The Influence of Corporate Ownership Structure on Real Earnings Management for Corporate Income Tax Savings

Susi Dwimulyani
email: susi.dwimulyani@yahoo.com

Abubakar Arief
aboebakararif@yahoo.com
Under Graduate Program in Tax Accounting, Economic Faculty, Trisakti University

Abstract

The issue of this research is the change in the statutory corporate income tax rate from Income Tax Law No. 17 (2000) to Income Tax Law No. 36 (2008). Income Tax Law Number 36 (2008) had single rate of 28% in 2009 and 25% in 2010 and after that had lower corporate income tax rate than Income Tax Law Number 17 (2000). Income Tax Law Number 17 (2000) has effective tax rate closed to 30%.

The objective of this research is to investigate the influence of corporate ownership structure from public companies listed at Indonesian Stock Exchange (IDX) on earnings management for saving the corporate income tax through real activities manipulation in the year before Income Tax Law No. 36 (2008) is applied. The real earnings management model proposed by Roychowdhury (2006) is used to examine the research hypotheses. The results of this research find that (1) the companies listed on IDX have done real earnings management for saving corporate income tax in the year before Income Tax Law No. 36 (2008) is applied and (2) companies that have ownership structure with single majority shareholders have done larger real earnings management than companies with dispersed shareholders' ownership structure.

Keywords: corporate ownership structure, real earnings management, corporate income tax.

INTRODUCTION

Based on Income Tax Law No. 17 (2000), the calculation of corporate income tax is done progressively by effective rate closed to 30%. In Income Tax Law No. 36 (2008) applied effectively on January 1st 2009, taxable income are charged by using single rate of 28% for the tax year 2009 and 25% starting tax year 2010 and after. The result of this changes is the reduction in income tax to be paid by companies. Drafting the law takes relatively long process. People are able to follow and to know when the law is formally ratified and when it starts to be applied. Consequently, the rate reduction of tax rate is known by public before being applied. This phenomenon can create incentive company's manager to conduct earnings management to reduce earnings in previous period before reducing determined tax rate in order to save tax.

Therefore, the research on the influence of income tax reduction in earnings management is interesting to be done.

Accounting numbers are the measurement for corporate performance. It results corporate manager reluctant to reduce reported earnings. The pressure faced by the company in capital market would create the cost of financial report that its amount is influenced by the corporate ownership structure (Cloyd et al., 1996). Public companies with dispersed ownership structure only uses audited financial statement to evaluate management performance, so the reduction of reported earnings for tax savings generates the evaluation that company's performance is poor, while companies with concentrated ownership structure have various channels to communicate management performance. Therefore, companies with dispersed ownership structure would bear larger cost of financial report than concentrated ownership structure (Cloyd et al., 1996).

The structure of public companies in Indonesia were concentrated (Claessens et al., 2000 and Sanjaya, 2010). A concentrated ownership structure shows that the majority of company's shareholders was controlled by controlling shareholders. Controlling shareholders are family, government, or institutions that have control on a company (Claessens et al., 1999). Controlling shareholders are able to arrange corporate financial and operational policy by using voting rights in a shareholders' general meeting. If controlling shareholders are single majority, which have voting right above 50%, in this condition controlling shareholders can affectively control the company.

Whenever income tax savings is able to increase company's value, then, controlling shareholders are expected to affect manager to conduct decreasing earnings management profit in the previous periods before tax rate decreasing to save tax. Thus, this research aims to give empirical support of the influence of corporate ownership structure on the readiness of manager in conducting decreasing real earnings management. This research has two research questions: 1) Whether public companies listed on Indonesian Stock Exchange conduct decreasing real earnings management in the year before Income Tax Law No. 36 (2008) being applied; and 2) whether companies with concentrated ownership structure conduct larger real earnings management compared to the ones with dispersed ownership structure.

The results of hypothesis testing give support that public companies listed in Indonesian Stock Exchange (IDX) have conducted decreasing real earnings management to save tax in the year before Income Tax Law No. 36 (2008) is applied. Moreover, companies with concentrated ownership structure, in this case, the presence of controlling shareholders with single majority, conduct decreasing real

earnings management larger than the ones with dispersed ownership structure to save tax.

THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

Earnings Management

Earnings management is a selection of accounting policy or real actions done by manager to affect earnings in order to get certain purposes from reported earnings (Scott, 2009). Earnings management occurs when the manager uses judgment in financial statement and when structuring transaction to change financial statement that can mislead stakeholders on economic performance of company, or affect contractual result that depends on reported accounting numbers.

Watts and Zimmerman (1986) used agency theory to propose three hypotheses on earnings management motivation conducted by managers, as the followings; (1) Hypothesis of bonus program. This hypothesis stated that, ceteris paribus, a manager would shift the reported earnings from the following periods to the current periods in order to maximize rewards bonus; (2) Hypothesis of debt agreement. This hypothesis stated that, ceteris paribus, a manager would conduct earnings management to avoid breaking debt agreement. Companies that closed to break covenant debt would shift the reported earnings from the following periods to the present periods; and (3) Hypothesis of political cost. A manager would hold reported earnings from the present periods to the following periods to reduce earnings and political risks. Scott (2009) explained earnings management pattern as the followings: (i) taking a bath; (ii) income minimization; (iii) income maximization; and (iv) income smoothing.

Real Activity Manipulation

The measurement of earnings management conventionally has used discretionary accurals proxy. This model has obtained many critisisms in term of the presence of bias and noisy estimating (Dechow et al., 1995). As the consequence of accrual model performance was that it often gave mixed results. Dechow and Skinner (2000) explained other ways in conducting earnings management which was through real activity manipulation called real earnings management. Even though this real earnings management has not been studied as much as accrual model, survey done by Graham et al. (2005) found that managers preferred conducting real activity manipulation, such as reducing discretionary expenses, rather than conducting accrual manipulation. This real earnings management was different significantly from accruals basis since it affected directly to cash flows.

Roychowdhury (2006) defined real activities manipulation as management action that deviate from normal business practices with the purpose to mislead

stakeholders. It focused on companies with earnings closed to zero. He found evidence that the company trying to avoid loss conducted real earnings management by three ways: (1) increase selling by accelerate timing and/or adding unsustainable selling; (2) conducting excess production, so they allocated overhead more on inventories that were able to reduce cost of goods sold; or (3) reducing aggregate discretionary expenses aggresively.

Earnings Management for Income Tax Savings

According to Badertscher *et al*. (2006), to reduce current value of tax payment, a suitable earnings management is by manipulating real operation that is by reducing reported income, so it also reduces its taxable income. For the tax purposes so that the expense can be admitted, there are three conditions that have to be fulfilled (Guenther 1994; Gunadi 2009). Firstly, based on all event tests that determine the taxpayer liability to pay the expense, it has to be occurring. Secondly, the total amount from the taxpayer liability has to be accurately determined. Thirdly, before the expense items that might occur, economic performance must have occurred.

Besides accelerating expenses, to suspend taxable income, managers are also able to delay revenues recognition. A manager who tries to suspend taxable income would suspend revenues by delaying the 'whole event' that determine the rights of taxpayer to recognize revenues as postponing goods delivering in the end of year. The companies delaying to recognize income, so the income would not be realized in the end of year for the purpose of tax, similarly, the income would be delayed in external financial statement. Revenues suspension for the purpose of tax also has to fulfill sufficient condition.

Under sufficient condition, if a manager tries to delay taxable income, so he/she would delay its accounting earnings. Operational decision is on the manager's hands, while delaying revenues recognition and/or accelerating expenses until fulfilling sufficient condition are operational decisions not accounting policy, so the suitable earnings management to delay income tax payment is earnings management with real activities manipulation.

Techniques of Real Earnings Management

The technique of earnings management through real activities manipulation that would be used in this study is using a model developed by Roychowdhury (2006). This empirical model is developed to examine companies conducting earnings management to avoid loss. Therefore, earnings management conducted is to increase earnings. If the earnings management conducted is to reduce earnings, so the contrary of Roychowdhury model (2006) would be used, which is: manipulating selling

to reduce temporary selling, accelerating discretionary expenses, and reducing production activities.

