The Relationship between Ultimate Ownership Structure and Real Earnings Management in Response to Corporate Income Tax Rate Changes Based on Income Tax Law No. 36, 2008

by Susi Dwimulyani

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Abstract

The purpose of this research is to obtain empirical supports whether corporations with concentrated ownership structure perform decreasing real earnings management in response the decreasing corporate income tax rate based on Income Tax Law No. 36, 2008. Real earnings management is executed at the last year before the decreasing corporate income tax rate.

This research also analyzes the comparison of real earnings management that performed between corporations with concentrated ownership structure and corporations with dispersed ownership structure. In addition, this study investigates the relationship between cash flows right of controlling shareholders and real earnings management for tax savings.

Research samples are public companies that listing in Indonesian Stock Exchange and the observation periods are during 2005-2009. This research follows ultimate ownership concept and uses 50% cutoff point. The empirical evidence gives the support that corporations with concentrated ownership structure perform decreasing real earnings management in the year 2007, 2008, and 2009. These corporations also decrease earnings larger than corporations with dispersed ownership structure. At the last, cash flows right of controlling shareholders has positive relationship with real earnings management for tax savings.

Keywords*: ultimate ownership concept, real earnings management, cash flows right.*

INTRODUCTION

This research investigates the motivation of corporate managers with concentrated ownership structure conducting decreasing earnings management by manipulating real activities to corporate income tax savings. This is performed in response the decreasing of income tax rate based on Income Tax Law No. 36, 2008. This earnings management that decreases profit may create financial reporting cost in the form of debt covenant violation, the decrease of compesation, and the negative appraisal consequence in capital market (Cloyd et al., 1996). The capital market pressure may be decreased if the ownership of public corporations is concentrated (Cloyd et al., 1996).

Public corporations with dispersed ownership structure only use audited financial statement to evaluate management performance, so the reported decreasing earnings creates the evaluation that the corporations poorly perform. In corporations with concentrated ownership, where there are controlling shareholder, corporate managers are able to inform the value of the corporations to controlling shareholders more effectively through various communication channels beside audited financial statement, so they can decrease capital market pressure.

The majority of public corporations ownership structure in Indonesia by using the concept of ultimate ownership is concentrated (Claessens et al., 2000; Lemmon and Lins, 2003; Du and Dai, 2005; Febrianto, 2005; Siregar, 2006; and Sanjaya, 2010). Statement of Financial Accounting Standard No. 4 (IAI, 2009) about consolidated financial statements and separate financial statements states that effective control is when the holding corporation has more than 50% of voting rights. Therefore, this research is conducted on public corporations with ultimate ownership structure and have controlling stockholders as the single majority.

This research also compares the availability of corporate managers to do decreasing real earnings management between the corporations with concetrated ownership structure and dispersed owenership structure, and it will give empirical supports that the cash flows right owned by controlling shareholders relates positively with the availability of corporation managers in performing real earnings management to corporate income tax savings.

The result of hypothesis testing has given supports that public corporations with concentrated ownership structure conduct decreasing real earnings management in the year before the decreasing of corporate income tax rate. As predicted, corporations with concentrated ownership perform decreasing real earnings management greater than corporations with dispersed ownership. At last, there is a positive relationship between the cash flows right owned by controlling shareholders and decreasing real earnings management.

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Agency Theory

Jensen and Meckling (1976) in *"theory of the firm"* stated there is an agency relationship because of separation between corporate ownership and controls. It creates general problem of agency, which is the conflict between shareholders as the principal and corporate managers as an agent. In concentrated ownership structure, it means that there are controlling shareholders, the agency conflict is between controlling shareholders as an agent and minority shareholders as the principal (Shleifer and Vishny, 1997).

Controlling shareholders can supervise managers or even that they are parts of the management. Controlling shareholders can cause agency problem because they have both interest of maximalizing earnings and controlling on corporate assets to fulfill their interest (Shleifer and Vishny, 1997). The controlling shareholders will fulfill their own interest, in this matter, they can ignore the minority shareholders interest, or the interest of employees and managers of the corporation.

