

Do Related Party Transactions and Tax Avoidance Affect Firm Value?

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ABSTRACT

Firm value is affected by several factors, including corporate actions. To increase efficiency of operations, companies engage in several activities such as related party transactions (RPT) and tax avoidance (TA). Previous research shows inconsistencies as to whether these actions influence firm value positively or negatively. There is also a lack of studies that have investigated these actions in Indonesia. This research investigates whether RPT and TA affect Indonesian firms' value. The study also uses debt, profit, and size as control variables. Employing a quantitative explanatory research method, the study looks at 184 Indonesian manufacturing companies, with 2012–2015 as the observation years. Through multiple regression analysis, results show that utilization of RPT and TA by companies increased firm value. The results show that Indonesian companies benefited from RPT and TA, and also that stockholders don't view RPT and TA negatively.

Keywords: Firm Value, Related Party Transaction, Tax Avoidance.

1. INTRODUCTION AND RESEARCH BACKGROUND

As one of the emerging countries in South East Asia, Indonesia's gross domestic product is the highest in the region. Based on data provided by the World Bank, Indonesian GDP in 2015 reached 861.9 billion USD, while the GDP in Malaysia and Singapore were only 296.2 billion and 292.7 billion USD, respectively. Indonesia's financial markets also display amazing growth. Indonesian market capitalization in 2005 was 81.248 billion USD, while in 2015 the value was 353.271 billion USD—an increase of 334%. This data shows that Indonesian companies are still very attractive for investors.

The general definition of firm value (FV) is an economic measure reflecting the market value of a business (Wild & Subramayam, 2011). It is a sum of claims by creditors and investors. Firm value is one of the fundamental metrics used for many purposes in business, such as business valuation, financial modelling, accounting, portfolio analysis, and risk analysis. To analyse firm value, financial analysis was supplemented by several types of information, mainly from the market, industry, and the company's financial statement itself. Financial statements provide information that describes the financial condition and financial performance of the company (Kieso et al., 2015). In every corporate action of the company, the financial consequences will appear on the financial statements. Therefore, the research on firm value will focus on several financial information effects towards investor and creditor perceptions of the company (Belkaoui, 2005; Godfrey et al., 2013).

Many companies in Indonesia are affiliated with groups of companies. Intergroup transactions are sometimes known as related-party transactions (RPTs). RPTs may

happen for several reasons, one of which is the shareholders trying to maximize the return of all their investments by instructing companies to undertake transactions with their related parties, and sometimes this results in a favourable outcome for one party and an unfavourable outcome for another party (Pratama, 2017). RPTs can be perceived by stakeholders as positive or negative actions. RPTs can be perceived as one way to make transactions more efficient, and they can improve the financial statements of overall groups of companies. RPTs can also benefit the company through communication and contracting efficiencies as well as reductions in holdup problems (Ryngaert & Thomas, 2007). RPTs are also sometimes perceived as negative actions by investors, who may think that the income information is compromised by the effect of RPTs, and therefore that it will create a financial distortion (Pratama, 2017a). Another negative perception is that the RPT is also a mechanism for majority shareholders to extract company resources through tunnelling activities (Liew et al., 2015). Previous research investigating RPT and firm value has showed inconsistent results. Research conducted by Wang and Yuan (2015) in China and Nekhili and Cherif (2011) in France showed that RPT negatively affected firm value. Research conducted by Liew et al. (2015) showed that RPTs generally affect firm value positively, except in the case of family firms, in which RPTs reduce firm value. Utama et al. (2010) stated that RPTs are not significantly different from non-RPTs in terms of impact on firm value.

Companies and groups of companies can also increase profits by reducing several types of expenses, especially expenses that cannot contribute directly to the company's performance (Anthony & Govindarajan, 2007; Jones, 2012). One of the expenses that cannot contribute directly is a tax expense. Tax avoidance (TA) practice by companies is a classical situation with pros and cons. Tax avoidance can provide tax savings, therefore increasing profits, but from an ethical perspective, tax avoidance can be seen as noncompliance. Indonesian tax compliance is still low, and many corporations engage in tax avoidance practices. As a result, the effect of tax avoidance on firm value is not consistent. Research by Kim et al. (2011) showed that tax avoidance was positively associated with the risk of stock price crash. Desai and Dharmapala (2006) and Chen et al. (2010) also showed that tax avoidance practices reduced firm value. However, research by Soufiene et al. (2016) in Tunisia showed that tax avoidance increased firm value. Similar results were found by Jacob and Schutt (2014) in Germany and Lestari and Wardhani (2015) in Indonesia.

