“The mediating role of financial reporting aggressiveness in corporate tax avoidance strategies”

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THE MEDIATING ROLE OF FINANCIAL REPORTING AGGRESSIVENESS IN CORPORATE TAX AVOIDANCE STRATEGIES

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Abstract

Tax avoidance, often driven by managerial discretion, remains a critical issue in corporate governance due to its implications for financial transparency and regulatory compliance. This study investigates how Transfer Pricing, Thin Capitalization, Leverage, and CSR Disclosure – strategies employed by managers – affect Tax Avoidance and examines the mediating role of Financial Reporting Aggressiveness. Grounded in agency theory, the study analyzes data from 20 firms listed on the Indonesian Stock Exchange from 2019 to 2023 using PLS-SEM. The findings reveal that Transfer Pricing ($\beta = 0.062$, $p = 0.002$), Leverage ($\beta = 0.046$, $p < 0.001$), and CSR Disclosure ($\beta = 0.061$, $p < 0.001$) significantly increase Tax Avoidance, with Financial Reporting Aggressiveness acting as a mediator. However, Thin Capitalization does not significantly influence Tax Avoidance ($\beta = 0.028$, $p = 0.422$). These results suggest that managers exploit these mechanisms to minimize tax burdens, often at the cost of long-term shareholder interests. The study calls for stronger corporate governance and stricter oversight of CSR reporting and financial transparency to mitigate such practices.

Keywords tax avoidance, transfer pricing, thin capitalization, leverage, CSR disclosure, financial reporting aggressiveness

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INTRODUCTION

Tax avoidance by multinational corporations has emerged as a critical issue for economies worldwide, raising concerns among tax authorities, shareholders, and the public (Huseynov & Klamm, 2012; Asrindah & Atmoko, 2024). In Western countries, such as Australia, Canada, the United Kingdom, and the United States, the complexity and scale of tax avoidance practices have intensified the scrutiny of corporate financial strategies (Taylor & Richardson, 2012). Indonesia exemplifies the significant economic impact of these practices, with the Tax Justice Network (2020) reporting annual losses of approximately 68.7 trillion IDR due to corporate tax evasion. Despite legal boundaries, tax avoidance practices raise questions about corporate governance and the ethical implications of these strategies.

Agency theory provides a valuable lens through which to examine these practices, explaining the relationship between principals (shareholders) and agents (managers) within a contractual framework (Jensen & Meckling, 1976). This theory suggests that the separation between ownership and management often results in agency problems, as managers may act in their self-interest rather than maximizing shareholder value. Agency problems arise from differing objectives, where man-

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agers prioritize personal welfare, potentially leading to decisions that may not align with shareholder interests or societal expectations. This divergence can include engaging in tax avoidance practices to increase reported profits, thus enhancing managerial bonuses or the company's market valuation.

Research into tax avoidance often focuses on mechanisms such as transfer pricing, thin capitalization, and leveraging, all of which can be seen as tools managers use to minimize tax liabilities (Anesa et al., 2019; Sikka, 2010). Agency theory posits that these practices may reflect managerial opportunism, where managers leverage their informational advantage to make decisions that benefit themselves at the expense of principals Ross (1973). For instance, transfer pricing allows managers to shift profits to jurisdictions with lower tax rates, thereby reducing the firm's overall tax burden and potentially enhancing short-term financial performance. However, such actions can lead to agency costs, including monitoring expenses, bonding costs, and residual losses, as shareholders and tax authorities strive to align managerial actions with broader objectives.

While previous studies have explored the relationship between transfer pricing and tax avoidance, there remains a research gap in understanding how these practices vary across different contexts and how they interact with other corporate governance mechanisms, such as Corporate Social Responsibility (CSR) disclosures. Some studies indicate a positive relationship between CSR and tax avoidance, suggesting that companies may use CSR initiatives to offset the negative perception of aggressive tax strategies (Davis et al., 2016; Zeng, 2019). Agency theory provides a framework to understand these dynamics, as it highlights the potential for managers to use CSR as a legitimizing tool to mitigate agency problems and reduce potential reputational damage associated with tax avoidance.

