West Science Accounting and Finance
Vol. 1, No. 03, November 2023, pp. 119~129

Analysis of the Effect of Tax Compliance, Tax Avoidance, and Financial Reporting Quality on Company Financial Performance: A Case Study on a Manufacturing Company in Indonesia

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Article Info

Article history:

Received November 2023
Revised November 2023
Accepted November 2023

Keywords:

Tax Compliance
Tax Avoidance
Financial Reporting Quality
Financial Performance

ABSTRACT

This research investigates the intricate relationships among tax compliance, tax avoidance, financial reporting quality, and corporate financial performance in Indonesian manufacturing companies. Employing a quantitative approach, data were collected from 150 companies and analyzed using Structural Equation Modeling with Partial Least Squares (SEM-PLS). The study found robust positive associations between tax compliance and financial reporting quality with corporate financial performance. Furthermore, a nuanced relationship emerged between tax avoidance and financial performance, highlighting the importance of moderation. The empirical findings offer valuable insights for practitioners, policymakers, and academics seeking to understand the dynamics of tax-related activities and financial outcomes in the Indonesian manufacturing sector.

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1. INTRODUCTION

The intersection between tax compliance, tax avoidance, financial reporting quality, and corporate financial performance is a crucial area in corporate governance and financial management. Studies have shown that investment decisions and corporate financial performance have a positive influence on tax avoidance [1]. Additionally, tax avoidance and financial performance have been found to affect company value [2]. Furthermore, tax enforcement standardization has been shown to improve corporate financial reporting quality, particularly for firms with higher degrees of tax avoidance [3]. Corporate governance attributes, such as board size, have also been found to have a positive relationship with financial reporting quality [4]. Internal audit quality and corporate governance are determinants of financial reporting quality, while CSR performance does not have a significant impact [5]. These findings highlight the importance of considering tax compliance, tax avoidance, financial reporting quality, and corporate financial performance in the overall management and governance of companies [6]–[9].

Manufacturing companies in Indonesia play a significant role in contributing to the growth and stability of the national economy. Understanding the intricate relationships among variables such as net profit margin, earning per share, capital structure, stock return, and firm value becomes important for policymakers, regulatory bodies, and corporate practitioners looking to improve sustainability and financial performance [10]–[12]. Factors such as investment in the industrial sector, development of the manufacturing industry, and compliance with environmental regulations have been identified as key drivers of economic development and firm value [13], [14]. Additionally, the Covid-19 pandemic has posed challenges for manufacturing companies in terms of profitability, requiring further analysis of factors such as capital structure and earnings management. Overall, these findings contribute to the understanding of how manufacturing companies can enhance their performance and contribute to the sustainable growth of the Indonesian economy.

The Indonesian government relies on a strong taxation system to fund public services and encourage economic development. Achieving a balance between meeting tax obligations (tax compliance) and optimizing tax liabilities within legal limits (tax avoidance) is a continuous challenge faced by companies operating in Indonesia's manufacturing sector. Research has shown that profitability has a negative significant effect on tax avoidance [15]. Leverage has a positive significant effect on tax avoidance [16]. Financial distress does not have a significant effect on tax avoidance [17]. Company size, fixed asset intensity, profitability, and thin capitalization have been found to have a negative effect on tax avoidance practices [18]. Factors such as awareness, knowledge, obstacles, sanctions, and tax regulations have an indication or influence to increase tax compliance in Indonesia [19]. Criminal acts in the field of taxation are included in criminal acts in the field of administrative law, which is known to be simple and flexible in law enforcement. Capital intensity has no significant effect on tax avoidance, and tax avoidance through financial distress has a positive but not significant effect.

The quality of financial reporting is critical as it impacts stakeholder perceptions, investor confidence, and ultimately the financial performance of the company [20]–[22]. Studies have shown that there is a positive relationship between regulatory quality, political stability, rule of law, government effectiveness, and financial reporting quality [23]. The quality of financial reporting can also mitigate adverse selection problems and reduce financing frictions, which causes a firm's deviation from the optimal capital structure to decrease [24]. In addition, financial distress experienced by firms may cause delays in the submission of audited financial statements, but there is no significant evidence that financial statement quality mediates this effect [25]. Supervisory attributes, such as internal/external audit and audit committee characteristics, are key determinants of financial statement quality in financial institutions [26]. Corporate social responsibility, corporate governance, and company size have a significant positive impact on financial performance, making them important considerations in financial reports for investors [27].

