various purposes, but that is not what is actually meant by the legislator, confidentiality as well as the shape of the scheme in which the consultants generally show a tool or a way to tax avoidance by taxpayers keeping requirements secret than possible (Council of Executive Secretaries of Tax Organizations, 1991).

Dyreng, Scott D, et al (2010:1164) proposed the broad and easy to understand measures of tax avoidance by two standard measures. The first is the

firm‟s effective tax rate as defined under GAAP (GAAP ETR), which is total expense (current plus deferred tax expense) divided by pre-tax accounting income (adjusted for special items). The second measure is the firm‟s cash taxes paid divided by pre-tax accounting income adjusted for special itemshereafter, cash effective tax rate, or CASH ETR. The second measure is the firm‟s cash taxes paid divided by pre-tax accounting income (CASH ETR). More suitable in Indonesia proposed by Hanum and Zulaikha (2013:3) said that effective tax rate (ETR) will be measured by current tax expense divided by income before tax. In my opinion, tax avoidance is the effort to reduce the taxable income but accordance with tax regulation. In this research was come from Hanlon and Heitzman (2009:2) explanation that do tax avoidance without break the tax law.

$$Cash\ ETR = \frac{Current\ Tax\ Expense}{Income\ Before\ Tax}$$

2.1.3 Corporate Governance

Corporate governance is a study of the relationship directors, managers, employees, shareholders, customers, creditors and suppliers of the company and the relationship between each other (Monks and Minow, 2004:9). Irawan and Aria (2012:9) explained that the central issue of corporate governance is based on the separation between ownership and control of the company. Also the corporate

governance is defined as the effectiveness of the mechanisms aimed at minimizing agency conflict, with particular emphasis on legal mechanisms preventing the expropriation on minority shareholders (Johnson et al., 2000:141). It is closely related to trust either of the companies that execute them or to the business climate in a country (Sulistyanto and Lidyah, 2002:1). It can be said that corporate governance is a term that regulated the relation between directors, managers, employees, shareholders, customers, creditors, and suppliers of the company based on the ownership and control of company to minimizing agency conflict to make a good business climate in a country.

The principles of corporate governance in Indonesia stipulated in the Decree of State Minister (*Keputusan Menteri*) Kep-117/M-MBU/2002 on the implementation of good corporate practices in Chapter II Article 3 includes the five principles of transparency, independency, accountability, responsibility, and fairness. This five principles are very important because the application of the principles of good corporate governance consistently proven to improve the quality of financial reporting (Desai and Dharmapala, 2009:538). The Indonesian Institute for Corporate Governance (IICG) express purpose of good corporate governance is to regain the trust of investors and national and international creditors, meet the demands of global standards, minimizing the cost of losses and the cost of prevention of abuse of authority management, minimizing the cost of capital to reduce the risk faced by creditors, increasing the value of company stock, and raised the company's image in public eyes. Corporate governance has benefits to reduce agency cost consisting of the costs of monitoring and bonding

costs (Watts and Zimmerman, 1986). Corporate governance can reduce monitoring costs due to increasing supervision and transparency (or decrease information asymmetry). While bonding agency costs are costs incurred by the agent, which reflect management's efforts to demonstrate to the principal that they will not abuse the authority given to him (Kusumawati and Riyanto, 2005:2).

In the research of Hanum and Zulaikha (2013:3) used three component of corporate governance there are independent commissioners, audit committees, and institutional ownership. While in the previous research of Annisa and Kurniasih (2012:127) used board of committee, audit committees, institutional ownership, and audit quality. In further this research will use five characteristics of corporate governance, there are independent commissioners, audit committees, institutional ownership, managerial ownership, and audit quality. This component of corporate governance had presented the internal and external factor of corporate governance. The independent commissioners, audit committees, and managerial ownership are the internal factor of corporate governance. Meanwhile, the institutional ownership and audit quality presented the external factor of corporate governance. These factors will confirm whether it can confirm to corporate governance or not. The confirmatory method was chosen for knowing the confirmed variable for the next process of the relation.

2.1.3.1 Independent Commissioners

The Board of Commissioners is the core of corporate governance assigned to ensure the implementation of corporate strategy, overseeing management in managing the company, as well as requiring the implementation of accountability.

Also the Independent commissioner is really needed for developing a company as a part of commissioners. Independent commissioner is defined as a person who is not affiliated in any way with the controlling shareholder, has no affiliation with the board of directors or board of commissioners and not served as a director of a company associated with the company owner according to regulations issued by the Stock Exchange, the number of independent commissioners proportional to number of shares held by shareholders who do not act as a controller with the provisions of the number of independent commissioners at - least thirty percent (30%) of all members of the commissioner, in addition it is an independent commissioner to understand laws - laws and regulations on capital markets as well as proposed by shareholders stock which is not a controlling shareholder in the General Meeting of Shareholders (Pohan, 2008).

