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# Journal of International Accounting, Auditing and Taxation

journal homepage: [www.elsevier.com/locate/intaata](http://www.elsevier.com/locate/intaata)

## Top management team heterogeneity, governance changes and book-tax differences<sup>☆</sup>

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### ARTICLE INFO

#### Keywords:

Top management team  
Heterogeneity  
Malaysia  
Book-tax differences  
Psychologically and socially inspired-upper  
echelons theory

### ABSTRACT

Book-tax differences (BTD) explain the differences between accounting and tax incomes. This study examines the extent to which the heterogeneity of the top management team (TMT) is related to a firm's BTD level with a specific focus on the effect of the 2012 changes in Malaysian corporate governance regulations. Psychologically and socially inspired-upper echelons theory is used to hypothesize that the TMT's age, tenure, education, and gender heterogeneities will be significantly related to the firm's BTD level. Using a sample of Bursa Malaysia listed firms for the eight-year period from 2008 to 2015, our findings suggest significant relationships between BTD and heterogeneity in age, tenure and education. We attribute the relationship between age and tenure heterogeneity to the subsample period prior to the change in the corporate governance regulations. The analysis based on levels of heterogeneity suggests that the relationship between BTD and heterogeneity in education is only significant within low heterogeneity subsample. This study contributes to the existing literature and practice by providing new evidence to support psychologically and socially inspired-upper echelons theory in explaining the effect that TMT heterogeneity has on a firm's BTD level. This study also provides new insights on financial reporting and taxation from a governance perspective.

### 1. Introduction

In this paper, we analyze the extent to which top management team (TMT) heterogeneity is related to the levels of book-tax differences (BTD) of public-listed corporations in Malaysia. We rely on psychologically and socially inspired-upper echelons theory to posit the relationships within the TMT's strategic and social frameworks.

BTD arise from differences between the computations of accounting and tax incomes. The differences can reflect managerial behaviors towards earnings and taxes, and the extent of passive interactions between both income measures (Graham, Raedy, & Shackelford, 2012). Past research finds the non-conformity of book and tax income relevant to accounting-related information content, including in the aspects of tax planning, earnings management and earnings persistence (Graham et al., 2012; Hanlon,

<sup>☆</sup> Accepted by Robert K. Larson.

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<https://doi.org/10.1016/j.intaccaudtax.2018.07.002>

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2005). Taxation studies use BTM as a proxy for tax planning (Blaylock, Shevlin, & Wilson, 2012; Desai & Dharmapala, 2009).<sup>1</sup>

Arguments of “unfair share of tax”, “the rich pay less”, and “detrimental effects on public provision” lead some regulators to conclude that certain aggressive tax planning strategies unfairly magnify BTM and may lead to underpayment of income tax. Accordingly, many governments very critically assess aggressive tax planning activities. In Malaysia, for example, the Government strengthened the enforcement provision in its 2016 Budget recalibration to help combat tax evasion (Malaysian Ministry of Finance, 2016). Similarly, more stringent tax audit procedures and schemes have been recently adopted by the Malaysian tax authority – Inland Revenue Board of Malaysia (IRBM) – to increase tax revenue through increased compliance (IRBM, 2015). In this setting, we investigate the effects of TMT-related factors on firm BTM levels (as a proxy for tax planning) in order to assess the indirect effects of the management team’s attributes on the country’s tax revenues.

Prior research focused on the agency perspective of taxation, for example, the extent to which corporate governance mechanisms relate to tax planning levels (Armstrong, Blouin, Jagolinzer, & Larcker, 2015; Lanis & Richardson, 2011). However, the prior research does not consider the notion that corporate strategic decisions (including tax planning strategies) may also be influenced by the heterogeneity of the TMT (Carpenter, 2002).<sup>2</sup> Accordingly, by examining the relationship between BTM and heterogeneity of TMT we may gain insights with respect to the relevance of the attributes of top executives as a team in predicting firm BTM levels. To our knowledge, this is the first study to examine the extent to which the TMT heterogeneity explains firms’ BTM levels. Therefore, investigating the extent to which the TMT heterogeneity is related to BTM allows an assessment of whether the dynamics of TMT can explain firms’ BTM levels, including as a proxy for tax planning engagement.

