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Auditor characteristics on tax avoidance by non-financial companies: Evidence from the Indonesia Stock Exchange

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ABSTRACT

Tax revenue realization in Indonesia is not inseparable from tax avoidance by business entities. The research was conducted to examine the effect of auditor characteristics as proxied by auditor industry specialization, audit tenure, and audit opinion on tax avoidance by non-financial companies listed on the IDX. This study used a set of panel data that consisted of non-financial companies listed on the IDX operating in the 2017-2020 period. The data were obtained from the companies' annual report. The result of this study demonstrated that auditor industry specialization had a significant positive effect on tax avoidance, while audit tenure did not affect tax avoidance. There was a positive relationship between audit opinion and tax avoidance. This research has limitations as it was only conducted for a short period. Further research can develop this model by including variables which were excluded from this study and involving more samples and sectors of the research objects.

Introduction

The potential for tax revenue in Indonesia is very promising considering the number of business entities registered as taxpayers (Said, 2017). However, the tax income realization in the country has not been optimum yet. This is potentially influenced by tax avoidance and tax evasion by companies that are subject to corporate tax (Makhabati & Adiwibowo, 2019). In fact, tax avoidance and tax evasion are closely related to underground economy or black economy (Manita & Khoirunurrofik, 2021) which accounts for 8% of Indonesia's GDP (Samuda, 2016). Such phenomena can be manifested in the form the transfer of taxpayers' assets to countries that apply zero tax rates (tax haven countries), which influences the percentage of the realized tax revenues. Thus, tax avoidance has become one of the many factors that influence the total tax revenue in Indonesia (Hajawiyah et al., 2021).

Hajawiyah et al. (2021) argues that the potential tax revenue can be measured from the number of existing tax sources. Tax revenue is defined as the revenues received by the tax office for tax payments from taxpayers (Hajawiyah et al., 2021). In a broad sense, tax avoidance is the ability to pay taxes in relatively small amounts compared to the company's pre-tax income (Dyreng et al., 2008). Thus, tax avoidance significantly affects the amount of taxes paid to the state. On a large scale, tax avoidance will make significant losses to the country, so the effort to improve tax compliance is important. Several studies have been conducted in the accounting and finance literature related to the company's efforts in reducing its tax obligations. For examples, tax avoidance (Annisa & Kurniasih, 2012; Hogan & Noga, 2011; Salehi et al., 2020), tax management (Mulyadi & Anwar, 2015), tax aggressiveness (Balakrishnan et al., 2018; Higgins et al., 2015; Kim & Zhang, 2016), and tax planning (Shaipah et al., 2012). One of the factors that are interesting yet not widely explored as a determinant in tax studies is a company's auditor characteristics.

Aggressive tax avoidance by companies has negative implications for the country as it threatens the realization of tax revenue by the government that is actually useful for funding government programs for the people. Thus, aggressive tax avoidance becomes an important issue as it reduces the contribution of the private sector to support the country's development through government programs. In addition, aggressive tax avoidance also reduces the accountability of a company, thus increasing the urgency for further studies on this issue. One of the significant aspects in ensuring the accountability of a company is external audit. External audit has the ability to provide assurance of how accountable a company is, one of which related to corporate taxation.

However, there are two views in describing the impact of auditor characteristics on tax avoidance. The first view sees tax avoidance as a form of an empirical phenomenon based on agency theory and its implications for tax decisions based on managers' interests (Salehi et al., 2020). In order to control this, the role of stakeholders is very important in providing direction and supervision related to agency cost management (Jensen & Meckling, 1976). Hence, the auditor may play a significant role in detecting tax avoidance and report it to the stakeholders. On the other hand, the second view suggests that the companies normally attempt to reduce additional taxes owed and usually rely on tax consultants that may also be provided by the parties related to the auditor (Hogan & Noga, 2011). In fact, 65 per cent of companies use tax consulting services and other services from auditors. A qualified auditor will be able to understand the client's industry and tend to understand more about the client's tax issues. Considering these two contrasting views, investigating the impact of auditor characteristics on tax avoidance becomes interesting.

