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The effect of profitability and leverage on tax avoidance with interest coverage as a moderating variable

Murdhaningsih*, Nabilah Farras Luthfi, Bunga Anisah Harared

Economics and Business Faculty, Universitas Pembangunan Nasional Veteran Jakarta, Jakarta, Indonesia

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Abstract

This study aims to examine the effect of financial performance indicators—Return on Assets (ROA), Return on Equity (ROE), Debt to Asset Ratio (DAR), and Debt to Equity Ratio (DER)—on tax avoidance, with the Interest Coverage Ratio as a moderating variable. The research sample comprises industrial sector companies listed on the Indonesia Stock Exchange (IDX) from 2019 to 2022. Using panel data regression analysis, the results of Model 1 show that DAR has a significant effect on tax avoidance. Furthermore, model 2 shows that the Interest Coverage Ratio moderates the relationship between ROA, ROE, and DAR on tax avoidance, but is not significant on DER. These findings indicate that the financial structure and the company's ability to cover interest expenses influence tax avoidance behavior. This study contributes to understanding how internal financial factors influence corporate tax planning strategies. Further research is recommended to explore broader sectors and add other financial and non-financial variables to obtain a more comprehensive picture of tax avoidance behavior..

Public Interest Statement

This study helps the public understand how companies' financial conditions, particularly debt levels and interest payments, influence their tax planning behavior. The findings are helpful for regulators, investors, and taxpayers to identify potential tax avoidance practices and promote fair taxation.

Keywords: Tax Avoidance, profitability, Leverage, Interest Coverage
Paper type: Research paper

✉ Corresponding:
Murdhaningsih
Email: murdhaningsih@upnvj.ac.id

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Abstrak

Penelitian ini bertujuan untuk menguji pengaruh indikator kinerja keuangan—Return on Assets (ROA), Return on Equity (ROE), Debt to Asset Ratio (DAR), dan Debt to Equity Ratio (DER)—terhadap tax avoidance, dengan Interest Coverage Ratio sebagai variabel moderasi. Sampel penelitian terdiri dari perusahaan sektor industri yang terdaftar di Bursa Efek Indonesia (BEI) selama periode 2019 hingga 2022. Dengan menggunakan analisis regresi data panel, pada model 1 hasil penelitian menunjukkan bahwa DAR yang berpengaruh signifikan terhadap tax avoidance. Selain itu, pada model 2 menunjukkan bahawa Interest Coverage Ratio terbukti mampu memoderasi hubungan antara ROA, ROE, dan DAR terhadap tax avoidance, tetapi tidak signifikan pada DER. Temuan ini mengindikasikan bahwa struktur keuangan dan kemampuan perusahaan dalam menutup beban bunga memiliki peranan penting dalam mempengaruhi perilaku penghindaran pajak. Penelitian ini memberikan kontribusi dalam memahami bagaimana faktor internal keuangan berpengaruh terhadap strategi perencanaan pajak korporasi. Penelitian selanjutnya disarankan untuk mengeksplorasi sektor yang lebih luas dan menambahkan variabel keuangan maupun non-keuangan lainnya guna memperoleh gambaran yang lebih komprehensif mengenai perilaku penghindaran pajak.

Pernyataan kepentingan publik

Penelitian ini membantu masyarakat memahami bagaimana kondisi keuangan perusahaan, khususnya tingkat utang dan pembayaran bunga, dapat mempengaruhi praktik penghindaran pajak. Temuan ini bermanfaat bagi regulator, investor, dan wajib pajak dalam mendeteksi potensi praktik penghindaran pajak serta mendorong terciptanya sistem perpajakan yang lebih adil.

Kata Kunci: Penghindaran Pajak, Profitabilitas, Leverage, Interest Coverage

INTRODUCTION

Taxes are an obligation that must be fulfilled by every individual or entity as a form of participation in supporting national development. Taxes play a vital role as the main source of state funding in running the economy (Kalbuana et al., 2020). According to Law Number 16 of 2009 concerning General Provisions and Procedures for Taxation, Article 1, Paragraph 1, taxes are defined as mandatory contributions paid by individuals or entities to the state, which are enforced by law, do not provide direct benefits, and are used entirely for the interests of the state and the welfare of the community.

