EARNINGS MANAGEMENT: TAX AGGRESIVENESS, CORPORATE GOVERNANCE, AND FINANCIAL PERFORMANCE

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ABSTRACT

Earnings management can be considered as an act of fraud, as it can provide irrelevant information due to the manipulation of financial statements, which can mislead the users in their decision-making processes. This research obtains empirical evidence regarding various factors influencing earnings management, including tax aggressiveness, director size, independent director, audit quality, managerial ownership, institutional ownership, firm size, leverage, and sales growth. The study analyzes 186 data from consumer cyclicals and consumer non-cyclicals companies listed in Indonesia Stock Exchange (IDX) from 2020 to 2022. The results indicate that audit quality and managerial ownership significantly affect earnings management. Specifically, higher audit quality negatively impacts earnings management, suggesting that robust audit practices can mitigate such manipulations of earnings. Additionally, managerial ownership also has a negative effect on earnings management; when management holds shares, their interests align more closely with those of the owners, reducing the likelihood of earnings management. Conversely, factors such as tax aggressiveness, director size, independent director, institutional ownership, firm size, leverage, and sales growth do not influence earnings management.

Keywords: Earnings Management, Tax Aggressiveness, Corporate Governance, Financial Performance, Managerial Ownership

INTRODUCTION

Earnings management refers to actions taken by management to manipulate the financial reports. It is an important issue in accounting for practitioners (Dechow et al., 2011). Typically, companies engage in earnings management to mitigate potential losses. This practice involves real actions chosen by managers, such as the selection of accounting policies, which can influence earnings to meet specific reporting objectives. Earnings management allows management to prepare financial statements by either increasing or decreasing the reported profit levels (Mayasari et al., 2019). The manipulation of financial statements, known as earnings management, can diminish the economic value of these statements and reduce their reliability in the reporting process. Identifying earnings management and making appropriate adjustments to reported data is a crucial task in financial statement analysis (Subramanyam and Wild, 2009). Earnings management remains an important phenomenon in the accounting field that warrants study, particularly during the COVID-19 pandemic. Many companies faced operational and financial challenges during this period, leading to an increase in earnings management practices to sustain their profits. This research aims to identify the factors influencing earnings management during the COVID-19 pandemic from 2020 to 2022.

Earnings management creates a conflict of interest between management and the company's owners (shareholders). Agency theory explains the relationship between the parties who hold power (the principal), such as shareholders, and the party receiving that power (the agent), such as company management (Jensen and Meckling, 1976). In the process of selecting the most effective contract, the relationship between the agent and the principal is central to agency theory. Information asymmetry arises as a consequence of these agency relationships. By establishing goals in advance, agents can exploit this information asymmetry to their advantage (Susanto and Pradipta, 2020). According to agency theory, the accounting methods necessary to reduce contract costs often vary depending on the specific circumstances (Godfrey et al., 2010). The issues that arise from agency theory can lead to profits gained through earnings management. Management can present the company's financial reports to assess its performance, allowing management (the agent) to make informed decisions for the company's welfare (Susanto and Pradipta, 2020).

Tax Aggressiveness and Earnings Management

Tax aggressiveness refers to a tax planning strategy that encompasses two distinct practices: tax evasion, which is illegal, and tax avoidance, which is legal. The primary objective of tax aggressiveness is to minimize the tax burden (Frank et al., 2009). In Indonesia, tax aggressiveness often manifests in actions that lead to legal practices, specifically tax avoidance (Aman and Durya, 2022). Company management actively seeks ways to exploit loopholes and reduce their tax liabilities, aiming to pay the least amount of tax possible, which ultimately decreases the overall tax burden (Khan and Tjaraka, 2024). The aggressive taxation action can result from tax savings that are carried out legally according to existing regulations by submitting information to the tax authorities. These tax savings are carried out by companies by utilizing existing laws and regulations, so that the actions taken are tax aggressive in legal, which is tax avoidance. Usually, aggressive actions do not violate tax laws because they take advantage of weaknesses in tax laws (Hashim et al., 2016). The government can overcome aggressive tax reporting by preventing and supervising companies that are taxpayers who are indicated to report aggressive taxes. This is done to avoid the taxes paid by the company by carrying out significant tax implications, but tax avoidance can reduce government tax revenues. (Hashim et al., 2016).

