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# THE IMPACT OF TAX AVOIDANCE, PROFITABILITY, LEVERAGE, AND COMPANY SIZE ON EARNINGS MANAGEMENT

**Yasa Mulya Kusuma[1], Hendro Lukman[1*]**

[1]Faculty of Economics and Business, Universitas Tarumanagara, Jakarta - Indonesia
[*]*Email: hendrol@fe.untar.ac.id*

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***ABSTRACT***

*Companies doing earnings management have different goals or can be caused by several factors. several factors that can cause management to carry out earnings management include profit, leverage, company size, tax avoidance and others. This study aims to obtain empirical evidence and analysis of the influence of these factors on earnings management in non-cyclical consumer goods companies listed on the Indonesia Stock Exchange for the 2015-2020 period. Sampling using purposive sampling method. The number of data samples studied were 173 data from 31 companies. The analysis of this research is multiple linear regression analysis. The results of this study indicate that tax avoidance has an effect on earnings management, while other variables, profitability, leverage, and firm size have no effect on earnings management. The implication of this research is that the government must continue to close loop-wholes in tax laws and regulations to minimize earnings management practices*

***Keywords:*** *Earnings Management, Tax Avoidance, Profitability, Leverage, Firm Size*

## 1. INTRODUCTION

Financial statements are useful for providing an information on the performance of a company. This information is useful for investors or financial statements users for making economic decisions. The first thing people see when reading financial statements is to read the financial statements that have been presented. During this Covid-19 pandemic, many companies want to look good in the eyes of the public, one way is to carry out earnings management.

Earnings management is the intervention of company management in the external financial reporting process that aims to obtain personal interests [1]. There are four ways that company management can carry out earnings management, namely taking a bath, income minimization, income maximization, and income smoothing. Management motivation to practice earnings management includes bonus purpose, political motivation, taxation motivation, CEO change, initial public offering, and the importance of providing information to investors [2]. Earnings management occur when managers use their own judgement in financial reporting and in posting transactions to change financial statements with the intention of presenting a false picture of company performances for readers of financial statements [3]. Information that does not show the actual situation can be beneficial and detrimental. Profitable for the company, but detrimental to financial statements users, investors, creditors, and even the government. Such as cases that shock the world namely Enron Corporation case or those that have occurred in Indonesia such as PT Garuda Indonesia case. The adverse effects caused by earnings management motivated this research.
The study uses variables that can influence company management to practice earnings management in Indonesian Companies. These variables include tax avoidance, profitability, leverage, and company size.

Tax avoidance is one of tax planning. This tax evasion is not a crime. Tax avoidance is more tax planning while still complying with tax regulations. This tax planning looks at regulatory weak points that companies can take advantage of. Tax settings will affect the amount of profit. Thus, the tax avoidance factor is one of the reasons companies carry out earnings management. According to a study from [4] shows that tax avoidance had an effect on earnings management, however, researchers [5], [6], and [7] stated that tax avoidance has no effect on earnings management.

Taxes will relate to profits. Tax planning indirectly aims to regulate the amount of profit. Unstable profits from year to year for public companies can affect investor confidence. Likewise, the company's profits experienced very large fluctuations. Therefore, earnings can be a reason for management to carry out earnings management. The results of the study from [8], [9], [10], and [11] said that earnings had an effect on earnings management. This result contradicts the results of research from [12]. Another factor that is considered by management to manage earnings is the amount of debt or leverage. Excess leverage will cause the company's interest expense to be high. However, debt is needed by the company in increasing the company's working capital. Thus, this leverage becomes one of the management factors in carrying out earnings management practices. This can be seen in the results of research from [12], [13], and [14] which says that leverage has an effect on earnings management, in contrast to the results of research [5], [8], [5], [9], [10], and [11] which states that leverage has no effect on earnings management.

