

Financial Distress, Earnings Management, and Tax Avoidance: evidence from Indonesia

Eka Fitriyani¹, Sekar Mayangsari^{2*}

^{1,2} *Master of Accounting, Universitas Trisakti, Jakarta, Indonesia*

ABSTRACT: This study aims to verify the correlation between financial distress and earnings management of tax avoidance. The population in this study are primary and non-primary consumer goods companies listed on the Indonesia Stock Exchange (IDX) for the period 2019 to 2021. Sample collection was performed using a purposive sampling method, resulting in a total of 94 companies that published complete financial reports and recorded a positive value on profit before tax. This study was tested by using the Multiple Regression Analysis test. The results show that financial distress has a significant positive effect on tax avoidance, meanwhile earnings management has no significant effect on tax avoidance. This research used several control variables as well, which are profitability, leverage, liquidity, sales growth, firm size, and the results show that profitability and firm size has a significant negative effect on tax avoidance, leverage has a significant positive effect on tax avoidance, while liquidity, sales growth have no significant effect on tax avoidance.

KEYWORDS : *tax avoidance, financial distress, earning management*

I. INTRODUCTION

Corporate tax avoidance is an integral part of the company's capital management strategy, the tax burden is a major expense item for companies, and management can be motivated to develop strategies to reduce the amount of corporate tax that must be paid to meet the company's capital needs (Richardson et al., 2015). Corporate tax avoidance has an impact on business and society, which will affect the company's reputation, future profitability, company value, stock prices, and cost of capital. From a societal perspective, corporate tax avoidance can hinder the financing of projects that are important to society (Majeed and Yan, 2109). With this impact, the importance of taxes has increased the value of factors that influence tax avoidance.

Companies experiencing financial distress are companies that are struggling with promises made to their creditors (Tron, 2021). Quoted from dataindonesia.id, in a survey of people's main obstacles in fulfilling their tax obligations, the indicator survey showed 32.6% of respondents overall that the main obstacle felt by the community in paying taxes was financial conditions that were not good (Rizaty, 2022). Research conducted by Mulyaningsih et al. (2021) found that public companies experienced increased financial difficulties between 2015 and 2020 during the Covid-19 pandemic. In addition, despite government intervention to lighten the corporate tax burden, companies still rely on debt to support their operations due to a lack of internal funding from retained earnings. Due to the conditions of the Covid-19 pandemic that occurred from 2020-2021, which also caused deteriorating economic and financial conditions, companies facing an increased risk of bankruptcy can see the potential costs of tax avoidance (for example, tax penalties and reputation damage) to be minimal compared to the potential profits (eg, the ability to continue as a going concern (Richardson, 2015). Indeed, if the potential costs of bankruptcy are high enough, firms may be willing to pursue aggressive tax avoidance practices regardless of the risk of being audited by tax authorities.

Based on a study conducted by Nugroho et al. (2020), manufacturing companies in Indonesia from 2017-2018 show that financial distress has a positive effect on tax aggressiveness. The financial distress experienced by the company motivates management to seek sources of funds quickly with unexpected risks. The easiest fund to obtain is the tax payment fund. Meanwhile, the use of funds from debt will increase the interest expense and the possibility of rejection from creditors. Another cause is the inspection of the tax apparatus carried out after the end of the tax year, so it is impossible to detect it early unless it leads to tax avoidance or tax sanctions. Another study conducted by Richardson (2015), an Australian public company covering the 2006-2010 period, especially due to the impact of the Global Financial Crisis (GFC) in 2008, shows that financial distress is significantly and positively related to tax avoidance.

Apart from financial distress, earnings management is also a measure that can be used for corporate tax avoidance practices. Earnings management is a choice of accounting policies or concrete actions taken by management to achieve company goals (Scott, 2015). Managers have their motives when carrying out earnings management practices, these motives include increasing compensation income and job security; to present higher profits by hiding performance setbacks; to benefit from import assistance; to display the portfolio/financial statement performance before being displayed to clients or shareholders (window-dress); to avoid paying corporate taxes and breaching loan contracts; to meet analysts' and investors' earnings expectations and maintain reputation; to reduce regulatory costs or increase regulatory benefits; and for the purpose of making initial public offerings (Amidu et al., 2019).