1. LITERATURE REVIEW

Tax avoidance has long been a subject of significant interest in corporate governance and financial management studies, largely due to its broad implications for corporate ethics, financial performance, and regulatory compliance. Several theoretical frameworks have been proposed to understand the motivations behind tax avoidance, with agency theory and positive accounting theory offering valuable insights. Agency theory, introduced by Jensen and Meckling (1976), centers on the relationship between two key players in a firm – the shareholders (principals) and the managers (agents). According to this theory, managers, entrusted by the shareholders to make decisions on their behalf, may prioritize their own self-interest, leading to behaviors that are not aligned with maximizing shareholder wealth. In the context of tax avoidance, this theory suggests that managers may engage in strategies to minimize the company's tax liabilities, even if such actions do not benefit the shareholders in the long term. These managerial actions are a reflection of the agency problem, where there is a misalignment of interests between principals and agents, often leading to increased agency costs, which include the costs of monitoring and controlling managerial behavior (Palliam & Shalhoub, 2003).

The notion of agency costs, as described by Jensen and Meckling (1976), encompasses the various expenses associated with ensuring that managers act in the best interests of the shareholders. These include monitoring costs, bonding expenditures, and residual losses that arise from managers pursuing objectives like tax avoidance that may not align with the shareholders' broader financial goals. The separation of ownership and control within a company thus creates fertile ground for such opportunistic behavior, with tax avoidance being one potential outcome. Herianti and Chairina (2019) extended agency theory by suggesting that the division between decision management (initiation and implementation of decisions) and decision control (ratification and monitoring of those decisions) exacerbates this issue, particularly when managers have significant autonomy in implementing tax-related strategies. Despite the presence of contracts and corporate governance mechanisms aimed at aligning interests, the inherent conflict between the goals of principals and agents makes it difficult to eliminate agency problems completely, especially in complex financial areas like tax management.

Positive accounting theory, articulated by Watts and Zimmerman (1990), complements the agency theory perspective by positing that managers, acting in their own best interests, make accounting choices that serve to maximize their personal utility. This includes opportunistic behavior aimed at reducing tax liabilities through various financial maneuvers, which can increase company profits in the short term. Tax avoidance thus becomes one of the strategies managers might employ to enhance their personal performance metrics, as lower tax obligations can lead to higher reported earnings, which are often tied to executive compensation packages. Desai and Dharmapala (2006), as well as Frank et al. (2008), explored how such opportunistic managerial behavior is often facilitated by the flexibility inherent in accounting standards, which allows managers to manipulate financial reporting in ways that reduce tax burdens while presenting a favorable financial outlook.

Several empirical studies have further examined the specific factors that influence a company's propensity for tax avoidance, revealing that practices like transfer pricing, thin capitalization, leverage, and CSR disclosure play critical roles in shaping tax strategies. Transfer pricing, in particular, has been identified as a key mechanism through which multinational corporations shift profits to low-tax jurisdictions, thereby reducing their overall tax liabilities. Amidu et al. (2019) and Davies et al. (2018) have both demonstrated that transfer pricing is positively associated with tax avoidance, as it allows companies to reallocate taxable income across borders in ways that minimize tax exposure. This practice has been consistently linked with a higher degree of tax avoidance, especially among firms operating in multiple countries with varying tax regimes. Wier (2020) adds to this discussion by confirming that transfer pricing remains one of the most effective tools for multinational corporations to engage in tax avoidance, particularly when coupled with the use of tax havens (Robin et al., 2021).

Similarly, thin capitalization has been shown to significantly contribute to tax avoidance. Companies that prioritize debt financing over equity financing often engage in thin capitalization to exploit tax advantages, as interest payments on debt are typically tax-deductible. Modigliani and Miller (1963) were among the first to highlight how firms can benefit from the tax shield provided by debt financing. Subsequent research, including studies by Hanlon and Slemrod (2009) and Taylor and Richardson (2012), supports the argument that thinly capitalized companies are more likely to engage in tax avoidance as they seek to maximize the tax benefits associated with high levels of leverage. By structuring their operations to rely heavily on debt, these companies can reduce their taxable income through interest deductions, thereby achieving significant tax savings. This, in turn, aligns with the opportunistic behavior predicted by both agency theory and positive accounting theory, where managers use financial structures to pursue tax minimization strategies that may not always align with the long-term interests of shareholders.

Leverage itself plays a crucial role in shaping corporate tax avoidance behavior. Debt financing, as mentioned, offers the advantage of tax-deductible interest payments, which reduces a company's taxable income. Gupta and Newberry (1997), in their seminal work, demonstrated that companies with higher levels of debt tend to engage in more aggressive tax avoidance strategies, leveraging the tax deductibility of interest expenses to lower their tax burden. This finding has been corroborated by other researchers, such as Rego (2003), who found that highly leveraged firms are more likely to minimize their tax liabilities through a combination of interest deductions and other tax planning techniques. The implication here is that leverage serves as both a financial strategy and a tax avoidance tool, with companies using debt not only to finance operations but also to reduce their tax obligations in a manner consistent with the predictions of agency theory and positive accounting theory.

