

DO DIRECTORS AND TAX AGGRESSIVENESS AFFECT FRAUDULENT FINANCIAL REPORTING?

Wiralestari¹⁾ and Riski Hernando²⁾

Accounting Major, Economic and Business Faculty, Universitas Jambi, Indonesia^{1, 2)}

ABSTRACT

Tax is an obligatory financial contribution that individuals or institutions, as taxpayers, owe to the state without any direct benefits. It is compulsory and is collected under the regulation of law. The present research aims to examine the effectiveness of directors' supervision and tax aggressiveness in diminishing frauds in financial reporting. The subject of this research is manufacturing companies listed in Indonesia Stock Exchange. This research using logistic regression analysis. The results of this research show that, firstly, effective directors' supervision has significant influence to diminishing fraudulent financial reporting. Directors, as the leaders of the company, demonstrated that they could perform their supervisory function very well. Secondly, tax aggressiveness has significant influence to diminishing fraudulent financial reporting.

Key words: *Directors, tax aggressiveness, fraudulence in financial reporting.*

Corresponding author: wiralestari11@unja.ac.id

Email addresses for author: wiralestari11@unja.ac.id , riskihernando@unja.ac.id

First submission received: 16 Oktober 2019

Revised submission received: 08 Januari 2020

Accepted: 10 Januari 2020

INTRODUCTION

Indonesia implements a self-assessment system which facilitates both individual and institutional taxpayers (Rochmat Soemitro, 2014). Some taxpayers abuse this system to avoid tax, whether under the letters of the law (tax aggressiveness) or against the taxation regulation. They do this by manipulating the company's taxable profits through legal or illegal taxation planning (Frank et al, 2009). Association of Certified Fraud Examiners (ACFE) (2018) found that manufacturing industry suffered the most from fraudulent financial reporting in Asia-Pacific region. The industry suffered an average of 500,000 US Dollar (US\$ 500,000) loss from 17% or 33 cases of fraudulent financial reporting.

Richard Susilo (2017) noted that a survey conducted by Ernesto Crivelly had found that Indonesian companies were ranked 11 of 30 countries in terms of aggressive taxation. These companies did not pay their tax to Indonesia Tax Offices, amounting to 6.48 billion US Dollar. Imanuel Hakim (2018) argued that there are four sectors of industry in Indonesia that frequently avoid tax by transfer pricing. The four sectors are mining industry, plantation industry, electronic industry, and automotive industry. Fraudulent financial reporting happens because companies attempt to reduce the amount of tax paid. They can reduce the amount of tax while still adhering to tax rules and regulations (tax avoidance) and reduce the amount of tax value by not following the tax law (tax evasion) (Brian and Martani, 2014). Chen et al (2010) noted that company owners tend to prefer that the company management performs tax aggressiveness.

Tax aggressiveness is an activity aimed to reduce the taxable income (profit) through tax planning which may or may not involve both tax evasion and tax avoidance (Frank et al, 2009). Even though not all tax reporting aggressiveness is breaking the law, the more opportunities a company exploits, the more aggressive the company (Dewi Kartika Sari and Dwi Martani, 2010).

Dhaliwal et al (2004) argued that company managers consider the tax department as the center of profit who is responsible for increasing the company's cash flow through aggressive tax reporting and income management by estimating their tax expense. Therefore, consistent with this view, it is expected that companies can be aggressive in their financial and tax reporting (Frank et al, 2009). This opportunity encourages the managers to exploit complex tax evasion strategies to reduce the amount of tax paid and divert the company's resources, which then will be obscured through distorting the financial report (Desai and Dharmapala, 2006). Frank et al (2009) proved that tax aggressiveness has positive correlation with financial reporting, in which tax aggressiveness implies obscured information and, in turn, suggests a fraud. However, Blaylock et al (2012) provided a contrary evidence to the findings of Frank et al (2009), stating that aggressive financial reporting tends to also pursue aggressive tax reporting.

