

# The Influence of Tax Avoidance, Firm Size, Firm Age, and Leverage towards Earnings Response Coefficients

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## Abstract

This study aims to examine the effect of tax avoidance, firm size, firm age, and leverage on earnings response coefficient. The population in this study are all manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2017-2019. The sample used as a whole consisted of 97 of 165 companies with 144 observations. The results of this study use multiple linear regression analysis and indicate that tax avoidance, firm size, and leverage have a positive effect on earnings response coefficient, while firm age has no influence on earnings response coefficient.

**Keywords:** Tax avoidance, firm size, firm age, leverage, earnings response coefficient.

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## Introduction

Quality companies that investors covet are companies that have increased sales and net profits from year to year. The level of earnings quality information content can be measured using Earnings Response Coefficient (ERC). ERC is very useful in fundamental analysis to calculate the actual inventory value using company financial data and helps investors to assess market reactions based on company profits (Raza, Ihsan, and Jan,

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2017). A low ERC indicates earnings that are less informative for investors to make economic decisions. High-quality earnings information is characterized by investor responses at the time of earnings announcements (Scott, 2015).

Based on agency theory, because of the interests of the company to improve the quality of the current profit value for the welfare of the company itself and for the interests of investors, there are various ways to improve earnings quality. One of the common methods used is the practice of tax avoidance by companies with the aim of minimizing their tax expenditures. Tax avoidance is an effort to reduce tax debt that is legal (Gravelle, 2010, p.1). The benefit of tax avoidance is to increase tax saving which has the potential to reduce tax payments, thereby increasing cash flow (McGuire, Wang, and Wilson, 2011). Tax avoidance is a problem that is quite complex and unique because on one hand tax avoidance is permitted because it is legal, but on the other hand tax avoidance is undesirable because it can affect state revenue from the tax sector. Said to be legal because tax avoidance creates creative compliance where taxpayers comply with applicable tax laws, but find gaps that exist in taxation regulations themselves (McBarnet, 2001).

Crabtree and Kubick (2014) stated that corporate tax avoidance will have an impact on the timing of the announcement of the annual financial statements. That is, company managers can be involved in tax planning throughout the year to complete earnings management activities. Permanently designed tax planning reduces corporate tax liability, which in turn increases income after tax and can help companies meet market expectations. Therefore, the results of research conducted by Mukhlisin & Anissa (2018) stated that tax avoidance reduces the quality of earnings information based on investor perceptions. This research is also supported by research from Kubata, Lietz, and Watrin (2013), which states that tax avoidance has a negative effect on earnings information as measured by earnings response coefficient. Several previous studies state that a company cannot report commercially high earnings together with reporting low income in a fiscal manner. Ariff and Hashim (2014) found a positive relationship between tax avoidance and aggressive financial reporting and showed that tax avoidance could increase shareholder wealth and be in line with the opportunistic interests of managers.

Based on research that has been done, there are several determinants that can affect earnings response coefficient, including the firm size, firm age, and the leverage of a company. From the results of research conducted by Anita and Anggraini (2019), it was found that firm size had a negative effect on ERC. However, contrary to the research revealed by Zakaria and Daud (2013), there is a positive relationship between firm size and ERC. This research is based on the broader information available on large companies, the easier it is for investors to interpret the information in their financial statements regarding economic profit.

A long-established company is generally more stable and investors can monitor the company's performance from year to year. Meanwhile, newly established companies have less experience and are often unstable. However, Loderer and Waelchli (2010) stated that age can progressively weaken company performance. The company's aging phenomenon is related to organizational rigidity which makes it difficult for companies to find, accept, and implement signals of innovation from the market.

Hasanzade, Darabi, and Mahfoozi (2013) concluded that companies without leverage or companies with lower leverage have a higher ERC than companies with higher leverage or companies with higher leverage. However, contrary to Khoshtinat and Fallah (2006) in the results of his study showed that there is no relationship between leverage and ERC. There is also research conducted by Valipour and Moradbeygi (2011) which states that leverage has a positive relationship with earnings quality as measured by earnings response coefficient.

