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Effect of CEO Compensation on Corporate Tax Avoidance and Role of Audit Quality as Moderation Variable

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Abstract

This research aims to investigate the influence of CEO Compensation on Corporate Tax Avoidance (CTA) and examine the role of Audit Quality (AQ) as a moderating variable that can increase the influence of CEO compensation on CTA. This study employed quantitative research by moderated regression analysis (MRA) with the STATA program, and this method used the annual report of firms listed on the Indonesian stock exchange from the 2018-2020 period with a sample of 195 firms. The results showed that CEO compensation influences CTA as measured by DER. That is, the higher CEO compensation made the company can improve CTA. The results of this research also show that Audit Quality (AQ) as a moderation variable is proven empirically able to decrease the influence of CEO compensation on CTA.

Keywords : CEO Compensation, CTA, Audit Quality
JEL Classification : G30, G32, G34

1. INTRODUCTION

Importance in selecting and making decisions to pursue a field to achieve goals (Mennita and Abdillah, 2022). Users of financial statements can be referred to as stakeholders, who expect financial reports to be achieved and generated high profits for the company (Abdillah et al., 2020). The company as a corporate taxpayer is one of the contributors to tax contributions in Indonesia (Rachdianti et al., 2016). There is an evasion of taxes made by the company resulting in the government has strategy to minimize activities (Annuar et al, 2014).

The company considers that tax is a burden that must be issued on income earned in one period which can reduce net income. On the side, tax revenue for the government is state income which has an important role to finance maintenance. Differences in interests between taxpayers and the government cause taxpayers to reduce the tax burden through various efforts to avoid legal and illegal taxes (Moeljono, 2020).

Tax sector revenue contributes majority of the state budget from the government (Rakayana et al., 2021). For several years, the determination of the target figure for tax revenues often misses the actual revenue figure and considers failed to achieve the target (Kahpi, 2015). From 2018-2020, Indonesia's performance tax ratio or tax ratio is still low compared to Western European or ASEAN countries, such as Philippines, Singapore, Malaysia, and Thailand. During this period, Indonesia's tax ratio stagnated at 10-12% (Ardillah and Halim, 2022). Meanwhile, Singapore recorded a level of 13-14%, Malaysia 12-15%, the Philippines 17-18%, Thailand 17-17.5%, and the highest was Western Europe at 41% (Ramalan, 2021).

Revenue from taxes must continue to be increased and optimized so that the country's economic growth. Tax revenue cannot rely solely on increasing the role of the Director General of Taxes, but also on the participation and enthusiasm of the taxpayers (Friskianti & Handayani, 2014). Corporate Tax Avoidance tends to be carried out by the company when the company has a higher profit. In addition, the mechanism supervising the performance of directors through the implementation of good governance manages to determine the level of CTA (Nugroho & Firmansyah, 2017).

Compensation issues for chief executive officers are a very important issue and are being discussed ongoing in the financial literature (Usman et al., 2015). In recent years the issue of compensation is of concern to academics, standard setters, and the public (Gigliotti, 2013). This level of executive compensation relates to how company performance operates. This shows that every bonus given to the CEO has a big responsibility to the company.

Research by Gaertner, (2013); Wang and Yao, (2021), explain that CEO compensation affects CTA. Another study conducted by Armstrong et al., (2013); Chee et al., (2017), give different results that CEO compensation does not influence CTA. The inconsistency of the research results on the effect of CEO compensation on CTA is thought to be because executive compensation does not affect management in making decisions to do CTA (Ardillah and Prasetyo, 2021). However, management should have an effect on making a decision in the company (Köse, 2016).

This research refers to the research of Gaertner, (2013), explaining the relationship between CEO compensation and CTA. The results of his research indicate that CEO compensation has effects on CTA. The first difference in this study is the measurement of CTA calculated by changes in working capital from EBIT or Earnings Before Interest and Taxes (Satyadini, 2018), which previously study only used ETR (Effective Tax Rate). Thus, EBIT takes the added value for studies using financing profit as the dependent variable (Beer et al., 2018).

The second difference in this study is the addition of Audit Quality as a moderating variable between CEO compensation and CTA. Based on Jihene and Moez, (2019), explain that the Audit Quality (AQ) moderates the disclosure of CEO compensation and CTA. AQ influences CEO compensation and CTA, so CEO compensation becomes a moderation of the relationship between CEO compensation and CTA.

