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Analysis of the Effect of Financial Ratios on Tax Avoidance with Earnings Management as a Mediating Variable

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Abstract

This study examines the relationship between profitability, earnings management, and tax avoidance in property and real estate companies in Indonesia. Using data from 14 publicly listed companies during 2017-2022, this study utilizes multiple linear regression and mediation analysis to investigate: 1) the direct effect of profitability on tax avoidance, 2) the effect of profitability on earnings management, 3) the impact of earnings management on tax avoidance, and 4) the mediating role of earnings management. The results showed a significant positive relationship between the three variables. Higher profitability is associated with increased earnings management and tax avoidance. Earnings management is also positively correlated with tax avoidance. Furthermore, earnings management partially mediates the relationship between profitability and tax avoidance. These findings contribute to the literature on corporate finance practices by shedding light on the complex dynamics between financial performance, reporting strategies, and tax planning. The research highlights the need for increased regulatory oversight and strong corporate governance mechanisms to ensure financial reporting integrity and tax compliance. The study also provides valuable insights for policymakers, investors, and other stakeholders in understanding and addressing aggressive financial manipulation and tax avoidance strategies in the corporate sector.

Keywords: Profitability, Earnings Management, Tax Avoidance

1. INTRODUCTION

Tax, as defined in Law No. 16/2009 Article 1 Paragraph 1 on General Provisions and Procedures for Taxation, is a compulsory contribution to the state owed by individuals or entities that is compelling based on law, with no direct reward and is used for state purposes for the greatest prosperity of the people. In the first quarter of 2023, state revenues showed strong growth, reaching IDR 647.2 trillion, representing a 29% year-on-year increase and reaching 26.3% of the annual target set in the 2023 State Budget (APBN). This fiscal performance was largely underpinned by tax revenue, which reached IDR 432.2 trillion, meeting 25.2% of the budget target and showing 33.8% year-on-year growth. (Kementerian Keuangan Republik Indonesia, 2022). Taxation is therefore an important instrument in financing government operations and development initiatives.

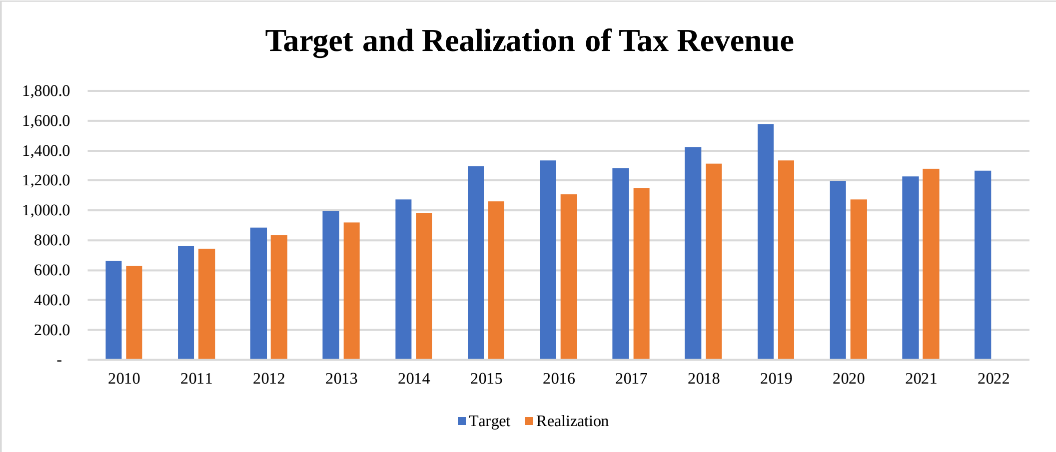

Figure 1. Target and Realization of Tax Revenue 2010-2022

Source: CITA, 2022

An examination of historical data from 2010 to 2022 shows a continuous trend of underachieving tax revenue realization compared to the set target, with the exception of 2021. This pattern is shown by the lowest point of tax revenue realization in 2016 at 81.6%, as illustrated in Figure 1. The consistent shortfall in meeting tax revenue targets could be due, in part, to tax avoidance strategies employed by taxpayers. (Widyasari et al., 2021). Such practices potentially include the exploitation of regulatory ambiguities, the utilization of legal loopholes, and the strategic analysis of alternative fiscal options, leading to the minimization, postponement, or overall avoidance of tax liabilities.