Specifically, we focus on the influence of a group of senior individuals, termed “TMT” by upper echelons literature, on firms’ BTM levels. In particular, psychologically and socially inspired-upper echelons theory, focuses on the importance of psychological, social and other observable behavioral characteristics of TMTs in shaping firms’ strategic decisions and major organizational outcomes (Michel & Shaked, 1984). The theory recognizes the central roles of senior executives’ behaviors, beliefs, cognitions, social interactions, values and perceptions on firm performance (Hambrick & Mason, 1984), of which TMT’s choices and actions through their powerful roles can significantly influence and affect the organization (Carpenter, Geletkanycz, & Sanders, 2004).

It is also argued that the effects of TMT heterogeneity vary within the strategic and social – including behavioral and psychological – contexts of the TMT members’ tasks, with strategic heterogeneity often claimed by researchers to be related to strategic decisions, such as decisions relating to securing competitive edge and international operations. Others assert that social heterogeneity is relevant to resolving behavioral, psychological and social conflicts (Carpenter, 2002; Hambrick, Cho, & Chen, 1996).

We assert that TMT heterogeneity may also affect tax planning decisions and strategy. This is because taxation is one of the functional areas that can directly contribute to the organizational performance within the strategic context of the organization’s goal, in which the level of performance that can be achieved by the TMT is conditional upon the degrees of social conflict or harmony that exist among the TMT members. We further assert that ignoring the influence of TMT on firms’ BTM levels would necessarily lead to incomplete conclusions regarding how corporate governance affects firms’ strategic decisions, as differences in individual characteristics of corporate elites may imply variations in BTM levels. This study, therefore, aims to investigate the extent to which TMT heterogeneity, consisting of age, tenure, gender and educational background, can explain firms’ observable BTM levels. The analysis employed consists of an objective examination of firms’ BTM levels, while controlling for observable variations of top management characteristics.

This study analyses taxation, finance, and TMT data of non-financial listed Malaysian firms over an eight year period: 2008-2015. The data are also analyzed using subsamples of periods prior to and subsequent to the change of *Malaysian Code of Corporate Governance* in 2012, and subsamples of low and high heterogeneity.

We find a significant negative relationship between a firm’s BTM level and TMT age, and tenure heterogeneities. We also note a significant relationship between the BTM level and TMT education heterogeneity, but in contrast to age and tenure heterogeneities, the nature of the relationship is positive. We attribute the relationship between age and tenure heterogeneity to the subsample period prior to the change in the corporate governance regulations. The analysis based on levels of heterogeneity suggests that the relationship between BTM and heterogeneity in education is only significant within low heterogeneity subsample. Our study contributes to the existing literature by providing new evidence to support psychologically and socially inspired-upper echelons theory in explaining the effect of heterogeneity of TMTs on firms’ BTM levels within the strategic and social context of the organization and the TMT itself. The study provides new insights on BTM from a governance perspective and, in particular, on what level an observable heterogeneity within TMT can explain firms’ BTM levels. From the tax authority’s perspective, the findings suggest heterogeneity as an additional factor that needs to be considered in tax investigation and audit framework. The findings on BTM and TMT heterogeneity can be useful to the public and, in particular, to shareholders and industry players in highlighting that heterogeneity of TMT characteristics can be indicative of tax planning engagement. Similarly, the findings can be beneficial to other stakeholders such as creditors, suppliers, and employees through broadening the view of which management characteristics can explain differences between financial reporting and tax reporting. This can then offer insights into potential reputational risks to which public corporations are exposed.

The paper proceeds as follows: Section 2 presents issues relating to BTM and governance within the Malaysian corporate context.

<sup>1</sup> In the absence of publicly available tax return data, differentiation of the legality aspect of tax planning (i.e. avoidance versus evasion) is restricted. We, therefore, define tax planning as activities that can generate tax benefits (Abdul Wahab & Holland, 2012) without explicitly differentiating the activities into avoidance and evasion.

<sup>2</sup> We define TMT as consisting of the board chairman, the chief executive officer (CEO) and all the other executive directors.

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