Taxes are often considered a burden by corporate taxpayers because they can reduce the net profit received by companies. In addition, companies do not receive full compensation for the taxes they have paid. This condition encourages many companies to implement various strategies to reduce the amount of tax paid as low as possible, one of which is through tax avoidance practices (Amelia and Nurdayanti, 2022). According to Nur Diana and Umaimah (2022), tax avoidance can be understood as a legal practice carried out by exploiting legal loopholes in tax provisions to minimize tax obligations.

The topic of tax avoidance remains a relevant issue to study because empirical findings from previous studies show inconsistencies, indicating a research gap. For example, research by Dalam and Nofriyanti (2020) found that profitability has a positive influence on tax avoidance practices. Similar results were also reported by Noveliza & Chismonica (2021), who stated that the higher the profit earned by a company, the higher the income tax burden it bears, thereby encouraging companies to adopt tax avoidance strategies to reduce that burden. Conversely, S., M.

A., & Mahpudin, E. (2024) found that profitability and leverage do not influence tax avoidance, contrary to the findings of Fahmi & Naibaho (2025), who showed that leverage significantly impacts tax avoidance practices.

This study aims to examine the effect of profitability and leverage on tax avoidance by placing the interest coverage ratio as a moderating variable. The originality of this study lies in the exploration of the interest coverage ratio as a moderating variable between profitability and leverage on tax avoidance. This approach contributes new insights, particularly to the Indonesian literature, by explaining the context in which capital structure is not only assessed by the amount of debt but also by the company's ability to pay interest.

THEORETICAL FRAMEWORK AND HYPOTHESES

Agency Theory

Agency theory describes the relationship between capital owners (principals), namely shareholders, and company management (agents). In this context, shareholders are not directly involved in the company's operational activities, but rather act as providers of funds and facilities to support the company's activities. Conversely, the party that runs the company's daily operations is the management, which is responsible for managing the company's resources effectively. Ideally, management is expected to make decisions that align with the interests of shareholders. However, in practice, management often acts in its interests (Shapiro, 2005). According to Sdiq and Abdullah (2022), the separation of ownership and management creates an agency relationship that may lead to conflicts of interest between shareholders as principals and managers as agents. In this context, management can implement tax planning strategies as part of its responsibilities, one of which is tax avoidance, i.e., explicit efforts to reduce tax burdens (Hanlon & Heitzman, 2010).

Tax avoidance

Tax avoidance is one of the company strategies to alleviate the company's tax burden by minimizing the amount of tax that must be paid legally (Sulistiyanti & Dwi Saputra, 2021). According to Jusman and Nosita (2020), tax avoidance is a tax avoidance strategy that exploits loopholes in a country's tax regulations to reduce the amount of tax payable. In practice in various countries, tax avoidance can be classified into two categories, namely acceptable tax avoidance and unacceptable tax avoidance. Yuanita et al. (2020) argue that corporate tax avoidance behavior is contingent upon the investor protection level and legal systems of a country, meaning a scheme that is legal in one jurisdiction may be impermissible in another.

The relationship between roa and tax avoidance

Return on Assets (ROA) measures how effectively a company generates profits from all of its assets. A high ROA reflects a company's efficiency in utilising its assets to generate profits. About tax avoidance, ROA is often used as an important indicator to assess the extent to which a company is motivated to optimise its tax burden. Companies with solid financial performance generally have sufficient capacity to pay taxes, making them more likely to comply with tax regulations (Rachman et.al., 2025).

H1: Return on Assets (ROA) influences tax avoidance

The relationship between ROE and tax avoidance

Return on Equity (ROE) measures a company's ability to generate profits for shareholders from each unit of equity invested. A high ROE indicates a good return on investment and efficient use of capital. In the context of tax avoidance, companies with high ROE tend to avoid engaging in tax avoidance strategies to maintain their good corporate image. Research by Andriawan, Roekhudin, and Iqbal (2024) argue that companies with strong reputations (denoted by high brand value) are less inclined to engage in aggressive tax avoidance to protect their image.

H2: Return on Equity (ROE) influences Tax Avoidance.

The relationship between DAR and tax avoidance

The Debt to Assets Ratio (DAR) shows the proportion of assets financed by debt. Companies with high DAR tend to have significant interest expenses, which can reduce taxable income because interest is a tax-deductible expense. This provides an incentive for companies to increase their use of debt as a legal tax avoidance strategy. Research by Trisanti (2021) shows that high leverage is associated with tax avoidance practices. Companies with high DAR often utilise interest expenses to reduce their tax liability.