This research hopefully can investigate further the effect of RPTs and TA on Indonesian firms' value. The Indonesian business environment, which has many affiliated companies and low tax compliance, can provide interesting but clear insights. There is also a lack of studies investigating RPTs, TA, and firm value in Indonesia, so this study can add to the empirical literature on firm value research in Indonesia.

The rest of this paper is divided as follows: (1) literature review and hypothesis development, in which we will explain several critical and essential theories and previous research for building sound hypotheses; (2) research method, where we will explain the population and sample selection, data collection, and data analysis; (3) results and discussion, where we will describe the data and discuss the results from our analysis; and (4) conclusion and suggestions, which will include several recommendations based on the results.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Agency Theory and Firm Value

Investors perceive the value of the firm by the accomplishments made by management (Holmstrom & Tirole, 1989). Such accomplishments are not always derived from the motivation to increase the company's performance. Other motivations could include a management agenda or intention to obtain a bonus, called the bonus plan hypothesis (Belkaoui, 2005).

Jensen and Meckling (1976) stated that the agency problem is a conflict of interest inherent in any relationship in which one party is expected to act in another's best interests. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and its stockholders (Gitman, 2006). The manager, acting as the agent for the shareholders, or principals, is supposed to make decisions that will maximize the shareholders' wealth, even though it is in the manager's best interest to maximize his or her own wealth. Managers possess a greater quantity of information and sometimes conceal bad information to achieve personal gain (Godfrey et al., 2013). This information asymmetry can lead to the problem of moral hazard. Investors and creditors can make wrong decisions because of insufficient information and/or fraudulent misinformation.

Related party transactions can be associated with second agency theory. Scott (2006) argued that agency conflict can be expanded into conflict between majority and minority stockholders. Ryngaert and Thomas (2007) also concluded that majority stakeholders will try to absorb all the company profit and financial resources for themselves, an activity known as 'tunnelling'. Tunnelling activities are organised mainly through related party transactions. Off-the-market transactions usually do not reflect the fair price of the transactions. They lack the appropriate arm's length, a core principle for tax planning and reporting (Jones, 2012). Hanlon and Heitzman (2010) stated that tax avoidance can be conducted by arranging transactions with related parties, such as through thin capitalization or transfer pricing schemes. Companies that do not conduct transactions at arm's length may incur tax audits or investigation by the authorities (OECD, 2012).

2.2 Related Party Transactions and Firm Value

A related party is defined in International Accounting Standard (IAS) No. 24 as a person or entity that is related to the entity that is preparing its financial statements. Related parties, according to IAS 24, can be divided into several parties, persons, or entities: a person or a close member of that person's family if that person has control or joint control over the reporting entity; has significant influence over the reporting entity; or is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. An entity is related to a reporting entity if any of the following conditions applies. (1) The entity and the reporting entity are members of the same group. (2) One entity is an associate or joint venture of the other entity. (3) Both entities are joint ventures of the same third party. (4) One entity is a joint venture of a third entity and the other entity is an associate of the third entity. (5) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. (6) The entity is controlled or jointly controlled by a person. (7) A person has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). (8)

The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Related-party transactions can be distinguished by two effects: abusive and efficient (Gordon et al., 2004; Utama et al., 2010). Efficient RPTs rationally fulfil the economic demands of a company. Transactions involving companies may contain excessive cost and create burdens in a company. Pozzoli and Venutti (2014) stated that RPT is an instrument to optimize the economic activity of each company in the same group by minimizing the transaction cost. The minimum transaction cost means that resources can be allocated for other business functions, hence creating an opportunity in the company (Sanchez et al., 2017). RPTs may also be abusive, whereby the controlling shareholders' wealth is maximized at the expense of the minority shareholders (Utama et al., 2010). Nekhili and Cherif (2011) stated that RPTs have a higher association with the risk of financial statement fraud, in which RPTs may, indeed, be used to enable companies to present results that comply with the demands of the managers, who are themselves obliged to meet the expectations of investors or creditors. These two different types of RPT can help explain why previous research about RPTs in regard to firm value is inconsistent. If the RPT is abusive, the accuracy of the financial statement is in doubt, so the firm value will be reduced; however, if the RPT is efficient, the firm value will be increased. The Indonesian situation regarding RPTs is still in doubt. Previous research showed that the prevailing form of RPT in Indonesia is an abusive one (Utama et al., 2010), yet other research conducted by Liew et al. (2015) and Sanchez et al. (2017) showed that RPT is positively associated with firm value. Given these inconsistencies from previous research, we can propose a hypothesis as follows:

H₁: There is an influence of RPT toward firm value.

