International Journal of Economic Research

ISSN : 0972-9380

available at http: www.serialsjournals.com

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Volume 14 • Number 14 • 2017

The Study of Indonesian Tax Law Amendment Towards Investor Reaction, Tax Avoidance and Corporate Governance

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ABSTRACT

Since the enactment of Law No. 36 Year 2008 regarding income tax in Indonesia, which became effective in 2009, there was a significant change and decrease in corporate income tax rate. Corporate income tax rate changed to 28% (enacted in 2009) and 25% (enacted in 2010). This study aims to investigate investors' reactions to corporate tax avoidance when there is a change in tax rates in Indonesia. This study uses data of manufacturing companies listed on the Indonesian stock exchange. The results show that investors react positively to the tax avoidance of the company in the year of tariff change and react negatively after the change of tariff. Different reactions related to corporate governance practices.

JEL Classification Codes: G39.

Keywords: Investor reaction; tax avoidance; effective tax rate; corporate governance.

1. BACKGROUND

Tax avoidance is an attempt by a taxpayer to not engage in a taxable act or an effort which is still within the framework of the provisions of the taxation legislation to minimize the amount of tax payable (Xynas 2011). There are several reasons that the manager's actions to minimize taxation obligations are considered to be an increasingly important corporate activity in America (Desai and Dharmapala 2009a). First, taxes will reduce at least one-third of earnings before corporate taxes (Graham et. al., 2012). Second, the tax paid by the company is considered as transfer of wealth from the company to the government (Watts and Zimmerman 1978). Third, the purpose of the company's

business and financial policies is to maximize the value after tax (Jones and Rhoades-Catanah 2004).

Taxes will affect the company's cash flow, and taxes are also an element of reduced earnings available to the company either to be shared to shareholders or reinvested. Tax avoidance activities can increase the company's cash flow and increase the company's wealth so as to improve shareholder's welfare. Company tax avoidance actions should be responded positively by shareholders and investors.

Although tax avoidance activities conducted by the company can provide benefits for shareholders, but previous research on the effect of tax avoidance on investor reaction showed significant variations of result. Desai and Hines (2002); Hanlon and Slemrod (2009) reported that tax avoidance by the company had a negative effect on investor reaction. On the other handDesai et. al., (2007); Desai and Dharmapala (2009a); Blaylock et. al., (2012) reported that tax avoidance by the company had a positive effect on investor reactions. However Weber (2009) reported that tax avoidance by the corporation did not affect investor reactions.

In the traditional theory, tax avoidance is considered an activity to transfer the welfare of the state to shareholders (Desai and Dharmapala 2009b), therefore the separation of ownership and control becomes important. Shareholders expect the actions of managers on their behalf to focus on earnings maximization which includes pursuing opportunities to reduce tax liabilities, as long as the additional benefits is greater than the costs incurred.

Tax avoidance can illustrate a form of agency problem, where the manager's decision reflects the manager's personal interests with the separation of ownership and the separation of control. Understanding how governance is linked to tax avoidance will gain a better understanding of how governance works in the long run and short term, so that owners can design the right incentives and oversight for management in order for managers to make effective and efficient tax decisions.

This study aims to test how investors react to tax avoidance undertaken by the company at the time of tax tariff changes in Indonesia. Changes in tax laws in Indonesia resulted in a significant reduction in tax rates. Related with the changes in tax rates,the prior study proves that the decrease in tax rates utilized the company tax avoidance to maximize the value of the company (Scholes et. al., 1992; Guenther 1994; Chung 1998; Roubi and Richardson 1998; Lopez et. al., 1998).

This study also looks at how the role of corporate governance in the relationship between investor reaction to tax avoidance that conducted by company. This is because corporate tax payments illustrate the amount of corporate transfers to the government and this is directly related to shareholders (Desai and Dharmapala 2008). The existence of an agency problem inherent in a public company can be exploited by an opportunistic manager diverting company resources for personal gain. Corporate governance can provide confidence that the tax avoidence by the company is solely the interests of the company not the interests of management.