The urgency of the study is supported by the fact that the previous studies in this field have several limitations, one of which is the inconsistency of research findings. Firstly, the auditor industry specialization variable in some previous studies by Hogan and Noga (2011), McGuire et al. (2012), and Lee and Kao (2018) stated that auditor industry specialization influenced tax avoidance. This is not in accordance with studies by Salehi et al. (2020) and Bauer et al. (2012), showing that auditor industry specialization had no effect on tax avoidance. Then, the audit tenure variable in research by Jeong and Bae (2013), Shiba (2015), Frey (2018), and Salehi et al. (2020) was found to have an effect on tax avoidance. Meanwhile, in research by Suyadnya and Supadmi (2017), it was found that audit tenure had no effect on tax avoidance. Given the limitations of previous studies, this study attempted to answer the question regarding the impact of auditor industry specialization, audit tenure, and audit opinion on company's tax avoidance.

Our research was conducted to examine the effect of auditor characteristics as proxied by auditor industry specialization, audit tenure, and audit opinion on tax avoidance in the non-financial companies listed in the Indonesia Stock Exchange. This research provides useful recommendations for the Indonesian government, especially the Directorate General of Taxes, in detecting the indications of corporate tax avoidance based on auditor characteristics. The first part is the introduction. The second part contains a literature review. The third part describes the research method. The fourth part presents the research results. Finally, the las part is the conclusion of this study.

Literature Review

Agency Theory

Tax avoidance as a form of opportunistic behavior by taxpayers to minimize the tax burden can be explained through the perspective of agency theory (Desai & Dharmapala, 2006). Agency theory explains agency relationships that lead to agency conflicts because both have conflict of interests (Jensen & Meckling, 1976). The conflict of interests between the agent and the principal results in the failure to achieve the principal's goal even though the agent is obliged to fulfill the principal's interests (Mantysaari, 2009). In this case, the government (principal) has legal rights to collect taxes from the income earned by the company as a taxpayer (agent), but the company has its own interests to maximize profits. These contrasting interests cause the state revenue provided by taxes to be less optimal because of the opportunistic actions of taxpayers through tax avoidance (Widyanto et al., 2019).

The variables of interest in this study were also related to the agency theory. The first variable was auditor industry specialization. Corporate management to fulfill its opportunistic desires utilizes information asymmetry in financial statements. This is contrary to what is expected by investors, i.e., financial statements should contain relevant and reliable financial information. This is related to how tax industry specialist auditors conduct financial statement audits (Hogan & Noga, 2011; Salehi et al., 2020). The second variable was audit tenure. The corporate management that intend to attempt tax avoidance have auditor-client expectations with the Public Accounting Firms (Lee & Kao, 2018). Hence, whenever the audit results are in line with management's expectations, it is possible to extend the contract with the Public Accounting Firm. Investors as principals have a will for a limit for one Public Accounting Firm to audit one company, assuming the interests of the auditor-client's expectations. The third variable was audit opinion that illustrates accountability and compliance, including taxation practices (Kanagaretnam et al., 2016). Misconducts such as aggressive tax avoidance can be indicated and become crucial points for determining audit opinions.

Effect of Auditor Industry Specialization on Tax Avoidance

Companies that make tax savings usually use the services of an auditor for tax decisions (Hogan & Noga, 2011). Companies have a tendency to attempt tax avoidance, but auditor industry specialization can be a factor to prevent or allow tax avoidance in client’s business (Lee & Kao, 2018). In their research, McGuire et al. (2012) found that companies that use the services of tax auditors have more involvement in tax avoidance practices. Companies use the competence of auditors in financial and tax matters to carry out tax planning efforts (Salehi et al., 2020). Meanwhile, the findings of Bauer et al. (2012) demonstrate no effect between auditor industry specialization and tax evasion. During this pandemic, many companies were affected by financial problems and business continuity, so companies in Indonesia were indicated to use auditor industry specialization in the imposition of tax planning. Based on the abovementioned explanation, the first hypothesis was proposed as follows:
H_1: Auditor industry specialization affects tax avoidance.

