
Examining the Impact of Audit Quality and Financial Performance on Corporate Tax Avoidance: Empirical Evidence from Public Listed Companies in Malaysia

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Abstract: The global financial crises, including the one experienced in Malaysia, have raised concerns about the reliability of accounting reports prepared by Malaysian listed companies. In response, regulatory and professional institutions have advocated for reforms aimed at promoting transparency in accounting reports. To this end, this study provides empirical evidence on the direct impact of audit quality and financial performance on corporate tax avoidance among companies listed on Bursa Malaysia. The panel data approach was used to collect data from 276 listed companies on Bursa Malaysia, with 1,656 observations covering a six-year period from 2013 to 2018. Multiple regression analysis was used to examine the relationship between audit quality, financial performance, and tax avoidance. The findings of this study indicate that audit quality and financial performance have a significant negative association with tax avoidance among Malaysian listed companies. These results suggest that firms with high audit quality and strong financial performance are less likely to engage in tax avoidance practices. The study has implications for policymakers and regulators, as it highlights the need for continued efforts to improve audit quality and financial reporting practices. Additionally, the findings suggest that measures aimed at improving financial performance among Malaysian listed companies may help reduce the prevalence of tax avoidance practices. Therefore, this study contributes to the ongoing debate on the effectiveness of regulatory and professional reforms aimed at promoting transparency and accountability in the financial reporting practices of Malaysian listed companies.

Keywords: corporate tax avoidance, effective tax rate, tax.

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INTRODUCTION

Tax can be described as a major element to each state (Putranti & Setiawanta, 2015). Where the taxation revenue for each country is usually one of the most important sources for State Treasury especially in developing countries (Feranika et al., 2017). However, Sandy & Lukviarman (2015) argued that the realization revenue from tax has not reached the country's target. One of the main reasons for that may result of taxpayer's practices to the activities of tax avoidance. The efforts of Companies to implement avoiding taxation activities take



place in several states including Malaysia. According to Rizqia & Lastiati (2021) the efforts of Companies to implement avoiding taxation activities take place in several states including the Malaysian community. Based on the PricewaterhouseCoopers report, there has been a growth in the activities of tax avoidance since 2010 In Malaysia.

As mentioned by Puspita & Harto (2014) the practices of avoiding tax can't be separated from agency theory. Where, Eksandy (2017) explained that the tax avoidance decision made by companies' managers may bring a conflict of interest among the managers and shareholders, which causing an agency problem. Sandy & Lukviarman (2015) also indicated that Tax avoidance activities provides opportunities to the management to make opportunistic practices with short-term purposes, which might harm the interests of the company's shareholders in the long run. The implemented tax avoidance activities by managers will cause country losses by reducing the government revenue from tax (Khairunisa et al., 2017). Thus, managements must fulfil their responsibilities as taxpayers (Yunistiyani & Tahar, 2017). Because of The accounting reports of company's include information that may be used by any user of stakeholders in making their decisions, the audit quality for these reports is fundamental to be able to present the company's real value, including whether there are any tax avoidance practices (Rizqia & Lastiati, 2021).

Among the factors that cause the practices of tax avoidance activities is the quality of auditing (Lestari & Nedy, 2019). The quality of auditing represents a primary element to maintaining the reliability of financial reports, where the audit quality is the confidence fundamental on the accounting reports integrity and its credibility which is too significant for efficient-functioning markets. As mentioned by Macharia & Gatuhi (2013) the audited financial statement is said to be a technique of control applied to protecting the interests of shareholder and minimizing the asymmetry of financial information so as to guarantee that the audited reports of accounting are considered free of material distortion. Moreover, the auditors usually assist in reducing the chances of engaging in substantial misstatements like earnings management and tax avoidance. The accounting report may describe it as more credible and reliable when it is audited by big four firm than those which audited by non-big four firm. The present study can provide contributions through the investigation into audit quality of financial reports by taking into consideration the classification of auditing firm and its impact on financial performance.

Tax avoidance has been defined by Winata (2014) that it is an effort being made by the managements in order to reduce the taxation cost without getting out of tax regulations. The practices of tax avoidance are applied by companies as a result of having regulations loopholes for taxpayers due to Various alternatives in governing accounting and tax regulations (Rachmawati & Martani, 2014). Where the differences of regulations within accounting and taxation are grouped to short term and long-term differences. As indicated by Persada & Martani (2014), long term differences happen as a result of differences in the objects of taxation that are not allowed in the regulations of tax. As this difference does not influence future payments of tax thus it does not outcome in a deferred tax asset or liability. Like several of previous studies such as (Sudibyo & Jianfu, 2016; Goh et al., 2016; Duan et al., 2018; Drake et al., 2020; Dyreng et al., 2010; Huang & Zhang, 2020; Armstrong et al., 2012), this paper uses cash effective tax rate (CETR) as proxies of corporate tax avoidance. Where (CETR) is not biased by changes in accounting accruals of tax. Moreover, (Dyreng et al., 2008) pointed out that the proxy of (CETR) reflects any practices of avoiding tax which minimize the cash Payments of taxation in the present year, including those that defer cash tax paid by creating short term difference of book-tax.