According to Jihene and Moez (2019), an effective governance mechanism to safeguard the interests of shareholders on the opportunistic behavior of managers is AQ. AQ will give confidence to the information presented in the financial statements because the information has been checked by the auditor. An audit report so to speak quality if the auditor is able to assess the fairness and is able to detect the occurrence of indication of fraud on the company's financial statements (Krisna, 2019). AQ has a role in maintaining the disclosure of information provided by management to shareholders. To be able to assess fairness and detect indications of fraud, it is required a more experienced and competent auditor at the Big Four Public Accountant (Krisna, 2019). CTA behavior can be influenced by agency problems in agency theory (Jensen and Meckling, 1976). Therefore, this study contributes to the confirmation of agency theory.

This research has several contributions both theoretically, and practically. Theory contributes to the influence of CEO influence on tax avoidance and the role of AQ using agency theory. The use of AQ is expected to be able to provide CEO compensation in overcoming the problem of tax avoidance so that agency theory gives shareholders confidence in company management in Indonesia. Practically contribution is considered one of the most effective governance mechanisms.

It is hoped that the research carried out can provide theoretical benefits by adding related scientific insights. Besides, this research is expected to be an input for the regulator in decision-making. Based on the above problems, this study aims to test empirically the effect of CEO compensation on CTA and AQ as moderation.

2. LITERATURE REVIEW

Agency Theory

Agency theory assumes that executives act in their own interests, then a mechanism is needed so that executives do not ignore the interests of shareholders (Jensen and Meckling, 1976). Based on Panda and Leepsa, (2017); Yasa and Novialy, (2012), explain that the agency relationship is an agreement between one or more of the principals who have given responsibility responsible to the agent to run the company's operations including corporate decision-making.

In this case, the principal authorizes the agent to run the company in the hope of the principal getting the maximum profit or profit, while on the part of the agent who knows the work operations and the state of the company trying their best so that the company can have maximum profit so that it can be seen by the principal that the performance that has been done looks good. It shows there is a difference in the interests of both the agent and the principal, so it is called the information asymmetry. One way to minimize information asymmetry is to use the principal to give a big bonus to the agent. This action is taken in order to control the agent (Suhendah and Imelda, 2012). CEOs with small compensation tend to be more daring to carry out CTA.

Corporate Tax Avoidance

CTA is a tax saving by utilizing legal provisions for tax liability (Lim, 2011). Based on Susyanti (2015: 12), CTA is a form of resistance in a variety of legally justifiable ways. CTA is not illegal in tax law although it often gets less attention either from the tax office because they are considered to have less nationalist assumptions. In contrast tax evasion, is an effort to reduce the amount of tax by violating the rules applicable to taxation. Tax evaders can be subject to administrative sanctions as well as criminal based on actions (Priantara, 2009: 453-454).

CEO Compensation

Compensation is everything that is given by the company as remuneration for the performance produced in the interests of a company, especially to the executive. The high compensation given to executives is able to increase the level of tax avoidance of the led companies to even greater. In this study, executive compensation in question is a form of award given by the company to executives or employees in the form of financial or goods as an award for performance that has been done.

Compensation is a payment of financial services to employees as remuneration for work that has been done and as motivation implementation of activities in the future

(Handoko, 2008). Based on Scott (2006:303) explains executive compensation as an agency contract or agreement between a company and a manager that aims to align the interests of company owners and managers by providing compensation to managers based on one or more performance measurements in operating the company.

Executives who act as operational leaders of the company make CTA policies if they benefit from these policies and actions. Providing high compensation to executives in this case is one of the best ways to bridge the differences in interests between those who run and are directly involved in the company's operations and the principal. Compensation is given to executives in the hope that the company will run in accordance with applicable policies (Handoko, 2011).

Audit Quality

Based on Arinda & Dwimulyani, (2018), AQ is everything that happens when the auditor does work by analyzing the financial statements of the client company. Based on the audit report is a picture of a company. A dummy variable is a tool used to measure AQ in a company, namely whether or not a public accounting firm is used by the company.

According to multiple references, the Big Four public accountant (Price Waterhouse Cooper, Deloitte, KPMG, Ernst & Young) shows a lower risk of fraud compared to firms audited by the KAP Non-Big Four (Annisa and Kurniasih, 2012). In addition to AQ, management can be used as a force for the implementation of corporate governance if it is implemented effectively. Risk management is a strategy used to develop and manage all risks within the company (Meizaroh and Lucyanda, 2011).

