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The Relationship of Audit Quality and Leverage on Tax Avoidance

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Abstract. This study explores the relationship between audit quality, financial leverage, and tax avoidance strategies in publicly traded non-financial firms in Indonesia from 2018 to 2022. Given that taxation is a key source of state revenue, variations in tax regulations and corporate incentives contribute to diverse tax avoidance practices. The research examines three dimensions of audit quality—audit tenure, audit specialization, and audit firm type—and their respective impacts on tax avoidance. Employing a quantitative approach with secondary financial data from 843 IDX-listed firms, the study applies the Feasible Generalized Least Squares (FGLS) method to mitigate heteroscedasticity and autocorrelation in panel data, enhancing the robustness of findings. Results reveal that audit specialization significantly reduces tax avoidance, suggesting that industry expertise among auditors strengthens compliance. However, audit tenure, audit firm type, and leverage exhibit no significant influence. These insights emphasize the need for greater awareness among auditors and policymakers regarding tax avoidance determinants within Indonesia's regulatory landscape. Future research should further explore external factors, such as the COVID-19 pandemic, and additional variables to provide a more comprehensive understanding of corporate tax behavior.

Keywords: tax avoidance, audit specialization, audit tenure, audit firm, leverage.

JEL Code: H26, M41, M42.

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Introduction

In general, the main source of earnings in Indonesia and other countries is taxes. Taxation regulation differ for every state. They are depending on the tax system in that country. As in Indonesia, General Provisions and Taxation Procedures (KUP) in Law Number 28 of 2007 clarify that tax is a mandatory contribution to the state owed by individuals or entities that are coercive based on the law without getting direct compensation and used for the needs of the state to the greatest extent for the prosperity of the people. Variances of interest between tax law and taxpayers lead to an initiative for avoiding tax.

Prevention towards tax avoidance issues is one of the auditor‘s responsibility, which is followed by the auditor‘s understanding of financial statement reporting. In the long run, error presentation detection will be improved along the line. Considering the tenure for auditing, it is most likely being used by the entities' managers. Long-run tenure provides entities to understand the flow that creates chances for a loophole (Azizkhani et al., 2018; Salehi et al., 2018).

Tenure aside, retention of tax avoidance in Indonesia is the law that organizes loan provisions. As high as the liability in entities will greatly impact the state's earnings. Leasing and licensing practices are widely adopted as managerial planning to avoid tax payments. Loan interest expenses incurred by a loan from financing/investment will be used as advantages to reduce tax payment obligations. This variance of financing (debt bias) is often carried out by doing thin capitalization. Restricting relevancy ratio of thin capitalization related to the effect of entities capital structure (Blouin et al., 2014).

Audit capabilities as an auditor is genuinely needed to ensure the feasibility of the information contained in the financial statement (Rashdan, 2022). The value of an entity is reflected in the eligibility of the financial statements by providing the good quality of the audit results. The quality is measured from the auditor's capabilities in the determining the materiality's level and fraud detection to increase public's trust in the companies' activities. Entity's managers will try to avoid Big4 firms with high audit quality to reduce the risk while being identified by the tax authorities (Jihene and Moez, 2019).

Auditor's specialization plays a role in fraud detection, as followed by experiences. Guidelines are provided in the form of databases which is related to the inspection that have been carried out in several industries. Within the database, auditors understand the effectiveness of detailed practices, possible failures and uncommon transactions that occur in the industry. A comprehensive understanding of industry characteristics and trends will increase the effectiveness of the audit process and provide benefits in reducing the occurrence of tax avoidance (Gul et al., 2018).

This study seeks to explore the intricate relationship between audit quality, leverage, and tax avoidance within Indonesia's non-financial public firms. Focusing on entities listed on the Indonesia Stock Exchange (IDX) from 2018 to 2022, the research excludes financial institutions due to their unique regulatory and accounting frameworks. Employing a robust quantitative approach, the study relies on secondary data sourced from audited financial statements and corporate reports available through IDX. A purposive sampling technique was utilized to refine the dataset, resulting in a final sample of 154 entities, encompassing 770 firm-year observations. Through multiple regression analysis, this research examines how audit tenure, auditor specialization, audit firm type, and leverage influence corporate tax strategies. By shedding light on these dynamics, the study offers valuable empirical insights contributing to the broader discourse on audit effectiveness and tax compliance within Indonesia's evolving regulatory landscape.

1. Literature review

1.1 The effect of audit quality on tax avoidance

Financial Services Authority Regulations (POJK) in Indonesia about the deployment of public accountant services and public accounting firms in financial services activities, third section: restrictions on the use of audit services, declare the restriction of tenure on audit services on specific industries. Prior research held on Korean (Jeong and Bae, 2013) followed by observation data from KOSPI (Korea

Stock Price Index) shows an increasement in tax avoidance in audit tenure. Accumulated client-specified knowledge by auditor tenure could have occurred for the client's tax avoidance planning. As for having more experience over time towards the client's company, auditors are expected to gain more understanding (Salehi et al., 2018).

