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## **The Impact of Tax Incentives, Political Costs, Litigation Risk and Equity Valuation on Accounting Conservatism**

**Abstract.** *In Indonesia, as in other countries, according to the requirements of the tax authorities, there is a need for reconciliation to match accounting profit and fiscal profit. Some rules are allowed in accounting standards but not in taxation. In reducing losses, the company must provide evidence of transparent financial statements that prioritize conservatism. Accounting conservatism is a set of bookkeeping guidelines that call for a high degree of verification before a company can make a legal claim to any profit. The general concept is to factor in the worst-case scenario of a firm's financial future. The authors of this study attempt to assess the level of accounting conservatism based on several factors, namely through tax incentives, political costs, litigation risk, and equity valuation. The purpose of this study is the analysis of the impact of tax incentives, political costs, litigation risk, and equity valuation on accounting conservatism. The secondary data used in this study are financial reports and annual reports published on the Indonesia Stock Exchange (IDX, [www.idx.co.id](http://www.idx.co.id)) for 2015-2020. The sample of this study is manufacturing companies listed on the Indonesia Stock Exchange. Based on the criteria that have been determined using the purposive sampling method, there are 23 manufacturing companies. The results show that tax incentives and equity valuation have a positive and significant effect on accounting conservatism in manufacturing sector companies in Indonesia. Instead, factors such as political costs and litigation risk negatively affect accounting conservatism.*

**Keywords:** *tax incentives, political costs, litigation risk, equity valuation, accounting conservatism.*

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## **Вплив податкових стимулів, політичних витрат, ризику судових процесів та оцінки власного капіталу на консерватизм бухгалтерського обліку**

**Анотація.** *В Індонезії, як і в інших країнах деякі правила визначення прибутку дозволені стандартами бухгалтерського обліку, але на практиці не можуть бути використані бухгалтером згідно вимог податкового законодавства. Зменшуючи/збільшуючи збитки, компанія повинна розкрити відповідні докази правомірності у*

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прозорих фінансових звітах, які формуються на засадах бухгалтерського консерватизму. Консерватизм бухгалтерського обліку – це набір принципів бухгалтерського обліку, які вимагають високого ступеня перевірки, перш ніж компанія зможе пред'явити юридичні вимоги щодо будь-якого прибутку. Загальна концепція полягає у врахуванні найгіршого сценарію фінансового майбутнього компанії. Автори цього дослідження роблять спробу оцінити рівень бухгалтерського консерватизму на основі кількох факторів, а саме через податкові стимули, політичні витрати, ризик судового розгляду та оцінку власного капіталу. Мета дослідження – аналіз впливу податкових стимулів, політичних витрат, ризику судових процесів та оцінки власного капіталу на консерватизм бухгалтерського обліку. Інформаційною основою аналізу є інформація з річних фінансових звітів, що опубліковані на Індонезійській фондовій біржі (IDX, [www.idx.co.id](http://www.idx.co.id)). Вибірка даних охоплює період з 2015 по 2020 рік. Об'єктом цього дослідження є 23 виробничі компанії, акції яких котируються на Індонезійській фондовій біржі. Результати проведеного аналізу свідчать, що податкові стимули та оцінка власного капіталу мають позитивний і значний вплив на консерватизм бухгалтерського обліку у компаніях виробничого сектору Індонезії. Натомість такі фактори як політичні витрати і ризик судових позовів негативно впливають на бухгалтерський консерватизм.

**Ключові слова:** податкові стимули, політичні витрати, ризик судових позовів, оцінка власного капіталу, консерватизм бухгалтерського обліку.

## INTRODUCTION

Financial statements are one of the sources of accounting information required to be published for accountability from the management to the owner's resource manager. Financial statements cannot be separated from the preparation process as a form of accounting information produced by the company. The financial statements must be completed correctly and presented honestly by disclosing facts to users; this is following the Statement of Financial Accounting Concept (SFAC No. 2).

Financial Accounting Standards (SAK) provide freedom to choose the accounting method used in preparing financial statements. It means that the company has the opportunity to select one of several alternatives offered in financial accounting standards appropriate to its conditions (Verawati et al., 2015). So, in this case, the concept of conservatism indirectly affects the financial statements. Conservatism can be defined as an attempt to choose generally accepted accounting methods that will result in the slowest possible recognition of revenue, recognition of expenses as quickly as possible, lower valuation of assets, and higher valuation of liabilities. Specifically, this principle suggests that reporting the weakest values for assets and revenues is preferable and the highest for debts and expenses (Belkaoui Riahi, 2000).

