IMPACT OF TAX AVOIDANCE ON FIRM VALUE AND THE MODERATING ROLE OF CORPORATE GOVERNANCE: EVIDENCE FROM PAKISTAN MANUFACTURING FIRMS

***Noroze Khan**
MS Scholar, Faculty of Management sciences, Foundation University Islamabad.
Email: norozekhan999@gmail.com

Naeem Ullah
Faculty of Management Sciences, Foundation University Islamabad

Nida Aman
Management Studies Department, Bahria University Islamabad

Numair Ahmed Sulehri
Faculty of Management Sciences, Foundation University Islamabad

Abstract

This study aims to examine the impact of tax avoidance on firm value and the moderating role of corporate governance, using a sample of 120 non-financial firms listed on Pakistan Stock Exchange from the period 2013 to 2017. This research used a proxy ETR (effective tax rate) to measure tax avoidance. Tobin Q is used to measure economic value of the firm. Corporate governance index (CGI) is employed to measure the corporate governance. Dynamic panel estimation under GMM environment is estimated to tackle the problem of endogeneity. This research documented that tax avoidance is negatively associated with the firm value. Consistent with prior studies that agency conflict plays an important role in this relationship and became a root cause of decreasing firm value. Corporate governance mitigates this agency conflict. The study indicates that under good governance, the cash flows due to tax avoidance contribute to increase in firm value rather than personal benefits of management.

Keywords: *Tax avoidance, firm value, corporate governance, Effective tax rate, agency conflict*

INTRODUCTION

Tax avoidance is considered one of the major corporate strategies (Hanlon and Heitman, 2010). When a company avoids taxes, it will increase its cash flows and the net income (Austin & Wilson, 2017). Expectedly, this will increase shareholder's wealth in the form of residual claim (Rego & Wilson, 2012). Recently, tax avoiding has become a topic of interest for political and academic discussion (Huseynov,Sardali,& Zhang, 2017). Nevertheless, majority of people have taken interest in this issue in reaction to media channels reporting about various international firms, which are involved in tax avoidance practices (Kanagaretnam, Lee,Lim,& Lobo , 2016). These include some large corporations such as Starbucks, Apple and Facebook (Davis et al, 2016). Furthermore, it also includes Enron (McGill & Outslay, 2004). This discussion indicates that tax avoidance is a universal aspect in today's business environment. Inspite of this common phenomenon, many firms pay enough taxes every year. Thomsen and Watrin (2018) posits that for 2005-16 most of the United States(US) firms pay 30%-40% effective tax rates and also found that one out of ten firms had Effective Tax Rate (ETR) less than 20% (Thomsen & Watrin, 2018).

According to Lee et al., (2015), avoidance of tax is a method which is adopted by companies themselves and it is an organized operation to reduce the load of tax by using legal and illegal means. Moreover, avoidance of tax is an activity, which is ambiguous and tricky for others and at the end, becomes a means for managers to satisfy their self-interest. Tax avoidance is permissible in law but firms use illegal means to get benefit from legal procedures (Jamei et al, 2017). Firms, which take tax benefits by tax avoidance, are not fulfilling their social duties. Due to this, general investors show negative reaction that decreases value of the firm (Hanlon and Heitman, 2010). Developing countries have total dependency on taxes and loans because they do not have strong financial keep up and in this way if company goes for tax avoidance activities then it will give irreparable loss to the country and society. Because the money from tax is used for welfare of the societies and is ultimately beneficial for the country's development. Tax is used for societal wellbeing and if companies prefer activities of tax avoidance, then it will lead to the issue of market sustainability (Freedman, 2003; Bird et al., 2018).

The evidence of tax avoidance impact on firm value is mixed. If cash flow from tax avoidance is used for personal benefits, it decreases firm value. However, in case of transparent processes, tax avoidance can enhance firm value. Thus, corporate governance mitigates negative impact of tax avoidance on firm value (Chen et al., 2013). The objective of this study is to examine the impact of tax avoidance on firm value and the role of corporate governance in mitigating agency conflicts that are caused by tax avoidance activities to enhance firm value in developing economies like Pakistan.

Firms want to get profits and increase their value by reducing the taxable income through activities of avoiding tax. Rather than this, we can see the possible harm to firms is more than the benefit in the form of cost like agency, audits, revised tax appraisal, and law procedures. All these costs may exceed the benefits of tax avoidance (Ying,Wright & Huang, 2017). Companies do tax avoidance through different means like non-fulfillment of returns, by providing incorrect returns, by manipulating profits before tax, describe false proceedings, exaggerate cost and fail to comply with delivery of relevant taxes (Sharayri & Momani, 2009). Moreover, in Asian countries, reason behind agency conflict is non-transparency of firms and due to weak corporate governance agency conflict increases (Claessens & Fan, 2002).