H3: Debt to assets ratio (DAR) influences tax avoidance

The Relationship between DER and Tax Avoidance

The Debt to Equity Ratio (DER) measures a company's financing structure between debt and equity. A high DER indicates a company's dependence on debt financing. Similar to DAR, a high DER also allows companies to obtain tax savings through interest expense deductions, which encourages tax avoidance practices. Ambarita et.al. (2024) state that a capital structure containing more debt has the potential to encourage tax avoidance practices.

H4: Debt-to-Equity Ratio (DER) influences Tax Avoidance

Interest Coverage can moderate the relationship between ROA and tax avoidance.

The Interest Coverage Ratio (ICR) measures a company's ability to meet its interest obligations on debt. Companies with a high ICR have strong interest payment capabilities, reflecting financial stability and sound financial management. When interest coverage is high, companies with high ROA may be more compliant with tax obligations because they are not overly burdened by debt, thereby weakening the relationship between ROA and tax avoidance. Research by Lee and Park (2023) found that firms with high interest coverage ratios tend to refrain from aggressive tax avoidance as their financial strength reduces the perceived need to engage in such strategies.

H5: Interest coverage can moderate the relationship between ROA and tax avoidance

Interest coverage can moderate the relationship between ROE and tax avoidance.

Interest coverage can also weaken the relationship between ROE and tax avoidance. When companies have a strong ability to pay interest on debt, the incentive to avoid taxes in order to maintain ROE will decrease, as companies feel more financially secure. The results of a study by Taylor and Richardson (2014) show that funding structure and financial conditions moderate the relationship between financial performance and aggressive tax strategies.

H6: Interest coverage can moderate the relationship between ROE and tax avoidance.

Interest Coverage can moderate the relationship between DAR and tax avoidance.

Interest coverage can strengthen the relationship between DAR and tax avoidance. When a company has a high DAR ratio and also has a good ability to pay interest, the company will be more flexible in utilising debt for tax planning purposes. The Interest Coverage Ratio measures a company's ability to pay interest expenses from its operating income (EBIT). The higher the ICR, the greater the company's ability to meet its interest obligations, reflecting financial flexibility. According to Andrini and Putra (2025), companies with high leverage and favorable dividend policies tend to be more active in engaging in tax avoidance. This is due to a combination of financial flexibility and tax savings from interest expenses, which allows companies to design more aggressive tax strategies.

H7: Interest Coverage can moderate the relationship between DAR and tax avoidance

Interest Coverage can moderate the relationship between DER and tax avoidance.

Similar to DAR, interest coverage can also strengthen the relationship between DER and tax avoidance. Companies with debt-dominated capital structures and high interest-paying capabilities will take advantage of this condition to engage in more aggressive tax avoidance. Studies by Rego (2003) and Lim (2011) show that a debt structure combined with stable financial conditions enables companies to engage in tax planning actively.

H8: Interest Coverage can moderate the relationship between DER and tax avoidance.