Meanwhile, research in Germany (Frey, 2018), followed by non-financial entities from German CDAX, rising in tax avoidance is an outcome of shorter audit tenure measured on tax expenses (effective tax rate) or cash tax-paid (cash effective tax rate). Within the same result, research in Indonesia and Malaysia by Rizqia and Lastiati (2021), audit quality has no impact on tax avoidance. Based on the aforementioned arguments, the subsequent hypothesis is formulated:

H1.1: The degree of audit tenure exhibits a significant negative impact on the degree of tax avoidance.

Maintaining audit quality is proven by the auditor quality and the audit firm quality. Developmental abilities in auditing due to the increasing pressure from world professional standards (Mayhew and Wilkins, 2003). Demand for industry specialization is one of the encouragements for audit firm to develop themselves in meeting the needs of the market (Craswell et al., 1995). Expertise in specific industries will decrease tax avoidance. A significant negative relationship between auditor specialization and the tax paid by the company is concluded by Hogan and Noga (2012). Meanwhile, Kanagaretnam et al. (2016) find that the auditor specialization is significantly negatively associated with tax avoidance. This is due to the reasoning with high quality of auditors concerned about the potentially detrimental practices of tax avoidance. Otherwise, Lee and Kao (2018) find that tax avoidance is more likely performed by entities in Taiwan. The auditor industry specialization played a significant role in supervising tax avoidance activities. The audit quality showed an impairment when meeting with clients who have interests. After IFRS was implemented in Taiwan, there was a shift in tax avoidance implementation. Donatella (2022) declared that there is no concrete evidence in auditor individually without audit firm specialization. The best quality is a unity of auditor industry specialized and audit firm specialized. Based on the aforementioned arguments, the subsequent hypothesis is formulated:

H1.2: The degree of audit specialization exhibits a significant negative impact on the degree of tax avoidance.

Law of the Republic of Indonesia No.5 of 2011 concerning Public Accountants defined Public Accounting Firms as business entities established under the provisions of laws and regulations and obtain a business license based on this law. Big4 audit firms are less effective in preventing practical earning management (Kim et al., 2003). Research in UK based on The Amadeus Database shows private firms using Big4 audit firms tend to be involved in tax avoidance compared to private firms using non Big4 audit firms (Beuselinck et al., 2023). There is no significant effect on public firms using Big4 audit firms and non-Big4 audit firms (Chen et al., 2021). Alternately,the audit firm is not merely as symbolic words, because of the contribution in reducing and restricting tax aggressiveness (Qawqzeh, 2023). One of the various techniques in practical management which is being used is tax avoidance (Marwat et al., 2023). Based on the aforementioned arguments, the subsequent hypothesis is formulated:

H1.3: The degree of audit firm exhibits a significant negative impact on the degree of tax avoidance.

1.2 The effect of leverage on tax avoidance

Referring to Financial Services Authority Regulations (POJK), leverage, such as debt ratio, significantly influences tax avoidance. Debt ratio, as a financial analysis tool, serves as an indicator to measure companies' financial condition regarding debt financing (Kasmir, 2017, p. 151). A study in the UK (Riguen et al., 2021) demonstrates that firms with higher leverage are more likely to engage in tax avoidance. The opportunity to avoid taxes through debt financing and greater marginal benefits of tax avoidance is especially prominent in growth firms. One of the marginal benefits is the utilization of loan interest as tax deductions (Harberger, 1959; Tambini, 1969; Stickney and McGee, 1982). Conversely, Mocanu et al. (2021) identify the relationship is negative between leverage and tax avoidance, suggesting that larger companies with lower leverage ratios are predisposed to tax avoidance.

Research conducted by Rani et al. (2023) in Indonesia concludes that leverage has an insignificant effect on tax avoidance. This finding is attributed to the high risk of default on debt, which could lead to financial failure. Based on the aforementioned arguments, the subsequent hypothesis is formulated:

H2: The degree of leverage exhibits a significant positive impact on the degree of tax avoidance.

2. Methodology

2.1 Sample selection and data source

Financial statements and audit reports were obtained from the Indonesia Stock Exchange (IDX) for the period 2018 to 2022. This timeframe captures both the COVID-19 and post-COVID-19 eras, during which the global financial crisis significantly influenced corporate financial stability and reporting practices. The study focuses on 843 publicly listed non-financial entities on the IDX, deliberately excluding financial institutions due to their distinct regulatory and accounting frameworks. However, financial companies were excluded from the analysis due to distinct accounting practices specific to their industry, as outlined by Indonesian tax regulations.