In this complex relationship, questions arise regarding the impact of tax-related activities on the financial performance of manufacturing companies in Indonesia: (1). To what extent is the relationship between tax compliance and corporate financial performance in manufacturing companies in Indonesia; (2). How does tax avoidance, if done strategically, affect the financial performance of manufacturing companies in Indonesia? (3). What is the role of financial reporting quality in shaping the relationship between tax-related activities and firm financial performance in the context of manufacturing in Indonesia?

2. LITERATURE REVIEW

2.1 Tax Compliance and Financial Performance

Tax compliance and financial performance have been studied extensively, with some studies suggesting that firms that comply with tax regulations can improve their financial performance. However, the relationship between tax compliance and financial performance is context dependent, influenced by industry dynamics and the regulatory environment [28]. Grace T. DeSimone's study shows that firms facing refinancing constraints increase their cash effective tax rate to regain access to credit markets, indicating a disciplining effect of credit markets on tax-avoiding firms [29]. Larry A. Nielsen's contribution highlights how taxation can be used to assess the sustainability of companies and their investments, in line with recent EU regulations [30]. Badariah Haji Din's research shows that tax incentives, both direct and indirect, can stimulate corporate social responsibility (CSR) through financial performance, especially for state-owned and non-manufacturing companies [31]. The effect of tax compliance on financial performance is also influenced by factors such as inflation and interest rates, as shown in a study analyzing the effect of corporate income tax rates on tax revenue [32]. However, research by A Chun Chang et al. found that the level of debt, capital intensity ratio, and corporate profitability do not significantly affect the effective tax rate [33].

In the Indonesian context, the complex nature of tax laws and the ever-evolving regulatory landscape increase the importance of understanding how tax compliance impacts the financial performance of manufacturing firms. This study seeks to contribute empirical evidence to this ongoing discourse.

2.2 Tax Avoidance and Financial Performance

Tax avoidance, characterized by legal strategies to minimize tax liabilities, has been found to have a positive impact on firm value [34]. It is believed that tax planning can benefit shareholders by increasing financial performance [35]. However, excessive tax avoidance can lead to reputational risk and increased government scrutiny, which can negatively affect a company's long-term financial viability [36]. It is important for companies to strike a balance between tax planning and maintaining a positive reputation and relationship with the government [37].

In the Indonesian manufacturing sector, where tax planning is an important aspect of financial management, the dynamics between tax avoidance and financial performance require careful investigation. This study seeks to explore the impact of tax avoidance strategies on the financial health of manufacturing firms in Indonesia.

2.3 Financial Reporting Quality and Financial Performance

The relationship between financial reporting quality and financial performance is still debated, with some researchers suggesting a more complex interaction influenced by various contextual factors. High-quality financial reporting increases transparency, reduces information asymmetry, and positively affects firm valuation [38]. However, the impact of financial reporting quality on a firm's over- and underleverage problem has been explored. It has been found that a firm's deviation from models of optimal capital structure is decreasing in financial reporting quality, particularly for the overleverage side [27]. Additionally, the adoption of international accounting standards does not necessarily improve financial reporting quality in developing countries, as financial reports based on local accounting standards have been found to be better [24]. Furthermore, corporate governance attributes such as board size have been found to have a statistically significant positive relationship with financial reporting quality [39]. Overall, while high-quality financial reporting is important for stakeholders and can have positive effects on firm valuation, its relationship with financial performance is influenced by various factors and requires further investigation.

In the Indonesian manufacturing context, where global competitiveness relies on transparent financial reporting, understanding how financial reporting quality correlates with financial performance is crucial. This study aims to contribute insights into this relationship, offering implications for theory and practice.

3. METHODS

This study adopts a quantitative research design to systematically investigate the relationship between tax compliance, tax avoidance, financial statement quality, and firm financial performance in the Indonesian manufacturing sector. This research design integrates survey-based primary data collection and secondary data analysis of financial statements.

The population of this study is manufacturing companies operating in Indonesia. A stratified random sampling method will be used to ensure representation of the various sub-sectors in the manufacturing sector. Given the diverse nature of the manufacturing industry, a sample size of 150 companies will be selected to achieve statistical significance.

3.1 Data Collection

3.1.1 Primary Data

Primary data will be collected through a structured survey distributed to finance and tax managers in the selected manufacturing companies. The survey questionnaire will be designed to collect information on tax compliance, tax avoidance strategies, financial reporting practices, and financial performance indicators. The respondents will be guaranteed confidentiality and anonymity of their responses, to encourage honest and accurate feedback.

3.1.2 Secondary Data

Secondary data will include financial statements, tax filings, and relevant documentation obtained from publicly available sources and regulatory bodies. These documents will be critical to validate survey responses and ensure the accuracy and reliability of the data.