Effect of Audit Tenure on Tax Avoidance

Bae (2017) found that there was a positive relationship between audit tenure and tax avoidance practices. Tax arrangements can be adjusted to the longer the audit tenure. Companies that have been audited, and then re-audited

by the same company will have an increased ETR level (Frey, 2018). With longer audit tenure, it will be easier for the company to identify the method estimated by the auditor. Jeong and Bae (2013) and Shiba (2015) also mentioned that audit tenure had a positive association with aggressive tax avoidance behavior. More specifically, Jeong and Bae (2013) stated that corporate tax avoidance increased with longer auditor tenure, reflecting that the client has benefit in tax planning, in which tax payments could be minimized when the auditor tenure increases. Furthermore, the sudden changes that occurred during COVID-19 provided a reason for companies to increase audit tenure, indicating an increase in tax avoidance behaviour. Thus, we formulated the following hypothesis:
H_2: Audit tenure affects tax avoidance.

Effect of Audit Opinion on Tax Avoidance

The credibility of financial statements can be seen through the company's audit process. The final result of the company's audit process is an audit report which is an illustration of the level of independence of the auditor during the audit process and its relation to fair and unreasonable audit opinion. The level of corporate transparency can be measured by the extent of the tax avoidance by the company (Li & Ma, 2018). In short, tax avoidance behaviour can affect the auditor's opinion. This argument is supported by the findings from Salehi et al. (2020) in which an unqualified audit opinion was less related to tax avoidance than those companies receiving a qualified audit opinion from external auditors. Khan et al. (2017) also found that a modified audit opinion was related to the tax avoidance level in the company. Thus, the hypothesis can be formulated as follows:
H_3: There is a relationship between audit opinion and tax avoidance.

Research Method

This was a causal study. The research was conducted to test the effect of independent variables on the dependent variable using a quantitative approach. The population of this study was all non-financial companies listed on the IDX operating in the 2017-2020 period. The researcher used non-financial companies as the population because the business processes between non-financial and financial companies have different segments. Thus, examining the economic development of non-financial companies in Indonesia was interesting. The data were collected from the annual reports as well as the company's financial statements following the specified period. The data were in the form of non-financial companies listed on the IDX for the 2017 to 2020 period. As a result, the research data were panel data. Panel data is a set of longitudinal data in the form of a combination of time series data and cross-section data (Gujarati, 2004). Our sampling method used purposive sampling. We selected a sample with the following criteria: 1) We excluded data with incomplete information that could not be used as research material; 2) We excluded data that did not use rupiah currency; and 3) We excluded observations of firms that had negative income before tax. Finally, this study involved 235 samples.

Table 1. Variable Measures

Variable	Symbol	Measurement	Authors
Tax Avoidance	ETR	Effective Tax Ratio, calculated by Income Tax divided by Earning Before Income Tax	Bae et al. (2017); Lee and Kao (2018), Bauer et al., (2012), Salehi et al. (2020)
Auditor Industry Specialization	Special	Dummy variable: 1 for public accounting firm that has a market share of more than 30%; and 0 otherwise.	Frey (2018), Lee and Kao (2018), Bauer et al. (2012), Mcguire et al. (2012), Salehi et al. (2020)
Audit Tenure	AT	The number of consecutive years since the company has been audited by the same accounting firm	Lestari and Nedya, (2019), Salehi et al. (2020), Suyadnya and Supadmi (2017)
Audit Opinion	AO	Dummy variable: 1 if the auditor issues an unqualified opinion without an explanatory paragraph; and 0 otherwise.	Riguen et al. (2021), Salehi et al. (2020)
Firm Size	SIZE	Natural logarithm of total assets	Bae et al. (2017), Cahyono et al. (2016), Lee and Kao (2018), Salehi et al. (2020), Sumunar et al. (2019), Suyadnya and Supadmi (2017)
Firm Age	AGE	The number of years since the company has been listed on the Indonesia Stock Exchange	Salehi et al. (2020)
Profitability	ROI	Return on Investment, calculated by Earnings After Tax divided by Total Assets	Berliana and Mahpudin (2021), Salehi et al. (2020)
Leverage	DAR	It is calculated through total debt scaled by total assets	Lee and Kao (2018), Rizqia and Lastiati (2021), Rusydi (2013), Salehi et al. (2020), Sumunar et al. (2019)

