



# Minimizing Tax Avoidance by Using Conservatism Accounting through Book Tax Differences (Case Study in Indonesia)

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## ABSTRACT

The research's first purpose is to analyze directly conservatism accounting influence towards book tax differences and tax avoidance. The second purpose is to analyze indirect influence of towards tax avoidance through book tax differences. The research is conducted to companies enlisted in Indonesian Stock Exchange and belongs to LQ45 during 2013 to 2015. The number of companies sample taken by purposive sampling is 23 corporations, therefore total observation is 69 observations. The acquired data analysed by path analysis. This research conclude that conservatism accounting practice significantly influence book tax difference practice but did not influence tax avoidance. Conservatism accounting practice is also has no influence towards tax avoidance committed by book tax differences. This book tax difference is only significantly influential to commit tax avoidance. This research can contribute in taxation field as input in tax planning formulation.

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## 1. Introduction

Tax avoidance is one of tax collection problems that cause state's income to decrease. Tax avoidance is usually committed by using exception and cuts permitted in the regulation or unregulated things in tax regulation. Perspective on tax avoidance is different in each company, depends on the interest of related stakeholders. According to Dyreng, Hanlon, & Maydew (2010), individual implementer is the one who hold significant role in determining the level of company's tax avoidance. The government in this case Directorate General of Taxes can not punish the company because the nature of tax avoidance itself does not violate the rule. Tax avoidance does not belong in the category of tax laws because the taxpayer's attempt to minimize or avoid the tax expense is committed by various ways made possible by tax laws. According to Finnerty, Merks, Petriccione, & Russo (2007), the ways that can be done for such things are: first, moving the tax subjects and or objects to countries that implement special treatment on tax or tax haven country on substantive tax planning. Second, tax avoidance attempt can be done through formal tax planning that give the taxpayer lowest tax expense. The third, by using anti-avoidance requirements towards transfer pricing, thin capitalization, treaty shopping, and controlled foreign corporation (specific anti avoidance rule), and transaction without business substance (general anti avoidance rule). In recent years, the tax authorities tries as hard as they can, not only to enforcing clear boundaries between tax avoidance and tax evasion in tax planning, but also to prevent taxpayer from entering obscurity caused by tax laws (Bovi, 2005). With so many negative impacts caused by tax avoidance, a research is needed to minimize tax avoidance. The research that can be conducted is by searching variables related to tax avoidance.

Businessman financial report making is certainly unseparated from general policies, i.e., financial accounting standard. Bookkeeping recording in accordance with accounting is using basic principle of conservatism. This conservatism is financial report to know and measure assets and profits conducted with full caution due to economic and business activity's uncertainty. The implication of this principle implementation is accounting model choice is oriented to the method that report lower profits and assets or higher loan (Watts, 2003). This can cause conservatism principle implemented said as indirectly can influence financial report result accuracy, where the compiled financial report will further made as a foundation in decision and policy making for company's management in related matters. According to Basu et al., (1997) and Watts (2003), stated that conservatism is accounting practice that decrease profits

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(and lower net assets) when faced with bad news but does not increase profits (and increase net assets) when faced with good news.

Information source for financial information users consisted of investor, creditor, manager, and other user, required responsible financial report. The developing issue related with tax regulation analysis is book tax differences. Book tax difference is the difference between taxable income based on taxation and taxable income based on accounting standard. Taxation regulation and accounting have different purpose and results in different reports, the difference on this financial report occur in almost all countries. This phenomenon causes tax avoidance that possibly committed by tax payer for their tax planning. Besides, this book tax differences is often used as factor in research due to it's usability to track profit management and tax activity closely related with tax avoidance (Lee, Vetter, & Williams, 2015).

The explanation above thus justified the selection of conservatism accounting and book tax differences as research variables on minimizing tax avoidance. Therefore this research discusses minimization of tax avoidance by using conservatism accounting by book tax differences. This research simultaneously uses tax avoidance, conservatism accounting and book tax differences. This simultaneousness has never been applied in previous researches.

## **2.Literature Review**

Tax avoidance is the attempt to alleviate taxes without violating the laws. Hanlon & Heitzman (2010) stated that there is no universally accepted definition of tax avoidance, everyone or every researcher has different understanding. Tax avoidance defined largely as an attempt for tax deduction and reflected all transactions influencing company's explicit tax debts. Tax payer always wants small tax payment. Therefore many tax payers commit tax avoidance both legally and illegally. The term tax avoidance means the legal one, meanwhile the illegal one is tax evasion. According to Dyreng, Hanlon, & Maydew (2010); Hanlon & Heitzman (2010) tax avoidance is any activity that affect tax payer, both activity permitted by tax or special activity for tax deduction. The legal tax avoidance usually inseparable with the illegal tax evasion because most of the behaviors around the transaction technically legal. The transaction legality of tax avoidance often set not according to facts. Tax avoidance usually exploits tax laws weakness and not violating taxation laws.