Based on agency theory, that the greater the number of independent commissioner on the board of commissioners, the better they can fulfill their role in overseeing and controlling the actions of the executive director. The premise of agency theory is that the independent commissioner on the board of directors is required to supervise and control the actions of directors, in connection with their opportunistic behavior (Jensen and Meckling, 1976:305). Independent commissioners along the other commissioners, together perform supervisory duties and determine the long-term policy strategy and short-term benefit for the company, but did not break the law included in the determination of tax-related strategies (Hanum and Zulaikha, 2013:4). It can be hoped that independent commissioners can give the effective and efficient result for taking the company

decision making beside other commissioners and shareholders. Variable independent commissioner measured by looking at the proportion of independent commissioner on the board of commissioners based on Hanum and Zulaikha (2013:4).

$$\text{Independent Commissioners} = \frac{\text{Total of Independent Commissioners}}{\text{Board of Commissioners}} \times 100\ \%$$

2.1.3.2 Audit Committee

The audit committee has become a common component in corporate structure governance of public companies. The audit committee is an additional committee that assists the board of directors in overseeing the company's management based on the decision of the Chairman of Bapepam Number Kep-29/PM/2004. The audit committee can be an effective tool to conduct oversight mechanisms, reducing agency costs and improve the quality of corporate disclosures. Pohan (2008) in his research explained that the board of directors shall establish an audit committee consisting of at least three members, appointed and dismissed and responsible to the board of commissioners. The audit committee consisting bit, it tends to act more efficiently, but also have adequate weakness, namely the lack of diversity of experience of members, so that the members of the audit committee should have an adequate understanding of the financial reporting and internal control principles (Annisa and Kurniasih, 2012:126).

The audit committee function provides an overview of issues related to financial policy, accounting and internal control (Sharma, et al., 2009:245). Based on the function of the audit committee is to help commissioners to avoid asymmetry of information by monitoring and making recommendations to management and the board of commissioners of the controls that have been run (Hanum and Zulaikha, 2013:3). This committee also serves as supervisor of financial reporting process and internal controls, as IDX requires all issuers for to establish and have an audit committee chaired by an independent commissioner (Annisa and Kurniasih, 2012:126). Therefore the more control for a company management that can be resulting the high quality information and effective working. The audit committee variables measured by the total number of committee members in a company.

Audit Committee = Total Number of Committee Members

2.1.3.3 Institutional Ownership

Institutional ownership share holding company is majority owned by the institution or institutions (insurance companies, banks, investment companies, asset management and other institutional ownership) Anggraini (2011:26). By large institutional owners and rights votes held, institutional ownership may force managers to focus on economic performance and avoid opportunities for self-interested behavior (Annisa and Kurniasih, 2012:125). It can be said that

institutional ownership can had a big part to handle the work of the operational company.

The institutional ownership can be really useful for determining the aggressiveness of tax policy. Results of research conducted by Mahdi and Fariba (2013:55) is the size of the concentration of institutional ownership will influence of aggressive tax policy by company, and a greater concentration short-term institutional ownership will increase aggressive tax policy, but increasingly large concentration of ownership of long-term shareholder will further reduce the action aggressive tax policy. Institutional ownership as originating from an external supervisor will encourage the management company by monitoring the company's management in order to generate profits based on the rules that apply, because it is basically more institutional ownership to see how much management obey the rules in generating profits (Hanum and Zulaikha, 2013:7). Based on the explanation there is an indication of institutional ownership have contributed to the establishment of policies related to the effective tax rate. Institutional ownership variable measured by the proportion of institutional ownership based on the number of existing investors in a company.

$$\text{Institutional Ownership} = \frac{\text{Total of Institutional Ownership}}{\text{Number of Existing Ownership}} \times 100\ \%$$

2.1.3.4 Managerial Ownership

Managerial ownership is the stockholders which also the owner of the company from management who actively participate in decision making of the company (Murwaningsary, 2009:32). In the agency theory explained that the

interests of management and the interests of shareholders may conflict. The case is about resulting managers prioritize personal interest, otherwise shareholders not like personal interest of the manager, since such spending would add to the cost of the company. From this case Jensen and Meckling (1976) found that managerial ownership managed to become mechanisms to reduce agency problems aligning the interests of managers with the interests of managers with shareholders. Their research found that the manager population with external shareholders' interests can be put together if managerial ownership enlarged so that the manager will not manipulate earnings to its interests. This can be concluded that managerial ownership can reduce the agency problems between external and internal part of the company because the tendency doing manipulated is reduced since they have the part of company stock.