Another factor is the size of the company. The company's growth comes from retained earnings and reinvested into the company. Profit setting will indirectly affect the growth or size of the company. Thus, the size of the company will be considered by management to practice earnings management. Research that relates firm size to earnings management practices [13] stated that firm size has an impact on earnings management practices. While research [8] said company size has no effect on earnings management which is supported by [5], [10], [11], [15], and [16].

One of the factors that becomes a consideration of earnings management practices is taxes. Taxes that do not fluctuate are of concern to the tax officer for inspection. Particularly in practice in Indonesia, if there is an overpayment, you can be sure the officer will examine the company's taxes. Therefore, tax avoidance becomes a variable in earnings management practices even though there are still differences of opinion from previous researchers regarding whether tax avoidance has an effect or not on earnings management.

Large fluctuating company profits will affect investor confidence which will have an impact on stock prices. Generally, investors want a steady profit to assess the company's growth. Profit fluctuations will also lead to the possibility of risky tax overpayments on tax audits. Therefore, profit is a factor in making decisions to practice earnings management. From previous researchers, there are still research results on the influence of profitability on earnings management practices.

Another factor in is the amount of debt, the amount of debt will result in a decrease in profits and can indicate the company is not good at managing finances. Therefore, setting the ratio of debt to capital will be considered in earnings management practices. As with other factors, the results of previous studies still have different opinions about the influence or not of leverage on earnings management.

The size factor of the company is no less important in making earnings management policies. Assets are capital to generate profits. If the company has large assets with disproportionate profits, it shows that management is not using assets properly, and vice versa. Thus, the amount of total assets is also a consideration in earnings management practices. The effect of asset size is still debatable from the results of previous research studies, some say that there is an effect of company size on earnings management, some say the opposite.

Based on the explanations above, the study tries to answer the following questions: 1) Does tax avoidance have an impact on earnings management? 2) Does profitability have an impact on earnings management? 3) Does leverage have an impact on earnings management? 4) Does company size have an impact on earnings management?

Based on the explanations above, the study tries to answer the following questions: 1) Does tax avoidance have an impact on earnings management? 2) Does profitability have an impact on earnings management? 3) Does leverage have an impact on earnings management? 4) Does company size have an impact on earnings management? Thus, the purpose of this study is to analyze the effect of tax avoidance, profitability, leverage and company size on earnings management, especially for the non-cyclical consumer goods industry. With this research, it is hoped that it will contribute to management in considering earnings management, and investors can understand whether companies practice earnings management by comparing other information, both qualitative and company or product news in the community.

## Theoretical Review

### *Agency Theory*

This theory arises because it is felt that there is a separation of owners of capital from business management which basically involves risk sharing (17). This separation can be seen from two sides, namely to create governance that separates ownership and control (18), and which relates to the ability of capital owners to manage a business. However, each party has different interests which can become a problem in providing information (19). To ensure that there is alignment of interests between them, an agreement is needed. Agreements or contracts between one or several owners of capital, called principals (investors) and executors or company management, known as agents, are called agency theory [20]. The relationship between the two parties is the principal as the resource provider and the agent as the party managing the resource. Because the principal and the agent have their own interests, it results in a difference in information between the agent's and the principal's. This difference in information is known as information asymmetry. This information asymmetry will lead to a conflict called the agency problem. Management has more and detailed information and prioritizes personal interests above the interests of shareholders [21] so that earnings management practices can facilitate management interests

### *Accounting Positive Theory*

Positive accounting theory basically has the premise that the purpose of accounting theory is to provide a predictive picture of accounting practice. In predicting based on this theory has two perspectives. The first perspective states how the theory generally works, and the second perspective is that this theory can be used to measure predictive consequences for user welfare (22). Positive accounting theory seeks to explain a process by using accounting abilities, knowledge and understanding as well as using the most appropriate policies to deal with certain conditions in the future (23). The theory developed by Watts and Zimmerman, 1986 which explains in analysing the accounting theory with a normative approach is too simple so it does not provide a strong theoretical basis. In a normative accounting approach that focuses more on developing accounting principles, for example by paying attention to recognition and measurement in accounting (24). In contrast to the positive accounting theory approach which states which measurements are used that are useful for the market, and management for the reasons (24).