On the other hand, the relationship between Corporate Social Responsibility (CSR) disclosure and tax avoidance is more complex. While some studies suggest that firms with higher levels of CSR disclosure are less likely to engage in aggressive tax avoidance due to concerns about reputa-

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tion and public scrutiny, other research points to a different conclusion. Davis et al. (2016) and Zeng (2019) found that firms with strong CSR practices might still engage in tax avoidance, as CSR efforts can serve as a form of reputational management that offsets the potential negative perceptions of tax minimization strategies. In this context, CSR disclosure becomes a double-edged sword: while it promotes transparency and ethical behavior, it can also be used strategically to divert attention from less socially responsible actions, such as tax avoidance. Gulzar et al. (2018) and López-González et al. (2019) argue that firms engaging in aggressive tax avoidance may use CSR activities to balance out the reputational risks associated with such practices, presenting themselves as socially responsible while simultaneously engaging in tax minimization tactics.

Moreover, recent studies have highlighted the mediating role of financial reporting aggressiveness (FRA) in the relationship between these factors and tax avoidance. Amidu et al. (2019) and Wier (2020) argue that FRA serves as a critical mediator, with aggressive financial reporting practices amplifying the effects of transfer pricing, thin capitalization, and leverage on tax avoidance. Gupta and Newberry (1997) and Bradley et al. (1984) demonstrated that companies engaging in aggressive financial reporting are more likely to exploit the flexibility of accounting rules to minimize their tax liabilities, further emphasizing the interconnectedness of financial reporting, corporate governance, and tax avoidance. The interaction between FRA and CSR disclosure, however, remains nuanced. While aggressive financial reporting can enhance the tax avoidance benefits of leverage and thin capitalization, its impact on CSR disclosure is less clear, with some firms choosing to downplay their tax avoidance practices in the interest of maintaining a strong CSR profile.

Referring to the theory and empirical findings, this study aims to fill the gap by offering a comprehensive analysis of how agency theory explains the use of transfer pricing, thin capitalization, leveraging, and CSR Disclosure in corporate tax avoidance practices. It also seeks to investigate the role of financial reporting aggressiveness as a mediating factor. By integrating agency theory, this study contributes to a deeper understanding of the motivations behind tax avoidance strategies and offers insights into how these practices can be managed through corporate governance and regulatory interventions. Next, the following are several hypotheses that will be developed and tested.

H1: *Transfer pricing has a direct positive effect on tax avoidance.*

H2: *Thin capitalization has a direct positive effect on tax avoidance.*

H3: *Leverage has a direct positive effect on tax avoidance.*

H4: *CSR disclosure has a direct positive effect on tax avoidance.*

H5: *Aggressive financial reporting mediates the relationship between transfer pricing and tax avoidance.*

H6: *Aggressive financial reporting mediates the relationship between thin capitalization and tax avoidance.*

H7: *Aggressive financial reporting mediates the relationship between leverage and tax avoidance*

H8: *Aggressive financial reporting mediates the relationship between CSR disclosure and tax avoidance.*

2. METHODS

2.1. Model approach

In the absence of existing or enlarged theories, this study analyzes exploratory correlations using the PLS-SEM model (Sholihin & Ratmono, 2013). The two tests that make up the PLS-SEM technique are the inner/structural model and the outer/measurement model (Hair et al., 2022). Using the outer/measurement model, transfer pricing, thin capitalization, leverage, and CSR disclosure are examined. When there is no indication of multicollinearity and the generated variable's indicator coefficient is large, it is considered important (Hair et al., 2022).

Table 1. Operational definition and measurement of variables

Variables	Equation symbols	Operational Definition	Measurement
Dependent Variable			
Tax avoidance	TAX	Company efforts to reduce or minimize the company's tax burden. The measurement of tax avoidance in this study is proxied using the effective tax rates (ETR) ratio	Income tax divided by income before tax
Independent Variables			
Transfer pricing	TP	The price calculated for the delivery of goods/services or other intangible assets from one company to another company that has a special relationship	Receivables transactions divided by total receivables
Thin capitalization	TC	Investment decisions by companies in funding their business operations prioritize debt funding rather than using equity capital in their capital structure, whether sourced from debt from related or non-related parties	Average debt divided by safe harbor debt amount (SHDA)
Leverage	LV	The ratio is used to measure the extent to which company assets are financed by debt	Total debt divided by total asset
CSR disclosure	CSR	The level of disclosure of corporate social responsibility towards society	Corporate Social Responsibility Disclosure Index
Mediation Variable			
Financial reporting aggressiveness	FRA	Activities to increase company profits through income regulation, whether or not in accordance with applicable accounting principles	Total accruals minus non-discretionary accruals