A prime example is the case of the Toshiba Company in Japan. In September 2015, the CEO of Toshiba Corporation Hisao Tanaka, and other board members finally decided to resign because they were considered responsible for accounting irregularities. Sources close to the government environment told that the Securities and Exchange Commission Surveillance (SESC) plans to impose fines on Toshiba (<http://bisnis.liputan6.com> and [www.cnnindonesia.com](http://www.cnnindonesia.com)). This irregularity incident was discovered when the research team's examiner revealed that Tanaka carried out the company's profits as President from 2008. The company manipulated its profit reports with a value of US\$ 1.2 billion over the last few years. Reports by independent accountants and lawyers said Toshiba's operating profit had been overstated by US\$1.22 billion. The investigation found that the business division pressured Tanaka and Sasaki (Vice Director) to meet challenging targets. They overestimated

profits and delayed reporting losses amid a culture of not going against the boss's wishes. As a result of this incident, the public questioned the performance of the company's management. This was related to the emphasis on tax values in which managers tried to seek profit, including a lack of caution against litigation risk and a lack of transparency in equity values due to manipulating financial statements from year to year.

In Indonesia, many companies have not implemented conservative accounting in financial statements, causing the mistrust of users of financial statements. As an example, we can take the financial statements of the real estate company PT. Hanson International Tbk. This company was proven to have manipulated the Annual Financial Report (LKT) for 2016. In an examination conducted by the OJK, it was found that the manipulation of sales of ready-to-build lots (KASIBA) amounting to Rp. 732 billion made the company's revenue rise sharply, questioning the recognition with the full accrual method, although the transaction was not disclosed in 2016 LKT. According to OJK, by not submitting PPJB to the auditor who audited PT Hanson International Tbk's LKT, the 2016 LKT revenue was overstated with a material value of Rp 613 billion. This caused the company's share price to fall from 165.75 rupiahs to 50 rupiahs per share until 28 August 2020, when PT Hanson International Tbk was declared bankrupt (Kompas.com).

Thus, this company also has a high political cost attachment due to political interests and also fictitiously enlarges the value of equity to gain benefits for officials who have high positions in the institution. This is because investor relations with agents have different interests. They underlie agency theory, which affects enormous tax burdens, increases political costs, and has a high risk of litigation that occurs in the company. The agency theory describes two conflicting economic actors: the principal and the agent. An agency relationship is a contract in which one or more people (principal) order another person (agency) to perform a service on behalf of the principal and authorizes the agent to make the best decision for the principal (Ichsan, 2013).

Based on the above phenomenon, the application of conservatism is carried out to reduce corporate income taxes. Companies can choose methods that tend to be conservative

## Accounting

to minimize tax costs to the extent permitted by the applicable Financial Accounting Standards. Financial statements that can increase investor confidence need to apply conservatism. The conservatism, in theory, is related to signaling theory. A condition or signal is an action taken by the company's management to provide instructions for investors to assess the company's prospects, especially given the value of the company's equity.

In Indonesia, tax regulations require fiscal reconciliation to match accounting profit and fiscal profit. Some rules are allowed in accounting standards but not in taxation, such as donation fees that should not be charged and must be corrected. Although in tax, it remains a consideration for the company's choice to apply conservative accounting (Ardilasari, 2018). In reducing losses, the company must provide evidence of transparent financial statements that prioritize conservatism which can be seen based on several factors, namely through tax incentives, political costs, litigation risk, and equity valuation.

### LIERATURE REVIEW

According to many studies, accounting conservatism is influenced by several factors. The main focus in the financial statements is income information. One of the principles relating to financial statements and income information is accounting conservatism, namely an act carefully in determining the amount of the profit. Alfian & Sabeni (2013) indicate some of the factors that influence significantly to selection of accounting conservatism, such as leverage, capital intensity ratio and growth opportunity. Agustina, Rice, & Stephen (2015) tried to determine what factors influence companies to apply accounting conservatism. Alkurdi et al. (2017) study indicates a significant and positive relationship between foreign and institutional ownership with accounting conservatism, but the concentration of ownership does not affect the conservatism. Andreas et al. (2017) measure accounting conservatism using total accrual (earnings before extraordinary items + depreciation – cash flow from operation). Their multiple regression analysis partially shows that company growth, profitability, and investment opportunity set positively affect accounting conservatism. Hong (2017) states that various factors affect the conservative accounting of corporations. One of the important roles of conservatism is that companies conduct conservative accounting to cut agency costs due to information asymmetry.

