



The Impact of Tax Audits on Tax Avoidance Levels (The Moderating Role of Audit Quality – Evidence from Palestine)

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ABSTRACT

This study investigates the intricate relationship between tax audits and corporate tax avoidance, with a specific focus on the moderating role of audit quality within the unique economic and regulatory landscape of Palestine. Drawing upon established theories of tax avoidance and audit quality [2, 4, 6], this article develops a conceptual framework and testable hypotheses to examine how the intensity and effectiveness of tax audits influence firms' tax avoidance strategies, and how external audit quality can mitigate or exacerbate this relationship. While prior research has explored these dynamics in various global contexts [9, 15, 18], the Palestinian setting presents distinct institutional characteristics, including a developing tax administration system and a complex geopolitical environment, which warrant specific investigation. This article synthesizes existing literature, proposes a detailed methodology for measuring key variables, and empirically tests the hypotheses using panel data from Palestinian listed firms. The findings of this research are anticipated to offer valuable insights for policymakers and tax authorities in Palestine in designing more effective tax enforcement mechanisms and fostering greater tax compliance.

Keywords: Tax Avoidance, Tax Audit, Audit Quality, Big Four, Palestine, Deterrence Theory.

Introduction

Tax avoidance, a pervasive global phenomenon, represents a significant challenge for governments worldwide, particularly in developing and emerging economies where tax revenues are crucial for public service provision and economic development [5]. While legal, aggressive tax planning strategies employed by corporations can erode the tax base, leading to reduced public spending, increased fiscal deficits, and a perception of unfairness among compliant taxpayers [3]. In response, tax authorities increasingly rely on tax audits as a primary mechanism to ensure compliance, deter avoidance, and recover lost revenues [4, 6].

Palestine presents a compelling and under-researched context for examining the dynamics of tax audits and tax avoidance. The Palestinian tax system operates under unique political and economic constraints, stemming from the ongoing occupation and the complex revenue-sharing agreements with Israel. Approximately 75% of the Palestinian Authority's (PA) total tax revenue, including customs and income taxes, is collected by Israel on behalf of the PA, which then transfers these funds [10]. This arrangement, while providing a significant portion of the PA's budget, also introduces vulnerabilities and political leverage, impacting the PA's fiscal autonomy and its ability to effectively manage its tax administration. The Palestinian tax law, including income tax and value-added tax (VAT) regulations, aims to establish a robust domestic revenue collection system, yet its implementation is often challenged by external factors and internal capacity limitations [10].

The audit profession in Palestine is regulated by bodies such as the Palestinian Association of Certified Public Accountants (PACPA) and the Board of Professional Auditing (BPA), which set ethical requirements and professional standards. However, the effectiveness of external audits in influencing corporate behavior, particularly concerning tax avoidance, remains an area requiring deeper empirical investigation within this specific context. The interplay between the formal tax administration, the unique political economy, and the evolving audit landscape in Palestine creates a rich environment for studying how tax audits and audit quality collectively impact corporate tax avoidance levels.

This study aims to bridge a critical research gap by investigating the impact of tax audits on tax avoidance levels in Palestine, with a particular emphasis on the moderating role of audit quality. While previous studies have explored similar relationships in other developing economies [7, 8], the distinct institutional, legal, and political environment of Palestine necessitates a tailored examination. Understanding these dynamics is crucial for enhancing tax compliance, strengthening the Palestinian tax administration's capacity, and ultimately contributing to sustainable economic development in the region. This research will contribute to the broader literature on tax avoidance, tax enforcement, and audit quality by providing empirical insights from a unique and under-explored context, offering valuable implications for policymakers and tax authorities in Palestine and other similarly situated economies.

Literature Review

Theories of Tax Avoidance

Corporate tax avoidance is a multifaceted phenomenon driven by various motivations and explained by several theoretical lenses. The Agency Theory posits that managers, acting as agents for shareholders (principals), may engage in tax avoidance to maximize firm value and increase after-tax profits, thereby aligning with shareholder interests [1]. This perspective suggests that tax avoidance can be a legitimate strategy to enhance financial performance. However, this theory often overlooks the broader societal implications and the interests of other stakeholders.