Under certain conditions, agents or managers have an interest in pursuing bonuses so that they tend to choose accounting procedures for changes in earnings to achieve their interests. (23), one of which is by managing earnings management. there are three hypotheses in positive accounting theory that are quite related to earnings management, namely the bonus plan hypothesis, the debt-equity hypothesis, and the political cost hypothesis [25].

## Literature Review

*Tax Avoidance and Earnings Management*

Tax avoidance is a way to reduce taxes that is still within the bounds of tax law and can be justified, particularly by tax planning [26]. There are three principals of tax avoidance, namely delaying tax payments by deferring income, tax arbitrage that utilizes differences in tax rates, and tax arbitrage that utilizes differences in tax treatment [27]. According to agency theory, company management has its own interest in achieving good results, one of which can be achieved by tax avoidance. Some companies tend to pay a small amount of tax, which leads them to practice earnings management by minimizing their profits. The tax burden is considered burdensome for companies and the owners, which leads to tax avoidance [28]. Bonus plan hypothesis in accounting positive theory states that company management will practice earnings management to achieve their bonus plan.

*Profitability and Earnings Management*

Profitability is a description of the company's ability to generate profits. A company with a high level of profitability can be said to be able to generate large amounts of profit. According to the theory of agencies and the theory of positive accounting, the management of the enterprise tends to have an interest in declaring significant profits, in order to obtain a certain bonus (bonus plan hypothesis). When the company's profitability is low, the company's management tends to practice earnings management to meet investor expectations. However, sometimes investors do not pay attention to information on the level of profitability of an enterprise, so that management often ignores the level of profitability as well.

*Leverage and Earnings Management*

According to the debt equity hypothesis in positive accounting theory, company management tends to maintain the company's leverage level so as not to violate credit terms with creditors. Companies that have a high level of leverage will tend to practise profit management in order to maintain the trust of creditors. Conversely, if a company that has a low level of leverage or can be said to not really need other parties' loans, the company will tend to make financial reports with the actual situation. leverage is a description of a company's ability to pay off obligations [29] because leverage will be considered by management to conduct earnings management before the financial statements are published.

*Company Size and Earnings Management*

Large-scale companies tend to get more attention from the public, thus allowing management in large-scale companies to carry out one of the earnings management practices, namely by smoothing income to maintain the stability of the company's performance. On the other hand, small-scale companies tend to want to get more attention from investors in order to get an injection of funds for company development. Large companies have various advantages over small companies [30].

**Research Hypothesis**

Tax avoidance is a practice carried out by company management by trying to reduce the nominal tax payment in a legal way. When the company wants to avoid paying a large amount of tax, company management tends to practice earnings management by shrinking its profits (income minimization). that way, in addition to paying a small amount of tax, company management will also get the desired bonus. This tax avoidance consideration is in line with agency theory, where management performs tax evasion to show good performance to get reward Thus, tax avoidance can be said to have an influence on management practices. This is like the results of research conducted by [4]. Based on the explanation and research results, the hypothesis built in this study is
**$Ha_1$:** Tax avoidance has a positive influence on earnings management.

Profitability describes the company's ability to generate profits. Good, stable profits and share prices can become one of the key performance indicators of management so that this is used for the benefit of agents to get rewards in the form of bonuses that non-active shareholders may not know in detail. This condition is in line with agency theory where there is an information asymmetry between the agent and the principal. When the company's profitability level is low, company management tends to maximize profits (income maximization) so that it still looks profitable in the eyes of the public. And, when the company's profitability level increases, company management also tends to do income smoothing so that its profits continue to be stable and large. Research from [8], [9],[10], and [11] showed that earnings have an influence on earnings management practices. Based on the explanation and research results, the hypothesis built in this study is
**$Ha_2$:** Profitability has a positive influence on earnings management.

