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Eveana Mosuin
Faculty of Accountancy, Universiti Teknologi MARA Sabah Branch Kota Kinabalu Campus, eveana@uitm.edu.my

Nor Balkish Zakaria
Accounting Research Institute, Universiti Teknologi MARA, Malaysia, norbalkish@uitm.edu.my

Yvonne Joseph Ason
Faculty of Accountancy, Universiti Teknologi MARA Sabah Branch Kota Kinabalu Campus, yvosan@uitm.edu.my

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SPECIAL ISSUE ARTICLE

The Conceptual Review on the Effect of Corporate Governance Monitoring Mechanisms on Tax Avoidance

Eveana Mosuin [a], Nor B. Zakaria [b,*], Yvonne J. Ason [a]

[a] Faculty of Accountancy, Universiti Teknologi MARA Sabah Branch, Kota Kinabalu Campus, Malaysia
[b] Accounting Research Institute, Universiti Teknologi MARA, Malaysia

Abstract

Taxes are the primary source of revenue for many nations in order to increase budget revenues and fund national development. Taxation serves multiple purposes because it can positively impact a nation's investment, education, social and economic development. However, tax authorities require assistance with the issue of tax non-compliance, which impedes tax administration and collection. One of the categories of tax non-compliance is tax avoidance, which is one of the company's strategies for legally reducing its tax burden by exploiting loopholes in tax regulations to minimise tax liability. Tax avoidance is when a company follows a particular tax strategy in the hopes that the tax measures will not be legally audited or questioned, but the action is risky if the tax methods are considered unlawful. Although the implementation of corporate governance practices within listed firms, the issue of corporate taxation revenues in Malaysia remains a cause for concern, as they constitute a significant portion of the government's overall income collection. Therefore, effective governance practices may offer improved tax avoidance oversight among Malaysian companies which in turn improve the company's integrity and in line with the national SDGs agenda. However, embedding good governance practices among common governance mechanism studies in monitoring tax avoidance is still scarce, particularly in an emerging country, Malaysia. This study investigates the impact of corporate governance monitoring mechanisms on tax avoidance. The secondary data analysis will be conducted based on the reported financial statements by Malaysian listed companies from 2018 until 2022 (5 years). STATA Software will be used to analyse the data for this study. The findings of this study may show how the corporate governance monitoring mechanisms determine whether a company's management operates in the best interests of its shareholders and whether tax avoidance options are utilised in the shareholders' best interests.

Keywords: Tax avoidance, Corporate Governance, Corporate Governance mechanisms

1. Introduction

Taxes serve as the principal means of generating money for numerous countries, thereby bolstering budgetary inflows to support national development initiatives. Taxation has several functions as it has the potential to exert a favourable impact on a nation's investment, education, and social and economic growth (Osho et al., 2020). Countries with rising economies, such as Malaysia, require substantial tax revenues to facilitate the smooth and successful progression of the nation's

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* Corresponding author.
E-mail addresses: eveana@uitm.edu.my (E. Mosuin), norbalkish@uitm.edu.my (N.B. Zakaria), yvosan@uitm.edu.my (Y.J. Ason).

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development and engagement on both national and international platforms (Neog & Gaur, 2020). According to Gomes (2016), corporations often disclose substantial profits. However, they actively pursue strategies to minimise their tax liabilities with the aim of enhancing their overall corporate value. Tax non-compliance is a significant challenge for tax authorities regarding tax administration and collection (Mohamad & Ali, 2017).

The phenomenon of tax avoidance is increasingly prevalent among multinational corporations. Tax avoidance is a practice employed by companies wherein they strategically structure their financial affairs within the bounds of the law to maximise their utilisation of available tax benefits (Pasternak & Rico, 2008). The corporation employs tax avoidance as a legitimate tactic to reduce its tax obligations by exploiting loopholes in tax regulations. Tax avoidance is not considered illegal as it provides taxpayers with a means to circumvent, diminish, or alleviate their tax obligations within the boundaries set by Tax Law (Lim, 2011). The Malaysian Judiciary generally upholds the international notion that the establishment of agreements to reduce tax obligations is acceptable, as long as such arrangements remain within the boundaries of legal compliance. Therefore, corporate tax avoidance is perceived as a value-enhancing endeavour as it diminishes the portion of earnings that must be allocated to the government in the form of corporate taxes.