The Influence of CEO compensation on CTA

The executive as an individual is the holder of control and policy over the company. As the chief executive, if the executive does something, he will benefit from an action taken, therefore the executive who has ownership of the company will directly or indirectly try to increase the company's cash flow to obtain high profits. Armstrong et al. (2015) studied the relationship between managerial incentives and corporate tax avoidance. They found a significant and positive association between the two variables suggesting that risk-taking equity incentives motivate managers to engage in risky activities like tax avoidance. Thus, tax avoidance practice is not necessarily associated with a high level of CEO compensation.

This is because he will find something if he also gets on it. Actions on tax avoidance can obtain tax payments that indirectly positively affect the company's cash flow. Therefore, it can be concluded that the greater the compensation received by the CEO compensation, they are getting bolder in doing CTA. So, the hypothesis can be determined as follows:

H1: CEO compensation has a positive effect on CTA

The Influence of CEO compensation on CTA and Moderated by Audit Quality

Research by Kanagaretnam et al. (2016); Gaya et al. (2017) found that auditor quality as proxied by auditor size had a significant negative effect on CTA behavior. This study hypothesizes that AQ as proxied by the size of public accountant is negatively related to CTA because the higher the AQ, the lower the company will undertake CTA. Agency theory illustrates that the difference in interests between management and shareholders can have an impact on decision-making in the company. Providing high compensation to management triggers tax avoidance efforts which are supported by a low level of AQ.

This indicates that the implementation of good AQ can reduce CEO actions in tax avoidance.

According to Jihene and Moez (2019), AQ is an effective governance mechanism to safeguard the interests of shareholders against the CEO's opportunistic behavior. This statement is supported by research from Jihene and Moez (2019) which states that AQ is able to detect errors and trigger companies to take lower tax avoidance actions with a high level of CEO compensation. So, the hypothesis can be determined as follows:

H2: AQ negatively affects CEO compensation and CTA

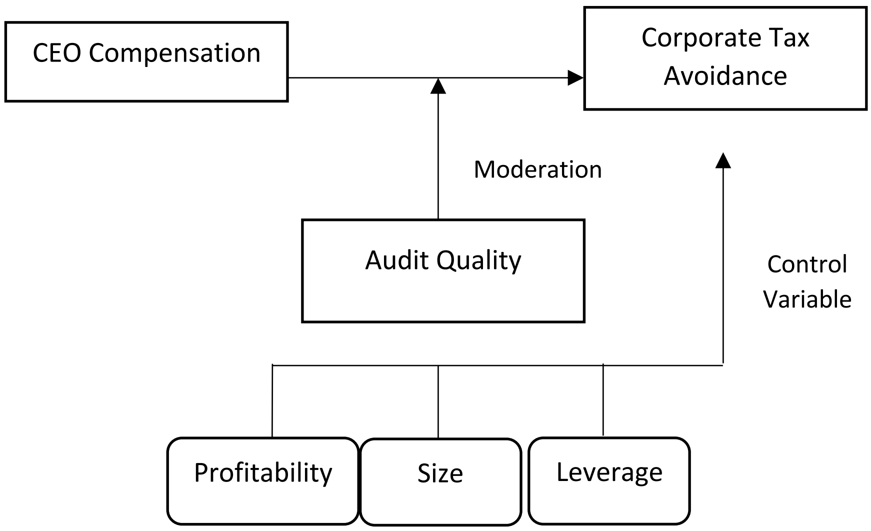

Figure 1. Research Model

3. RESEARCH METHOD

Determination of this study samples by decision sampling. For evaluation samples, samples are taken according to certain criteria. Decision sampling selects subjects who can best provide the information researchers needed (Sekran and Bougie, 2013:252).

Table 1. Judgmental sampling

Number	Criteria	Number of Companies
1	The firms listed on the main board in IDX.	352
2	The firm does not publish a financial report respectively during the period of 2018-2020	(101)
3	The firms which have negative profits during 2018 – 2020	(108)
4	The firms have Cash Effective Tax Rates (CETR) more than once.	(38)
5	Number of the firms which fulfill the criteria in taking the sample	90
	Total	195

Annual reports were obtained from IDX and the company's website. Obtain sample integration and control for moderator effects using moderated regression analysis (MRA)

(Ghozali, 2009:203). The data were confirmed with STATA. The operational definition of each variable is given in Table 2.

