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Investor Reaction to Real Earnings Management for Tax Avoidance (The Case in Indonesia)

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ABSTRACT

This study aims to determine whether companies in Indonesia use real earnings management to avoid taxes. This study also analyzes how investors react to corporate real earnings management for the purpose of tax avoidance. The sample used is a manufacturing company listed on the Indonesia Stock Exchange during 2009 to 2014, which is suspected of tax avoidance. The results of this study prove: (1) companies in Indonesia use real earnings management to avoid taxes. (2) The investor reacts positively to tax avoidance by the company for tax purposes (3) Although real earnings management can be used as an alternative in tax avoidance but this study proves that real earnings management does not mediate the relationship between tax avoidance and investor reactions.

Keywords: *tax avoidance; investor reaction; real earnings management*

I. INTRODUCTION

Tax minimizing is one of the company's motivations to manage earnings. This research is a development of Putrid an Tanno (2015) research. The absence of research on the use of real earnings management to do tax avoidance so that this study wanted to see whether there is a relationship between tax avoidance and real earnings management. The shift from accrual to real earnings management after the Sarbanes-Oxley Act (SOX) period is due to either the auditor or the regulator giving less attention to the real activities manipulated by management.(Graham et al. 2005; Bartov and Cohen 2006; Roychowdhury 2006; Cohen et al. 2008; Cohen and Zarowin 2008). The study aims to determine whether the company in Indonesia also use real earnings management to make tax avoidance. It also wanted to know how investors react to real earnings management by companies for tax avoidance purposes. This paper is organized as follows. In section II, the inter relationships between tax avoidance, real earning management and investor reaction are provided. Section II discusses the research methodology and data collection. The results are presented in section IV. The discussion and conclusion in the final section.

Tax avoidance activities, conducted by companies that can be interpreted as a transfer of wealth from the government to shareholders, is expected to be a positive signal for investors that will be able to increase the company's stock price. The existence of agency problems associated with tax avoidance makes tax avoidance

that should be aimed at the interests of shareholders as a tool for management to make earnings management that is not in accordance with corporate objectives. This study uses real earnings management as a mediation variable, which will mediate the relationship between tax avoidance reactions of investors.

Tax Avoidance and Investor Reaction

The view that the tax paid by the company is the transfer of wealth from the company to shareholders (Watts and Zimmerman 1978) so that tax avoidance by the company can be interpreted as a transfer of wealth from the government to shareholders (Desai and Dharmapala 2009). Tax avoidance activities can increase the company's cash flow and increase the company's wealth to provide benefits for shareholders.

According to Ball (1972); Sunder (1973), (1975); Ricks (1986); Lanen dan Thompson (1988) the company that changed the method of valuation of inventory and depreciation of its fixed assets for tax reasons is to change into a method that can make its tax pay less and get a positive reaction from investors when the company announces the change of method. Investors ignore low book earnings but appreciate the tax benefits of adopting the new method.

Blaylock et al. (2012) found that firms with large differences between book-tax income caused by tax avoidance were positively responded by the market. The results of this study also indicate that investors are able to see up to the source of the big book-tax positive difference is whether from earning management or tax avoidance.

Tax avoidance conducted by the company can be interpreted as a signal to investors that the company put forward the interests of shareholders. If managers make tax avoidance efforts optimally and investors have confidence in tax avoidance measures should occur a positive relationship between tax avoidance and investor reaction.

Tax Avoidance and Real Earnings Management

The existence of the relationship between tax avoidance and agency theory is related to the problems inherent in public companies introduced by Slemrod (2004); Chen and Chu (2005); Crocker and Slemrod (2005). The separation of ownership in public companies that creates a conflict of interest and information asymmetry may give management the opportunity to make an accounting method or policy choices for personal gain. Tax avoidance action by the company is actually used as a shield for management in making earnings management.

The researchers prove that the various methods used by firms to tax avoidance are the main objectives for earnings management (Guenther 1994; Mills 1998; Schrand and Wong 2003; Phillips et al. 2003; Desai 2003; Dhaliwal et al. 2004; Hanlon 2005; Frank and Rego 2006; Cook et al. 2008; Blouin et al. 2010).

Real Earnings Management and Investor Reaction

Earnings management is one form of opportunistic behavior of management who have the freedom to choose the method or accounting policy that can affect earnings. Profit management indicates the existence of earnings management in accordance with the expected management, thus allowing the information provided manager is not in accordance with actual company conditions. Earnings management by management for personal gain can mislead shareholders about the organization's economic performance (Healy dan Wahlen, 1999).