There are three basic techniques in panel data analysis, namely the pooled least square model (Common Effect), the fixed-effect model (Fixed Effect), and the random effect model (Random Effect) (Gujarati, 2004). The best estimation among these techniques was used for testing the effect of auditor industry specialization, audit tenure, and audit opinion on tax avoidance. Further, to get a comprehensive analysis of the effect of the independent variables, control variables were used, consisting of a company size variable with a classification of the company's total assets, company age, profitability, and leverage.

This study used panel data regression analysis for hypothesis testing with the help of the Stata version 14 program. We used the samples from 87 non-financial companies in Indonesia with a total of 235 observations and a significance level of 90%. Tax avoidance was used as the dependent variable while auditor industry specialization, audit tenure, and audit opinion were employed as the independent variables. We also used several control variables, namely Size, Age, ROI, and DAR as the control variables. The model used to test the hypothesis is defined as follows:

$$ETR = a + \beta_1 Special + \beta_2 Tenure + \beta_3 Opinion + \beta_4 SIZE + \beta_5 AGE + \beta_6 ROI + \beta_7 DAR + \in$$

Where:
ETR = Tax Avoidance (ETR)
β_1-β_7 = Regression Coefficient
∈ = Errors
Special = Auditor Industry Specialization
Tenure = Audit Tenure
Opinion = Audit Opinion Type
SIZE = Company Size
AGE = Company Age
ROI = Return On Investment
DAR = Debt to Total Asset Ratio

Results and Discussion

Descriptive Statistics

The research data analysis started with descriptive statistics to analyze the general summary of our data. The result as presented on Table 2 shows that the average value of the tax avoidance proxied with ETR was at 0.248 or around 25%., thus classified as a low ETR value, indicating a higher level of the company's tax avoidance. The auditor industry specialization and audit opinion variables were dummy variables, so the descriptive statistics were carried out separately. Auditor industry specialization was categorized by the type of public accounting firm that audit the company. There were 52.8% companies audited by specialized public accounting firms and 47.2% audited by non-specialized public accounting firms. In relation to the audit opinion variable, it can also be emphasized that in 209 financial years, the auditor has issued a reasonable opinion without any additional language and additions, i.e. 89% of the total research financial year, have provided a qualified audit report.

Table 2. Result of Descriptive Statistics

Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ETR	235	0.248	0.042	0.134	0.349
Special	235	0.528	0.5	0	1
Tenure	235	5.379	3.103	1	13
Opinion	235	0.889	0.314	0	1
Size	235	29.289	1.574	25.726	33.495
Age	235	17.826	9.967	1	39
ROI	235	0.074	0.046	0.006	0.24
DAR	235	0.401	0.175	0.016	0.813

Multiple Regression Analysis

This study estimated the model to determine the best model for this study. The results showed that the Random Effect model was the best model used in this study. Table 3 presents the results of the Auditor Industry Specialization regression on tax avoidance. The coefficient value of 0.001 indicated that Auditor Industry Specialization affected tax avoidance, which supported hypothesis 1. The coefficient of Audit Tenure was negative at 0.616, thus not supporting hypothesis 2. The coefficient of audit opinion was -0.63, indicating that audit opinion had a negative effect on tax avoidance. From Table 3, it can be seen that all the control variables, except ROI, did not support the hypotheses. These results indicated that the company's ROI influenced tax avoidance. Companies with high profits will have to pay greater taxes, so these companies will tend to avoid tax.

