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Corporate Governance, Audit Oversight Board and Tax Avoidance: Malaysian Family Listed Firms

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Abstract

The aim of this study is to examine the impact of corporate governance and Audit Oversight Board (AOB) on tax avoidance of family-owned listed on Bursa Malaysia. Consistent with prior research, this study uses effective taxes rate (ETR) to measure tax avoidance. Using a sample of 1,333 firm-year observations of Malaysian family-owned public listed companies from 2014 to 2018, this study finds corporate governance and AOB affects tax avoidance practice. In particular, the findings indicate that there are significant and negative relationship between audit committee size and AOB and ETR. The results suggest that audit committee size and AOB are the most effective corporate governance mechanism in mitigating tax avoidance strategies of such firms.

Keywords: Tax Avoidance, Malaysia, Family-owned Firms, ETR

Introduction

Corporate tax is an essential source of government funding for almost all countries. It is a tax imposed by the government that all businesses must pay in order to support its social and political goals. Such taxes, however, come at a high cost to the businesses and reduce the cash flow available to the shareholders (Chen et al., 2010). Due to that, managers are more likely to engage in tax evasion and avoidance in order to lower their tax obligations. Tax evasion is a criminal crime in which businesses avoid paying their true tax obligations. Contrarily, tax avoidance is a legitimate activity that entails using different tax planning techniques to reduce tax liability. Indeed, Hidaya and Khalid (2021) state that tax avoidance is an unethical tax management strategy that aim to reduce amount of tax paid which in turn might lowering the company's operation costs. According to Pasternak and Rico (2008) corporate tax avoidance is the practice of arranging company's financial and economic affairs to minimize tax using various strategies including legal deductions, exemptions, and allowances. Although tax avoidance is a legal strategy but it will result in revenue losses to the country (Wahab et al., 2017).

Prior studies highlight the effect of corporate governance and audit quality on tax avoidance including size of the board (Armstrong et al., 2013; Setayesh et al., 2014;

Masyayekhi & Seyedi, 2015; Mohammadreza et al., 2017), size of board committee (Collier, 2006; Oussil & Taktak, 2018; Van & Quang, 2021; Mc Mullen, 1996; Lisic et al., 2019; Ashfaq & Rui, 2019). Nevertheless, these empirical research produce mixed results. Given that, this study aims to reexamine the impact of three corporate governance mechanisms; firm board size, firm board audit committee size and board independent as well as audit quality; Audit Oversight Board (AOB) on tax avoidance among Malaysian family listed firms.

This study chooses family-listed firms on Bursa Malaysia as a research setting because Malaysia has been characterized mainly by a highly concentration of family ownership. In additional, to the best of authors knowledge, very limited studies examine the impact of audit quality; AOB on tax avoidance practices among Malaysian family listed firms.

Section two provides the review of literature on corporate governance, audit quality and tax avoidance. Section three elaborate the research method of the study. Section four presents and discusses the findings. The final section provides summary and conclusions.

Literature Review

Tax Avoidance

Tax avoidance has been seen as a way to save money on taxes while increasing a company's value. Money has been transferred from the government to the corporation's owners as part of a tax-saving scheme. Tax avoidance, according to Hanlon and Heitzman (2010), is the practice of lowering explicit taxes through both legal tax-saving and tax-sheltering activities. Sari (2014) stresses that legal tax avoidance was not prohibited, but it commonly attracts unfavorable attention by the tax authorities because it causes significant revenue losses for the governments.

Corporate Governance

Corporate governance is defined as the system of control mechanisms, by which the suppliers of money to firms ensure themselves of gaining a return on their investment (Shleifer & Vishny, 1997). According to Desai and Dharmapala (2006), depending on the governance structure of the companies, the effect of strong power incentives on tax hiding may differ. Tax avoidance will boost a company's worth for well-governed enterprises, but not for poorly governed ones (Desai & Dharmapala, 2009). In a nutshell, it shows that the shareholders and investors are protected with corporate governance in place, and most studies discover a connection between corporate governance and how well a corporation operates.

Board Size and Tax Avoidance

Prior studies state that the degree of tax avoidance may vary depending on the board's size. Beasley (1996) discovered that the size of the board affects the likelihood of accounting fraud. Jensen (1993); Garcia-Meca and Ballesta (2009) suggest that the number of directors is one of the important factors in the effectiveness of a board. There are two views on this issue. Proponents of agency theory believe that a larger board has more opportunity to control and monitor the actions of management as it has a greater number of people with more expertise (Dalton et al., 1999), and valuable experience (Xie et al., 2003) to prevent or limit managerial opportunistic behaviour. Finkelstein and D'Aveni (1994) noted that a larger board has more problem-solving capabilities, as the burden facing the directors is equally shared among them.