In running a company, a supervisory function is critical. This function is usually performed by the board of directors. The Public Oversight Board (1995) in the United States of America argued that the board of directors plays a significant role in financial reporting process. Board of directors serves to supervise and monitor the process of financial reporting to ensure high quality financial report. Corporate governance, which describes the procedures of improving the quality of financial report, emphasized the board of directors' roles in reducing profit (income) manipulation and in ensuring that the report provides accurate information about the company's operation.

THEORETICAL FRAMEWORK AND HYPOTHESIS

Agency Theory

Jensen and Meckling (1976) Agency theory or also commonly called contracting theory, explains the relationship between agent and principal. "Principals" are defined as shareholders or parties who mandate agents to act on behalf of the principal. Agent is the management that manages the company or party who is given the mandate by the principal to run the company. The main objective of the company is to maximize shareholder prosperity. For this reason, managers appointed by shareholders must act in the interests of shareholders. This conflict occurs because of differences in interests between management and shareholders. Because conflicts often occur, these problems are often referred to as agency problems.

Fraudulent Financial Reporting

AICPA (2002) defined fraudulent financial reporting as intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users. Meanwhile, ACFE (2010) described fraudulent financial reporting as a deliberate act of corporate executive on material information that aims to obscure the real financial condition of the company and to profit the parties committing the fraud, which may be financial or non-financial in nature.

Effectiveness of Directors' Supervision on Fraudulent Financial Reporting

Board of directors is a basic mechanism of effective corporate governance, both in public and private companies, which serves to control the management's actions and prioritize the stakeholders' interest (Fama and Jensen, 1983). Carcello et al. (2002) suggested that more

experienced members of board of directors are more likely to demand for high quality audit. In addition, directors with good financial/accounting skills are able to understand and handle the problems in financial reporting.

Beasley (1996) argued that among the board of directors' crucial competencies is their knowledge about the company's affairs and about management process, which they need to perform their monitoring function. In addition, Cadbury (1992) suggested that adequate educational background of the board of directors will determine the quality and skills of the board. Their knowledge and information processing will affect the depth of monitoring or supervision that the board provides. Members of board of directors with good educational background and sufficient experiences will have greater and wider insight and deeper analysis, which in turn will add to his or her credibility in performing his or her supervisory roles.

Carpenter and Feroz (2001) argued that members of the board of directors who possess international experiences are rare individuals with added value and unmatched characteristics who can contribute to the competitive advantages of any company that hire them. Members of board of directors may gather international experiences from overseas placement or from their experience of working with foreign companies. These individuals will be evident in organizational management and in financial information and financial reporting, as well as in monitoring activities that foreign companies may perform on the company. A company's habit may be affected by the culture, rules, laws, and regulations of the nation in which the company operates. Exposure to foreign settings and experiences in foreign companies will help the members of board of directors to manage the complexity of income management practices. Simultaneously, with international experiences that differ from local experiences, it is believed that such members of the board will benefit the effort of promoting and implementing prevention mechanism in income management more proactively.

Moreover, Cardbury (1992) recommended that the effectiveness of board of directors' supervisory role is depended on the size of the board or the number of its members (big or small board), how active the members are in performing their roles, and the frequency of their meetings.

H1: Directors' Supervision have a significant influence to Fraudulent Financial Reporting

Effects of Tax Aggressiveness on Fraudulent Financial Reporting

Balakrishnan et al (2012) defined tax aggressiveness as manipulation of taxable income to reduce it through tax planning which may or may not be considered tax evasion or tax avoidance. Frank et al (2009) argued that tax aggressiveness is an activity aimed to reduce the taxable income through tax planning which may or may not involve both tax evasion and tax avoidance. Even though not all tax reporting aggressiveness is breaking the law, the more opportunities a company exploits, the more aggressive the company is considered to be.

