Investor Perception of Tax Avoidance and Quality of Earnings Information

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Abstract
This study aims to determine investor perceptions of tax avoidance and investor perceptions of the quality of earnings information in companies that avoid taxes. The study was conducted on non-financial companies listed on the Indonesia Stock Exchange for the period 2012-2015 with a final sample of 634 observational data, after deducting companies that suffered losses, not indicated to avoid tax evasion and deviant data. Data analysis was done with descriptive statistics and inferential test. The hypothesis in this study was tested by multiple linear regression. The result of the regression analysis proves that tax avoidance has a positive effect on the investor's response so that it can increase the value of the company. Test results also prove that tax avoidance reduces the quality of earnings information based on investor perspective. The difference in the sign of the regression coefficient proves that tax avoidance will be responded positively by the investor if tax evasion does not decrease the quality of earnings information.
Keywords: tax avoidance, earnings response coefficient, earning quality, cummulative abnormal return

1.   Introduction

The self-assessment system in the tax collection system provides flexibility for taxpayers in calculating, paying and reporting its own tax obligations. In Indonesia, the self-assessment system is regulated in article 12 of the General Taxation Laws Act. The application of this tax law seems to provide an opportunity for taxpayers to reduce the amount of tax due to tax avoidance. Although literal no laws are violated, all parties agree that tax avoidance is something that is practically unacceptable. This is because tax avoidance directly affects the erosion of the tax base, resulting in reduced tax revenues required by the state.

When taxes are a driving factor in corporate decisions, managerial actions designed to minimize corporate tax liability is considered important for tax avoidance strategies undertaken by management in line with shareholder interests (Chen et al., 2010 and Armstrong et al., 2012). Tax avoidance will transfer wealth from the state to shareholders thereby reducing agency problems. However, tax avoidance may result in agency costs due to potential risks associated with avoidance resulting in higher agency costs than tax savings (Desai and Dharmapala, 2006, Kim et al., 2011, Rezaei and Ghanaeenejad 2014). This shows that tax avoidance for shareholders has two opposite consequences, so the consequences of tax avoidance by investors' perceptions need to be examined.

The contradictions of these theorists are also consistent with the results of previous research. Rezae and Ghanaeenejad (2014) show that there is a negatively significant relationship between the value of tax avoidance companies. This negative influence is also in line with research Desai et al. (2007). Instead, Assidi (2015) proves to find that there is a significant and positive relationship between effective tax rate and future stock return volatility. This Result supported by Rego and Wilson (2012).

In addition to the effect on investor perceptions, tax avoidance policy also affects the quality of earnings information. The difference in after-tax profits caused by different avoidance strategies suggests that the quality of profit after tax information is also different. Hanlon and Heizmand (2010) state that because the income tax expense is an accrual-based expense, portions of it can potentially be manipulated to affect after-tax earnings. The net after-tax earnings that investors use to make investment decisions will be biased because of different tax avoidance strategies. Tax avoidance strategies determine the quality of earnings information, in the perspective of the agency theory of tax avoidance policies aimed at aligning management interests with shareholders. This means that the company's profit derived from tax avoidance is good information for investors because its interests are accommodated by management, so the company's earnings are considered qualified. On the contrary, the profit generated from tax avoidance of opportunistic motives to cover the complexity of corporate problems will have an impact on the high agency cost, then this earnings information becomes negative information for investors. In the perspective of signal theory, there are two opposite sides of the investor's reaction to tax avoidance activities by the company. On the one hand, shareholders see a positive side of tax avoidance because tax reductions can increase investor wealth. On the other hand, in the perspective of agency costs, the complexity of tax avoidance can protect managers from opportunistic attitudes, but these actions may negatively affect shareholders (Ariff and Hashim, 2014).

The consequences of tax avoidance studies show inconsistent results. Ariff and Hisham (2014) prove that tax avoidance can increase shareholder wealth and align with opportunistic interests of managers. Frank et al.