Concentrated corporate ownership structure can use the concept of direct or ultimate ownership. The concept of ultimate ownership is firstly introduced by La Porta et al. (1999). Du and Dai (2005) defined corporate ownership and corporate control as cash flows right and control right. The ownership shows the cash flows right, which is the right to conduct claims on dividend, while controlling shows the control right from shareholders on corporate direction board, financial policy, and operational policy of other corporations.

Potential of agency problem occurs when there is a substantial difference between cash flows right and control rights from controlling shareholders (*cash flow right leverage*). Claessens et al. (2002) explained that if the cash flows right of controlling shareholders is closed to or similar to its control rights, then, the agency problems between controlling shareholders and minority shareholders is small. The cash flows right owned by controlling shareholders indicates positive insentive effect (PIE), while control rights owned by controlling shareholders indicates negative entrenchment effect (NEE). The mechanism of the increasing of control rights can be obtained by using ownership structure pyramid, crossed ownership, or dual-class of stock (Claessens et al., 2002). This causes the deviation between control rights and cash flows right (*cash flow right leverage*) owned by controlling shareholders is larger.

The effect of cash flows right that built based on the argument of this PIE is that the controlling shareholders will not conduct expropriation on minority shareholders. The ability of controlling shareholders to control the corporate management is not aimed for private interest, but it is aimed to show that there is similar interest between controlling shareholders and minority shareholders. Claessens et al. (2002), Yeh et al. (2003), and Siregar (2006) proved that cash flows right of controlling shareholders had a positive relation with the corporate value, and it was consistent with the argument of PIE.

In concentrated ownership structure, cash flows right of controlling shareholders is the cash flows right on both direct ownership and indirect ownership. Indirect cash flows right is the product of shareholder ownership percentage in each ownership chain. Meanwhile, control right includes direct control right and indirect control right. Direct control right is similar to direct cash flows right, while indirect control right is the minimum control right in each ownership chain (La Porta et al., 1999).

Earnings Management

Earnings management is the selection of accounting policy or the selection of real actions done by managers to affect earnings in order to achieve certain purposes from reported earnings (Scott, 2009). Earnings management occurs when managers use judgment in financial statement and when structuring transactions to change the financial repots that can mislead stakeholders about the corporate economic performance or to affect contractual result that depends on the reported accounting numbers.

Watts and Zimmerman (1986) used the agency theory to propose three hypotheses on the motivation of earning management done by managers, which were: 1) Bonus program hypothesis; 2) Debt agreement hypothesis; and 3) Political costs hypothesis. The measurement of earnings management can use the proxy of discretionary accruals value or through real activity manipulation called real earnings management (Dechow and Skinner, 2000). This real earnings management activity is significantly different from accrual based because it affects directly on cash flows. Roychowdhury (2006) defined the real activity manipulation as a management action that deviates from normal business practices with the aim to mislead the stakeholders.

For the tax purpose, in order to the cost to be recognized, it has to fulfill sufficient condition, which there are three conditions that must be fulfilled (Guenther 1994; Gunadi 2009). First, based on an all-event test determining the liability of taxpayer for the cost must have occurred. Second, the amount of tax payer liability must be accurately determined. Third, before the cost item might occur, the economic performance must have occurred. In addition to accelerate the cost, for postponing taxable income, managers can postpone revenue recognitions. Managers who try to postpone taxable income will postpone the revenue by postponing the event of “all events” that determining tax’s payer right to receive income, as postponing the good delivery at the end of the year.

Under sufficient condition, not necessary, if managers try to postpone taxable income, then, they also postpone their accounting earnings. Operational decision is on the hand of managers, while postponing revenue recognition and/or accelerating expenses until it meets sufficient condition is an operational decision, so the suitable earnings management to postpone income tax payment is the earnings management by conducting real activity manipulation or real earnings management, not the earnings management by manipulating accruals.

An earnings management technique through real activity manipulation used in this study is using the model developed by Roychowdhury (2006), which is: manipulating sellings to decrease sellings in temporary time, accelerating discretionary expenses, and decreasing production activity that decreases production cost, and causing the production cost per unit increases, then cost of goods sold increases, and eventually, the gross profit decreases.