2.2. Data

The annual financial reports on the Indonesian Stock Exchange and the Indonesian Capital Market Directory for the years 2019–2023 provided the data for the study sample. Purposive sampling was utilized when collecting samples to ensure that the required number of samples was obtained. Using the data, samples were chosen according to a number of criteria, including 1) companies using currencies other than the rupiah; 2) companies that went public after 2014; 3) companies with insufficient data; 4) companies without associated receivables; 5) companies without foreign relations; and 6) companies with positive profits. Based on these standards, a total of twenty companies were chosen, and observations were made over a period of five years (2019–2023). Thus, 100 samples are used in the analysis.

3. RESULTS AND DISCUSSION

The descriptive statistics and model tests provide essential insights into the variables under study, including Transfer Pricing (TP), Thin Capitalization (TC), Leverage (LV), CSR Disclosure (CSR), Tax Avoidance (TAX), and Financial Reporting Aggressiveness (FRA). These results highlight both the variability in firms' financial behaviors and the robustness of the analytical model.

Table 2 presents a detailed summary of the descriptive statistics for the key variables. The Transfer Pricing (TP) variable exhibits a broad range, with values extending from 0.00 to 0.98, and a mean value of 0.33. This significant range, coupled with a standard deviation of 0.31, underscores the variation in transfer pricing practices across the sample, with some firms abstaining from transfer pricing and others employing it extensively, reflecting differing strategies for tax minimization.

Thin Capitalization (TC) shows even greater variability, ranging from –5.40 to 1.88, with a mean of 0.57. The negative minimum value suggests that some firms rely heavily on debt financing, leading to extremely thin capitalization. However, the standard deviation of 0.15 indicates that most firms maintain more moderate levels of thin capitalization, although a few outliers exert a notable influence on the overall distribution.

Leverage (LV) ranges from 0.10 to 0.82, with a mean of 0.40 and a standard deviation of 0.19, suggesting moderate leverage among firms. The variation in leverage levels reflects the differing financial strategies adopted by firms, with some opting for higher levels of debt in their capital structure, while others maintain more conservative debt ratios.

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CSR Disclosure (CSR) ranges from 0.02 to 0.51, with a mean of 0.19 and a standard deviation of 0.12. These values indicate that CSR disclosure is relatively low across the sample, with minimal variation. Most firms appear to provide limited transparency regarding their CSR activities, suggesting that corporate responsibility disclosure is not a high priority for many companies in this dataset.

The Tax Avoidance (TAX) variable exhibits a broad range, from -5.23 to 4.91, with a mean of -36 and a standard deviation of 1.29. This wide spread reveals substantial differences in tax avoidance behaviors, with some firms engaging in aggressive avoidance strategies, while others may overpay taxes or exhibit inefficiencies in tax management. The presence of both negative and positive extreme values reflects the diverse approaches to tax planning within the sample.

Financial Reporting Aggressiveness (FRA) spans from 0.07 to 0.84, with a mean of 0.27 and a standard deviation of 0.11. This suggests that while some firms employ aggressive financial reporting techniques, the majority tend to be more conservative. The moderate mean and relatively low standard deviation imply that most firms exhibit moderate levels of financial reporting aggressiveness.

The descriptive statistics highlight the diversity of corporate practices related to transfer pricing, thin capitalization, leverage, CSR disclosure, tax avoidance, and financial reporting aggressiveness. The extreme values observed in variables such as TC and TAX emphasize the presence of outliers, suggesting unique firm behaviors in these areas.

In addition to the descriptive statistics, the measurement model results confirm the reliability and validity of the constructs used in the analysis. Table 3 shows that all variables – Transfer Pricing, Thin Capitalization, Leverage, CSR Disclosure, Tax Avoidance, and Financial Reporting Aggressiveness – exhibit significant weights, with p-values below 0.001, indicating strong statistical significance. This reinforces the robustness of the measurement model, which meets the criteria for a formative measurement approach.