Corporate earnings management can be a signal used by investors to assess how management manages the company. Earnings management can be a negative signal for investors to assess the company. Some studies prove that the company's earnings management actions have a negative effect on investor reactions (Keung et al. 2010; Jategaonkar et al. 2012; Wu et al. 2012).

The earnings management used in the previous research is generally accruals earnings management. The development of earnings management literature shows that earnings management performed by managers is not only done by manipulating accruals alone, also by manipulating real activity, called real earnings management (Graham et al. 2005; Bartov and Cohen 2006; Roychowdhury 2006; Cohen et al. 2008; Cohen and Zarowin 2008).

According to Roychowdhury (2006), managers intervene in the financial reporting process not only through accounting methods or estimates but also through decisions relating to operational activities. Managers also have incentives to manipulate real activities during the year to meet earnings targets. Graham et al. (2005) proves that managers like real earnings management activity compared to accrual earnings management, since real earnings management activities cannot be distinguished from optimal business decisions and are more difficult to detect, even though the costs used in such activities are economically significant for firms.

As expected Graham et al. (2005), Cohen et al. (2008) found that managers have shifted away from accrual to real earnings management after the Sarbanes-Oxley Act (SOX) period. This evidence implies that in the post-SOX period the need to avoid accrual earnings management becomes greater than the previous period, thus, affecting managers to shift from accrual-based to real earnings management activities.

The absence of previous research on the use of real earnings management to tax avoidance so that the use of real earnings management by managers to tax avoidance is based on the risk or cost in tax avoidance. Corporate tax avoidance activities are associated with risks and uncertainties because of the possibility of being detected by the tax authorities. If the company is proven to conduct an unauthorized tax avoidance will get sanction from tax authorities that can harm the company.

Financial executives prefer to manipulate earnings through real activities rather than accrual activities because accrual manipulation tends to make the auditor or regulator check quickly rather than if decisions about real activity or production are made. This indicates that neither the auditor nor the regulator gives less attention to the real activities manipulated by management. This resulted in addition to being used to achieve earnings targets, real earnings management can also be used by companies to conduct tax avoidance.

Tax Avoidance, Real Earnings Management and Investor Reaction

The link between tax avoidance and agency theory is due to the separation between ownership and control over a widely owned company. This agency problem gives management the opportunity to choose the accounting methods and policies for the manager's personal interest, namely to make earnings management.

Desai et al. (2007) states self-serving managers facilitate transactions that reduce corporate taxes, diverting corporate resources for personal use. Researchers such as Guenther (1994); Mills (1998); Schrand and Wong (2003); Phillips et al. (2003); Desai (2003); Dhaliwal et al. (2004); Hanlon (2005); Frank and Rego (2006); Cook et al. (2008); Blouin et al. (2010) proves that the various methods used by companies to do tax avoidance is the main purpose for earnings management. Tax avoidance that should be able to increase shareholder wealth after related to the agency problem resulted in tax avoidance activities conducted by the company is used as a shield for managers in making earnings management.

Figure 1 Empirical Research Model

Source: Processed data used in this article

II. METHODS

The research population is all manufacturing companies listed on the Indonesia Stock Exchange period 2009 to 2012 which is suspected to tax avoidance. The criteria for tax avoidance are referring to Putri and Tanno (2015) research where the

company is considered tax avoidance is a company that has ETR (Effective Tax Rate) value in the applicable tax tariff. Sampling method in this research using purposive sampling method. The process of selecting samples is done in two stages. The first stage is based on the following criteria: manufacturing companies that publish Audited Financial Statements as of December 31 are consistent and complete from 2009-2012, have a period of financial statements ending every December 31, the financial statements do not use foreign currency, companies that do not have negative pre-tax profits.

After the company was selected in accordance with the first stage, the second stage of selection is to determine the company suspected tax avoidance is to compare the company's ETR value with the applicable tax rate. In 2009, the prevailing tax rate is 28% so that the companies suspected of tax avoidance are companies that have a value of having ETR below 28%. In 2010 to 2012 the prevailing tax rate is 25%, so the company that allegedly tax avoidance is a company that has an ETR value below 25%. Hypothesis testing is done by using WarpPLS version 4.0 program.

The population of the research was all manufacturing companies listed on the Indonesian Stock Exchange from 2009 to 2012. The samples chosen were manufacturing companies assumed to do tax avoidance. The total samples were 80 companies consisting of 20 in 2009, 21 in 2010, 18 in 2011, and 21 in 2012. The hypotheses were tested using the program of WarpPLSversi 4.0. The definition and the measurement of the variables are resumed in detail in table 1.

