

Effect of Profitability, Leverage and CEO Narcissism on Tax Avoidance

Silpa Latipah Hariani* & Waluyo

Mercu Buana Univesity, Jl. Meruya Selatan No.1, RT.4/RW.1, Meruya Sel., Kec. Kembangan, Kota Jakarta Barat, Daerah Khusus Ibukota Jakarta 11650, Indonesia

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*Corresponding author: Silpa Latipah Hariani

Abstract

This study analyzes the influence of profitability, leverage and CEO narcissism on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017. This study uses secondary data, which is obtained from the company's annual report through the official website of the Indonesia Stock Exchange, www.idx.co.id and www.sahamok.com. The companies taken in this study were 41 out of 145 companies conducted by purposive sampling and the number of observations made during 2013-2017 so that the number of observations was 205 samples. Data were analyzed using analysis with SPSS 25. The study stated that profitability, leverage and CEO narcissism variables had a positive and significant effect on tax avoidance.

Keywords: Profitability, Leverage, CEO Narcissism, Tax Avoidance.

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INTRODUCTION

One of the country's main sources of income comes from the tax sector. Tax revenue in Indonesia is used for national financing activities. The role of tax in development financing is recognized to be quite large, more than 70% of the total state budget (kemenkeu.go.id/APBN2017). Therefore, the tax sector revenue must be increased optimally so that the pace of the country's economic growth and implementation of development can run well. However, the government's plan to optimize the revenue of the tax sector is not without constraints there are differences in interests with private and corporate taxpayers as far as possible to avoid paying taxes [1]. One obstacle in order to optimize tax revenue is the existence of tax avoidance [2].

Tax avoidance refers to the reduction of tax payments in a legal manner, for example through applicable tax regulations [3]. Related to tax avoidance, the phenomenon of tax avoidance that occurs in Indonesia can be seen from the Indonesian tax ratio in 2017, which is still low in tax revenue compared to other countries' tax ratios, this shows that the not yet optimal tax revenue can indicate the existence of tax avoidance activities by companies in Indonesia.

Another phenomenon related to tax avoidance is in the case of a company affiliated company in Singapore, namely PT Rajawali Nusantara Indonesia. In terms of capital, PT RNI depends on affiliate debt. That is, owners in Singapore provide loans to RNI in Indonesia. The owner does not make investments, but as if giving debt. In the 2014 PT RNI financial report, a debt of Rp. 20.4 billion was recorded. Meanwhile, the company's turnover is only Rp. 2.178 billion. Not to mention there are losses held in the same year's report valued at Rp. 26.12 billion. From the financial statements it can be seen that the company is trying to reduce profits by raising loans which later interest payments can reduce taxes [4].

Based on the tax avoidance phenomenon there are several factors that influence companies in paying taxes that are low seen from the factors of the company's financial condition towards tax avoidance, namely at the level of company profitability, leverage and CEO narcissism. Profitability is the basis for taxation. According to Rodriguez and Arias [5] profitability is a determinant of tax burden, which means that profitability has a positive effect on tax avoidance, it is proven that companies with greater

profits will pay greater taxes, while companies that have low profit levels will have an effect towards low tax revenues. This is because the higher the profitability of the company, the higher the tax payment and the level of profitability can be influenced by the efficiency of corporate tax payments. The more efficient the management of corporate taxes, the higher the level of profitability that the company is expected to be.

The next financial condition that is predicted to affect tax avoidance is leverage. Leverage is the level of debt that companies use in financing. Companies use leverage with the aim that the profits obtained are greater than the cost of assets and sources of funds thereby increasing shareholder profits. Companies can use the level of leverage to reduce profits and will affect the reduced tax burden [6]. In addition to profitability and leverage researchers will analyze CEO Narcissism against tax avoidance. Narcissism is a level of excessive self-confidence in which a person considers himself very important and has a need to be greatly admired. So that the nature of narcissism will be more likely to be involved in tax avoidance actions [7].

Chatterjee and Hambrick [8] emphasize that narcissistic CEOs tend to show off and prefer to take dramatic and bold strategic actions rather than pursuing additional improvements to the status quo. This shows that the higher the Narcissism CEO causes the higher tax avoidance by the company. This research is a modified research from Nugraha and Meiranto [9] that uses financial reports to explain the occurrence of tax avoidance. variables used by previous researchers, namely corporate social responsibility, company size, profitability, leverage and capital intensity as factors that influence tax aggressiveness in non-financial companies listed on the Indonesia Stock Exchange in the period 2012-2013.

The difference of this research to the previous research is the use of proxy tax avoidance where several studies use the Effective Tax Rate (ETR) proxy. But in this study using the Cash Effectiveness Tax Rate proxy refers to the calculations made by Chen *et al.*, [10] which aim to identify the aggressiveness of corporate tax planning.