Consistent with the theory, empirical studies document mixed results. For example, Anggraeni and Kurnianto (2020) examine the effect of board size on tax avoidance. Using 370 observations consisting from 114 manufacturing companies listed on the Indonesia Stock

Exchange from 2013-2017, the results indicate that the size of a board of directors is positively related to tax avoidance. Similarly, Pratama (2017) investigates whether company characteristics and corporate governance play a significant role in company's tax avoidance. The results showed that board size significantly affected tax avoidance practices of 70 companies in Indonesia. Recently, Egbunike et al, (2021) investigate the effect of corporate governance on tax avoidance of quoted manufacturing firms in Nigeria. The study focused on internal corporate governance mechanisms and the population comprised of all quoted manufacturing companies on the Nigerian Stock Exchange (NSE). The results showed that board size were significant. Thus, in line with the prior research this study hypothesis that:

H_1: Firm that has larger board size is more likely to mitigate tax avoidance.

Board Independence and Tax Avoidance

Fama and Jensen (1983) theorise that the board of directors is the highest internal control mechanism, responsible for monitoring the actions of top management. However, they argue that the ability of the board to act as an effective monitoring mechanism depends on its independence from management. Independent directors are believed to be able to monitor managers as they have incentives to develop their reputations as experts in decision control (Agrawal & Chadha, 2005). Thus, the presence of independent directors on the board is seen as a check and balance mechanism, enhancing a board's effectiveness and constraining opportunistic behaviour among managers. Alkurdi and Mardini (2020) explore the impact of ownership structure and board of directors' composition on the extent of tax avoidance strategies. Using sample of the Jordanian first market companies listed on the Amman Stock Exchange from 2012 to 2017, comprising 348 observations, the result shows that tax avoidance is negatively related to board independence.

However, Murni et al (2016); Yuniarwati et al (2017) fail to find any relationship between board independence and tax avoidance. Using Malaysia as a research setting, Ibrahim and Farahiyah (2021) studies on the relationship between the board's independence and corporate tax avoidance. The quantitative data came from the annual reports of the top 100 Malaysian companies based on FTSE tradable index. The quantitative analysis shows board independence not negatively related to corporate tax avoidance. In addition, Sunarto et al (2021) examine the effect of independent board on tax avoidance in banking companies listed on the Indonesia Stock Exchange over the 2014-2018 period. Using cluster sampling method of 209 companies that published complete annual reports, the results revealed independent board did not affect tax avoidance.

Nevertheless, this study predicted a negative association between board independence and tax avoidance practices, as the theory suggests.

H_2: Board independence is more likely to mitigate tax avoidance.

Audit Committee and Tax Avoidance

An audit committee is in charge of controlling the process of financial reporting and internal controller (Annisa & Kurniasih, 2012). Audit committee with accounting or financial competence may perform a better supervision for the management, therefore an immediate correction would be made when a manipulation is found (Harto, 2014). The results of research by Dewi and Jati (2014) and research by Diantari and Ulupui (2016) prove that audit

committee has a negative influence on tax avoidance. Research conducted by Abbott et al (2000) states that the audit committee independence may hinder financial reporting aggressiveness and accounting fraud. Forker (1992) argues that the existence of an audit committee can improve the internal control system and considers it as an effective monitoring device to improve the quality of information disclosure. Beasley and Salterio (2001) also argue that the board of directors and the audit committee are important internal monitoring mechanisms as it controlling the process of financial reporting and internal controls (Annisa & Kurniasih, 2012). In addition, Hsu et al (2018) examine whether audit committee members tailor their approach to overseeing the corporate tax avoidance process according to the firm's business strategy. The result show that audit committee affect tax avoidance. Arismajayanti and Jati (2017) examine the influence of audit committee independence on tax avoidance. Using 176 manufacturing companies listed on the Indonesia Stock Exchange period 2013-2016, the results indicate that audit committee independence has a negative effect on tax avoidance. Dang and Nguyen (2022) examine the impact of the characteristics of the audit committee independence on tax avoidance in Vietnam. The article uses data of non-financial firms listed on the Ho Chi Minh City and Ha Noi Stock Exchange over the period 2010–2019.The result found audit committee independence has a positive correlation to tax avoidance. Consistent with the theory, this study predicts that:

H_3: Audit committee size is more likely affect tax avoidance.
H_4: Audit committee independent is more likely to mitigate tax avoidance.