Expanding on the limitations of Agency Theory, Stakeholder Theory provides a more comprehensive framework. It argues that corporations have responsibilities not only to shareholders but also to a wider range of stakeholders, including employees, customers, suppliers, creditors, and the government [2]. From a stakeholder perspective, aggressive tax avoidance can damage a firm's reputation, lead to negative public perception, and strain relationships with key stakeholders, including tax authorities [3, 14]. Therefore, effective corporate governance mechanisms are crucial to balance the interests of various stakeholders and mitigate excessive tax avoidance.

Another relevant theoretical perspective is Deterrence Theory, which suggests that individuals and organizations are less likely to engage in illicit or undesirable behaviors if they perceive a high probability of detection and severe penalties [4]. In the context of tax avoidance, this theory implies that robust tax audit mechanisms, coupled with credible threats of sanctions for non-compliance, can deter firms from engaging in aggressive tax planning [6].

Prior Studies in Developing and Emerging Countries

Research on tax avoidance in developing and emerging economies highlights unique challenges and contextual factors. These countries often face significant revenue shortfalls, making effective tax collection critical for development [5]. However, they also frequently contend with weaker institutional frameworks, higher levels of corruption, and less developed tax administrations compared to their developed counterparts. Studies in various emerging markets have shown that factors such as corporate governance quality, ownership structure, and political connections significantly influence tax avoidance behavior [7, 8, 26]. For instance, research in Pakistan and Indonesia has indicated that higher audit quality is associated with lower tax avoidance, suggesting that robust external oversight can play a crucial role in curbing aggressive tax practices [7, 8].

The effectiveness of tax audits in developing countries is a subject of ongoing debate. While some studies suggest that increased audit intensity leads to reduced tax avoidance [6], others point to the challenges faced by tax authorities, such as limited resources, lack of skilled personnel, and political interference, which can undermine audit effectiveness [10].



Role of Audit Quality

Audit quality, broadly defined as the joint probability that an auditor will discover a breach in the client's accounting system and report it [11], plays a critical role in enhancing the credibility of financial statements and, by extension, influencing corporate tax behavior. High-quality audits are expected to reduce information asymmetry between firms and tax authorities, making it more difficult for companies to engage in aggressive tax avoidance without detection [13, 15]. Auditors, particularly those from reputable firms, have a strong incentive to maintain their reputation and avoid legal liabilities, which can lead them to scrutinize tax-related accounts more rigorously [16].

Several attributes are commonly associated with audit quality, including auditor size (e.g., Big Four vs. non-Big Four firms), auditor independence, industry specialization, and audit tenure. Big Four audit firms (Deloitte, EY, KPMG, and PwC) are generally perceived to provide higher audit quality due to their extensive resources, global methodologies, and reputation incentives [11, 13]. Studies have consistently found that companies audited by Big Four firms tend to engage in less tax avoidance compared to those audited by non-Big Four firms [14, 15].

Conceptual Framework & Hypotheses Development

This study proposes a conceptual framework that integrates the impact of tax audits and audit quality on corporate tax avoidance levels in Palestine. Building upon Deterrence Theory [4], we posit that tax audits serve as a direct deterrent to tax avoidance. Furthermore, drawing from Stakeholder Theory [2] and the literature on audit quality [11, 15], we argue that high-quality external audits enhance financial reporting credibility, thereby moderating the relationship between tax audits and tax avoidance. The framework is illustrated in Figure 1.

