Research on the Impact of Tax Evasion on Audit Fees of Companies in China

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Keywords: Tax Evasion, Tax Differences, Audit Fees.

Abstract: Based on the value effect and agency effect of tax evasion, this paper discusses the relationship between tax evasion and audit fees by using the method of large sample study and least square regression. The regression results of this paper show that tax evasion increases the risk of the auditors, so they will increase the audit fees as a compensation, and the audit fees are positively related to the degree of tax evasion. This paper enriches the research on the effect of corporate tax avoidance from the auditor's perspective, and also provides institutional investors with countermeasures for corporate governance under different risk levels. For listed companies, they should establish a correct concept of tax evasion; and for accounting firms, they need not only to rely on the positive effect of tax avoidance under low tax evasion, but also to prevent and resolve the risk of management's opportunistic behavior under high tax evasion.

1 INTRODUCTION

Tax risk is usually a risk that an enterprise's tax related behavior fails to correctly and effectively comply with the provisions of the tax law, which may lead to the loss of future profits of the enterprise. Enterprises need to pay taxes according to laws and regulations. However, with the increasing pressure on enterprises to operate, in order to maintain normal operation, enterprises have reduced expenditure in various ways, and tax expenditure accounts for a large proportion of total enterprise expenditure. Therefore, companies have the motivation to delay this part of expenditure as much as possible through the activity of tax evasion. Due to the differences between China's accounting system and tax system, information asymmetry and insufficient policy implementation, enterprises have provided operating space for tax avoidance, It makes tax avoidance feasible (Li Yinxiang and Xu Wenjing, 2022). However, tax evasion is an activity that is divorced from the edge of laws and policies. The tax risks generated by tax evasion are very important for enterprise risk management. Although tax expenditure has been saved to a certain extent, improperly handled tax risks will cause great trauma to the enterprises, seriously interfere with the normal operation of enterprises, and even lead to business crisis and even bankruptcy of the entire enterprise, Therefore, tax evasion is also an important source of audit risk.

The audit fee is a certain amount of fee charged by the certified accountant to the auditee to make up for the cost paid in the audit process after providing audit services. Therefore, to some extent, audit fees reflect the compensation required by certified public accountants for audit risks, that is, the greater the audit risks undertaken by certified public accountants, the higher the audit fees. When a company conducts tax evasion activities, there are chaotic and uncertain transactions within the company, which improves information asymmetry in tax related aspects of the enterprise, blurs the true accounting information of the enterprise, and may even create conditions for management fraud or urge the management to purchase audit opinions to cover up some negative information. At this time, the certified public accountants may need to spend more time and energy to understand the audited entity and assess the risk of material misstatement of the financial statements. The certified public accountants are faced with greater audit burden and risk, so they will increase audit fees as appropriate. Most of the existing scholars believe that tax evasion increases

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the risk of the auditee, and the CPA will increase the audit fees as a compensation, which means that tax evasion has a negative impact on enterprises. By analyzing the impact path of tax evasion on audit fees, this paper theoretically explores whether the tax evasion of the auditee will have different mechanisms on audit risk and audit fees.

The structure of the following parts of this paper is as follows: The second part is literature review and theoretical analysis. Through literature review in related fields, research hypotheses are proposed; The third part is the research design; The fourth part is empirical regression, descriptive statistics and regression results; The fifth part is the conclusion and related discussion.

2 LITERATURE REVIEW AND THEORETICAL ANALYSIS

2.1 The Mechanism of Corporate Tax Evasion

Summarizing the research of relevant scholars at home and abroad, corporate tax evasion can form two different mechanisms: the value effect and the agency effect of tax evasion.

2.1.1 The Value Effect of Tax Evasion

Cai and Liu (2009) thought that tax evasion could decrease the tax payable of companies, retain more cash flow, ease the financing burden and enhance the sustainable operation ability of enterprises. Chen Shenglan and Jia Siyuan (2016) believed that tax evasion had a significant positive net effect on the cash holding value of enterprises. The cash saved by tax evasion for enterprises was conducive to reducing leverage, reducing enterprise capital costs, capturing investment opportunities, and even distributing it to shareholders. Song Hang and other scholars (2019) believed that tax evasion reduced the possibility of enterprises falling into financial difficulties and was conducive to dealing with the uncertainty of the business environment.