This study focuses on corporate governance related to the owner of the company, that is board of commissioners. The Board of Commissioners is responsible and fully authorized in making decisions on how to conduct direction, control and supervision over the management of resources in accordance with company objectives (Syakhroza 2003). Supervision by the board of commissioners is a very important

mechanism in aligning the interests of shareholders and management. The quality of corporate governance is broadly related with better corporate performance (Aman and Nguyen 2008).

Using manufacturing companies suspected of tax avoidance during the period 2009 to 2012, the results contribute to the literature by providing empirical evidence that; the First, investor reacts positively to the tax avoidance undertaken by the company at the time of the tax tariff change; Second, investors reacts negatively to the tax avoidance undertaken by the company after the change of tax rate; and Third is the change of investor reaction related to the practice of corporate governance.

The next discussion is organized as follows: Part II will discuss Literature Review and Hypothesis Development. Part III deals with Methodology. Part IV will discuss the results of the study. Part V concludes with a conclusion.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Tax Avoidance and Investor Reaction

The political cost theory that states that taxes is a transfer of wealth from the company to the government (Watts and Zimmerman 1978). Taxes are involuntary payments that are a deduction element of earnings, whether distributed to shareholders, or to be reinvested. Tax avoidance undertaken by the company can be interpreted as a wealth transfer from the government to shareholders (Desai and Dharmapala 2009a). *Tax avoidance* activities undertaken by the company can increase the company's cash flow and shareholder wealth. Managers actions to minimize taxation obligations are considered to be an increasingly important corporate activity so that *tax avoidance* practices of corporate taxes are widespread.

Tax avoidance activities undertaken by the company can be a positive signal for the company because this can mean that the company prioritizes the interests of shareholders. Although in minimizing taxes, the company should consider its impact on financial reporting, because of tenly the strategy of tax minimization by using various alternative methods of accounting choice is also the effect of reducing the reported earnings (Shackelforda and Shevlin 2001).

According to Ball (1972); Sunder (1973), (1975); Ricks (1986); Lanen and Thompson (1988), the company that changed the assessment method of inventory and depreciation of its fixed assets for tax reasons that is to change into a method that can reduce its tax payment 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 (Ball 1972; Sunder 1973, 1975; Ricks 1986; Lanen and Thompson 1988)

Blaylock et. al., (2012) found that firms with large differences between book-tax earnings caused by tax avoidance responded positively to the market as evidenced by greater earnings response coefficients. The results of this study also indicate that investors are able to see up to the source of the large and positively of book-tax differences whether from *earnings management* or *tax avoidance*.

Tax avoidance undertaken by the company can be interpreted as a signal to investors that the company emphasizes on the interests of shareholders. If managers make the tax avoidance efforts optimally and investors have confidence in the tax avoidance, then it should be occured a positive relationship between

tax avoidance and the value of the company or investor reaction. Based on the above description, the research hypotheses to be tested are:

H1a: Tax avoidance has a positive effect on investor reaction at the time of tax tariff change

H1b: Tax avoidance has a positive effect on investor reactions after the occurrence of tax tariff changes

Tax Avoidance, Investor Reaction and Corporate Governance

In traditional theory, the tax avoidance is considered an activity to transfer the welfare of the state to shareholders (Desai and Dharmapala 2009b), therefore the separation of ownership and control becomes important. Risk-neutral shareholders will accept managers acting on their behalf to achieve maximum earnings, including reducing tax liabilities as long as the expected earnings remains to be greater than the estimated cost. Separation of ownership and management directs corporate tax decisions reflecting the manager's personal interests. This separation of controls and supervision shows that tax avoidance is an important activity, so the owner needs to design the appropriate incentives and supervision for management in order for managers to make effective and efficient tax decisions, i.e. when the costs incurred are still less than the benefits to be received.

In the agency literature, tax avoidance can facilitate managerial opportunities for improper earnings manipulation or resource placement. Tax avoidance describes a continuation of the company's tax planning strategy. Tax avoidance activities create opportunities for management in conducting activities designed to cover up bad news or mislead investors (Desai and Dharmapala 2006). Managers can justify a tax avoidance transaction by claiming that complexity and non-compliance are important in minimizing the tax avoidance detected by tax auditor.

This separation of controls and supervision indicates that tax avoidance is an important activity, so the owner needs to design appropriate incentives and supervision for management in order for managers to make effective and efficient tax decisions, i.e. when the costs incurred are still less than the benefits should be received.

