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The Tax Avoidance Opacity

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Abstract

This study reviews the relationship between tax avoidance and earnings transparency. Tax avoidance is perceived as management actions that entail possible hidden actions and hidden information, hence opacity. Furthermore, this study explores the effects of companies' ownership structure, including its ultimate and second-largest owners, along with its family ownership and corporate governance, like the board and audit committee's effectiveness in moderating the relationship between tax avoidance and earnings transparency. Using samples of companies from the Indonesian Stock Exchange between 2008-2012, this study finds that tax avoidance negatively relates to earnings transparency. It is also found that concentrated ownership strengthens the negative tax avoidance-earnings transparency relationship, and effective board and audit committees weaken the relationship. However, this study cannot prove that family ownership and second-largest shareholder have moderating power over the relationship. This study is among the first studies that use earnings transparency to indicate the company's earnings quality and one of a few research types that look into the second-largest shareholder's role.

Keywords: Corporate governance, earnings transparency, ownership structure, tax avoidance

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1. INTRODUCTION

Tax is always a substantial issue in corporate earnings reporting. In Indonesia, it counts as much as 25%. Simultaneously, the tax percentage may exceed half of the corporate earnings in other countries. On the other hand, earnings exhibit the achievement of the company's management. Therefore, companies should focus on reporting earnings effectively to increase shareholder value and its impact on the reward is also achieved.

Management of the companies is in the dilemmatic decision. While investors require the companies to gain higher net income to increase their share price, companies think higher earnings are associated with higher tax payments. Therefore, companies' management considers tax management, defined as any creative actions corporations take to pay as little tax as possible (Slemrod, 2004), as a significant aspect of the company performance reporting.

Tax avoidance is one of many tax management decisions that companies choose. This action, despite legal, is not without consequences. Previous studies found that firms that avoid tax tend to have a higher number of discretionary accruals (Frank et al., 2009) and have lower earnings persistence (Tang & Firth, 2012), hence lower earnings quality. Tax avoidance is also perceived as hidden actions and information (Slemrod, 2004), which means less transparency and higher information asymmetry.

Earnings transparency is defined as how well the firm's earnings report captures changes in its economic value (Barth, 2013). The more considerable extent it captures its economic value changes, the more transparent the earnings are. As companies that avoid tax (Slemrod, 2004), the information provided in their earnings may also be low in transparency.

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This paper examined the relationship between the companies' tax behaviour and reported earnings transparency, hence its opacity. Further, it evaluates whether the ownership structure and corporate governance affect the relationship whether the structure and corporate governance can increase transparency in tax avoidance cases. Even though this study is not the first study that examines the relationship between tax avoidance and earnings quality, this study is the first one that uses earnings transparency as a proxy for earnings quality. Moreover, it is also one of the few studies that examine the second-largest shareholder's role in mitigating agency problems.

This paper is organized into the following order. First is the introduction, followed by the literature study that shows the previous study on tax avoidance and earnings opacity. Then, research methodology, data gathering, and hypothesis are followed. Results and discussion are in the next section. Lastly, the findings are concluded.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Tax avoidance is highly dependent on management discretion and indicates a low level of corporation's transparency. Previous studies investigated factors determining management indiscretion when tax management is associated explicitly with opportunistic behaviour (Desai et al., 2006; Moore, 2012). Studies by Lim (2011) concluded that tax avoidance would have a lesser effect on the capital cost when shareholders have control in supervising management.

In Indonesia, like in many other Asian countries, companies' ownerships are more concentrated with family dominating pyramidal shareholder structure (Fan & Wong, 2002; LaPorta et al., 1999; Diyanty, 2012). With this shareholding structure, institutional shareholders' role is considerably less prominent than ultimate controlling shareholders (UO) and family-owned shareholders (Douma et al., 2006).

With this structure, the ultimate owner has more control over management through excess control rights over cashflow rights (Claessens et al., 2002). The agency problem (Jensen & Meckling, 1976) usually exists between the ultimate and non-ultimate owners (Diyanty, 2012; Attig, 2008). The reason is that the ultimate owner can influence management to undertake actions that benefit ultimate owners (entrenchment effect), including tax avoidance.