Conservatism accounting stated that conservatism accounting generates profits with higher quality because conservatism accounting practice prevents the company to exaggerate earnings and present profits and assets which are not overstated. Conservatism accounting in company applied in different levels. One of the very defining factor towards conservatism level in company financial report is management and company's internal parties commitment in providing transparent, accurate, and not misleading informations towards the investors (Watts, 2003).

Book tax differences are part of taxation level unobserved from tax planning. Based on previous researchers' intuition, the difference between profit values based on company book (commercial profit) with profits based on tax calculation (fiscal profit), called as book-tax difference (BTD). This Book tax differences reflects company tax avoidance. This is committed by company by attempting to report high book profit for the interest of stockholders, but implementing strategy to acquire low tax. According to Wilson (2009) book-tax differences can reflect tax avoidance long term and short term strategy. Company's financial report is a very needed information source by various parties, investors, creditors, manager, and for taxation. Every measurement from company's financial report has deficiency, but useful for researcher's estimation (Hanlon & Heitzman, 2010). According to Abdul Wahab & Holland (2015), academic researchers and activists use the difference between financial income and expected tax income as the definition of book tax differences. Jackson (2015), in his research divide total book-tax differences into two categories, i.e., permanent and temporary book-tax differences. The research result revealed temporary book-tax differences able to predict future changes in pretax earnings. Meanwhile permanent book-tax differences permanen can predict future changes in the term of tax costs.

The researches conducted previously that are related with this research are Givoly & Hayn (2002) have researched effective tax rate used to see the influence of book tax differences towards tax avoidance shown influencing results. Watts (2003) and George A. Plesko (2004) also added that the implementation of conservatism accounting to company towards tax avoidance where the results is not influential. Blaylock, Shevlin, & Wilson (2012) also have researched all kinds of company enlisted in US Stock Exchange by testing the role of book tax differences towards tax avoidance. Book tax differences in this research are tested and resulted in conclusion that shows temporary book tax differences can give additional information on the amount of accruals. Hanlon & Heitzman (2010) research results in influential book tax differences towards tax avoidance. Meanwhile Jackson (2009) conducted research on the influence of book tax differences towards profit accumulation which it's result is negatively influential, in other words the implementation of book tax differences reach bigger differences with accrual booking therefore earning persistence grew smaller. Guenther et al. (2014), in their research saw that effective tax rate affect book tax differences and influence tax avoidance. Last, Annuar, Salihu, & Obid (2014) researched corporate tax avoidance. Corporate ownership structure influences tax avoidance.

This research's hypotheses are:

Hypothesis 1: There is influence of conservatism accounting towards book tax differences.

Hypothesis 2: There is influence of conservatism accounting towards tax avoidance.

Hypothesis 3: There is influence of book tax differences towards tax avoidance.

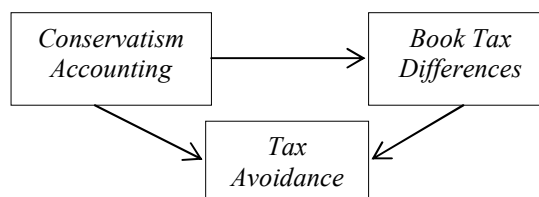
Hypothesis 4: There is influence of conservatism accounting towards tax avoidance to book tax differences.

### 3. Methodology

This is quantitative research which in its processing helped by SPSS 18.0 for Windows Statistics Program to see the inter-variable influence researched and to proof the hypothesis truth. The study population consisted of 71 corporations ready to go public, enlisted in LQ45 list in three periods (2013-2015). Meanwhile corporation samples taken by purposive sampling are 23 corporations with 69 observations. Those corporation samples have fulfilled certain criterias as following:

1. Published audited annual report.
2. Belong to the category of go public corporations enlisted in LQ45 index in Indonesian Stock Exchange in 2013-2015 consecutively.
3. Have data in accordance with researched variables

Based on previous researches conducted by researchers in accordance with research roadmap, the following graphic 1 shows the research plan.