Furthermore, the Variance Inflation Factor (VIF) values for all variables are well below the thresh-

Table 2. Descriptive statistics

Variables	Min	Max	Mean	St. Deviation
TP	0.00	0.98	0.33	0.31
TC	–5.40	1.88	0.57	0.15
LV	0.10	0.82	0.40	0.19
CSR	0.02	0.51	0.19	0.12
TAX	–5.23	4.91	–36	1.29
FRA	0.07	0.84	0.27	0.11

Note: TP = Transfer pricing; *TC* = Thin Capitalization; *LV* = Leverage; *CSR* = CSR Disclosure; *TAX* = Tax Avoidance; *FRA* = Financial Reporting Aggressive.

Table 3. Measurement model results

Indicators	Parameter	Result	Rule of thumb	Interpretation
TP	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	1.123	VIF < 5	
TC	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	1.006	VIF < 5	
LV	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	1.818	VIF < 5	
CSR	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	1.810	VIF < 5	
TAX	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	1.884	VIF < 5	
FRA	Significant Weight	*p-values* < 0.001	*p-values* < 0.01 (level = 1%)	Accepted
	VIF	3.470	VIF < 5	

old of 5, indicating no issues with multicollinearity. Specifically, the VIF values range from 1.006 for Thin Capitalization to 3.470 for Financial Reporting Aggressiveness. These results indicate that the relationships among the variables are independent of multicollinearity, further supporting the integrity of the model. Fulfilling these criteria indicates that the measurement model is robust and reliable, with all specified variables meeting the necessary conditions for a formative measurement model without any issues of multicollinearity.

After confirming the adequacy of the measurement model, the structural (inner) model was tested using several criteria to evaluate model fit. Table 4 illustrates that the structural model meets all the required indices. The Average Path Coefficient (APC) was 0.193, with a p-value of 0.003, while the Average R-squared (ARS) was 0.627, with a p-value of 0.000. These results confirm that the model is a good fit for the data. Additionally, the Average Block VIF (AVIF) and Average Full Collinearity VIF (AFVIF) were 1.836 and 1.852, respectively, both of which are well below the acceptable threshold of 3.3, indicating no issues of collinearity within the model.

The model also demonstrated a strong Tenenhaus GoF (GoF) value of 0.792, which exceeds the minimum threshold of 0.25, indicating a large global fit. The R-squared Contribution Ratio (SPR) was 0.998, and the Statistical Suppression Ratio (SSR) was 1.000, both of which are well above the required thresholds of 0.90 and 0.70, respectively. Finally, the Nonlinear Bivariate Causality Direction Ratio (NLBCDR) was 0.889, further supporting the model's robustness.

In conclusion, the results indicate that the model fits the data well, with all variables demonstrating significant weights and no issues of multicollinearity. The model's fit indices suggest a strong predictive capability, making it a reliable tool for analyzing the relationships between transfer pricing, thin capitalization, leverage, CSR disclosure, tax avoidance, and financial reporting aggressiveness.

The findings of this study shed light on the dynamics of corporate Tax Avoidance and the roles played by Transfer Pricing, Thin Capitalization, Leverage, CSR Disclosure, and Financial Reporting Aggressiveness. These results align with both agency theory and positive accounting theory, confirming the strategic use of these mechanisms to influence tax avoidance, often reflecting managerial opportunism.

Figure 1 presents the results from the structural model assessment based on the PLS-SEM analysis. Once the necessary model fit criteria are confirmed, hypothesis testing is performed by examining the relationships between the variables, including their path coefficients and levels of significance. The results, as depicted in Figure 1, indicate that Transfer Pricing has a significant positive effect on Financial Reporting Aggressiveness ($\beta = 0.138$, $p = 0.04$), supporting the hypothesized relationship. Additionally, both Leverage ($\beta = 0.249$, $p < 0.01$) and CSR Disclosure ($\beta = 0.250$, $p < 0.01$) demonstrate significant positive effects on Financial Reporting Aggressiveness. These findings suggest that firms with higher leverage and greater CSR disclosure are more likely to engage in aggressive financial reporting practices. In contrast, Thin Capitalization does not show a significant positive relationship with Financial Reporting Aggressiveness ($\beta = 0.049$, $p = 0.26$), implying that thinly capitalized firms may not adopt aggressive financial reporting as a tax avoidance mechanism.