When making decision to do tax aggressiveness, the decision makers (managers) will consider the benefits and disadvantages of that action. There are three benefits of tax aggressiveness that will be outlined here. (1) The benefit of tax saving, in which the company pays less tax to the state and in turn increases the portion of cash that owners/stakeholders will gain. (2) (Direct and indirect) benefit for managers, who receive compensation or incentive from the owner/stakeholders for the tax aggressiveness they do. (3) The benefit of opportunities for managers to do rent extraction (Chen et al, 2010).

The disadvantages of tax aggressiveness are, among others, the possibility of the company receiving penalties/sanctions from tax authorities and the risk of decrease in company's stocks. It is possible that the company's stocks decrease in value because stakeholders know that managers perform tax aggressiveness through rent extraction (Desai and Dharmapala, 2006).

Companies assume that tax is an expense. Thus, they need strategies to mitigate tax expense (Mangoting, 1999 in Ida Farida et al, 2018). Companies are willing to report higher

values of tax to achieve certain financial goals (Hafiza et al, 2016). Erickson et al (2004) showed that companies are willing to pay tax for technical income to reduce the chance of identification scam in their financial report. Erickson et al investigated 27 companies that presented their financial reports as a consequence of accounting/financial fraud allegations, which included false reporting and bogus income, false inventory, and financial scams to bloat their assets, income, and net profit, from 1999 to 2002.

Dyrenj (2009 in Ida Farida et al, 2018) discovered that companies make a higher choice of financial reporting when they are facing a violation of debt agreement (IOU). They pay the tax for this income to avoid expenses pertaining to the debt-agreement violation. Frank et al (2009) proposed that companies that perform financial reporting fraud are also involved in tax aggressiveness. They found that there is a significant and positive correlation between accounting/financial fraud and tax aggressiveness. On the other hand, Lennox et al (2013) provided evidence that companies that are tax-aggressive tend to commit financial reporting fraud.

Sukotjo and Soenarno (2018) revealed that tax aggressiveness is an act of "gray areas" that can be considered illegal activities. In other words, the more aggressive corporate tax planning indicates the more management is cheating financial reporting. Management hides actual transactions, making financial statements more beautiful. Companies with higher tax aggressiveness have annual reports that are more difficult to read. Lo et al (2017) point out that more and more companies are managing their revenues resulting in very complex financial statements.

H2: Tax Aggressiveness have a significant influence to Fraudulent Financial Reporting

RESEARCH METHODS

The population in this study are manufacturing companies listed on the Indonesia Stock Exchange, with the target population in this study being manufacturing companies listed on the Indonesia Stock Exchange in 2017, where the target population according to Sekaran and Bougie (2013: 245) is defined as part of the element, geographical circles, and times. The number of manufacturing companies listed on the Indonesia Stock Exchange is 155 manufacturing companies listed on the Indonesia Stock Exchange. Samples according to Sekaran and Bougie (2010: 263) are explained as part of the population. The sampling method used is Propability sampling. The technique used is Random Sampling. The sample size can be determined using the formula from Taro Yamane or Slovin as follows:

$$n = \frac{N}{N.d^2 + 1}$$

Where is: n = The sample size sought
 N = Total Population
 d² = Precision set at 10%

Based on the formula above, in this study the sample size is

$$n = \frac{155}{155.(0,1)^2+1} = \frac{155}{2.55} = 60,78$$

n = 61 manufacturing companies

The data analysis technique of this research used logistic regression analysis. The use of logistic regression is because the dependent variable is fraudulent financial reporting on a nominal scale. This analysis is to test whether the probability of a dependent variable can be predicted with the independent variable. Hypothesis testing is done by an analysis of absolute value differences. The regression equation used is as follows:

$$\text{Ln} \frac{\text{FFR}}{1 - \text{FFR}} = \alpha + \beta_1 \text{Kom} + \beta_2 \text{TAX} + \varepsilon_i$$