Manipulating profits through earnings management is one of management's goals for tax purposes, where companies will report lower profits to reduce their overall tax liabilities (Susanto et al., 2019).

H_1: Tax aggressiveness affects earnings management.

Director Size and Earnings Management

The board of directors in a company consists of individuals who determine important policies for the organization. The board is responsible for overseeing management functions; however, directors are not permitted to participate in management activities or represent the business in interactions with external parties (Susanto et al., 2017). Directors have the responsibility to create and manage an effective corporate governance mechanism for the company. Research indicates that larger boards are less likely to engage in earnings management practices, as a larger board allows for closer monitoring of the organization. Conversely, larger boards may be less effective in preventing earnings manipulation compared to smaller boards. This is due to the fact that coordination and problem-solving become increasingly difficult as the director members becomes too big (Githaga et al., 2022). Furthermore, smaller boards are more likely to mitigate the risk of free-riding among individual board members, thereby enhancing their accountability and oversight roles. To establish effective corporate governance within a company, directors must supervise and take responsibility for the complexities of the organization while ensuring the effectiveness of decision-making processes (Susanto, 2013).

H_2: Director size affects earnings management.

Independent Director and Earnings Management

The presence of independent directors can effectively prevent the practice of earnings management (Yanthi et al., 2021). The existence of an independent board is designed to safeguard against potential information asymmetry and opportunistic management tactics (Susanto et al., 2019). Independent directors play a crucial role in monitoring and reducing earnings management practices (Ningrum, 2021). They perform essential supervisory and oversight functions, providing an independent and objective review of the financial reporting process, internal controls, and the audit function (Githaga et al., 2022). The practice of earnings management tends to decrease when a company has a higher number of independent directors. These directors are better positioned to detect instances of earnings management, as they do not have ties to management (Susanto, 2016).

H_3: Independent director affects earnings management.

Audit Quality and Earnings Management

The audit report issued by the auditor is significantly influenced by the quality of the audit. The relevance and reliability of a company's financial statements are essential for assisting external parties in making informed business decisions (Wahyono et al., 2019). The purpose of the audit report is to provide assurance regarding the integrity and reliability of the financial reports presented by management (Wahyono et al., 2019). Audit quality can be assessed based on the auditor's ability to detect errors in the client's financial statements. Generally, large public accounting firms, such as the Big Four, are known for their high audit quality, as they are better equipped to identify earnings management practices. Consequently, the involvement of a Big Four public accounting firm can reduce earnings management (Wijaya et al., 2020).

H_4: Audit quality affects earnings management.

Managerial Ownership and Earnings Management

Managerial ownership refers to the situation in which a manager holds shares in the company. As a shareholder, a manager with ownership stakes can make decisions that enhance profitability (Wimelda and Chandra, 2018). Research indicates that managerial ownership positively influences earnings management, as a higher level of ownership can expand the scope of earnings management practices (Mayasari et al., 2019). Managerial ownership provides an opportunity for managers to align their personal interests with those of the company by co-owning shares and actively participating in the decision-making process. Conversely, managers with minimal or no ownership in the company may be more prone to engage in opportunistic behaviors, such as earnings management. The extent of managerial ownership within a company can potentially mitigate such opportunistic actions. This is because managers who own shares in the company are accountable for the consequences of their decisions. When managers have shares in the company, they are more likely to align their actions with the interests of the company's owners and shareholders, which can lead to a reduction in earnings management (Prasetyo and Suhendah, 2023).

H_5: Managerial ownership affects earnings management.

Institutional Ownership and Earnings Management

Institutional ownership refers to the percentage of shares owned by organizations such as insurance companies, pension funds, and other businesses. The level of institutional ownership can significantly influence how management prepares its financial records, which, in turn, may constrain management behavior (Sembiring, 2022). Institutional ownership can also assist companies in establishing effective corporate governance mechanisms (Saftiana et al., 2017). Management is often inclined to engage in earnings management practices to meet the profit expectations of institutional shareholders (Alexander, 2019). However, institutional

ownership has a negative impact on earnings management because the substantial number of shares owned by institutional investors allows them to monitor management closely, making management less likely to engage in earnings management (Susanto et al., 2021). Institutional investors should be able to exert considerable influence over a company's decisions due to their significant shareholdings. Nevertheless, institutional ownership does not necessarily restrict earnings management. This may be attributed to the tendency of institutional investors to act more like temporary owners, focusing on short-term earnings rather than as sophisticated investors who possess the power and opportunity to limit management's discretion in conducting earnings management.