Audit Quality; Audit Oversight Board and Tax Avoidance

Kanagaretnam et al (2016) highlight the primary role of auditor is to evaluate the validity of the recognition and disclosure of tax-related items in the financial statement, which in turn indirectly affect tax avoidance strategies of client firms. They add that auditors could be exposed to litigation and reputational cost if the client firm is prosecuted by the tax authorities for being tax non-compliant. Jahene and Moez (2019) stress that audit quality protect users against managerial misconducts including tax avoidance activities.

A review of the literature documents that audit quality limit tax avoidance. For example, Kanagaretnam, Lim, and Lobo (2016) examine the relation between auditor quality and tax aggressiveness using 41,958 firm-year observations across 31 countries during the 1995 to 2007 period. They find that Big 4 auditors (proxy of audit quality) has a significant and negative relationship with the proxy of tax aggressiveness. The results reveal that Big 4 auditors are associated with a lower likelihood of corporate tax aggressiveness. Further, Gaaya et al (2017) examine whether audit quality affects tax avoidance practices by family firms. Based on a sample of 55 Tunisian listed companies from 2008 to 2013, the findings show that audit quality limit family firms incentives to be involved in tax avoidance strategies. The results suggest that external audit quality is an efficient corporate governance device that is likely to monitor family corporate decisions. Therefore, it is expected that companies controlled by high quality of audit firms are less likely to be engaged in tax avoidance strategies.

In a related study but using Tunisian data, Jihene and Moez (2019) investigate the moderating effect of audit quality on CEO compensation and tax avoidance. They hypothesize that if the audit is of high quality, managers are less motivated to engage in tax-saving positions to extract higher rents because they would bear damaging consequences if tax authorities detect aggressive positions. Consistent with their argument, the study finds that a negative association between CEO compensation and tax avoidance in well-audited firms. In

addition, Lestari and Nedya (2019) examine the relationship between audit quality and tax avoidance of 312 Indonesian manufacturing listed firms. Using three proxies of audit quality; auditor size, audit fees and audit tenure, the results show that auditor size and audit fees have negative association with tax avoidance.
Based on the empirical studies and theory suggested, this study uses audit quality proxy by Audit Oversight Board and hypothesis that:

H_5: Audit quality is more likely to mitigate tax avoidance.

Methodology

Sample Selection and Data Collection

Our sample comprised 1,333 firm-year observations of Malaysian family-owned public listed companies from 2014 to 2018. The data required for computing tax avoidance and firms' specific characteristics as control variables were collected from Thompson Reuters' Datastream. Meanwhile the data on family ownerships and various governance variables were collected from the companies' annual reports.

Operationalisation of the Dependent, Independent and Control Variables

Dependent Variables: Tax Avoidance

The dependent variable for this study is tax avoidance. Following prior research, this study uses ETR to measure tax avoidance. ETR is the ratio of the total tax expenses to the total income before tax. Consistent with Abdul Wahad et al (2017), this study classifies family-owned firms as tax avoidance firms when the ETR is lower than corporate statutory tax rates. Observations with a negative value for tax avoidance are coded as 1, represent as tax avoidance firms. Observation with a positive value for tax avoidance are coded as 0, represent non-tax avoidance firms.

Independent Variable: Corporate Governance Attributes

The key independent variable in this study is corporate governance. This study uses five proxies to measure corporate governance namely, board size, board independence, audit committee size, audit committee independence and AOB. Consistent with prior studies by Fahriani and Priyadi (2016), this study uses the number of directors on the board to measure firm board size (BODSIZE) during the observation period. The variable for director independence (BODIND) is measured as the percentage of independent directors sitting on the board (Reguera et al., 2017). In keeping with a prior research by Dang and Nguyen (2022), this study would examine two aspects of the audit committee: its size and the proportion of independent members. Meanwhile, the AOB is a dummy variable indicating whether the firm has undergone AOB inspection or not. We use the AOB Annual Report to identify AOB-inspected firms.

Control Variables

We control for a number of variables in the test. These control variables are classified into two categories: firm characteristics and board characteristics. Following Chan et al (2013), we control for firm's size. Size is measured as a natural logarithm of the total assets. Large firms often receive more media attention, have a higher analyst following and face a greater level of public scrutiny that results in less tax aggressiveness. Second, the study controlled for leverage. Firms with higher levels of debt have lower ETR because of the deductibility of

interest payments for tax purpose (Chan et al., 2013). Third, the study controlled for market to book ratio (MB). MB is a proxy for firms' investment opportunities. Spooner (1986) argues that firms with greater investment opportunities have higher ETRs. A year dummy and an industry dummy were also included in the study to control for year and industry effects.