Table 4. Model fit indices

Criteria	Result	*p*-values	Rule of thumb
Average Path Coefficient (APC)	0.193	0.003	p < 0.05
Average R-squared (ARS)	0.627	0.000	p < 0.05
Average Block VIF (AVIF)	1.836	–	≤ 3.3
Average Full Collinearity VIF (AFVIF)	1.852	–	≤ 3.3
Tenenhaus GoF (GoF)	0.792	–	≥ 0.25
R-squared Contribution Ratio (SPR)	0.998	–	≥ 0.90
Statistical Suppression Ratio (SSR)	1.000	–	≥ 0.70
Nonlinear Bivariate Causality Direction Ratio (NLBCDR)	0.889	–	≥ 0.70

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Furthermore, Transfer Pricing, Leverage, and CSR Disclosure have a significant positive impact on Tax Avoidance, with each relationship showing strong significance ($p < 0.01$). The findings further indicate that Financial Reporting Aggressiveness acts as a mediator between Transfer Pricing and Tax Avoidance, Leverage and Tax Avoidance, and CSR Disclosure and Tax Avoidance. This suggests that aggressive financial reporting practices amplify the tax avoidance strategies associated with these independent variables.

Three key findings from the path coefficient test are highlighted in Table 5. First, Transfer Pricing shows a significant positive effect on Financial Reporting Aggressiveness at the 5% significance level ($\beta = 0.138$). This suggests that transfer pricing is a key driver of aggressive financial reporting practices, as managers may use these tactics to manipulate financial outcomes in ways that serve their personal objectives, even at the expense of shareholders' interests. This aligns with agency theory (Jensen & Meckling, 1976), which posits that managers, acting as agents, may engage in opportunistic behaviors that diverge from the goals of the principals (shareholders). The significant relationship between Financial Reporting Aggressiveness and Tax Avoidance, at a 1% significance level, further indicates that tax avoidance motivations underlie aggressive reporting behaviors, with managers adjusting financial statements to reduce tax liabilities, as Scott (2015) discussed.

Second, the study finds that Leverage and CSR Disclosure have a positive impact on Financial Reporting Aggressiveness. Specifically, firms with substantial CSR disclosures, coupled with high levels of debt used for asset financing, are more likely to engage in tax evasion through aggressive financial reporting. This supports the findings by Gupta and Newberry (1997), who demonstrated that businesses often exploit tax breaks when using debt for asset acquisition, encouraging aggressive financial reporting. In this scenario, CSR activities may enhance the firm's credibility with the public and investors, while aggressive financial practices are employed to minimize tax burdens. This dual behavior reflects the complexity of corporate strategies, where CSR disclosures serve to bolster a firm's reputation while simultaneously enabling tax avoidance (Davis et al., 2016; López-González et al., 2019).

Finally, the analysis shows no significant relationship between Thin Capitalization and Financial Reporting Aggressiveness, a finding that is consistent with the trade-off theory proposed by Modigliani and Miller (1963). This theory suggests