Based on a study conducted by Amidu et al. (2019), Nugroho et al (2020), Thalita et al (2020), earnings management has a positive relationship with corporate tax avoidance. Another study conducted by Nadhifah and Arif (2020) shows that earnings management has a negative effect on tax avoidance. This shows that companies will tend to carry out earnings management through an income minimization strategy. The lower the profit of a company, the lower the tax burden that is borne by the company. This strategy will reduce the intensity of tax avoidance practices because the tax burden is already lower than before.

II. LITERATUR REVIEW

1. Theoretical Overview

Agency theory explains the agency relationship, which is a set of contracts or agreements between principals (stakeholders such as shareholders, creditors, government) and agents (executors or managers) within a company (Jensen and Meckling, 1976). The problem that often arises from agency relationships is asymmetric information where the agent has more information about the company's internal conditions than the principal (Scott, 2015). Asymmetric information creates the tendency for agents to take inappropriate actions, such as manipulating profits in preparing financial reports or what is commonly known as earnings management.

The selection of accountant policies aimed at maximizing company profits is often referred to as positive accounting theory. Positive accounting theory assumes that managers will rationally choose good accounting policies according to them. Company managers who are actively exploring will choose to change the reported profit from the current period in order to increase the present value of the bonus flow, so that even though high profits will not have an impact on high taxes.

2. Empirical Review and Hypothesis Development

2.1 Financial Distress and Tax Avoidance

Financial distress is a decline in the company's financial condition before bankruptcy, which will also decrease the company's economic capacity. Companies that are in this condition are at risk of being more aggressive in practicing tax avoidance for the sake of their business continuity. Nugroho, et al (2020) explained that higher financial distress equals to higher tax aggressiveness, in his research he found that financial distress has a positive effect on tax avoidance. Sadjiarto, et al (2020) found that financial distress has a positive effect on tax avoidance. Companies that are in a state of financial distress will get greater profits in tax avoidance practices than reducing the costs of other companies, so companies have no choice but to take higher risks and be more aggressive in taxation, because it is important for companies to increase their income. Richardson et al. (2015) examined the impact of financial distress on corporate tax avoidance, including the global financial crisis in Australia. They concluded that financial distress has a positive relationship with tax avoidance and that the relationship between financial distress and tax avoidance has increased due to the global financial crisis. Dang & Tran (2021) found that financial distress has a positive effect on tax avoidance, the more dangerous a company's capital position is, the more involved it will be in tax avoidance.

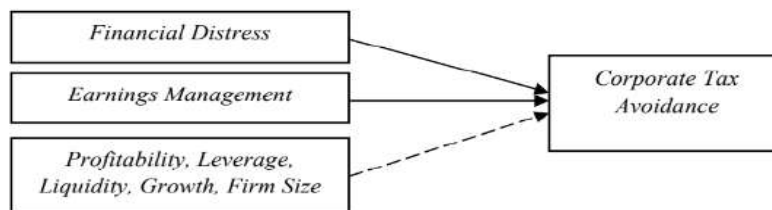
In contrast to the research results of Nadhifah and Arif (2020) that financial distress has a negative effect on tax avoidance, because this will have a negative impact on the value or image of the company in the eyes of stakeholders because it has indirectly given a negative signal for tax avoidance actions. Monika and Noviari (2021) found that financial distress has a negative effect on tax avoidance. Companies that experience financial distress are considered too risky to do tax avoidance. This is because the company will find it increasingly difficult to fund its company's activities. Based on this explanation, a hypothesis can be proposed:
H₁: Financial distress is positively associated with corporate tax avoidance.

2.2 Earnings Management and Tax Avoidance

Earnings management is defined as an act of active manipulation of accounting information to give a better impression of the company's financial performance, in this case profit (Amidu et al., 2019). This action can result in recorded profits that are larger or even smaller in one accounting period than in another period due to the manager's desire to achieve the target. With regard to tax avoidance, companies tend to carry out earnings management through an income minimization strategy, meaning that the smaller the company's income, the lower the tax to be paid.