This shows that the effect of shareholder in the tax avoidance of the company depends on the ability of the shareholder to control the manager. Wang (2010), proves that the transparency of the company influences the tax avoidance action. The results of this study found that tax avoidance affects the value of the company, especially for companies with good transparency. Study by Tang et. al., (2009), evidenced that BTD negatively affect the company's earnings in the next period.

Another study of book tax defferences was conducted by Hanlon (2005) with using book tax differences as one of the indicators in predicting and presenting earning, cash flow and accrual in the future. The results of this study prove that companies with large BTD tend to less persistent earnings compared with companies with smaller BTD.

Hanlon and Slemrod (2009) tested how the market reaction to tax avoidance conducted by the company. Hanlon and Slemrod stated that tax aggressiveness actions can increase or decrease the value of the company's stock. If tax aggressiveness is seen as an attempt to undertake tax planning and tax efficiency, then the effect is positive on firm value. However, if viewed as non complienceactions, it will increase the risk that reduces the value of the company. The results of this study prove that the market reacts negatively

to tax avoidance actions. Companies with greater tax disclosure get better reactions. When the company has better corporate governance, then the reaction will be more positive. More consumer-oriented companies have more negative reaction and that reaction depends on investor perceptions of corporate tax avoidance levels. Hanlon and Slemrod (2009)concluded that the market surpraisepositively.

Study in Indonesia on the influence of book tax differences with persistence earnings and corporate value was conducted by Martani et. al., (2010) indicated that companies with large negative BTD have lower persistence earnings than small companies. BTD has a relationship with company value. This research found that BTD have a positive effect to company performance in the future.

The shareholder, as the supervisor, agrees to tax avoidance actions made by the management when the benefits to be received for the fee are still higher than the cost incurred. In addition, taxes are also one of the motivating and decisive factors in corporate decision making. In Indonesia, law enforcement and discipline of regulatory application are still low, so tax avoidance is more viewed as a benefit rather than a risk, because the risk of detection can be minimized.

Corporate governance is a system that regulates and controls companies that are expected to provide and increase the value of the company to shareholders (Walsh and Seward 1990). The relationship between corporate governance and tax avoidance is because tax avoidance transactions are usually very complex which allows managers to engage in various activities that endanger shareholders. The information asymmetry between the two causes a high chance of abuse of managerial positions in tax avoidance methods. Corporate governance can be used to help companies aligning ownership and management interests (Hart 1995). Corporate governance is a clear rule of law, procedures and relationships between decision-making parties and those who exercise control over those decisions.

This study focuses on corporate governance related to the owner of the company, that is board of commissioners. The tax payable by the company will be directly related to the shareholders because it describes the amount of transfer of the company to the government and corporate governance (Desai and Dharmapala 2008). Supervision by the board of commissioners and shareholders is a very important factor in aligning the interests of shareholders and management.

The different interest between a company and management can be parallelized using the control mechanism of corporate governance. The quality of the of the corporate governance is closely related to the performance of a company (Aman and Nguyen 2008; Laux and Laux 2009; Prencipe and Bar-Yoseff 2011; Tangjitprom 2013).

The board of commissioner as the top organization leadership has the responsibility to direct, to control, and to monitor the use of resources in order to parallelize the organization goal determined. In term of corporate governance, the focus of the discussion will always be the board of commissioner because they have the responsibility and full authority to make a decision about how to direct, control, and supervise the resource management in accordance with the company's goals (Fama and Jensen 1983a, 1983b; Syakhroza 2003). Therefore, if the company has a good board of commissioner, the company will have a good performance. Quality of this function is the determinant to the effectiveness of the corporate governance. The Committee of Governance Policy (KNKG, 2004) stated that the board of commissioner has the responsibility and authority to control management action, and gives suggestion to management as necessary. The hypothesis proposed is:

H2a: The Board of Commissioners positively moderates (strengthening) the effect of Tax Avoidance on investor reactions in the period of tax tariff change.

H2b: The Board of Commissioners positively moderates (strengthening) the effect of Tax Avoidance on investor reactions after the period of tax tariff change

The empirical research model of this study can be seen in Figure 1.