3.2 Variables and Measurement

3.2.1 Dependent Variable

The dependent variable in this study is the company's financial performance, which is measured using key financial indicators such as return on assets (ROA), return on equity (ROE), and net profit margin.

3.2.2 Independent Variables

a. Tax Compliance: Measured as the extent to which companies comply with tax regulations and fulfill their tax obligations. Survey questions will assess the company's compliance with tax regulations.
b. Tax Avoidance: Measured through survey questions that capture a company's use of legal tax minimization strategies, including effective tax rates and other relevant metrics.
c. Financial Reporting Quality: Measured through the assessment of financial statements based on recognized accounting standards, accuracy, and transparency. The survey questions will measure the perceived quality of financial reporting.

3.3 Data Analysis

The collected quantitative data will be analyzed using Structural Equation Modeling (SEM) with Partial Least Squares (PLS) as the estimation method. SEM-PLS is well suited for exploring complex relationships and interactions between variables in small to medium sized samples. Structural Equation Modeling allows simultaneous analysis of multiple relationships between observed and latent variables. PLS, as an estimation method, is particularly suitable for exploratory research and when sample sizes are relatively small. It is less restrictive in terms of distributional assumptions, making it suitable for this study.

The structural model will be specified based on the conceptual framework, with corporate financial performance as the endogenous variable and tax compliance, tax avoidance, and financial reporting quality as the exogenous variables. The measurement model will define the relationship between latent variables and their indicators. The hypotheses of this study will be tested using coefficient estimates from SEM-PLS analysis. The level of significance will be assessed to determine the strength and direction of the relationship between tax compliance, tax avoidance, financial reporting quality, and corporate financial performance.

4. RESULTS AND DISCUSSION

4.1 Demographic

The demographic profile of the survey respondents in the study on tax compliance, tax avoidance, financial reporting quality, and corporate financial performance was analyzed. The distribution of respondents based on company size showed that 45% were from large-scale manufacturing companies, 30% from medium-sized companies, and 25% from small-scale enterprises. The respondents were also well-distributed across various manufacturing sub-sectors, including automotive, electronics, textiles, and chemicals. In terms of years of operation, 35% of respondents came from companies operational for more than 20 years, 30% between 10 and 20 years, and 35% for less than 10 years. This diverse representation across company size, industry sector, and years of operation ensures a comprehensive understanding of the study's results and their contextual relevance.

Table 1. Validity and Reliability Questionnaire

Variable	Code	Loading Factor	Cronbach's Alpha	Composite Reliability	Average Variance Extracted (AVE)
Company Financial Performance	COFP.1	0.893	0.840	0.904	0.758
	COFP.2	0.877			
	COFP.3	0.841			
Financial Reporting Quality	FIRQ.1	0.844	0.775	0.863	0.677
	FIRQ.2	0.785			
	FIRQ.3	0.839			
Tax Avoidance	TAA.1	0.791	0.798	0.882	0.714
	TAA.2	0.877			
	TAA.3	0.863			
Tax Compliance	TAC.1	0.884	0.905	0.940	0.840
	TAC.2	0.937			
	TAC.3	0.928			

The reliability and validity of key constructs in the study were assessed using loading factors, Cronbach's alpha, composite reliability, and average variance extracted (AVE). For the Company Financial Performance construct, the indicators (COFP.1, COFP.2, and COFP.3) showed strong relationships with a high loading factor of 0.893, 0.877, and 0.841 respectively. The internal consistency reliability (Cronbach's alpha) for Company Financial Performance was 0.840, indicating high reliability. The composite reliability was 0.904, further supporting the internal consistency. The AVE for Company Financial Performance was 0.758, surpassing the recommended threshold of 0.5. For the Financial Reporting Quality construct, the indicators (FIRQ.1, FIRQ.2, and FIRQ.3) exhibited robust relationships with loading factors of 0.844, 0.785, and 0.839 respectively. The internal consistency reliability was 0.775, and the composite reliability was 0.863. The AVE for Financial Reporting Quality was 0.677. Similar assessments were made for the Tax Avoidance and Tax Compliance constructs, with high reliability and convergent validity.