There are several studies on earnings management and tax aggressiveness, such as Nugroho et al. (2020), which found that earnings management that was performed through abnormal operating cash flow, operating production costs, and abnormal discretionary expense, influenced tax aggressiveness behavior empirically. Amidu et al. (2019), Thalita et al (2022), Purba (2018), Irawan et al. (2020), Arief et al. (2016) found that earnings management has a positive effect on tax avoidance. In contrast, research by Nadhifah and Arif (2020) found that earnings management has a negative effect on tax avoidance, while Ginting and Elly (2018) and Henny (2019) found that earnings management does not affect tax avoidance. Based on this explanation, a hypothesis can be proposed:

H₂: Earnings Management is positively associated with corporate tax avoidance.



III. RESEARCH METHODS

1. Data Source

This study examines the effect of financial distress and earnings management on tax avoidance. This study uses quantitative analysis. The population in this study are primary and non-primary consumer goods companies listed on the Indonesia Stock Exchange (IDX) for the period 2019 to 2021. The sample in this study is a purposive sampling technique based on judgment. The criteria for the companies sampled in this study are as follows:

- i. Primary and non-primary consumer goods sector companies listed on the Indonesia Stock Exchange which provide complete data in their Financial Statements from 2019 to 2021.
- ii. The company recorded a positive value on profit before tax.

The population in this study amounted to 188 companies with a sample of 94 companies

2. Variable Measurement

Tax Avoidance is measured using a cash effective tax rate proxy to describe tax avoidance activities by companies because Cash ETR is not affected by changes in estimates such as assessment allowances or tax protection. Cash ETR describes all tax avoidance activities that reduce tax payments to tax authorities, because Cash ETR is directly calculated from the cash paid for taxes divided by profit before tax (Dyreng et al, 2008).

$$\text{CETR} = \frac{\text{The amount of tax paid working capital}}{\text{Earnings before tax}}$$

Financial distress uses the Altman Z-Score model. A higher Z-Score indicates a healthier financial situation. Z-Score has a negative correlation with tax avoidance. To adjust for measurements with variables, the resulting Z-Score is multiplied by -1; thus, a higher value reflects a worsening financial condition. Financial distress prediction is calculated as follows:

$$Z = 1,2 \frac{\text{working capital}}{\text{total asset}} + 1,4 \frac{\text{retained earning}}{\text{total asset}} + 3,3 \frac{\text{profit before tax}}{\text{total asset}} + 0,6 \frac{\text{cost of goods sold}}{\text{bv of total liabilities}} + 0,999 \frac{\text{sales}}{\text{total asset}}$$

Earnings management adopts Jones' model which is modified by Dechow (1995) is the most powerful test of earnings management. The Modified Version of the Jones Model implicitly assumes that all changes in credit sales in the period of occurrence come from earnings management, this is based on the reasoning that it is easier to manage revenue by exercising discretion over the recognition of revenue on credit sales than managing revenue by applying discretion over the recognition of revenue on credit sales cash sales (Dechow et al., 1995),

The non-discretionary and discretionary accruals are the constituents of the total accrual. The non-discretionary accrual depends on the firm's level of activity while the discretionary accruals reflect the subjective accounting choices made by managers. Thus managers exercise their discretion over accounting

methods and estimate as well as over the timing to recognized accruals. Hence, the study adopts the discretionary portion of the total accruals to proxy for earnings management, the calculation model is as follows:

1. $TAC_{it} = NI_{it} - CFO_{it}$
2. $\frac{TAC_{it}}{A_{it-1}} = \beta_1 \left[\frac{1}{A_{it-1}} \right] + \beta_1 \left[\frac{\Delta REV_{it}}{A_{it-1}} \right] + \beta_2 \left[\frac{PPE_{it}}{A_{it-1}} \right] + \varepsilon_{it}$
3. $NDA_{it} = \beta_1 \left[\frac{1}{A_{it-1}} \right] + \beta_1 \left[\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right] + \beta_2 \left[\frac{PPE_{it}}{A_{it-1}} \right] + \varepsilon_{it}$
4. $DA_{it} = \frac{TAC_{it}}{A_{it-1}} - NDA_{it}$