(2009) find a strong positive relation between tax avoidance and aggressive financial reporting and suggest that insufficient costs exist to preclude firms from simultaneously pursuing tax planning strategies and earnings management in the same reporting period. Meanwhile, Chen, Wang, and Tang (2014) prove that tax avoidance behavior can reduce company value. In contrast, several other studies have found that aggressive tax planning affects earnings quality and information asymmetry (Ayers, Jiang, and Laplante (2009), Comprix, Graham, and Moore (2011)). Desai and Dharmapala (2009) found that the overall effect of corporate tax avoidance activities on corporate value did not differ significantly from zero. Furthermore, Hanlon and Slemrod (2009) can not prove the market reaction to news of tax protection involvement.

Based on the theoretical gaps and inconsistencies of previous research results, this study aims to 1) re-examine investor perceptions of tax avoidance by firms, and 2) to examine investor perceptions of the quality of earnings information from tax avoidance. In contrast to previous research that proclaimed investor perceptions with stock prices, stock returns, stock price volatility and stock return volatility, this study used Cumulative Abnormal Return as a proxy for investor perception. In addition, dissimilar previous research that examine the quality of earnings with earnings management, this study will test the quality of earnings with earnings response coefficient. Choice of earnings quality based on investors' perception of tax avoidance is interesting to examine on the grounds that previous research on taxation in accounting research area has not been much studied, especially about investor perception of tax avoidance so that this research can contribute to the company about whether or not to avoid tax as actualization of contract agency to increase company value. The difference of company policy about tax avoidance impact on the quality of earnings information produced by the company.

2. Literature review and Hypothesis

The agency theory states that a conflict of interest between shareholders and management occurs because management will not want to be involved in tax avoidance even though it will increase value for shareholders unless they can gain personal benefit from the avoidance. Tax avoidance is considered by investors as an activity of value enhancement. Managers undertake tax avoidance activities for the sole purpose of reducing corporate tax liability. In addition, tax planning motivated by the synergy of interest, tax planning activities carried out by managers acting in the interests of shareholders. Therefore, reducing the transfer from shareholders to the government through tax planning activities generally increases shareholder wealth.

Ariff and Hasyim (2014) state that the firms generally engage in tax avoidance activities to reduce the amount of taxes that they must pay. Firms benefit from greater tax savings because such savings have a positive implication on both the cash and earnings of the firms. Chen et.al. (2013) state that according to classic agency theory, the free cash flow deriving from tax avoidance would lead to the occurrence of company-paid consumption and the building of "personal empire", which will shrink future cash flow and decrease firm value. Moreover, aggressive tax avoidance behavior is associated with administrative punishment and subsequent reputation loss, which also decreases future cash flow and firm value.

Alternative theoretical relationships of tax avoidance and agency problems, tax avoidance can create shields for managerial opportunism and lease transfer. This paradigm perspective emerges with an emphasis on the relationship between corporate governance and taxation arrangements. In this view, corporate tax avoidance requires not only different costs, but these costs may outweigh the benefits to shareholders, given that opportunities for asset transfers are highly likely to occur under these conditions (Desai dan Dharmapala 2006, Desai et al., 2007, and Desai dan Dharmapala, 2006), Rezae and Ghanaeenejad (2014) state that tax avoidance activities are traditionally viewed as tax saving devices that transfer resources from the state to shareholders and thus should increase after-tax firm value. An emerging literature in financial economics, however, emphasizes the agency cost implications of tax avoidance and suggests that tax avoidance may not always enhance outside shareholder wealth. Based on the above theoretical description can be hypothesized as follows:

Hypothesis 1: Tax avoidance has a positive effect on investor perception

Tax avoidance strategy is closely related to information disclosure required due to agency problems. Information transparency helps reduce agency conflicts among all stakeholders (Armstrong et al., 2010), to adjust market value by diverting current and future cash flows through management decision making changes (Lambert et al., 2007). On the other hand, transparency also makes business operations more open to governments, weakening the ability to avoid taxation so that tax avoidance transparency for double-edged swords (Zhang et al.2009). Tax decisions in publicly listed firms are not directly made by shareholders (principal), but by their agents. In this principal-agent relationship, agents possess private information regarding the extent of legally permissible reductions in taxable income and may also use tax avoidance to inflate the tax shields of a firm (Crocker and Slemrod, 2005). Information asymmetry between managers and shareholders may facilitate managers to act in their own interest, while tax activities may provide an opportunity for managerial opportunism (Desai and Dharmapala 2006). Crabtree and Kubick (2014) state that managers, endowed with private information about the firm and its future prospects, may be inclined to manipulate the timing of the earnings announcement in order to alter the news released to the market and/or exploit news for personal gain.

An alternative explanation for these results is the extent to which corporate tax avoidance impacts the timing of the annual earnings announcement. That is, managers may engage in tax planning throughout the year which may or may not complement earnings management activity. Tax planning designed to permanently reduce the firm's tax liability increase after-tax earnings which may assist the firm in meeting market expectations.

Tax avoidance is generally defined as a reduction in the company's explicit tax liability (Dyreng et al., 2008) so that tax avoidance firms will generate greater profits than firms that do not tax avoidance. The greater the net earnings reflect the company's economic performance so that large profits are regarded as quality information and more and more users of financial statements rely on the earnings information for decision making. Tax avoidance in the context of financial statement announcement can be a signal for investors. The reduction of taxable income is generally preferred by investors rather than the decrease in reported earnings since a decrease in profits means that it will reduce the company's profitability. Therefore, companies have an incentive to play with both issues of reporting high earnings to shareholders and creditors to increase market value and to disclose low taxable income in order to increase cash flow by lowering tax payments.

In a different perspective, tax avoidance may be undesirable by shareholders when agency costs are considered because they can be subject to the discretion of the opportunistic manager. Desai and Dharmapala (2006) argue that tax planning, which is usually complex and opaque, provides an opportunity for managerial opportunism. From this perspective, tax planning promotes a lack of transparency, which then gives a 'shield' for managers to take the rent at the expense of shareholders by shrinking their accounting earnings. In addition, tax avoidance activities can allow managers to engage in activities designed to conceal unfavourable news and mislead investors. Similar to the underlying incentives in hiding adverse operating results, tax avoidance activities facilitate the accumulation of unfavourable news over a long period of time (Kim et al., 2011). The ability to hide and collect such news through tax avoidance can result in extreme outcomes. In short, agency costs in tax avoidance activities may outweigh the potential tax savings incurred by shareholders. Based on the description above, then this research develop hypothesis as follows:

Hypothesis 2: Tax avoidance reduces the quality of earnings information based on investors' perceptions

3. Research methodology.

The sample in this study is non-financial companies listed on the Indonesia Stock Exchange period 2012-2015. The exempted samples in this study were companies that lost and or not did tax avoidance (positive CERT ratios). Referring to the above two criteria and after deducting the outlier data, we get the final sample of 634 observation data. This study tested the agency theory and the quality of profit information with research design around the date of the announcement of annual financial statements. The date of the announcement of the financial statements is the date on which the company submits the financial statements to the financial services authority (OJK) with an observation window 10 days before and 10 days after the date of submission of the financial statements. Selection of this window with the consideration that the reaction to information in the semi-strong market is based on information contained in the financial statements around the reporting date.

Based on the research objectives, the analytical tool used to test the hypothesis is the ordinary least square, which is described in two research models as follows:

$$CAR_{it} = \alpha_0 + \alpha_1 CETR_{it} + \alpha_2 ROA_{it} + \alpha_3 DTA_{it}\varepsilon_{it}..(1)$$
$$CAR_{it} = \alpha_0 + \alpha_1 UE_{it} + \alpha_2 CERT_{it} + \alpha_3 UExCERT_{it} + \alpha_4 ROA_{it} + \alpha_5 DTA_{it} + \varepsilon_{it}.. ..(2)$$