The audit firm size usually indicates to the proxy for the quality of audit. Specifically, larger audit firms have a higher tendency to resource distribution to gain better reputation, which raises their audit service value. Therefore, the management infractions and errors in the company's financial report could be specified

(Gunn & Michas, 2018). as mentioned by El Ghouli et al. (2016) that the audit firm reputations too important which were the motive for big four firms of auditing to generate accurate financial reports as it is proved that a higher audit quality was create by these audit firms compared to the non-big four firms.

Nadia (2015) discussed the scope of audit quality that summarizes competence, independence, and audit firm's size. Where the big auditing firm has professional and independence through the high auditor's ability, based on that the big four firms is competent to produce high quality of auditing reports (Rizqia & Lastiati, 2021). As Nadia (2015) also indicated that the big auditing firms usually seek to have the best quality of auditor's competencies that can detect the activities of earnings manipulation by managers for the purposes of taxation.

Koubaa & Jarbouli (2017) studied the relationship among book-tax differences and audit quality for the companies listed in Tunisia market; the outcomes showed that there is an indirect relationship between abnormal differences of book-tax and quality of audit that is mediated by quality of earnings; furthermore, companies with big book-tax differences have higher quality of auditing. Gaaya et al. (2017) examined the moderating effect of audit quality on the relationship between family ownership and tax avoidance for companies in listed Tunisia market; their study showed that there is a revealed a proposed moderating interaction that the relationship between tax avoidance and audit quality could have different interceptions. The following first hypotheses that formulated to investigate in the relationship between audit quality and corporate tax avoidance in Malaysian listed companies.

For-profit companies surely have a major purpose to seek earnings as much as potential and for the tax is an expenditure that will minimize the profit of companies, subsequently, the company will make more effort to reduce this expense. Thus, the companies will be more accurate in making policies to reduce the burden of tax. Where the avoiding tax activities preferred over the activities of tax evasion (Tarmidi et al., 2020). In line of previous studies that investigated the impact of financial performance on corporate tax avoidance like, (Puspita & Harto, 2014; Wiratmoko, 2018; Hidayat, 2018; Tarmidi et al., 2020; and Ariawan & Setiawan, 2017) which show that the profitability of company impact tax avoidance. The second hypotheses formulated to investigate in the relationship between financial performance and corporate tax avoidance in Malaysian listed companies.

There is an essential role for the financial performance of the listed companies on the stock exchange market, it is also viewed as an element to attract the investors as well as minimizing the cost of capital for the companies. Where any company that has a good financial performance will create a good position for it in the capital market. Moreover, Ado et al. (2020) indicated that the stakeholders rely on the audited accounting reports to make their decisions related to the company's efficiency. Wherefore, the good financial reports quality will positively influence financial performance. According to many authors there are several elements utilized in the companies' financial performance measurement. The current study measured financial performance using a company's profitability. Profitability can measure the ratio of income to average assets, which is called return on assets (ROA).

METHODS

Our paper used the secondary data that available in the published annual financial reports of Malaysian listed companies. This paper consist target population of 925 listed companies on bursa Malaysia as of December 2018. From the study population 276 Malaysian companies have been sampled, involving of 1,656 firm-year observations which are from six selected industries (Construction, Consumer product, Industrial product, Plantation, Properties and Trading & services) as shown in Table 1. The study excluded financial companies

and the technology sector, in addition to sectors that consist of a small number of companies less than 10. The present study period covers 6 years from (2013 until 2018). The study period was selected to be after the application of the Malaysian standards for financial reporting and before the Covid-19 pandemic.

Table 1 List of the Sample Study

No.	Industries	No. of selected firms
1	Construction	12
2	Consumer product	60
3	Industrial product	62
4	Plantation	17
5	Properties	42
6	Trading & services	83
Total		276

To examine the relationship between audit quality and financial performance towards corporate tax avoidance. The following equation has been formulated.

$$TA = \alpha_0 + \beta_1 AQ + \beta_2 FP + \varepsilon$$

Where:

TA = Tax Avoidance of firm i in year t.

AQ = Audit Quality of firm i in year t.

FP = Financial performance of firm i in year t.

In achieving the research objectives, this study uses Audit Quality and Financial Performance as independent variables (Table 2).

Table 2 Summary of Variable Measurement

No.	Variables	Measurements	Proxies	Sources
Dependent Variable:				
1	Tax Avoidance	Cash Effective Tax Rate	TA	(Duan et al., 2018)
Independent Variables:				
1	Audit Quality	a Big Four firm would be represented by (1), while a non-Big Four firm would be represented by (0)	AQ	(Chen & Chen, 2011)
2	Financial Performance	The proportion of income before tax to total assets.	FP	(Chen & Chen, 2011)

RESULTS AND DISCUSSION

Descriptive statistical results taken from the variables of the current study incorporated into the model as presented in Table 3.

Table 3 Descriptive Statistics Analysis

	Mean	Min	Max	Std. Dev.	Skewness	Kurtosis
TA	.218	0	0.456	.127	-.034	2.271
AQ	.389	0	1.000	.488	.456	1.208
FP	.042	-.075	0.163	.056	.11	3.04

Note: TA: Tax Avoidance, AQ: Audit Quality, FP: Financial Performance.