Table 1 Resume of Definition and Measurement of Variable

<i>Variable</i>	<i>Definition</i>	<i>Measurement</i>
Exogenous Tax Avoidance	Tax avoidance rate is the average level of tax avoidance or the average level of no liability.	Tax avoidance Rate = Prevailing Tax rate Regulation –effective tax rate. In 2009, the prevailing tax rate regulation was 28%, while in 2010-2012, it was 25%
Endogenous Cumulative Abnormal Return	Cumulative abnormal return during events period for each securities	The steps: 1. The events periods were 12 months starting from the third month after accounting year 2. The estimation period was 24 months 3. The estimation of normal return of each security was calculated using market model $R_{i,t} = \alpha_i + \beta_{i,t} \cdot R_{M,t} + \varepsilon_{i,t}$ Where $R_{i,t}$ is the actual return on security, $\beta_{i,t}$ is the beta coefficient for security, $R_{M,t}$ is the expected return on the market portfolio 4. To seek the abnormal return of each security was conducted by calculating the differences between the actual return and estimation return: $AR_{i,t} = R_{i,t} - E(R_{i,t})$ Where $AR_{i,t}$ is the Abnormal return, $R_{i,t}$ is the actual return, $E(R_{i,t})$ is the expected return. 5. CAR= the cumulative abnormal return of each share during 12 months was observed starting

Mediator	The sum of the abnormality of Cash Flow from Operation (CFO), discretionary cost, and production cost	<p>from the third month after accounting year is finished. $CAR_{(ti,tp)i,t} = \sum_{t1 \rightarrow tp} AR_{i,t}$</p> <p>Where $CAR_{(ti,tp)i,t}$ is the cumulative abnormal return, $AR_{i,t}$ is the Abnormal return.</p> <p>The steps:</p> <ol style="list-style-type: none"> 1. Determining the abnormality of CFO from the equation of residual value of the normal CFO $(CFO_{it}/A_{it-1}) = \alpha_0 + \alpha_i (1/A_{it-1}) + \alpha_2 (S_{it}/A_{it-1}) + \alpha_3 (\Delta S_{it}/A_{it-1}) + \epsilon_{i,t}$ where CFO_{it} = the Cash flow from operating, A_{it-1} = the Total Asset, S_{it} = the Total Sales, $\Delta S_{it} = S_{it} - S_{it-1}$ 2. Determining the abnormality of the production cost from the equation of residual value of the normal production cost $(PROD_{it}/A_{it-1}) = \alpha_0 + \alpha_i (1/A_{it-1}) + \alpha_2 (S_{it}/A_{it-1}) + \alpha_3 (\Delta S_{it}/A_{it-1}) + \alpha_4 (\Delta S_{it-1}/A_{it-1}) + \epsilon_{i,t}$ where $PROD_{it}$ = the production cost: $PROD_{it} = COGS_{it} + \Delta INV_{it}$, A_{it-1} = the total asset, S_{it} = the total sales, $\Delta S_{it} = S_{it} - S_{it-1}$ 3. Determining the abnormality of the discretionary cost from the residual value of the equation of normal discretionary cost $(DISEXP_{it}/A_{it-1}) = \alpha_0 + \alpha_i (1/A_{it-1}) + \alpha_2 (S_{it}/A_{it-1}) + \epsilon_{i,t}$ $DISEXP_{it}$ = the discretionary expense, A_{it-1} = the total asset, S_{it} = the total sales 4. Real earnings management is the sum of the abnormal CFO, the production cost, and the discretionary cost before which the CFO and the discretionary cost is multiplied -1.
Real Earnings Management		

III. RESULTS

Full test results of the research model with WarpPLS 4.0 are presented in Table 2, Table 3 and Figure 2.

Based on the model output of fit and quality indices table 2 model has the value of $APC = 0.395$, $\rho < 0.001$, $ARS = 0.156$, $\rho = 0.015$, $AARS = 0.145$, $\rho = 0.002$, $AFVIF = 1.011$, (acceptable if ≤ 5 , ideally ≤ 3.3), and $GoF = 0.395$ (small > 0.1 , medium > 0.25 , large > 0.36). WarpPLS provisions state that the value of ρ for APC and ARS should be less than 0.05 (significant). The AFVIF value as a multicollinearity indicator must be less than 5 and the terms for GoF value are small > 0.1 , medium > 0.25 , large > 0.36 . Referring to these provisions, it can be concluded that this research model is fit.