## **Review Literature and Hypothesis**

Godfrey, Hodgson, Tarca, Hamilton, and Holmes (2010, p.363) stated agency theory is a contractual relationship between company members, owners or shareholders (principal) and managers (agents). The difference in interests between the principal and agent causes conflict (agency problem). Conflict occurs when a manager has fewer shares than the number of shares of the company. Shareholders want high company value and managers also want high profits.

One component of accounting that is the concern of stakeholders in a company is profit. Profit is something that is used as an assessment of the sustainability of a company's business by the owners of the company's interests. Earnings information that is announced in the financial statements is very useful for stakeholders to be used as a basis for decision making, so the quality measurement of earnings information is crucial in making the right decision. In measuring good quality earnings can be measured using Earnings Response Coefficient (ERC). Scott (2009) stated that ERC is defined as a coefficient to measure the level of abnormal market return of a security against the unexpected component of earnings reported by the company. A low ERC indicates earnings that are less informative for investors to make economic decisions. High-quality earnings information is characterized by investor responses at the time of earnings announcements.

Tax avoidance is an attempt to reduce tax debt that is legal. The benefit of tax avoidance is to increase tax saving which has the potential to reduce tax payments, thereby increasing cash flow (McGuire et al., 2011). In contrast to tax avoidance, tax evasion in its efforts to reduce the tax burden in an illegal way, namely by violating applicable tax provisions.

Brigham and Houston (2013) stated that firm size is a scale that can classify companies into large and small companies. The size of a company can be seen from the total assets, sales, and market capitalization of the company. The larger the size of the company, the more information available to investors to make investment decisions. However, the measure most often used in measuring the size of a company is through its assets, because assets are considered relatively more stable when compared to sales and market capitalization.

Firm age is calculated since the company was established and can survive on the Indonesia Stock Exchange (IDX). Firm age also shows how long the company can continue to exist and be able to compete in the business world. Loderer and Waelchli (2010) stated that firm age is calculated since the company did the listing because the

company has a very meaningful economy. When the company is listed on the IDX and goes public, the company must publish its financial statements to the public and stakeholders which will affect the company's ownership and capital structure, increase media exposure, increase profit opportunities, and demand different corporate governance structures.

Leverage is a ratio that compares total liabilities with total assets owned by a company at the end of the year. In other words, leverage measures how much assets owned by companies are financed with debt. Kasmir (2017, p.165) stated that leverage is a ratio to measure the extent to which a company is financed with debt, in a broad sense it is said that the ratio is used to measure the company's ability to pay all of its obligations, both short-term and long-term if the company is dissolved. Thus, the greater the leverage ratio, the greater the debt owned by the company. And the greater the debt of a company, the smaller the profit of a company. This is because the greater the amount of debt will cause interest expense which will then reduce profits.

Based on agency theory, the existence of corporate interests to improve the quality of the current profit value for the welfare of the company itself and for the interests of investors, raises various ways to improve earnings quality. One method used is the practice of tax avoidance by companies with the aim of minimizing their tax expenditures. Tax avoidance aims to increase tax saving which has the potential to reduce tax payments, thereby increasing cash flow (McGuire et al., 2011). High cash flow indicates high corporate income as well, so that it can help the company in meeting market expectations. This hypothesis is also supported by the results of research conducted by Ariff and Hashim (2014) who found a positive relationship between tax avoidance and aggressive financial reporting and showed that tax avoidance could increase shareholder wealth and be in line with opportunistic interests of managers. For this reason, the following hypothesis is formulated:

**H<sub>1</sub>:** Tax avoidance has a positive effect on earnings response coefficient.

Firm size can be used as one of the information that can be used by investors to assess the profit of a company in making investment decisions. The total assets owned by the company, operational activities carried out by the company, and the number of new innovations carried out by the company will affect the company's ability to generate profits. Investors will generally respond more to companies that have greater profits with a high ERC indication. Large companies are considered to have more information than small companies. According to Anita and Anggraini (2019), the availability of information resources at large companies will increase ERC in the long run. Information available throughout the year on large companies allows stakeholders to interpret the information contained in finances more perfectly, so they can predict cash flows more accurately and reduce uncertainty. This hypothesis is also supported by the results of research conducted by Sherla (2016), Lilik (2012), and Zakaria & Daud (2013) in their research findings that the more extensive information available to large companies, the more it is easy for investors to make investment decisions. For this reason, the following hypothesis is formulated:

**H<sub>2</sub>:** Firm size has a positive effect on earnings response coefficient.

As company get older, companies will improve financial reporting better over time. A long-established company shows stability and investors can review the company's performance from the earnings information contained in the financial statements. Indirectly, a company that is proven to be able to survive in the business world for a long time and has a good reputation, can indicate the quality of the company. This hypothesis is also supported by the results of research conducted by Rohmah (2017) who found a positive influence on the age of the company on the quality of financial statements, where the quality of financial statements is indicated by the amount of profits and rewards obtained by a company. In other words, the profit response coefficient is also high. For this reason, the following hypothesis is formulated:

**H<sub>3</sub>:** Company age has a positive effect on earnings response coefficient.

Leverage is the amount of assets owned by a company financed with debt. Debt owned by a company is able to increase the company's capital. Companies that have a high degree of leverage will encourage management to conduct earnings management and improve performance so that they can pay off the company's debt. Debt that can be repaid has a positive impact on the company to become more developed. A high level of corporate debt can be used to fund the company's operational activities and then the company can generate large profits and can pay off its debt from the profits generated. Therefore, high corporate debt will be reacted well by the company so that the profits generated by the company will be of good quality. This assumption is supported by research conducted by Valipour and Moradbeygi (2011) which states that leverage has a positive relationship with earnings quality as measured by earnings response coefficient. For this reason, the following hypothesis is formulated:

**H<sub>4</sub>:** Leverage has a positive effect on earnings response coefficient.

## **Research Methodology**

The population in this study were all manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2017-2019. The sample used as a whole consisted of 97 of 165 companies with 144 observations. The several criteria for determining the sample used in this study are as follows:

1. Manufacturing companies listed on the IDX in 2017-2019.
2. The company publishes the audited financial statements and stated in rupiah.
3. Data in the company's annual report contains complete information related to the variables used in the study.
4. The company did not experience losses during 2017-2019 so as not to cause the CETR and ERC values to be distorted.

Firm size can be classified according to total assets, net sales, and market capitalization of the company. In this study, company size is measured using natural logarithm of total assets owned by the company (McGuire et al., 2011).

$$Firm\ Size = Ln\ Total\ Assets$$

In this study, firm age is calculated annually from the date the company was listed on the IDX. This is because when the company is listed on the IDX and goes public, the

company must publish its financial statements to the public and stakeholders so that the information contained therein can be used well by the parties in need.

Leverage measures how much assets a company has financed with debt. Debt to Total Asset Ratio (DAR) is the ratio used in this study to measure the level of solvency of a company because it can measure how much the total assets of a company is financed with total debt.

$$Debt\ Ratio\ (DAR) = \frac{Total\ liabilities}{Total\ assets}$$

The measurement of tax avoidance in this study uses the Cash Effective Tax Rate (CETR) formula. According to Dyreng, Hanlon, and Maydew (2010) Cash Effective Tax Rate (CETR) is good to be used to describe tax avoidance activities, because CETR is not affected by changes in estimates such as valuation allowance or tax protection. The higher the CETR value of a company, the lower the tax avoidance practices of a company.