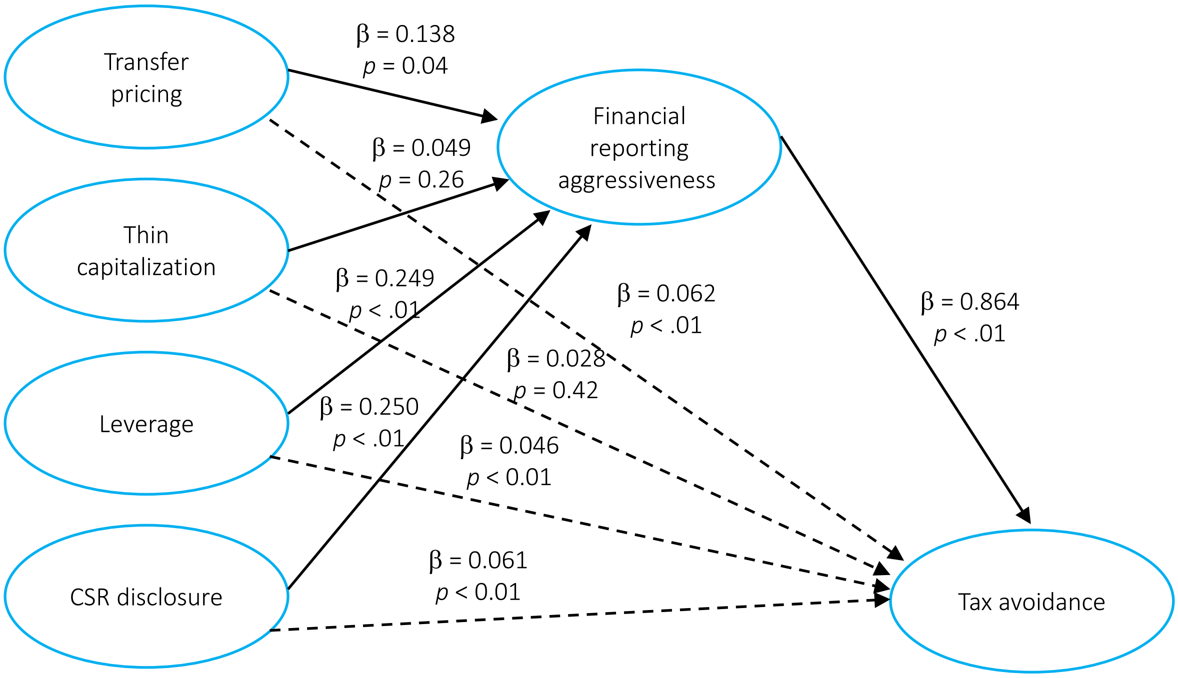

Figure 1. PLS-SEM analysis

Table 5. Path coefficients and *p*-values

Path	Expected Sign	Path coefficients	*p*-value
Transfer pricing → Financial reporting aggressive	(+)	0.138**	0.043
Thin capitalization → Financial reporting aggressive	(+)	0.049	0.267
Leverage → Financial reporting aggressive	(+)	0.249***	0.000
CSR disclosure → Financial reporting aggressive	(+)	0.250***	0.000
Financial reporting aggressive → Tax avoidance	(+)	0.864***	0.000

that as debt levels increase, firms become more cautious in their financial reporting practices to mitigate the risks associated with excessive leverage. Consequently, high debt levels prompt managers to be more prudent, using interest from thin capitalization primarily as a tax avoidance mechanism rather than aggressively manipulating financial reports.

Utilizing the methodology outlined by Hair et al. (2022), this analysis incorporates a mediating variable to assess the mediation effects. The mediation analysis results, as presented in Table 6, reveal five key findings. First, the test results strongly support *H1*, confirming that Transfer Pricing has a direct, positive, and significant effect on Tax Avoidance (coefficient = 0.062, $p = 0.002$). This finding aligns with previous research (Amidu et al., 2019; Barker & Brickman, 2017; Park, 2016; Sikka & Willmott, 2010), which demonstrates that businesses utilizing transfer pricing strategies to shift taxable income to low-tax jurisdictions are more likely to engage in tax avoidance. Higher levels of transfer pricing are thus associated with increased tax avoidance, as firms exploit these techniques to minimize their tax liabilities (Davies et al., 2018; Wier, 2020).

Second, the results reject *H2*, as there is no significant direct relationship between Thin Capitalization and Tax Avoidance (coefficient = 0.028, $p = 0.422$). This outcome is consistent with studies by Anindita et al. (2022) and Lee et al. (2020), which similarly found no substantial impact of thin capitalization on tax avoidance. The trade-off theory, as proposed by Modigliani and Miller (1963), explains that beyond a certain debt threshold, the benefits of debt financing, such as tax savings, become outweighed by the risks associated with higher leverage. Thus, high debt levels may prompt more cautious behavior in aggressive financial reporting, reducing the direct impact of thin capitalization on tax avoidance (Modigliani & Miller, 1963).

Third, *H3* and *H4* are supported, with evidence showing that both Leverage and CSR Disclosure have significant positive impacts on Tax Avoidance (coefficients of 0.046 and 0.061, respectively, both $p < 0.001$). These findings are consistent with prior studies on leverage by Bradley et al. (1984) and Dyreng et al. (2008) and on CSR disclosure by Gulzar et al. (2018). Interest-bearing debt allows firms to lower their tax liabilities, thereby facilitating tax avoidance. Simultaneously, CSR disclosure enhances a firm's credibility by aligning it with societal and investor expectations, which paradoxically can foster tax avoidance as it improves the firm's reputation while masking tax minimization practices (Freeman et al., 2001).

Fourth, the mediation analysis supports the acceptance of *H5*, *H7*, and *H8*. The relationships between Transfer Pricing, Leverage, and CSR Disclosure with Tax Avoidance are all partially mediated by Financial Reporting Aggressiveness, as evidenced by significant indirect effects (coefficients of 0.344, 0.374, and 0.588, respectively). This suggests that Financial Reporting Aggressiveness serves as a partial mediator, amplifying the effects of Transfer Pricing, Leverage, and CSR Disclosure on Tax Avoidance (Marchini et al., 2018). Firms with high levels of CSR disclosure, significant transfer pricing activities, and higher leverage are more likely to engage in aggressive financial reporting, which in turn drives their tax avoidance strategies.