Agency conflict arises between the shareholders and the managers (Jensen & Meckling, 1979). Shareholders think about the growth of the company and managers give protection to their personal interests. Shareholders want to obtain excessive profit from their investments and on the other hand, managers want to get more and more personal gains from the designation they hold. They do not follow the aim of their shareholders and go for their own intentions (Sharayri & Momani, 2009). However, when a firm goes for tax avoidance activities it totally ignores moral prospects of its stakeholders. Besides this, when activities of avoiding tax are started by a company then such a company becomes highlighted and the general public give their opinions and raise objections regarding that company. The company is exposed by objections of the public exactly like the case of the politicians (Christensen,Dhaliwal & Graffin, 2014).

Corporate governance of firms works in favor of shareholders and it deals investors in a way that they realize their investment is in safe hands and they will surely get return on their investment (Shleifer, & Vishny, 1997). Corporate governance is a process adopted by companies to mitigate agency conflicts that increases their shareholder value (Mustapha & Ayoib, 2011). In developing countries, corporate governance is very important to deal with agency issues and lack of investors trust (Wang et al., 2011). Thus, good corporate governance mitigates the agency conflicts and this can force managers to use cash flow from tax avoidance to benefit shareholders (Chen et al., 2013).

To best of my knowledge, this is the first study in Pakistan that investigate corporate governance and tax avoidance nexus on value of firm. Majority of the researchers conduct agency framework researches in developed countries and this research is conducted in a developing country like Pakistan. Different researches are conducted in Pakistan regarding these variables separately but this is the first study, which incorporate agency framework.

In the next section, literature review is conducted for the variables of tax avoidance and the corporate governance. Theoretical framework and hypothesis are constructed in this section as well. Section 3 is comprised of methodology, operationalization of variables and the regression models. Section 4 consists of results and discussion and section 5 contains conclusion, contribution, and limitation.

LITERATURE REVIEW

Tax Avoidance

Tax avoidance is an activity to save tax from which firm value can be enhanced. Hanlon and Heitman (2010) defined tax avoidance as a legal activity by which we can save money with clear reduction in tax, and on the other side, it is near to tax shelter activity. Tax shelter is defined as giving substantial benefits to corporations by using complicated tax reporting which provide unintended benefits. Researchers have different points of view regarding tax avoidance. Some say it is a legal activity and some say it is an illegal activity.

Along with managers, there are multiple groups of people involved in making strategies of tax planning and in public listed companies, managers have ultimate authority to take decisions on behalf of the shareholders. From the agency theory, managers who are involved in tax planning are free to go for tax avoidance arrangement, which is full of complexities and is only beneficial for them. This complication in technologies of tax planning give them protection from the inspection of internal and external audit committees and also from other concerned people. Leung et al., (2019) says that when there is imbalance of information between shareholders and tax expert managers regarding avoidance of tax activities in the firm, it will help managers to divert these activities in their own benefit rather than shareholders' benefit. This became the main reason of creating negative relationship between agent and principal. Asymmetry of information provide managers a shield for protecting their own interests.

According to Islam and Hashim (2020), when companies commence activities of tax avoidance in a result of these activities, it gave non-transparency (opaqueness) to their financial statements. This non-transparency have a negative effect on the value of the firms and especially of those firms, which have weak corporate governance. This negative relationship is mitigated by a strong level of corporate governance. According to Chen et al., (2014) activities of tax avoidance do not go for increase in value of those firms which are opaque in nature as compared to those which have transparency in their operations.

Chen et al., (2013) state that in aspect of classical agency theory the amount that is saved while avoiding tax will give dominance to appearance of company's paid conception and increased scope of individual interest, due to which future cash flow of the company gets smaller and reduces the firm value. Nafti et al., (2020) also support the theory of (Desai & Dharmapala, 2006) that there is a negative relationship between tax avoidance activities and the value of firm and corporate governance plays a very important role to mitigate this negative relationship. Wahab et al., (2012) proved that between tax avoidance and firm value there is a negative relationship. When they studied all elements individually, they found that the reason behind negative relationships is the consistent difference of the amount on which tax is applicable and the calculation of accounting year profit. Wahab et al., (2012) concluded that tax avoidance is not worth anything for shareholders and it decreases the value of the firm. Findings of Wahab et al. (2012) are also similar with results of (Desai & Dharmapala, 2009) in context of UK (United Kingdom).