2. Background of study

Avoiding taxes has gained attention from the general public due to media coverage highlighting the tax avoidance tactics employed by prominent multinational firms (Kovermann & Velte, 2019). Tax avoidance has emerged as a subject of growing significance within political and intellectual discourse (Kanagaretnam et al., 2018). Prominent instances such as the Enron case (McGill & Outslay, 2004; Wilson, 2009) and more recent cases involving major multinational corporations such as Apple, Facebook, and Starbucks (Davis et al., 2016) have contributed to the perception that the practice of aggressive tax avoidance is prevalent within the contemporary business landscape.

In Malaysia, it is mandatory for all companies to declare and compute their taxable income utilising the self-assessment system (SAS). As a result of SAS, taxpayers are now more accountable for submitting accurate tax returns and keeping sufficient records for audit purposes. Certain studies indicate that the complexity of a tax system influences tax noncompliance. According to Isa (2014), most businesses can compile their financial records in accordance with accounting standards, but cannot prepare their tax computations in accordance with tax law. Two forms of tax non-compliance exist, i.e., tax avoidance and tax evasion. According to Norshamimi and Noor (2012), tax planning is synonymous with tax avoidance because it is conducted in conformance with the Income Tax Act's regulations to reduce the tax burden on stakeholders. However, tax avoidance becomes tax evasion if it is conducted aggressively.

Tax avoidance and tax evasion are two practices that have had a substantial detrimental effect on government revenue generation, hence exerting a negative influence on the overall national economy. As asserted by KC (2018), the act of tax evasion is deemed both illegal and unethical due to its adverse effects on government revenue and its hindrance to overall economic progress. Tax evasion refers to the act of deliberately concealing taxes through the submission of fraudulent documents, misleading assertions, or unrealistic facts. Modugu and Omoye (2014) suggest that tax evasion refers to the act of intentionally concealing the accurate taxable income by means of distorting facts, manipulating numerical data, submitting inaccurate tax filings, or misrepresenting tax obligations. In contrast, tax avoidance refers to the deliberate employment of various tactics by a taxpayer to minimise their tax liability within the boundaries of the law. Regardless of the circumstances in which they occur, tax avoidance and tax evasion generally have negative consequences for an economy and contribute to economic instability, particularly in developing nations, impeding further progress.

From 2013 to 2018, tax avoidance cases increased, according to the IRBM Annual Report. In 2013, Malaysia was reported to have 617 cases of tax avoidance. In 2014, there were 689 cases, followed by 1063 in 2015, 1454 in 2016, 2169 in 2017, and 2935 in 2018 (Annual report of IRBM, 2013–2018). In 2018, the director-general of the Customs Department, Datuk Seri Subromaniam, stated that Malaysia had lost RM2.5 billion in uncollected taxes over the previous three years. In 2017, Malaysia lost one billion ringgit (NST, 2018). The federal government relies heavily on these uncollected amounts to finance the nation's development. Consequently, this issue must be treated seriously.

According to Amin et al. (2011) good corporate governance has a substantial impact on ensuring that taxes are paid. Taxes have an impact on the company's financial decision-making, while corporate governance is a system that regulates an organisation to ensure that it works efficiently in fulfilling the interests of both external (government)

and internal stakeholders (management) (Desai & Dharmapala, 2009) and increase the SDG achievement, which can also be important for drawing in ethical investment (Gugler, 2015) and increasing a firm's reputation (Li et al., 2010). Additionally, all businesses needed a monitoring system for affective corporate governance in order to address global challenges and create a more sustainable future for everybody. According to this, firms with great governance are more likely to develop a high level of transparency, which in turn discourages businesses from strategically avoiding or evading paying taxes (Desai & Dharmapala, 2007). Understanding how corporate governance may reduce the risks associated with corporate tax avoidance is crucial because it sheds light on how to put effective corporate governance into practice (Gomes, 2016). In addition, according to Armstrong et al. (2015) the utilisation of tax avoidance alternatives in the best interests of shareholders is likely to be influenced by good corporate governance.

Numerous scholarly investigations have examined the correlation between corporate governance and tax avoidance. These studies have explored various aspects, such as management compensation (Armstrong et al., 2012; Gaertner, 2014; Seidman & Stomberg, 2017), board composition (Richardson et al., 2015), audit practices (Kanagaretnam et al., 2016; Klassen et al., 2016) ownership structure (Badertscher et al., 2013; McGuire et al., 2014), and other related factors. Moreover, many countries are starting to recognise how essential good corporate governance is to creating an environment enabling business sectors to function well and sustain growth. The ability of the organisation to maintain and enhance its performance would be facilitated by good corporate governance. However, the continued effort to achieve an ideal corporate governance system that can effectively mitigate the risk of tax avoidance and preempt such scandals in the future remains a persistent undertaking (Desai et al., 2003).