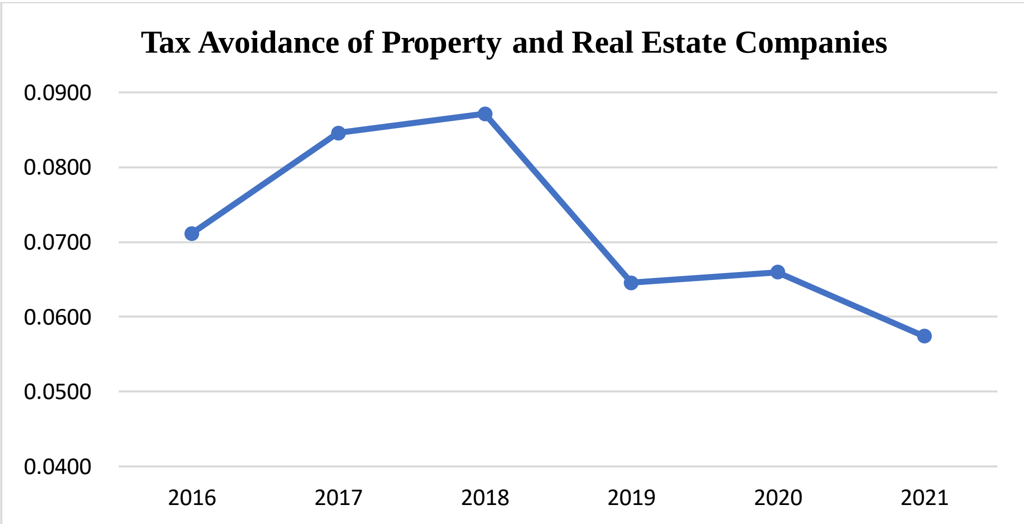

Figure 2. Chart of Tax Avoidance of Listed Property and Real Estate Companies on the Indonesia Stock Exchange (IDX)

Source: Results of data processing using Microsoft Excel

Analysis of tax avoidance trends can be effectively conducted through examination of Effective Tax Rate (ETR) values, which provide a comprehensive statistical summary of the cumulative effects of various tax incentives and corporate tax rate modifications. This is evidenced by the downward trend in ETR values depicted in Figure 2, with tax avoidance activities most prominent among property and real estate companies observed over the 2019-2021 period. This phenomenon coincides with the economic downturn triggered by the Covid-19 pandemic, as corroborated by data from the Central Bureau of Statistics showing economic growth of only 2.97 percent year-on-year in the first quarter of 2020, followed by a contraction of 5.32 percent in the following quarter. The Directorate General of Taxes (DGT) states that indications of tax avoidance can be seen through an analysis of the company's financial ratios (Kurniawan, 2020). Profitability, defined as the company's ability to generate profits from sales, total assets, and equity (Gultom, 2021)is a key metric in this context. High profitability ratios indicate efficient management practices (Faizah, 2022). Agency Theory postulates that stakeholders delegate the responsibility of earnings management to agents, who may be incentivized to engage in tax avoidance strategies to maintain high corporate profits while reducing tax liabilities.

The relationship between profitability and tax avoidance has been the subject of extensive scientific investigation, resulting in different findings. Studies by (Indira Yuni & Setiawan, 2019; Juliyanti & Wibowo, 2021; Kimsen et al., 2019; Mahdiana & Amin, 2020; Marsahala et al., 2020) showed a significant positive correlation between profitability and tax avoidance. Conversely, research conducted by (Fatimah et al., 2021; Januari & Suardikha, 2019; Mulyati et al., 2019; Rahayu et al., 2023) showed no effect of profitability on tax avoidance practices.

Earnings management, which is conceptualized as a deliberate action taken by company management to manipulate earnings in accordance with their interests, has also been studied in relation to profitability and tax avoidance. Research conducted by (Cahyadi & Davianti, 2020; Chairunnisa et al., 2022; S. Ernawati et al., 2021; Saniamisha & Fung Jin, 2019; Syarif M Helmi et al., 2023) showed a significant positive relationship between profitability and earnings management. However, research by (Agustia & Suryani, 2018; Rahmah & Iskandar; Martinus Robert Hutauruk et al., 2022; Sitanggang et al., 2022) did not find such a relationship.