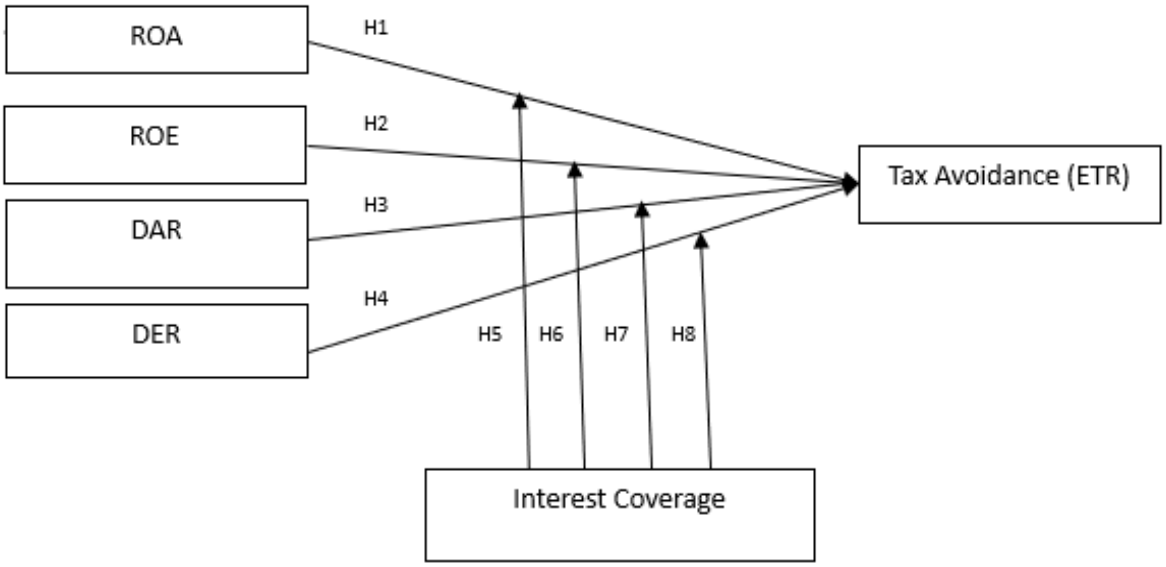

Figure 1
Conceptual Framework

METHOD

This study uses a quantitative approach to identify the magnitude of the influence or relationship between the variables under study. The data used comes from secondary sources, namely, company annual reports. The research population includes all companies listed on the Indonesia Stock Exchange, and the sample was selected using purposive sampling. The criteria for sample selection include: (1) companies operating in industries listed on the IDX; (2) companies that have published complete financial and annual reports for the period 2019–2022; and (3) companies that did not incur losses during the observation period. In this study, the exogenous variables (independent variables) are ROA, ROE, DAR, and DER. Tax Avoidance acts as the endogenous variable (dependent variable) , and the moderating variable is Interest Coverage. The operational measurement of the variables is shown in Table 1.

Table 1
Operational Definition Variables

Variable	Type of Variable	Indicator / Proxy	Formula / Measurement	Scale	Source
Return on Assets (ROA)	Independent	Efficiency in using assets to generate profit	ROA = Net Income / Total Assets	Ratio	Brigham & Houston (2021)
Return on Equity (ROE)	Independent	Rate of return on shareholders' equity	ROE = Net Income / Total Equity	Ratio	Kieso et al. (2020)
Debt to Asset Ratio (DAR)	Independent	Proportion of assets financed by debt	DAR = Total Liabilities / Total Assets	Ratio	Ross et al. (2022)
Debt to Equity Ratio (DER)	Independent	Level of debt relative to shareholders' equity	DER = Total Liabilities / Total Equity	Ratio	Wild et al. (2019)
Tax Avoidance	Dependent	Tax avoidance measured through tax expense effectiveness	ETR = Total Tax Expense / Earnings Before Tax	Ratio	Taylor & Richardson (2014)
Interest Coverage Ratio (ICR)	Moderating	Ability to cover interest expenses with operating income	ICR = EBIT / Interest Expense	Ratio	White et al. (2020)

Data analysis procedures

This study aims to investigate the effect of profitability risk and leverage ratio on tax avoidance, while also examining the moderating role of interest coverage in this relationship. This analysis uses panel data collected from companies listed on the Indonesia Stock Exchange. A multiple linear panel regression model is used to estimate the effect, as determined in the following equation:

Model 1 :
$Y = a + \beta1.X1 + \beta2.X2 + \beta3.X3 + \beta4.X4 + e$

Model 2 :
$Y = a + \beta1.X1.Z + \beta2.X2.Z + \beta3.X3.Z + \beta4.X4.Z + e$

RESULTS AND DISCUSSION

Analysis of Results

Descriptive statistical analysis was used to provide a concise and clear overview of the research data. The results of this analysis are presented in table 2.

Table 2
Statistik Deskriptif

	ROA	ROE	DAR	DER	Tax Avoidance
Mean	6.940	12.387	0.133	0.990	0.274
Median	6.315	10.535	0.125	0.595	0.233
Maximum	22.340	34.490	0.710	5.260	1.000
Minimum	0.040	0.060	0.000	0.000	0.000
Std. Dev.	5.253	8.755	0.134	1.109	0.164

Based on a descriptive analysis of 44 companies, the average Return on Assets (ROA) was 6.94%. The average Return on Equity (ROE) was 12.39%, indicating that the companies in the sample were generally efficient in generating profits from their assets and equity. The maximum values for ROA and ROE are 22.34% and 34.49%, respectively. In contrast, the minimum values are very low, at 0.04% and 0.06%, reflecting significant variation in financial performance among companies. The standard deviation is relatively high, especially for ROE (8.76), indicating a fairly large spread of data.