Cumulative Abnormal Return (CAR) is a proxy of stock price or market reaction, with the calculation:

$$CAR_{i,t} = \sum A_b(R_{i,t})$$

$A_b(R_{i,t})$: Abnormal return for stock i on day t

But before getting the value of CAR, then first must calculate the value of abnormal return of company stock, by way of:

$$A_b(R_{i,t}) = R_{i,t} - E(R_i)$$

$R_{i,t}$ *: Actual return for stock i on day t*
$E(R_i)$ *: Expected Return for stock i on day t*

Therefore, to get an abnormal return of stock, it must be calculated actual return and expected return of stock. Actual return is the income that has been received by investors, in the form of capital gain obtained from the calculation:

$$R_{i,t} = \frac{P_t - P_{t-1}}{P_{t-1}}$$

R_{it} *: Actual return of company stock i on day t*
P_t *: stock price company i on day t*
P_{t-1} *: stock price company i on day t*

The model used to calculate the expected return of stock is Capital Asset Pricing Model or better known as CAPM, CAPM model example used by Bartholdy and Peare (2004) with the following model:

$$E(R_{i,t}) = R_f + \beta_i[E(R_m) - R_f]$$

$E(R_{it})$: *Expected Return stock$_i$ on day t*

R_f : *Risk free rate*

$E(R_m)$: *Return of market portfolio calculated by way*

$$E(R_m) = \frac{IHSG_t - IHSG_{t-1}}{IHSG_{t-1}}$$

$IHSG_t$: *Composite Stock Price Index in day t*

$IHSG_{t-1}$: *Composite Stock Price Index in day t-1*

β_i : *Systematic risk from stock i to market portfolio*

$$\beta_i = \frac{Covar\ (R_i, R_m)}{Var(R_m)}$$

Unexpected earnings are measured using the formula

$$UE_{i,t} = \frac{(E_{i,t} - E_{i,t-1})}{E_{i,t-1}}$$

$UE_{i,t}$: *Unexpected earnings of firm i in year t*

$E_{i,t}$: *Corporate accounting earnings i in year t*

$E_{i,t-1}$: *Corporate accounting earnings i in year t-1*

Cash effective tax rate i.e. cash issued for tax expense divided by profit before tax. CETR for this research measure with following formula

$$CETR = \frac{\sum_{t}^{n} = 1\ Cash\ Tax\ Paid\ it}{\sum_{t}^{n} = 1\ Pretax\ Income\ it}$$

CERT it is Measurement of tax avoidance company in year t, Cash tax paid it is tax paid company cash in year t. Pre-tax Income is the Company's profit before tax in year t the greater the CETR cash indicates the lower the tax avoidance rate. DTA and ROA in this study are control variables that illustrate the agency conflict that has been studied and the results are relatively consistent with stock prices. DTE is derived from liabilities divided by equity and ROA is measured by earnings after tax divided by total assets.

The research model 2 was developed from the Earnings Response Coefficient model. The model was developed by Cho and Jung (1991). Cho and Jung (1991) classified the theoretical approach of ERC into two groups: (1) an economics-based valuation model developed by Holthausen and Verrechia (1988) and Lev (1989) indicating that the strength of investor response to earnings information signal (ERC) is a function of future uncertainty. The greater the noise in the enterprise reporting system (the lower the profit quality), the smaller the ERC and (2) the assessment model based on the time series based valuation model developed by Beaver, Lambert, and Morse (1980). The Earnings Response Coefficient (ERC) model is:

$$CAR_{it} = \alpha_0 + \alpha_1 UE_{it} + \varepsilon_{it}$$

The first hypothesis in this study is seen from the value of t value for α_1 in the research model 1 and α_2 on the research model 2. Hypothesis accepted if t value greater than t table with 1%, 5% or 10% significance level and positive regression coefficient. Meanwhile, the second hypothesis is tested by looking at t value for α_3 in the second model.