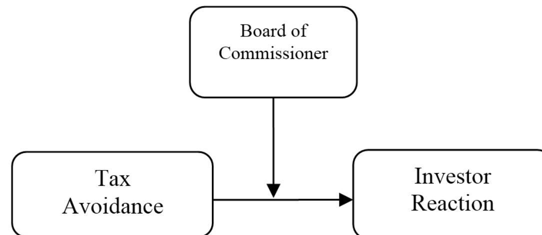

Figure 1: Empirical Research Model
***Source:* Developed for this**

3. METHODOLOGY

Data

The study population is all manufacturing companies listed on the Indonesia Stock Exchange period 2009 to 2012. The use of 2009 and 2010 is due in 2009 and 2010 as the change of tax rate in Indonesia. This study focuses not only on the year of change of tariff but also at the time of tax tariff change.

The sample is a manufacturing company suspected to conduct tax avoidance. In this study used the word suspected to conduct the tax avoidance because in Indonesia there is no tax avoidance law, so there is no clear criteria whether a company conducts tax avoidance or not. Criteria for tax avoidance companies are referring to research of Putri and Tanno (2015),where the company considered to conductes tax avoidance is a company that has the value of ETR (Effective Tax Rate) under the statutory tax rates.

Sampling method in this research is using purposive sampling method. The sample selection process is done in two stages. The first stage is based on the following criteria:

1. Manufacturing companies which publish Audited Financial Statements per December 31 are consistent and complete from 2009-2012.
2. Have a period of financial statements ending on 31 December
3. The financial statements which do not use foreign currency
4. Companies which do not have negative pre-tax earnings.

After the company was selected in accordance with the first phase, the second stage of selection is to determine the company that suspected to do the tax avoidance. It compares the company's ETR value with the applicable tax rate. In 2009 the prevailing tax rate is 28% so that the company suspected to do the tax avoidance is a company that has a ETR value under 28%. In 2010 to 2012, the prevailing tax rate is 25%, so the company suspected to do the tax avoidance is a company with an ETR value less than 25%. Hypothesis testing is performed using WarpPLS version 4.0 programs.

Variables

Tax Avoidance (TA) as independent variable. Follow Putri et. al., (2016), TA is average level of tax avoidance conducted or average of non liability. TA measured by ETR (effective tax rate) which calculating by dividing the total tax expense to income before taxes. In 2009, the statutory tax rate was 28%, while in 2010-2012 the statutory tax rate is 25%.

Cumulative abnormal return (CAR) as dependent variable. CAR is Cumulative abnormal return during events period for each securities The step to calculate CAR:

1. Events periods are 12 months starting from third month after accounting year
2. Estimation period is 24 months
3. Estimating normal return of each security with using market model:

$$\mathbf{R}_{i,t} = \alpha_i + \beta_{i,t} \cdot \mathbf{R}_{\mathbf{M},t} + \varepsilon_{i,t} \quad (1)$$

   where, $R_{i,t}$ is expected return on security, $\beta_{i,t}$ is beta coefficient for security, $RM_{i,t}$ is the expected return on the market portfolio $R_{i,t} = \alpha_i + \beta_i \cdot R_{M,t} + \varepsilon_{i,t}$

4. To seek abnormal return of each security is differences or actual return with estimation return:

$$\mathbf{AR}_{i,t} = \mathbf{R}_{i,t} - \mathbf{E}(\mathbf{R}_{i,t}) \quad (2)$$

   where, $AR_{i,t}$ is Abnormal return, $R_{i,t}$ is actual return, $E(R_{i,t})$ is expected return.

5. CAR = Cumulative abnormal return of each share during 12 months starting from third month after accounting year is finished:

$$\mathbf{CAR}_{(ti,tp)i,t} = \Sigma_{t1 \to tp} \mathbf{AR}_{i,t} \quad (3)$$

   where, $CAR_{(ti,tp)i,t}$ is cumulative abnormal return, $AR_{i,t}$ is Abnormal return.

Bord of commissioner (BOC) as moderating variables. Folloe Lipton and Lorsch (1992), Jensen (1993), Yermack (1996) BOC measurement is is number of commissioner board owned by the company.