Reducing selling in temporary time can be done by: (i) delaying goods delivering at the end of year; (ii) tighten selling requirements, such as reducing or ommiting discount, credit requirements being tightened; (iii) installment sales. The reduced volume of sales causes the revenues of the current year low, but the cash flows will increase because of high cash flows as the result of cash sales and receivable payments. Therefore, sales management activities cause the cash flows from operating activities of current periods increased compared to normal selling level and as the result of abnormal reducing of account receivable.

A manager of a company is able to arrange production activities. Whether the company would produce larger goods than needed, so the final inventory would increase, or reduce production activities to reduce inventory. Production in undercapacity scale causes overhead cost divided by the total unit of fewer goods, so that the average cost per unit and cost of goods sold will increase. In addition, conducting fixed asset revaluation that is included overhead cost components of factory could be used to increase cost of goods closed to fair value (Gunadi 2009). Increasing cost of goods sold would affect operation margin reduction.

Discretionary expenses that can be accelerated are: (i) advertisement expense, (ii) research and development expense, (iii) fixed asset buying is changed to be leasing so that leasing installment expense is larger than depreciation expense of fixed asset, (iv) giving donations, likes: donation of natural disaster relief, donation of research and development, donation of education facility, donation of sport coaching, and development costs of social infrastructure, as well as (v) accelerating selling, general, and administration expenses, such as employees' training expense, maintenance and improvement expense, and traveling expense.

Corporate Ownership Structure

The essence of agency problem is the separation between controlling and ownership (Jensen and Meckling, 1976). The agency problems in this context is related to the difficulty of funders in getting guarantee that the fund that they invested is not expropriated by manager or wasted in loss projects. In this term, the presence of controlling shareholder as single majority, which is a shareholder who has more than 50% of the total outstanding shares, so the controlling shareholder has power effectively to control the company (La Porta *et al.*, 1999). The company's controlling is not on manager's hands, but on the hands of controlling shareholder. Although the manager of the company is a professional, manager would feel afraid to lose his/her position, if he/she does not follow the controlling shareholder's desire (Claessens *et*

al., 2002). The controlling shareholder with majority voting rights could influence the result of decision in shareholders' general meeting.

Hypotheses Development

Income tax expense covered by the company reduce the availabilty of resources in the company. This causes company's manager always tries to minimize its tax expense. The company's manager would choose accounting policy or real actions to conduct earnings management that reduces earnings in order to reduce current tax expense (Badertscher *et al*., 2006). Therefore, reducing of statutory income tax rate can create motivation of manager to conduct decreasing earnings management in the periods before the tax rate is applied (Guenther, 1994; Yin and Cheng, 2004; and Yamashita and Otogawa, 2007).

Net income before tax and taxable income are related (Shackelford and Shevlin, 2001). They also stated that tax gave company's incentive to adjust reported accounting earnings to taxable income. Mills (1998) proved that the different increasing between accounting earnings and taxable income increase audit adjustments by Internal Revenue Service. This finding indicated that between accounting earnings and taxable income is not independent, so researchers could continue to use information of financial statement in making inference about the influence of tax. Therefore, as long as the company is profitable and has taxable income, the relation between reported earnings and taxable income gives incentive to the manager to conduct decreasing earnings management for reducing the current value of income tax.

Badertscher *et al*. (2006) said that tax pressure was expected to create incentive for real operation manipulation. A manager would change operation activities of the company to reduce both accounting earnings and taxable income in order to produce benefit of current tax. Lee and Swenson (2011) succeeded to get empirical support on companies in the USA and Canada that in the years with high tax rate companies conducted real earnings management by accelerating discretionary expenses to reduce their income tax expense, in line with Roychowdhury's model (2006).

Thus, the application of Income Tax Law No. 36 that reduce the statutory income tax rate, could give motivation to manager to conduct decreasing real earnings management, by delaying revenues and/or accelerating expenses in the periods of high tax rate. This real earnings management reduced not only current value of income tax payment, but also the total amount of income tax that must be paid to the government. The research hypotheses that can be determined as the followings:

H1: Public companies conduct decreasing real earnings management in the last year before Income Tax Law No. 36 (2008) is applied.

The perception of company's value between manager and shareholders sometimes different (Cloyd *et al.*, 1996). Shareholders perceive the value of the company from its cash flows, while managers perceive it from reported earnings. This can bring interest conflict between company's shareholders and managers. Shareholders concern to maximize cash flows in order to increase company's value, while company's managers concern more to reported earnings because their performances are evaluated by earnings that have fulfilled the target. To maximize company's value, according to managers, is by reporting higher earnings not by reducing tax payments.

