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The Impact of CEO Narcissism on Tax Avoidance with an Emphasis on Internal Control Systems[1]

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Research Paper

INTRODUCTION

Taxes are defined as a portion of the income or wealth of individuals or entities that are paid to the government to pay for part of the general expenses and to preserve the social, economic, and political interests of the country Moradi et al., (1392). Companies are trying to reduce their income tax or defer it, and in this regard, they use various tools such as tax avoidance, tax evasion, and earnings management depending on the company's situation to reduce the amount of tax payable Hanlom & Heitzman (2010).

In a study by Feng Lin et al., (2020), the impact of CEO narcissism on earnings management behavior was investigated. The results of their research show that CEO narcissism has a positive and significant impact on real earnings management behaviors and that CEO narcissists directly influence financial decisions and have a supervisory impact on the real earnings management behaviors of managers. Kim et al. (2018) investigated the moderating role of CEO narcissism on the relationship between tax avoidance and avoidance of uncertainty. They used four indicators to measure CEO narcissism, namely: the prominence of the CEO's photo in annual reports, the CEO's reputation in the community, the CEO's cash compensation divided by the cash compensation of the second senior executive of the company, the CEO's non-cash compensation divided by the non-cash compensation of the second senior executive of the company. The findings show that companies that operate in societies with high tax avoidance are less involved in social responsibility and CEO

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narcissism moderates this relationship positively. Ham et al, (2018), studied the relationship between CEO narcissism and investment policies, and company performance was investigated using the CEO's signature size in the Tehran Stock Exchange archives, which is used to measure narcissism in individuals. The findings show that CEO narcissism is positively correlated with over-investment, especially in research and development expenses and mergers and acquisitions. This relationship was not found for capital expenditures. Also, companies led by narcissistic CEOs experienced lower financial productivity in the form of profitability and operating cash flows. Francis et al, (2018) examined the relationship between management ability and tax avoidance in their study. The findings of their research show that there is a negative and significant relationship between management ability and tax avoidance. Their research showed that CEOs with higher ability are less likely to engage in tax avoidance activities.

This article examines the effect of CEO narcissism on tax avoidance, emphasizing the role of internal control mechanisms. Based on the theoretical background, the following hypotheses are proposed in this study:

- Hypothesis 1: CEO narcissism positively influences tax avoidance.
- Hypothesis 2: The presence of an audit committee moderates the impact of CEO narcissism on tax avoidance.
- Hypothesis 3: The quality of internal controls moderates the impact of CEO narcissism on tax avoidance.

MATERIALS AND METHODS

This study is applied in terms of purpose and descriptive-correlational in terms of nature. The statistical population encompasses 125 companies (including 16 industries) listed on the Tehran Stock Exchange investigated between 2010 and 2020. Data for the study was collected from company financial statements and other information sources located on the website of the Securities and Exchange. Organization and the Rahvar Nowin software, as well as the explanatory notes of the financial statements and the reports of the board of directors. The software Eviews and Panel data with fixed effects were used to test the hypotheses and regression.

To determine the sample size the following criteria were included in systematic exclusion: First, for comparability, the financial year ending at the Esfand29 was considered. Second, the companies in question must not have been financial (banks and financial institutions) and financial intermediaries. Third, its financial information must have been available. Fourth, the financial year didn’t change during the period of research.

To test the hypothesis, the multi-variable regression analysis was used:

H1) $ETR_{i,t} = \beta_0 + \beta_1 CEO\text{-}narcisssm_{i,t} + \beta_2 LEV_{i,t} + \beta_3\, ROA + + \beta_4 BSIZE_{i,t} + \beta_5 FSIZE_{i,t} + \varepsilon_{i,t}$ (1-3)

H2) $ETR_{i,t} = \beta_0 + \beta_1 CEO\text{-}narcisssm_{i,t} + \beta_2 ACSIZE_{i,t} + \beta_3\, CEO\text{-}narcisssm{*}\, ACSIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5\, ROA + \beta_6 BSIZE_{i,t} + \beta_7 FSIZE_{i,t} + \varepsilon_{i,t}$ (2-3)

H3) $ETR_{i,t} = \beta_0 + \beta_1 CEO\text{-}narcisssm_{i,t} + \beta_2 IC_{i,t} + \beta_3\, CEO\text{-}narcisssm{*}\, IC_{i,t} + \beta_4 LEV_{i,t} + \beta_4\, ROA + \beta_5 OWNCON_{i,t} + \beta_6 BSIZE_{i,t} + \beta_7 FSIZE_{i,t} + \varepsilon_{i,t}$ (3-3)

RESULTS AND DISCUSSION

The results of Hypothesis 1 testing demonstrate a positive and significant association between CEO narcissism and tax avoidance. In other words, narcissistic CEOs are more likely to adopt aggressive tax strategies to reduce their tax burden.

The results of Hypothesis 2 testing reveal that the presence of an audit committee weakens the positive influence of CEO narcissism on tax avoidance. In other words, an audit committee can deter narcissistic CEOs from engaging in tax avoidance.

The results of Hypothesis 3 testing show that the quality of internal controls weakens the positive influence of CEO narcissism on tax avoidance. In other words, internal controls, by reducing information asymmetry and improving decision-making processes, prevent narcissistic CEOs from evading taxes.

CONCLUSION

This study provides evidence that CEO narcissism can lead to increased tax avoidance activities. However, the findings also suggest that strong internal control mechanisms, particularly a robust board of directors and an independent audit committee, can play a role in mitigating this effect.

The findings of this study have several implications for corporate governance and regulatory practices. Investors should be aware of the potential risk of tax avoidance associated with narcissistic CEOs and consider this factor when making investment decisions. Boards of directors should also be aware of this risk and take steps to implement strong internal control mechanisms to mitigate it. Additionally, regulators may want to consider policies that increase transparency and accountability for CEO compensation and tax planning practices.

In light of this research's findings, it is recommended that regulatory bodies, such as the Securities and Exchange Organization, implement relevant guidelines and monitor company performance to prevent tax

avoidance by narcissistic CEOs. Furthermore, companies can strengthen their audit committees and improve internal control systems to deter tax avoidance by CEOs.

Keywords: CEO's narcissism, Tax avoidance, Internal Control Quality, Audit Committee.

JEL Classification: M41, M48.