Table 2. Operationalization of variables

Variable	Definition	Indicator
CTA	CTA is the reduction of explicit taxes with perfectly legal tax saving activities (Hanlon and Heitzman, 2010).	EBIT
CEO Compensation	CEO compensation can be calculated using the total compensation received by the executive for a year as a proxy for executive compensation (Armstrong et al., 2012).	Total Compensation Received
Audit Quality	AQ is the advantage of auditors from big four KAPs compared to non-big four KAPs (Cristian, 2018).	Big 4 Audit Firm Public and Dummy
Firm Size	The size of the company.	SIZE = Natural log of total asset
Profitability	Firms' ability to use their capital to obtain revenue (Pahuja, 2009).	ROA = Net Profit / Total Assets x 100%
Leverage	The ratio used to measure the firm's assets financed (Pahuja, 2009)	Debt Ratio =The total amount of debt / Total Assets X 100%

This research applied estimated generalized least square (GLS) of random effects (RE) and fixed effect models to panel data to understand the effect of CEO compensation and CTA and AQ as moderation. GLS used the Houseman test to find among RE and FE models (Abdillah, 2022). The form regression model used in this study was as follows:

$$\boldsymbol{CTAi.t} = \boldsymbol{\alpha i.t} + \boldsymbol{\beta 1}\text{CEO}\boldsymbol{i.t} + \boldsymbol{\beta 2}\text{AUDIT}\boldsymbol{i.t} + \boldsymbol{\beta 3}\text{SIZE}\boldsymbol{i.t} + \boldsymbol{\beta 4}\text{PROFIT}\boldsymbol{i.t} + \boldsymbol{\beta 5}\text{LEV}\boldsymbol{i.t} + \boldsymbol{\beta 6}\text{CEO}\boldsymbol{i.t} * \boldsymbol{\beta}7\text{AUDIT}\boldsymbol{i.t} + \boldsymbol{\epsilon i.t}$$

$\boldsymbol{CTAi.t}$	:	Corporate Tax Avoidance *i* period *t*
$\boldsymbol{\alpha}$	:	Constanta
$\boldsymbol{\beta}$	:	Regression Coefficient
CEO$\boldsymbol{i.t}$	:	CEO Compensation *i* period *t*
AUDIT$\boldsymbol{i.t}$	:	Audit Quality *i* period *t*
SIZE$\boldsymbol{i.t}$	:	Company Size *i* period *t*
PROFIT$\boldsymbol{i.t}$	:	Company Profitability *i* period *t*
LEV$\boldsymbol{i.t}$	:	Leverage *i* period *t*
$\boldsymbol{\epsilon i.t}$	:	*Error*

4. RESULTS AND DISCUSSION

Descriptive statistical tests are used to describe the subject of this study, including standard deviation, minimum, maximum, and mean. Table 4 shows the results of descriptive statistical tests for the variables in this research

Table 1. Descriptive statistics

Variables	N	Min	Max	Mean	Standard Dev
CTA	195	0.00	0.52	0.26	0.13
CEO	195	21.01	50.03	31.02	13.02
AQ	195	0	1	0.5O	0.39
Size	195	24.71	34.89	29.71	13.21
Profitability	195	0.01	32.02	13.11	09.24
Leverage	195	0.10	0.42	0.29	0.19

Notes: CTA (Corporate Tax Avoidance), CEO (Chief Executive Officer) Compensation, AQ (AQ), SIZE (Firm Size), Profilability (Return of Asset), LEV (Leverage).

The descriptive statistics results of this study are shown in the table above. The CTA variable has an average value of 0.26 and a standard deviation value of 0.13. CEO Compensation variable has a mean value of 31.02 and a standard deviation of 13.02. The AQ variable has a mean value of 0.5O and a standard deviation of 0.39. The Size control variable has a mean value of 29.71 and a standard deviation of 13.21. The profitability control variable has a mean value of 13.11, with a standard deviation of 09.24. Thus, the value of the leverage control variable has a mean of 0.29 with min and max values of 0.10 and 0.42 and a standard deviation of 0.19.

Table 2. Regression Equation

Variables	Constanta	CEO	AQ	Leverage	Age	Size	R-Square
Score	0.187	0.049	0.102	0.211	0.110	0.012	0.89

Notes: CEO (Chief Executive Officer) Compensation, AQ (AQ), SIZE (Firm Size), Profilability (Return of Asset), LEV (Leverage).

In the study, the results of a standard hypothesis test using the Shap-Wilk test for the financial industry showed significantly higher scores than alpha (O.O51). Thus, the residual model for each variable is normally distributed. Testing the multicollinearity hypothesis using the Variance Expansion Factor (VIF) test in the financial industry shows that the VIF value for each independent variable is less than 1O and the tolerance for each independent variable is greater than or equal to O.1O. Therefore, no multicollinearity issues are found. The results of testing the Brusch-Pagan model and testing the variable variance hypothesis in the financial industry received significant values (Prob) over no problem with variance.