The Debt to Asset Ratio (DAR) has an average value of 13.33%, indicating that most companies have a financing structure that is more dominated by equity than debt. Similarly, the Debt to Equity Ratio (DER) has an average of 0.99, indicating that the use of debt is still relatively balanced against equity. However, the maximum DER value reaches 5.26, indicating that there are companies with a capital structure that is highly dependent on debt. Meanwhile, the average Tax Avoidance value of 0.2746, with a maximum value of 1 and a minimum value of 0, indicates that tax avoidance practices vary among companies, with some companies not engaging in tax avoidance at all and others having very high levels of tax avoidance. The standard deviation value of 0.165 also confirms that there are significant differences in tax avoidance behaviour among companies in the sample.

Panel selection of panel data estimation techniques

The Chow test is a method used to determine whether the Common Effect Model (CEM) or the Fixed Effect Model (FEM) is more suitable for panel data estimation. In a Chow test conducted using Eviews 10, a probability value of 0.3434 was obtained. Since this value is greater than the significance level of 0.05, we accept the null hypothesis (H0) and reject the alternative hypothesis (Ha). Therefore, the more appropriate model to use is the Common Effect Model (CEM), and the analysis will continue with the Hausman test.

Table 3.
Model selection results

Redundant Fixed Effects Tests			
Test cross-section fixed effects			
Effects Test	Statistic	d.f.	Prob.
Cross-section F	1.182156	(12,27)	0.3434
Cross-section Chi-square	18.579365	12	0.0992

Correlated Random Effects - Hausman Test				
Test Summary			Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random			3.399135	4	0.4934
Null (no rand. effect)	Cross-section	Period	Both	
Alternative	One-sided	One-sided		
Breusch-Pagan	0.074517	0.520341	0.594858	
	(0.7849)	(0.4707)	(0.4405)	
Honda	-0.272979	0.721346	0.317044	
	(0.6076)	(0.2353)	(0.3756)	
King-Wu	-0.272979	0.721346	0.515550	
	(0.6076)	(0.2353)	(0.3031)	
GHM	--	--	0.520341	
	--	--	(0.4281)	

The Hausman test is a statistical method used to decide whether the Fixed Effect Model or the Random Effect Model (REM) is more suitable. Suppose the Hausman statistic value is smaller than the significance level of 0.05. In that case, we accept the alternative hypothesis (Ha), indicating that the Fixed Effect Model is the appropriate choice. Conversely, if it is greater than 0.05, the Random Effect Model is more appropriate. Suppose either the Common Effect Model or the Fixed Effect Model is used. In that case, the next step is to conduct a classical assumption test. However, if the Random Effect Model is selected, a classical assumption test is not necessary. The Hausman test results yielded a probability value of 0.4934, which is higher than the significance level of 0.05. These results indicate that we accept the null hypothesis (H0) and reject the alternative hypothesis (Ha), making the Random Effect Model (REM) the most suitable estimation model.

Given the differences in model selection results between the Chow test and the Hausman test, it is necessary to perform the Lagrange Multiplier test to determine the most appropriate model. The Lagrange test helps identify the best panel data regression model. According to the output results in Table 3, the Breusch-Pagan probability value is 0.7849, which is greater than 0.05. Therefore, we reject the null hypothesis (H0) and accept the alternative hypothesis (Ha), concluding that the appropriate model for further analysis is the Common Effect Model (CEM).

Discussion

The regression analysis in model 1 aims to test the effect of independent variables on dependent variables using panel data, which is a combination of time series and cross-section data. The estimation was performed using the Common Effect Model (CEM) approach in panel regression. The estimation results obtained through Eviews10 are presented as follows:

Table 4.
Model 1 with Panel Data Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.222	0.035	6.184	0.000
ROA	-0.003	0.023	-0.144	0.886
ROE	0.000	0.002	0.180	0.857
DAR	0.239	0.075	3.152	0.003
DER	-0.014	0.025	-0.556	0.580
F-statistic	2.717			
Prob(F-statistic)	0.043			
Adjusted R-squared	0.137			

Model 1 with Panel Data Regression Analysis

The coefficient of determination is used to assess the extent to which the model explains the dependent variable. Based on the Eviews 10 output in Table 4, the R Square value of 0.1377 indicates that the independent variables in this model explain approximately 13.77% of the variation in the dependent variable. Meanwhile, the remaining 86.23% is influenced by other factors outside the model that are not covered in this study.

Based on the estimation results, the constant value of 0.2224 indicates that if all independent variables are zero, the company's Tax Avoidance level is estimated to be 0.2224. Furthermore, the ROA variable has a coefficient of -0.0033 with a probability value of 0.8860, which means that ROA has a negative but insignificant effect on tax avoidance. This means that an increase in profitability based on total assets is not substantial enough to affect the company's tax avoidance rate. ROE has a positive coefficient of 0.0003 with a probability value of 0.8575, but it is also insignificant. This indicates that an increase in return on equity does not necessarily encourage companies to engage in or reduce tax avoidance.