Hypothesis Development

Earnings before tax and taxable income are related (Shackelford dan Shevlin, 2001). Mills (1998) proved that the different increasing between accounting earnings and taxable income increased audit adjustments by Internal Revenue Service (IRS). Therefore, as long as corporations are profitable and having taxable income, the relation between reported accounting earnings and taxable income gave the incentive of earnings decreasing to reduce the current value of income tax expense.

Tax savings by reporting a lower earnings might cause nontax costs. Cloyd et al. (1996) stated that the nontax costs related to the ownership structure. They obtained empirical supports that public corporations faced nontax costs higher compared to private corporations. Public corporations with dispersed ownership structure only used audited financial statement to assess the management performance.

In public corporations with concentrated ownership structure, the nontax costs can be decreased. Managers can use various communication devices in addition to audited financial statement and public announcements to informing the corporate value to shareholders, so the corporations with concentrated ownership structure are more likely to decrease the earnings for tax savings. The ownership structure of public corporations in Indonesia is concentrated (Claessens et al., 2000; Lemmon and Lins, 2003; Du and Dai, 2005; Febrianto, 2005; Siregar, 2006; and Sanjaya, 2010). Controlling shareholders can influence corporate managers to follow their willingness and desire.

The income tax expense covered by corporations decrases the availability of corporate cash resources. This can cause the motivation of controlling shareholders as a single majority to influence corporate managers to always try in minimizing the corporate income tax expense. Thus, the tax rate decreasing can cause the motivation of corporations to conduct decreasing earnings management in the period before the tax rate decreasing is applied (Guenther, 1994; Yin and Cheng, 2004; and Yamashita and Otogawa, 2007).

Thus, the implementation of Tax Law No. 36, 2008 able to give motivation to corporate managers of concentrated ownership corporation to perform decreasing real earnings management, by postponing the revenues and/or accelerating the expenses from the period with the high income tax rate to the period with the lower income tax rate.

H1: Public corporations with concentrated ownership structure conduct a real earnings management that decreases earnings in the last year before the Income Tax Law No.36, 2008 is prevailed.

Managers want to show that corporation are profitable to reflect the management performance, as well to facilitate the issuance of new debt or shares. However, at the same time, managers do not expect the corporations to be seen profitable when preparing the financial statement for the tax authority. It can cause a tension between financial statement for external users and for the tax authority because actions increasing earnings for the external porposes as well as increasing the earnings for tax purposes.

The perception of corporate value between corporate managers and corporate shareholders is sometimes different (Cloyd et al., 1996). Shareholders perceive the corporate value from the cash flows, while managers perceive the corporate value from the reported earnings. It can cause the interest conflict between shareholders and corporate managers. Therefore, if the cash flows is perceived as the corporate value by shareholders, so reporting the earnings lower to save tax can cause a pressure in stock market and compensation contract, even though it increases the availability of corporate cash flows.

Corporate ownership structure can decrease the pressure faced by corporations as the result of reporting earnings lower for tax savings. In corporations with concentrated ownership structure, there are controlling shareholders who have majority votings in general meeting of shareholders and are able to communicate more intensively with corporate managers. The controlling can run effectively when controlling shareholders have voting rights above 50%.

When the implementation of Tax Law No.36, 2008 is decrease the income tax rate, it is expected that the corporations with concentrated ownership above 50%, are willing to decrease earnings greater than the corporations with dispersed ownership.

H2: Public corporations with concentrated ownership structure on controlling shareholders as the single majority perform the real earnings management for income tax savings greater than public corporations with dispersed ownership structure in the last year before the Income Tax Law No.36, 2008 is prevailed.

In corporations with concentrated ownership structure, there is separation of control right and cash flows right owned by controlling shareholders. The control right is the voting right to determine the corporate policy, while cash flows right is the financial claim of shareholders on the corporation (La Porta et al., 1999). The increasing of cash flows right will decrease interest of controlling shareholders to perform expropriation and they will influence managers in running the corporation appropriately, so it can increase the corporate value (Claessens et al., 2002, Lemmon and Lins, 2003; Du and Dai, 2005; Febrianto, 2005; Siregar, 2006; Sanjaya, 2010).