Tax Avoidance and Firm Value

Desai and Dharmapala (2009) came to know that tax avoidance activities cause agency problems that have a negative impact on firm value. Between principal and agent, inequality of information would give a benefit to manager, managers have more detailed information of business operations. On other hand, the complex tax avoidance cycle is a protective guard for managers, which they use for their personal benefits (Desai & Dharmapala, 2007). It is not mandatory that from tax avoidance activities shareholders always get increase in their wealth because in the presence of agency problems, anything can happen. Likewise, managers of Enron who were behind the shield of structuring finance transactions exploited company profits, which at the end lead to the company's failure. Chen et al., (2014) found that tax avoidance and firm value have negative and significant relationship. Thus, studies of other developed countries also tell that it is not necessary that tax avoidance activities would increase firm value.

With the process of tax avoidance, there are some possible costs, which we have to bear for the purpose of tax avoidance. These costs are of two types. Direct costs and indirect costs. While direct cost is the cost which we can clearly see like information of charges given to the individuals involved in the process of tax avoidance and other reorganized organizational charges, which are mandatory to achieve the self-gains that are specified by (Wahab & Holland,2012). While the indirect costs includes direct appropriation (only for the use of managers), credibility loss of financial statements, reputational cost, and possible sanctions by tax authorities (Frank et al., 2009; Desai et al., 2007).

Chen et al., (2014) found that tax avoidance and firm value have negative and significant relationship. Thus, studies of other developed countries also tell that it is not necessary that tax avoidance activities would increase firm value. Therefore, our first hypothesis is

H_1: There is a significant negative relationship between tax avoidance and value of firm in Pakistan

Corporate Governance and Firm Value

Our first hypothesis investigates the single relation between the tax avoidance and the value of firm but it does not incorporate the moderating role of corporate governance. Shleifer and Vishny (1997) define corporate governance as "control system, by which shareholders of company satisfy themselves that they will get return on their investment". As the definition clearly shows that corporate governance is the system of protecting shareholders interest. Agency theorists found that matter of tax avoidance is inseparable with corporate governance (Chen et al., 2014). When a conflict arises in an organization than a mechanism is needed to resolve that conflict and that mechanism is known as corporate governance (Ali et al, 2021), this definition is in support of agency theory.

The experimental knowledge shows that corporate governance has preventive impact on principal and agent conflict, and propose that after resolving agency conflict it results in better firm's value. Desai and Dharmapala (2006) corporate governance structure of firms decide that it goes with high incentives for tax avoidance or it goes with transparency. Chen et al., (2014) tells that with increase in tax avoidance activities, agency cost increases and firm value automatically decreases but those companies which have better corporate governance, reduced this negative effect. Overall, the frame of knowledge shows that corporate governance is a protective shield for shareholders' interests. Better corporate governance resolves many issues and mitigate the negative effects.

A firm is generally known for its well-built prestige, it is considered as the most productive asset for a company (Pirzada & Rudyanto, 2020). Firms continuously work hard to get positive word of mouth and in making their reputation as a firm with good reputation. Firms take every decision very carefully by keeping their reputation in mind. They check their decisions' effects on their reputation (Cragg et al., 2002). Reputation of a company is totally based on the moral principal that they follow while taking good or bad business decisions (Trevin et al., 2012). Tax avoidance from a company is a moral decision of a company, which shows the bad ethics of a business (Graham et al, 2014). So corporate governance can handle better in decision-making that what is good for company and how to resolve issues within the company. Overall, the frame of knowledge shows that corporate governance is a protective Shield for shareholders' interests. Better corporate governance resolves many issues and mitigate the negative effects. So, our second hypothesis is

H_2: Corporate Governance Positively mitigates tax avoidance to enhance firm Value