**Graphic I. Research Plan**

#### Research Variable

##### Tax avoidance

Tax avoidance defined largely as explicit tax deduction and reflects all transactions influential to company's explicit tax debt. The equation to measure tax avoidance is:

$$GAAP\ ETR = \frac{Income\ Tax\ Expense}{Profit\ Before\ Tax} \dots\dots (I)$$

##### Conservatism Accounting

Conservatism accounting is reaction that tends to orient towards prudent reaction in admitting and measuring income and assets. Conservatism measured by using accrual. In accrual is negative, then the profit is categorized as conservative, caused by the profits lower than acquired cash flow (Givoly & Hayn, 2002).

$$KON\_ACC = \frac{NI - CF}{RTA} \dots\dots (II)$$

- KON\_ACC : The level of conservatism accounting  
 NI : Profit before extraordinary items  
 CF : Operation cash flow added with depreciation expenses  
 RTA : Average total assets

##### Book Tax differences

Book tax differences (BTD) is the difference of the amount of accounting profit amount with profits measured in accordance to taxation rules. According to M. Jackson (2009) to calculate book tax by decreasing fiscal net profits with commercial net profits.

$$BTD = \frac{Profit\ Before\ Tax - Profit\ After\ Tax}{Average\ Assets} \dots\dots (III)$$

### 4. Result And Discussion

This research use path analysis to know the causality connection that shows direct and indirect influences between independent variable with dependent variable. This Path analysis according to J. L. Jackson, Dezee, Douglas, & Shimeall (2005); Wuensch (2016) can be used to determine nonexperimental data with many variations or variable suitable with certain problem. This thing caused path analysis often called with causal modeling. This research used three variables, i.e., conservatism accounting (CA)

variable measured with KON\_ACC, book tax differences (BTD) variable measured with BTD, tax avoidance (TA) variable measured with GAAP ETR. By using path analysis, the relation between those variables, direct or indirect mediated or mediated by other variable can be known (Shevlin, Urcan & Vasvari, 2013).

### Descriptive Test Result

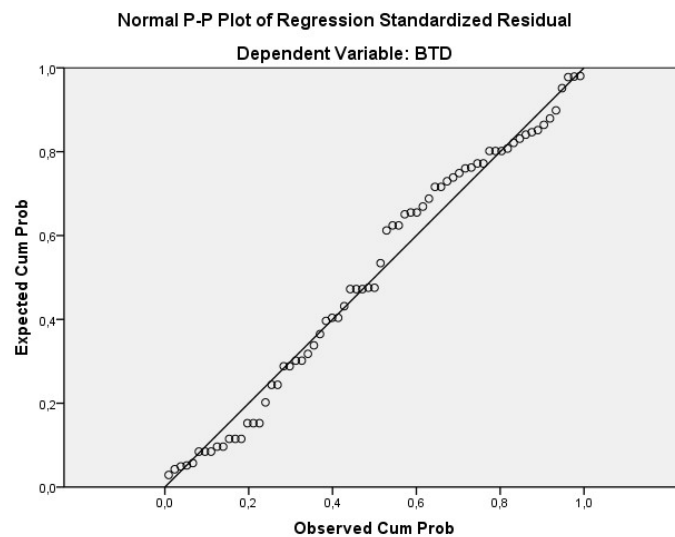
**Table I. Descriptive Test Result**

Variables	Mean	Std deviation	Minimum	Maximum
Tax Avoidance	0,2266	0,16090	-0,96	0,55
Conservatism accounting	-0,0312	0,14439	-0,32	1,03
Book Tax differences	0,0205	0,11298	-0,99	0,14

Source: Processed secondary data (2017)

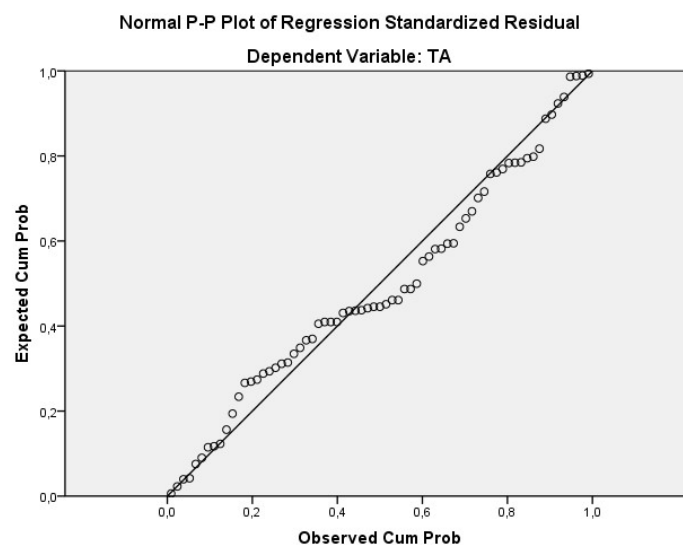
Table 1 result shows the acquired data resulted in tax avoidance around average mean value as much as 0.2266 or 22.66%, deviation standard as much as 0.16090 and minimum value -0.96 until maximum 0.55. Next tax avoidance produced conservatism accounting with (average) mean value as much as -0.312 or as much as -(31.2)%, with deviation standard 0.14439 and minimum value as much as -0.32 until maximum value as much as 1.03. Meanwhile data acquired results in book tax differences around (average) mean value as much as 0.0205, deviation standard 0.11298, and minimum value range -0.99 to maximum 0.14.

