The relationship between non-duty member of the board and its role on the tax gap

Abolfazl darehzereshki

Department of Accounting, Young Researchers and Elites Club, Yazd Branch, Islamic Azad University, Yazd, Iran

Abstract: The historical background of the corporate governance dates back to the 1990s when major financial corruptions occurred in some of the largest enterprises. Corporate governance also develops a structure by which the goals of the enterprises are established and the ways to achieve these goals are clearly identified.Corporate governance is a set of functions, mechanisms and policies seeking for the better direction of the managers and achievement of responsiveness, transparency, justice and stakeholders' right (including government). The present study is classified as a correlation-descriptive study and the theoretical data are gathered from the library studies. The required data is collected from the stock exchange and the related financial reports. The sample is composed of 56 listed firms on the Tehran Stock Exchange during a period covering the years from 2007 to 2011. The findings revealed that the percentage of the non-executive board members has no impact on reducing the tax gap.

Introduction

The historical background of the corporate governance dates back to the 1990s when major financial corruptions occurred in some of the largest enterprises. Corporate governance also develops a structure by which the goals of the enterprises are established and the ways to achieve these goals are clearly identified (Al-Najjar, 2010, 177). By separating the ownership from management, the directors handle the affairs of the entities (Fama and Jensen, 1983). Sloan (2001) developed an economic and financial approach and defined corporate governance as a mechanism used in mitigating the problems by separating the management from the suppliers.

In terms of a limited perspective of corporate governance, government is known as a shareholder and the firms pay the earnings of the government; however, the general perspective of the corporate governance raises some questions including: do the firms fairly observe the rights of the governments? Do the firms issue transparent information so that the tax could be fairly and properly evaluated?

As noted above, it seems that some of the corporate governance measures might be considered as the key factors relating to the transparent information about the governmental tax. These elements include the non-executive members of the board, non-duality of CEO, the presence of the internal auditor and the institutional shareholders. Providing more transparent information is expected to motivate the firms in accomplishing their responsibility towards the stakeholders. As a consequence, providing more transparent information leads to the more accurate and proper calculation of the tax (Abdi and Babajani, 2010).

Literature Review

We will review some studies already conducted on business cycles and company performance. Emami and Mehrabian (2007) investigated fluctuations in business cycles and inflation uncertainty through heterogeneity models of conditional variance of general regression. They estimated the effect of business cycle fluctuations on long-term economic development using cointegration tests and vector error correction models. The results showed that business cycle fluctuations might decrease economic development in the long run. The reason is that fluctuations in production development in Iran have led to production uncertainty, which has decreased investment and eventually economic development.

Perez and Timmermann (2007) studied fluctuations in stock return when business cycles were altering. They found considerable fluctuations in stock returns during business cycle alterations.

Antonio et al. (2007) addressed the question whether or not business cycles and biased profitability behavior account for trading speed in three major European markets. They reported that global trading conditions influenced the profitability of trading speed in European markets.

Guaray and Gonzales (2008) investigated the relationship between corporate leadership system and the criteria for company performance appraisal such as distribution of profits, P.B ratio (market value to equity book value) and Tobin Q in The Caracas Stock Exchange. The results showed that one percent increase in corporate leadership system index increased profit distribution by 11.3 percent, P.B ratio by 9.9 percent and Tobin Q by 2.7 percent.

The collapse of the companies such as Enron and WorldCom in the United States and Tel Van in Australia in 2001 highlighted the significance of efficient performance of the non-executive board members. On the other hand, the Higgs Report (2003) is considered as a strict response to the significant influence of the inefficient non-executive members of the companies simulated to Enron.

Chan et al (2010) examined whether deviation from the tax accounting base and acceptance of the international financial reporting standards leads to the nonconformity of the tax regulations and whether it is shown in the behaviors of the managers. They found that the consistent tax and accounting regulations reduce the gap between the taxable income and accounting earnings. They also showed that any reduction of taxable income confirms the nonconformity of the tax regulations. Limiting the gap between tax regulations and accounting standards might reduce the opportunities and incentives of nonconformity of the law regulations, they additionally indicated.

Fridman (2006) investigated the consistency of the tax regulations and financial accounting in the United States and England. Their findings showed that the full consistency of the tax and business accounts is not possible. Accordingly, the more consistency between tax regulations and financial reporting is required by the American participants in order to prevent earnings manipulation.

Lanis and Richardson (2011) found that the number of the non-executive board members has a significant negative association with the aggressive tax trend. In other words, the more numbers of the non-executive members of the board shows that the few firms tend to manage the taxes.