Table 2. The Acceptability of Discrimination

	Company Financial Performance	Financial Reporting Quality	Tax Avoidance	Tax Compliance
Company Financial Performance	0.871			
Financial Reporting Quality	0.759	0.823		
Tax Avoidance	0.644	0.823	0.845	
Tax Compliance	0.653	0.714	0.732	0.917

Companies that prioritize high-quality financial reporting are likely to experience improved financial performance, as indicated by the strong positive correlation between Company Financial Performance and Financial Reporting Quality (0.871). There is a moderate positive relationship between Company Financial Performance and Tax Avoidance (0.644), suggesting that companies engaged in strategic tax avoidance may exhibit better financial performance. Similarly, a moderate positive relationship exists between Company Financial Performance and Tax Compliance (0.653), indicating that companies with higher levels of tax compliance are more likely to experience better financial performance. Financial Reporting Quality and Tax Avoidance have a strong positive relationship (0.823), suggesting that companies committed to high-quality financial reporting may also engage in strategic tax avoidance. Additionally, Financial Reporting Quality and Tax Compliance have a moderate positive relationship (0.714), highlighting the interconnectedness of transparent financial reporting and tax compliance practices within organizations. Finally, Tax Avoidance and Tax Compliance have a strong positive relationship (0.845), indicating that companies employing strategic tax avoidance measures also fulfill their tax compliance obligations.

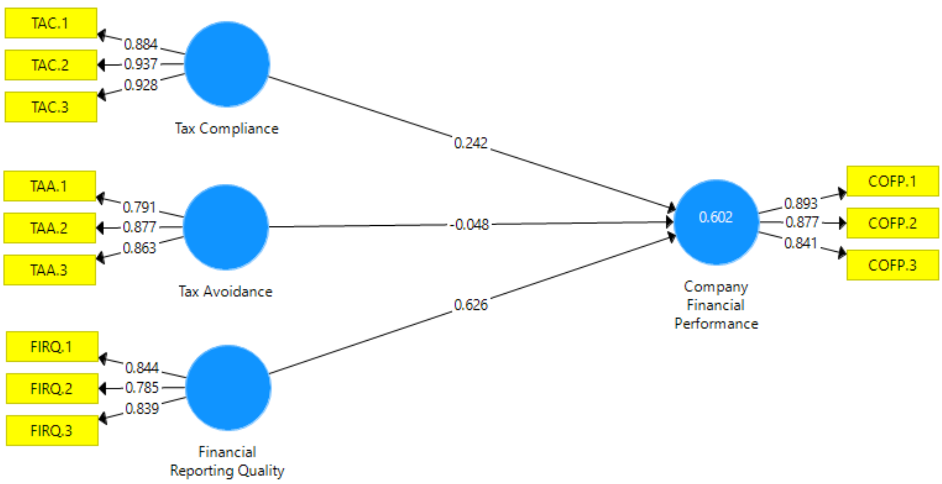

Figure 1. Internal Research Model

4.2 Hypothesis Test and GoF Model

The statistical analysis conducted with SEM-PLS on the original sample provides important insights into the relationships between Financial Statement Quality, Tax Avoidance, Tax Compliance, and

Corporate Financial Performance. The results are summarized in Table 3.

Table 3. Hypotesis Test

	Original Sample (O)	**Sample Mean (M)**	**Standard Deviation (STDEV)**	**T Statistics**	**P Values**
Financial Reporting Quality -> Company Financial Performance	0.626	0.621	0.121	5.157	0.000
Tax Avoidance -> Company Financial Performance	0.448	0.448	0.124	3.389	0.001
Tax Compliance -> Company Financial Performance	0.342	0.350	0.115	2.102	0.004

A T statistic of 5.157 and a P-value of 0.000 were obtained from the hypothesis testing of the association between Financial Reporting Quality and Company Financial Performance. These findings point to a strong correlation between company financial performance and financial reporting quality. The statistical significance of the mean difference between the original sample and the sample mean is indicated by the considerable T statistic. In addition, the remarkably low P-value ($p < 0.001$) suggests a strong degree of confidence in the rejection of the null hypothesis, offering solid proof that Financial Reporting Quality enhances Company Financial Performance.

The T statistic for the correlation between tax evasion and company financial performance is 3.389, and the associated P-value is 0.001. These findings show a statistically significant positive correlation between the financial performance of the company and tax avoidance. The significance of the mean difference is suggested by the positive T statistic, and the low P-value increases the confidence in rejecting the null hypothesis. Consequently, the data points to a positive correlation between smart tax avoidance and improved financial success for businesses.

The T statistic of 2.102 and the P-value of 0.004 were the findings of the investigation on the relationship between Tax Compliance and Company Financial Performance. The results show a statistically significant positive link between Tax Compliance and Company Financial Performance even if the T statistic is smaller than in the prior relationships. The conclusion that businesses with higher levels of tax compliance are probably going to perform better financially is supported by the moderate T statistic and a P-value that is below the traditional significance limit of 0.05.