$$CETR = \frac{Tax\ paid}{Earnings\ before\ tax}$$

$$Tax\ Avoidance = \frac{1}{CETR}$$

Earnings Response Coefficient (ERC) is a coefficient to measure the level of abnormal market return of securities against the unexpected component of earnings reported by the company. In this study, ERC calculated monthly. ERC can be calculated in the following stages:

1. Calculate Cumulative Abnormal Return (CAR)

$$CAR_{it} = \sum AR_{it}$$

CAR<sub>it</sub> : Cumulative Abnormal Return of stock i on period t  
 AR<sub>it</sub> : Abnormal Return of stock i on period t

- a. Calculate Abnormal Return (AR)

$$AR_{it} = R_{it} - CAPM$$

AR<sub>it</sub> : Abnormal Return of stock i on period t  
 R<sub>it</sub> : Actual Return of stock i on period t  
 CAPM : Expected return of stock i on period t

- b. Calculating the expected return using the Capital Asset Pricing Model (CAPM)

$$CAPM = R_f + \beta(R_m - R_f)$$

CAPM : Expected return of stock i on period t  
 R<sub>f</sub> : Returns obtained from securities with free risk  
 β : Systematic risk of stock i relative to the index  
 R<sub>m</sub> : Return on the market

- c. Calculate β (beta)

$$\beta = \frac{\text{Covar}(R_i, R_m)}{\sigma^2(R_m)}$$

- $\beta$  : Systematic risk of stock i relative to the index
- $R_i$  : Returns obtained from stock i
- $R_m$  : Returns on the market (associated with CSPI)
- $\sigma^2$  : Variants of returns on the market (CSPI)

d. Calculate Actual Return ( $R_{it}$ )

$$R_{it} = \frac{P_t - P_{t-1}}{P_{t-1}}$$

- $R_{it}$  : Actual Return of stock i on period t
- $P_t$  : The company's stock price in the period t
- $P_{t-1}$  : The company's share price in the period t-1

2. Calculate the ERC coefficient by performing a simple linear regression on the CAR and EU relationship

$$CAR_{it} = \alpha_0 + \alpha_1 UE_{it} + \varepsilon_{it}$$

- $CAR_{it}$  : Cummulative Abnormal Return of stock i on period t
- $\alpha$  : A constant
- $UE_{it}$  : Unexpected earnings of the company i in the period t
- $\varepsilon_{it}$  : Component error

Where:

$$UE_{it} = \frac{(E_{it} - E_{i,t-1})}{E_{i,t-1}}$$

- $UE_{it}$  : Unexpected earnings of the company i in the period t
- $E_{it}$  : Earnings of the company i in the period t
- $E_{i,t-1}$  : Earnings of the company i in the period t-1

In this study also uses a control variable which is a variable that is controlled or made constant, so that the influence of the independent variable on the dependent variable is not influenced by external factors that are not being studied (Sugiyono, 2014, p.41). In this study the control variables used are return on assets and debt to equity ratio.

Return on Assets (ROA) is a profitability ratio that measures a company's ability to generate profits from the use of all its resources or assets. In other words, ROA measures how efficient a company is in managing its assets to generate profits during a period. ROA is expressed as a percentage (%) with the following formula:

$$ROA = \frac{\text{Earnings after tax}}{\text{Total assets}} \times 100\%$$

Debt to Equity Ratio (DER) is a ratio that shows the ratio of debt and capital of a company. This ratio is related to the problem of trading on equity, which can have a positive and negative effect on the profitability of the company's capital.

$$DER = \frac{\text{Total liability}}{\text{Total equity}} \times 100\%$$

## Result and Discussion

Data analysis in this study includes descriptive statistical analysis, classic assumption test, and hypothesis test. Descriptive statistical analysis described in the table below.

## Result and Discussion

Data analysis in this study includes descriptive statistical analysis, classic assumption test, and hypothesis test. Descriptive statistical analysis described in the table below.