Analytical Method

The analytical methods used to test the hypothesis is path analysis by using WarpPLS program version 4.0. The equation for the regression model is described as follows:

$$\text{CAR} = \beta_1 \text{TA} + \beta_2 \text{TA} \times \beta_3 \text{BOC} + \varepsilon \quad (5)$$

where, CAR = Cumulative abnormal return

TA = Tax Avoidance

BOC = board of commissioners

4. RESULT OF RESEARCH

Descriptive statistics of the sample data are shown in the Table 1.

Table 1
Descriptive Statistics

Description	*N*	*Mean*				*Standard Deviation*			
		2009	*2010*	*2011*	*2012*	*2009*	*2010*	*2011*	*2012*
TA	80	0.10	0.20	0.21	0.19	0.09	0.05	0.03	0.08
CAR	80	0.56	0.19	0.32	0.29	1.17	0.59	0.80	0.57
BOC	80	4.30	4.48	4.50	4.24	2.11	1.83	2.04	1.97

Source: Data Processed is used in this dissertation
Note: TA: Tax avoidance; CAR: Cumulative abnormal return ; BOC: Board of Commissioner

Full test results of the research model with WarpPLS 4.0 are presented in Table 2 for tariff change period and Table 3 for the period after the tariff change.

Table 2
Output WarpPLS 4.0
On the Period of Tax Tariff Change

Model Fit and Quality Indices			
APC = 0.324, ρ < 0.001 ARS = 0.294, ρ = 0.001 AARS = 0.257, ρ = 0.003 AVIF = 1.146, acceptable if ≤ 5, ideally ≤ 3.3 AFVIF = 1.216, acceptable if ≤ 5, ideally ≤ 3.3 GoF = 0.542, small ≥ 0.1, medium ≥ 0.25, large ≥ 0.36			
Path		*Coefficients*	*ρ-value*
TA → CAR		0.242	0.008
BOC × TA → CAR		0.406	<0.001
R^2Q^2	*Full*	*Collin*	*VIF*
CAR	0.294	0.269	1.194
Total Effec		*Coefficients*	*ρ-value*
TA → CAR		0.284	0.008
BOC × TA → CAR		0.406	<0.001
Effect Size		*Coefficients*	
TA → CAR		0.094	
BOC × TA → CAR		0.2	

Source: Processed data used in this article

Table 3
Output WarpPLS 4.0
After the Period of Tax Tariff Change

Model Fit and Quality Indices			
APC = 0.276, ρ = 0.002 ARS = 0.147, ρ = 0.034 AARS = 0.100, ρ = 0.077 AVIF = 1.010, acceptable if ≤ 5, ideally ≤ 3.3 AFVIF = 1.290, acceptable if ≤ 5, ideally ≤ 3.3 GoF = 0.384, small ≥ 0.1, medium ≥ 0.25, large ≥ 0.36			
Path		*Coefficients*	*ρ-value*
TA → CAR		–0.344	<0.001
BOC × TA → CAR		–0.208	0.019
R^2Q^2	*Full*	*Collin*	*VIF*
CAR	0.147	0.181	1.102
Total Effec		*Coefficients*	*ρ-value*
TA → CAR		–0.344	<0.001
BOC × TA → CAR		–0.208	0.019
Effect Size		*Coefficients*	
TA → CAR		0.111	
BOC × TA → CAR		0.036	

Source: Processed data used in this article

Note: TA: Tax Avoidance; CAR: Cumulative Abnormal Return; BOC: Board of Commisioners; BOC × TA → CAR: BOC moderates the relationship between TA & CAR.

In Table 2 Based on the model output of fit and quality indices model has APC value = 0.324, ρ < 0.001; ARS = 0.294, ρ = 0.001; AARS = 0.257, ρ = 0.003; AVIF = 1.146, (acceptable if ≤ 5, ideally ≤ 3.3); AFVIF = 1.216, (acceptable if ≤ 5, ideally ≤ 3.3); GoF = 0.542, small ≥ 0.1, medium ≥ 0.25, large ≥ 0.36.

On Table 3 Based on output modelfit and qualityindices model has APC value = 0.276, ρ = 0.002; ARS = 0.147, ρ = 0.034; AARS = 0.100, ρ = 0.077; AVIF = 1.010, (acceptable if ≤ 5, ideally ≤ 3.3); AFVIF

= 1.290, (acceptable if ≤ 5, ideally ≤ 3.3); GoF = 0.384, (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 a multicolinearity indicator 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.