This research adopts a quantitative approach, leveraging secondary data from corporate financial disclosures and audit reports. To enhance the accuracy and reliability of the analysis, the study employs the Feasible Generalized Least Squares (FGLS) method, a robust econometric technique designed to address issues of heteroscedasticity and autocorrelation in panel data. FGLS is particularly well-suited for handling unbalanced panel datasets, ensuring efficient parameter estimation and improving the validity of statistical inferences. By integrating this methodology, the study provides deeper empirical insights into the relationship between audit quality, leverage, and tax avoidance in Indonesia's public firms, contributing valuable evidence to the field of corporate taxation and financial governance

The selection of the sample was conducted by purposive sampling technique. The sample criteria are as follows:

(1) All listed entities in the Indonesia Stock Exchange from 2018 to 2022,

(2) Entities are not part of the financial industries,

(3) Listed before the period of 2018,

(4) Annual report and financial statement are completely reported to maintain the data used in the research,

(5) Profitable companies, due to the negative value of leverage ratio, are excluded.

Table 1. **Presents the sample selection process in this research**

Description	Entities
Number of listed companies in the Indonesia Stock Exchange	843
Entities in Financial Industries	(106)
Listed after the 2018 book's period	(227)
Incomplete Financial Statements and/or Annual Reports as research developed	(75)
Record Loss for any Book's Period	(281)
Entities for Samples	154
Observation (5 years)	770 data

Source: Indonesia Stock Exchange Compilation

2.2 Research variable

To study the association of variable audit quality and leverage to tax avoidance, here below is the formulating formula:

$$CETRit = \alpha0 + \alpha1AuTnit + \alpha2AuSpit + \alpha3AuFrit + \alpha4DERit + \varepsilon it; \quad (1)$$

here:

CETR – cash effective tax rate;

AuTn – audit tenure;

AuSp – audit specialization;

AuFr – audit firm;

DER – leverage.

2.3 Definitions of variable

Audit tenure, length of tenure in auditing by audit firms is measured by the total consecutive years where audit firms perform audit on the entities. This measurement has been used in the studies Myers et al., (2003) and Salehi et al. (2020). Furthermore, Audit Specialization (dummy variable speculation) in this study is measured using a dummy variable. This measurement has been used in the studies of Craswell et al. (1995) and Riguen et al. (2021). As specialization is measured by the entities industries, Audit Specialization is given a value of 1 if audited by an audit firm from the same industries within a percentage more than or equal to 20 percent. Audit Specialization is given a value of 0 if audited by an audit firm from the same industries within percentage less than 20 percent. Audit Firms, the type of audit firms is measured using a dummy variable. This measurement has been used in the studies of Bae (2017) and Chen et al., (2021). As audit firms' types are widely known as Big4 or Non-Big4, audit firms categorised as Big4 such as KPMG, PwC, EY, and Deloitte are given a value of 1. Thus, audit firms categorized as Non-Big4 are given a value of 0. Debt Ratio is used to monitor thin capitalization, which shows the debt level of tax avoidance activity from debt financing (Schwarz, 2009). This measurement has been used in the studies Dwenger and Steiner (2014) and Zafar et al. (2019). Tax Avoidance is measured by cash Effective Tax Rate (CETR) (Hanlon and Slemrod, 2009), which has been known as the most accurate and reliable proxy for assessing tax avoidance, offering a clear view of a company's actual tax payments in relation to its pre-tax income (Dyreng et al., 2008).

3. Results of the research

3.1 Descriptive statistics

Table 2 shows that the tax avoidance variable has an average of 0.40, with the lowest value of 0.00 and the highest value of 15.93. The standard deviation of 0.78 indicates a huge level of variance of tax avoidance among the entities. The leverage variable has an average of 0.89, with the lowest value of 0.04 and the highest value of 6.91. The standard deviation of 0.80. It can also be seen that audit tenure has a minimum value of 1 and a maximum value of 5, which show the average as 2.70 and the standard deviation as 1.40.

Table 2. **Ordinal data – descriptive statistics**

Variable	N	Min	Max	Avg	Std Dev
Audit Tenure (X1)	770	1	5	2.70	1.40
Leverage (X4)	770	0.04	6.91	0.89	0.80
Tax Avoidance (Y)	770	0	15.93	0.40	0.78

Source: Stock Exchange Data Compilation

Table 3. **Nominal data – descriptive statistics**

Variable	Description	Freq	Perc
Audit Specialization (X2)	Specialized Industry Audit Firm	705	91.56%
	Non-specialized Industry Audit Firm	65	8.44%
	Total	770	100.00%
Audit Firm (X3)	*Big*4 Audit Firm	329	42.73%
	Non-*Big*4 Audit Firm	441	57.27%
	Total	770	100.00%

Source: Stock Exchange Data Compilation

The Table 3 also shows that the percentage of specialized industry for audit firm is 91.56 and the percentage of non-specialized industry for audit firm is 8.44. The usage percentage of the Big4 audit firm is 42.73 and the usage percentage of non-big4 is 57.27.