Theoretical framework

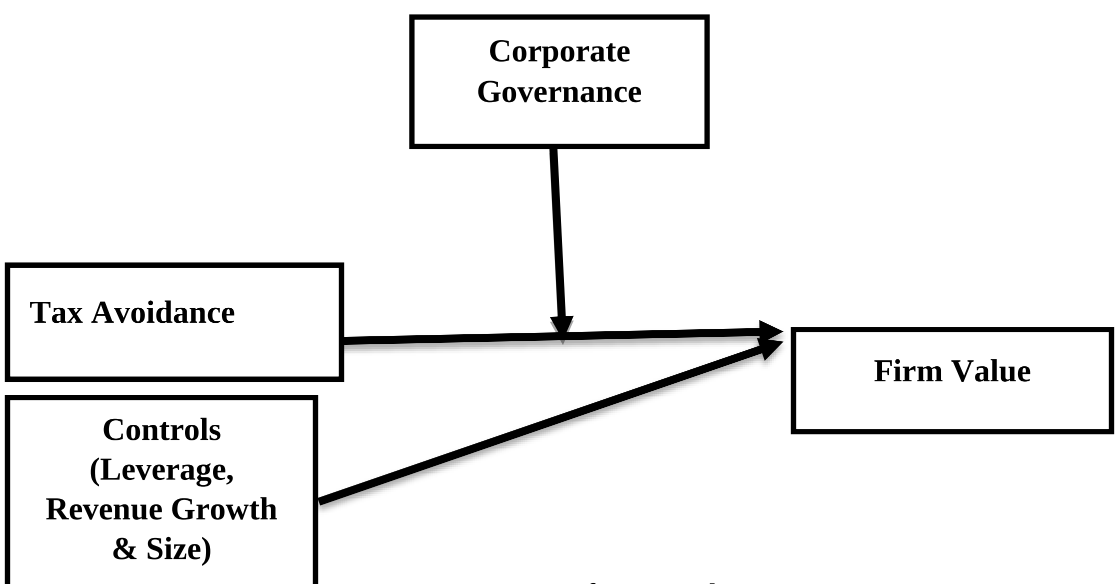

Figure 1 framework

METHODOLOGY

Data and Sample

This is a quantitative study and secondary data is collected from BSA (Balance sheet analysis of Non-Financial Firms) publish by SBP and financial statements of companies. The population of this study is all non-financial firms listed on Pakistan stock exchange. However, 120 listed non-financial firms are selected as a sample after removing all those firms that fail to provide data on different variables of the study or remain non-profitable during the estimation period (Yee et al.,2018). Estimation period of this study is of five years starting from 2013 to 2017. However, 2012 is added for lead and lag considerations. The period of estimation is robust as Pakistan experienced different economic cycles and regime changes.

Panel Data Estimation Models

Dynamic panel data model is used to assess the impact of independent variable on dependent variable. This model is selected because it solves the endogenity problem of different variables used in the study and further it is the best-recommended model when corporate governance is used as it cures reverse causality inherit in corporate governance index. For hypothesis 1, we estimated the following dynamic panel data model under **GMM** environment. Following model is adopted from the study of (Yee et al., 2018).

$$TQ_{i,t} = \beta_0 + \beta_1 TQ_{i,t-1} + \beta_2\, ETR_{i,t} + Controls + Years\ Effect + Industry\ Effect + \varepsilon_{i,t} \qquad (Eq. 1)$$

For hypothesis 2, we have estimated the following dynamic panel data model under **GMM** environment. We have augmented the model used by (Yee et al., 2018) by including corporate governance and its interaction with ETR.

$$TQ_{i,t} = \beta_0 + \beta_1 TQ_{i,t-1} + \beta_2 CGI_{i,t} + \beta_3 ETR_{i,t} + \beta_4 (ETR * CG)_{i,t} + Controls + Years\ Effect + Industry\ Effect + \varepsilon_{i,t} \qquad (Eq. 2)$$

Where β_0 is constant interception, $\beta_1$to β_4 are coefficients, i is index and ε refers to residual error.

Definition of the variables used in Eq1 and Eq2

To measure value of the firm Tobi Q is used as a proxy. Tobin q is adopted from study of (Yee et al., 2018; Chen et al., 2013). It is measured by using formula

$$TQ = \frac{(\text{MV of ordinary shares} + \text{Total Borrowing})}{\text{Total Assests}}$$

Tax avoidance is measured by using proxy ETR. ETR is adopted from work of (Yee et al., 2018) and is calculated by using formula

$$ETR = \frac{Total\ Tax\ Expense}{Pre\ Tax\ Income}$$

Control variables (leverage, revenue growth, size) are used from work of (Chen et al., 2013; Yee et al., 2018) and are calculated by using formulas

$$LEV = \frac{\text{Total debts}}{\text{Total Assets}}$$

$$RG = \frac{(\text{Revenues Y2} - \text{Revenues Y1})}{\text{Revenues Y1}}$$

SZ= ln (Total assets)

CGI index is computed by taking firm level corporate governance attributes. Table 1 contains these Firm-level corporate governance attributes adopted from PhD work of Shah, (2009).