Table 3 disclosed that the value of mean for tax avoidance (TA) in companies listed on bursa Malaysia is 0.218 as well as the maximum and minimum values for TA are 0.456 and 0 respectively. It also indicates that audit quality (AQ) has an aggregate mean is 0.389 with minimum and the maximum values of 0 and 1. This mean that around 40% of Malaysian listed companies patronized the services offered by the Big4 firms. Table 3 disclosed that the mean value for financial performance (FP) in the companies Listed on bursa Malaysia is 0.042 and it represent the minimum and maximum values -0.075 and 0.163, respectively. That indicating a positive performance on Malaysian listed companies.

Pallant (2011), debated that the analysis of correlation is too significant in portraying the undeviating association direction and its strength between examined variables. According to (Hair et al., 2010) who explained that the zero value of correlation means that there is no relationship, while the ± 1.0 value indicates to a perfect relationship.

Table 4 Correlation Analysis

Variables	(1)	(2)	(3)
(1) TA	1.000		
(2) AQ	-0.546**	1.000	
(3) FP	-0.270**	0.040	1.000

As presented in Table 4 that the audit quality has a negative and significant statistically correlation with corporate tax avoidance at 1% level of significant. This is an indicator on the course of the relationship between audit quality and tax avoidance in the model of regression. Table 4 shows financial performance to be positively and significantly related to tax avoidance at 1% level of significant.

The current paper utilized the analysis of linear regression as a statistical process in order to investigate the relationships that arise between tax avoidance as a dependent variable and two independent variables including audit quality and financial performance for 276 listed companies on bursa Malaysia. The following table represents the outcomes of analysis to the linear regression model.

As appears in Table 5, the R-squared from the regression model is 0.077. This result indicates that audit quality and financial performance explain 7.7% of tax avoidance disparity as being measured using CETR. However, this is being regarded as a satisfactory result. Where In a case that the sample is small, the value of R-squared is a relatively optimistic overestimation of the real population value (Tabachnick & Fidell, 2007). The result of R-squared indicates that 0.077 of the change on the dependent variable is debated as an outcome of changes

in the independent variables within the research. This also means that the variation in tax avoidance, which measured by CETR, is statistically justified through the equation of regression. The results shown in Table 5 also indicate that the model is statistically significant where ($p < 0.01$) that means the applied model is strong.

In general, the outcomes in Table 5 showed that the two variables for the present paper have statistically significant relationship towards tax avoidance (measured by CETR). Where, audit quality shows a negative and statistically significant relationship toward tax avoidance among the listed companies on bursa Malaysia. This result was based on the information mentioned in Table 5 which shows a regression coefficient value -0.078 and p-value of >0.006 . This means that audit quality has a negative and statistically significant relationship towards tax avoidance. This negative result notes that when Malaysian companies rely more on the big 4 firms for audit services, the practice of tax avoidance activities will decrease and vice versa. This finding similar to the results of Lestari & Nedy (2019); Salehi et al. (2020); Riguen et al. (2020) which shows that auditor size negatively affects the tax avoidance. Table 5 also present that there is a negative and statistically significant relationship between financial performance and tax avoidance. This result may indicate that low financial performance may be one of the incentives to practice tax avoidance activities (Sánchez-Ballesta & Yagüe, 2021). This outcome confirms the results of (Tarmidi et al., 2020). They also found that profitability has statistically significantly negative relationship towards tax avoidance.

Table 5 The Relationship between audit Quality, Financial Performance and Tax Avoidance

TA	Coef.	Std. Err.	t-value	p-value	[95% Conf	Interval]	Sig
FP	-0.353	0.031	-11.53	0	-0.293	-0.414	***
AQ	-0.078	0.028	-2.74	0.006	-0.022	-0.133	***
Constant	-1.071	0.103	-10.42	0	-1.272	-0.869	***
Mean dependent var	-2.091		SD dependent var		1.783		
R-squared	0.077		Number of obs		1656		
F-test	69.03		Prob > F		0		
Akaike crit. (AIC)	6487.103		Bayesian crit. (BIC)		6503.34		

Note: TA: Tax Avoidance, AQ: Audit Quality, FP: Financial Performance.

CONCLUSION

The main objective of the current study is investigating the effect of audit quality and financial performance on corporate tax avoidance of the Companies Listed on bursa Malaysia. The study investigates the relationship between two independent variables (audit quality and financial performance) with a specific dependent variable which is tax avoidance. Based on the outcomes of the balanced panel data analysis, the two examined variables namely audit quality and financial performance were established to have negatively and significant associated with tax avoidance which was measured by cash effective tax rate (CETR). Because of the big four firms' expertise and competence, it can minimize the practice of tax avoidance activities. Moreover, the negative relationship between financial performance and tax evasion means that the lower the financial performance, the more the practice of tax evasion activities in the listed companies on bursa Malaysia. Based on the discussed results, the

current study provides significant knowledge to the regulators and policy makers about the importance of audit quality and financial performance in minimizing the practice of tax avoidance activities.

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