2.1.2 The Agency Effect of Tax Evasion

However, the complexity and concealment of tax avoidance also provide an opportunity for the management to seek rent, which leads to tax avoidance becoming a "black box" that causes agency problems. The agency effect mechanism believes that tax evasion has certain risks, which will weaken the effectiveness of the contract. Normal remuneration cannot compensate for the risks brought by tax avoidance, which will worsen the principal-agent problem. In addition, for tax evasion, enterprises need to design complex and vague economic exchanges to support their tax avoidance arrangements, which reduces the transparency of enterprise information and makes it more difficult for shareholders to supervise the management. Considering their own interests or reputation and other factors, the management does not arrange tax evasion activities with the goal of maximizing enterprise value, resulting in enterprises failing to make full use of preferential tax policies to pay more taxes, Or make too radical tax avoidance strategies (Desai, 2006).Graham and other scholars (2012) believe that tax evasion is often related to abnormal accounting estimates, accounting judgments and related transactions, which reduces the credibility of financial statements, blurs the true performance of enterprises, increases the risk of financial restatement, increases the workload of auditors and raises the potential litigation risk. This tax avoidance behavior that damages the quality of enterprise accounting information obviously increases audit costs. Liao Xinxin (2016) believed that in order to avoid being reviewed by the tax authorities, the management would usually construct complex and opaque transactions to cover up their tax avoidance behavior. This aggravates the information asymmetry between the internal and external of the enterprise, making the management have the opportunity to use the complex and hidden tax avoidance activities to engage in profit manipulation, tunneling and other self-interest behaviors to erode shareholder wealth.

2.2 The Effect of Tax Evasion on Audit Fees

2.2.1 The Value Effect of Tax Evasion on Audit Fees

Beck et al. (2014) believed that tax evasion enhances the sustainable operation ability of enterprises, mainly because tax evasion saves the expenditure that should be handed over to the tax collection and management authority, and converts these expenditures into the operating cash flow of the company, thus reducing the possibility of enterprises suffering from financing difficulties, high financing costs and other difficulties, and also reducing the probability of enterprises facing financial constraints or going bankrupt, thus making it possible for auditors to reduce the risk assessment value.

2.2.2 The Agency Effect of Tax Evasion on Audit Fees

Desai and Dharmapala(2005)believed tax evasion may aggravate the agency conflict, which is mainly because after tax evasion becomes a financial adjustment tool, the management may no longer be responsible, fair and honest, but instead hope to fulfill the compensation contract concluded with the board of directors through tax evasion and other manipulation behaviors, which helps to fufill the requirements of the compensation contract in a disguised way, reduces the effectiveness of the compensation incentive, even induces the manager to commit fraud opportunistic behaviors such as rent-seeking and defensive behaviors that seek their own interests increase the incentive and supervision costs of the board of directors, thus making the management have the motivation to purchase and manipulate audit opinions in the form of increasing audit fees to send a positive signal to the outside world.

2.2.3 The Influence of Accounting Information Quality on Audit Fees

Hope and other scholars (2013) believe that tax evasion may increase the risk of information disclosure of enterprises. This is mainly because companies, in order to avoid tax evasion from being exposed to the vision of tax collection and management departments, will implicitly disclose transactions related to tax evasion, increasing the degree of information asymmetry, reducing the credibility of financial statements, blurring the true performance of enterprises, and increasing the risk of financial restatement, increased the audit resource input of firms and potential legal litigation risks.

Based on the review of the above theories, this paper proposes two opposite research hypotheses:

H1: The degree of tax evasion is negatively related to audit fees

H2: The degree of tax evasion is positively related to audit fees

3 RESEARCH DESIGN

3.1 Data Source

The financial data of this paper is selected from the CSMAR database, using A-share listed companies as empirical samples, with the annual distribution interval of 2011-2020, and the following data screening and cleaning procedures are implemented: (1) eliminate the enterprise samples with missing values; (2) Clear ST or * ST company; (3) Remove the sample with negative income tax expense and pre tax profit. A total of 67275 sample observations were obtained after data cleaning. In order to eliminate the interference of extreme abnormal data on the empirical results, this paper implements a 1% tail reduction for all variables.