Corporate ownership structure can reduce the pressure faced by the company as the result of lower reported earnings for tax savings. In companies with concentrated ownership, there are controlling shareholders who have majority voting rights in shareholders' general meeting and are able to communicate intensively with company's managers. Although earnings reducing occurring in the current periods indicated that the performance of company's managers is poor, controlling shareholders are able to know things that are actually done by company's managers, which is tax savings. This can affect on the increase of cash flows in the company, so it can increase the company's value.

Based on the explanation that effective controlling can be done when controlling shareholders have voting rights above 50% and the application of Income Tax Law No. 36 (2008) is reducing income tax rate, it is expected that in the companies with ownership structure concentrated on controlling shareholders as single majority are willing to reduce larger earnings than companies with dispersed ownership structure in the periods before Income Tax Law No. 36 (2008) is applied to save income tax, because it can increase value of the company. The research hypothesis can be determined as the following:

H2: Companies with concentrated ownership structure on controlling shareholders as a single majority, conduct real earnings management to save income tax larger than other companies in the last periods before Income Tax Law No. 36 (2008) is applied.

RESEARCH METHODOLOGY

Sampling Technique

Sampling is done by purposive sampling with criteria as the followings:

1. Companies listed in Indonesian Stock Exchange (IDX) in the periods of 2006-2010.
2. All kinds of companies are samples in this research, except Banks and Non-banking Finance Institution, Security Companies, Insurance, Lending and Saving Institutions, Mining, Agriculture, Farming, and Forestry. Companies in those industries are predicted to respond the change of tax rate with different ways from other companies (Guenther, 1994).
3. Companies do not have taxable loss or in the periods of getting net operating carryforwards and are charged effective rate closed to 30% in the year of 2007; with effective rate of 30% or 25% in the year of 2008; and with the rate of 28% or 23% in the year of 2009.
4. Companies that have fulfilled criteria as suspect firms are identified their ownership structures, whether included in concentrated or dispersed companies by using 50% cutoff to determine the single majority of controlling shareholders.

Identification of Research Variable

To estimate the parameter in regression that then is used to get the normal level of activities use the following model (Roychowdhury 2006):

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

Explanations:

CFO_{it} = operating cash flow of company *i* in year*t*

$PROD_{it}$ = production cost of company *i*in year *t* = $COGS_{it} + \Delta INV_{it}$

$DISEXP_{it}$ = discretionary costsof company i in year t = $R\&D_{it} + ADV_{it} + SG\&A_{it}$

A_{it-1} = total asset in year *t-1*

Prediction error of this model is real activities manipulation (abnormal level), that are calculated as follows:

Abnormal Level = actual level – normal level

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

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

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

The proxy of $UXCFO_{qt}$ and $UXDEX_{qt}$ have positive direction, meaning that the larger value (more positive) shows larger decreasing earnings management has been done. The proxy of $UXPROD_{qt}$ has negative direction, meaning that smaller value (more negative) shows larger decreasing earnings management that has been done. To get the whole effect of real activities manipulation, before adding up the value of $UXPROD_{qt}$ is multiplied by -1 (Cohen dan Zarowin 2010), so it shows similar direction.

Hypothesis Testing Model

Before conducting examination of research hypothesis, firstly, classical assumption examination of data normality is conducted to determine the use of parametric or non-parametric test.

The examination of first hypothesis (H1), is done as the followings:

1. Comparing proxy of real earnings managements (UXCFO, UXPROD, dan UXDEX) in the years of 2007, 2008, and 2009 from *suspect firms*.
2. Conducting *independent sample t test*.
3. To ensure more, the total cummulative testing from those three proxies of real earnings managements is done, and then, conduct *independent sample t test*.
4. The hypothesis is accepted if there is a significant difference from the proxy of earnings management of suspect firms with its rest samples.

To examination the H2, suspect firms are grouped into the group of companies with concentrated ownership structure and the group of companies with dispersed ownership structure. The examination to support H2 is conducted by comparing the proxy of earnings management from companies with concentrated ownership structure and companies with dispersed ownership structure in the years of 2007, 2008 and 2009. Next, independent sample t test is conducted to determine that the proxy of earnings management is larger and different significantly.