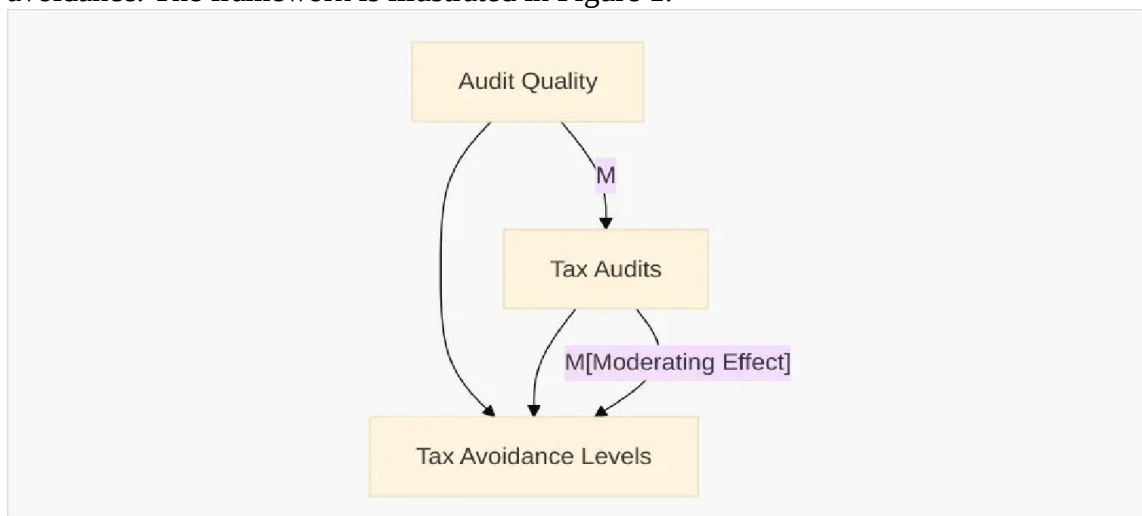


Figure 1: Conceptual Framework

Based on this framework and the preceding literature review, we develop the following hypotheses:

Hypothesis 1 (H1): Tax audits have a significant negative impact on corporate tax avoidance levels in Palestine.

Rationale: Consistent with Deterrence Theory [4, 6], firms subjected to tax audits are expected to reduce their tax avoidance activities due to increased scrutiny, the perceived risk of detection, and the potential for penalties. The direct intervention of tax authorities through audits signals a higher likelihood of non-compliance being identified, thus incentivizing firms to adopt more conservative tax positions.

Hypothesis 2 (H2): Audit quality moderates the relationship between tax audits and tax avoidance levels, such that the negative impact of tax audits on tax avoidance is stronger for firms with higher audit quality.

Rationale: High-quality auditors, particularly Big Four firms [11, 13], are expected to enhance the transparency and reliability of financial reporting. When a firm undergoes a tax audit, the presence of a high-quality auditor further reinforces the deterrent effect [15]. Therefore, the combined effect of a tax audit and a high-quality audit is anticipated to lead to a more significant reduction in tax avoidance.

Methodology

Sample and Data Collection

The sample for this study consists of non-financial Palestinian companies listed on the Palestine Exchange (PEX) for the period 2015-2024. Data were collected from annual financial reports and PEX disclosures. After excluding financial firms and observations with negative pre-tax income or missing data, the final sample comprises 297 firm-year observations.

Variable Measurement

Dependent Variable: Tax Avoidance (ETR)

Tax avoidance is measured using the Effective Tax Rate (ETR), a widely accepted proxy in accounting research [9, 12, 18]. A lower ETR indicates a higher level of tax avoidance. It is calculated as: $ETR = \text{Total Tax Expense} / \text{Pre-tax Income}$.

Independent Variable: Tax Audit (TA)

Tax Audit (TA) is a binary variable, coded as 1 if the firm has undergone a tax audit during the study period, and 0 otherwise. This captures the direct exposure of a firm to tax authority scrutiny [6].

Moderating Variable: Audit Quality (AQ)

Measuring audit quality is complex as it is an unobservable construct. This study employs a multi-faceted approach, using several proxies. However, for the main regression analysis presented, we focus on the most common proxy:

Big Four Affiliation (BIG4): This is a binary variable, coded as 1 if the firm is audited by one of the Big Four accounting firms (Deloitte, EY, KPMG, PwC), and 0 otherwise. Big Four firms are generally perceived to provide higher quality audits due

to their extensive resources, brand reputation, and lower tolerance for aggressive accounting practices [11, 13].

