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Internal control and tax avoidance: A possible mitigation effort

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Abstract

Companies view taxes as a cost that has the potential to reduce profits. Tax avoidance is a company's action to reduce the amount of tax that must be paid in a legal way. This paper aims to provide an analysis of the potential for reducing tax avoidance through internal controls implemented by companies through literature studies. The study was carried out by selecting relevant literature, analysis as well as mapping and interpretation of the results. Based on the dominance of the findings, it can be considered that effective internal control has the potential to prevent aggressive tax avoidance by companies.

Keywords: Internal Control, Tax Avoidance, Agency Problem, Mitigation

INTRODUCTION

Taxes make the largest contribution to state income. A series of policies were issued by the Ministry of Finance to achieve tax revenue targets. However, optimizing tax revenues is accompanied by obstacles that must be faced. Tax avoidance is one of the obstacles to obtaining higher tax revenues (Tanujaya & Cantikasari, 2022).

For companies, taxes are a burden that allows economic benefits to be reduced (Wardani & Rumahorbo, 2018). The obligation to pay taxes will of course reduce the profits that the company should receive. This condition makes the interests of the state and companies incompatible. To achieve maximum profits, companies will carry out various strategies to reduce the tax burden, which means companies carry out tax avoidance practices.

Taxes are a cost that has the potential to reduce company profits. Tax burden is one of the business expenses that will be streamlined in order to achieve the company's mission. There are two basic strategies for minimizing tax payments, namely reducing income or exaggerating company expenses. Tax avoidance is part of tax planning which is intended to regulate in such a way that tax payments by companies are at a minimum limit. Even though it does not violate applicable tax regulations, the practice of tax avoidance has a negative connotation, especially for the tax office. Efforts to avoid taxes by companies will result in state revenues from this sector being suboptimal.

Tax avoidance is a step that is legally implemented to reduce the amount of tax that must be paid. The emphasis on the minimum amount of tax that must be paid is to obtain targeted profits and liquidity. The practice of tax avoidance is carried out by exploiting legal loopholes resulting from a scheme or transaction that has not been clearly regulated so that it does not violate the law (Dyreng et al., 2019).

Studies on tax avoidance have two different perspectives (Bimo et al., 2019). Firstly, management views tax avoidance as tax planning to increase company value. Investments are made by retaining cash and transferring management. The second perspective, tax avoidance is seen as a tool of management interests. Avoiding or reducing the cost of paying taxes is to increase bonuses and compensation for management.

Agency problems are still the main perspective of most research on tax avoidance. Agency theory stands on the assumption that principals and agents act to maximize their own interests (Jensen

& Meckling, 1976). What the agent does may not be in the interests of the principal, so the principal needs to design adequate supervision.

Internal control is one of the company's supervisory designs. Internal control is a monitoring mechanism that aims to ensure that financial reports are free from material misstatement (Ashbaugh-Skaife et al., 2008). The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines internal control as a series of processes and actions designed by a company to provide adequate confidence in achieving goals, namely efficient and effective business activities, reliable financial reports and compliance with regulations. Internal control plays a role in ensuring that there are no violations of provisions carried out by the company.

In the context of tax avoidance, effective internal controls mitigate management errors when making judgments and estimating corporate tax policies. Internal control also ensures that management does not violate applicable laws and regulations (Rae et al., 2017), including tax regulations. Effective internal control encourages management to make tax plans that comply with applicable regulations and do not harm the company in the future. This also prevents management from being opportunistic and careful in carrying out tax planning activities.

This research aims to analyze the potential of internal control as an effort to prevent tax avoidance through a literature review of empirical research that has been conducted in Indonesia. Aggressive tax avoidance must be prevented, and if proven to violate the rules, the company can be subject to sanctions and loss of reputation and in the long term hamper business continuity. Internal control as a supervisory design is expected to be able to manage company tax planning.

LITERATURE REVIEW

Tax avoidance is part of tax planning which is intended to regulate in such a way that tax payments by companies are at a minimum limit. Maximizing profits is the company's mission, one of which is pursued through tax management. Tax burden is one of the business expenses that will be streamlined in order to achieve the company's mission. There are two basic strategies for minimizing tax payments, namely reducing income or exaggerating company expenses. Even though it does not violate applicable tax regulations, the practice of tax avoidance has a negative connotation, especially for the tax office. Efforts to avoid taxes by companies will result in state revenues from this sector being suboptimal.

Tax avoidance is not the same as tax evasion. The practice of tax avoidance is carried out by taking advantage of legal loopholes resulting from a scheme or transaction that has not been clearly regulated so that it does not violate the law. The Organization for Economic Cooperation and Development (OECD) states that tax avoidance has 3 characteristics, namely: (1) the existence of artificial elements through various arrangements, (2) the use of loopholes that are not actually the intention of policy makers and (3) confidentiality of tools or methods in practice. tax avoidance (Finnerty et al., 2007).

The trend of tax avoidance in a country can be seen from its tax ratio (Yuli P & Irmayani, 2022). Tax avoidance activities in a company can be measured in various ways, including: Effective Tax Rate (ETR), Cash Effective Tax Rate (CETR) and Book-Tax Difference (BTD). ETR is calculated by comparing tax expense with profit before tax. ETR is considered to reflect the fixed difference between accounting profit calculations and fiscal profit. CETR is calculated by comparing cash disbursement with profit before tax. CETR is able to identify the aggressiveness of tax avoidance using both fixed and temporary differences. BTD is calculated by the difference between accounting profit and fixed profit. A large difference indicates aggressive behavior in avoiding taxes.