LITERATURE REVIEW, FRAMEWORK AND HYPOTESIS

LITERATURE REVIEW

Agency Theory

Agency theory describes a contract in which one or more people (principals) use another person (agent) to work on behalf of the principal which includes delegating authority to the agent in decision making [11], so that managers have an important role in taking company decisions [12]. If both parties act to maximize their own interests, there is reason to believe that the agent will not always act in the interests of the

owner [11]. The difference in interests between the principle and the agent can affect various things related to the company's performance, one of which is the company's policy on corporate tax. The taxation system in Indonesia that uses the self assessment system gives the company the authority to calculate and report its own tax. The use of this system can provide an opportunity for agents to manipulate taxable income to be lower so that the tax burden borne by the company is getting smaller.

There are several ways to control the actions of agents related to tax management activities carried out, namely by evaluating the results of the company's financial statements using financial ratios compared to tax avoidance actions that the agent might do. The ratio used is profitability, leverage and CEO Narcissism compared to company CETR obtained from tax expense compared to pre-tax profit.

Freud's Personality Theory

Sigmund Freud [13] revealed narcissism or the phase of love for oneself or the phase of ego formation (the phase of attention to oneself), a narcissist who was amazed at himself, he often stood in front of the glass to pay attention to his beauty or skills. Companies led by narcissistic CEOs tend to use unethical accounting methods more often to improve company performance, manipulate taxes, and increase CEO compensation [14, 15, 7].

Tax Avoidance

Tax avoidance is an effort to minimize the tax burden legally which is often done by companies that are still within the framework of applicable tax regulations, where the methods and techniques used tend to take advantage of weaknesses contained in the tax laws and regulations themselves, to minimize the amount of tax payable [16].

According to Suandy [17] Tax avoidance is legal income manipulation that is still in accordance with tax regulations to minimize the amount of tax payable. Guire *et al.*, [18] revealed that tax avoidance strategies are carried out by companies with the aim of reducing the amount of tax payments that must be made and increasing the company's cash flow.

Profitability

Kabajeh *et al.*, [19] say that profitability ratios are indicators for the overall efficiency of the company. This is usually used as a measure for profits generated by a company over a period of time based on the level of sales, assets, capital used, net worth and earnings per share. The profitability ratio measures the company's income capacity and is considered an indicator for growth, success, and control. This ratio also shows the progress and rate of return on investment made by investors.

Leverage

Yulfaida [20] leverage is the amount of debt the company has for financing and can measure the amount of debt-financed assets. Leverage describes the source of operating funds used by the company and shows the risks faced by the company. Therefore, the greater the level of debt the company has, the greater the risk faced by the company.

CEO Narcissism

The American Psychiatric Association in Morf & Rhodewalt [21] defines narcissism as a personality pattern that has a feeling of pride in oneself, prioritizes self-interest, and desires more attention to itself. Narcissism lacks moral, exploitative sensitivity, is very aggressive in pursuing what is believed to be his, and thinks that he is above the law [22-25].

The personality of a narcissistic CEO tends to commit deviant behavior because his character expects positive responses from others [26]. Narcissism character is a character that can be associated with tax avoidance.

Framework

Effect of Profitability on Tax Avoidance

One of the main objectives to be achieved by the company is profit, which this advantage can be obtained by utilizing the resources owned by the company. High profits are of course a good thing for a company. However, high profits mean a high tax burden. Annuar *et al.*, [27] that the most obvious benefit of tax avoidance measures is the saving of cash from avoidable taxes. Cash savings lead to an increase in the company's cash flow where companies can invest using cash that can be saved, thereby increasing the value of the company.

Research results from Richardson *et al.*, [28] shows that there is a significant relationship between profitability and tax avoidance. Similarly, the Kraft [29] study, and Delgado *et al.*, [30], showed the same results. Whereas Zarai's research [31] found that the higher the company's profitability will have an impact on the higher effective tax rate, which means that the lower tax avoidance is done. In contrast to the research conducted by Cahyono *et al.*, [32] which shows that profitability does not affect tax avoidance. Based on previous research, the hypothesis in this study was formulated as follows.

Effect of Leverage on Tax Avoidance

Leverage is a measure of the percentage of total company assets obtained from creditors [33]. Mills [34] argues that leverage reflects the complexity of corporate financial transactions, so companies with high levels of leverage have more ability to avoid taxes through financial transactions. It is possible for

companies to use debt to meet their operational and investment needs. However, debt will cause a fixed rate of return called interest. The interest expense borne by the company can be used as a deduction from corporate taxable income to reduce the tax burden. This has implications for the increasing use of debt by companies.