The higher the level of leverage of a company, the company will look risky and vulnerable to collapse. If this happens, investors will be reluctant to provide more resources for the company to operate. as a result, companies with high levels of leverage tend to encourage their management to practice earnings management. In positive accounting theory, debt is not only seen in terms of recording, but the meaning that will be received by the user. Because setting the amount of debt in the records will be the basis for carrying out earnings management so as to give a good impression to users. If that happens, investors will be hesitant to give the company more resources to operate. Consequently, corporations with high levels of indebtedness tend to encourage their management to practice earnings management. The relationship of leverage on earnings management practices based on research [12], [13], and [14] showed that leverage has an effect on earnings management practices
Based on the explanation and research results, the hypothesis built in this study is
**$Ha_3$:** Leverage has a positive influence on earnings management.

In general, companies can be distinguished based on the size of the company through its total assets. The use of assets to obtain profit which describes from records in accordance with general provisions is a normative accounting theory approach. However, this can give an unfavorable perception if the utilization of asset resources is not optimal or according to user expectations, so with positive accounting theory the size of the company is a consideration in earnings management so that it has a good meaning or according to user expectations. The greater the total assets owned by the company, it can be said that the company is on a large scale. People tend to pay more attention to large-scale companies because they are considered to have an influence on the economy. This makes large companies tend to report the results of their performance in the financial statements transparently in order to maintain the company's image. On the other hand, the smaller the scale of the company, the more likely it will carry out earnings management practices in order to attract investors to invest their funds in the company. Based on research [5], [10], [15], [16], and [11] showed the size of the company had no influence on earnings management practices. Based on the explanation and research results, the hypothesis built in this study is
**$Ha_4$:** Company size has a negative influence on earnings management.

## 2. RESEARCH METHOD

The research design in this study uses a causal research design. The data population used in this study are non-cyclical consumer goods companies listed on the Indonesia Stock Exchange. The determination of the object of research on non-cyclical consumer goods is because this industry produces consumer goods which are not basic consumer needs, so there are many alternative products. The price of this product is not too much influenced by government policy factors, but is influenced by the purchasing power and "want" of consumers so that management will have the opportunity to carry out earnings management to maintain investor confidence and share prices in the market.

Samples were taken using non-probability sampling techniques in the form of purposive sampling with the following criteria: 1) Noncyclical consumer goods companies that are consistently listed on the Indonesian Stock Exchange during 2015 to 2020. 2) Noncyclical consumer goods companies that publish annual financial reports consistently from 2015 to 2020. 3) Noncyclical consumer goods companies that publish financial reports with periods ending on December 31 during 2015 to 2020. 4) Noncyclical consumer goods companies that earn profits consistently from 2015 to 2020. The research period is determined from 2015 to 2020, because in the first quarter (Q1_ 2020 the Indonesian economy is in normal condition. Entering the second quarter (Q2) and until the end of 2022 Indonesia is in the era of the Covid-19 Pandemic which can be ascertained the company's performance from 2020 to 2022 cannot be compared to the year before the Covid-19 Pandemic.

Operationalization of variables and instruments along with the measurement of each variable can be described as follows:

**Table 1** Operationalization of Variables

| Variable | Indicator | Scale |
|---|---|---|
| Earnings Management (DA) | $DA_t = \left(\frac{TAC_t}{A_{t-1}}\right) - NDA_t$<br>TAC : Total accrual<br>A : Total Assets<br>NDA : nondiscretionary accrual | Ratio |
| Tax Avoidance (ETR) | $ETR = \frac{Income\ Tax\ Expense}{Income\ Before\ Tax}$ | Ratio |
| Profitability (ROA) | $ROA = \frac{Net\ Profit}{Total\ Assets}$ | Ratio |
| Leverage (LEV) | $LEV = \frac{Total\ Liabilities}{Total\ Assets}$ | Ratio |
| Company Size (SIZE) | $SIZE = \log natural\ total\ asset$ | Ratio |

Source: Compiled by Authors

## 3. RESULTS AND DISCUSSION

Using the data processing application IBM SPSS version 26, conducted a descriptive test, and classical assumption tests such as normality, multicollinearity, autocorrelations and heteroscedasticity were performed.