3.2 Correlation matrix

Table 4 demonstrates a negative and significant relationship between the AuSp variable and the TaxAv variable, aligning with the proposed hypothesis. This result indicates that an increase in the AuSp level corresponds to a decrease in the level of tax avoidance. This finding provides empirical support for hypothesis H1.2. Furthermore, Table 4 reveals that the correlation values among all variables are below 0.8, confirming the absence of multicollinearity issues in the models employed in this study.

Table 4. **Correlation matrix**

	TaxAv	AuTn	AuSp	AuFr	Lvrg
TaxAv	1.00000				
AuTn	0.03070	1.00000			
AuSp	-0.06620	-0.01170	1.00000		
AuFr	-0.08270	0.02580	-0.14380	1.00000	
Lvrg	0.17700	-0.01950	-0.06850	0.04130	1.00000
Notes: TaxAv, the level of tax avoidance; AuTn, the tenure of audit; AuSp, the speciality of auditor; AuFr, type of audit firm; Lvrg, leverage scaled by total debt on total equity.					

Source: Stata17 regression

3.3 Regression results

Table 5 demonstrates that Audit Tenure exhibits a negative and statistically insignificant coefficient. This finding suggests that the duration of audit tenure negatively influences, albeit insignificantly, the level of tax avoidance. As the duration of audit tenure increases, companies' propensity for tax avoidance decreases. This result aligns with the findings of Frey (2018) and Rizqia and Lastiati (2021), who reported no significant impact of audit tenure on tax avoidance. However, this study contradicts the findings of Jeong and Bae (2013) and Salehi et al. (2018). Consequently, hypothesis H1.1 is rejected.

Table 5 indicates that Audit Specialization has a negative and statistically significant coefficient. This result implies that the level of audit specialization usage negatively and significantly affects the extent of tax avoidance. As the utilization of audit specialization increases, the likelihood of companies avoiding tax decreases. This finding corroborates prior research by Hogan and Noga (2012), Kanagaretnam et al. (2016) in 31 different countries, and Riguen et al., (2021) in the UK. However, it contradicts the findings of Lee and Kao (2018), who reported a positive relationship between audit specialization and tax avoidance in Taiwan. Therefore, hypothesis H1.2 is accepted.

Table 5. **Regression results**

Variable	Sign	Coefficient	t-statistic
Audit Tenure (X1.1)	-	-0.358557	0.103
Audit Specialization (X1.2)	-	-6.773702	0.022
Audit Firm (X1.3)	+	0.0763268	0.843
Leverage (X2)	+	0.1690836	0.795

Source: Stata17 regression

Table 5 reveals that the Audit Firm has a positive and statistically insignificant coefficient. This result suggests that the level of audit firm engagement has a positive, albeit insignificant, correlation with the extent of tax avoidance. As the engagement of audit firms increases, companies' propensity for tax avoidance also increases. This finding is consistent with Chen et al., (2021) but contradicts the research of Kim et al. (2003) and Qawqzeh (2023). Consequently, hypothesis H1.3 is rejected.

Table 5 demonstrates that leverage has a positive and statistically insignificant coefficient. This result indicates that the level of leverage positively influences, albeit insignificantly, the extent of tax avoidance. As the utilization of leverage increases, companies' propensity for tax avoidance also increases. This finding aligns with Rani et al. (2023) but contradicts the Financial Services Authority Regulations (POJK), Riguen et al. (2019), and Mocanu et al. (2021). Therefore, hypothesis H2 is rejected.

Conclusions and recommendations

The study concludes that there are insightful findings on the relationship between audit quality, leverage, and tax avoidance in Indonesia. This study also shows that the level of audit quality proxied by audit specialization negatively influences tax avoidance significantly, meaning that higher audit specialization is associated with lower levels of tax avoidance. This agrees with prior studies by Hogan and Noga (2012) and Kanagaretnam et al. (2016) in the understanding of industry expertise about 31 different countries that will contribute to reducing tax avoidance practices. However, no significant evidence has been found regarding the effect of audit quality when represented by audit tenure and audit firm on tax avoidance; this may mean that these dimensions of audit quality need further investigation in future studies. The study did not support the association between leverage and tax avoidance, too against Rani et al. (2023) findings. These factors will provide the most useful implications for auditors, policymakers, and researchers in understanding the variables determining tax avoidance behaviour within the non-financial public firms of Indonesia. For this, future research in the area may consider the influence of the COVID-19 pandemic on tax avoidance practice, adding other variables which could be relevant to the dynamics of tax avoidance so that a comprehensive understanding of the tax avoidance phenomena in the Indonesian context is provided.

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