The inconsistency in these research findings has prompted further investigation into the potential mediating role of earnings management in the relationship between profitability and tax avoidance. The studies conducted by (Martinus Robert Hutauruk et al., 2022; Rahmawati, 2022) support the significant positive mediating effect of earnings management. In contrast, research by (Azahra & Handayani, 2023; Dhian Mahardhika & Surjandari, 2022; Edastami & Kusumadewi, 2022; Karuniansyah & Anwar, 2021) failed to prove this mediating effect.

The complex interaction of these various factors underscores the need for further research to explain the intricate relationship between profitability, earnings management and tax avoidance in corporate finance practices.

2. LITERATURE REVIEW

2.1. Profitability (X)

Profitability is a fundamental aspect of business operations that reflects the company's ability to generate income relative to expenses and other costs (Farida & Siswanti, 2020; Linawati et al., 2023). It is a key metric that demonstrates a company's efficiency and effectiveness in utilizing its resources to create value for its stakeholders, including shareholders, employees, and customers. Profitability is often measured using various financial ratios that provide insight into different aspects of a company's financial performance. These ratios include metrics such as return on assets (ROA), return on equity (ROE), gross profit margin, and net profit margin, among others, which help assess how well a company is utilizing its assets to generate profits (Melani et al., 2023). In the context of the relationship between financial ratios and tax avoidance with earnings management as a mediating variable, profitability plays an important role. Profitability ratios, such as net profit margin, are an indication of a company's ability to manage costs and generate profits from its operations (Linawati et al., 2023). Companies with higher profitability may have more resources available to engage in tax planning strategies to minimize their tax liabilities, including tax avoidance practices. (Kiswanto & Hidayah, 2023). In addition, profitability is closely related to earnings management, where companies can manipulate their financial statements to portray a more favorable financial position, potentially affecting tax liabilities (Istanti et al., 2023).

Financial distress, another factor that can affect tax avoidance, is inversely related to profitability. Companies experiencing financial difficulties may use aggressive tax planning strategies to reduce financial pressure and increase their profits (Kiswanto & Hidayah, 2023). However, the impact of financial distress on tax avoidance may vary depending on the level of firm profitability and the extent of earnings management practices used. In addition, the relationship between profitability and tax avoidance may be further influenced by factors such as executive characteristics, capital intensity, and sales growth, as has been highlighted in previous research. In the realm of financial management, the interaction between financial ratios, tax avoidance and earnings management underscores the complexity of the decision-making process in organizations. (Melani et al., 2023). Managers need to navigate the trade-off between maximizing profitability, ensuring compliance with tax regulations, and maintaining transparency in financial reporting (Istanti et al., 2023). The mediating role of earnings management in the relationship between financial ratios and tax avoidance adds a layer of complexity to this dynamic, highlighting the need for a comprehensive understanding of how these factors interact (Kiswanto & Hidayah, 2023).

The impact of financial ratios on tax avoidance and earnings management may have broader implications for corporate governance and stakeholder perceptions. (Hatane et al., 2021). Companies that engage in aggressive tax avoidance or earnings management practices may face reputational risk and regulatory scrutiny, which may affect their market value and long-term sustainability. Therefore, it is important for companies to strike a balance between optimizing profitability through efficient financial management practices and upholding ethical standards in their tax planning and reporting processes (Linawati et al., 2023).

2.2. Earnings Management (Z)

Earnings management is an important concept in corporate finance and accounting, which involves the manipulation of financial statements to achieve specific goals. It is often associated with the strategic adjustment of financial information to mislead stakeholders about a company's financial performance or position (He, 2023). This practice can be driven by a variety of motivations, such as meeting profit targets, influencing stock prices, or tax avoidance (Zhou, 2022). Research has shown that earnings management behavior is positively correlated with the rigidity of corporate income tax expense, indicating a link between financial reporting practices and tax management strategies (He, 2023). In China, motivations for earnings management include raising capital and avoiding tax deductions, highlighting the importance of financial ratios in influencing tax-related decisions (Zhou, 2022).