Agency problems are still the main perspective of most research on tax avoidance. Agency theory is concerned with the interaction of two parties. In this case, it is the relationship between the agent played by company management and the principal played by shareholders. Agency theory stands on the assumption that principals and agents act to maximize their own interests (Jensen & Meckling, 1976). What the agent does may not be in the interests of the principal, so the principal needs to design

adequate supervision. In the context of tax avoidance, management has the discretion to carry out tax planning based on the complexity and freedom it has.

Internal control is one of the company's supervisory designs. Internal control is a monitoring mechanism that aims to ensure that financial reports are free from material misstatement (Ashbaugh-Skaife et al., 2008). The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines internal control as a series of processes and actions designed by a company to provide adequate confidence in achieving goals, namely efficient and effective business activities, reliable financial reports and compliance with regulations. The existence and implementation of an effective internal control system can provide confidence that the company's operations and development are healthy (Leng & Ding, 2011). Internal control plays a role in ensuring that there are no violations of provisions carried out by the company.

In the context of tax avoidance, effective internal controls mitigate management errors when making judgments and estimating corporate tax policies. Internal control also ensures that management does not violate applicable laws and regulations (Rae et al., 2017), including tax regulations. Effective internal control encourages management to make tax plans that comply with applicable regulations and do not harm the company in the future. This also prevents management from being opportunistic and careful in carrying out tax planning activities.

Tax avoidance increases the risks that companies must face (Rakhmayani et al., 2022). More and more tax avoidance practices are carried out by companies, increasing the possibility of re-correction by tax inspectors and resulting in larger tax liabilities than before. This will also have an impact on the uncertainty of the company's cash flow. Through internal control, aggressive tax avoidance can be minimized and carried out in order to increase company value in the long term.

METHODS

This research uses descriptive qualitative research through a literature review to examine and synthesize previous research. The study was carried out by selecting relevant literature, analysis, mapping and interpretation of previous literature. The stages in the literature review method are determining the literature that will be reviewed and then analyzing it and finally mapping the results of the review (Sekaran & Bougie, 2016).

Literature selection was carried out through various sources using Google Scholar to obtain articles directly or by connecting to the journal website that published the article. The search was carried out using the keywords "Tax Avoidance and Internal Control" published within the last 5 years. The focus of this review is on internal control as a determinant of tax avoidance. From the articles produced through this search, data screening and extraction were carried out to carry out article content analysis. We selected main articles that used Indonesia as a research area. However, the discussion is not limited to this area.

RESULTS AND DISCUSSIONS

A synthesis of research regarding the impact of tax avoidance related to corporate risk produces two groups. The first group concludes that there is a negative influence of internal control on tax avoidance (Dini et al., 2022; Rachmawati & Rohman, 2022; Tanujaya & Cantikasari, 2022). The second group concluded that there was no relationship between internal control and tax avoidance (Carolina & Purwantini, 2020; Christiantyo & Fahria, 2022; Dinata & Candra, 2023).

Dini et al. (2022), Rachmawati & Rohman (2022) and Tanujaya & Cantikasari (2022) conclude that internal control has a negative effect on tax avoidance. This means that the better internal control is carried out, the less the company will avoid tax.

Furthermore, Rachmawati & Rohman (2022) revealed that effective company internal control helps companies achieve company goals and ensure that company performance complies with the law. The more effective internal control is, the less likely management is to behave opportunistically in carrying out tax avoidance. Management is motivated to be careful in preparing tax plans that are in accordance with applicable policies so as to avoid tax risks related to imposing sanctions or fines on

violators. As a result, company supervision and control increases so that it can prevent and detect when management carries out aggressive tax reduction.

Similar results from outside Indonesia, Fan et. Al (2022) shows that internal control weaknesses are positively related to tax avoidance related to tax bookkeeping. This shows that companies that have weak internal controls have the potential to carry out more profit regulation and tax avoidance than companies with good internal controls. Meanwhile Liu et. al (2022) found that applying the elements of internal control can reduce tax evasion. High-quality internal controls discourage aggressive tax avoidance. Internal control has a positive mediating role in the relationship between tax avoidance and firm value.

Neutral research results were obtained by Carolina & Purwantini (2020) and Dinata & Candra (2023). The research concluded that there was no significant influence of internal control on tax avoidance. Empirical research which concludes that internal control has no effect on tax avoidance emphasizes internal control measurements which are not necessarily in accordance with the company's actual conditions as a supporting argument. However, it cannot be concluded directly that the implementation of internal control in companies cannot reduce tax avoidance.

Based on the results obtained, there is a gap where the measurement of internal control through disclosure cannot be fully believed to reflect the internal control that actually occurs in the company. However, all research agrees that internal control is a monitoring mechanism within a company that can reduce management's tendency to behave opportunistically in making management decisions. Chen et al (2018) also show that the quality of internal control increases tax avoidance for less protected companies, but limits tax avoidance for overprotected companies. Tania & Mukhlasin (2020) concludes that internal control can reduce tax avoidance by preventing and detecting errors made by management, whether intentional or unintentional, so that management complies with applicable regulations. However, this is also influenced by the company's internal environment because as a system, internal control is influenced by the environment in which the system is located. Seeing the dominance of empirical research findings and synthesis, internal control suppresses company actions to carry out activities that have a negative impact on company value. Thus, effective internal control has the potential to reduce aggressive tax avoidance behavior by companies.

CONCLUSIONS

Tax avoidance is a step that is legally implemented to reduce the amount of tax that must be paid. Even though it does not violate applicable tax regulations, the practice of tax avoidance has a negative connotation, especially for the tax office. Internal control suppresses the company's actions to carry out activities that have a negative impact on company value. Effective internal control has the potential to reduce aggressive tax avoidance behavior by companies. This literature review has the weakness of the limited number of articles. Through this literature review, empirical research regarding the influence of internal control on tax avoidance can discuss the characteristics and interests of the companies involved so that it is more comprehensive.

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