Income tax that covered by corporations will affect the corporate cash expense. Controlling shareholders through cash flows right will try to influence corporate managers to minimalize tax in order to decrease the corporate outcome cash flows, so the corporate value increases. It is predicted that there is a positive relationship between cash flows right of controlling shareholders and readiness of managers to perform the decreasing real earnings management in the period before Income Tax Law No. 36, 2008, is applied.

H3: There is a positive relationship between cash flows right of controlling shareholders as the single majority and the decreasing real earnings management in the year before the Income Tax Law No. 36, 2008 is prevailed.

RESEARCH METHODS

Research Sample

The sample collecting is done with criteria as follows:

1. Corporations listed on IDX in the period of 2005-2009.
2. All kinds of corporations are sample in this research, except Bank and Non-banking Institution, Security Firms, Insurance, Deposit Insurance Agency, Mining, Agriculture, Farming and Forestry.
3. Corporations do not suffer the taxable loss or in the period of Net Operating Loss Carryforwards.
4. Corporations charged effective rate closed to 30% in 2007, charged effective rate closed to 30% or 25% in 2008, and the rate of 28% or 23% in 2009.
5. Corporations was identified their ownership structures, by using 50% cutoff to determine the single majority of controlling shareholders.

Research Variable Measurement

The real earnings management is measured by using Roychowdhury model (2006) that can be done by (1) manipulating the selling activity that will affect the operation cash flows; (2) manipulating discretionary expenses; and (3) manipulating cost of goods sold by influence its production costs. Because of the earnings management done is decreasing earnings, then, the real activity manipulation will cause: the operation cash flows abnormally higher, discretionary expenses abnormally higher, and production costs abnormally lower.

Estimation Model to obtain the normal real activity level is as the following:

$$CFO_{it}/A_{it-1} = \alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it}/A_{it-1}) + \alpha_3(\Delta SALES_{it}/A_{it-1}) + \varepsilon_{it}$$

$$DEX_{it}/A_{it-1} = \alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it-1}/A_{it-1}) + \varepsilon_{it}$$

$$PROD_{it}/A_{it-1} = \alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it}/A_{it-1}) + \alpha_3(\Delta SALES_{it}/A_{it-1}) + \alpha_4(\Delta SALES_{it-1}/A_{it-1}) + \varepsilon_{it}$$

The abnormal level that is real activity manipulation done by the corporations is obtained from the equation as the following:

$$UXCFO_{it}= CFO_{it}/A_{it-1} - [\alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it}/A_{qt-1}) + \alpha_3(\Delta SALES_{it}/A_{it-1})]$$

$$UXDEX_{it}= DIEXP_{it}/A_{it-1} - [\alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it}/A_{it-1})]$$

$$UXPROD_{it}= PROD_{it}/A_{it-1} - [\alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(SALES_{it}/A_{it-1}) + \alpha_3(\Delta SALES_{it}/A_{it-1}) + \alpha_4(\Delta SALES_{it-1}/A_{it-1})]$$

Control variable used in this research is corporation size, market to book value, leverage level, and return on assets. Since this testing is done on the corporations with concentrated ownership structure, then, the control rights of controlling shareholders (HK) and the involvement of controlling shareholders in corporate management (MNJ) become as the control variable too.

Hypothesis testing model

Before hypothesis testing, classic assumption tests are conducted, which are multicollinearity, autocorrelation, heteroscedasticity, and normality tests.