Descriptive test results can be seen in the table below:

**Table 2.** Descriptive Test Result

| Variables | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Earnings Management (DA) | 173 | -.2477 | .3293 | -.0289 | .0795 |
| Tax Avoidance (ETR) | 173 | .0249 | .5957 | .2448 | .0727 |
| Profitability (ROA) | 173 | .0064 | .3816 | .0926 | .0772 |
| Leverage (LEV) | 173 | .1405 | .8108 | .4580 | .2009 |
| Company Size (SIZE) | 173 | 26.6558 | 32.7256 | 29.5245 | 1.3990 |

Source: Output from SPSS

From Table 2, it shows that the dependent variable, namely earnings management (DA), has a maximum value of 0.3293 occurring at PT HM Sampurna Tbk in 2015 and a minimum value of -0.2477 occurring at PT Sumber Alfaria Trijaya Tbk. 2018 For the independent variable tax avoidance the maximum value is at PT Budi Starch & Sweetener TBk in 2015 with a value of 0.5957 and PT Wilmar Cahaya Utama Tbk in 2018 for a minimum value of 0.0249. For other variables, the maximum of Profitability (0.3816) was obtained by PT Unilever Indonesia in 2015, and the minimum value (0.0064) occurred at PT Budi Starch & Sweetener TBk in 2015. Meanwhile for the leverage variable it has a maximum value of 0.8108 occurring at PT Midi Utama Indonesia Tbk in 2017 and a minimum value of 0.1405 occurred at PT Ultra Jaya Milk Industry Tbk in 2018. Finally for company size the maximum value occurred at PT Indofood Sukses Makmur Tbk in 2020 with a value of 32,725, while the minimum value occurred at PT PT Sekar Laut Tbk in 2015 with a value of 26.6558

Normality test using this Kolmogorov-Smirnov test showed on Table 3 below:

**Table 3.** Kolmogorov-Smirnov Test Result

| | **Unstandardized Residual** |
|---|---|
| N | 173 |
| Asymp. Sig. (2-tailed) | 0.200[c,d] |

Source: Output from SPSS

While the results of the no multicollinearity test where the data does not occur no multicollinearity between independent variables if the tolerance value is more than 0.1 and VIF value is less than 10 can be shown in Table 4 below.

**Table 4.** The Result of Multicollinearity Test

| **Model** | **Tolerance** | **VIF** |
|---|---|---|
| **(Constant)** | | |
| ETR | .972 | 1.028 |
| ROA | .890 | 1.123 |
| LEV | .924 | 1.082 |
| SIZE | .946 | 1.057 |

Source: Output from SPPS

Based on the results in the table, all independent variables have a tolerance value of more than 0.1 and a VIF value of less than 10, so it does not indicate that there is no multicollinearity.

Autocorrelation test using Run Test where the independent variable does not experience autocorrelation if the Symp value. Sig (2-tailed) shows greater than 0.05. The results of this test are as follows:

**Table 5**. The Result of Autocorrelation Test

| | **Unstandardized Residual** |
|---|---|
| Test Value[a] | .00184 |
| Cases < Test Value | 86 |
| Cases >= Test Value | 87 |
| Total Cases | 173 |
| Number of Runs | 75 |
| Z | -1.906 |
| Asymp. Sig. (2-tailed) | .057 |

Source: Output from SPSS

Table 5 shows the Asymp value. Sig. (2-tailed) 0.057 which is more than 0.05 so that the independent variables do not occur autocorrelation

Heteroscedasticity test was carried out using the Glesjer test. Free regression model and heteroscedasticity if the significant value (sig.) is greater than 0.005. The results of the heteroscedasticity test are as follows:

**Table 6**. The Result of Heteroscedasticity Test

| **Model** | **Sig.** |
|---|---|
| (Constant) | .014 |
| ETR | .271 |
| ROA | .639 |
| LEV | .202 |
| SIZE | .080 |

Source: Output from SPSS

In Table 5 above, all variables show a value of more than 0.05 so that this regression model does not have heteroscedasticity.