Finally, *H6* is rejected, as the mediation analysis indicates that Thin Capitalization is not mediated by Financial Reporting Aggressiveness in its relationship with Tax Avoidance (indirect effect coefficient = 0.004, $p = 0.217$). This is consistent with the trade-off theory (Modigliani & Miller, 1963), which posits that managers weigh the tax benefits of high debt levels against the associated risks. When the risks of large debt outweigh the tax benefits, firms are less likely to engage in ag-

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Table 6. Mediation effect results

Structural paths	Coefficient	*p*-value	Interpretation
Direct Effect			
Transfer pricing → Tax avoidance	0.062	0.002	*H1* is supported
Thin capitalization → Tax avoidance	0.028	0.422	*H2* is not supported
Leverage → Tax avoidance	0.046	0.000	*H3* is supported
CSR disclosure → Tax avoidance	0.061	0.000	*H4* is supported
Indirect Effect			
Transfer pricing →Financial reporting aggressive → Tax avoidance	0.344	0.015	Partial mediation
Thin capitalization →Financial reporting aggressive → Tax avoidance	0.004	0.217	No meditation
Leverage →Financial reporting aggressive → Tax avoidance	0.374	0.000	Partial Mediation
CSR Disclosure →Financial reporting aggressive → Tax avoidance	0.588	0.000	Partial mediation

gressive financial reporting, which diminishes the mediating role of financial reporting in the thin capitalization-tax avoidance relationship.

The study's results, hence, illuminate the dynamic role of corporate strategies such as Transfer Pricing, Thin Capitalisation, Leverage, CSR Disclosure, and Financial Reporting Aggressiveness in influencing Tax Avoidance. The findings support agency theory and positive accounting theory, indicating that managers strategically leverage these mechanisms to minimise tax burdens, sometimes at the expense of shareholders' interests. Notably, the mediating effect of Financial Reporting Aggressiveness implies that firms employ aggressive reporting as a complementary strategy to bolster tax avoidance initiatives.

These insights highlight the complex interplay between corporate financial strategies and tax-related decisions, underscoring the need for regulatory scrutiny to mitigate opportunistic tax practices. Future research might further explore the specific conditions under which these strategies become prominent, potentially examining the moderating effects of regulatory frameworks or economic conditions.

CONCLUSION

This study explored the relationships between Transfer Pricing, Thin Capitalization, Leverage, and CSR Disclosure with Tax Avoidance while also assessing the mediating role of Financial Reporting Aggressiveness. Based on data from 20 firms listed on the Indonesian Stock Exchange from 2019 to 2023, analyzed through PLS-SEM, the results demonstrate that Transfer Pricing, Leverage, and CSR Disclosure significantly influence Tax Avoidance. Additionally, Financial Reporting Aggressiveness partially mediates these relationships, intensifying the impact of these independent variables on tax avoidance practices. Conversely, Thin Capitalization did not show a direct or mediated effect on tax avoidance, suggesting that the role of debt in corporate tax strategies may be more nuanced than expected.

The findings provide theoretical insights by supporting agency theory, particularly in demonstrating how managerial opportunism drives aggressive financial reporting and tax avoidance behavior. The partial mediation by Financial Reporting Aggressiveness suggests that tax avoidance is not only shaped by external corporate mechanisms such as leverage and CSR but also by internal financial reporting practices. This highlights the importance of managerial discretion in shaping corporate tax strategies, where managers may engage in opportunistic behavior to reduce tax burdens and enhance financial performance, sometimes at the expense of shareholders' long-term interests.

In terms of practical implications, the study reveals that CSR Disclosure can paradoxically be used as a tool for tax minimization, allowing firms to enhance their public image while engaging in aggressive tax avoidance. Policymakers and regulators should be aware of this dual function of CSR activities and consider implementing more stringent reporting requirements to mitigate such behavior. Moreover, Financial Reporting Aggressiveness should be closely monitored by tax authorities, particularly in firms with high levels of leverage and transfer pricing activities, as it serves as a key indicator of tax avoidance tendencies.

Despite its contributions, the study has limitations. The sample size is relatively small and limited to firms listed on the Indonesian Stock Exchange, which may restrict the generalizability of the findings to other contexts. Future research should expand the sample to include a more diverse range of industries and regions to enhance the robustness of the findings. Additionally, the reliance on secondary data may not fully capture the complexity of managerial decision-making. Future studies could incorporate qualitative methods, such as interviews or case studies, to gain deeper insights into the motivations behind tax avoidance and the role of financial reporting aggressiveness.

AUTHOR CONTRIBUTIONS

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