Chen et al (2010) indicated that the family ownership might impact the tax policies. They showed that the family owned corporations confirm aggressive tax policies less than those corporations without family ownerships. These findings confirm that the family owned corporations prevent tax management to avoid the reduction of the stock's market value derived from the concerns of the minority shareholders about the tax functions.

Minik and Noga (2010) explored the impacts of corporate governance characteristics of the tax management. They revealed that the incentive plans work as a motivation for the managers to invest in long-term programs. They also found that the tax management holds benefits for the shareholders and is positively associated with the increases in the shareholders' earnings.

Sartori (2008) found the interactive reactions between corporate governance and tax. In fact, the corporate governance regulations have structural impacts on meeting the tax obligations. In addition, it was found that the tax plans (from the perspective of the government) and their relationship with the tax strategies (from the perspective of the corporations) might significantly impact the establishment of dynamic corporate governance.

Abor and Biekpe (2007) defined corporate governance as a process and structure used by the management to direct the affairs and to increase the welfare and responsiveness and finally increase the benefits of the shareholders to its maximum level.

Young Byun (2007) suggested that the successful corporate governance mitigates the information asymmetry. He also argued that the proper corporate governance impacts: (1) protection of the shareholders' rights, (2) protection of the management rights, (3) more appropriate disclosure and information asymmetry, (4) more auditing and handling of the affairs and (5) more appropriate dividend policy.

Hypotheses Development

This study develops a hypothesis: There is a significant association between the percentage of the non-executive members and the difference of the income tax and final tax.

Data Analysis

The collected data from the financial statements of the firms, notes to the financial statements and different software are compiled in EXCEL database. As the second step, EVIEWS software is used to analyze the data and the hypotheses are tested by considering the variables correlation and regression equations in panel data. Quantitative statistical methods and multivariate regression analyses along with White cross-section, Chaw test (F statistics), R^2 and Durbin-Watson statistics have been employed.

Variables Definition and Calculation

The dependent variable of the study is defined as the gap between income tax and final tax of the firms.

The independent variable of the study is composed of the non-executive members of the board defined as those members who have no executive responsibility and do not receive constant annual or monthly salary.

Control variables

These control variables include:

- Firm Size

The size of the firm is calculated by the natural logarithm of the market value of the equity or sales or total assets.

- Financial leverage

The financial leverage is computed by dividing the debts by the assets and is considered as a controlling variable of the study.

- Effective tax rate

The effective tax rate is computed by dividing the total tax by the taxable income.

Research Model

The models of this study include a regression model as follows:

$$\text{Gap} = \alpha_i + \alpha_1 \text{ Out}_{it} + \alpha_2 \text{ SIZE}_{it} + \alpha_3 \text{ LEV}_{it} + \alpha_4 \text{ ETR}_{it} + \varepsilon_{i,t}$$

The significant coefficient of non-executive members (α_1) confirms the significant relationship. The above model has been also used by Babajani and Abdi (2010).

The significant coefficient of internal audit (α_1) also confirms the significance of the model.

The variables of the equation are as follows:

Gap: The gap between the income tax and final tax;

α_0: Constant coefficient;
α_1 ـــ α_7: The variable coefficients
Size: Size of the firms
Lev: Financial leverage
ε: Coefficient of errors.

Hypothesis Analyses

Hypothesis: There is a significant relationship between the percentage of the non-executive members and the difference between income tax and final tax.

Model 1

$$\text{Gap} = \alpha_i + \alpha_1 \text{ Out}_{it} + \alpha_2 \text{ SIZE}_{it} + \alpha_3 \text{ LEV}_{it} + \alpha_4 \text{ ETR}_{it} + \varepsilon_{i,t}$$

The findings of the Chaw test are shown in tables 2 and 3.

Table 2. Results of the redundant fixed effects tests

Redundant Fixed Effects Tests			
Test cross-section fixed effects			
Effects Test	Statistic	d.f.	Prob.
Cross-section F	6.3625	(57.128)	0
Cross-section Chi-square	296.4523	57	0

Table 3. Results of the fixed effect tests

Redundant Fixed Effects Tests			
Test period fixed effects			
Effects Test	Statistic	d.f.	Prob.
Period F	.0.28954	(4.279)	0.6542
Period Chi-square	1.6214	4	0.6431

The probability of Chaw test about the cross-section fixed effects is lower than 5% and the probability of the period fixed effect is higher than 5% which reject H0 arguing the equality of the intercepts for the cross-section fixed effects. Consequently, the cross-section fixed effect model is prioritized.