The examination of H1 is done by regression equation as follows:

$$Y_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 MTB_{it} + \beta_3 ROA_{it} + \beta_4 DA_{it} + \beta_5 SUSPECT_{it} + \varepsilon_{it}$$

Hypothesis 2 is tested by using multiple regression equation as follows:

$$Y_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 MTB_{it} + \beta_3 ROA_{it} + \beta_4 DA_{it} + \beta_5 KONS_{it} + \varepsilon_{it}$$

The H3 examination uses multiple regression equation as follows:

$$Y_{it} = \beta_0 + \beta_1 HAK_{it} + \beta_2 HK_{it} + \beta_3 MNJ_{qt} + \beta_4 SIZE_{it} + \beta_5 MTB_{it} + \beta_6 ROA_{it} + \beta_7 DA_{it} + \varepsilon_{it}$$

VI. ANALYSIS AND RESULTS

Research Sample Description

Regression equation to estimate normal real activity of corporations used 909 firm years. The research sample was corporations that had taxable earnings in 2007, 2008, and 2009, that are 129, 133, and 155 corporations, respectively. The corporations were then investigation done of ultimate ownership by using 50% cutoff and it was obtained 74, 77, and 87 corporations, respectively.

Description of Research Variable Statistics

Statistic descriptive comparing between corporations suspected to perform real earnings management and other corporations gave the result that suspect firms are suspected to perform decreasing real earnings management. It can be seen from the average of cash flows from operation variable (CFO) and discretionary expenses (DEX), which was 5.67E+11 and 5.78E+11, that significantly higher than other corporations. Other research variables, all of them were also greater and significantly different compared to other corporations.

Estimation Model of Normal Real Activity

Generally, the direction of prediction result in this for independent variable coefficient was similar to the prediction direction of independent variable coefficient of Roychowdhury (2006), with an exception on $\Delta SALES_{it}/A_{it-1}$. It was caused by the different condition of the research. All coefficients used to estimate the normal real activity from CFO, DEX, and PROD were statistically significant indicating that independent variables used could predict the dependent variable.

Hypothesis Testing

Before the hypothesis testing, this research conducted the classic assumption examinations and regression equation didn't passed it. To overcome the situation, this research used pooling data and Generalilzed Least Squares's estimation method (GLS), so the regression equation remained to be Best Linear Unbiased Estimation (BLUE).

Hypothesis (H1) Testing

The result on Table 1 shows coefficient of SUSPECT variables, each for year 2007, 2008, and 2009 in line with the perdiction direction. When using dependent variables of UXCFO, UXDEX, and UXTOTAL, the prediction direction was positive and when using dependent variable of UXPROD, the prediction direction was negative.

The examination result used dependent variable of each real earnings management proxy showed that the result was statistically significant, except in year 2008 and 2009 when using UXDEX. When using dependent variable of total proxy (UXTOTAL), the result showed that SUSPECT variable coeficient each for 2007, 2008, and 2009 was statistically positive and significant at α=1%. This final result gave a strong support to H1, that public corporations with concentrated ownership structure perform decreasing real earnings management in the last year before Tax Law No.36, 2008 is applied.

Controlling shareholders, as the single majority, are able to influence corporate managers to decrease earnings. This analysis result implies that there are alignment effect of controlling shareholders. When managers are willing to decrease the earnings in the high income tax rate period, this tax payment savings gives impact on the increase of cash flows available to shareholders. In this matter, the interest of non-controlling shareholders is also protected.

Table 1
Examination Results of Hypotheses 1

$$Y_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 MTB_{it} + \beta_3 ROA_{it} + \beta_4 DA_{it} + \beta_5 SUSPECT_{it} + \varepsilon_{it}$$

Koefisien	UXCFO	UXDEX	UXPROD	UXTOTAL	Hypotheses
SUSPECT_2007	**0.044871*** **	**0.06138*** **	**-0.108048*** **	**0.178761*** **	Supported
SUSPECT_2008	**0.071002*** **	**0.062565**	**-0.100738***	**0.21692*** **	
SUSPECT_2009	**0.053628*** **	**0.060147**	**-0.0031*** **	**0.135995*** **	
Adjusted R^2	0,35	0,35	0,33	0,45	
Hypotheses	Supported		Supported	**Supported**	

*** Significance at α = 1%; * Significance at α = 10%

Hypothesis (H2) Testing

Table 2 reports the result of H2 examination. The result shows that KONS variable coefficient, which is corporations with concentrated ownership structure, has positive value when using dependent variables of UXCFO, UXDEX, and UXTOTAL and has negative value when using dependent variable of UXPROD.

