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Indonesia's LQ45 Index: Tax Discount Facility and Earnings Management

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Abstract:*This study aims to find empirical evidence of differences in accrual earnings management and real earnings management between companies that get tax discount facility and those that do not in the LQ45 Index in Indonesia. The population of this study is all companies registered in the LQ45 Index from 2014 to 2018.*The hypothesis is tested using the Mann Withney Test. *Based on the results of this study, there is no difference in accrual earnings management or real earnings management between companies that get tax discount facility and those that do not in the LQ 45 Index. It happens because companies registered in the LQ45 Index are 45 companies that are highlighted by investors and other stakeholders. The companies are encouraged to maintain the trust of investors and other stakeholders.*

Key Words*:Accrual Earnings Management, Real Earnings Management, Tax Discount Facility, LQ45 Index*

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I. Introduction

The Government of Indonesia issued Government Regulation number 77 of2013 on Reduction of Income Tax Rates for Domestic Corporate TaxPayers in the form of Public Companies. The income tax rate has been cut by a 5% tax discount off the normal rate of 25%. The Indonesian government provides that taxation facility because they want to increase the role of the capital market and public ownership in publicly traded companies. One factor that supports the development of a country's capital market is the trust of investors(Azizah, 2017). The trust arises from the financial statements which present financial information that reflects the actual condition of the company's economic reality.

Azizah (2017), Azizah et al., (2019), Majid et al., (2020)prove that companies in Indonesia prefer doing earnings management, either accrual earnings or real earnings management. When related to taxation aspects, Chen, *et.al* (2010) explained that tax is one crucial aspect that is highly considered by companies. Moreover, based on the political cost hypothesis developed by Wattz and Zimmerman (1986), companies tend to engineer profits reduction to minimize political costs they must bear.

There are inconsistent results from previous studies related to the effect of tax on earnings management. Lestari *et.al.* (2018) prove that tax planning has a significant effect on earnings management. The results of the study are the same as those conducted by Negara and Saputra (2017), Sutrisno*et.al.* (2018), andRomantis et al., (2020). While Wardani and Santi (2018) prove that tax planning has no effect on earnings management, similar to those of Saputra (2018), as well as Aditama and Purwaningsih (2014).

Based on the background described above and the differences in the results of previous studies, the researcher is interested in examining tax discount facility and earnings management in the LQ45 companies in Indonesia. This study aims to empirically examine the differences in accrual earnings management practices and real earnings management practices among companies that get tax discount facility and those that do not get at the LQ45 Index in Indonesia.

This research is expected to be able to contribute to investors and other users of financial statements who invest in companies of the LQ45 Index in Indonesia to realize that actual earnings management practices do occur even in companies with high capitalization.

II. Literature Review, Hypothesis Development, And Methods

2.1. The Agency Theory

Jensen and Meckling (1976) explained that in the agency relationship between owners and managers as agents can cause agency problems. Agency problems arise because of differences in interests. It can happen because the agent does not act in the interest of the owner.

This agency relationship should be able to make the company's value increases because it is managed by people who know and understand how to run a business and are closely monitored by the owner, but the opposite happens from what is expected(Azizah, 2017).Agency problems will arise if one party has a desire to maximize one's welfare (moral hazard), even though it harms the other.

2.2. The Game Theory

According to Neumann and Morgenstern (1953), the game consists of at least two people and a set of rules that can create a competitive situation. The rules made must allow every player to action. With clear rules and game facility available, the parties involved in the game will choose a strategy to maximize their own or group's victory or even to maximize the opponent's victory.

2.3. Tax Evasion

According to Pohan (2016), tax evasion is an effort that is carried out legally and safely for taxpayers because it does not conflict with taxation provisions, where the methods and techniques used tend to exploit the weaknesses (grey area) existing in tax laws and regulations itself, to minimize the amount of tax owed.

One example of tax avoidance is to take advantage of the tax rate reduction facility. Corporate taxpayers in Indonesia in the form of an open company can obtain a 5 % tax cut from the normal rate or in other word, the income tax rate will be 20%.

2.4. Earnings Management

Subramanyam and Wild (2010) explain that earnings management is a process for beautifying or cosmetic financial reports. Roychowdhury (2006) explains that there are two earnings management techniques, namely accrual earnings management and real earnings management. Accrual earnings management is manipulation done by managers by engineering discretionary accruals that have no direct influence or consequence on cash flow.