2.3 Tax Avoidance and Firm Value

Jones (2012) described tax avoidance as consisting of legitimate means of reducing taxes. In a company's perspective, Jones (2012) also argued, the objective of business decisions is to maximize the value of the firm; therefore if a transaction results in an increase in any tax for any period, the increase (tax cost) is a cash outflow, and if a transaction results in a decrease in any tax for any period, the decrease (tax savings) is a cash inflow. In other words, tax avoidance also can be viewed by a cost-benefit principle (Chen et al., 2010). Tax cost must be lower than tax savings, so the company can increase its value. Hanlon and Heitzman (2010) argued that tax avoidance has been defined very broadly. The usual theme of tax avoidance research is noncompliance or aggressiveness. Darussalam, et.al (2007) defined aggressive tax avoidance as an 'unacceptable method of reducing income taxes from point of view of tax authority, although it is legal to conduct it'.

The theory of corporate tax avoidance has been discussed heavily in previous research. Hanlon and Heitzman (2010) elaborated agency theory to explain tax avoidance behaviour. They stated that in the corporation, there is a separation between ownership and control. Managers will act and think that if tax avoidance is a good activity, then the owners ought to structure appropriate incentives to ensure that managers make tax-efficient decisions. However, Desai and Dharmapala (2006) also stated that investors will view aggressive tax avoidance as a reduction in firm value, especially in a company with lack of good corporate governance. Kim et al. (2011) stated that complex tax avoidance

creates tools and manipulation schemes for managers to manufacture earnings and conceal negative operating outcomes for an extended period. However, in a company with strong corporate governance, tax avoidance will have a positive effect on firm value. (Pratama, 2017b). Wang (2010) stated that companies with high value transparency tend to conduct less aggressive tax avoidance, and tax avoidance practice is deemed as a normal practice of companies to yield tax savings. Several previous research studies, such as research done by Lestari and Wardhani (2015), found that in Indonesia tax avoidance negatively affects firm value. Since the majority view of tax avoidance is that of a negative action, therefore we can propose a hypothesis as follows:

H₂: There is a negative influence of tax avoidance toward firm value.

2.4 Control Variables

To create a robust model, we inserted three control variables: leverage, size, and profit. Leverage is the ratio of long-term debt to total assets. Debt is an important mechanism to force managers to generate cash flows to pay interest and the principal, thereby mitigating agency conflicts created by free cash flows (Shleifer & Vishny, 1997; Kieso et al., 2015). Previous research usually has shown leverage to be negatively related to firm value. High leverage is a big burden for the company and will not produce optimal capital structure (Gitman, 2006); however, as stated by Ross et al. (2005), leverage can also improve company performance by increasing earnings per share (EPS).

Size is defined as the natural logarithm of total assets. Firm size is a typical determinant of firm value and firm performance. It is also associated with higher costs of monitoring, as larger firms are more complex and have more arm's-length transactions. Previous studies usually have shown that there is a negative association between size and firm value (Lestari and Wardhani, 2015). This could occur because companies that achieve a high level of assets usually are in the maturity or declining stage of the company life cycle. However, research by Koanantachai (2013) in Thailand showed that the higher the total assets of the company, the higher the firm value. Companies that have higher total assets are expected to have more resources to conduct additional activities that will improve the companies' business, therefore increasing firm value.

Profitability is a main performance indicator of any company (Wild and Subramanyam, 2011; Gitman, 2006). High profitability means that companies can cover all expenses and then produce higher dividends. The higher the level of profitability, the higher the firm's value. The hypotheses of control variables can be described as follows:

H₃: There is an influence of leverage toward firm value

H₄: There is an influence of size toward firm value

H₅: There is a positive influence of profit toward firm value

3. RESEARCH METHOD

This descriptive explanatory research uses a quantitative approach, focusing on 145 manufacturing companies listed on the Indonesian Stock Exchange. We selected manufacturing companies since these companies have the most complicated business processes, which can lead to more mechanisms to conduct tax avoidance practices, and in Indonesia most affiliated companies comprise manufacturing companies. To select the

sample, we used purposive sampling with several criteria. We describe the criteria and the sample number in Tables 1 and 2:

Table 1 Sample Selection Criteria

Number of manufacturing companies listed on the IDX in the year 2015	145
Number of companies listed on the IDX after 31 December 2012	(30)
Number of companies that have negative equity	(10)
Number of companies that do not have a complete financial statement published on the IDX or company website	(30)
Number of companies that have negative ETR or ETR value > 1	(12)
Number of companies with incomplete information in their financial statements	(17)
Total number of companies	46
Observation year	4
Total sample (46 x 4)	184

Table 2 Variable Measurement

Variable	Symbol	Measurement
Firm Value	FIRM	Return on Equity (ROE) (income after tax/shareholder equity)
Related-party transaction	RPT	Natural logarithm (Ln) of the RPT value in financial statements
Tax avoidance	TAX	Effective tax rate (income tax expense/pre-tax income)
<i>Control Variables</i>		
Profitability	PROFIT	ROA (net income: total assets)
Company size	SIZE	Natural logarithm (Ln) of total assets
Leverage	DEBT	DER (total debt/total equity)

To test the hypotheses, we used the multiple regression analysis model below:

$$FIRM = \alpha_0 + \alpha_1 RPT + \alpha_2 TAX + \alpha_3 DEBT + \alpha_4 SIZE + \alpha_5 PROFIT + \varepsilon \quad (1)$$

The data analysis was conducted using multiple regression analysis. Classical assumption tests in the form of normality, multicollinearity, heteroscedasticity, and autocorrelation were performed to ensure that the model fit before entering the regression process.

4. RESULTS AND DISCUSSION

4.1 Descriptives

In this section, we will present the descriptives for each variable. FIRM has a mean score of .1531 and standard deviation of .11349. We can see that the dispersion of the data is quite high. The minimum score is .00 while the maximum score is .75.

RPT has a mean score of 26.2757, or if converted into a monetary amount, Rp. 244.543.135.896. The maximum score is 32.44, or if converted into a monetary amount, Rp. 114.834.577.906.968, and the minimum score is 20.38, or if converted into a monetary amount, Rp. 680.854.466. The range of the RPT is very high, indicating the variability of the RPT amount in the company. But we found that in affiliated companies the mean of RPT is relatively higher compared to nonaffiliated companies. The mean RPT scores in affiliated companies and nonaffiliated companies are 29.7654 and 23.1267, respectively.

TAX has a mean score of .2722. This score shows that on average, companies in the sample didn't avoid taxes. If the companies avoided paying taxes, the effective tax rate should be below 25% (the tax rate enacted to corporate taxpayers in Indonesia). The minimum TAX score is .01 while the maximum amount is .74. In our sample, we also found that 72 out of 184 (39.13%) companies have a TAX mean value less than 0.25, and 112 out of 184 (60.87%) have a TAX mean value equal or higher than 0.25. This could have occurred since in the years 2012–2015 the Directorate General of Tax in Indonesia was intensifying tax audit and monitoring, so that taxpayers couldn't achieve too many tax savings.

DEBT has a mean score of .8106. This score indicates that our sample uses debt heavily. This could have occurred since the years of observation (2012–2015) were a relatively stable period for the Indonesian economy, and many companies had a lower cost of debt; thus they issued debt extensively during this period. The minimum score is .11 and the maximum is as high as 4.13.

PROFIT has a mean score of .1011 and a standard deviation of .07383. Although the standard deviation is not excessively high, the range of the data is quite large. The minimum score is .00 while the maximum score is .42. SIZE has a mean score of 28.4086, or if converted into a monetary amount, Rp. 2.054.907.386.025. The maximum score is 33.09, or if converted into a monetary amount, Rp. 219.681.878.378.150, and the minimum score is 20.38, or if converted into a monetary amount, Rp. 111.639.820.585.

The data description can be seen in Table 3.