4. Results and Discussion

Table 1 Statistic Descriptive

	CAR	UE	CETR	ROA	DTA
Mean	-0.007052	0.023919	-0.390305	0.104119	0.454067
Median	-0.006110	0.018815	-0.266714	0.077145	0.446773
Std. Deviation	0.066963	1.073485	0.529456	0.101265	0.253276
Minimum	-0.214108	-6.671598	-7.495384	0.001091	0.000320
Maximum	0.165439	9.161616	-0.000148	0.903631	2.876290

Table 1 presents descriptive statistics of mean, median, and standard deviations. Mean CAR -0.007052 indicates that investors give a negative response and median CAR -0.006110 shows that most investors also give negative responses. The mean EU that represents the average of the abnormal earnings of 0.023919, the median EU value of 0.018815 show that most of the firm's year earnings t is greater than the year t-1. The Mean CETR -0.390305 median of -0.266714 and the standard deviation of 0.529456. Meanwhile, DTA and ROA as control variables show a deviation that is not too high with the average value for DTA 0,454067 and median of 0.446773, and ROA with a mean value of 0.104119 and median of 0.077145.

The result of the multivariate analysis in table 2 model 1, adjusted R square equal to 0,040 with F value equal to 9.904 significant at level 1%. Meanwhile, model 2 shows an adjusted R square value of 0.0740 which means that the independent variable can explain the dependent variable only by 7.40%. Anova analysis shows

that F value of 11.268 with a significance value of 0,000 giving the meaning that at least 1 variable ie EU, CERT, UExCETR ROA or DTA significantly influence CAR.

The relationship between tax avoidance (CETR) and CAR can be seen in model 1 and model 2. Model 1 shows that t value of CETR of 2,913 with significance level of 0.004 and regression coefficient of 0.014 proves that hypothesis 1 is accepted. In other words, tax avoidance positively affects investors' perceptions. This result is reinforced by test result on model 2, regression coefficient of 0.008 (positive) with t value 1.774 significant at 10% level proves that tax avoidance has a positive effect on firm return, in other words, it can be stated that investors see tax avoidance as a positive signal that managers act in the interests of shareholders. These results are consistent with traditional perspectives that investors see tax avoidance as a positive signal that in avoidance policy it means there has been a transfer of assets from the state to shareholders. Assidi (2015) used 40 French firms listed on the CAC 40 during the period from 2009 to 2013 show that there is a significant and positive relationship between the ETR and future stock return volatility. Jacob and Schütt (2014) studied two dimensions of tax avoidance such as the uncertainty and the expected level of future tax rates, concluded that, for firms with effective tax avoidance, pre-tax earnings had a considerable impact on a firm's value. In addition, firms, with volatile effective tax rates, received a discount on their earnings. This result incosistent with Lestari and Wardhani (2015) and Pratama (2018), found that in Indonesia tax avoidance negatively affects firm value. Differences in research results due to differences in research design. The value of the firm in other studies is the value of the company's book calculated along with the closing date of the company's book. CAR on this research reflects the CAR value around the date of financial statement announcement.

Table 2 Multivariate analysis of tax avoidance, earning quality and investor perseption

Variable	Expected Sign	Model 1			Model 2		
		B	t value	Sig.	B	t value	Sig.
(Constant)					-0.017	-2.741	0.006
UE	+				0.008	2.935	0.003
CETR	+/-	0.014	2.913	0.004	0.009	1.774	0.077
UExCETR	+/-				-0.011	-1.864	0.063
ROA	+	0.104	4.024	0.000	0.091	3.556	0.000
DTA	+	0.009	0.891	0.373	0.010	0.985	0.325
F value		9.904			11.268		
Sig.		0.000			0.000		
Adjusted R square		0.04			0.074		
Durbin watson		1.992			2.024		
n		634			634		