Keterangan :

- DA_{it} = Discretionary accruals
 NDA_{it} = Nondiscretionary accruals
 TAC_{it} = Total accrual
 NI_{it} = Net income
 CFO_{it} = Total net cash flow from operating
 A_{it-1} = Total assets previous year
 ΔRev_{it} = Current revenue reduced revenue previous year
 PPE_{it} = Property, Plan, and Equipment
 ΔRec_{it} = Current Receivable reduced receivable previous year
 ε = Error

We employ a number of additional control variables which prior studies have shown to affect the relationship among financial distress, earnings management and tax avoidance. Firm performance (ROA) is the ratio of firm profit before tax to total assets. Leverage (DAR) is total debt scaled by total assets. Firm liquidity (CR) is measured as current assets over current liabilities, liquidity is expected to positively relate to tax avoidance. Firm's growth potential is measured as the difference between current year's and previous year's revenue over the previous year's revenue. The logarithm of total assets is employed as a proxy for firm size.

3. Regression model

The analytical model used in this study is multiple linear regression. To test the hypothesis of the relationship between financial distress, earnings management and tax avoidance, it will be formulated as follows:

$$TA_{it} = \alpha + \beta_1 Z_{it} + \beta_2 EM_{it} + \beta_3 ROA_{it} + \beta_4 DAR_{it} + \beta_5 CR_{it} + \beta_6 GROWTH_{it} + \beta_7 SIZE_{it} + \varepsilon$$

Keterangan :

- TA_{it} = Tax Avoidance
 Z_{it} = Financial Distress
 EM_{it} = Earnings Management
 ROA_{it} = Profitability
 DAR_{it} = Leverage
 CR_{it} = Liquidity
 $Growth_{it}$ = Company Growth
 $Size_{it}$ = Firm Size
 α = Constant
 $\beta_1 \dots \beta_7$ = Regression Coefficient
 ε = Error

IV. RESULT AND DISCUSSION

The results of the Descriptive Statistical Analysis are shown in Table 1.

Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
CETR	278	0.0009	2.4402	0.3272	0.3659
Z	278	-0.9244	14.9751	3.4781	2.1299
EM	278	-0.0182	0.0269	0.0004	0.0034
ROA	278	-0.1993	0.6072	0.0646	0.0833
DAR	278	0.0015	1.8870	0.4254	0.2086
CR	278	0.4114	140.2452	3.3061	9.4277
GROWTH	278	-0.9085	1.1019	0.0605	0.2544
SIZE	278	26.2465	32.8204	28.9495	1.4311

Based on the above table, the CETR value ranges around 0.0009 to 2.4402 with an average of 0.3272 and a standard deviation of 0.3659. Where the smaller the CETR value or close to 0, the greater the possibility of tax avoidance being carried out, but average value is lower than the standard deviation, so this indicates that the data used is varied and the sample used for tax avoidance cannot represent the entire population. The financial distress value ranges from -0.9244 to 14.9751 with an average of 3.4781 and a standard deviation of 2.1299. The Earnings management value ranges from -0.0182 to 0.0269 with an average of 0.0004 and a standard deviation of 0.0034. Its average value is lower than the standard deviation, so this indicates that the data used is varied and the sample used for earnings management cannot represent the entire population.

Profitability shows a negative minimum value of -0.1993. The existence of a negative ROA value indicates that there are samples that experience poor profitability during the study period, with an average of 0.0646 and a standard deviation of 0.0833. Leverage shows an average value of 0.4254. This shows that most of the company's assets are financed through debt, namely 42.54%. Liquidity shows an average value of 3.3061. This shows that the average company has 3.3 times more current assets needed to cover its current liabilities. Sale growth is on the average 6.05% indicating that primary and non-primary consumer goods companies averagely increases sales by 6.05%. This is an indication of poor sales growth among the sample firms. However, it is observed that a particular firm in one year recorded a maximum value of 93.95%. Firm size shows an average value of 28.9495, this value is greater than the standard deviation of 1.4311. This shows that the majority of the sample are large companies.