Logistic Regression Models

To test the research aims, we run the following regression models:

$TA_{ft}=\alpha + \alpha_1 BODSIZE+\alpha_2 BODIND+ \alpha_3 AUDSIZE+\alpha_4 AUDIND+\alpha 5AOB +f(control\ variables)+\xi$ (1)

Where,

Dependent variables:

TA_{ft}	1 if the ETR is less than the statutory tax rates, 0 otherwise,

Independent variables:

$BODSIZE_{ft}$	The number of directors on the board,
$BODIND_{ft}$	The proportion of independent directors on the board,
$AUDSIZE_{ft}$	The number of audit committee
$AUDIND_{ft}$.	The proportion of independent directors of audit committee,
AOB_{ft}	1 if AOB inspection firms and 0 otherwise,

Control variables:

$SIZE_{ft}$	Natural log of total assets of firm *f* in year *y*,
LEV_{ft}	Total liabilities to total assets of firm *f* in year,
MB_{ft}	Market to book ratio of firm *f* in year *y*,
$YEAR_{ft}$	Year,
IND_{ft}	Industry

Results and Findings

Descriptive Analysis

The results show that 1041 firm year observations are engaged in tax avoidance strategies from 2014 to 2018 period. The results reveal that more that 70 percent of Malaysian family-owned firms are more likely to use various tax planning in reducing corporate tax burden.

Correlation Analysis

Coakes (2005) claims that correlation analysis aids researchers in determining if one variable is related to another by looking at the linear relationship between two variables. For this study, a correlation analysis was performed to examine the relationship between board size, board independence, audit committee size, audit committee independence, audit quality and the tax avoidance in Malaysia. A Spearman correlation test was used to ascertain whether there are any multicollinearity problems among the variables. In general, multicollinearity exists when the independent variables are highly correlated to each other, and the values of the coefficients are 0.8 or 0.9 and above (Field, 2000). Table 1 shows the summary of the correlation analysis results between the variables. The statistics show that the correlation values among the variables range between 0.005 and 0.586 These values indicate that there is no multicollinearity among the variables in this study as none of the correlations is higher than 0.8.

The results also indicate a statistically significant negative relationship between audit quality; AOB and tax avoidance

Table 1
Correlation Analysis

	Tax Avoidance	AOB	BODSZ	BODIND	AUDSZ	AUDIND
Tax Avoidance	1					
AOB	.-.152**	1				
BODSZ	-.006	.027	1			
BODIND	-.010	.018	.398**	1		
AUDSZ	-.035	-.063*	.154**	.309**	1	
AUDIND	-.011	.005	.159**	.376**	.586**	1

note: **Significant at 5% level; *Significant at 10% level

Logistic Regression Analysis
Table 2 reports the results of the logistic estimation of corporate governance, audit quality on tax avoidance. A total of five hypotheses were formulated and tested. The results show that AOB and AUDSZ have significant and negative association with the tax avoidance proxy, ETR. This suggests that the Audit Oversight Board and larger audit committee board limits Malaysian family listed firms engaging in tax avoidance. The results support prior studies Kanagaretnam et al (2016) and Gaaya, Lakhal, and Lakhal, (2017) that document audit quality mitigate tax avoidance. Further, the findings also support Sandhi (2018) that find audit committee has a significant negative effect on tax avoidance.

Table 2
Logistic Estimation Analysis on Corporate Governance, Audit Quality and Tax Avoidance

	B	**S.E.**	**Wald**	**df**	**Sig.**
AOB	-.755	.140	28.935	1	.000
BODSZ	.007	.044	.026	1	.871
BODIND	.053	.089	.361	1	.548
AUDSZ	-.281	.154	3.321	1	.031
AUDIND	.071	.130	.297	1	.586
PROFIT	.238	1.304	.033	1	.855
SIZE	-.081	.059	1.928	1	.165
GROWTH	-.078	.071	1.229	1	.268
LEV	.210	.358	.345	1	.557
Constant	2.869	.878	10.677	1	.001
R-squared	15.61%				

Summary and Conclusion
The purpose of this paper was to examine the relationship between corporate governance mechanism; board size, board independence, audit committee size, audit committee independence and audit quality; AOB and tax avoidance. The study used a sample of 1,333

firm-year observations of Malaysian family-owned public listed companies from 2014 to 2018. Overall, the result of the study finds that audit committee board size and AOB have significant and negative relationship with tax avoidance. In general, the findings suggest the number of audit committee members and AOB are the most effective corporate governance mechanism in mitigating tax avoidance strategies of Malaysian family listed firm.

This study is not without its limitations. First, this study examines only Malaysian family-owned firms listed on Bursa Malaysia. To provide more interesting and meaningful results, future studies could examine all Malaysian family-owned firms both list and non-listed. Second, this study only focuses on single measures of tax avoidance. Another avenue for future research could be to use other proxies for measuring tax avoidance in order to test for the robustness of the results of this study.

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