The Effect of Audit Quality on Tax Avoidance: Evidence from Listed Companies in Sri Lanka

Nilupuli N.V.A.N.[1] and Manawadu I.[2]

[1]*School of Accounting and Business, Institute of Chartered Accountants of Sri Lanka*
[2]*Department of Interdisciplinary Studies, University of Moratuwa*

[1]*nimna.nilupuli@gmail.com*, [2]*imanawadu.uom@gmail.com*

Abstract

The objective of this study is to investigate the effect of audit quality on tax avoidance in listed manufacturing and diversified holding companies in Sri Lanka. The audit quality is determined based on the size of the auditor. That is, by checking if the financial statements are audited by big four firms. This study uses a quantitative approach, with a population of 33 manufacturing and 14 diversified holding companies listed in Colombo Stock Exchange in the period of 2015-2019 with an exclusion of banking, finance & insurance sector due to inherent limitations. Fixed effect model and random effect model were used to analyse the data. The result of the panel regression shows that there is a negative relationship between audit quality and tax avoidance in Sri Lanka. However, the relationship is not significant statistically. This study contributes to tax avoidance literature that audit quality also a determinant of tax avoidance.

Keywords: *Colombo Stock Exchange (CSE), corporate tax avoidance, earning management, Board characteristics, Agency theory*

1. Introduction

Tax is an obligation of each individual in a country (Annuar, Salihu, Normala, & Obid, 2014). This study focuses on corporate taxation and the corporate tax avoidance literature by determining the relationship between board characteristics and return on equity. Corporate entities must oblige to prevailing tax laws in a country, which will, calculated from their net income before tax multiplied by current tax rate. Tax payer believes that tax is an obligation that obstructs the growth of the company (Annuar et al., 2014). There are many ways for a company to minimize their tax liability, through legally mechanisms (tax avoidance).

According to Pratama (2017), tax avoidance can be used as a legal tool to reduce taxes. At the same time government wants to imply more taxes on companies as it is the primary source of income in the country. This potential crisis between two parties can be defined as agency conflict. Tax avoidance is an exploit faced by many organizations in the world thus the impact and relationships between