Other studies found that the ultimate owners (companies with family as their ultimate owners) usually undertake less tax avoidance than tax aggressiveness (Chen et al., 2010). This is because these companies aim to preserve a family reputation to be inherited. They believe that the reputation would uphold the sustainability for the companies for the next generations.

Laeven & Levine (2006) and Attig et al. (2008) found that other ultimate owners hold some monitoring roles, those are the second (third, fourth, and even fifth) largest shareholders or multiple largest shareholder (MLS). This role is becoming essential for companies whose shareholding structure is more concentrated in controlling management, particularly when the ultimate owner has aligned interest with the management (Attig et al., 2008). Moreover, Attig et al. (2008) found that MLS hold a more prominent monitoring role in companies in developing countries, including Indonesia, where the legal protection of minority is considered ineffective. This research only examines the second-largest shareholder's role. It is noted that a concentrated shareholding structure only involves a few or family-owned shareholders (Diyanti, 2012).

Other factors that could mitigate companies' tax avoidance are adopting good corporate governance (CG). According to Desai & Dharmapala (2006), good corporate governance (CG) could help management decide if the company carries out rent diversion or tax avoidance in the form of tax shelter. CG also reduces the unfavourable impact between tax avoidance and company values (Wahab & Holland, 2012).

CG consists of policies developed to clarify the relationship between shareholders, management, commissioners, and other stakeholders. CG is the mechanism that assists external parties in carrying out monitoring activities against the companies to undertake corporate activities that maximize both ultimate owners and other shareholders' value. Adopting good corporate governance could lower the rent diversion in companies' tax avoidance, thus increasing information transparency.

2.1 The Impact of Tax Avoidance on Earnings Transparency

Many studies associate tax avoidance with earnings quality. Companies that carry out tax avoidance and tax aggressiveness often undertake earnings management (Dhaliwal et al., 2008; Blaylock et al., 2010; Tang & Firth, 2011; Tang & Firth, 2012; Frank et al., 2009). Blaylock et al. (2010) argue that the difference between accounting

income and tax income would impact earnings quality. The positive difference in which accounting income is more considerable than tax income exhibits tax avoidance, increasing earnings (upward earnings management). Companies that carry out upward earnings management tend to reverse the accrual accounting in the following year. The positive or negative difference would undoubtedly lower the earnings quality by lower transparency.

Studies by Tang & Firth (2011) found that abnormal BTD, or the difference between accounting income and tax income, which resulted from other factors than the difference between accounting standard and tax regulation, intensifies the companies' earnings management and tax avoidance.

With the premise that earnings management impact earnings quality through its transparency, this paper hence proposes the first hypotheses as follows:

Hypothesis 1: Tax avoidance negatively impacts the company's earnings transparency

2.2 Role of ultimate owners, second-largest shareholders and corporate governance in moderating the relationship between tax avoidance and earnings transparency

This paper's further objective is to affirm the influence of shareholding structure and CG implementation on the relationship between tax avoidance and earnings transparency. The shareholding structure that the paper examines includes a family-owned structure and second-largest shareholders. This paper's corporate governance aspects are the board of commissioners and the audit committee's effectiveness.

Tax avoidance could lead to lower transparency and asymmetric information between the company's management and shareholders and debt holders through management rent-diversion (Lim, 2011). Previous studies also exhibited that corporate governance (CG) and ownership structure has a mitigating role for the agency problem resulting from tax avoidance (Desai & Dharmapala, 2006; Desai & Dharmapala, 2009).

2.2.1 The role of family (ultimate) owners

Companies whose shares are owned by the family are often perceived as having more excellent value than those who do not belong to non-family (Maury, 2006). Companies that belong to families in the US show less tax aggressive than those not owned by family shareholders (Chen, 2010). The family-owned companies seem to conserve the reputation and sustainability by taking more risk-averse than those who do not own by family.