Table 1

Firm-level corporate governance attributes

Variables	Acronyms	Formula
Ownership Structure	OS	Shares held by the board of directors/ Total no. of shares outstanding,
]Ownership Concentration	OC	Shares owned by top-10 shareholders/ Total no. of Shares
Institutional Ownership	IO	Shares held by institutional owners/ Total No. of Shares
Board Size	BS	Natural log of total No. of Board members.
Board Independence	BI	Non-Executive Directors/ Total No. of Directors in Board

Audit Committee Independence	ACI	Non-Executive directors in Audit committee/ Total No. of Directors in Audit Committee

Corporate governance index is constructed by using methodology of (Aggarwal et al, 2011). All firm level corporate governance attributes are converted into five quintiles and after that, an additive index is obtained year wise for every firm using the following formula

$$C.G\ index = \frac{(Sum - Minimum)}{Range}$$

Where sum is year wise addition of all corporate governance quintiles for every single firm, Minimum is the lowest value of sum in every year across the sample, Range =Max – Min where maximum is the largest value of sum across the sample.

RESULTS AND DISCUSSIONS

Table 2
Summary statistics

	Count	Mean	Sd	Min	max
TQ	605	2.128	4.262	.317	59.127
ETR	605	.243	.255	-3.911	.948
CG Index	605	.529	.192	0	1
Lev	605	.450	.185	.0072	.955
RG	605	.093	.254	-.945	2.642
SZ	605	15.943	1.512	11.495	19.787
N	605				

TQ stands for Tobin Q, ETR stands for effective tax rate, CG index stands for corporate governance index, Lev stands for leverage, RG stands for Revenue Growth and SZ stands for firm size.

Table 2 includes the summary statistics of all the variables. This includes 605 observations of 120 listed non-financial companies of Pakistan stock exchange. Mean of Tobin q is 2.129. This indicates that firms had growth opportunities that could enhance their economic value. The mean for ETR is 0.243. This indicates that on average, Pakistani firms paid a tax rate of 24% as against 35% applicable via income tax ordinance. This difference indicates that Pakistani firms are engaged in tax avoidance. Value for corporate governance mean is 0.53. Generally, firms having higher means of corporate governance index indicates that overall governance quality of the firm is good. However, its minimum is zero that indicates that sample does contains firm that have very poor governance scores. The mean value of leverage is 45 percent and its value ranges from minimum 7 percent to maximum 95 percent. This indicates that majority of the assets in Pakistan are funded through debt financing. Some researchers also quote similar values of leverage like 66.7 percent in their study (Ullah et al., 2017). SZ have mean value of 15.9 and with minimum value 11.4 and maximum value of 19.7. These values are quite similar with values of (Yee,Sapiei & Abdullah,, 2018). Revenue growth of the Pakistani firms has mean of 9 percent. This lower revenue growth is a result of recovery phase of Pakistani economy from 2013-2017.

Table 3
Correlation matrix

	(1)					
	TQ	ETR	CG Index	Lev	RG	SZ
TQ	1.00					
ETR	-0.08**	1.00				
CG Index	0.07	-0.02	1.00			
Lev	0.03	-0.03	-0.04	1.00		
RG	0.03	-0.05	-0.03	0.12***	1.00	
SZ	0.06	-0.06	-0.02	0.20***	0.01	1.00

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table 3 is the correlation matrix of under studied variables. The correlation coefficient of ETR is positive and significant at 1.000. The negative coefficient advocates that ETR (tax avoidance) is negatively related with Tobin q (firm value), with value of 0.08. This result is matched with results of (Yee,Sapiei & Abdullah,, 2018). Where corporate governance has positive and significant impact on TQ (Tobin q) with value of 7 percent this result is in line with (Desai & Dharmapala, 2009) and (Yee,Sapiei & Abdullah,, 2018). While corporate governance also have negative correlation with tax avoidance (ETR) with value of 0.02.which tells us, that increase in corporate governance will decrease the number of tax avoidance. This result is robust with results of (Chen et al., 2013) and (Yee,Sapiei & Abdullah,, 2018).

The table indicates that some of independent variables are correlated with each other. Thus to cure for multi-collinearity and auto-collinearity issues, the study resorts to dynamic panel data estimation under GMM environment.