Table 3 Variables Description

Variables	Minimum	Maximum	Mean	Std. Deviation
RPT	20,38	32,44	26,2757	2,58164
DEBT	,11	4,13	,8106	,61785
FIRM	,00	,75	,1531	,11349
TAX	,01	,74	,2722	,09935
PROFIT	,00	,42	,1011	,07383
SIZE	25,49	33,09	28,4086	1,61848

4.2 Multiple Regressions Analysis and Discussion

The multiple linear regression analysis can be seen in Table 4:

Table 4 Multiple Linear Regression Results

Variable	Expected Sign	Coefficient	Std. Error	t-Statistic	Prob.
C	(?)	-0.032121	0.061509	-0.522209	0.6022
RPT	(?)	0.005651	0.001898	2.977466	0.0033***
TAX	(+)	0.080819	0.047548	1.699717	0.0909*
DEBT	(?)	0.045261	0.007502	6.033137	0.0000***
PROFIT	(+)	1.459019	0.085553	17.05390	0.0000***
SIZE	(?)	-0.005964	0.002636	-2.262762	0.0249**
Adjusted R-squared		0.832521			
F-statistic		182.9353			
Prob (F-statistic)		0.000000***			

Notes:

- ***: significant at $\alpha = 1\%$
- ** : significant at $\alpha = 5\%$
- * : significant at $\alpha = 10\%$

As shown in Table 4, all independent variables are significantly affected by the dependent variables; therefore all the research hypotheses are accepted. The adjusted R-squared of the model is 83.25%, and the F-test showed that the model is fit to be analysed.

This research proved that RPTs positively affect firm value. The research therefore proved that the use of RPTs is not always viewed negatively by investors and creditors. These results are similar to those of Liew et al. (2015), but not in accordance with Wang and Yuan (2015) and Nekhili and Cherif (2011). Regarding their results, Huang and Liu (2010) stated that the efficient transaction hypothesis considers RPTs as sound business exchanges fulfilling economic needs of the firm. Huang and Liu (2010) also stated that RPTs have benefit as follows: (1) contracting party representatives appointed as board members to facilitate the achievement of better coordination of the different activities; (2) quicker feedback or more insights; (3) deeper reciprocal knowledge as well as greater familiarity, which can create more convenient terms and conditions for both parties and justify transactions that are not feasible at arm's length; (4) possible mitigation of holdup problems; and (5) possible additional supplementation of CEO and director cash remuneration or compensation for increased risk. These benefits help the company to coordinate each activity more efficiently, and as a result they increase the company firm value.

This research proved that TAX negatively affects firm value. This result also empirically proved that Indonesian investors still express considerable concern for tax avoidance. Tax avoidance can be classified as a noncompliance action. This research result is similar to previous research conducted by Desai and Dharmapala (2006) and Kim et al. (2011). Chen et al. (2010) stated that tax avoidance behaviour increases agency costs and reduces firm value. Desai and Dharmapala (2006) stated that tax avoidance is a result

of information asymmetry that exists between managers and shareholders. Tax avoidance can facilitate managers in acting in their own interests, so as a result there is a negative association between tax planning and firm value.

All control variables also showed significant results. DEBT has a positive association with firm value. This result showed that debt is not always a burden for a company, but can be a tool for optimal capital structure. Gitman (2006) stated that the amount of leverage in the firm's capital structure—the mix of debt and equity—can significantly affect its value by affecting risk and return. Generally, increases in leverage result in increases in risk and return. PROFIT has a positive association with firm value. This result is consistent and empirically proves the signalling theory. Godfrey et al. (2013) stated that profit information provides a signal to the investor that the company is doing well, and the investor will appreciate the company with higher profit amount. SIZE has a negative association with firm value. This result is similar to previous research as stated in the literature review. Dushnitsky and Lenox (2006) stated that investors prefer to invest in companies that still have higher growth prospects. As the company expands in size, its growth prospects begin to decline, so investors will pay less interest to this kind of company.

5. CONCLUSIONS AND SUGGESTIONS

This research showed several points. First, RPTs and tax avoidance mechanisms are two corporate actions that help companies to achieve their targets. But when both actions come into the mind of investors and creditors, they are viewed as drastically different. RPTs are perceived to be an effort of a company to coordinate and allocate resources more efficiently between its affiliates, and therefore RPTs are perceived to bring good results for company performance. Tax avoidance, although it creates tax savings for the company, is still viewed as a noncompliant act, and it carries a significant risk of censure or penalty by tax authorities. Second, when investors try to maximize the profit obtained from their investment, they will be conservative, tend to prefer companies that obey the law, and also conduct operations efficiently.

This research has several limitations that can be improved in future research. First, the research is focused on manufacturing companies only. Future research might expand this research into other business sectors. Second, this research is still in early stages, and to make a more robust model, it is suggested that researchers add several variables that could interact between RPT, TAX, and firm value, such as corporate governance, information disclosure, and monitoring. Finally, future researchers could modify several proxies used in the variables, to provide for a more robust variable measurement.

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