Dependent variable: CAR

The Unexpected Earning (UE) the regression coefficient is 0.008 and t-statistics 2.935 indicating that the investor gives a positive response to the company's announced earnings. The hypothesis 2 tested in this research is tax avoidance effect on earnings quality based on investor perception. Table 2 shows the t count for UExCETR of -1.864 and the significance of 0.067 which means that UExCETR significantly negatively influences the CAR at the 10% level. In other words, it can be stated that the hypothesis in this study is accepted. These results prove that tax avoidance measures will reduce the quality of earnings information. The quality of profit information will be reduced if the company chooses to take tax avoidance policy. This result is in line with the research of Kim et al (2011) which proves that tax avoidance has risks because in tax avoidance it contains elements of profit management, opportunistic management behavior and bad corporate governance. If bad news is accumulated within the company through tax avoidance, earnings management, and other opportunistic activities, and then, the company's specific bad news tends to be released in larger quantities (after long disclosure delays) causes a strong reaction to the disclosure of earnings information can ultimately lead to extreme negative returns. Crabtree and Kubick (2014) also prove that corporate tax avoidance impacts corporate information risk and therefore becomes a significant risk characteristic that should be considered in evaluating company-specific risks.

The difference of regression coefficient marks between CETR and UExCETR indicates that tax avoidance directly affects the investor response reflected in the CAR. This suggests that assuming that other variables are constant, investors will react positively to tax avoidance as investors assume that tax avoidance by management is done to minimize tax costs so that there is the transfer of wealth from the state to shareholders. The negative sign at UExCETR indicates that tax avoidance reduces the quality of earnings information based on investors' perceptions. Tax avoidance may affect investors if such avoidance can improve the quality of earnings information. The income information is eligible if the information is transparent and not manipulative, in respect of tax avoidance, income information is eligible if such information is avoided from tax avoidance risk. Desai and Dharmala (2009) state that in particular, corporate governance must be an important determinant of a

recognized corporate tax savings assessment. While the immediate effect of tax avoidance is to increase the value after corporate taxes, this effect is potentially offset, especially in poorly regulated firms, by increased opportunities for managerial lease transfers. Thus, the net effect of cost-benefit tax avoidance on corporate value should be greater for firms with stronger governance. This study is consistent with Crabtree and Kubick (2014), directly proving that tax avoidance positively affects cumulative abnormal returns. Furthermore, this study obtains strong evidence that tax avoidance is not transparent will reduce the quality of information based on investor perceptions.

5. Conclusion

The consequences of tax avoidance can be explained by the agency theory. Tax avoidance occurs because of information asymmetry between management and stockholder. Investors will respond to the tax avoidance policy because it assumes that the company's liabilities are reduced so that net profit after tax increases, so investors assume there is a transfer of wealth from the state to stockholders. Meanwhile, tax avoidance will reduce the quality of earnings information according to investors' perceptions. Investors see that net after-tax profits on firms that avoid induced earnings management, are at risk of agency and legal costs, and poor governance. The consequences of this tax avoidance are tested with the aim of analyzing the effect of tax avoidance on investor reactions and analyzing the effect of tax avoidance on the quality of earnings information based on investors' perceptions.

Analysis by using linear regression with sample company in Indonesia Stock Exchange get proof that tax avoidance positively affects investor perception. The study also proves that tax avoidance reduces the quality of information, since net income after taxes on firms with tax avoidance policies is less transparent, carries the risk of legal uncertainty, and potential agency costs in tax avoidance activities may outweigh potential tax savings issued by shareholders, through tax avoidance activities will be responded negatively by investors because

This research contributes to the development of agency theory as a basis for explaining the consequences of tax avoidance developed by Desai and Dharmala (2006). Grey area theories as a result of the contradiction of the direction of the consequences of tax avoidance can be explained that tax avoidance directly affects investor perception and tax avoidance affect the investor response through the quality of profit information. In the context of earnings information, this study contributes to the discussion of signal theory. Tax avoidance provides a negative signal on the quality of earnings information based on investor perspective. In addition, this research also contributes to incorporate the area of taxation research and financial accounting research.

The results of this study have implications for both management and stockholders that tax avoidance is done to reduce tax costs to increase corporate value, on the other hand, tax avoidance also carries risks about potential losses, such as tax penalties. The limitations of this study are not to directly examine the transparency of the quality of earnings information. Researchers can then test transparency through corporate governance on tax avoidance to produce quality earnings information.

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