RESEARCH RESULTS

Sample Characteristics

The numbers of research population used in regression equation to determine each research parameter are: 252 companies (2006), 289 companies (2007), 302 companies (2008), 299 companies (2009), and 299 companies (2010). At last, suspect firms each amounted: 135 companies (2007), 147 companies (2008), and 108 companies (2009).

Descriptive statistic of research variables

Descriptive statistic of research variables explain each proxy of earnings managements of population and research sample, which are: abnormal level of cash

flows from operation (UXCFO), discretionary expenses (UXDEX), and production costs (UXPROD).

The directions of UXCFO and UXDEX from research sample have positive directions, and the direction of UXPROD has negative directions. The directions all of real earnings management proxies are in line with the prediction that research sample is expected conducting decreasing real earnings management.

Based on the results of data normality testing, using *one-sample kolmogorov-smirnov test*, the research sample is normally distributed. Then to test hypothesis, parametric testing is applied.

Hypothesis Income Tax Rate Reduction and Earnings Management in Public Companies

The examination of the first hypothesis is done by *compare mean independent sample t-test* for each proxy of earnings managements which their results can be observed on table 1. In the testing of each proxy of earnings managements, if $\alpha = 10\%$, there are proxies of earnings management that are significantly different and not significantly different between sample firms and its population. The abnormal level that significantly different as: UXCFO in the year of 2008 and 2009, UXDEX in the year of 2007 and 2009, and UXPROD in 2007, 2008, and 2009. This shows that the first hypothesis is marginally accepted.

In the examination with proxy of total real earnings management, from all proxies of real earnings management on research samples show positive numbers mean that sample firms conduct decreasing real earnings management for tax savings in the year before Income Tax Law No. 36 (2008). After examination is done by using *compare mean independent sample t-test* with $\alpha = 5\%$, gave the significant results are in all of the year 2007, 2008, and 2009. These results can support H1 that companies conduct decreasing real earnings management for tax savings in the years of 2007, 2008, and 2009.

Hypothesis Income Tax Rate Reduction, Corporate Ownership Structure, and Earnings Management in Public Companies

To support H2 that companies with concentrated ownership structures conducting earnings management larger and different significantly than companies with dispersed ownership structures, the examination used *compare mean independent sample t-test* with $\alpha = 5\%$ of total proxy of real earnings management. The examination result shows that companies with concentrated ownership structures conduct decreasing real earnings management larger and different significantly than companies with dispersed ownership structures in the years of 2007, 2008, and 2009. H2 supported by data.

This shows that in companies with concentrated ownership structures, controlling shareholders as a single majority can influence company management to be willing to reduce earnings for tax savings. Although the management knows that by reducing earnings the performance of the management is judged lowered by investor, but the manager is ready because controlling shareholders as a single majority know the cause of company's reduced earnings, which is for saving tax. By moving earnings of this year to the following year, then, companies not only delay tax payment but also can save the total amount of income tax that has to be paid to the tax authority in overall.

CONCLUSIONS, LIMITATIONS, AND IMPLICATIONS

Companies listed in IDX have conducted real earnings management that reduces earnings in responding the reduction of statutory income tax rate based on Income Tax Law No. 36 (2008). This research supports the study done by Lee and Swenson (2011). Overall, this research gives new empirical evidence in Indonesia about earnings management to save tax conducted by companies with real activities manipulation.

The limitation of this research is that it only examines the earnings management in the years approaching the change of income tax rate. The next research may complete it by putting in normal periods, which are the years when the change of tax rate does not occur, whether or not the real earnings management occurs, as the comparative testing with the periods approaching the change of income tax rate. This is done to investigate that earnings management conducted by companies in the years approaching the effectiveness of new tax rate truly is the respond to the change of tax rate.

The implication of this research especially is for government as the policy maker to the state income from tax sector. This research may give empirical evidence that public companies conduct earnings management by manipulating real activities to save tax, so it is able to give input as consideration when determining target of state income from tax sector. The ability of the company to conduct earnings management to save tax may cause the target of determined state income is not achieved.

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