Despite corporate governance practices among listed companies, corporate taxation revenues in Malaysia remain a cause for concern as they constitute a significant portion of government revenue. Therefore, effective governance practices are essential for preventing tax avoidance. Incorporating good governance practices into common governance mechanism research on tax avoidance monitoring is still scarce, particularly in Malaysia, an emerging nation. Consequently, this research aims to examine the relationship between corporate governance mechanisms such as Corporate Social Responsibility (CSR), ownership structure, executive incentives, and audit quality on tax avoidance. This study seeks to achieve specific objectives: 1) To examine the significant effect of CSR on tax avoidance, 2) To examine the significant effect of ownership structures on tax avoidance, 3) To examine the significant effect of executive incentives on tax avoidance. 4) To examine the significant effect of audit quality on tax avoidance. The study period of this study is from the year of 2018–2022.

3. Related theories and hypotheses development

3.1. Agency theory

From a business perspective, the establishment of a corporation is facilitated by a contractual arrangement between two entities: principals, who possess the economic assets of the corporation, and agents, who assume the role of managing the economic resources provided by the proprietors. The issue of agency arises inside a corporation when there is a separation between ownership and control, resulting in the potential for decision-making that is not optimal (Eisenhardt, 1989). In the context of agency theory, the proprietor makes a request to the manager to decrease the portion of profits allocated to the government as tax payments. When implementing the agency theory, managers will actively explore avenues to employ techniques and methodologies for valuing assets, liabilities, capital, revenue, and expenses that align with tax regulations. Within the context of execution, managers actively participate in tax planning strategies with the objective of minimising tax payments while adhering to existing tax legislation. This tax strategy continues the agency theory practice, wherein owners mandate managers to engage in legal tax avoidance measures to minimise the tax liability and hence reduce the amount of net profit subject to taxation. This practice involves providing incentives to managers in return for generating results that align with the interests of the primary owner. The study's findings (Kraft, 2014; Richardson et al., 2015) suggest that managers employ tax avoidance strategies by leveraging regulatory relief offered by the government and offsetting tax losses. Additionally, Kurniasih et al. (2013) highlights that compensation from the government takes the form of fiscal loss compensation, which is provided in the subsequent tax year to offset the losses incurred.

3.2. Stakeholder theory

From the viewpoint of the stakeholders, a company fulfils not only its traditional duty of satisfying

the expectations of its shareholders but also the various expectations of other stakeholders. Further explanation of stakeholder theory's emphasis on the fact that a company's responsibility goes beyond financial or operational performance is provided by Guthrie et al. (2006). This pertinent idea states that a company's management must meet its duty to its stakeholders by participating in activities like CSR that are seen as crucial by the stakeholders. Increased CSR disclosures show that businesses are thinking about more than just their personal interests. They are also thinking about the social conditions in their communities. CSR is typically characterised as a company's social engagement, responsiveness, and accountability that extends beyond its core business operations and beyond what is traditionally required by law and the government.

3.3. Corporate social responsibility (CSR) and tax avoidance

There are different points of view in the writings about how CSR and tax avoidance are related. Whether the relationship between the two ideas is good or bad rests a lot on how the CSR concept is used by the author and which way the assumed cause-and-effect chain goes. Some (Lanis & Richardson, 2012; Zeng, 2018) see CSR as a factor in tax avoidance, while others (Col & Patel, 2019) see tax avoidance as a factor in CSR. Kovermann and Velte (2021) say that Huseynov and Klamm (2012) were the first to look into how CSR and tax avoidance are linked. Huseynov and Klamm (2012) find that companies with weak CSR tend to avoid taxes more aggressively than other companies. This is especially true for companies with bad administration. But they also find that well-run companies with strong community ties (which is a form of strong CSR) also avoid taxes fiercely. They see this as proof that well-run companies use the money from tax avoidance for CSR. A number of studies that use ratings or index inclusion to measure CSR as an aggregate construct, find a negative correlation between CSR and tax avoidance (Jones et al., 2017; Mgbame et al., 2017). Davis et al. (2016) on the other hand, show evidence for a positive association between CSR performance and tax avoidance and clarify their findings by pointing out that tax payments and CSR activities serve as substitutes, which means that businesses must decide between paying taxes and engaging in CSR. However, Amidu et al. (2016) study was unable to find any conclusive associations. The following is the study's hypothesis, which is based on the discussion above:

H1. CSR has significant effect on tax avoidance

3.4. Ownership structure and tax avoidance

a) Institutional ownership and Tax avoidance

Institutional shareholders are among the most crucial elements in the oversight of managers' behaviour, which yields favourable consequences (Gillan & Starks, 2003). Regarding agency issues, institutional ownership is essential to agency theory (Jensen & Meckling, 2019). One strategy to address this problem is the existence of an outside organisation or agency. Institutional ownership is an outside aspect that can affect how a management behaves because the institution is in charge of monitoring the manager's opportunistic behaviour, which includes paying taxes. The growing amount of institutional share ownership will encourage management to comply more closely to taxes requirements. Managers are encouraged by the institution's function to show a true tax burden. Mappadang et al. (2018) found that institutional ownership has a detrimental effect on tax avoidance, which lends support to this argument. Another study on the effect of institutional ownership on tax avoidance tactics was examined by (Ying et al., 2017b) discovered that a corporation adopting and using less tax avoidance tactics is one with a large percentage of institutional shareholders. They have the potential to both encourage tax avoidance, which would increase business profitability, and limit tax avoidance to the point where the dangers outweigh the benefits (Kovermann & Velte, 2019). Bird and Karolyi (2017) demonstrated a correlation between institutional ownership and tax avoidance. They argued that the presence of institutional investors with tax planning knowledge makes tax planning more applicable and that tax shelters are extensively utilised. Accordingly, the following hypothesis, which is related to institutional ownership's association with tax avoidance, is proposed without suggesting either a positive or negative direction:

H2a. Institutional ownership has significant effect on tax avoidance

b) Foreign ownership and Tax avoidance

Foreign ownership is considered to be a useful resource for a corporation due to its ability to facilitate the oversight and enhancement of firm performance. Several studies have consistently found a positive correlation between foreign ownership and tax avoidance when examining the effects of foreign ownership on tax avoidance (Egger et al., 2010;

Salihu et al., 2013). According to Bradshaw et al. (2016), tax avoidance is common when foreigners make up the bulk of a company's ownership structure. Aggarwal et al. (2011) found that the monitoring role of foreign ownership has an impact on enterprises' tax avoidance, and they made the case that the presence of foreign investors improves and strengthens the use of corporate governance within organisations. According to Hasan et al. (2016), foreign institutional investors increase the scope of their investments and so play a larger part in corporate decision-making, which enhances the comparability of accounting across international financial markets. Huizinga and Nicodème (2006) backed up the idea that foreign ownership is higher in smaller countries and added that because of its monitoring function, foreign ownership is used as a tool to limit tax burdens, which serves to lessen inequalities in the international tax system. In contrast, some earlier research suggests that tax avoidance is adversely related to a company's high percentage of foreign ownership According to Badertscher et al. (2013), foreign investors' ability to influence management through their voting rights on a company's accounting and taxation policies has a detrimental impact on tax avoidance. Diverging viewpoints on the relationship between foreign ownership and tax avoidance were found in the literature review. The following is the study's hypothesis:

H2b. Foreign ownership has significant effect on tax avoidance

3.5. Executive incentives and tax avoidance

Executives play an important role in the company's management because they occupy the highest decision-making position. According to the research of Surachman (2017), executive decision has a positive effect on tax avoidance. Businesses that avoid taxes as a result of actions made at the executive level. Executives will feel rewarded by earning bigger rewards if it is connected to tax avoidance (Chee et al., 2017), which will inspire them to improve their company's performance. One of these is the employment of tax avoidance techniques to improve the effectiveness of tax payments. There have been numerous investigations into executive incentives and tax avoidance. According to Armstrong et al. (2015), there is a strong negative correlation between tax avoidance and incentives given to corporate directors. Araujo (2019) discovered that executive compensation had a detrimental effect on tax avoidance. However, Jihene and Moez (2019) offer proof that CEO salary has a favourable impact on tax avoidance. Dewi et al. (2015), on the other hand, disproved the contrary findings of prior studies by proving that executive compensation has no bearing on tax avoidance. This justification leads to the following development of the hypothesis:

H3. Executive incentives has significant effect on tax avoidance.