### Normality Test and Heteroscedasticity Tes Result



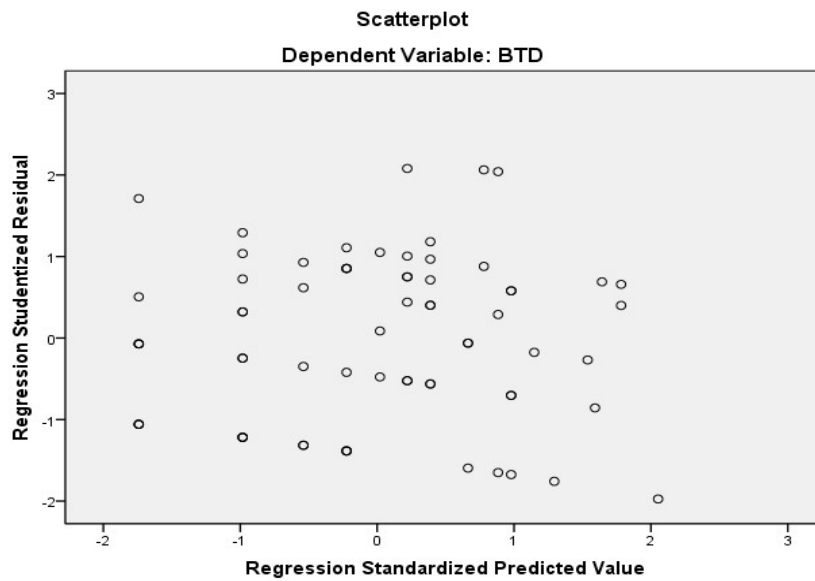
**Graphic II. Normality Test Graphic Model 1**

Graphic 2. Shows that residual spots spread around diagonal line, therefore the residual resulted from first model of  $BTD = \rho_1 CA + \varepsilon_1$  and second model i.e.,  $TA = \rho_2 CA + \rho_3 BTD + \varepsilon_2$  stated as normal distributing.

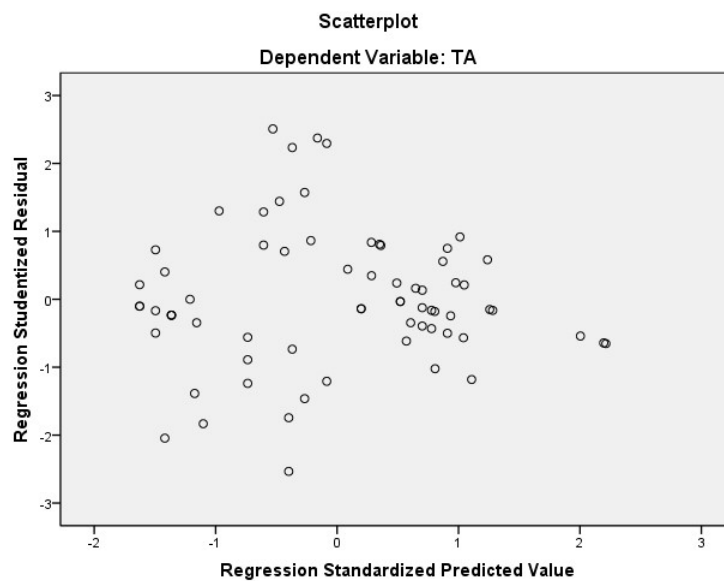


**Graphic III. Normality Test Graphic - Model 2**

Test result in graphic 3 shows residual spots spread randomly, therefore residual resulted from first model of  $BTD = \rho_1 CA + \varepsilon_1$  and second model, i.e.,  $TA = \rho_2 CA + \rho_3 BTD + \varepsilon_2$  can be stated there is no heteroscedasticity.