In the other case, Claessens & Yutroglu (2013) stated that most South East Asia companies, including Indonesia, are primarily owned by families. With this structure, information asymmetry between the management of the companies and the owner is lesser. Their interests are even aligned (Diyanti, 2012). In such cases, agency problem type II, of which the agency problem arises, are between the ultimate owners and minority shareholders. It is perceived that the ultimate owner can influence management in undertaking corporate actions hence disadvantaging minority shareholders (Diyanty, 2012). In other words, the interest alliances between ultimate owners and management could lead to potential entrenchment performed by the ultimate owner that adversely impacts the interest of minority shareholders and other stakeholders. As one of management discretional actions, tax avoidance could be an entrenchment. It could only be beneficial for generating cash flow for the family owner rather than to residual claimants.

While some studies found that the family-owned structure may strengthen the relationship between tax avoidance and earnings transparency (for family companies that inquire about maintaining their reputation), others argue that this relationship may be weakened through the potential entrenchment inherent in family ownership. This paper then proposes the following hypothesis 2:

Hypothesis 2: The negative impact of tax avoidance on the companies' earnings transparency with a family-owned structure would be different from those not owned by a family.

2.2.2 The influence of ultimate owners

The ultimate owner's considerable influence is the significant difference between control rights (CR) and cash flow rights (CFR). The more considerable difference of the CR compared to CFR leads to higher chances of ultimate shareholders to expropriate minority shareholders (Claessens et al., 2002; Attig et al., 2008; Fan & Wong, 2002).

Companies who undertake tax avoidance tend to have lower earnings transparency because ultimate owners are perceived to expropriate minority shareholders in order for them to maximize their wealth and interests. The larger

the cash flow leverage held by ultimate owners, the more significant influence of ultimate owners on managing the corporation, including managing earnings (Claessens et al., 2002; Diyanty, 2012). This argument is examined through the following hypotheses 3:

Hypothesis 3: The higher the ratio of control rights over cash flow rights are, the stronger the influence of the negative impact of tax avoidance on earnings transparency

2.2.3 The influence of second-largest shareholders on the relationship between avoidance and earnings transparency

The second-largest shareholders significantly reduce agency problems and asymmetric information by determining the chances of expropriation risk arising by ultimate owners that impact minority shareholders (Attig et al., 2008). In particular, agency problem type II, which exists between controlling and non-controlling shareholders (Shleifer and Vishny, 1997), can be reduced with parties with a monitoring function. The second-largest shareholders can be referred to as parties that can have such a role (Attig et al., 2008).

On the other hand, second-largest shareholders could also contribute to the occurrence of tax avoidance if they have aligned interests with either management of the company or the ultimate owner (Kim et al., 2007) in achieving objectives that are not in the company's best interest (Thomsen et al., 2006). Therefore, the second-largest shareholders' presence could positively and negatively impact the relationship between tax avoidance and earnings transparency. Thus, this paper suggests the following hypotheses 4:

Hypothesis 4: The negative impact of tax avoidance on the companies' earnings transparency with the second-largest shareholders would be different from those with second-largest shareholders.

2.2.4 The influence of Corporate Governance (CG) on the relationship between tax avoidance and earnings transparency

Theoretically, the CG mechanism is often used to reduce the agency problem. Previous studies on CG found that companies whose CG implementation effectively tend to have better earnings quality. Jiang et al. (2008) further found that the companies that acquired high CG scores have low absolute discretional accrual, named better earnings quality. Therefore, as CG adoption could minimize rent diversion and improve information transparency and symmetry, it is strongly argued that CG adoption could impact the relationship between tax avoidance and earnings transparency. The paper hence suggests the following hypotheses 5:

Hypothesis 5: The more vigorous CG implementation in the company leads to weakening tax avoidance's negative influence on earnings transparency.

3. RESEARCH METHODS

To investigate tax avoidance's effect on its earnings reporting and the influence of ownership structure and corporate governance, a sample from companies listed on the Indonesia Stock Exchange from 2008 until 2012 was gathered. Following Barth et al. (2013), earnings transparency is calculated using cross-sectional data's explanatory power obtained from the relationship between returns and earnings. Tax avoidance is measured by abnormal book-tax difference adopting Tang & Firth (2011).