Table 1. Descriptive Statistical Analysis

Variable	Minimum	Maximum	Mean	Std. Deviation
ERC	-0.360	0.0650	0.001953	0.0178449
Tax Avoidance	0.5860	61.5245	4.518417	5.4274935
Firm Size	1.8352877132	9.6537796000	8.07	1.600
Firm Age	2	40	21.21	10.789
Leverage	0.0904	1.8234	0.408762	0.2135806
ROA	0.0003	4.2760	0.120527	0.3803502
DER	0.0994	8.7464	0.918588	1.0615252

Source : SPSS 20.0 Data Processing Results

Data in Table 1 was collected from 144 manufacturing companies listed on the IDX. Seen from mean value, the quality of earnings is small with a high level of tax avoidance, a relatively large size of the company, a long age of the company, and the level of total assets financed with proper debt.

Table 2. Normality Test

	Unstandardized Residual
N	144
Kolmogorov-Smirnov Z	1.150
Asymp. Sig. (2-tailed)	0.142

Source : SPSS 20.0 Data Processing Results

It can be seen from Table 2 that the significance value of 0.142 is greater than the predetermined significance value of 0.05 (5%). The conclusion from the results of the normality test of the second research model is that the residual value is normally distributed.



Table 3. Determination Coefficient Test ( $R^2$ )

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.455	0.207	0.173	0.0162305

Source : SPSS 20.0 Data Processing Results

From Table 3, the adjusted R Square value is 0.173 or 17.3%. This means that 17.3% of the ERC variable can be explained by the variable tax avoidance, firm size, firm age, leverage, ROA, and DER. While the remaining 82.7% ERC variable can be explained by other factors not listed in this study.

Table 4. ANOVA Test

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.009	6	0.002	5.977	0.000
Residual	0.036	137	0.000		
Total	0.046	143			

Source : SPSS 20.0 Data Processing Results

Obtained a significance value of 0,000 where the significance value is smaller than the predetermined significance value of 0.05 (5%). This means that  $H_0$  is rejected and  $H_1$  is accepted. So it can be concluded that the variable tax avoidance, firm size, firm age, leverage, ROA, and DER together influence the ERC variable.

Table 5. Statistics t Test

Model	B	t	Sig.
Tax Avoidance	0.001	3.135	0.002
Firm Size	0.002	2.036	0.044
Firm Age	5.171E-5	0.405	0.686
Leverage	0.036	3.955	0.000
ROA	-0.001	-2.626	0.010
DER	-0.003	-1.434	0.154

Source : SPSS 20.0 Data Processing Results

Hypothesis 1 suspects that tax avoidance has a positive effect on earnings response coefficient. Based on Table 5 the significance value of tax avoidance is obtained 0.002 where the significance value is smaller than the predetermined significance value of 0.05 (5%). This means that  $H_1$  is accepted. It can be concluded that tax avoidance has a positive effect on earnings response coefficient.

The interests of the company to improve the quality of the current value of profits for the welfare of the company itself and for the interests of investors, led to various ways to improve the quality of earnings. One method used is the practice of tax avoidance by companies with the aim of minimizing their tax expenditures. Tax avoidance aims to increase tax saving which has the potential to reduce tax payments, thereby increasing cash flow (McGuire et al., 2011). High cash flow indicates high corporate income as well,

so that it can help the company in meeting market expectations. The results of this study are in line with the results of research conducted by Ariff and Hisham (2014) who found a positive relationship between tax avoidance and aggressive financial reporting and showed that tax avoidance can increase shareholder wealth and is in line with the opportunistic interests of managers.

Hypothesis 2 suspects that firm size has a positive effect on earnings response coefficient. Based on Table 5, the significance value of tax avoidance is obtained at 0.044 where the significance value is smaller than the significance value that has been set at 0.05 (5%). This means that  $H_2$  is accepted. It can be concluded that firm size has a positive effect on earnings response coefficient.