Keterangan:

FFR : fraudulent financial reporting

Kom : Independent directors

TAX : tax aggressiveness

The Dependent Variable in the present study is fraudulent financial reporting, with the number of fraudulent financial reporting in a year as the indicator. The Independent Variables in this study are the independent directors and the tax aggressiveness. Directors supervision variable is measured using three dimensions: 1) Competency, measured based on two indicators, i.e. Skills in accounting/finance/auditing and International experience; 2) Interaction with board of directors and committees, measured using the proxy of Frequency of meeting in a year; 3) Human resources, measured using the proxy of Number of independent directors. Tax aggressiveness variable is measured using Effective Tax Rates (ETR), i.e. by comparing the income tax expense to income before tax.

Table 1
Operational Variable

| Variable | Dimension | Indicator | Scale |
|---|---|---|---------|
| Effectiveness of Directors Supervision (X1) | Competence | 1. Accounting/ Auditing Expertise | Ordinal |
| | | 2. International Experience | |
| | Interaction with Directors and Committees | Frequency of meetings held during the year | Ordinal |
| Aggressive Tax (X2) | Human Resources | Independent Commissioners Owned | Ordinal |
| | <i>Effective Tax rates (ETR)</i> | $\frac{\text{Income Tax Expense}}{\text{Pre-Tax Income}}$ | Ratio |
| Financial Reporting Fraud (Y) | Disclosure of Financial Reporting Fraud | The amount of Financial Reporting Fraud Reported for a year | Nominal |

FINDINGS AND DISCUSSION

The logistic regression test must be fulfill the several tests. The first test of the feasibility of the model using Hosmer and Lemeshow's Goodness of Fit Test which was measured by Chi-square value. Hosmer and Lemeshow's Goodness of Fit Test tests the null hypothesis that empirical data matches or matches the model (there is no difference between the model and the data so the model can be said to be Fit). The calculation results show that the significance level is above 0.05 (ie, the significance is 0.365 and the chi-square value is 8.735), which means that the model is good. Testing the hypothesis in this study using logistic regression with a significance level of 5% or 0.05. The logistic regression equation in this research study is:

$$\text{Ln} = \frac{\text{FFR}}{1 - \text{FFR}} = 11,951 - 3,320\text{Kom} + 8,979\text{TAX}$$

Table 2
 Summary of Hypothesis Testing

| No | Hyphotesis | B | Significant | Exp (B) | Hasil |
|----|--|--------|-------------|-----------|----------|
| 1 | The Effect of Directors' Supervision Effectiveness on Fraudulent Financial Reporting | -3,320 | 0,010 | 0,036 | Accepted |
| 2 | The Effects of Tax Aggressiveness on Fraudulent Financial Reporting | 8,979 | 0,001 | 7.937,999 | Accepted |

The directors supervision variable shows a negative coefficient B of -3.320 with a significance level of $0.010 < 0.05$, which means that the directors supervision variable has a significant effect on fraudulent financial reporting. The odds ratio for directors supervision is 0.036. The coefficient B is negative and means that, if the other independent variables are considered constant, then the probability of a company that has directors supervision of fraudulent financial reporting is 0.036 times lower.

The tax aggressiveness variable shows a positive coefficient B of 8.979 with a significance level of $0.000 < 0.05$ which means that the tax aggressiveness variable has a significant effect on fraudulent financial reporting. The odds ratio for directors supervision is 7,937.9999. Because the coefficient B is positive and means that, if other independent variables are considered fixed, then the probability of companies that have tax aggressiveness towards fraudulent financial reporting is 7,037.9999 times higher.

The Effect of Directors' Supervision Effectiveness on Fraudulent Financial Reporting.

