# The Effect of Corporate Financial Performance and Tax Administration System toward Optimal Tax Reporting and Taxpayers Compliance: A Study on Taxpayers Listed in DJP D.I Yogyakarta 2010-2013

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## ABSTRACT

*Corporate taxpayers contribute substantially to the total tax revenue in Indonesia, yet the level of taxpayer compliance is low. The purpose of this study is to empirically test the Theory of Stakeholders (Freeman, 1984), Theory of Cognitive Behavioral Prescriptive (Ajzen and Fishbein, 1981), Theory of Ability to Pay (Wagner, 1883), Theory of Willingness to Pay (Kahneman, Knetsch, and Thaler, 1990) and Theory of Justice (Adams, 1963) in explaining the optimal tax reporting and corporate taxpayer compliance in DJP DI Yogyakarta. This study uses secondary data available in DJP D.I Yogyakarta. Research is done using panel data that includes 104 corporate taxpayers in 2010-2013. Data is analyzed using structural equation model analysis that is Structural Equation Modeling (SEM) and GSCA (Generated Structured Component Analysis). The results of this study show that taxpayer compliance is influenced by the willingness of taxpayers to pay taxes (in line with the theory of Willingness to Pay) but is not influenced by the ability of the taxpayer (Theory of Ability to Pay) on the characteristics of taxpayers mostly SMEs such as those in DJP D.I Yogyakarta. The tax administration system through the examination and appeals has an important role to increase the awareness, knowledge, and understanding of taxpayers against the regulations in force in taxation. This study also proves empirically the Theory of Stakeholder in explaining the optimal tax reporting, in which financial performance significantly influences optimal tax reporting. However, optimal tax reporting cannot be a mediating variable on the influence of financial performance and tax administration system on taxpayer compliance. This can be caused by the limited capacity of tax administrators in examinations and appeals compared to the number of taxpayers served. These results imply the importance of developing Benchmarking Performance method to improve the audit program (inspection) as well as more effective and efficient appeals that suit the characteristics of corporate taxpayers in developing countries characterized by the high proportion of medium and small scale taxpayers and high information asymmetry.*

***Keywords:*** *corporatefinancial performance of the company, administration system, optimal tax reporting, taxpayer compliance*

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## 1. INTRODUCTION

Taxes are one source of state revenue. The size of the tax will determine the performance of the state budget to finance state expenditures, both for construction financing and for routine financing. In Indonesia, the tax revenue benefits 74.86% of total domestic revenue in 2012 (APBN, 2014). The corporate income tax in Indonesia (in 2010) accounted for 45% of total tax revenue in Indonesia (Arnold, 2012 p.7), yet compliance of corporate taxpayer is lower than the individual taxpayer compliance (Figure 1).

**Figure 1. The Ratio of Compliance on Annual Tax Return Report on Income Tax in 2012 (Source: Ditjen Pajak, 2013)**
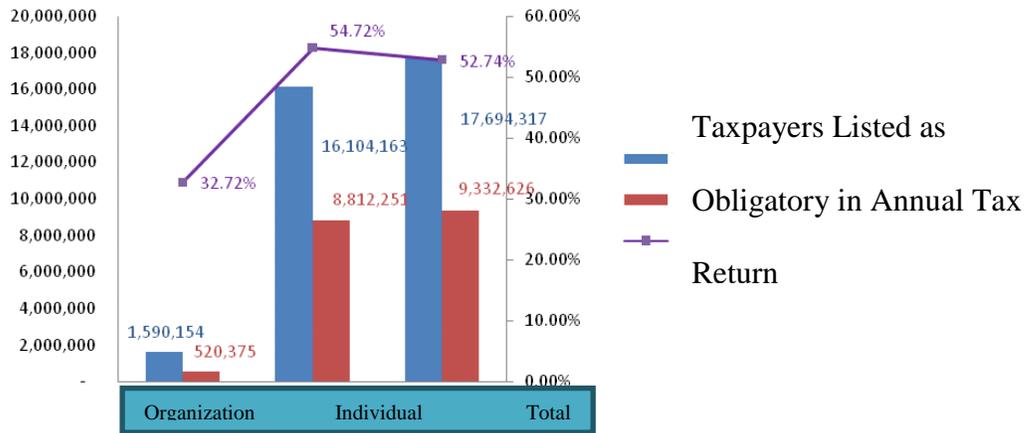


In the regional level, the number of taxpayers listed at Yogyakarta Regional Office of Directorate General of Taxes (*Direktorat Jenderal Pajak* for Special Region of Yogyakarta or DJP DI Yogyakarta) increased in 2012-2014. The number of taxpayers listed increased from 23,105 (in 2012) to 28,926 (2014) or an increase of 25.19%, but the compliance rate decreased in 2014 (56.35%) than in 2012 (61.00%).