Managers usually do accrual earnings management at the end of the accounting period when they know how much profit targets have not been accomplished. Accrual earnings management practices are limited by accounting standards (generally accepted accounting principles or GAAP) and accrual manipulation in previous years. Another weakness of accrual earnings management is that it is easily detected by auditors, investors, and regulators (government).

Whereas real earnings management can be made by manipulating a company's daily activities. This earnings management can be done at any time during the company's current accounting period to achieve certain profit targets, through sales manipulation, reduction in discretionary costs, and massive production.

2.5. Hypothesis Development

The role of tax planning in conceptual earnings management practices can be explained by agency theory and positive accounting theory. The company tries to pay as little tax as possible because paying taxes means reducing the company's economic capability. On the other hand, the government need funds from tax revenue to finance government spending. The government tries to maximize revenue from the tax sector through tax laws. On the other hand, managers who manage companies want the smallest tax payments possible. The difference in interests between the government and management is what ultimately makes the manager will do a variety of ways to pay taxes to a minimum. So it is not surprising that managers often do earnings management, one of which is done by tax planning.

The positive accounting theory in the third hypothesis, The Political Cost Hypothesis (Wattz and Zimmerman (1986), explains that companies dealing with political costs tend to engineer profit reduction to minimize the political costs they must bear. The game theory developed by Neumann and Morgenstern (1953) explains that the parties involved in a game will choose the best strategy to win the game.

Previous researches discussing the effect of tax planning on earnings management practices in Indonesia have been widely carried out by several previous researchers, including Sumomba (2010) and Wijaya and Martani (2011). It can be concluded, with the desire of the management to reduce and make the tax burden as small as possible, it encourages the managers to minimize tax payments even though the company has received a 5 % tax discount facility.

Based on the theoretical background and the results of previous studies, the hypotheses formulated are as follows:

H_{a1}: There are differences in accrual earnings management practices among companies that get tax discount facility and those which do not in the LQ45 Index.

H_{a2}: There are differences in real earnings management practices among companies that get tax discount facility and those which do not in the LQ45 Index.

2.6. Research Methods

The population in this study were all companies in the LQ45 Index in Indonesia. The sampling technique used was purposive sampling, with sample selection criteria:
1. Companies listed in the Indonesia's LQ45 Index for the 2014-2018 period,
2. The companies publish audited financial statements on December 31, and are not grouped into the financial services industry, hotel industry, construction, travel, transportation, and real estate types, and
3. Have the financial data needed in this study

To measure accrual earnings management practices, this study uses discretionary accruals proxies based on the modified Jones model (Dechow et.al., 1995). The value of discretionary accruals in this study is absolute because what is of concern in this study is the accrual earnings (discretionary accruals) management.

Real earnings management uses a formula developed by Roychowdhury (2006). Real earnings management (ML_Riil) is calculated by summing the standardized values of three real earnings management variables, namely the residual value of abnormal cash flow from operations multiplied by -1, the residual value of abnormal production costs, and the residual value of abnormal discretionary costs multiplied by -1.

Companies that get and do not get tax discounts will be the distinguishing variable in this study. Companies that get tax discounts will be in group 1 and those that do not will be in group 2.
Companies get a tax discount if:
1. Stocks are traded on a stock exchange in Indonesia,
2. The number of shares that are issued to the public is at least 40% of the total paid-up shares and are owned by a minimum of 300 parties (shareholders), either individuals or entities, and
3. Each party (shareholder) may only own shares of less than 5% (five percent) of the total paid-up shares.

To analyze the difference between accrual and real earnings management in the two sample groups studied, companies that get tax discount facility and those that do not in the LQ45 Index, are done in 2 ways. The first is if the residual sample is normally distributed, then hypothesis testing can be done with an independent sample t-test. Whereas if one of the samples or both has an abnormally distributed residual, then the hypothesis is tested using the Mann Withney test (Ghozali, 2015).

To test for normality in this study, the researcher used the Kolmogorov-Smirnov test, with the criterion if the p-value was bigger than 0.05, then the residuals were normally distributed. By using the SPSS 23 program, the hypothesis is tested using the independent sample t-test based on criteria if the significance value <0.05 so Ho is rejected and Ha is accepted. When using the Mann Withney test, hypothesis testing is taken based on criteria if the significance value <0.05 so Ho is rejected and Ha is accepted.