In doing the good corporate governance, the managerial ownership is an essential part to build a public trust to make a good and healthy corporation. As the research by Herawaty (2004:102) managerial ownership had other motive. In the research based on the theory, she said that managerial ownership can be useful as corporate governance mechanism that can reduce the manager act in profit manipulating. This the side effect by the managerial ownership beside the reducing profit manipulating, to make a trustable company as a result of doing good corporate governance.

Based on the explanation, as a part of corporate governance, managerial ownership is the number of shares held by management in a company. The

proportion of managerial ownership is measured based on the percentage of ownership. Here is the formula.

$$\text{Managerial Ownership} = \frac{\text{Total of Management Share}}{\text{Number of Existing Share}} \times 100\ \%$$

2.1.3.5 Audit Quality

Audit quality comprises actual and perceived quality (Taylor, 2005:3). Actual quality is the degree to which the risk of reporting a material error in the financial accounts is reduced, while perceived quality is how effective users of financial statements believe the auditor is at reducing material misstatements. Higher perceived audit quality may then help promote investment in audited clients (Jackson, et al., 2008:422). Further explained by Mukti and Wardhani (2012:171) that audit quality increases with the size of the public accounting firm used by the company because the bigger the public accounting firms the more ability to specialize and innovate through technology. Thus, the possibility to find violations in the company‟s accounting system is larger than the small public accounting firm. With the resources and comparative advantages held by large auditors, the error detection and correction of the company‟s financial reporting can be done well (Mukti and Wardhani, 2012:171).

Audit quality plays a role in revealing transparency as one important element in corporate governance. In their research, Annisa and Kurniasih (2012:126) said that transparency to shareholders can be achieved by report related matters of taxation on the market capital and shareholders meetings. The

public accounting firm take an important side to present a reliable report that had transparency to the shareholder side to avoid the unexpected thing happened by management.

As Annisa and Kurniasih (2012:126) stated that the financial statements were audited by auditors from The Big Four Public Accountant Firm, according to some reference more credible quality so show the actual value of the company, therefore, suspected of companies audited by the Firm of The Big Four (PricewaterhouseCoopers - PWC, Deloitte Touche Tohmatsu, KPMG, Ernst & Young-E&Y). This research will use this measurement to measure the audit quality variables.

2.2 Previous Research

Several of empirical researches have been conducted and chosen to find the effect of corporate governance for corporate tax avoidance. These researches are used as a contribution for this research. The research that conduct by Hanum and Zulaikha (2013) about The Effect of Corporate Governance Characteristics for Efective Tax Rate that used State-Owned Enterprises Listed in Indonesia Stock Exchange in year 2009-2011 found that the component of corporate governance had not significant effect for effective tax rate. This Fifty (50) State-Owned Enterprises (SOEs) samples research used independent commissionaire, audit committee, and institutional ownership as corporate governance elements which regress to the effective tax rate that used as a proxy for the current research.

Annisa and Kurniasih (2012) researched about The Effect Of Corporate Governance For Tax Avoidance found that institutional ownership, the percentage of independent board, and the number commissioners had not significant effect to tax avoidance. Eventhough, this 200 companies of 2008 listed companies sample research found that number of audit committee and audit quality had an effect to tax avoidance. Sources: Appendix 1.

2.3 Hypothesis

In this section will be explained about how the hypothesis made and the explanation about the relation of inter-variable.

2.3.1 The Effect of Corporate Governance to Tax Avoidance

Corporate governance consist external and internal component. There are independent commissioner, audit committee, and managerial ownership as internal factors and institutional ownership and audit quality as external factors. Independent commissioner is a part of corporate governance that had important role on major policy of Effective Tax Rate for company as known for the proxy of tax avoidance (Hanum and Zulaikha, 2013:3). The research that conduct by Annisa and Kurniasih (2012:125) found that the corporate governance that consist of increasing in the percentage of independent board to the number of commissioners as a whole does not significantly affect tax avoidance policy that done by a company. Independent board that is part of the commissioners did not perform supervisory functions well against management (Antonia in Hanum and Zulaikha, 2013:6).

The audit committee will assure financial reporting required by the shareholders of the company. In doing corporate governance, audit committee had an important role to monitoring and evaluating the performance of the company. Annisa and Kurniasih (2012:126) found that there is a significant influence of number of audit committee on tax avoidance because the existing audit committee in accordance with the terms of the Stock Exchange that requires the least amount of audit committee should be three people, less than three persons, not accordance with the regulations IDX (Pohan, 2008), so if the number of audit committee of a company not in accordance with the IDX rules will improve management in conducting minimization measures for the sake of profit tax (Pohan, 2008). On the other hand, the result of Hanum and Zulaikha (2013:6) found that audit committee had positive effect but not significant for effective tax rate, but this happened because the audit committee, which is part of the company have the task of monitoring and evaluating the performance of operational company did not go well.