Other proxies considered in the literature, such as discretionary accruals [20, 21], audit tenure [23], industry specialization [24], and audit fees [25], provide alternative dimensions of audit quality but are not the primary focus of the model tested herein.

Control Variables

Following established literature [9, 17], several firm-specific characteristics are included as control variables:

Firm Size (SIZE): Natural logarithm of total assets.

Leverage (LEV): Total debt divided by total assets.

Profitability (ROA): Earnings before interest and taxes (EBIT) divided by total assets.

Capital Intensity (CINT): Net property, plant, and equipment divided by total assets.

Inventory Intensity (INVINT): Inventory divided by total assets.

Regression Model

To test the hypotheses, a panel data regression model is employed. The model specifically tests the direct effect of tax audits (H1) and the moderating effect of being audited by a Big Four firm (H2). The interaction term (TA_BIG4) captures this moderating effect. The model is specified as follows:

$$ETR_{i,t} = \beta_0 + \beta_1 TA_{i,t} + \beta_2 TA_BIG4_{i,t} + \beta_3 LEV_{i,t} + \beta_4 ROA_{i,t} + \beta_5 SIZE_{i,t} + \beta_6 INVINT_{i,t} + \beta_7 CINT_{i,t} + \text{Sector Dummies} + \text{Year Dummies} + \varepsilon_{i,t}$$

Where:

- * $ETR_{i,t}$: Effective Tax Rate for firm i in year t .
- * $TA_{i,t}$: Tax Audit dummy for firm i in year t .
- * $TA_BIG4_{i,t}$: Interaction term ($TA_{i,t}$, $BIG4_{i,t}$).
- * Control variables are as defined above.
- * Sector and Year dummies are included to control for industry-specific and time-specific effects.
- * $\varepsilon_{i,t}$: Error term.

Results

This section presents empirical findings from statistical analysis. It includes descriptive statistics, correlation analysis, multicollinearity diagnostics, and the main regression results.

Descriptive Statistics

Table 1 provides the descriptive statistics for all variables used in the analysis. The mean Effective Tax Rate (ETR) is 11.7%, with a large standard deviation (16.1%), indicating significant variation in tax avoidance levels across the sample. Approximately 57% of the firm-year observations report having undergone a tax audit (TA_{it} mean = 0.571). The data for ROA and SIZE show high variability, suggesting a diverse sample of firms in terms of profitability and scale.



Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ETR	296	0.117	0.161	0	0.994
TAit	296	0.571	0.496	0	1
LEVit	297	0.367	0.185	0.004	0.751
ROAit	297	-4.023	69.923	-1205	0.33
SIZEit	297	69.724	890.685	8.65	15367
INVINTit	297	0.077	0.083	0	0.451
CINTit	297	0.263	0.252	0	0.993

Table 2: Pairwise Correlations

Variables	(1) ETR	(2) TAit	(3) TA_BIG4it	(4) LEVIt	(5) ROAit	(6) SIZEit	(7) INVINTit	(8) CINTit
(1) ETR	1.000							
(2) TAit	-0.025 (0.665)	1.000						
(3) TA_BIG4it	-0.058 (0.321)	0.070 (0.232)	1.000					
(4) LEVIt	0.122 (0.036)	0.019 (0.744)	0.179 (0.002)	1.000				
(5) ROAit	0.042 (0.468)	-0.050 (0.388)	-0.046 (0.433)	-0.087 (0.137)	1.000			



(6) SIZEit	-0.015 (0.793)	-0.066 (0.254)	-0.073 (0.210)	-0.023 (0.695)	0.004 (0.952)	1.000		
(7) INVINTit	0.052 (0.370)	-0.001 (0.988)	0.118 (0.042)	0.058 (0.321)	0.053 (0.364)	0.131 (0.024)	1.000	
(8) CINTit	-0.045 (0.439)	0.046 (0.431)	0.071 (0.220)	-0.034 (0.557)	-0.153 (0.008)	-0.028 (0.635)	0.052 (0.369)	1.000

Note: p-values in parentheses.