Based on Table 2, the amount of the effect size of each relationship is known. The effect size shows the absolute individual contribution of each latent variable predictor at the value of R^2 of the criterion variable. The estimation result shows the

effect size $TA \rightarrow CAR$ is 0.156. The R^2 value of the test result shows that R^2 endogenous variable is 15.6% (CAR).

Based on WarpPLS output as shown in Table 2, the coefficient value of $TA \rightarrow CAR$ is 0.395 and significant with $p < 0.001$. Thereby can be concluded that tax avoidance have a positive effect to investor reaction.

Table 2. Output of WarpPLS 4.0 Direct Effect

TA $\rightarrow$ CAR	
<i>Model Fit and Quality Indices</i>	
APC=0.395,	P<0.001
ARS=0.156,	P=0.015
AARS=0.145,	P=0.020
AFVIF=1.011,	acceptable if ≤ 5 , ideally ≤ 3.3
GoF=0.395,	small ≥ 0.1 , medium ≥ 0.25 , large ≥ 0.36
<i>Path Coefficients dan p-value :</i>	
TA $\rightarrow$ CAR	0.395 $p < 0.001^{***}$
<i>R-Squared:</i>	
TA $\rightarrow$ CAR	0.156
<i>Effect Size:</i>	
TA $\rightarrow$ CAR	0.156

Source: Processed data used in this article

Note: ***, **, * indicate significant at a 1%, 5%, and 10% level

TA: Tax Avoidance

CAR: Cumulative Abnormal Return

Figure 2. Path Analysis of Real Earnings Management Mediation

Source: Processed data used in this article

The test results of the full research model with WarpPLS 4.0 are presented in Table 3 and Figure 2. Based on the model output of fit and quality indices model has the value of $APC = 0.276$, $P < 0.001$, $ARS = 0.144$, $P = 0.021$, $AARS = 0.128$, $P = 0.031$, $AVIF = 1.103$, (acceptable if ≤ 5 , ideally ≤ 3.3), $AFVIF = 1.033$ (acceptable if ≤ 5 , ideally ≤ 3.3) and $GoF = 0.380$ (small ≥ 0.1 , medium ≥ 0.25 , large ≥ 0.36). WarpPLS provisions state that the value of ρ for APC and ARS should be less than 0.05 (significant). The AVIF and AFVIF values as multicollinearity indicators should be less than 5 and the terms for GoF values are small ≥ 0.1 , medium ≥ 0.25 , large ≥ 0.36 . Referring to these provisions, it can be concluded that this research model is fit.

Table 3 shows the path coefficients and ρ values of each direct relationship in the research model with the mediation variable is real earnings management. Line $TA \rightarrow CAR$ shows the coefficient value of 0.356 and significant with value $\rho < 0.01$. Path $TA \rightarrow REM$ shows coefficient value 0.342 and significant with value $\rho < 0.01$. The $REM \rightarrow CAR$ path shows a coefficient value of -0.130 and is significant with $\rho = 0.06$. Indirect effect indirect effect $TA \rightarrow CAR$ shows coefficient value -0.044 $\rho = 0.224$.

Tabel 3 Output of WarpPLS 4.0 Indirect Effect

<u>Model Fit and Quality Indices</u>					
APC=0.276, P<0.001					
ARS=0.144, P=0.021					
AARS=0.128, P=0.031					
AVIF=1.103, acceptable if <= 5, ideally <= 3.3					
AFVIF=1.033, acceptable if <= 5, ideally <= 3.3					
GoF=0.380, small >= 0.1, medium >= 0.25, large >= 0.36					
Path Coefisiens dan ρ-value :					
TA → CAR		0.356	ρ<0.001		
TA → REM		0.342	ρ=0.001		
REM → CAR		-0.130	ρ=0.060		
	R ² :	Q ²	Full Collin.	VIF	CAR
0.172	0.178	1.040			
REM	0.117	0.096	1.036		
Effect Size:					
TA → CAR		0.141			
TA → REM		0.117			
REM → CAR		0.031			
Indirect Effect					
TA → CAR		-0.044	ρ=0.224		