As a part of corporate governance, managerial ownership in Jensen and Meckling (1976) found that managerial ownership managed to become mechanisms to reduce agency problems aligning the interests of managers with the interests of managers with shareholders. In addition, the managerial ownership is an essential part to build a public trust to make a good and healthy corporation. Herawaty (2008:102) said that managerial ownership can be useful as corporate governance mechanism that can reduce the manager act in profit manipulating. This the side effect by the managerial ownership beside the reducing profit

manipulating, to make a trustable company as a result of doing good corporate governance. With a trustable management hopefully can decrease a tax avoiding act in the company.

Institutional ownership invest in a company for a profit as high the dividend will got, so often invest in large numbers and become the majority shareholder. Basically institutional ownership better see how far management obey the rules in generating profits. Based the explanation there is an indication of institutional ownership in doing corporate governance have contributed to the establishment of related policy effective tax rate (Hanum and Zulaikha, 2013:3).

Audit quality plays an important role in the disclosure of transparency to shareholders. Increased transparency to shareholders in the case of taxes increasingly demanded by authorities public (Annisa and Kurniasih, 2012:126). The reason is the presence of assuming that the tax implications of behavior aggressive, shareholders do not want the company take an aggressive position in terms of tax and would prevent such actions if they know beforehand (Annisa and Kurniasih, 2012:126). The results of their study are significantly so if a company is audited by Public Accounting Firm (*Kantor Akuntan Publik*) The Big Four will be more difficult to make tax policy aggressive. If the nominal tax to be paid too high usually will force companies for tax evasion, the more qualified the audit of a company, then these companies tend not to do manipulation of profit for tax purposes.

Based on explanation above about the corporate governance content, therefore the proposed hypothesis is:

H1: The corporate governance has an effect on tax avoidance.

2.4 Conceptual Framework

In this framework, there are independent commissioner, audit committee, institutional ownership, managerial ownership, and audit quality as a reflective factor for corporate governance. The corporate governance became the independent variable, and tax avoidance became the dependent variable. The component of corporate governance will confirm their value of corporate governance. Also the corporate governance processes the direct effect to tax avoidance.

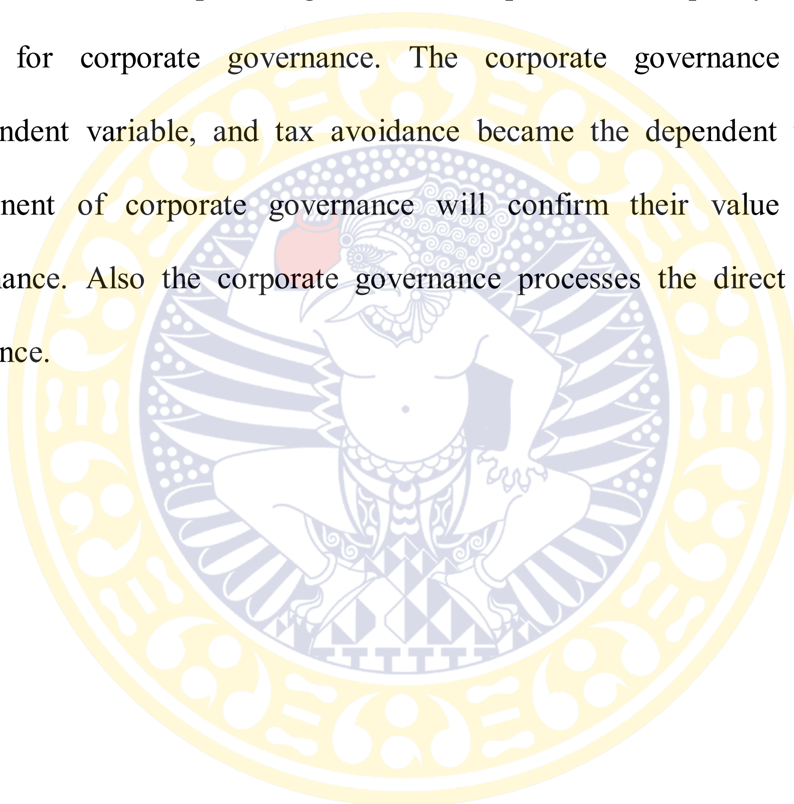

Figure 2.1 Conceptual Framework