The quality of internal control in an organization plays an important role in inhibiting real earnings management practices. Research has indicated that high quality internal control mechanisms can significantly reduce the level of real earnings management in the firm. (Liu et al., 2023). In addition, the presence of Qualified Foreign Institutional Investors (QFII) as shareholders may also have an impact on real earnings management, with higher QFII shareholding ratios associated with lower levels of real earnings manipulation. This suggests that the quality of internal control and external ownership structure may influence the level of earnings management within the firm. Furthermore, the mediating role of earnings management in various financial relationships has been explored in the academic literature. For example, the effect of corporate governance mechanisms on firm value has been investigated, with earnings quality acting as a mediating variable in this relationship (Kodriyah et al., 2021). Similarly, human capital has been identified as a mediating factor in audit committee effectiveness and its impact on real earnings management practices. (Istanti et al., 2023). These findings underscore the interconnected nature of financial variables and the mediating influence of earnings management on organizational outcomes.

In the context of financial distress, earnings management, business strategy, and corporate life cycle have been investigated as factors that contribute to corporate financial stability. State-owned enterprises have been considered as moderating variables in understanding the impact of these factors on financial distress (Anggraini & Hendranastiti, 2023). This research highlights the complex interactions between organizational characteristics, strategic decisions, and external factors in shaping financial outcomes and the potential role of earnings management in mitigating or exacerbating financial challenges. In addition, the relationship between disclosure quality, earnings management, and stock price crash risk has been investigated, especially in the context of Chinese companies after listing (Wang et al., 2023). This research emphasizes the importance of transparent financial reporting practices in mitigating stock price volatility and the potential implications of earnings management on market risk. In addition, the effect of firm size, ownership structure, leverage, and audit quality on earnings management has been investigated to provide insight for regulators and investors in preventing opportunistic financial practices (Sawitri et al., 2023).

2.3. Tax Avoidance (Y)

Tax avoidance is a strategic financial practice that involves the use of legal means to minimize tax liabilities within the limits of the law. One strategy used in tax avoidance is to utilize financial ratios to create a tax shelter effect, where interest generated from debt is treated as a financial cost, not included in pre-tax profit, thus aiding tax avoidance (Jiang, 2023). Financial ratios, such as the leverage ratio, are critical in determining how companies can benefit from tax avoidance strategies. Earnings management, the manipulation of financial statements to present a desired financial picture, acts as a mediating variable in tax avoidance strategies (Zhou, 2022). Companies can perform earnings management by changing accounting estimates to influence financial results, which can be attributed to tax avoidance strategies to indirectly impact tax liabilities. Executive characteristics, capital intensity, sales growth, and financial distress all play a role in tax avoidance strategies (Kiswanto & Hidayah, 2023). The executive character variable has a significant positive effect on tax avoidance, while capital intensity has a significant negative effect. This highlights the importance of considering human elements alongside financial metrics in tax planning. During the Covid-19 pandemic, profitability and firm size were found to significantly influence tax avoidance strategies (Yuniastuti et al., 2022). Utilizing financial indicators such as profitability and firm size becomes very important in shaping tax strategies, especially during times of economic uncertainty. In addition, factors such as liquidity, profitability, inventory intensity, and corporate social responsibility (CSR) affect tax aggressiveness (Kusmuriyanto et al., 2023). Companies consider various financial and non-financial indicators in tax planning decisions to adopt a holistic approach to tax management.

2.4. Previous Research

Tax avoidance is a multifaceted phenomenon that is influenced by various factors such as financial ratios, earnings management, and audit quality. The impact of financial statement ratios and audit quality on tax avoidance, with an emphasis on short-term and long-term implications. (Budi Astuti et al., 2023). This research provides a basic understanding of how financial indicators and audit practices can shape tax avoidance strategies in organizations. In addition, the interrelationship between tax avoidance, corporate social responsibility, financial performance, and firm value, explains the intricate relationship between these variables in the context of Egyptian listed companies. (Abd-Elmageed & Abo Ashour, 2021). Furthermore, the mediating role of earnings management with respect to tax avoidance, highlights the interaction between controlled transactions, transfer pricing, and tax avoidance (Kramarova, 2021). This research underscores the importance of understanding how earnings management practices can influence tax avoidance strategies within firms. In addition, the moderating effect of the COVID-19 pandemic on the relationship between financial distress and tax avoidance, provides insights into how external economic shocks may impact tax planning behaviors (Ariff et al., 2023).