**Table 1. The Increase in the Number of Listed Taxpayers and Compliance of Organizational Taxpayers and Non-Employee OP DJP D.I Yogyakarta Year 2012-2014**

|  | 2012 | 2013 | 2014 |
|---|---|---|---|
| Listed Organizational Taxpayers | 23,105 | 25,601 | 28,926 |
| Listed Organizational Taxpayers of Obligatory Annual Tax Return Report | 15,581 | 19,114 | 19,114 |
| Realization on Annual Tax Return Report on Income Tax of Listed Organizational Taxpayers | 9,505 | 10,562 | 10,770 |
| Ratio of Compliance by Listed Organizational Taxpayers of Obligatory Annual Tax Return Report | 61.00% | 55.26% | 56.35% |

Source: Kanwil DJP DI Yogyakarta

Taxpayer compliance behavior is a very complex phenomenon that is viewed from many perspectives. Several theoretical models to explain the taxpayer compliance among others include Theory of Stakeholder (Freeman, 1984 p. 1-292), Theory of Cognitive Behaviour Prescriptive (Ajzen and Fishbein, 1981 p. 179-211), Theory of Ability to Pay (Wagner, 1883 p .1-59), Theory of Willingness to Pay (Kahneman, Knetsch and Thaler, 1990 p. 262-292), and Theory of Justice (Adams, 1963 p. 36-422).

Theoretical model is widely available in explaining non-compliance, but a variety of models cannot be directly used to predict the behavior of non-compliance by the Tax Administrator (in this case is the Tax Directorate in Indonesia). First, these theories were originally developed in advanced countries. Characteristics of taxpayers and tax administration system in developed countries will be much different

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from the ones in developing countries. Empirical studies that test these theories are also mostly done in developed countries with large-scale enterprises listed in the capital market as taxpayers, and are very limited in developing countries. So far there has been no theoretical and empirical literature that explains the theory which of the five theories that correspond to the characteristics of taxpayers and tax administration system characteristics in developing countries. Taxpayers in developing countries are characterized by the high proportion of small and medium enterprises, the low culture of financial reporting, the low compliance in the tax reporting materials, and the high asymmetry of information between tax payers and tax administrators.

Second, the characteristics of tax administration system in developing countries is characterized by the limited capacity of the tax administration staff compared to the number of taxpayers served. One of the main challenges in tax administration is the identification of taxpayers for efficient audit programs (minimal cost) and effective role in the prevention effort, as well as to be fair and reasonable, especially for the examination of enormous target population of taxpayers (Syed and Kalirajan, 2000 p.208). Benchmarking performance in taxpayer compliance models have some potential benefit in tax reporting compliance measurements (optimal tax reporting). That is because benchmarking of performance provides a complete picture about the activities or operation of companies in a tax year that is needed by tax authorities to make accurate diagnosis determining what elements of the calculation of corporate income indicating impropriety—of how much input is absorbed in production to produce output. Benchmarking research performance in the model of taxpayer compliance so far is limited. One benchmarking performance model is the model developed by Syed and Kalirajan (2000). However, compliance cannot only be predictable through financial factors, so the need to include non-financial factors (economic-behavioral approaches) in the model is crucial.

Third, the empirical testing on the five theories is done partially rather than simultaneously. Simultaneous testing is required to compare between theories appropriate in explaining the taxpayer compliance in context of research. Fischer et al. (1992) develop the five simultaneous testing. The model by Fischer *et al.* (1992) predicts taxpayer compliance involving aspects of financial performance (economy), and behavioral (psychosocial). The model by Fischer *et al.* (1992) is widely developed in developing countries in predicting the various types of taxes, such as income of individuals (Chau and Leung, 2012), property taxes (Umar *et al.,* 2012); however, taxpayer compliance is more focused on the taxpayer personally while corporate taxpayer compliance analysis has not been widely discussed. Taxpayers (company) have different characteristics than individual taxpayers. On the other hand, corporate income tax accounted for 45% of total tax revenue in Indonesia, yet with lower level of compliance than personal taxpayers (Figure 1), so that it becomes the background of this study.