Large companies are considered to have more information than small companies. Firm size can be used as one of the information that can be used by investors to assess the profit of a company in making investment decisions. The total assets owned by the company, operational activities carried out by the company, and the number of new innovations carried out by the company will affect the company's ability to generate profits. Investors will generally respond more to companies that have greater profits with a high ERC indication. Anita and Anggraini (2019) stated that the availability of information resources in large companies will increase ERC in the long run. Information available throughout the year on large companies allows stakeholders to interpret the information contained in finances more perfectly, so they can predict cash flows more accurately and reduce uncertainty. The results of this study are in line with the results of research conducted by Sherla (2016), Lilik (2012), and Zakaria & Daud (2013) who in their research found that more extensive information was available on large companies. The easier it is for investors to make investment decisions.

Hypothesis 3 suggests that firm age has a positive effect on earnings response coefficient. Based on Table 5, the significance value of tax avoidance is obtained 0.686 in which the significance value is greater than the significance value that has been set at 0.05 (5%). This means that  $H_3$  is rejected. Then it can be concluded that firm age does not affect the earnings response coefficient.

According to Gral (2014), a company that has long been established has a more solid strategy to be able to survive in the future because the more experience and learning the company has will make the company more competent. But according to Loderer and Waelchli (2010), the aging phenomenon shows organizational rigidity and inertia that makes it difficult for companies to recognize, accept, and implement signals of innovation in the market. Correspondingly, COGS and overhead costs continue to rise along with the increase in the company's age, decreased margins, and decreased growth. In fact, there are many successful and successful long-standing companies that are able to generate high profits, survive and compete with other industries, and even enter the list of the best companies in Indonesia. However, there are also many companies that have recently been established or certain subsidiaries that have recently been established, as well as start-up companies that have good quality earnings information, which are able to capture signals of innovation in the market, which are able to meet market needs, and even considered to have the potential to become a growing company. In addition, there are also many companies that have long existed but eventually went bankrupt and were unable to compete with new companies because it was difficult to catch the signal of innovation in

the market. The results of this study are not in line with the results of research conducted by Rohmah (2017) who found a positive influence on the firm age on the earnings response coefficient.

Hypothesis 4 suggests that leverage has a positive effect on earnings response coefficient. Based on Table 5, the significance value of tax avoidance is obtained 0,000, where the significance value is smaller than the significance value that has been set, which is equal to 0.05 (5%). This means that  $H_4$  is accepted. Then it can be concluded that leverage has a positive effect on earnings response coefficient.

Companies that have a high degree of leverage will encourage management to conduct earnings management and improve performance so that they can pay off the company's debt. Debt that can be repaid has a positive impact on the company to become more developed. A high level of corporate debt can be used to fund the company's operational activities and then the company can generate large profits and can pay off its debt from the profits generated. Therefore, high corporate debt will be reacted well by the company so that the profits generated by the company will be of good quality. The results of this study are in line with the results of research conducted by Valipour and Moradbeygi (2011) which states that leverage has a positive relationship with earnings quality as measured by earnings response coefficient.

## Conclusion

This study aims to determine and provide empirical evidence of the influence of variable tax avoidance, firm size, firm age, and leverage on earnings response coefficient. The test results in this study, showed that tax avoidance, firm size, and leverage have a positive effect on earnings response coefficient, while firm age has no influence on earnings response coefficient. Which means the greater the level of tax avoidance practices, the greater the size of a company, and the greater the assets owned by companies financed with debt, the higher the quality of earnings measured by earnings response coefficient. But how long does the company's life do not affect earnings quality as measured by earnings response coefficient.

Future research can also add several independent variables that can explain the earnings response coefficient variable. Other variables that might explain ERC, for example corporate governance, capital structure, and earnings management. Then future research can change the way the firm age variable is measured to be calculated from the date the company was founded, because in this study the measurement of the firm age variable is calculated from the date registered on the IDX and the results show that the firm age variable has no effect on the ERC variable.

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