Thus, many factors influence accounting conservatism. However, the impact of these factors may vary from country to country and industry, which requires separate research.

### RESEARCH HYPOTESIS

This study is based on the hypothesis that:

H<sub>1</sub> = Tax incentives affect accounting conservatism;

H<sub>2</sub> = Political costs affect accounting conservatism;

H<sub>3</sub> = Litigation risk affects accounting conservatism;

H<sub>4</sub> = Equity valuation affects accounting conservatism.

### RESEARCH METHODOLOGY

This study is based on the basic principles of signal theory and agency theory.

Agency theory focuses on the growing fact that an individual called the agent would act as a party trusted by another individual or group named the principal in every organization. The relationship between the two will occur within an organization or company. This relationship is usually described by the relationship between shareholders (stockholders) as principal and manager or manager as an agent. The concept of agency costs, showing its relationship to the problem of "separation and control", investigates the nature of agency costs generated by the existence of debt and equity (Jensen and Meckling, 1976).

Michael Spence (1973) first developed the signal theory in his Job Market Signaling research. This theory involves two parties, the parties in management provide signals, and external parties, such as investors, act as parties who receive the signal. Spencer said that management tried to provide available information for investors by giving a signal. Then, investors will adjust their decisions based on their understanding of signals from management in the form of signals of financial statements.

The secondary data used in this study are financial reports and annual reports published on the Indonesia Stock Exchange (IDX, www.idx.co.id) for 2015-2020.

The model used in this study is as follows:

$$Y = \alpha + \beta_1 X1 + \beta_2 X2 + \beta_3 X3 + \beta_4 X4 + \epsilon$$

The dependent variable in this study is accounting conservatism, which is measured using the earning/accrual measure, which is the difference between net income and cash flow. Formula for calculating accrual measure:

$$CONit = Niit - Cfit$$

Note:

CONit = the level of conservatism *i* in year *t*;

Niit = net income before extraordinary items are deducted;

Cfit = the cash flow of *i* company's operational activities in year *t*.

The independent variables in this study are tax incentives, political costs, litigation risk, and equity valuation.

The explanation of these variables is as follows:

1. The formula for Tax Retention Rate (TRR):

$$TRR = \frac{Net\ Income\ it}{Pretax\ Income\ (EBIT)\ it}$$

Note:

TRR it = Tax Retention Rate;

Net Income it = The net profit of company *i* in year *t*;

Pretax Income (EBIT) it = Profit before tax of company *i* year *t*.

2. The formula for Company Size:

$$SIZE = \text{Log Natural (Total Assets)}$$

The company size is measured as the logarithm of the company's total assets.

3. The formula for Debt-to-Equity Ratio:

$$DER = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Note:

DER = Debt-to-Equity Ratio;

Total Liabilities = Total debt owed by the company;

Total Equity = Total difference between the total assets and liabilities of the company.

4. The formula for Equity valuation:

$$MtBV = \frac{\text{Share Value}}{\text{Share Book Value}}$$

Note:

MtBV = Market to Book value;

Share Value = Number of managerial shares;

Share Book Value = Number of shares outstanding.

### RESULTS AND DISCUSSION

Multiple linear analysis requires several assumptions so that the model can be used. The assumption used in this study is the normality test, heteroscedasticity test, multicollinearity test, and autocorrelation test.

Table 1

#### One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		138
Normal Parameters <sup>a,b</sup>	Mean	,000000
	Std. Deviation	189586,808
	Most Extreme Differences	
	Absolute	,183
	Positive	,183
	Negative	-,171
Test Statistic		,183
Asymp. Sig. (2-tailed)		,259

According to Table 1 results, the Asymp. Sig. (2-tailed) is more significant than 0.05. Consequently, the regression data met the assumption of normality, which means that the data used in this study were normally distributed.