After passing all the classical assumption tests, a regression test was carried out. The results of the regression test are as follows:

**Table 7**. The Result of Regression Analysis

| | | **Unstandardized Coefficients** | | **Sig.** |
|---|---|---|---|---|
| | **Model** | **B** | **Std. Error** | |
| 1 | (Constant) | .028 | .124 | .824 |
| | ETR | .318 | .081 | .000 |
| | ROA | -.002 | .080 | .985 |
| | LEV | -.059 | .030 | .053 |
| | SIZE | -.004 | .004 | .396 |

Source: Output from SPSS

Based on the results of the regression test, the equations in earnings management in this study are:

$$DA = 0.28 + 0.318\ ETR - 0.002\ ROA - 0.059\ LEV - 0.004\ SIZE + e$$

The results of the regression test show that tax avoidance (ETR) has a positive effect on earnings management, this can be seen from the value of sig. ETR variable is 0.000 (less than 0.05). While the profit variable (ROA) with a value of sig. 0.985, Leverage (sig. 0.053), and Company Size (SIZE) with a sig value of 0.396 show no effect on earnings management practices in non-cyclical consumer goods companies.

The contribution of the independent variable to the dependent variable, the R test shows a value of 32%, which means there are still 68% of other factors that cause earnings management practices.

## 4. CONSLUSION AND RECOMMENDATIONS

Based on the results of the regression test, below is presented the hypothesis analysis table as follows:

**Table 8**. Hypothesis Analysis

| Influence | Hypothesis | Regression | Result |
|---|---|---|---|
| ETR on DA | Positive influence | Positive influence | Accepted |
| RAO on DA | Positive influence | Negative influence | Rejected |
| LEV on DA | Positive influence | Negative influence | Rejected |
| SIZE on DA | Negative influence | Negative influence | Accepted |

Source: Compiled by Authors

Based on the results of the study above, it can be concluded that tax avoidance has a positive and significant impact on earnings management as same as hypothesis. This is because if the company's management wants to pay a small amount of tax, the company will outsmart it by manipulating the profit earned by the company. According to the agency theory and bonus plan hypothesis in positive accounting theory, company management has a self-interest in order to generate appropriate profits and get the desired bonus through small tax payments.

On the other hand, profitability has no significant impact on earnings management. The result is rejected from hypothesis. The reason, profitability is often ignored by investors and users of financial statements, thus making company management tend to also ignore the level of company profitability if they want to do or not practice earnings management.

Leverage also has no significant impact on earnings management. The result is rejected from hypothesis. The explanation is, if the company has a high level of leverage but is still categorized as safe and still meets the requirements of creditors, then company management tends not to be motivated to practice earnings management.

The last variable company size also has no significant impact on earnings management. The results as well as hypothesis. Company size tends not to influence company management in practicing earnings management. large-scale companies tend to be transparent in reporting their finances because large-scale companies tend to be more concerned by the public.

In general, the conclusion that the practice of earnings management in the non-cyclical consumer goods industry in Indonesia in the 2015-2020 period is more due to tax factors, is the reason for tax planning, in this case tax avoidance.
The implication of this research is that the government must continue to close loop-wholes in tax laws and regulations to minimize earnings management practices

This study is certainly not free from all limitations. In this study, the observation period is only 6 years (from 2015-2020) so there are only 173 data used as research samples, and this does not reflect the real condition of all companies in the study population. In future study, can increase the observation period. Then, the companies studied only include noncyclical consumer goods companies listed on the Indonesia Stock Exchange. In future study, research can add or replace other research populations. Last, the independent variables used in this study consist of only four variables, namely tax avoidance, profitability, leverage, and company size. In future study, there are many other independent variables that can be studied and affect earnings management, such as managerial ownership, institutional ownership, company growth, and free cash flow. This is done so that there is a greater variety of information regarding the factors that influence earnings management.

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