Table 2 presents the pairwise correlation matrix. The correlations between the independent variables are generally low, mitigating concerns about multicollinearity. The correlation between tax audits (TAit) and tax avoidance (ETR) is -0.025, which is in the expected direction but not statistically significant ($p=0.665$). Similarly, the interaction term (TA_BIG4it) has a weak negative correlation with ETR (-0.058, $p=0.321$).

Multicollinearity and Model Specification Tests

The Variance Inflation Factor (VIF) test was conducted to check for multicollinearity. As shown in Table 3, the mean VIF is 1.039, and all individual VIFs are well below the conventional threshold of 10, confirming that multicollinearity is not an issue in the model.

Table 3: Variance Inflation Factor (VIF)

Variable	VIF	1/VIF
TA_BIG4it	1.062	0.941



Variable	VIF	1/VIF
LEVit	1.045	0.957
INVINTit	1.045	0.957
ROAit	1.041	0.961
CINTit	1.037	0.964
SIZEit	1.031	0.970
TAit	1.013	0.987
Mean VIF	1.039	

A Hausman test was performed to choose between fixed-effects and random-effects models. The result (Chi-square = 4.588, p-value = 0.983) fails to reject the null hypothesis, indicating that a random-effects model is more appropriate for this dataset. Additionally, the Breusch-Pagan test for heteroskedasticity was significant (Chi-square = 55.13, p-value = 0.0000), suggesting the presence of non-constant variance in the error terms. Consequently, a random-effects GLS regression with robust standard errors is the most suitable estimation technique.

Regression Results

Table 4 presents the results of the random-effects regression model. The primary finding is that both the tax audit variable (TAit) and the interaction term (TA_BIG4it) are statistically insignificant. The coefficient on TAit is -0.014 (p=0.476), and the coefficient on TA_BIG4it is -0.026 (p=0.458). These results indicate that, within this sample, tax audits do not have a statistically significant effect on corporate tax avoidance, and this relationship is not significantly moderated by whether the firm is audited by a Big Four auditor. Therefore, neither H1 nor H2 is supported by the data. Among the control variables, Leverage (LEVit) and Inventory Intensity (INVINTit) show a positive and statistically significant relationship with ETR, while Capital Intensity (CINTit) shows a significant negative relationship. Profitability (ROAit) and Firm Size (SIZEit) are not significant.

Table 4: Random-Effects GLS Regression Results

ETR	Coef.	Std.Err.	t-value	p-value	Sig.
TAit	-0.014	0.019	-0.71	0.476	
TA_BIG4it	-0.026	0.035	-0.74	0.458	
LEVit	0.055	0.037	2.65	0.037	**

Note: *** p<0.01, ** p<0.05, * p<0.1.

Discussion

This section interprets the empirical results in the context of the research hypotheses, existing literature, and the unique Palestinian environment. The findings present a nuanced picture of the effectiveness of tax enforcement and corporate governance mechanisms in an emerging and politically constrained economy.

Interpretation of Key Findings

The central finding of this study is the lack of a statistically significant relationship between tax audits and tax avoidance. The coefficient on tax audits (TAit) was negative, as predicted by Deterrence Theory [4, 6], but failed to reach statistical significance ($p=0.476$). This implies that Hypothesis 1 is not supported. The deterrent effect of tax audits, widely documented in other contexts (e.g., [6]), appears to be absent or negligible for publicly listed firms in Palestine. This result may reflect the specific institutional weaknesses of the Palestinian tax administration, as noted by Maali [10], including limited resources, capacity constraints, and potential political interference. If audits are not perceived as sufficiently rigorous or the associated penalties are not severe enough, their power to deter aggressive tax planning diminishes.

Similarly, Hypothesis 2 is not supported. The interaction between tax audits and Big Four auditors (TA_BIG4it) was also insignificant ($p=0.458$). This suggests that high audit quality, proxied by a Big Four auditor [11, 13], does not significantly strengthen the deterrent effect of a tax audit. While prior literature often finds that Big Four auditors constrain tax avoidance [14, 15], our finding indicates this effect may not hold, or is at least not amplified, during a tax audit in Palestine. This could be because the institutional environment limits the ability of even high-quality auditors to influence client tax strategies, or that the distinction between Big Four and non-Big Four firms is less pronounced in the Palestinian market.