**Graphic IV. Grafik Uji Heteroskedastisitas Model 1**



**Graphic V. Heteroscedasticity Test – Model 2**

**Auto-Correlation Test Result**

**Table II. Auto-Correlation Result**

<b>Models</b>	<b>Value of Durbin Watson</b>
Model 1	1.656
Model 2	1.864

Source: 2017 processed secondary data

Based on the information from table 2 it can be known that model 1 with the equation  $BTD = \rho_1 CA + \varepsilon_1$  resulted in Durbin Watson value 1.656, DW value is between  $dU - (4-dU)$ . This means that equation on model 1 has no auto-correlation. Meanwhile 2 with equation  $TA = \rho_2 CA + \rho_3 BTD + \varepsilon_2$  results in Durbin Watson value 1.864, DW values located in  $dU - (4-dU)$  means that model 2 has no auto-correlation. Based on auto-correlation conducted, two research models free from auto-correlation.

**Path Analysis**

According to J. L. Jackson, Dezee, Douglas, & Shimeall (2005) in path analysis, exogenous and endogenous variables occurred to make it easier in differing which variable depended on other variable

and which one is not in particular condition. This exogenous variable is independent variable meanwhile endogenous variable is dependent variable.

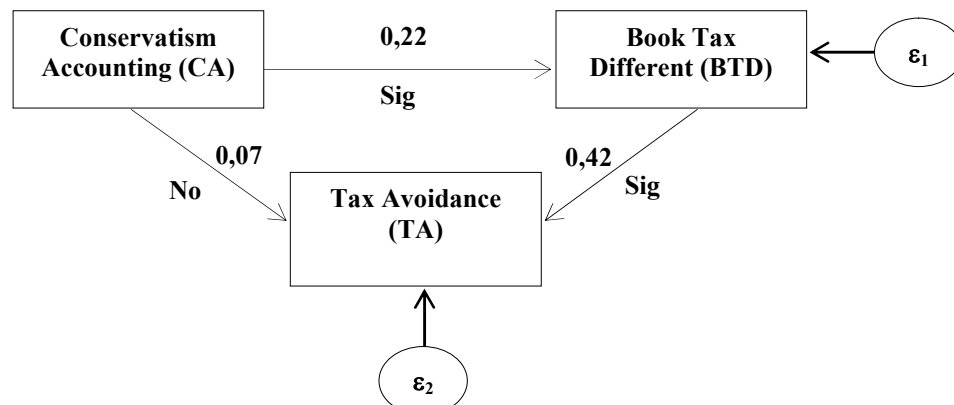
**Table III. Hasil Path Analysis**

Exogenous Variable	Endogenous Variable	Estimation Coefficient	t- statistic	p-value	Description
<i>Conservatism accounting (CA)</i>	<i>Book tax differences (BTD)</i>	0,225	1,892	0,063	Signifikan
<i>Book tax differences (BTD)</i>	<i>Tax avoidance (TA)</i>	0,429	3,805	0,00	Signifikan
<i>Conservatism accounting (CA)</i>	<i>Tax avoidance (TA)</i>	0,078	0,693	0,491	Tidak signifikan

Source: 2017 processed secondary data

Research result conducted as corresponding with table 3 shown that book tax differences (BTD) can be explained significantly by exogenous conservatism accounting (CA). Tax avoidance (TA) endogenous variable can be explained significantly by book tax differences exogenous variable, but can not be explained significantly by conservatism accounting (CA) variable. Those path coefficients are hypothesis in this research and can be presented in two equation models.

Model Testing



**Graphic VI. Path Result Analysis**

Based on Graphic 6, next the two equation models can be written as following:

Model 1 :  $BTD = 0,225 CA + \epsilon_1$

Model 2 :  $TA = 0,078 CA + 0,429 BTD + \epsilon_2$

Based on *path analysis* results and model made, it can be known that:

1. The coefficient of path relation of conservatism accounting variable with book tax differences variable is 0.225 and significant 0.1 level.
2. The coefficient of path relation of conservatism accounting variable with tax avoidance variable is 0.078 insignificant on 0.1 level.
3. Path coefficient of book tax differences variable with dengan variable *tax avoidance* adalah 0,429 dan signifikan pada tingkat 0,1