3.6. Audit quality and tax avoidance

The majority of businesses want thorough audits to find any irregularities in the financial report. Conflicts of interest between agents and their principals must be resolved by auditors. It is believed that audit quality is a crucial governance trait that tends to limit managerial opportunism. The study conducted by Istianingsih (2020) investigated the influence of audit quality, as indicated by auditor size, on tax avoidance. The findings suggest that there is a negative relationship between audit quality, represented by auditor size, and tax avoidance. Abid and Dammak (2022), Study the impact of audit quality on the correlation between CSR performance and tax avoidance, the study's conclusions are significant for policymakers because they show how CSR companies can engage in CSR to counteract any negative effects that may result from tax avoidance when they are audited by high-quality auditors. As a result, they must be cautious of managers' opportunistic behaviour and strengthen surveillance to enforce tax and social compliance. An important governance feature that tends to limit executive opportunism is audit quality. The findings of Abid and Dammak (2022) are consistent with Istianingsih (2020). Ardillah and Prasetyo (2021) examined the influence of executive character, executive salary, audit quality, and audit committee on tax avoidance. Their investigation indicated that there is no significant relationship between audit quality and tax avoidance. Lestari and Nedya (2019) study shows that audit tenure has a favourable impact on tax avoidance whereas audit quality, as determined by audit fee and audit size, has a negative impact. However, Purba (2018) research on the effects of audit quality, earnings management, and CEO dualities on tax avoidance found that all three factors had a considerable impact on tax avoidance. As a result, the following theory is created:

H4. Audit quality has significant effect on tax avoidance

4. Methodology

4.1. Data collection and procedures

The present investigation will utilise secondary data. This study utilises data obtained from the listed companies on Bursa Malaysia FTSE top 100 companies. The primary rationale for the selection of the top 100 firms is grounded in the provisions outlined in MCCG 2017 and 2021, specifically in paragraph 2.6. This section emphasises the need to accommodate the diverse nature of listed companies and advocates for the adoption of flexible and proportional approaches in implementing certain best practices. Certain practices are exclusively suited to large companies. Large companies can be categorised as those who possess a market value of RM2 billion or higher at the commencement of their fiscal year, or are listed in the FTSE Bursa Malaysia Top 100 Index. The necessary data will be obtained through manual collection from the annual reports of the companies. The data collection phase for this study commenced in 2018 and will continue through 2022. The sample will be obtained based on the predetermined criteria outlined below:

1. The list comprises the top 100 firms that are listed on Bursa Malaysia FTSE.
2. The selection of companies for analysis should include data on the proportion of foreign investors from 2018 to 2022.
3. The selection of companies for analysis should include those that have reported the proportion of institutional investors from 2018 to 2022.
4. In line with previous research, the sample excludes banks, financial institutions, insurance businesses, and real estate investment trusts due to their utilisation of diverse accounting data and adherence to distinct regulatory frameworks.

4.2. The operational definition of variables

This study has a single dependent variable, tax avoidance, and four independent variables: Corporate Social Responsibility (CSR), ownership structure (represented by foreign and institutional ownership), executive incentives, and audit quality. The specific characteristics and attributes of each variable will be elaborated upon in the subsequent sections.

4.2.1. Tax avoidance (dependent variable)

The Cash Effective Tax Rates (Cash ETR) serve as a surrogate measure for tax avoidance within the scope of this research. This metric has been widely utilised in contemporary literary works (Kiesewetter & Manthey, 2017; Abdelfattah & Aboud, 2020; Mouakhar et al., 2020; Salhi et al., 2020; Pertiwi & Prihandini, 2021; Dakhli, 2022). Cash Effective Tax Rates (Cash ETR) refer to the proportion of cash allocated for tax expenditure in relation to pre-tax income, as defined by Dyreng et al. (2008). The formula utilised for the computation of tax avoidance is as follows:

Effective Tax Rate = (Tax expense -deferred tax expense)/(Income before Tax)

4.2.2. Corporate social responsibility (CSR) (independent variable)

Corporate Social Responsibility (CSR) serves as the primary independent variable in this research, and its measurement will be conducted through the use of the Global Reporting Initiative (GRI) index. The GRI index encompasses a comprehensive set of 91 elements that together assess CSR performance. The selection of this measurement is based on the comprehensive coverage of all economic, environmental, and social dimensions of corporate social responsibility (CSR) provided by the GRI Index (Wilburn & Wilburn, 2013). The formula for calculating the Customer Satisfaction Rating Index (CSRI) is as follows:

$$\mathbf{CSRIj} = \sum \mathbf{X_i\, j} \Big/ \mathbf{Nj}$$

CSRIj = CSR disclosure index of company j

N = The number of fulfilled indicators of CSR disclosures

X_i = Dummy variable (X_i = 1, if disclosure i is presented in the report, otherwise X_i = 0)

4.2.3. Ownership structure (independent variable)

This study will utilise foreign ownership and institutional ownership as proxies for the ownership structure. The measurement of foreign ownership is determined by calculating the percentage of foreign shares in relation to the total outstanding share capital, as outlined by (Richardson et al., 2015).