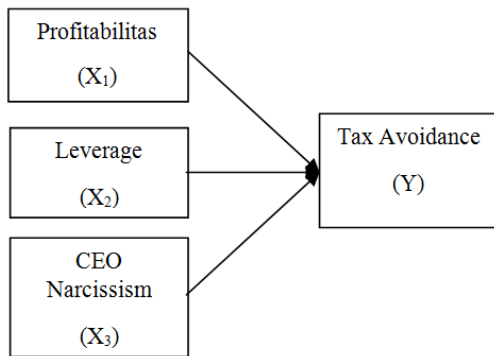
Liu and Cao [35] state that companies with more debt amounts will have a lower ETR. This is because interest costs can reduce the company's income before tax, and of course it will reduce the amount of tax to be paid. Waluyo [36] revealed that efficiency of taxes, profitability and growth of assets have an impact on leverage. This shows that companies tend to use taxes efficiently by maximizing costs, which can be reduced by income using debt.

Lanis and Richardson [28] also mention a negative relationship between leverage and ETR. But this situation can be used by companies to manipulate the amount of interest costs so that the profits obtained are smaller and the tax burden borne is also smaller.

Effect of CEO Narcissism on Tax Avoidance

A person with narcissism tends to commit deviant behavior because his character expects positive responses from others [26]. Individuals with narcissism have the view that their opinions are things that must be prioritized and considered [37]. The study also found that narcissism can lack moral, exploitative sensitivity, be very aggressive in pursuing what he believes to be his, and think that they are above the law [22-25]. O'Reilly, Doerr, Caldwell, and Chatman [38] document that narcissistic CEOs receive absolute and relatively larger payments compared to other executives in the company. Furthermore, narcissists are willing to manipulate people and situations to achieve personal gain [39]. When given the opportunity to take advantage of an aggressive strategy to avoid taxes, such as corporate tax avoidance, narcissists will most likely do so because of the exploitative nature that exists in them [7]. This shows that narcissistic CEOs have a positive influence on tax avoidance

Based on the previous description above, the model in this study can be illustrated in figure framework as follows:



Hypothesis

From the formulation of the problem posed in this study, statistical hypothesis remains to be verified as follows:

- H₁: Profitability has a positive effect on tax avoidance
- H₂: Leverage has a positive effect on tax avoidance
- H₃: CEO Narcissism has a positive effect on tax avoidance

Research Design

The researcher used the design of this study to analyze the effect of profitability, leverage and CEO narcissism on tax avoidance with the object of research of manufacturing companies registered with Burse Efek Indonesia.

Profitability is measured by an indicator of Net Profit Margin (NPM) [40], Alexandri [41], Bastian and Suhardjono [42]. Leverage is measured by the indicator Debt Asset Ratio (DAR) [43, 44]. CEO narcissism is measured by CEO photo size indicators in scale financial statements from (1) to (5), namely 1) Annual reports do not contain photos of CEOs. 2) CEO is photographed with other executives. 3) CEO is photographed alone and the photo occupies less than half a page. 4) CEO is photographed alone and the photo occupies at least half a page, and the photo shares the page with text. 5) CEOs are photographed alone and photos occupy the entire page [7, 45, 8]. While tax avoidance is measured by the Cash Effective Tax Rate (CETR) indicator [46-48].

This study uses secondary data collected from annual reports and annual financial reports of manufacturing companies in the Indonesia Stock Exchange in 2013 until 2017. Furthermore, this study uses a purposive sampling method with criteria, (1)

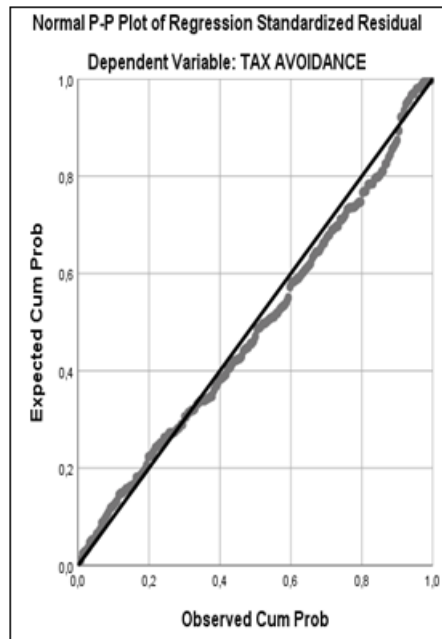
Registered manufacturing companies on the IDX for 5 consecutive years in the period 2013 to 2017, (2) manufacturing companies that publish CEO cash compensation during the 2013-2017 research period, (3) annual reports of manufacturing companies using Indonesian in their financial reporting and in rupiah currency monetary unit reporting, (4) manufacturing companies listed on the IDX with pre-tax income that is always positive or not experiencing a loss. From these criteria, there were 41 samples (205 observations).