In the Indonesian context, the influence of tax compliance, tax avoidance, and financial reporting quality on firm financial performance, provides valuable insight into the complex dynamics between these variables. (Fitri et al., 2023). In addition, the influence of capital structure, tax avoidance, firm size, and dividend payout ratio on firm value, provides a better understanding of how these factors interact on the Indonesia Stock Exchange. (Wardani et al., 2022). In addition, the moderating role of independent commissioners in the relationship between financial ratios, financial distress, and tax avoidance, offers insight into governance mechanisms that may influence tax planning strategies in organizations. (Pandapotan & Nurlis, 2023). In addition, the effects of transfer pricing, tax havens, and thin capitalization on tax avoidance, explain how international tax practices can influence corporate tax strategies (Rini et al., 2022).

Taken together, the synthesis of these studies underscores the multifaceted nature of tax avoidance, highlighting the complex relationships between financial ratios, earnings management, audit quality, corporate social responsibility, and external factors such as the COVID-19 pandemic. By examining these linkages, researchers can gain a comprehensive understanding of how firms navigate tax planning strategies in a complex and dynamic environment.

3. METHODOLOGY

This study aims to examine the relationship between profitability, earnings management, and tax avoidance in property and real estate companies in Indonesia. This study utilizes a multifaceted approach to investigate: (1) the direct effect of profitability on tax avoidance, (2) the effect of profitability on earnings management, (3) the impact of earnings management on tax avoidance, and (4) the potential mediating role of earnings management in the relationship between profitability and tax avoidance. The population of this study includes 85 property and real estate companies listed on the Indonesia Stock Exchange in 2022. Using purposive sampling methodology, 14 companies were selected for analysis over a six-year period from 2017 to 2022. This study relies on secondary data taken from the company's financial statements, which were collected through the documentation method.

The analytical framework combines descriptive and inferential statistical techniques. Descriptive analysis is used to explain the characteristics of the variables under study. Multiple linear regression analysis is used to test direct hypotheses regarding the relationship between profitability, earnings management, and tax avoidance. Sobel test is used to assess the mediating effect of earnings management practices.

The operationalization of key variables is as follows:

1. Profitability, conceptualized by (Muda et al., 2020) as the company's capacity to generate future profits and an indicator of operational success, is measured as the ratio of operating profit to total assets.

2. Earnings management, defined by (Muda et al., 2020) as management's discretionary efforts in financial reporting to influence stakeholders' perceptions of company performance, is measured using the Modified Jones Model of discretionary accruals.
3. Tax avoidance, characterized by (Lala Latifatul et al., 2023) as a legal strategy to minimize corporate tax liabilities, is operationalized through the Effective Tax Rate (ETR) metric.

This methodological approach aims to provide a comprehensive analysis of the complex interactions between profitability, earnings management, and tax avoidance practices in the property and real estate sector in Indonesia.

4. RESULTS

4.1. Descriptive Statistical Analysis

Table 1. Descriptive Statistics of Research Data

Variables	Minimum	Maximum	Means	Std. Deviation
Profitability (X1)	-0.027	0.369	0.045	0.053
Earnings Management (Z)	-1.690	1.033	-0.087	0.595
Tax Avoidance (Y)	0.0001	7.414	0.214	0.819