For determining the control power of ownership structures, the following measures are used:

- Cash-Flow Leverage (CFL) is the ratio of the ultimate owner's (UO's) control rights (CR) to its cashflow rights (CFR) (Claessens et al., 2002).
- Family shareholders are the firm's UO defined as an individual or a group of individuals who constitute a family (Diyanty, 2012). In this study, a family is a dummy variable given the value of 1 if the UO is an individual name within a family or group of families and 0 if otherwise.
- The second-largest shareholder (SLS) considers other shareholders' presence than the ultimate owner (UO). Following Attig et al. (2008), the SLS's role will be measured using a dummy variable: if the company has an SLS and 0 if otherwise.

Other than the ownership structure, the corporate governance (CG) variable is used to measure board commissioners and audit committees' effectiveness using the score developed by Hermawan (2009).

Some control variables are used in the model employed in this study. Those are:

- Leverage: higher leverage leads to the higher risk borne by the company, which results in lower earnings quality (Dechow et al., 1996).

- Growth: high growth rate is expected to have high discretionary accruals associated with performance, not manipulation (Siregar, 2005).
- Market to Book Ratio: shows how confident the market perceived the company, indicating higher transparency (Nelson et al. 2002).
- Size and Age: larger companies tend to have more earnings management, hence less transparency (Nelson, 2002). Older companies strive to maintain their reputation (Lim, 2011).
- ROA: shows company profitability. The higher its profitability, the less likely it manipulates its financial data, the higher its transparency is.

Table 1: Statistics Descriptive

Variable	N	Mean	SD	Min	Median	Max
ABTD	811	-0.013	0.069	-0.30	-0.01	0.75
ET	811	0.000	0.12	-0.37	0.0003	0.37
GROWTH	811	0.15	0.28	-0.74	0.12	1
LEV	811	0.51	0.62	-0.87	0.3	2.36
SIZE	811	5720	14100	6.4	1250	152000
MTBV	811	1.94	1.8	-1.26	1.28	7.34
ROA	811	0.05	0.08	-0.19	0.04	0.31
AGE	811	12.34	7.1	0.08	13.58	32
FAM	811	0.7	0.46	0	1	1
CFL	811	1.16	0.3	1	1	2.03
OWN2	811	0.7	0.46	0	1	1
CG	811	0.69	0.09	0.43	0.7	0.95
Earnings Transparency (ET): earnings transparency represents earnings relevance; ABTD: tax avoidance; Growth: sales growth; Lev: total debt to total equity; Size: the natural logarithm of total assets; MTBV: the market-to-book value of equity; ROA: return on the asset; Fam: 1 if the firm's UO is an individual or group of individuals in a family, and 0 if otherwise; CFL: a ratio of UO's CR to CFR; OWN2: 1 if the firm has an SLS and 0 if otherwise; CG: CG score.						

4. EMPIRICAL EVIDENCE

The following equation is used to regress the earnings transparency on tax avoidance, employing the control variables:

$$ETit = \alpha 0it + \alpha 1ABTDit + \alpha 2LEV\ it + \alpha 3GROWTH\ it + \alpha 4MTBV\ it + \alpha 5SIZE\ it + \alpha 6AGE\ it + \alpha 7ROA\ it + \varepsilon\ it$$

ET is earnings transparency representing earnings relevance. The relationship between earnings and returns and ABTD is the tax avoidance variable. Another equation is used to test the moderating variables on their roles to mitigate the relationship between tax avoidance and earnings transparency. Table 2 shows the result of the regression. The second column is for answering the first hypothesis 1 (H1). The next column is proof for the rest of the hypotheses tested in this study.