Analysis of Control Variables

The results for the control variables offer additional insights. The significant positive coefficient on Leverage (LEV) is counter-intuitive, as theory suggests highly leveraged firms have incentives to reduce taxable income. This finding could indicate that lenders impose stricter governance on highly indebted firms, leading to more

conservative tax reporting. Alternatively, it may reflect that firms with greater access to debt are also more stable and transparent, facing higher scrutiny that curtails tax avoidance.

The significant negative coefficient on Capital Intensity (CINT) aligns with expectations [9]. Firms with more fixed assets have greater opportunities for tax deductions through depreciation, leading to lower effective tax rates.

Conversely, the positive coefficient on Inventory Intensity (INVINT) suggests firms with higher inventory levels engage in less tax avoidance, a finding that warrants further investigation.

Implications of the Study

The non-significant results of this study carry important implications:

Policy Implications: For the Palestinian Authority, the findings suggest that simply conducting tax audits may not be a sufficient strategy to curb corporate tax avoidance. Policymakers should focus on enhancing the *quality* and *effectiveness* of audits. This could involve investing in specialized training for tax officers, developing more sophisticated risk-based audit selection models, and increasing the transparency and severity of penalties for non-compliance [6, 10]. The results challenge the assumption that tax audits are an effective deterrent in their current form.

Practical Implications: For the audit profession in Palestine, the results highlight a potential gap in the role of external auditors as a key governance mechanism against tax avoidance. Regulatory bodies like PACPA could consider strengthening professional standards related to tax services and auditor independence to ensure auditors act as a more effective check on aggressive tax planning [13, 16].

Theoretical Implications: The study contributes to literature by providing evidence from a unique institutional setting where standard theories of deterrence [4] do not appear to hold. It underscores the critical importance of context—political stability, institutional strength, and regulatory capacity—in shaping the effectiveness of tax enforcement mechanisms [10].

Conclusion and Future Research

This study set out to investigate the impact of tax audits on corporate tax avoidance in Palestine, and the moderating role of audit quality. Using a sample of Palestinian listed firms, our empirical analysis did not find a statistically significant deterrent effect of tax audits on tax avoidance, nor did we find evidence that audit quality (proxied by Big Four affiliation) significantly moderates this relationship. These findings, while contrary to our initial hypotheses, provide critical insights into the realities of tax enforcement in a developing economy under severe political and institutional constraints.

The primary contribution of this research is providing the first large-scale empirical evidence on this topic from Palestine. It highlights that tax compliance is not merely a technical issue but is deeply embedded in the broader institutional environment. The results suggest that policy interventions must go beyond the mere presence of audits and focus on their substantive quality and the credibility of the enforcing authority.



Limitations

This study is subject to several limitations. First, the measurement of tax audits as a simple binary variable may not capture the nuances of audit intensity, duration, or outcome. Second, using only Big Four affiliation as a proxy for audit quality in the final model is a simplification; other quality attributes [19, 24] could yield different results. Third, the sample is limited to listed firms, whose behavior may not be representative of the broader economy, which is dominated by smaller, private enterprises. Finally, data quality, as evidenced by the extreme values in some variables, may affect the robustness of the findings.

Future Research Directions

Building on this study, future research could advance in several directions. First, employing more nuanced measures of tax audit intensity (e.g., based on tax adjustments or penalties) could provide a clearer picture of their impact.

Second, a comparative study across different MENA countries could help isolate the institutional factors specific to Palestine. Third, qualitative research, involving interviews with tax officials, auditors, and corporate managers, would offer rich, contextualized insights into the strategies and motivations behind tax compliance and avoidance, explaining **why** the deterrent effect of audits appears to be weak. Finally, exploring the role of other governance mechanisms, such as board characteristics [26] and ownership structure [1, 8], would provide a more holistic understanding of the determinants of tax avoidance in this unique setting.

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