Table 3. Result of Multiple Linear Regression Analysis

ETR	Coef.	St. Err.	t-value	p-value	[95% Conf	Interval]
Special	-0.027	0.009	-3.19	0.001	-00.044	-0.011
Tenure	-0.001	0.001	-0.50	0.616	-0.003	0.002
Opinion	0.015	0.008	1.86	0.063	-0.001	0.03
Size	-0.005	0.003	-1.67	0.095	-0.01	0.001
Age	0.000	0.000	-0.05	0.961	-0.001	0.001
ROI	-0.229	0.072	-3.18	0.001	-0.37	-0.088
DAR	0.009	0.021	0.44	0.658	-0.032	0.051
Constant	0.433	0.087	5.00	0.000	0.263	0.602
Mean dependent var		0.248	SD dependent var			0.042
Overall r-squared		0.121	Number of obs			235
Chi-square		23.654	Prob > chi2			0.003
R-squared within		0.049	R-squared between			0.161

Discussion

Auditor industry specialization and tax avoidance

The regression result in this study demonstrated that auditor industry specialization had a positive impact on the decision-making policies of a company, related to the tax reporting of a company. The findings in this study are in line with Hogan and Noga (2011) study, reporting that companies that involve tax services consultation outside of the audit engagement will bring significant benefit to the company in which the company can make tax savings. This proves that there is a relationship between auditor industry specialization and tax avoidance. This finding supports hypothesis 1 and produces similar findings to previous studies conducted by Lee and Kao (2018) as well as McGuire et al. (2012). These studies documented that companies audited by external auditors with industry specialization tended to have more aggressive tax avoidance practices. Furthermore, Hoelscher and Seavey (2014) stated that auditor industry specialization had a positive relationship with corporate risk taking. Therefore, it may encourage the company to commit aggressive tax saving activities. Another study by Frey (2018) also supported our finding in which the engagements with tax certified individual auditors were associated with higher effective tax rates. In this regard, audit industry specialization in taxation leads to fee premium for tax aggressive client (Donohoe & Knechel, 2012). Taylor et al. (2018) also found that auditor specialization was positively related with higher tax aggressiveness and transfer pricing.

Audit tenure and tax avoidance

The audit tenure variable had no significant effect on tax avoidance. Hence, the finding rejected the proposed hypothesis 2. This result is similar to the finding generated by Suyadnya and Supadmi (2017) who reported that audit tenure had no significant effect on tax avoidance. This result is also supported by research by Angela et al. (2019), where the proxy for audit tenure as measured using public accounting firm and auditor partner tenure can have a different effect on corporate tax avoidance. The study from Suyadnya and Supadmi (2017) also showed that audit tenure did not affect the level of corporate tax payment effectiveness. Indeed, several studies in the past also support this insignificant result. Longer auditor appointment did not really affect the tax avoidance level of a company. From the regulatory point of view, the result is also in line with the auditor rotation requirement set by the regulatory bodies. In this regard, the implementation of auditor rotation has also been mandatory in Indonesia (Kalanjati et al, 2019), thus reducing the probability of long auditor tenure exceeding the regulated terms (Liu et al., 2021). Exceeding the maximum consecutive audit years stated in the regulation will be given serious concern and even sanction by the regulators. Therefore, both the company and public accounting firm will have no choice but obeying the regulation by replacing the auditor after five consecutive years of audit engagement. It aims to improve audit quality, ensure independency, and reduce potential malpractice that may result from long auditor-client relationship (Kalanjati et al., 2019; Suwarno et al., 2020). Finally, the implementation of limited audit tenure and auditor rotation expectedly prevents aggressive tax avoidance by companies.