Table 2

#### Heteroscedasticity Test

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	813,419	372,025		2,501	,140
Tax incentives	794,902	480,515	,222	2,740	,107
Political costs	168,719	145,612	,032	,359	,720
Litigation risk	545,190	385,903	,111	1,328	,187
Equity valuation	871,619	769,225	,249	2,739	,127

Based on the table 2 data, it can be seen that the results of the regression of the independent variables on the absolute value of the residuals show a significance value above 0.05. Consequently, it can be concluded that there is no heteroscedasticity in this regression model.

Table 3

#### Multicollinearity Test

##### Coefficients<sup>a</sup>

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	Tax incentives	,999	1,001
	Political costs	,836	1,196
	Litigation risk	,944	1,060
	Equity valuation	,796	1,256

Based on table 3, the VIF value from the tax incentive is 1.001, political cost is 1.196, litigation risk is 1.060, and the equity value is 1.256. Meanwhile, the tolerance value for each variable is tax incentive of 0.999, political cost of 0.836, litigation risk of 0.944, and equity value of 0.796. Consequently, all the independent variables used do not experience multicollinearity because the VIF value is  $< 10$  and the tolerance value is  $> 0.10$ , so is feasible to use.

Table 4

#### Multiple Regression Linear Analysis Results

Model		Unstandardized Coefficients	
		B	Std. Error
1	(Constant)	813,419	372,025
	Tax incentives	794,902	480,515
	Political costs	168,719	145,612
	Litigation risk	545,190	385,903
	Equity valuation	871,619	769,225

Based on table 4, multiple linear regression equations can be made as follows:

$$Y = 813,419 + 794,902X_1 + 168,719X_2 + 545,190X_3 + 871,619X_4 + e$$

Table 5

#### Autocorrelation Test Model Summary<sup>b</sup>

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,355 <sup>a</sup>	,126	,100	192416,61864	1,843

Based on table 5, the Durbin-Watson (DW) value of 1.843 has been obtained. Based on the criteria that have been determined in the table du value 1.7819 and the 4-dU value (1.7819) of 2.2181. Consequently, the Durbin-Watson value in this study is greater than the Durbin-Watson value table and smaller than the 4-dU value ( $1.7819 < 1.843 < 2.2181$ ), so there is no autocorrelation because it fits the criteria.

#### CONCLUSIONS

Based on the data analysis, the authors obtained the following results:

a) Tax incentives has a positive and significant effect on accounting conservatism in manufacturing sector companies in Indonesia. In this case, accounting conservatism is used to minimize profits by reducing the tax base or taking advantage of tax reductions. The government's policies in the PPh Law No. 36 of 2008 positively affect company management to increase the conservatism of the company's financial statements.

b) Political costs have a negative and significant impact on accounting conservatism in manufacturing sector companies in Indonesia. The greater the political costs incurred by the company don't have a positive impact on the rising of accounting conservatism of the company. Political costs include all costs or transfers of wealth that companies must bear related to antitrust actions, regulations, government subsidies, tax rates, labor demands, and so on. As a regulator and policy maker in a country where the company operates, the government will supervise large companies. But companies can still carry out other interests in political costs that are not by the principle of conservatism.

c) Litigation risk has a negative and significant impact on accounting conservatism in manufacturing sector companies in Indonesia. It means that the more substantial risk of litigation negatively affects the principle of accounting conservatism. The company's litigation risk is related to investors and creditors' possibly judging the company. The protection of outside investors is so important that many countries have discovered ongoing practices of extensive abuse or appropriation of corporate resources. This makes the primary reference for Agency theory, where investors or capital owners provide facilities and company operational funds to manage the company properly to agents (managers). It requires several rules that managers can obey to capital owners for the company's progress.

d) Equity value has a positive and significant effect on accounting conservatism in manufacturing sector companies in Indonesia. Equity comes from the owner's investment and the results of the company's operations. Equity will be reduced by the withdrawal of participation by the owner and the distribution of profits (dividends) or business losses. According to the signaling theory, companies need to provide information on each account to investors and potential investors in the financial statements. The report made by the manager is very much required by investors and business people as analysis and monitoring in the process of evaluating the equity carried out.

Disclosure of financial statements should be based on the principle of accounting conservatism. However, on the one hand, management should beware of mistakes and fraud, and on the other – to show all the factors that are of great importance to investors and other users of the company's reporting.

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