Table 4. Hypothesis Analysis

Estimation period: 2006 to 2011					
Gap $= \alpha_i + \alpha_1 \text{ Out}_{it} + \alpha_2 \text{ SIZE}_{it} + \alpha_3 \text{LEV}_{it} + \alpha_4 \text{ ETR}_{it} + \varepsilon_{i,t}$					
Cross-section fixed (dummy variables)					
Adjusted R^2	0.722275				
F	13.32128				
Std. deviation	20.69353				
(Prob)	0				
Durbin-Watson	2.004036				
Explanatory variable	Coefficient	Std. error	*t*	prob	Sig. level
QUT	0.01392	0.03001	0.463846	0.6432	-
SIZE	0.000000193-	0.000000171	1.12961-	0.2598	-
ERT	9.514265	0.305728	31.12	0	99%
LEV	8.86046-	2.486238	3.5638-	0.0004	99%
C	13.8363	1.893926	7.30562	0	99%

Based on F statistics, it can be concluded that the regression equation is significant at the 99 percent level of confidence. Durbin-Watson statistics confirm the relative independence of the data.

The adjusted R^2 of the model shows the relative amount of the independent variables and the dependent variable (tax gap). According to table 4, the adjusted R^2 of the model is 72 percent. That is, 72 percent of the variation in the dependent variable is explained by this model. Based on the probability of the main variable which is higher than five percent, it can be concluded that this variable is not significant at 95 percent of significance. It is also interpreted that there is no significant association between the percentage of the non-executive members and the percent of the difference between the income tax and final tax. All variables of firm size, financial leverage and effective rate of tax are significant at 99 percent of significance. However, the percent of the non-executive members is not significant and it is confirmed that there is a relationship between the percentage of the non-executive members and the tax gap.

Conclusion

The present study examines the relationship between the percentage of the non-executive members and the difference percentage of the income tax and final tax. The findings revealed that there is no significant direct relationship between these two variables. That is, the non-executive members have no role in increasing or decreasing the tax gap. Among the control variables, the effective tax rate is significant at the 99 percent level of confidence and has a direct relationship with the tax gap. The financial leverage is significant at 99 percent of significance and has an inverse association with the tax gap. The firm size proved to be insignificant and has no relationship with the tax gap. The findings of this hypothesis are consistent with the findings of Babajani and Abdi (2010).

Suggestions

Tax transparency and corporate governance are among the topics which have been much debated in different fields and play key roles in the development of the firms. As a result, the scholars should attach great importance to this subject in order to achieve the goals. Therefore, numerous and more precise studies are required to be conducted to reduce the error probability and increase the generalization of the findings.

Reference

1. Al-najjar, B. (2010). Corporate governance and institutional ownership, evidence from jordan, ISSN, 176-190.
2. Fama, E. F. (1980). "Agency Problems and the Theory of Firm." Journal of Political Economy 3: 88-95.
3. Babajani, vol. (2010). Fundamental change in the information system, the new system of tax accounting, tax, accounting studies, 10 and 11.
4. Abor, Joshua. and Biekpe, Nicholas.(2007), (Does Corporate Governance Affect the Capital Structure Decisions of Ghanaian SMEs?), University of Stellenbosch Business School, South Africa.
5. Byun, Y.(2007), (The Cost of Debt Capital and Corporate Governance Practices), Asia-Pacific Journal of Financial Studies, Seoul National University, Seoul, Korea, v36 n5 pp765-806.
6. Chen, K, C, W. Chen, Z. John We, K, C. (2009). Legal protection of investor, corporate governance,and the cost of equity capital, Jornal of corporate Finance 15, 273-289.
7. Fernandeze, J. (2007). "Mandatory CEO Retirements, Discretionary Accruals, and Corporate Governance Mechanisms". Journal of Accounting, Auditing & Finance 18 (2), 255 - 280.
8. Mutairi,M. E. A. (2010). The Effect of Corporate Governance, Corporate Financing Decision and Ownership Structure on Firm Performance: A Panel Data Approach from Kuwait Stock Exchange, University of Wollongong - Faculty of Commerce.
9. Stapledon, G. P. (1996). "Institutional Shareholders and Corporate Governance." Clarendon press, Oxford.
10. Richardson, S. A., R. G. Sloan, et al. (2004). "Accrual Reliability Persistence and Stock Prices." Working Paper, University of Michigan Business School.

7/17/2015