3.2 Variable Definition

At present, the commonly used indicator of tax evasion degree is the difference between accounting and tax. The difference between tax and accounting has the function of signal transmission, which can reflect the tax related behavior of enterprises to the stakeholders in the capital market. The difference between tax and accounting is significantly and positively related to the tax adjustment made by the tax authorities, indicating that under the background of the existing tax collection and management system, the difference between tax and accounting has become the key basis for the tax collection and management departments to study and judge the size of tax evasion suspicion of listed companies. This paper uses the accounting tax difference (Btd) to measure the degree of tax evasion. Btd is equal to (pre tax accounting profit taxable income)/total assets at the end of the period. The larger the Btd, the greater the difference between the accounting profit and the taxable income, so that enterprises are more likely to engage in tax avoidance activities.

Referring to the practice of existing literature, this paper takes the natural logarithm of the total annual audit fees of listed companies to obtain the audit fee index (lnfee).

In the selection of control variables, this paper uses the existing research literature for reference to control the company size, business complexity (Arlnv) and return on assets (ROA). Therefore, the fixed effects of year and industry classification are added to the model to control the potential factors affecting audit fees. We can see Table 1 for the detailed definition methods of the above variables.

Table 1: Variable definition.

Type	Variable	Variable name	Variable definition
Explained variable	lnfee	Audit fees	Natural logarithm of audit fees of listed companies
Explanatory variable	Btd	Tax evasion	Accounting - tax differences
Control variables	Size	Company size	The natural logarithm of the company's annual total assets
	Arlnv	Business complexity	Proportion of the sum of accounts receivable and inventory in total assets
	ROA	Return on assets	Ratio of net profit to assets

3.3 Econometric Model

In order to verify the link between tax evasion and audit fees, this paper uses OLS regression method to test and control the two fixed effects of year and industry. The model is as follows:

$$Lnfee_{i,t} = \beta_0 + \beta_1 Btd_{i,t} + controls + \varepsilon_{i,t} \quad (1)$$

3.4 Research Method

This paper establishes an empirical model and constructs a multiple linear regression equation by computer, uses stata 15 and excel forms as the tools to sort out the data of the paper. Stata is a complete and integrated statistical software that provides users with data analysis, management and professional charts. According to the established model to regress, and draw the conclusion of this paper based on the analysis of empirical results.

4 EMPIRICAL REGRESSION

4.1 Descriptive Statistics

Table 2 shows the results of descriptive statistical analysis of variables. Among them, the average value of audit fees (lnfee) is 13.659, the maximum value is 19.403, and the minimum value is 9.210, indicating that there is a large difference in audit fees between different enterprises, and there is no obvious distribution in the explained variables. The average value of tax evasion (Btd) is 0.03, the standard deviation is 0.994, and its standard deviation is 30 times of the average value. It can be seen that the volatility of tax evasion is large, and its maximum value is 7.518, indicating a considerable proportion of enterprises are engaged in tax evasion, and tax evasion is universal in the market.

Table 2: The outcome of descriptive statistics.

Variable	Obs	Mean	Std. Dev.	Min	Max
lnfee	67275	13.659	0.779	9.210	19.403
Size	67275	21.901	1.316	15.233	28.843
ARLNV	67275	0.218	0.160	5.801	0.976
ROA	67275	0.033	0.241	-30.806	7.964
Btd	67275	0.030	0.994	-252.519	7.518

Note: Table 2 is the descriptive statistical results, which is formed after inputting relevant instructions using the data processing software called Stata in the computer.