Based on Hausman's test, this study selected a panel regression model from the regression models between SM and social impacts on financial performance variables, resulting in a random effects model equivalent to 0.181. The R-square value is close to 1, which means that the independent variable provides almost all the information needed to predict the dependent variable (Ghozali, 2016). That means the R-squared results are large, and the model's CEO Compensation is very capable of explaining the variations that occur in corporate tax avoidance.

Table 3. Resuls of Moderation Regression Analysis

CTA	N	Coefficient	t-count	Sig.	R-Squared
CEO	195	0.78	3.35	0.00*	
AQ	195	0.01	0.13	0.04*	
CEO*AQ	195	-0.11	3.19	0.02*	0.89
SIZE	195	-0.19	3.01	1.11	
PROFIT	195	0.02	0.11	0.03*	
LEV	195	0.13	0.13	0.82	

*Sig. at level 0.05 ($p<0.05$)

Notes: CTA (Corporate Tax Avoidance), CEO (Chief Executive Officer) Compensation, AQ (Audit Quality), SIZE (Firm Size), Profilability (Return of Asset), LEV (Leverage).

Effect of CEO Compensation on CTA

CTA is considered to be an effective way to achieve corporate tax efficiency. These results are from research by Armstrong et al. (2012) which state that executive compensation affects CTA. Desai and Dharmapala (2006) argue that high compensation can motivate tax evasion. Likewise, Armstrong et al (2012) argue that high compensation disclosures reduce costs that must be applied by the company. According to Armstrong, et al (2015) Compensation given to executives or CEOs aims to influence their performance and increase the company's stock price. On the other hand, the company also increases profit after tax by reducing the company's tax payments.

According to the results of this study, it can be seen that the provision of executive compensation was achieved due to an increase in profits and tax payments. Therefore, the executive will try to reduce the payment of the high tax burden. In order for executives to carry out their duties properly, the company is by adding a compensation system in the form of bonuses, allowances, or welfare facilities, and adding a stock-based compensation system.

The results of this study support previous research conducted by Gaertner, (2013); Wang and Yao, (2021), which provides empirical confirmation that CEO compensation has a positive effect on CTA, but the results of this study do not support research conducted by Armstrong et al., (2013); Chee et al., (2017), which provides empirical confirmation that CEO compensation has no effect on corporate tax avoidance actions.

The Role of Audit Quality as a Moderating Variable

The results of this study prove that AQ weakens the effect of CEO compensation on CTA. The higher CEO compensation leads to lower CTA, and the existence of AQ can reduce opportunistic manager behavior will further reduce CTA. Based on the quality of the audit as an external party capable of good supervision of managers, it is predicted that a greater CEO compensation does not need to be done because AQ has evaluated managers.

Based on the role of AQ in evaluating management, the opportunistic nature of CEO compensation can be minimized and further pressure managers not to do CTA. Quality audit plays an important role in evaluating, and influencing managers which can reduce the occurrence of conflicts of interest. AQ is used as a measure of the strengths and weaknesses of evaluation mechanisms in corporate governance practices, and proves that in companies with AQ, management tends not to do CTA. Moreover, the impact of board compensation on tax avoidance will be negative.

5. CONCLUSION

Based on the results and discussion, it can be concluded that CEO compensation has a positive effect on CTA. This shows that the higher CEO compensation causes CTA to increase. From the results of hypothesis testing and discussion, it can be concluded that CEO compensation has a positive effect on CTA. This is due to the provision of executive compensation to improve performance and cost efficiency by avoiding taxation. In order for CEO compensation to carry out executives in accordance with their duties better, the company must provide a compensation system in the form of bonuses, benefits, or more welfare facilities and add a share-based compensation system. The higher the CEO compensation, the higher the corporate tax avoidance action.

Based on this research, we found a negative association between CEO compensation and corporate tax avoidance and AQ as moderation. The results of this study indicate that CEO compensation given to executives is an effective way to increase CTA. This result suggests that managers are willing to engage in risky activities that offer additional rewards. Thus, AQ is considered one of the most effective governance mechanisms.

This study has several limitations where this study is only limited to 195 companies that do not explain the general results in other industrial sectors. According to limitations, it is recommended for future research to expand the object of research with variations between industrial sectors (Abdillah et al., 2020) with the aim of broadly describing the state of tax avoidance in Indonesia. Finally, further research is expected to develop or add variables in tax avoidance research in order to be able to provide results that better describe the factors that influence tax avoidance.

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