Source: Data processing results using Eviews 10, 2024

The results of the descriptive analysis, as presented in Table 1, provide insight into the financial characteristics of the property and real estate subsector over the period 2017-2022. The profitability metric shows an average value of 0.045, indicating that companies in the sector exhibit an average ability to generate profits of 4.5% of their asset base. This ratio serves as an indicator of operational efficiency within the industry. Profitability values range from a minimum of -0.027, which was observed in PT City Retail Development Tbk in 2022, to a maximum of 0.369, which was recorded by PT Summarecon Agung Tbk in 2017. The negative profitability of PT City Retail Development Tbk may be due to an increase in investment or development activities, which although increases costs in the short term, has the potential to increase profits in the future. This interpretation is supported by the company's reported asset growth of 10% by 2022. In contrast, the peak profitability of PT Summarecon Agung Tbk in 2017 can be attributed to the successful launch of residential projects in strategic locations. The earnings management variable shows an average value of -0.087 with a standard deviation of 0.595 during the study period. The range is from a minimum of -1.690 (PT Ciputra Development Tbk, 2017) to a maximum of 1.033 (PT Metropolitan Kentjana Tbk, 2020). This difference shows that PT Ciputra Development Tbk shows better performance in generating net income, debt management, and business development compared to PT Metropolitan Kentjana Tbk. Regarding tax avoidance, the sample companies show an average value of 0.183 which indicates an average tax avoidance rate of 18.3%. The maximum tax avoidance value of 7.414 was observed in PT City Retail Development Tbk (2019), while the minimum value of 0.0001 was recorded by PT Metropolitan Kentjana Tbk (2017). This sizable variation implies that PT City Retail Development Tbk shows a much higher tendency to undertake tax avoidance strategies, which may have implications for its debt management capabilities and business expansion potential.

These findings provide a better understanding of the financial dynamics in the property and real estate sector in Indonesia, by highlighting significant variations in profitability, earnings management practices, and tax avoidance strategies among the sampled companies.

4.2. Regression Analysis Results

Table 2. Direct Effect T Test Results

Variables	Coefficient	t-Statistic	Maybe.	Conclusion
ROA (X) to ETR (Y)	49.07365	2.046985	0.0439	Significant
DAC (Z) to ETR (Y)	0.235341	2.778875	0.0068	Significant
ROA (X) to DAC (Z)	101.1759	3.347550	0.0012	Significant

Source: Data processing results using Eviews 10, 2024

The statistical analysis presented in Table 2 yields some significant findings regarding the relationship between profitability, earnings management, and tax avoidance:

1. Profitability and Tax Avoidance: The analysis shows a statistically significant positive relationship between profitability and tax avoidance ($p = 0.0439 < 0.05$, $\beta = 49.07365$). This result indicates that when a company's profitability increases, there is an increase in tax avoidance practices.
2. Profitability and Earnings Management: A strong positive relationship is seen between profitability and earnings management ($p = 0.0012 < 0.05$, $\beta = 101.1759$). The low p-value and high regression coefficient indicate a strong and statistically significant influence, implying that higher profitability is associated with increased engagement in earnings management practices.
3. Earnings Management and Tax Avoidance: The analysis shows a significant positive correlation between earnings management and tax avoidance ($p = 0.0068 < 0.05$, $\beta = 0.235341$). This finding suggests that firms that engage in more extensive earnings management practices are also more likely to exhibit higher tax avoidance behavior.

These results collectively suggest a complex interaction between profitability, earnings management, and tax avoidance in the sample firms. The positive relationship observed across the three variables suggests that as firms become more profitable, they tend to engage in increased earnings management and tax avoidance strategies. Furthermore, the significant relationship between earnings management and tax avoidance implies that these practices may be carried out simultaneously as part of a broader financial management strategy.

These findings contribute to the existing literature on corporate finance practices and provide valuable insights into the financial behavior of property and real estate companies in Indonesia. However, further research may be needed to elucidate the causal mechanisms underlying this relationship and to explore potential moderating factors.

Table 3. Test Results of Indirect Effect (Mediation)

Variables	Indirect Effect	Z Sobel	Z table (Z = 1.96)
ROA (X)→ DAC (Z)→ ETR (Y)	101.1759 x 0.235341 = 23.811	2.138	Bigger

Source: Data processing results using Eviews 10, 2024

The mediation analysis results presented in Table 3 provide strong evidence for the indirect effect of profitability on tax avoidance through earnings management. The Sobel test, a widely accepted statistical method for assessing mediation effects, yields a Z value of 2.138, which exceeds the critical threshold of 1.96 at the 0.05 level of significance. This statistically significant result supports the hypothesis that earnings management serves as a mediating variable in the relationship between profitability and tax avoidance. Specifically, the analysis shows that the effect of profitability on tax avoidance is not solely direct, but partially transmitted through the mechanism of earnings management practices. The mediation effect implies a more nuanced understanding of the financial decision-making process within the sample firms. This suggests that as profitability increases, firms may engage in earnings management strategies, which in turn facilitate greater tax avoidance activities. This finding is in line with the broader theoretical framework of corporate financial behavior, where earnings management can be viewed as an intermediary step in the process of translating higher profitability into lower tax liabilities.