4.2 Correlation Analysis

Based on the value effect of tax evasion, the quality effect of accounting information and the agency effect of tax evasion, this paper believes that there is a non-linear multi-dimensional relationship between the degree of tax evasion of the auditee and audit fees. Therefore, the samples are divided into two categories: the low tax avoidance sample (L-sample) and the high tax avoidance sample (H-sample). The audit fees, tax evasion and other variables in the samples are analyzed for correlation. The test results are shown in Table 3:

Table 3: Group correlation test results

Variable	L-sample		H-sample	
	lnfee	Btd	lnfee	Btd
lnfee	1		1	
Btd	-0.039***	1	0.045***	1

Note: Table 3 shows the statistical results after inputting the correlation analysis instruction by using the data processing software in the computer. And *** indicates a significant correlation at the 0.01 level (bilateral).

Among them, in the L-sample with low tax evasion, there is a significant negative correlation between audit fees (lnfee) and tax evasion (Btd) at the level of 1%, which is consistent with the assumption H1. In the H-sample with high tax evasion, there is a significant positive correlation between audit fees (lnfee) and tax evasion (Btd) at the level of 1%, which is consistent with the assumption H2. The results of correlation analysis show that there is a nonlinear relationship between the degree of tax evasion and audit fees. When the degree of tax evasion is low, the audit fees decrease with the increase of tax evasion; When the company has a high degree of tax evasion, the audit fees will increase with the increase of tax evasion.

4.3 OLS Regression Results

The following is the OLS regression results after regression in this paper, as shown in Table 4:

Table 4: Regression analysis results

Var	(1)	(2)	(3)
Cons	13.660*** （6.780）	3.827*** （2.539）	3.891*** （2.914）
Btd	0.005* （1.597）	0.019*** （1.710）	0.012*** （1.672）
Size		0.449*** （56.340）	0.449*** （56.340）
ARLNV			0.231*** （0.781）
ROA			-0.118*** (-1.450)
Grow			1.780* (1.741)
Year	control	control	control
Industry	control	control	control

Note: Table 3 shows the regression results formed by inputting multiple regression analysis instructions with the data processing software in the computer. And *** indicates a significant correlation at the 0.01 level (bilateral).

Column (1) is a regression between the audit fee of the explained variable (lnfee) and the degree of tax evasion of the explanatory variable. The regression result is positive at the 10% significance level, indicating that the higher the degree of tax evasion, the higher the auditor's fee will be; Column (2) shows that on the basis of regression of audit fees (lnfee) and tax evasion, plus the control variable size, the regression results are significantly positive; The last column (3) is a regression of all control variables with the control variables ROA, Grow and ARLNV. The regression results show that the larger the enterprise is, the higher the business complexity is, the higher the audit fees will be. Therefore, it supports the above hypothesis H2: tax evasion is positively related to audit fees.

5 CONCLUSION

The research finds that when the tax evasion degree is low, the value effect of tax avoidance dominates, and tax evasion is significantly negatively related to audit fees. With the improvement of the tax evasion degree of the auditee, accounting firms reduce audit fees; When the degree of tax evasion is high, the agency problem caused by tax avoidance is dominant, and tax evasion is significantly positively related to audit fees. With the improvement of the degree of tax evasion of the auditee, accounting firms require higher audit fees.

The empirical analysis process of this paper discusses the auditor's pricing decision under the risk of tax evasion. There are some suggestions for helping enterprises to formulate reasonable tax evasion policies. Firstly, companies should establish a correct concept of tax evasion. When conducting tax evasion, managers should not aim at minimizing the actual tax rate, but they should give consideration to the relevant costs and benefits, treat tax evasion rationally and be alert to the managers' self-interest and irrational short-sighted behaviors. Secondly, managers should not only rely on the positive effect of tax avoidance under low tax evasion, but also prevent and defuse the risk of managers' opportunistic behaviors under high tax evasion. In particular, we should judge whether tax evasion has exceeded the internal control system framework of enterprises. In addition, the audit firm should fully identify and absorb tax related information released by institutional investors, form two groups of external supervision forces, and jointly improve the governance effect of external supervisors. Third, the government should improve the listed companies and the implementation regulations, specifically require enterprises to report tax adjustment related information in the financial statements and their notes, and supplement institutional investors' research information related to intervention tax.

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