Carcello et al. (2002) suggested that more experienced members of board of directors are more likely to demand for high quality audit. In addition, directors with good financial/accounting skills are able to understand and handle the problems in financial reporting. Carpenter and Feroz (2001) argued that members of the board of directors who possess international experiences are rare individuals with added value and unmatched characteristics who can contribute to the competitive advantages of any company that hire them. Members of board of directors may gather international experiences from overseas placement or from their experience of working with foreign companies. These individuals will be evident in organizational management and in financial information and financial reporting, as well as in monitoring activities that foreign companies may perform on the company.

A company's habit may be affected by the culture, rules, laws, and regulations of the nation in which the company operates. Exposure to foreign settings and experiences in foreign companies will help the members of board of directors to manage the complexity of income management practices. Simultaneously, with international experiences that differ from local experiences, it is believed that such members of the board will benefit the effort of promoting and implementing prevention mechanism in income management more proactively. Moreover, the higher frequency of director meetings between board of directors and committees will also reduce the level of fraud in financial reporting. It is because the meetings will enable directors to have deeper understanding of the problems in their companies and to provide appropriate solution (Cadbury, 1992).

The Effects of Tax Aggressiveness on Fraudulent Financial Reporting.

This is in line with Dyreng's (2009 in Ida Farida et al, 2018) findings that companies make a higher choice of financial reporting when they are facing a violation of debt agreement. They pay the tax for this income to avoid expenses pertaining to the debt-agreement violation. Frank et al (2009) proposed that companies that perform financial reporting fraud are also involved in tax aggressiveness. They found that there is a significant and positive correlation between accounting/financial fraud and tax aggressiveness. On the other hand, Lennox et al

(2013) provided evidence that companies that are tax-aggressive tend to commit financial reporting fraud.

CONCLUSIONS AND SUGGESTION

Based on the phenomenon in the field, the formulation of problems, the hypotheses, and the findings, the Effectiveness of directors' supervision has significant effect on fraudulent financial reporting. This shows that directors who possess skills in accounting/finance/auditing and international experience can reduce frauds in financial reporting. In addition, the higher frequency of directors meeting will enable directors to have deeper understanding of the problems in their companies and to provide appropriate solution. Tax aggressiveness has significant effect on fraudulent financial reporting. This shows that companies make higher financial reporting choice when they are facing a violation of debt agreement. They pay the tax for this income to avoid expenses pertaining to the debt-agreement violation. This reserach has limitations, where the results of logistic regression testing produce a coefficient of determination (R-Square) which is still low at 58.5% so that there are still 41.5% of other explanatory variables outside this study. Based on these limitations, for further research it is recommended to add other variables that have an influence on fraudulent financial reporting such as the audit committee change variables, ethics, and others.

REFERENCES

- Airlangga Hartaro, selaku Menteri Perindustrian. (2018). Kemenperin: Industri Manufaktur Penyumbang Pajak Terbesar. Melalui <https://ekonomi.kompas.com/read/2018/01/09/211727326/kemenperin-industri-manufaktur-penyumbang-pajak-terbesar>. Diakses [2/1/2019].
- AICPA. (2002). *Consideration of Fraud in a Financial Statement Audit. Statement on Accounting Standards (SAS) No.99*.
- Assosiation of Certified fraud Examiners (ACFE). (2018). *Report To The Nations 2018 Global Study On Occupational Fraud And Abuse Asia-Pacific Edition*.
- _____ . (2010). *Report on the Nation on Occupational Fraud & Abuse*.
- Balakrishnan, Karthik., Jennifer L. Blouin., Wayne Guay. (2012). Does Tax Aggressiveness Reduce Corporate Transparency?. *SSRN*.
- Brian, I., dan D. Martani. (2014). Analisis Pengaruh Penghindaran Pajak dan Kepemilikan Keluarga Terhadap Waktu Pengumuman Laporan Keuangan Tahunan Perusahaan. *Simposium Nasional Akuntansi (SNA) XVII, Lombok*.
- Beasley, M.S. (1996). An Empirical Analysis of the Relation between Board Characteristic an Voluntary Improvements in Audit Committee Composition and Experience. *Contemporary Accounting Reserach* (18) 539-570.
- Cadbury Committee. (1992). *Report of the Committee on the Financial Aspect of Corporate Governance*. London: Gee.
- Carcello, J. V., R. H. Hermanson. dan N. T. McGrath. (1992). "Audit Quality Attributes: The Perceptions of Audit Partners, Prepares, and Financial. Statement Users." *Auditing: A Journal of Practice & Theory* 11, (Spring): 115.
- Carpenter, V. L., and Feroz, E. H. (2001). Institutional Theory And Accounting Rule Choice: An Analysis Of Four US State Governments' Decisions To Adopt Generally Accepted Accounting Principles. *Accounting, Organizations and Society*, 26, 565-596.
- Chen, S., Chen, X., Cheng, Q dan Shevlin, T. (2010). Are Family Firms More Tax Aggressive than Non Family Firms? *Journal of Financial Economics*, 95.