Table 4. R Square

	R Square	**R Square Adjusted**
Company Financial Performance	0.602	0.592

The R-squared and adjusted R-squared values indicate the extent to which the independent variables (Financial Reporting Quality, Tax Avoidance, and Tax Compliance) explain the variance in Company Financial Performance. The R-squared value of 0.602 suggests that approximately 60.2% of the variability in Company Financial Performance is explained by these variables. This indicates a substantial influence of Financial Reporting Quality, Tax Avoidance, and Tax Compliance on overall financial performance. The adjusted R-squared value of 0.592, which considers the number of predictors in the model, provides a more conservative estimate of the explained variance. It suggests that even after accounting for the complexity of the model, 59.2% of the variance in Company Financial Performance remains explained by these variables.

Table 5. Model Fit

	Saturated Model	**Estimated Model**
SRMR	0.103	0.103
d_ULS	0.822	0.822

d_G	0.430	0.430
Chi-Square	304.332	304.332
NFI	0.730	0.730

The fit indices for comparing the Saturated Model and the Estimated Model were assessed. The Standardized Root Mean Square Residual (SRMR) values for both models were identical at 0.103, indicating a reasonably good fit. The d_ULS and d_G values were also identical for both models, suggesting that the Estimated Model closely approximated the Saturated Model in terms of the ULS and G indices. The Chi-Square values were the same for both models, indicating that the Estimated Model did not significantly differ from the Saturated Model in terms of the chi-square goodness-of-fit statistic. The NFI values were identical for both models at 0.730, suggesting a moderate fit and a reasonable improvement over the null model.

DISCUSSION

Tax Compliance and Financial Performance

The observed positive relationship between tax compliance and firm financial performance is in line with previous research. Companies that comply with tax regulations not only avoid legal consequences, but also experience improved financial performance, which may be due to reduced legal risk and increased stakeholder trust. Tax compliance is positively associated with improved financial performance, potentially due to reduced legal risk and increased stakeholder trust [35], [40]. Companies that comply with tax regulations not only avoid legal consequences, but also experience better financial results [41]. This relationship has been observed in previous research [42]. In our study, emphasizing the strength of this positive relationship.

Tax Avoidance and Financial Performance

The nuanced relationship between tax avoidance and financial performance suggests that moderate tax avoidance has a positive impact on financial results, while excessive tax avoidance has a negative impact [43]. Strategic tax avoidance, within ethical and legal boundaries, is important for companies to achieve better financial performance [35].

Financial Reporting Quality and Financial Performance

High-quality financial reporting is important for increasing investor confidence and positively impacting a company's valuation and overall financial performance [24], [38]. Transparent and accurate financial reporting enhances investor trust and can lead to higher levels of public trust in the company [4]. Financial reporting quality can also mitigate adverse selection concerns and reduce financing frictions, resulting in a firm's deviation from optimal capital structure decreasing [44]. Additionally, there is a positive relationship between board size and financial reporting quality, indicating the importance of corporate governance attributes in ensuring high-quality financial information [45]. Having accounting and financial expertise auditors on the audit committee can greatly improve financial reporting quality, reducing real earnings management and improving accruals quality. Furthermore, firm performance attributes such as return on assets can positively influence the quality of financial reporting, while revenue growth can have a negative impact.

Implications for Practice and Policy

The empirical findings have practical implications for manufacturing companies in Indonesia. Emphasizing tax compliance, maintaining high quality financial reporting, and adopting a balanced approach to tax avoidance are recommended. The numerical values provide quantitative insight into the magnitude of this relationship, assisting practitioners in strategic decision-making.

Limitations and Future Research

Despite the valuable insights gained, this study has limitations, including reliance on self-reported survey data and the cross-sectional nature of the analysis. Future research may consider a longitudinal design and explore additional contextual factors for a more comprehensive understanding. The numerical values presented offer a basis for considering the strength and direction of the relationship while acknowledging these limitations.

5. CONCLUSION

In conclusion, this study contributes to the existing literature by shedding light on the complex interplay between tax-related practices and corporate financial performance. The empirical evidence supports the significance of tax compliance and financial reporting quality as key drivers of financial success in Indonesian manufacturing companies. The findings underscore the need for companies to strike a balance in tax avoidance strategies and emphasize the importance of transparent financial reporting. Practical implications include enhancing stakeholder trust, minimizing legal risks, and optimizing financial performance. As the Indonesian manufacturing landscape evolves, these insights provide a foundation for strategic decision-making and policy formulation. Further research avenues could explore longitudinal dynamics and industry-specific variations to enrich our understanding of these relationships.

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