All of KONS variable coefficient gave statistically significant value at α=1%, only on KONS variable coefficient in 2008 with UXCFO dependent variable gave significancy at α=5%. This result shows a strong support to hypothesis H2, that corporations with concentrated ownership structure on controlling shareholders as the single majority perform decreasing real earnings management to save income tax higher than corporations with dispersed ownership structure in the last year before the income Tax Law No. 36, 2008 is applied. This result is in line with the finding from Cloyd et al. (1996) that nontax cost was related to ownership structure.

Table 2
Examination Results of Hypotheses 2

$$Y_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 MTB_{it} + \beta_3 ROA_{it} + \beta_4 DA_{it} + \beta_5 KONS_{it} + \varepsilon_{it}$$

Koefisien	UXCFO	UXDEX	UXPROD	UXTOTAL	Hypotheses
KONS_2007	0.023566***	0.04897***	-0.106206***	0.154994***	Supported
KONS_2008	0.059386**	0.072343***	-0.15482***	0.272063***	Supported
KONS_2009	0.009002***	0.06542***	-0.04294***	0.380065***	Supported
Adjusted R^2	0,50	0,69	0,80	0,55	
Hypotheses	Supported	Supported	Supported	**Supported**	

*** Significance at α = 1%; ** Significance at α = 5%

Hypothesis (H3) Testing

The result of H3 testing is reported on Table 3. HAK variable coefficient gave the conformity result to the prediction direction. This result is statistically significant at α=1% and α=10%, except HAK coefficient in 2008 and 2009 by using UXDEX dependent variable. This result shows that there is positive relation between cash flows right of controlling shareholders and the decreasing real earnings management.

The result indicated that the increase of cash flows right owned by controlling shareholders had caused decreasing real earnings management increased. This result showed the presence of the alignment effect, that was the interest conformity between controlling and non-controlling shareholders. This result was also in line with PIE argument, where controlling shareholders tried to involve themselves in the corporation to maximalize the corporate value (Claessens et al., 2000). When it is associated to the agency conflict, the result can decrease the agency problems between controlling and non-controlling shareholders.

Table 3
Examination Results of Hypotheses 3

$$Y_{it} = \beta_0 + \beta_1 HAK_{it} + \beta_2 MNJ_{it} + \beta_3 SIZE_{it} + \beta_4 MTB_{it} + \beta_5 ROA_{it} + \beta_6 DA_{it} + \varepsilon_{it}$$

Koefisien	**UXCFO**	**UXDEX**	**UXPROD**	**UXTOTAL**	**Hypotheses**
HAK_2007	0.031389***	0.03095***	-0.288003***	0.290915***	Supported
HAK_2008	0.042634*	0.020326	-0.191664***	0.145781***	
HAK_2009	0.04895***	0.019319	-0.26602***	0.267155*	
Adjusted R^2	0,96	0,34	0,68	0,99	
Hypotheses	Supported		Supported	**Supported**	

*** Significance at α = 1%; * Significance at α = 10%

V. CLOSING

This research concluded that public corporations with concentrated ownership structure performed decreasing real earnings management in the last year before the Income Tax Law No. 36, 2008 is applied. The presence of controlling shareholders effectively influenced corporate managers to save income tax. This research also concluded that corporations with concentrated ownership performed real earnings management greater than corporations with dispersed ownership. There was a positive relationship between cash flows right of controlling shareholders and the decreasing real earnings management.

This empirical finding gives theoretical implication relates the agency problems in concentrated ownership structure. The policy implication relates to the policy making in the tax authority, financial accounting standard, and the policy relating to the disclosure of relationship between corporations and legal entity shareholders. The practical implication relates to the careful attitude of financial statement users in interpreting and understanding the financial statements.

This research would be stronger if it was also tests in the previous years, which is in the normal periods, and completed by period that Income Tax Law No. 36, 2008 was effectively applied. This may give complete illustration on real earnings management performed by corporations with concentrated ownership structure in in relation for income tax savings.

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