Audit opinion and tax avoidance

The regression results showed that audit opinion had a significant effect on tax avoidance at a significance level of 0.1. This indicates that a company that wants to manipulate earnings is positively related to modified audit opinions reported by an auditor. This means that companies are less involved in tax avoidance actions, so the quality of accounting information transparency increases, leading to unqualified audit reports by external auditors. This finding is in line with Salehi et al. (2020) and Riguen et al. (2021) that there was a relationship between the type of audit opinion with tax avoidance. Previous studies also documented similar results. Kanagaretnam et al. (2016) acquired robust empirical evidence that auditor quality had a negative relationship with the likelihood of aggressive tax avoidance. Audit opinion can be a reliable indicator whether a company is engaged in aggressive tax avoidance activities or not. Audit opinion can also be a reliable reflection of audit quality. In this case, well-audited companies are less likely to be engaged in risky tax saving activities (Jihene & Moez, 2019). Therefore, tax avoidance can be expected to be lower when a company acquires unqualified audit opinion. The level of transparency in a company involves the consideration related to the level of aggressive tax avoidance practice. With less aggressive tax avoidance, the auditor in this case will have more reason to issue an unqualified audit opinion.

Conclusion

Given the number of companies registered as taxpayers, the potential for Indonesian tax revenue is very promising. However, achieving national tax revenues is not yet optimal. The suboptimal realization of tax revenue may be affected by tax avoidance and tax evasion practices by businesses that are subject to taxes. Companies normally use tax avoidance to maximize after-tax income. Based on the results of the panel data regression analysis on 87 non-financial companies in Indonesia from 2017 to 2020, Therefore, the main objective of this study was to determine whether audit characteristics had a significant effect on tax avoidance in non-financial companies in Indonesia. In accordance with our expectations, the results of the first hypothesis showed that there was a relationship between auditor industry specialization and tax avoidance. We found that auditor involvement with corporate tax services will affect the firm's ETR level. Our findings are consistent with Hogan and Noga (2011), Mcguire et al. (2012), and Lee and Kao (2018) but not consistent with a study of Salehi et al. (2020).

Contrary to our expectations, hypothesis 2 was not supported, in which a significant relationship between auditor-client tenure and tax avoidance was not found. In fact, the results of our second hypothesis are similar to those of Suyadnya and Supadmi (2017), but not consistent with studies of Jeong and Bae (2013), Shiba (2015), Frey (2018) and Salehi et al. (2020). This might be influenced by the latest regulations related to audit period, namely Government Regulation Number 20 of 2015 article 11 paragraph (1) concerning Public Accounting Practices which explains that Public Accounting Firms are no longer limited to auditing a company. These restrictions only apply to public accountants, namely for 5 consecutive financial years, thus giving rise to a more random audit tenure.

In addition, our study found a positive relationship between audit opinion and tax avoidance. This relationship is due to the company's transparency interests which are indirectly related to tax avoidance. This is further supported by an audit opinion issued by an external auditor. Our findings are similar to those found by Salehi et al. (2020) and Riguen et al. (2021).

This study has several limitations. The first limitation is that this study was only conducted in a short time and with a small observational value. This is different from Salehi et al. (2020) research conducted in all corporate sectors on the Tehran Stock Exchange. Furthermore, the auditor characteristic variables can actually be further developed by using other proxies, for example the audit fee variable. This study did not use this variable due to limited access to audit fee data for each company. Further research expectedly can develop a research model by including variables excluded in this study and using more samples and sectors of the research object.

In general, the results of this study will have practical implications for the public and users of financial statements. This research expectedly will provide knowledge about the important role of an auditor in the credibility of financial statement information. This research can also be used as a basis for stakeholders to make decisions by reflecting on auditor characteristics and their relationship with corporate tax avoidance behavior in Indonesia. By reading this research, stakeholders will be able to assess which companies disclose financial information correctly based on the auditor's assessment. This investigation is a form of appeal for stakeholders in the company to always provide correct financial information and their working relationship with the auditors.

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