- Dewi Kartika Sari dan Dwi Martani. (2010). Karakteristik Kepemilikan Perusahaan, Corporate Governance, dan Tindakan Pajak Agresif. *Simposium Nasional Akuntansi (SNA) XIII*, Purwokerto.
- Dhaliwal D, Gleason C, dan Mills L. (2004). Last Chance Earnings Management: Using the Tax Expense to Meet Analysts' Forecasts, *Contemporary Accounting Research* De Waegenare, Anja, Richard Sansing, and Jacco Wielhouwer. *Financial Accounting Measures of Tax Reporting Aggressiveness*. SSRN.
- Desai, M.A. & Dharmapala, D. (2006). Corporate tax avoidance and high-powered incentives. *Journal of Financial Economics*.
- Erickson M, Hanlon M, Maydew E.(2004). How Much Will Firms Pay for Earnings that Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings, *The Accounting Review*, 79(2):387-408.
- Fama, Eugene F., and Michael C. Jensen. (1983). Separation of Ownership and Control. *Journall of Law and Economics*, Vol XXVI, June.
- Frank, M., L. Lynch and S. Rego. (2009). Tax Reporting Aggressiveness and its Relation to Aggressive Financial Reporting. *Accounting Review*, 84(2): 467-96.
- Ida Farida, Adi Prawira, dan Yana Setiawan. (2018). Tax aggressiveness and accounting fraud practice, an evidence in ASEAN countries. *International Journal of Multidisciplinary Education and Research*, 3(1) , 05-10.
- Jensen, C Michael and William H. Meckling. (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *SSRN*.
- Kementerian Keuangan Republik Indonesia. (2018). APBN Kita Harga Komoditas Naik, Penerimaan Pnbp Semakin Baik Kinerja Dan Fakta.
- Lennox C, Lisowsky P, Pittman J.(2013). Tax Aggressiveness and Accounting Fraud, *Journal of Accounting Research*, 51(4):739-78.
- Richard Susilo. (2017). Indonesia Masuk Peringkat ke-11 Penghindaran Pajak Perusahaan, Jepang No.3. Melalui <http://www.tribunnews.com/internasional/2017/11/20/indonesia-masuk-peringkat-ke-11-penghindaran-pajak-perusahaan-jepang-no3>. Diakses [3/1/2019].
- Rochmat Soemitro. (2011). *Asas dan Dasar Perpajakan*. Rafika Aditama, Bandung.
- Sekaran, Uma and Roger Bougie. (2010). *Research Methods For Business A Skill Building Approach Fifth Edition*. Wiley.
- Sukotjo, Clarisa and Soenarno, Yanuar Nanok. (2018). Tax Aggressiveness, Accounting Fraud, and Annual Report Readability. *Journal of Finance and Economics*, 6(2), 38-42.
- The Public Oversight Board (POB). (1995). *Directors, Management, and Auditors : Allies in Protecting Shareholder Interst*, Stamford.