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The impact of board of director oversight characteristics on corporate tax aggressiveness: An empirical analysis

Grant Richardson [a,*], Grantley Taylor [b], Roman Lanis [c]

[a] Discipline of Accounting and Information Systems, The Business School, The University of Adelaide, 10 Pulteney Street, Adelaide, SA 5005, Australia
[b] School of Accounting, Curtin Business School, Curtin University, GPO Box U1987, Perth, WA 6845, Australia
[c] School of Accounting, Faculty of Business, University of Technology – Sydney, Corner of Quay Street and Ultimo Road, Haymarket, Sydney, NSW 2000, Australia

A B S T R A C T

This paper examines the impact of board of director oversight characteristics on corporate tax aggressiveness. Based on a 812 firm-year dataset of 203 publicly-listed Australian firms over the 2006–2009 period, our regression results show that if a firm has established an effective risk management system and internal controls, engages a big-4 auditor, its external auditor's services involve proportionally fewer non-audit services than audit services and the more independent is its internal audit committee, it is less likely to be tax aggressive. Our additional regression results also indicate that the interaction effect between board of director composition (i.e., a higher ratio of independent directors on the board) and the establishment of an effective risk management system and internal controls jointly reduce tax aggressiveness.

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1. Introduction

Corporate tax compliance programs undertaken by tax authorities such as the Australian Taxation Office (ATO) emphasize that the strength of a firm's corporate governance structure has a major

* Corresponding author. Tel.: +61 (0)8 8313 0582; fax: +61(0)8 8223 4782.
E-mail address: grant.richardson@adelaide.edu.au (G. Richardson).

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bearing on whether it is likely to engage in corporate tax aggressiveness[1] (ATO, 2006, 2010). In 2003, the ATO placed tax planning and compliance at the center of good corporate governance strategies (ATO, 2005). In 2005, the ATO recognized that there were encouraging signs that tax aggressiveness was increasingly being accepted as an important corporate governance issue for the board of directors to consider (ATO, 2005).

In examining corporate governance and its association with tax aggressiveness, previous research (e.g., Desai and Dharmapala, 2006; Hanlon and Slemrod, 2009; Chen et al., 2010) does not attempt to break-down corporate governance into its key components. Thus, previous research fails to determine which particular aspects of corporate governance have a significant impact on tax aggressiveness. Recent research by Lanis and Richardson (2011) shows that the composition of a firm's board of directors influences its level of tax aggressiveness. However, no previous research has explicitly examined the association between other important board of director oversight characteristics (e.g., the effectiveness of a firm's risk management and internal control systems) and tax aggressiveness.

Tax authorities consider risk management to be an essential part of an effective corporate governance structure (ATO, 2006, 2010). Corporate stakeholders have become increasingly concerned about whether a firm has a satisfactory risk management system and sufficient internal controls to alleviate significant firm-related risks (Henderson Global Investors, 2005; KPMG, 2005; Erle, 2008), including tax risks dealing with the complexity of tax laws and regulations and potential uncertainties regarding the legal interpretation and application of tax laws and regulations in practice (Slemrod, 2004, 2007; Graham and Tucker, 2006). Research by Dyreng et al. (2008), Armstrong et al. (2012) and Rego and Wilson (2012) shows that it is uncertain whether executive management explicitly engage in aggressive tax strategies or whether they make aggressive financial, investment and other strategic decisions that lead to tax-aggressive behavior in the firm. It is possible that both avenues for tax-aggressive behavior are simultaneously present if the firm's governance structures (including the risk management system and internal controls) are weak and audit-related monitoring mechanisms are lacking.

The directors of many firms recognize that tax cannot be managed independently from a firm's other business activities, and it can have a significant influence on the decisions that are made as a result of the transactions undertaken (KPMG, 2005; Williams, 2007).[2] However, there is a clear disparity in the understanding of tax considerations between the board of directors, internal audit, and a firm's tax department (KPMG, 2005). In fact, a survey of board members found that only 22% of firms carried out regular formal reviews of the tax department by internal audit. Moreover, only 10% of tax departments felt that they were widely understood outside of the tax function (KPMG, 2005).

Tax authorities consider that tax risk management is the responsibility of the board of directors (Killaly, 2009; D'Ascenzo, 2008, 2010). The reason for this is that tax is considered to be an ethical issue with a firm's reputational capital at stake if tax arrangements become subject to public scrutiny and/or legal action (Williams, 2007; Erle, 2008). The board is ultimately responsible for implementing policies, processes and systems to ensure that tax risk is minimized in the firm. This involves ensuring that the firm does not engage in activities that are designed primarily to avoid corporate taxes (Erle, 2008; Hartnett, 2008; Schön, 2008). Thus, it is possible that tax aggressiveness may not only be detrimental to the firm, but it also could be regarded a socially irresponsible and illegitimate activity which can have a damaging effect on society as a whole.[3] Potentially, tax aggressiveness could bring-about a significant shortfall in corporate tax revenue which could be used by government to fund

[1] In line with existing empirical tax research (e.g., Frank et al., 2009; Chen et al., 2010; Lanis and Richardson, 2012), we define corporate tax aggressiveness as the downward management of taxable income through tax-planning activities. It therefore encompasses tax-planning activities that are legal or that may fall into the gray area, as well as activities that are illegal. Hence, tax aggressiveness can range along a continuum with many cases falling in the disputed gray zone on that continuum (Gilders et al., 2004). In this study, we focus our attention on tax aggressive activities closer to the illegal end of the continuum. Finally, although we employ the term 'tax aggressiveness' throughout the paper, it can be used interchangeably with tax avoidance, tax management and tax shelters.

[2] The results of an independent survey of board members indicate that at least 14% of firms had board-approved tax objectives (KPMG, 2005), although this is increasing over time (D'Ascenzo, 2008, 2010).

[3] This view is also consistent with Avi-Yonah (2008) and Schön (2008) whereby a firm has a significant influence that goes beyond its shareholders. Specifically, a firm is a 'real world' entity which has to survive the rigors of a competitive business environment and in this context will deal with many other entities and individuals.

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