The Results of Regression Analysis

The results of the Multiple Linear Regression are shown in Table 2.

	Beta Coefficient	Sig.
(Constant)	1.231	0.005
Z	0.024	0.028
EM	-7.840	0.261
ROA	-1.232	0.000
DAR	0.382	0.001
CR	0.001	0.797
GROWTH	0.013	0.891
SIZE	-0.037	0.015
Adjusted R Square : 0.117		
F : 5.092		Sig : 0.000

Based on table 2, the regression model obtained is:

$$TA_{it} = 1.231 + 0.024 Z_{it} - 7.840 EM_{it} - 1.232 ROA_{it} + 0.382 DAR_{it} + 0.001 CR_{it} + 0.013 GROWTH_{it} - 0.037 SIZE_{it} + \varepsilon$$

Table 2 shows the Adjusted Square value of 0.117. this shows that the percentage of variation in the dependent variable that can be explained by the variation in the independent variables is 11.7%. while the remaining 88.3% is explained by variations in other variables not included in the regression model in this research. The significance value (Sig.) is 0.000 < 0.05. so it can be concluded that the independent variable financial distress, earnings management simultaneously influences tax avoidance.

Table 2 shows that the test result of Hypothesis, which obtained a positive financial distress variable coefficient of 0.024. with a significance of 0.028 on the Current ETR (0.028 < 0.05 = significant). It means that financial distress variable positively influences the tax aggressiveness. Higher financial distress equals to higher tax avoidance.

Thus, H1 was accepted.

The results of this study are in line with research conducted by Nugroho, et al (2020). Sadjiarto, et al (2020). Richardson et al. (2015). Dang & Tran (2021) that financial distress has a positive effect on tax avoidance. Generally, firms' financial distress is increased during the financial crisis. During this period, firms are forced to save their cash through reducing current tax liabilities. The financial difficulties experienced by companies could be due to the impact of Covid-19 that occurred in the 2020-2021 period, which is the year that is the object of this research. As a result, several companies rely on debt to support their operational activities. Financial difficulties can result in company problems in paying debts, both the principal and the interest on the debt. Due to deteriorating economic and financial conditions, companies that face an increased risk of bankruptcy as a result of financial distress can see the potential for the tax burden that should be paid to fiscus to be minimal. Essentially, in times of financial distress, strategies that were previously viewed by the firm as more risky or costly for it to undertake may become more appealing and viable as the potential benefits of tax avoidance increase. In the sense that the company will be more aggressive in tax avoidance due to the conditions experienced without considering the possible effects of taking this action, such as tax fines that are billed by fiscus and damage to the company's reputation/value, because the company prioritizes the ability to continue its

business continuity.

On the independent variable earnings management, from the results of model testing, a negative beta value of -7.840 was obtained, with a significance of 0.261 on the Current ETR ($0.261 > 0.05$ = not significant).

Thus, H2 was rejected.

The results of this study do not support the research conducted by Amidu et.al. (2019), Thalita et.al (2022), Purba (2018), Nurfitriasih and Istiqomah (2022), Irawan et.al. (2020), Arief et.al. (2016) who found that earnings management has a positive effect on tax avoidance. Differences in the results of this study are thought to be caused by differences in research sites. The difference in research sites will cause differences in economic conditions and differences in tax regulations. Other reasons, this difference is thought to be caused by differences in the use of tax avoidance proxies and earnings management proxies.

The results of the study show that earnings management has no effect on fund tax avoidance in line with research conducted by Ginting and Elly (2018), and Henny (2019). Managers do not take advantage of pandemic conditions to change the level of accrual earnings management. The company's management still considers the company's internal conditions as a basis for determining the level of earnings management used.