The test results showed that R^2 value of endogenous variables was 29.4% and 14.7% (CAR). This research model has predictive relevance because it has a greater value of Q^2 than 0. Based on value of Full collinearity VIF which is less than 3.3 indicated in this research model there is not multi colinerity.

Hypothesis 1a states that tax avoidance has a positive effect on investor reaction in the period of tax tariff change. Based on the WarpPLS output as presented in Table 2 it is known that the coefficient value of the TA → CAR path is 0.242 and significant with the value ρ = 0.008. Thus, it can be concluded that tax avoidance have positive effect to investor reaction in period of change of tax tariff. Based on the description above can be concluded that hypothesis 1 is accepted with the coefficient of determination of 0.294.

Hypothesis 1b states that tax avoidance has a positive effect on investor reactions after the period of tax tariff change. Based on the WarpPLS output as presented in Table 3 it is known that the coefficient value of TA → CAR path is -0.344 and significant with ρ < 0.001. Thus it can be concluded that tax avoidance has a negative effect on investor reaction after the period of tax tariff change. Based on the description above can be concluded that hypothesis 1b is rejected by the coefficient of determination of 0.147.

Hypothesis 2A states that the board of commissioners moderates positive (strengthens) the effect of tax avoidance on investor reaction during the period of tax tariff change. Based on the WarpPLS output as presented in Table 2 it is known that the BOC × TA → CAR path, showing the coefficient value of 0.406 and significant with the value of ρ < 0.001. Thus it can be concluded that the board of commissioners moderates positively (strengthens) the relationship between tax avoidance and investor reactions in the period of tax tariff change. Based on the description above can be concluded that hypothesis 2a is accepted with coefficient value of determination 0.294.

Hypothesis 2b states that the board of commissioners moderate the positive (strengthen) the effect of tax avoidance on investor reactions after the period of tax tariff change. Based on the WarpPLS output as presented in Table 3 it is known that the BOC × TA → CAR path, showing the coefficient value -0.208 and significant with the value ρ = 0.019. Although the result is significant with the value of ρ = 0.019, the coefficient is negative, it means to moderate negatively that the board of commissioners moderate the negative (weakening) the effect of tax avoidance on the investor reaction after the tax tariff change period. This is not in accordance with the proposed hypothesis. Based on the above description can be concluded that hypothesis 2*b* is rejected that board of commissioner does not moderate positive effect to tax avoidance to investor reaction after period of change of tax tariff.

5. CONCLUSION

Based on the tests and discussion presented in the previous chapters, it can be concluded a number of findings related to the research hypothesis, such as:

1. Tax avoidance conducted by the company has a positive effect on investor reaction in the period of tax tariff change. The investor appreciates the company's effort to reduce the tax liability paid

when the tax tariff changed. The results of this study support the research (Desai and Dharmapala 2009a; Blaylock et. al., 2012)

2. Tax avoidance has a negative effect on investor reaction after the tax tariff change period. In the agency literature, tax avoidance can facilitate managerial opportunities for improper manipulation of earnings or resource placement. Tax avoidance describes a continuation of the company's tax planning strategy. Tax avoidance activities create opportunities for management in conducting activities designed to cover up bad news or mislead investors (Desai and Dharmapala 2006). Managers can justify transactions for tax avoidance by claiming that complexity and non-compliance are important in minimizing tax avoidance detected by tax auditor activity.

3. The Board of Commissioners moderates positively (strengthens) the relationship between tax avoidance and investor reactions in the period of tax tariff change (hypothesis 2a) and the Board of Commissioners moderates the negative relationship between tax avoidance and investor reactions in the period of tax tariff change. Despite having different coefficients but the results of research have the same meaning that strengthens the positive relationship between tax avoidance and investor reaction. The results of this study prove the effect of shareholder in the tax avoidance of the company depends on the ability of shareholders to control the manager. In lining with Wang (2010) Which proves the transparency of the company affect the tax avoidance actions undertaken. The results of this study found that tax avoidance affects the value of the company, especially for companies with good transparency. The results of this study support the research (Fama and Jensen 1983a, 1983b; Syakhroza 2003).

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