Source: Processed data used in this article

Note: ***, **, * indicate significant at a 1%, 5%, and 10% level

TA: Tax Avoidance

CAR: Cumulative Abnormal Return

REM: Real Earnings Management

The test results of the full research model with WarpPLS 4.0 are presented in Table 3 and Figure 2. Based on the model output of fit and quality indices model has a value of $APC = 0.276$, $P < 0.001$, $ARS = 0.144$, $P = 0.021$, $AARS = 0.128$, $P = 0.031$,

AVIF = 1.103, (acceptable if ≤ 5 , ideally ≤ 3.3), AFVIF = 1,033 (acceptable if ≤ 5 , ideally ≤ 3.3) and GoF = 0.380 (small > 0.1 , medium > 0.25 , large > 0.36). WarpPLS provisions state that the value of ρ for APC and ARS should be less than 0.05 (significant). The AVIF and AFVIF values as multicollinearity indicators should be less than 5 and the terms for GoF values are small > 0.1 , medium > 0.25 , large > 0.36 . Referring to these provisions, it can be concluded that this research model is fit.

Table 3 shows the path coefficients and ρ values of each direct relationship in the research model with the mediation variable is real earnings management. Line $TA \rightarrow CAR$ shows the coefficient value of 0.356 and significant with value $\rho < 0.01$. Path $TA \rightarrow REM$ shows coefficient value 0.342 and significant with value $\rho < 0.01$. The $REM \rightarrow CAR$ path shows a coefficient value of -0.130 and is significant with $\rho = 0.06$. Indirect effect indirect effect $TA \rightarrow CAR$ shows coefficient value -0.044 $\rho = 0.224$.

Based on Table 3, the amount of the effect size of each relationship is known. The effect size shows the absolute individual contribution of each latent variable predictor at the value of R^2 of the criterion variable. The estimation result shows the effect size $TA \rightarrow CAR$ is 0.141, $TA-REM$ is 0.117 and $REM-CAR$ is 0.031. The R^2 value of each endogenous variable is 17% (CAR), 12% (REM). This research model has a predictive relevance because it has value Q^2 above 0. Based on value of Full collinearity VIF which is under 3.3 indicated in the research model there is no multikolinearity

Real earnings management testing procedure as the mediation variable of the relationship between tax avoidance and investor reaction is in accordance with Baron and Kenny (1986) as follows (Sholihin and Ratmono, 2013) and see the value of VAF. Based on the calculation is known that the value of VAF of 12% can be concluded that almost no mediation effect. Thus, although the requirement to determine that Real Earnings Management (REM) is a mediation variable in the relationship between $TA \rightarrow CAR$ has been met, but the indirect effect coefficient is not significant and the value of VAF is 12% so it can be concluded that real earnings management is not a mediation variable between tax avoidance and investor reactions.

IV. CONCLUSION

Based on the test and discussion presented in the previous chapters, it can be concluded a number of findings:

1. Tax avoidance has a positive effect on Investor Reaction. This means that the greater tax avoidance that companies do, the higher the positive reaction of investors. Tax avoidance is a positive signal given by the company to shareholders because it can be interpreted that the company put forward the interests of shareholders. This study supports a number of previous studies that

the choice of accounting methods by companies that will minimize taxes paid by companies will be responded positively by the market. (Ball 1972; Sunder 1973, 1975; Ricks 1986; Lanen and Thompson 1988). Likewise, research conducted by Desai dan Dharmapala (2009a), Blaylock *et al.*(2012) proves that the tax avoidance of the company has a positive effect on investor reactions.

2. Tax avoidance has a positive effect on earnings management. One of the company's motivations for earnings management is tax motivation (Scott 2009). This study proves that tax avoidance also affects real earnings management. According to Roychowdhury (2006) the reason the company chooses real earnings management is more risky because it does not attract the attention of auditors and regulators, real earnings management can be used to achieve earnings targets and to prevent loss reporting. The results of this study prove that companies use real earnings management for tax incentives.
3. Real earnings management negatively affects investor reactions. Earnings management allows the manager's information not to match the actual conditions of the company. Earnings management by management for personal gain can mislead shareholders about the organization's economic performance. (Healy and Wahlen, 1999). Earnings management can be a negative signal for investors to assess the company. The results of this study prove that investors can not be "cheated" by earnings management conducted by the company. It can be seen that investors react negatively to earnings management conducted by the company. Based on the data in the financial statements the investor can assess the abnormal accruals of companies that tend to reflect earnings management (Healy and Wahlen, 1999).
4. Real earnings management is used by firms to make earnings management, but unlike previous research, the results of this study prove that real earnings management is not a mediation variable for the relationship between tax avoidance and investor reactions.

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