H_6: Managerial ownership affects earnings management.

Firm Size and Earnings Management

The size of a firm can be categorized into three types: small, medium, and large, based on its total assets. Wuryani (2012) discusses both the positive and negative effects of firm size on earnings management. Larger companies, due to their more complex operational activities, have the capability to engage in earnings management practices, which allows them to manipulate and manage their earnings (Gayatri and Wirasedana, 2021). Conversely, larger companies also have a reputation to uphold; as a result, they tend to avoid engaging in earnings management practices. To maintain their reputation, large firms refrain from manipulating their earnings (Wuryani, 2012). These larger companies are more likely to showcase wealth and high sales to attract investors. Consequently, managers must increasingly present healthy financial statements in alignment with investors' expectations. Thus, managers have a greater capacity to adjust profits to meet investor demands due to the increased size of the business, heightened investor expectations, and greater investor needs (Rahmawati and Fajri, 2021).

H_7: Firm size affects earnings management.

Leverage and Earnings Management

The leverage ratio is used to evaluate a company's ability to manage borrowed funds. It indicates the proportion of debt in relation to the company's overall financial structure. When the leverage ratio increases, managers may be incentivized to employ earnings management techniques, such as inflating profits or raising capital, to lower the leverage ratio. A higher leverage ratio suggests that the company may be at risk of insolvency or may have fewer assets compared to its debts. As a result, securing additional external funding becomes more difficult, as the company may be perceived as struggling to meet its debt obligations. To mitigate this issue, managers may resort to earnings management practices to bolster external stakeholders' confidence in the company's ability to repay its debts in the future. Increased leverage can heighten the risk of financial distress and bankruptcy (Alvin and Susanto, 2022). Christian and Sulistiawan (2022) found that leverage has a positive and significant effect on earnings management. Investors will face significant risks when the level of loan funds is high, leading them to demand larger profits from the company.

H_8: Leverage affects earnings management.

Sales Growth and Earnings Management

Sales growth measures the change in sales levels from one year to the next year (Firnanti et al., 2019). Healthy sales growth is characterized by a consistent increase in sales from the previous year to the current year (Jane and Firnanti, 2019). When sales increase, the company experiences positive growth, and management may choose to engage in earnings management to boost bonuses. Conversely, if sales decline, it indicates that the company is generating lower profits, which can lead to reduced investment from investors. In such cases, earnings management may occur when a company experiences negative sales growth in order to secure funding from creditors. High sales growth typically diminishes the motivation for earnings management. In contrast, companies with low sales growth are more likely to engage in earnings management practices (Setijaningsih and Merisa, 2022).

H_9: Sales growth affects earnings management.

The following figure illustrates the causal relationship between the independent variables—tax aggressiveness, director size, independent directors, audit quality, managerial ownership, institutional ownership, firm size, leverage, and sales growth—and the dependent variable, earnings management.

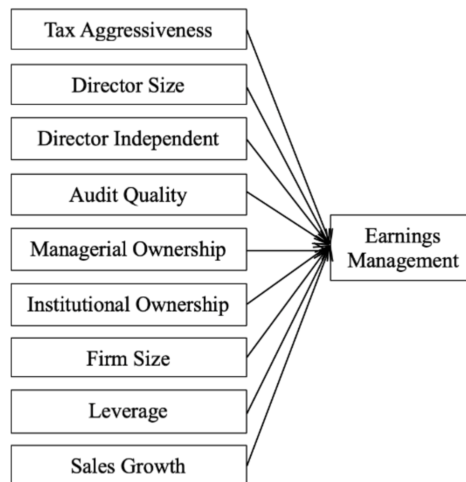

Figure 1 Research Model

RESEARCH METHOD

The population used in this study consists of consumer cyclicals and consumer non-cyclicals companies that were consistently listed in the Indonesia Stock Exchange (IDX) from 2020 to 2022. Below is a summary table of the sample selection criteria:

Table 1: Sample Selection Procedures

	Criteria Description	Total Companies	Total Data
1	Consistently consumer cyclicals and consumer non-cyclicals companies listed in Indonesian Stock Exchange (IDX) from 2019 to 2022	192	576
2	Consistently consumer cyclicals and consumer non-cyclicals companies do not have audited financial statement ended as December 31st from 2019 to 2022	(14)	(42)
3	Consistently consumer cyclicals and consumer non-cyclicals companies do not use Rupiah's currency in its reported financial statement from 2019 to 2022	(13)	(39)
4	Consistently consumer cyclicals and consumer non-cyclicals companies do not earn profit after tax from 2020 to 2022	(97)	(291)
5	Consistently consumer cyclicals and consumer non-cyclicals companies do not have institutional ownership from 2020 to 2022	(5)	(15)
	Total sample of companies before outlier	63	189
	Outlier data		(3)
	Total research samples		186

Research Variables

Earnings management refers to the practice in which management engages in the preparation of financial reports for stakeholders with the intent to smooth, inflate, or diminish earnings (Mayasari et al., 2019). By manipulating financial statements, earnings management is expected to help companies meet their objectives. In this study, earnings management is measured using discretionary accruals, as outlined by Kothari et al. (2005), as follows:

$$\frac{TA_{it}}{A_{it-1}} = \propto \left(\frac{1}{A_{it-1}}\right) + \beta 1 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}}\right) + \beta 2 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \beta 3 (ROA_{it-1}) + \varepsilon_t$$

TA_{it} is total accruals of firm i in year t
A_{it-1} is total asset of company i at the end of year t-1
ΔREV_{it} is changes in company earnings i in year t
ΔREC_{it} is change of net receivable of company i in year t
PPE_{it} is net property, plant and equipment company i in year t
ROA_{it-1} is return on assets of company i at the end of year t-1
ε_t is accrual discretionary i in year t.

Tax aggressiveness is a set of practices employed by businesses to minimize their tax liabilities. A common proxy for tax aggressiveness is the ratio of income tax expense to earnings before tax. The director size is determined by the number of board members in the company. The presence of independent directors is intended to protect against potential information asymmetry and management's opportunistic behavior. The proportion of independent directors is measured by dividing the number of

independent board members with the total number of board members in the company. Audit quality pertains to the auditor's ability to detect irregularities in a client's financial statements. This is represented using a dummy variable: "one" if a company is audited by one of the Big Four public accounting firms, while "zero" if a company is not audited by any of the Big Four firms. Managerial ownership can reduce the likelihood of earnings management practices, as managers and shareholders tend to share similar beliefs and objectives. The dummy variable for managerial ownership is "one" if the company has managerial ownership and “zero” to represent a company without managerial ownership. Institutional ownership is total percentage of shares owned by institutions. Firm size is often measured by a company's total assets, typically using the natural logarithm of total assets. The leverage ratio is calculated by dividing total liabilities by total assets. Sales growth is determined by the change in current sales compared to the change in sales from the previous year.

RESULT AND DISCUSSION

The descriptive statistics and t-test results are presented in table 2 and table 3.

Table 2: Descriptive Statistic Result

Variable	N	Minimum	Maximum	Mean	Std. Deviation
EM	186	-0,23948	0,32710	0,00000	0,08395
ETR	186	-1,47806	0,95209	0,25407	0,19698
DS	186	2	12	5,20	2,056
DI	186	0,00000	0,33333	0,03400	0,08279
AQ	186	0	1	0,51	0,501
MO	186	0	1	0,61	0,488
IO	186	0,07015	0,99973	0,70038	0,18482
FS	186	26,2982	32,8263	29,3416	1,46570
LEV	186	0,00041	0,88815	0,41853	0,18572
SG	186	-1,00000	2,65522	0,11139	0,30830

Table 3: t-Test Result

Variable	B	Sig.	Conclusion
(Constant)	0,083	0,620	-
ETR	-0,034	0,269	H_1 Rejected
DS	-0,006	0,121	H_2 Rejected
DI	-0,013	0,865	H_3 Rejected
AQ	-0,045	0,001	H_4 Accepted
MO	-0,029	0,024	H_5 Accepted
IO	-0,033	0,323	H_6 Rejected
FS	0,001	0,843	H_7 Rejected
LEV	-0,034	0,310	H_8 Rejected
SG	0,007	0,701	H_9 Rejected

Table 2 indicates that earnings management practices did not increase during the COVID-19 pandemic, as evidenced by a mean earnings management (EM) score of 0.00000. The COVID-19 pandemic significantly impacted many companies in Indonesia, leading to a normal decline in profits. Consequently, these companies did not engage in earnings management to preserve their profits. A majority of the companies (51%) were audited by Big Four public accounting firm and 61% of the companies have managerial ownership. The data also indicates that some companies did not have independent directors.