Development on the model by Fischer *et al.* (1992) for organizational taxpayers (companies) is still limited (some of which is done by Sapiei *et al.,* 2014). However, research by Sapiei *et al.* (2014), Chau and Leung (2012), Omar *et al.* (2012) used managerial preference of company as a proxy to measure the behavior of corporate compliance. Managerial preference to taxpayer compliance will vary and depend on the honesty of the manager in providing information about their company. The use of financial data to measure compliance and behavior in service has several benefits to improve the weaknesses of existing approaches.

Fourth, previous studies generally examine the effect of income, expenses, inspection, and penalties against tax reporting and taxpayer compliance, but the influence of financial performance (constructed from the performance of revenues and expenses) and tax administration system (constructed of inspection and fines) against tax reporting and taxpayer compliance is not yet available in the literature. Focus on testing the influence of income, expenses, inspection, and penalties against tax reporting and taxpayer compliance provides limitations in the test of the five theories in the model simultaneously.

The government should identify the various approaches in an effort to promote compliance (Alm *et al.*, 1992). Taxpayer compliance causes increases in income, and lowering the chance of audit and tax rates (Alm *et al.,* 1992). The above description provides the motivation to meet the gap in the literature of taxpayer compliance in the reporting and payment of tax by economic-behavioral approach. This study modifies previous research: 1) the research is done on the taxpayers in accordance with the characteristics of the taxpayers in Indonesia in general; 2) the study measures the tax reporting optimally through benchmarking performance by involving non-financial variables; 3) simultaneous testing is done to compare between theories in explaining taxpayer compliance in accordance with the context of research; and 4) this study

combines the performance of revenue and cost performance as a predictor variable and combining corporate financial performance and the examination of the appeal as a predictor variables for tax administration system.

## 2. CONCEPTUAL FRAMEWORK AND RESEARCH HYPOTHESES

*2.1 The Effect of Financial Performance on Optimal Tax Reporting*

Theory of Stakeholder (Freeman, 1984) explains that the company is composed of many stakeholders (investors, creditors, employees, managers, and tax administrators). Based on Theory of Stakeholder, the manager will manage the stakeholders' interests in short-term and long-term. Stakeholders have the right to get information of the company, while the company has a responsibility to provide reliable information. The role of company's public report is to provide the public with information on r the extent to which the company has fulfilled the responsibilities imposed by society (Deegan and Unerman, 2011 p.351). Several studies supporting the Theory of Stakeholder (Lanis and Richardson, 2011; Hoi *et al.*, 2013; Hanlon and Slemrod, 2009; Muller and Kolk, 2012) confirm empirically that high performance gives opportunity for the company to report optimal profits to improve the confidence of investors and creditors. Based on Theory of Stakeholder, then optimal tax reporting is in accordance with the company's financial performance.

Positive perspective on Theory of Stakeholder (managerial) (Jensen, 2002) argues that managers tend to report profitsin over-value or under-value (under-reporting). When the company is in a profit position, company managers tend to report high profits to increase the confidence of investors and creditors even over-value, but in relation to tax, it may be different. Managers often report profits below (under reporting) for the benefit of the tax savings. This study is conducted at SMEs that generally have low knowledge and understanding of the financial management of company, so the hypothesis in this study can be formulated as follows.

H1. Corporate financial performance has significant effect on optimal tax reporting

*2.2 The Effect of Tax Administration System to the Optimal tax Reporting*

Kirchler (2007) develops a model of Cognitive Behavioral Perspective Theory (Ajzen, 1991) on taxpayer compliance behavior. Based on the theory, Kirchler (2007) explains that external factors (in this case the tax administration system) provides pressure to fine, examination, and appeals that would affect cognitive processes (organism) before it affects the behavior (in this study is the behavior of taxpayer compliance). Justice is achieved if the rules are enforced through social sanctions, determining what people should and should not do in a particular social environment or in certain circumstances. Based on the description of the theory then theoretically tax administration system can significantly influence the optimal tax reporting.

Results of research on the effect of the tax administration of the justice system is the optimal tax reporting with Cognitive Behavioral Prescriptive approach as done by Alm and McKee (2006); Vossler *et al.* (2012), Anyaduba *et al.* (2012), and Modugu *et al.* (2012) confirm that results have not been consistent. Several studies (Alm and McKee, 2006; Alm *et al.*, 2006) confirm that examination and penalties on the previous year has effect on taxpayer compliance. Taxpayers who have been examined and got a fine for tax savings behavior tend to have an increased compliance in the following year. However, several other studies as performed by Modugu *et al.* (2012) state that fines are not related to compliance with tax reporting. Socialization (and calls) increases the awareness, knowledge, and understanding of taxpayers to comply, so it will encourage taxpayers to tax reporting (Anyaduba *et al.*, 2012)

In general, some studies have found effects of the tax administration system to optimal tax reporting, so that the hypothesis can be formulated as follows.