These results contribute to the existing literature by explaining the complex interrelationships among financial variables and underscore the importance of considering indirect effects in corporate finance research. Future research may benefit from exploring the specific mechanisms by which earnings management facilitates the relationship between profitability and tax avoidance, as well as investigating potential moderating factors that may affect the strength of this mediating effect.

5. DISCUSSION AND CONCLUSION

5.1. Effect of Profitability on Tax Avoidance

The empirical findings of this study indicate a significant positive relationship between profitability and tax avoidance, a result that can be contextualized within the framework of agency theory. This theoretical perspective, which explains the contractual dynamics between principals and agents, provides a plausible explanation for the observed phenomenon. Agency theory states that the principal delegates decision-making authority to the agent, who is tasked to act in the principal's interest. In the context of corporate taxation, this relationship becomes complex due to the different objectives between the tax authority (principal) and the company (agent). Tax authorities aim to maximize revenue for the state, while companies have an incentive to minimize their tax liabilities to ensure financial survival and profitability. This misalignment of interests creates tension that can manifest in corporate non-compliance and tax avoidance strategies. The positive correlation between profitability and tax avoidance suggests that as firms become more profitable, they may become more adept at exploiting legal loopholes to effectively manage their tax burden. This finding is in line with previous research conducted by Mahdiana et al., 2020; Muda et al., 2020; Putri & Nurdin, 2023 which all corroborate the significant positive relationship between profitability and tax avoidance. The consistency across these studies strengthens the validity of the current findings and suggests a strong pattern in corporate financial behavior. The observed relationship can be further interpreted through the lens of agency theory. As agents, corporate managers are incentivized to optimize performance metrics, including profitability. However, this drive for profitability may simultaneously motivate the pursuit of tax avoidance strategies to preserve earnings and, thus, compensation associated with financial performance. This study contributes to the growing literature on corporate tax behavior and provides valuable insights for policymakers and regulators. The findings underscore the need for more sophisticated tax policies that can address the complex interaction between profitability and tax avoidance in corporate financial strategies.

5.2. Effect of Profitability on Earnings Management

The empirical evidence from this study shows a significant positive correlation between profitability and earnings management, a finding that can be interpreted through the lens of

Agency Theory and Positive Accounting Theory. This relationship underscores the complex interaction between financial performance and managerial behavior within the corporate environment. Agency Theory states that differences in interests between agents (management) and principals (shareholders) can trigger earnings manipulation practices. In this context, management may be motivated to increase profitability metrics as a way to reflect superior corporate performance, thereby attracting new and existing investors. The positive relationship between profitability and earnings management suggests that as companies become more profitable, there is an increased tendency to engage in earnings management practices to maintain high levels of earnings and maintain investor attractiveness. This phenomenon can be further explained through the lens of Positive Accounting Theory, specifically the bonus plan hypothesis. This theoretical framework suggests that management may choose accounting methods that increase profitability to maximize their bonus compensation. Conversely, from a tax perspective, earnings management can be used as a tax avoidance strategy by artificially suppressing earnings to reduce tax liabilities. The findings of this study are in line with existing research, including research conducted by Chairunnisa et al., 2022; Edastami & Kusumadewi, 2022; D. Ernawati, 2019; Pradipta, 2019; Syarif M Helmi et al., 2023. These studies collectively corroborate the significant positive relationship between profitability and earnings management. The consistency across these investigations strengthens the validity of the current findings and suggests a strong pattern in corporate financial behavior. The observed relationship suggests that managers engage in earnings management by modifying financial statements through the strategic selection of accounting policies permitted in financial accounting standards. This manipulation can involve increasing or decreasing reported earnings, with the dual objectives of presenting favorable corporate performance and optimizing tax positions. This study contributes to the growing literature on corporate finance practices and provides valuable insights for regulators, investors and other stakeholders. The findings underscore the need for greater scrutiny of financial reporting practices, especially at highly profitable firms, and highlight the importance of strong corporate governance mechanisms to mitigate potential agency conflicts and ensure the integrity of financial reporting.