Foreign ownership = Number of Foreign Share / All Outstanding share

This study uses the measurement for institutional ownership that is frequently used by many academics and was also adopted by Ying et al. (2017a). It is calculated using the following formula:

Institutional ownership = Number of Institutional share / All Outstanding share

4.2.4. Executive incentives

Executive incentives are material or non-material rewards given to executives by the company's principals to motivate them to achieve the company's goals. The measure of executive incentives is executive incentives divided by total compensation (Banghøj et al., 2010).

Executive Incentives = Executive Incentives/All remuneration

Executive Incentives = (Total Executive incentives)

4.2.5. Audit quality (independent variable)

Audit quality is defined as a situation in which the company has conducted an audit utilising protocols and a reliable third party that adheres to high standards. The quality of audits is evaluated using dummy variables (Al-Manaseer et al., 2012). If the company is audited by one of the "big four" audit firms, it will be given a code of 1, and if not, it will be given a code of 0.

Audit fees, if Big 4 (Yes = 1, No = 0)

4.3. Test procedures

Since this study utilises company-provided data, which is highly unique from company to company due to the fact that each company has its own business practises, panel data techniques are likely to provide more accurate results for accomplishing this study's objectives. Hence, the approach employed in this study is most appropriate for conducting panel data analysis. This choice is justified by the utilisation of data to mitigate the limited temporal scope of the data series, which spans only five years (2018–2022), through the accumulation of cross-sectional data gathered from various companies. The acquisition and utilisation of time series data provide practical obstacles due to the extended duration of the covered time period. According to Jager (2008), in panel data analysis, the data were vertically arranged and separate intercept and slope coefficients were estimated for each explanatory variable. The approach employed in this study is in line with the assumption of homogeneity among the companies in the sample, and it is consistent with the concept of complete pooling of the panel. The sample utilised in this study is made homogeneous by exclusively selecting organisations that satisfy the criteria outlined in the MCCG 2017 definition of "Large Companies". The parameter will be assessed by the utilisation of the statistical software STATA.

5. Research timeline

This research is expected to be completed in 28 weeks based on the following indication of activities.

No	Research section	Weeks
1.	Title and Introduction	2 weeks
2.	Background of study	3 weeks
3.	Objectives	1 weeks
4.	Research Questions and Hypotheses development	4 weeks
5.	Research methodology	4 weeks
6.	Data Collection	8 weeks
7.	Data Analysis, Discussion and Conclusion	4 weeks
8.	Reviewing work for final submission	2 weeks

6. Conclusion

The study's results may provide insights into how corporate governance monitoring methods influence the alignment of a company's management with the shareholders' interests, as well as the utilisation of tax avoidance strategies in the shareholders' favour. This research makes a valuable contribution to the existing body of knowledge on corporate governance by examining the influence of corporate governance monitoring mechanisms on the alignment of management's actions with the shareholders' best interests. More specifically, it investigates the relationship between these mechanisms and the utilisation of tax avoidance strategies, with a focus on determining whether such strategies are employed in a manner that maximises shareholder value. The results suggest that firms characterised by strong governance structures are more inclined to possess effective internal control mechanisms, which promote transparency and hence discourage strategic tax avoidance or evasion by companies. Understanding the potential of corporate governance in mitigating the risks associated with corporate tax avoidance is of utmost importance. Moreover, the outcomes of this study will provide valuable insights for regulators, legislators,

professional accountants, auditors, company secretaries, and other pertinent professionals, offering substantial suggestions for enhancement. In addition, this research will present empirical findings pertaining to the monitoring mechanisms of corporate governance, specifically Corporate Social Responsibility, ownership structure, executive incentive, and audit quality. These mechanisms are aimed at deterring companies from participating in strategic tax avoidance or evasion, consequently reducing the likelihood of tax avoidance occurrences within corporate entities.

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