Meanwhile, the DAR variable shows statistically significant results with a coefficient of 0.2391 and a probability value of 0.0031. This means that the higher the debt-to-asset ratio, the higher the tendency for companies to engage in tax avoidance. This aligns with the view that highly indebted companies tend to seek ways to reduce their tax burden, one of which is by

leveraging the potential for reducing taxable income. The DER variable has a coefficient of -0.0144 with a probability value of 0.5809, indicating a negative but insignificant effect on tax avoidance. This means that the debt-to-equity structure does not have a significant effect on the tax avoidance behaviour of companies in this sample.

Model 2 with Panel Data Regression Analysis

Regression in model 2 was performed to analyse the effect of independent variables on dependent variables using panel data, which is a combination of time series data and cross-sectional data. The model used in this estimation was the Common Effect Model (CEM) as the selected panel regression approach. The estimation process was carried out using EViews 10 software, with the following results:

Tabel 5.
Model 2 with Panel Data Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.143	0.054	2.623	0.014
ROA * Interest Coverage	-0.231	0.086	-2.688	0.012
ROE * Interest Coverage	0.233	0.087	2.651	0.013
DAR * Interest Coverage	-0.035	0.013	-2.680	0.012
DER * Interest Coverage	-0.002	0.002	-1.376	0.180
R-squared	0.932			
Adjusted R-squared	0.888			
S.E. of regression	0.043			
F-statistic	21.445			
Prob(F-statistic)	0.000			

The interaction effects of profitability and leverage with interest coverage on tax avoidance show significant but contrasting results. The variable ROA*Interest Coverage has a significant negative coefficient of -0.2313 (p-value = 0.0126), indicating that more profitable firms with high interest coverage are less likely to engage in tax avoidance. Conversely, the variable ROE*Interest Coverage has a significant positive coefficient of 0.2333 (p-value = 0.0137), suggesting that firms with a higher return on equity and strong coverage are more likely to avoid taxes, possibly due to greater financial flexibility for proactive tax management. Furthermore, the Debt-to-Asset Ratio (DAR) interaction is negatively significant (coefficient: -0.0355, p-value: 0.0128), implying that highly leveraged firms with sound interest coverage also tend to pay less tax, likely because interest payments already provide a tax shield. In contrast, the Debt-to-Equity Ratio (DER) interaction was insignificant. The model's high R-squared value of 0.8886 indicates that the independent variables explain 88.86% of the variation in tax avoidance, leaving 11.14% to other factors outside this study.

CONCLUSION

This study shows that in model 1, of the four independent variables tested, only the Debt to Asset Ratio (DAR) significantly influences tax avoidance practices in industrial companies listed on the Indonesia Stock Exchange for the 2019–2022 period. Meanwhile, Return on Assets (ROA), Return on Equity (ROE), and Debt to Equity Ratio (DER) do not show significant effects. These results indicate that a company's financing structure, as measured by debt to assets, plays a greater role in encouraging tax avoidance practices than profitability and debt to equity structure. Furthermore, the moderation analysis in Model 2 shows that the Interest Coverage Ratio significantly strengthens or weakens the relationship between certain financial variables and tax avoidance. ROA, moderated by Interest Coverage, has a significant adverse effect on tax avoidance. In contrast, ROE, moderated by Interest Coverage, shows a significant positive effect. The interaction between DAR and Interest Coverage also shows a significant adverse effect. At the same time, DER, moderated by Interest Coverage, has no significant effect. Thus, the Interest Coverage Ratio is proven to act as a moderating variable in the relationship between corporate financial characteristics and tax avoidance strategies. However, its effect varies depending on the combination of variables involved. This study contributes to the understanding of how corporate financial flexibility affects tax avoidance behavior. It provides a basis for the development of corporate tax policies and governance in the future.

Limitations

This study has several limitations, including the data scope, which only covers companies listed on the Indonesia Stock Exchange during a specific period, so the findings cannot be generalized to all sectors or other countries. Furthermore, the study's focus is limited to specific variables, so there may be other factors influencing financial performance that were not analyzed. The statistical methods used also have limitations in interpreting the results, so the findings need to be reviewed, considering the industry context and each company's characteristics. Therefore, it is recommended that future research consider the use of additional variables.

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