



## Earnings, institutional investors, tax avoidance, and firm value: Evidence from Taiwan



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### ABSTRACT

This study examines the valuation of earnings from China and Taiwan by foreign and domestic institutional investors across a sample of Taiwanese electronics firms. We further compare the valuation of firm earnings reported in tax havens and non-tax havens, and whether these firms have changed tax avoidance activities since 2004 when the Taiwanese government enacted stricter auditing of transfer pricing regulation.

Our findings show that both operating income from the home country and investment income are positively associated with firm value. Operating income from China, however, is not significantly related to firm value when institutional ownership of the firm exceeds fifty percent. This result indicates that operating income is valued differently, depending on the location from which the income was generated. Non-operating income enhances firm value regardless of the revenue source. We also report that foreign institutional investors favor operating income from domestic and investment sources over earnings generated from non-domestic sources and other non-operating income. Furthermore, our results suggest that firms rearrange reported profits from subsidiaries located in tax havens to affiliates in other countries following the transfer pricing audit guide Taiwan implemented in 2004. Results also indicate firms may have been shifting profits to other low-tax-rate countries, or to countries which do not require firms to pay taxes, even if they are not doing business in that country.

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## 1. Introduction

Prior studies document that foreign institutional investment affects firm value more than domestic investment, particularly in emerging markets. Gillan and Starks (2003, p. 15) argue that “foreign institutional investment has become an important influence in emerging equity markets, and firms may be motivated to improve their corporate governance in order to attract foreign capital.” Internalization theory assumes foreign direct investment (hereafter FDI) increases a firm’s market value (Doukas & Travlos, 1988; Fatemi, 1984; Kim, 2000). For example, Bodnar and Weintrop (1997) find that firm earnings

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association coefficients are more constant and have a greater impact on incremental foreign earnings than domestic earnings due to relative growth opportunities overseas. Garrod and Rees (1998) document that earnings and net assets are valued more highly for multinational firms than for purely domestic firms because of international expansion opportunities. Using a sample of U.S. multinationals, Callen, Hope, and Segal (2005), however, assert that domestic earnings more accurately explain the variance of unexpected returns than do foreign earnings. In light of inconclusive results from evaluating U.S. multinational companies (hereafter MNCs), it remains unclear whether firm valuation will vary due to its composition of domestic or foreign institutional investment, or domestic earnings and foreign earnings from emerging markets.

MNCs have incentives to use transfer pricing arrangements to shift income to lower tax countries or tax havens, thus maximizing after-tax profits (Sikka & Willmott, 2010). This type of tax avoidance by MNCs has received considerable attention. Tax authorities have responded with stricter audits on transfer pricing arrangements for MNCs, particularly involving transactions with affiliates or related parties in tax havens. This audit response raises the question of whether MNCs are able to continue tax avoidance activity.

This study uses high-tech electronics firms in Taiwan to examine the variation in firm value associated with institutional investment within emerging markets. A unique feature of the Taiwanese sample is that almost all Taiwanese electronics firms have business operations in both China and Taiwan, which attracts both foreign and domestic institutional investment. In particular, many of these firms, with multiple geographic business operations, derive significant foreign earnings from operations in tax havens. Thus transfer pricing arrangements for tax avoidance are a common strategy to maximize after-tax profits. Additionally, the setting of these Taiwanese firms, unique from other emerging markets, may provide significant insights into firm valuation.

The first objective of this study is to examine differences in valuation of earnings by foreign and domestic institutional investors, when comparing operating income from China and operating income from Taiwan. The second objective is to examine the differences in firm value when operating income is reported from tax havens or non-tax havens. Finally, a third objective is to investigate whether firms have changed reported earnings due to tax avoidance activities subsequent to Taiwanese stricter audit regulation on transfer pricing effective in 2004.

Using a sample of Taiwanese electronics firms that includes 1346 firm-years of observation spanning a six-year period from 2000 to 2005, we find evidence supporting an incremental increase of firm value related to each component of earnings tied to significant foreign institutional ownership (more than twenty percent). However, domestic operating income and investment income enhance firm values only for firms with significant domestic institutional ownership (more than twenty percent) and with majority institutional ownership (more than fifty percent). The findings suggest that the value of operating income differs depending on where the operating income originated, but non-operating income enhances firm value regardless of revenue source. Therefore, operating income from Taiwan has a greater impact on firm value than operating income from other locations, including from China. The results also indicate that firms which disclose operating income from Chinese operations are valued differently by foreign and domestic institutional investors.

Results indicate that operating earnings from tax havens decreased after the change in Taiwanese transfer pricing audit regulation in 2004. This finding suggests that Taiwanese electronics firms have shifted income from tax havens to other countries through affiliated transactions in response to new government audit guidelines. Thus, our study of Taiwanese multinational firms adds to the extant literature on the impact of institutional ownership on firm value of MNCs, and contributes to accounting practices within the global business environment. Secondly, this paper contributes to a greater understanding of firms' transfer pricing arrangements to shift income for tax avoidance. Lastly, our empirical findings support host countries' accounting policies that include stricter government audit regulations on firms' transfer pricing and suggest guidelines for MNCs operating in emerging markets.

The remainder of this paper is organized as follows: Section 2 presents recent literature for review and develops hypotheses. Section 3 includes sample selection and research design. Section 4 presents empirical results and analysis. Section 5 concludes with a brief summary.

## 2. Literature review and hypotheses development

In emerging markets, foreign investment has become an important channel to raise capital. In general, foreign institutional investors play an important role in the market. They spend considerable time analyzing the fundamentals of their investment before allocating substantial capital into emerging markets. FDI strategies regarding foreign institutional investors' that overbuy and oversell information have often been followed by domestic institutional investors or individual investors, leading us to explore this valuation behavior as well.

Taiwan is among the most economically-charged emerging markets, and the electronics firms located there have unsurpassed reputations for high quality manufacturing and productivity (Ernst, 2003; Lowe & Kenney, 1999). On the other hand, Taiwanese firms operating in China, one of the biggest markets in the world, provide good business opportunities that benefit from a common language and similar cultures. Thus, China has become the main investment location for Taiwanese firms. According to the Investment Commission of Ministry of Economic Affairs in Taiwan (hereafter MOEA), the high-tech electronics industry represents the majority of outward investments in Taiwan. These considerations are relevant to our discussion of firm valuation behavior of various institutional investors of Taiwanese firms with operations in China.

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