RESULTS

Profitability affects tax avoidance. This is because the rise and fall of profits reflects the tendency towards tax avoidance practices. The greater the profit, the profitability of the company also increases, but this actually results in the amount of tax that must be paid by the company is also high. Thus, a company with a high level of profitability is likely to increase the risk of tax avoidance so that the value of CETR is lower. The results of this study are consistent with the research conducted by Kraft [29] and Delgado *et al.*, [30] but not in accordance with the research conducted by Zarai [31] and Cahyono *et al.*, [32].

Leverage affects tax avoidance. This is because that when the debt is high, the company will pay a fixed expense in the form of interest so that the CETR will decrease causing an indication of tax avoidance to increase. The results of this study are consistent with the study of Noor [49], Richardson and Lanis [28], Carolina *et al.*, [50], Waluyo [36] and Chen *et al.*, [10] not in accordance with the research of Christine Harrington and Walter Smith [43], Pradipta and Supriyad [51] and Prakosa [52].

CEO narcissism has an effect on tax avoidance. This is because the size of CEO photos in the company's annual financial statements in the index relating to superior feeling, elegance, and narcissistic exploitation can make CEO narcissism feel deserving of special treatment, an exception to the rules, or above the law, when given the opportunity to taking advantage of aggressive strategies for avoiding taxes, such as corporate tax avoidance, narcissism is likely to do so given the exploitative nature of it. The results of this study are consistent with the research conducted by Kari Joseph Olsen Stekelberg [7], Rijsenbilt and Commandeur [53], but not in accordance with the research conducted by



Picture Normal Probability Plot

Table Multikolinieritas

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	NPM	,984	1,016
	DAR	,986	1,015
	UFC	,985	1,015

a. Dependent Variable: Tax Avoidance

Table Multiple Regression

Model		Unstandardized Coefficients		Standardized Coefficients
		B	Std. Error	Beta
1	(Constant)	,111	,017	
	NPM	,006	,001	,449
	DAR	,199	,021	,502
	UFC	,009	,003	,142

a. Dependent Variable: Tax Avoidance

Table Koefisien Determinasi (R²)

Model	R	Adjusted R Square
1	.658 ^a	,425

a. Predictors: (Constant), NPM, DAR, UFC

Table Signifikansi Simultan (Table F)

ANOVA ^a			
Model		F	Sig.
1	Regression	51,174	,000 ^b
	Residual		
	Total		

a. Dependent Variable: Tax Avoidance
b. Predictors: (Constant), NPM, DAR, UFC

Table Hipotesis Parsial (Uji T)

Coefficients ^a			
Model		T	Sig.
1	(Constant)	6,696	,000
	NPM	8,396	,000
	DAR	9,385	,000
	UFC	2,660	,008

a. Dependent Variable: Kepatuhan Wajib Pajak

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSION

Based on the formulation of the problem, testing the hypothesis and the discussion presented in the previous chapter, conclusions can be drawn as follows:

- Profitability affects tax avoidance. This is because profitability is a determinant of tax burden, which is evidenced that companies with greater profits will pay greater taxes, while companies that have a low profit rate, will affect the low tax revenue. With a tax compensation system can reduce the amount of tax that must be borne the following year.
- Leverage affects tax avoidance. This is because the use of long-term debt can cause the company to pay a fixed fee in the form of interest on debt payments, the use of funds that cause this fixed burden can reduce taxable income. So that companies can take advantage of the use of debt to reduce taxable income. The manufacturing companies sampled have relatively large long-term debt.
- CEO narcissism has an effect on tax avoidance. This is because the size of CEO photos in the company's annual financial statements in the index relating to superior feeling, elegance, and narcissistic exploitation can make CEO narcissism feel deserving of special treatment, an exception to the rules, or above the law, when given the opportunity to taking advantage of aggressive strategies for avoiding taxes, such as corporate tax avoidance, narcissism is likely to do so given the exploitative nature of it.

RECOMMENDATION

Based on the results of data analysis, conclusions and limitations in this study, there are several suggestions that are proposed below:

- For regulators, pay attention to companies that have high sales and profits, but pay low taxes, so a tax audit must be conducted to overcome tax avoidance in the company. And pay attention to companies that have a high amount of debt while assets owned are small because they can increase the interest burden and reduce the payment of tax payable so that it is suspected that tax avoidance in companies and business enterprises has leaders who are characterized by excessive narcissism with characteristics of feeling proud of themselves itself, prioritizing self-interest, the desire for more

attention and addiction is photographed because it can cause tax avoidance.

- For companies that might be material to increase knowledge about tax avoidance so that management can do good tax planning so that there is no illegal tax planning that can harm the state and make the company's name and reputation worse in the eyes of the public.
- Academics and practitioners are expected to develop the concept of CEO narcissism and also to develop measurements of the implementation of CEO narcissism in the company.
- Adding other variables that are thought to affect company tax avoidance, such as business strategy, inventory intensity, and company transparency. Further research is recommended to use more companies that are used as research samples.

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