Determination Coefficient Test Result

**Table IV. Determination Coefficient Test Result**

Description	R <sup>2</sup>
Model 1	0.051
Model 2	0.205
$R^2_m = 1 - \{\sqrt{1 - R^2_1} * \sqrt{1 - R^2_2}\}$ $= 1 - \{\sqrt{1 - 0,051} * \sqrt{1 - 0,205}\}$ $= 0.1314$	

Test result corresponding with table 4, shows that R<sup>2</sup> as much as 0.1314 (13.14%), it means Tax Avoidance that can be explained overall by Conservatism Accounting and Book Tax Different are 13.14%. This means that contribution of Conservatism Accounting and *Book Tax Different* variable towards Tax

Avoidance is as much as 13.14%. Meanwhile the rests are as much as 86.86% explained by other variable not included in the model.

#### Inter-Variable Influence

The research result of direct, indirect, and total result can be seen in table 5, which shows each influence as following

**Table V. Direct, Indirect, and Total Influence**

Exogenous	Endogenous	Mediation	Direct	Indirect	Total
CA	BTD		0,225		0,225
CA	TA	BTD	0,078	0,078*0,429 = 0.033	0,078 + 0,033 = 0,114
BTD	TA		0,429		0,429

Source: 2017 processed secondary data

#### Direct Influence Result

Based on the above table 5, CA coefficient towards BTD is as much as 0.225, which means that CA positively influences BTD. CA coefficient towards TA as much as 0.078 which means CA positively influences TA. BTD coefficient towards TA is as much as 0.429, which means BTD positively influences TA.

#### Indirect Result

Result shows that CA coefficient towards TA through BTD is as much 0.033.

#### Total Influence Result

Total CA coefficient towards BTD is as much as 0.225, which means there is CA coefficient positive influence towards BTD. Total BTD coefficient towards TA is as much as 0.429 and CA total coefficient towards TA through BTD is as much as 0.114. Although the total CA results towards TA through BTD is smaller compared with each other coefficient results, but can still show that there is CA variable influence towards TA through BTD.

### Discussion

Hypothesis test result partially shows that conservatism accounting variable has significant influence towards book tax differences. This research supports Hanlon (2005) research, which showed that the company has to use caution principle conservatism accounting in making financial report in order that book tax differences will not cause company mistake in giving necessary financial information. According to research conducted by Koubaa & Jarboui (2017) also shows that total component and component difference in book tax differences in this case have differential implication towards conservatism accounting.

Book tax differences variable partial testing towards tax avoidance, showed that book tax differences variable significantly influences tax avoidance. This research supports research conducted by Jackson (2009); Blaylock, Shevlin, & Wilson (2012); Guenther et al. (2014); Hanlon & Heitzman (2010) it means that tax avoidance committed by corporations by applying book tax differences do not violate policies and laws.

Next partial test is conservatism accounting variable test towards tax avoidance. The result shows that conservatism accounting variable does not influence tax avoidance. This research is in accordance with previous research conducted by Watts (2003) and George A. Plesko (2004) which means that the presence of conservatism accounting or caution principle in financial report making is not the reason behind tax avoidance committed by companies. The research conducted by Asgari & Behpour (2014) also showed that there is a relation between conservatism accounting and corporation main tax is positive and significant. Company with high tax report adjustment report has big motivation to apply conservatism accounting to lower company's tax expense.

The result of conservatism accounting variable indirect test towards tax differences through book tax differences give indirect influence with the result is as much 0.033 or 3.3 %. This value is smaller compared with inter-variable direct influence. It means that eventhough inter-variable indirect influence is small yet it still influential between conservatism accounting towards tax avoidance through book tax differences. The company must implement decent tax planning in order for conservatism accounting principle used not contradicts with the implemented book tax differences or must be in accordance with laws to prevent committing tax avoidance that unregulated by laws or even violating laws.

### 5. Conclusions

Based on the research result on minimizing tax avoidance by using conservatism accounting through book tax difference towards LQ45 corporations enlisted in 2013-2015 Indonesian Stock

Exchange, it can be concluded that conservatism accounting practice significantly influences *book tax difference* dalam penyusunan laporan keuangan. Second conclusion, conservatism accounting practice does not influential in committing tax avoidance, it means that caution principle does not influence corporation to commit tax avoidance. Third conclusion, book tax differences influences significantly to commit tax avoidance, it means that the existence of financial report recording different principle for taxation interest is influential towards the company in committing tax avoidance. Last conclusion, conservatism accounting practice is not influential towards tax avoidance towards book tax differences; it means book tax differences using caution principle (conservatism accounting) can not explain tax avoidance practice.

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