Table 3 indicates that tax aggressiveness, measured by the effective tax rate (ETR), has a significant value of 0.269, which exceeds the threshold of 0.05. Consequently, the first hypothesis (H_1) is not accepted, suggesting that tax aggressiveness does not influence earnings management. This lack of effect may stem from the dual nature of tax aggressiveness, which encompasses both legal and illegal behaviors. Legal tax aggressiveness involves exploiting loopholes in tax legislation, while illegal tax aggressiveness refers to businesses failing to fulfill their tax obligations (Alexander and Christina, 2017). Similarly, director size (DS) presents a significant value of 0.121, also above the 0.05 threshold. Therefore, the second hypothesis (H_2) is not accepted, indicating that director size does not impact earnings management. This may be attributed to directors prioritizing operational stability over earnings, particularly in their efforts to navigate the challenges posed by the COVID-19 pandemic.

The significance value for independent directors (DI) is 0.865, which is above the threshold of 0.05. Therefore, the third hypothesis (H_3) is not accepted, indicating that independent director does not have an effect on earnings management. This may occur because management is less likely to engage in earnings management when there is independent oversight from the independent directors. It is also expected that this oversight can reduce the practice of earnings management within companies (Marchellina and Firnanti, 2021). In contrast, the significance value for audit quality (AQ) is 0.001, which is below the threshold of 0.05. Consequently, the fourth hypothesis (H_4) is accepted, suggesting that audit quality does have an effect on earnings management, and this effect is negative, as indicated by the negative coefficient value. Companies maintain a good reputation by employing auditors from the Big Four public accounting firms, which possess greater expertise and experience in auditing. This enhances the reliability of financial reports, thereby reducing the likelihood of earnings management practices (Yanthi et al., 2021).

Managerial ownership (MO) has a significant value of 0.024, which is below the threshold of 0.05. Therefore, fifth hypothesis (H_5) is accepted, indicating that managerial ownership has a negative effect on earnings management, as evidenced by the negative coefficient value. A substantial level of managerial ownership can minimize earnings management because

shareholders expect genuine returns from the company's performance. This expectation encourages management to enhance performance in order to generate profits rather than manipulate earnings. In the context of managerial ownership, management shares a similar position with the company's owners, which helps align the interests of shareholders and management. Consequently, this alignment can reduce earnings management (Prasetyo and Suhendah, 2023). In contrast, institutional ownership (IO) has a significant value of 0.323, which is above the threshold of 0.05. Therefore, the sixth hypothesis (H_6) is not accepted, indicating that institutional ownership does not have an effect on earnings management. This conclusion is based on the observation that institutional ownership lacks the necessary managerial oversight to effectively minimize earnings management.

Firm size (FS) has a significant value of 0.843, which is above 0.05. Therefore, the seventh hypothesis (H_7) is not accepted, indicating that firm size does not have an effect on earnings management. Investors are more likely to trust large companies due to their reputation, which suggests they are less interested in earnings management (Mayasari et al., 2019). Leverage (LEV) has a significant value of 0.310, which is above the threshold of 0.05. Therefore, the eight hypothesis (H_8) is not accepted, indicating that leverage does not have an effect on earnings management. Companies utilize leverage to finance operational activities through borrowed capital, which incurs an interest burden that must be repaid to creditors. Consequently, this may lead managers to engage in earnings management practices to artificially inflate the company's earnings, with the goal of maintaining a favorable financial appearance despite the presence of leverage. Sales growth (SG) has a significant value of 0.701, which is above 0.05. Therefore, the ninth hypothesis (H_9) is not accepted, indicating that sales growth does not have an effect on earnings management. This may occur because companies with high sales growth are not motivated to engage in earnings management. In contrast, companies with low sales growth may be more inclined to pursue earnings management practices.

CONCLUSION

Based on hypothesis testing, audit quality and managerial ownership have a negative effect on earnings management. High audit quality can reduce earnings management, as it has been shown to negatively impact such practices. Most companies are audited by the Big Four public accounting firms, which are known for their high audit quality. Additionally, managerial ownership negatively affects earnings management. When management holds shares, they align their interests with those of the owners, which discourages earnings management. Conversely, tax aggressiveness, director size, independent director, institutional ownership, firm size, leverage, and sales growth do not appear to influence earnings management.

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