One of the government regulations that is directly related to company profits is the corporate income tax. Profit management practices that are usually carried out by companies by carrying out income minimization explain that company profits are the benchmark in measuring the company's tax burden. Therefore, management will report profits according to its objectives, namely using accounting options that reduce profits or decrease income as a form of tax avoidance, or not do it. This relates to agency theory that the agent has acted in accordance with what the principle wants. The current pandemic condition has a negative impact on company performance, especially for consumer goods industry companies. The decrease in consumption causes the company to also experience problems related to sales, so that managers can increase the allowance for bad debts. As a result, profits are getting smaller and corporate taxes are decreasing. So it can be concluded that the opportunity due to the pandemic does not cause managers to increase accrual profits because the motivation of managers is only to provide full-disclosure. There is no effect of earnings management on tax avoidance, indicating that the greater the decreasing income made by the company, the company has no indication of tax avoidance.

From the test of profitability, the model test results obtained a negative beta value of -1.232 with a significance of 0.000 on Current ETR ($0.000 < 0.05$ = significant). These results prove that profitability has significant effect on tax avoidance. This explains that the variable profitability has an inverse relationship with tax avoidance. The profitability variable in this study uses the ratio of return on assets which is a comparison between a company's net profit and its total assets, so it can be concluded that the greater the return on assets of a company, the less aggressive the company's tax actions will be.

From the test of leverage, the model test results obtained a positive beta value of 0.382 with a significance of 0.001 on Current ETR ($0.001 < 0.05$ = significant). These results prove that leverage has significant effect on tax avoidance. This explains that the leverage variable has a unidirectional relationship with tax avoidance. The leverage variable in this study uses the debt-to-asset ratio, which is a comparison between a company's total liabilities and its total assets, so it can be concluded that the greater the debt-to-asset value of a company, the company's tax avoidance will increase.

From the test of liquidity, the model test results obtained a positive beta value of 0.001 with a significance of 0.797 on Current ETR ($0.797 > 0.05$ = no significant). These results prove that leverage has no significant effect on tax avoidance. This explains that the company's leverage does not affect tax avoidance. The absence of leverage on tax aggressiveness can be caused by certain factors that prevent companies from taking advantage of the interest expense on their debt in reducing the tax burden. If the debt owned by the company is too large, it will also have an impact on the risks it faces, that is the consideration taken by the company. The large debt owned by the company can also reduce stakeholder confidence, especially investors because of the large risks that the company will face in the future.

From the test of company growth, the model test results obtained a positive beta value of 0.013 with a significance of 0.891 on Current ETR ($0.891 > 0.05$ = no significant). These results prove that company growth has no significant effect on tax avoidance. Sales growth indicates an increase or decrease in the sales or revenue of the entity. Entities with high sales growth do not necessarily earn high profits either. This can be due to high costs or expenses as a result of high sales so that high sales growth can result in low profits. So the high or low sales growth does not have a significant effect on tax avoidance.

From the test of firm size, the model test results obtained a negative beta value of -0.037 with a significance of 0.015 on Current ETR ($0.015 < 0.05$ = significant). These results prove that firm size has significant effect on tax avoidance. This shows that the larger the size of the company, the company's tax avoidance will decrease, because there are impacts such as reputation and company value which will be worse if the company takes these tax avoidance actions.

V. CONCLUSION

We examine whether financial distress and earnings management has an impact on tax avoidance, where we use the research of Dechow (1995) to determine the Discretionary, for financial distress we measure it with the Altman Z Score and tax avoidance is measured using Cash Effective Tax rate (CETR).

The results showed that when the company experienced financial distress, management usually looked for a quick fund source with unforeseen risks. The easiest fund to obtain was the tax payment fund. Meanwhile, using fund from debt would add interest expense and a rejection possibility from creditors. Another cause was that audit from tax apparatus was conducted after the end of the tax year, thus, impossible to detect early, unless it led to tax avoidance or tax penalties. The earnings management that was performed through Discretionary accrual no influenced tax avoidance behaviour empirically.

Researchers still difficult to find the component of amount of tax paid working capital to measure cash effective tax rate, not all objects of observation, namely the company's financial reports present it, and the economic conditions of Covid-19 have an adverse impact on profits, thus making the research sample small. Finally, our regression models may be incomplete. Future research could possibly consider this issue.

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