III. Result

Based on the sample selection criteria, there are 23 companies that became the sample in this study. Testing the differences in accrual earnings management practices among companies that get tax discount facility and those that do not get in the LQ45 Index is calculated using the Mann Whitney Test. The Mann Whitney Test was carried out because, in normality testing, residual data were not normally distributed (table 1). Table 2 shows the results of the Mann Whitney Test.

Table 1: The result of normality test of accrual earnings management among companies that get tax discount facility and those that do not get in the LQ 45 Index

Accrual Earnings Management	Kolmogorov-Smirnov
	Sig.
Get tax discount facility	0,000
Do not get tax discount facility	0,000

Table 2: Mann Withney Test results for accrual earnings management among companies that get tax discount facility and those that do not get in the LQ 45 Index

Accrual Earnings Management	Rank Mean	Sig.	Result
Get tax discount facility	35.95	0.674	No difference
Do not get tax discount facility	33.91		

Based on table 2, it is known that the significance value of 0.674 is greater than the probability value of 0.05. Therefore, it can be concluded that Ho1 cannot be rejected. Thus, it can be said that there is no difference in accrual earnings management among companies that get tax discount facility and those that do not get in the LQ45 Index.

For the second hypothesis was calculated by using Independent Sample t-Test after the normality test had been done before and it was found that the residual data were normally distributed (table 3).

Table 3: The result of normality test of real earnings management among companies that get tax discount facility and those that do not get in the LQ 45 Index

Real Earnings Management	Kolmogorov-Smirnov
	Sig.
Get tax discount facility	0,200
Do not get tax discount facility	0,200

Table 4: Independent Sample t-Test results for real earnings management among companies that get tax discount facility and those that do not get in the LQ45 Index

Real Earnings Management	Mean	Levene's test		i-test		Result
		F	Sig.	t	Sig.	
Get tax discount facility	0,623	0,316	0,576	1,664	0,101	No difference
Do not get tax discount facility	0,518					

Based on table 4, the real earnings management t-test value of 1.664 and significant at 0.101. This shows that there is no difference in real earnings management among companies that get tax discount facility and those do not get in the LQ45 Index. These results reject Ha2 and accept Ho2.

IV. Discussion

Both hypotheses proposed were not successfully proven in this study. It is interesting to explore the logical reasons that cause no evidence of differences between accrual earnings management and real earnings management among companies that get tax discount facility and those that do not get in the LQ45 Index.

Companies registered in the LQ45 Index are 45 shares of companies that have high liquidity and high market capitalization of the total number of shares in the Indonesia Stock Exchange. It can be said that those companies are in good financial condition and business growth prospects. It can be concluded that the companies registered in the LQ45 Index have a high profile.

With a high level of market trust in companies registered in the LQ45 Index, it is easy for companies to exceed targeted profits, so that their earnings management is not too brutal, not only for companies that get tax discount facility but also those that do not. Sutrisno, Sari, and Astuti (2018) prove that earnings pressure has a significant effect on earnings management.

In addition, companies that get tax discount facility (20% of rate) are not encouraged to do earnings management that can reduce tax payments, compared to those that do not (25% of rate). This is because the tax rates charged are already low. In addition, being registered in the LQ45 Index, the companies are encouraged to maintain the trust of investors and other stakeholders. There have been many examples of uncovered earnings management practices that can cause a decline of trust of investors and communities that can lead to a decline in the company's stock price and can even lead to bankruptcy as happened in the Enron company. Romantis et al., (2020) support the results of this study that a reduction in tax rates (tax discounts) succeeded in moderating the relationship between tax planning and earnings management. A reduction in tax rates (tax discounts) weakens the relationship between tax planning and earnings management.

V. Conclusion

Some conclusions from this study are that there is no difference in accrual earnings management or real earnings management between companies that get tax discount facility and those that do not in the Indonesia's LQ45 Index. This can be due to companies registered in the LQ45 Index is 45 companies that have a high profile, so they are more highlighted by investors and other stakeholders. A tax rate of 20% obtained by companies that get tax discount facility does not necessarily encourage managers to conduct earnings management aggressively. In addition to the already low tax rates for companies that get tax discount facility, managers are aware of the worst consequences of earnings management practices that auditors might uncover, which can reduce the trust of investors and communities, and can cause the companies to collapse.

For investors and potential investors who want to invest or have invested in companies registered in the LQ45 Index in Indonesia, there is no need to hesitate. It is because the companies are aware of a large amount of public spotlight, so it encourages them to avoid massive earnings management. Likewise, with the tax discount facility, it does not make the company opportunistically avoid the tax.

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