Table 2: Effect of Tax Avoidance on Earnings Transparency

		No Moderation			With Moderation		
Variabel	Pred	Beta	p-value	Signf.	Beta	p-value	Signf.
C		0.154	0.000	***	0.222	0.000	***
ABTD	-	-0.132	0.070	*	-0.981	0.152	
LEV	+	0.023	0.018	**	0.022	0.021	**
GROWTH	+	-0.100	0.000	***	-0.105	0.000	***

MTBV	-	-0.007	0.020	**	-0.008	0.019	**
SIZE	+	0.001	0.402		0.002	0.299	
ROA	-	0.385	0.000	***	0.388	0.000	***
AGE	+	-0.001	0.276		-0.001	0.258	
FAM	+/-				0.004	0.400	
FAM*ABTD	+/-				-0.290	0.276	
CFL	+				-0.022	0.175	
CFL*ABTD	+				0.745	0.063	*
OWN2	+/-				0.002	0.434	
OWN2*ABTD	+/-				-0.299	0.266	
CG	-				-0.064	0.094	*
CG*ABTD	-				0.442	0.349	
AdjR-squared		3.41%			4.79%		
Prob F-stat		0.0000			0.0000		

Earnings Transparency (ET): earnings transparency represents earnings relevance; ABTD: tax avoidance; Growth: sales growth; Lev: total debt to total equity; Size: the natural logarithm of total assets; MTBV: the market-to-book value of equity; ROA: return on the asset; Fam: 1 if the firm's UO is an individual or group of individuals in a family, and 0 if otherwise; CFL: a ratio of UO's CR to CFR; OWN2: 1 if the firm has an SLS and 0 if otherwise; CG: CG score.

From Table 2, it can be deduced that tax avoidance negatively relates to earnings transparency. The result proves the hypothesis. The tax avoidance decision of the management implies hidden information and less transparency, hence opacity. This result support Slemrod's (2004) argument on the tax implication of hidden information. This result affirms Desai and Dharmapala's (2006) findings that tax avoidance can increase information asymmetry.

Next is the moderating variable. The third column of Table 2 shows the result of moderating variables tested in this study:

- It is found that family ownership does not have any moderating impact on the relationship between tax avoidance and earnings transparency. This suggests that tax avoidance's negative impact on earnings transparency is not found different between companies owned by family or by non-family. This result, however, does not support hypothesis 2.
- The cash-flow leverage ratio of the ultimate owner control rights to its cash-flow rights show, moderated against tax avoidance, shows a significant positive relationship with the earnings transparency. This supports hypothesis 3 and means that the higher the cash-flow leverage owned by the ultimate owner heightens the negative impact of tax avoidance on earnings transparency. This result implies the underlying perception of the market on expropriation effect by the ultimate owner, as found in previous studies of Claessens et al. (2002) and Attig et al. (2008).
- However, the second-largest shareholder variable in Table 2 does not significantly affect the relationship between tax avoidance and earnings transparency. This result is not according to hypothesis 4, which explains that the market does not perceive that the second-largest shareholder has any monitoring role to the management. Therefore, it cannot alter the management's market reaction to tax avoidance.
- CG score on the board and audit committee's effectiveness also does not mitigate the negative effect of tax avoidance on earnings quality. This result does not support hypothesis 5, which says that good corporate governance would convince the market of the monitoring scheme. Any management action such as tax avoidance would not be perceived as opacity. The result confirms that the market, however, is not.

5. CONCLUSION

This study aims to confirm the opacity of the tax avoidance carried out by companies whether the companies' ownership structures and their corporate governance would increase transparency. Using earnings transparency as a proxy for company transparency, this study can prove that tax avoidance will decrease companies' transparency. However, this study cannot offer evidence that ownership structure and corporate governance's monitoring roles can solve the agency problems caused by tax avoidance. This conclusion is derived from the fact that the second-largest shareholders' effectiveness and effectiveness cannot increase the negative relationship between tax avoidance and earnings transparency.

This paper also finds that the market views the controlling power of ultimate owners as a source of opacity. This concludes that the higher control rights owned by ultimate owners are perceived negatively by the market concerning tax avoidance behaviour (through higher irrelevance earnings to its returns).

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