Panel Data Estimation Results

Table 4 contains the results of dynamic panel data regression model under GMM environment. Results in model 1 are without the factor of corporate governance, it is analyzed to test our first hypothesis. The model 2 is with corporate governance factor and it is analyzed to test our second hypothesis.

Model 1 Results

Column 1 of table 4 reports results of model 1 that indicates that ETR has negative significant coefficient of -0.199 for firm value (TQ). Thus, our first hypothesis is accepted. This result confines to our past discussion and has not surprised us. In absence of corporate governance, cash flow savings due to tax avoidance not necessarily contributes to increase value of the firm. The result is in accord with the findings of (Chen et al., 2013; Nafti et al. 2020**).** This result shows negative and significant relationship between tax avoidance and firm value it means one unit increase in tax avoidance will reduce firm value by 0.199 unit. Chen et al., (2013) conclude their result by saying that negative value of tax avoidance means that shareholders respond tax avoidance negatively in China.

Model 2 Results

Column 2 of table 4 presents results of model 2. This model includes the introduction of mediatory role of corporate governance with tax avoidance. The results indicate that ETR (Tax avoidance proxy) has negative significant coefficient of -0.654 for firm value indicating that increase in tax avoidance will lead to decrease in firm value. Corporate governance (proxied by CG Index) has positive and significant coefficient for firm value. This result is in accord with past studies of (Yee et al., 2018). Firms with good governance score have strong governance frameworks that complies mangers to work for the benefit of shareholders and increase firm value. However, in model 2 our variable of interest is moderating role of corporate governance with tax avoidance (proxied by variable CG Index*ETR). The results indicate that our interaction term (CGIndex * ETR) has positive significant coefficient for firm value. This result is supported by the studies conducted by (Yee et al., 2018). The significance of interaction terms highlights a fact that cash flows due to tax savings, in the presence of good governance, contributes to increase value of firm (Huseynov et al., 2017; Desai & Dharmapala, 2009) and not the personal benefits of managers. This result helps us to accept our second hypothesis.

Discussion on control Variables

In both model 1 and 2, Leverage has positive significant coefficient for firm value. This result is in line with the studies of (Yee,Sapiei & Abdullah,, 2018). Since most of firms in the sample are levered, they employ leverage to take positive NPV projects to enhance their firm value.

In both model 1 and 2 size has negative significant coefficient for firm value. This result is in line with the findings of (Chen et al., 2013). Firms with larger size tends to mismanage their resources and due to rising costs convert their economies of scale in to diseconomies of scale that decreases firm value.

Table 4

Results with Dynamic panel data

	(Model 1) TQ	(Model 2) TQ
L.TQ	2.159***	2.356***
	(0.480)	(0.541)
ETR	-0.199*	-0.654*
	(0.120)	(0.364)
CG Index		0.330*
		(0.194)
ETR*CG Index		0.496**
		(0.209)
Lev	0.917***	0.811***
	(0.308)	(0.312)
RG	0.398	0.302
	(0.261)	(0.248)
SZ	-3.563***	-3.324***
	(0.879)	(0.921)
Intercept	-0.219	-0.261
	(0.211)	(0.199)
N	363	363
Years Effect	Yes	Yes
Industry Effect	Yes	Yes
Sargan Test	P-value: 0.1448	P-value: 0.1582

Abond Test	Order 1: p=0.727 Order 2: p=0.468	Order 1: p=0.907 Order 2: p=0.559

Standard errors in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

CONCLUSION

After analyzing the results, we came to the point that tax avoidance has negative impact on the firm value. According to Desai et al., (2009), tax avoidance is not only activity of transferring money from government but it smoothens ways for self-centered managers to extract their own benefits. Corporate governance plays a positive role in mitigating the negative relationship between tax avoidance and the firm value. Our study has similar results with the study of (Yee et al., 2018; Desai & Dharmapala 2009). In this agency framework, we conclude that shareholder does not value tax avoidance and consider it only beneficial for management and managers extract their personal benefits from these activities. However, good governance mitigates this agency conflict and cash savings due to tax avoidance are directed to increase firm value,

Findings of this study contribute to existing literature by providing evidence on economic consequences of tax avoidance activities and the role of corporate governance in in developing country like Pakistan. This study will help the policy makers in tax planning. This study also helps organizations to understand the negative relationship between tax avoidance and the firm value and negative consequences of tax avoidance activities in Pakistan. Limitation of our study is that we include data only from Pakistan non-financial firms. Future researchers are directed to collect data from other developing countries to conduct similar study.

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