5.3. Earnings Management Tax Avoidance

The empirical findings of this study indicate a significant positive relationship between earnings management and tax avoidance, a result that aligns with and extends the existing theoretical framework in the field of accounting and corporate finance. This relationship underscores the complex interaction between financial reporting practices and tax strategies employed by firms. The positive coefficient associated with earnings management in relation to tax avoidance suggests that as firms engage more extensively in earnings management practices, there is a corresponding increase in aggressive tax behavior. This observation implies that management manipulation of reported earnings has a direct impact on corporate tax liabilities, with adjusted earnings figures potentially reducing the tax burden. These findings can be interpreted in the context of the political cost hypothesis, a key component of positive accounting theory. This theoretical framework states that management tends to manipulate earnings as a way to avoid government regulations, including corporate income tax. The observed relationship between earnings management and tax avoidance provides empirical support for this hypothesis, which illustrates how financial reporting practices can be used strategically to navigate the regulatory landscape. The results of this study are consistent with previous research conducted by (Delgado et al., 2023; S. Ernawati et al., 2021; Farida & Siswanti, 2020; Thalita et al., 2022) all of which corroborate the significant positive relationship between earnings management and tax avoidance. The consistency across these various studies strengthens the validity of the current findings and suggests a strong pattern in corporate financial behavior. A key insight from this research is the observation that aggressive manipulation of tax returns often coincides with aggressive manipulation of financial statements. This dual manipulation strategy involves reducing reported tax income, which consequently lowers book profit while maintaining normalized book and tax profit differences. This approach allows companies to minimize their tax liabilities while potentially avoiding scrutiny that may arise from significant differences between tax income and book income. These findings have important implications for regulators, auditors and investors. The findings highlight the need for greater scrutiny of financial reporting practices and tax strategies, especially in firms that show signs of aggressive earnings management. In addition, the results underscore the importance of comprehensive corporate governance mechanisms that can effectively monitor and mitigate potentially harmful financial manipulation practices. This study contributes to the growing literature on the relationship between earnings management and tax avoidance, providing valuable insights into the complex decision-making process in corporate finance. Future research could further explore the specific mechanisms by which earnings management facilitates tax avoidance, as well as investigate potential moderating factors that may affect the strength of this relationship.

5.4. Earnings Management Mediates Profitability on Tax Avoidance

The empirical findings of this study explain the complex mediating mechanism through which earnings management facilitates the relationship between profitability and tax avoidance. This complex interaction between financial variables provides valuable insights into a firm's financial strategy and its implications for tax liability. High profitability, which indicates a firm's capacity to generate large profits, inherently leads to increased tax liabilities. However, this study reveals that corporate management often uses earnings management techniques to reduce this tax burden. These practices involve strategic manipulation of financial statements to report lower profits than actually realized. Such manipulation can be done through various means, including delayed revenue recognition, cost manipulation, or changes in accounting policies. The mediating role of earnings management in this context is very important. It allows highly profitable firms to engage in tax avoidance strategies by strategically adjusting their earnings reports. This finding suggests that in the absence of earnings management, the direct relationship between profitability and tax avoidance may be less clear or potentially insignificant, as high profitability would normally result in a higher tax burden without the intervention of creative financial reporting practices. The mediation analysis carried out in this study is in line with the methodological framework of (Ghozali, 2021)which states the need for a significant relationship between predictor and mediator variables, as well as between mediator and criterion variables. These results corroborate and extend the findings of several previous studies. Research by (Adyastuti & Khafid, 2022; Angin, 2020; Kumalasari, 2021; Sitanggang et al., 2022) showed a significant positive effect of profitability on earnings management. Complementing this, research conducted by (Delgado et al., 2023; MacCarthy, 2021; Thalita et al., 2022) provide evidence of a significant positive relationship between earnings management and tax avoidance. The synthesis of these findings suggests a comprehensive model in which firms with high profitability engage in earnings management practices, which then facilitate tax avoidance strategies. The model explains how firms can effectively reduce their tax liabilities even in the presence of high profitability through strategic manipulation of reported earnings. The results of this study make a significant contribution to the existing literature on corporate finance behavior and have important implications for regulators, auditors, and policy makers. The results underscore the need for greater scrutiny of financial reporting practices, especially in high-profitability firms, and highlight the importance of a robust regulatory framework to ensure the integrity of corporate financial reporting and tax compliance.

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