H2. Tax administration system has significant effect on optimal tax reporting

*2.3 The Effect of Financial Performance on Taxpayer Compliance*

Theory of Ability to Pay (ATP) was developed by Wagner (1883) which describes the behavior of a person or organization under the economic rationality approach. The behavior of a person or organization to pay for the public goods or services is affected by the ability (income, expenditure and wealth or assets). Wagner (1981) argues that tax collection is a fair taxation applied generally to all of the taxpayers and is charged to every taxpayer who has the ability to pay equally, and that the structure of the tax rate applicable to any taxpayer who has the ability to pay.

ATP is the classical economic theory that explains the effect of the ability to compliance, but a factor of income, expenses, and assets is widely adopted by the research-based behaviors to explain the taxpayer compliance (Fischer *et al.*, 1992; Chau and Leung, 2009; Umar *et al.*, 2012; Kirchler and Muehlbacher, 2012; Sapiei *et al.*, 2014). The studies generally find that income increases the ability and opportunity to compliance. Based on these descriptions, the following hypotheses can be formulated.

H3. Company financial performance has significant effect on taxpayer compliance

*2.4 The Effect of Tax Administration System on Taxpayer Compliance*

Theory of Willingness to Pay (WTP) was developed by Israeli economists; they are Kahneman, Knetsch and Thaler. Kahneman, Knetsch and Thaler are one of the initiators of Theory of Behavioral Finance which explains that the financial behavior involves not only the financial aspects (economic rationality), but also psychological and social aspects. Among the well-known theory is the Prospect Theory and Endowment Theory Effect as the theoretical foundations of Willingness to Accept (WTA) and the theory of Willingness To Pay (WTP) (Kahneman, Knetsch and Thaler, 1990).

Based on the theory of WTP, willingness to pay tax is affected by two main factors, namely coercion (enforcement of tax laws, tax rates, financial penalties, and examination) and awareness (for services, dissemination, and advocacy). Taxpayers would be obedient in tax payment if the benefits of tax savings is greater than the risk of fines, penalties, and examination (Becker, 1968; Allingham and Sandmo, 1972). The tax system (sanctions or fines, examination and the complexity of the tax system) will improve the attitude and perception of the fairness of taxes and taxpayer pressure to compliance. Taxpayers will be subject to payment of tax if the tax saving benefit is greater than the risk of sanctions or fines to be paid. Instead, taxpayers will not comply with the payment of taxes if the risk of sanctions or fines are smaller than the benefits derived from the non-compliance to avoid or delay payment. Some researchbased on Willingness to Pay as performed by Horowitz and Mcconnell (2003), Zhang *et al.* (2012), Ortega *et al.* (2013) Anyaduba *et al.* (2012) generally confirm that the implementation of tax administration by tax system administration increases the willingness of taxpayers to pay taxes. Based on the description above, the hypothesis is as follows.

H4. The tax administration system has significant effect ontaxpayer compliance.

*2.5 The Effect of Optimal Tax Reportingon Taxpayer Compliance*

Theory of Fairness of Tax System was developed from the theory of Justice (Adams, 1963) which explains that the justice received by a person or organization (distributive justice, procedural justice, and fairness retributive) will be supporting behavior for compliance. Adam (1963) states that people have thoughts, feelings, and views that affect their work. This theory was created specifically to predict the influence of rewards on human behavior. Adam suggests that individuals will make certain comparisons that affect their thoughts and feelings about the rewards, as well as produce a change in motivation and behavior. Injustice for excessive reward occurs when a person perceives himself rewarded more than the input to others. In such situations, guilt arises and individual will try to improve the ratio. Hechter and Opp (2005 p.3) describe justice is achieved if the rules are enforced through social sanctions, determining what people should and should not do in a particular social environment or in certain circumstances (Hechter and Opp 2005 p.5).

In connection with taxes, condition in which taxpayers feel that the tax benefits are not in accordance with the tax paid or tax paid is higher than the amount paid by other taxpayers within the same profits will encourage behavior of non-compliance. Theory of Fairness of Tax System has been proven by several studies (Spicer and Becker 1980; Alm, McClelland, and Schulz, 1992; Saad, 2010), finding that optimal tax reporting as a measure of fairness of the tax system has a significant effect on taxpayer compliance; yet, several other empirical studies (as done by Saad, 2012) has not found consistent results. Based on the description above, the hypothesis is formulated as follows.

H5. Optimal tax reporting has significant effect on taxpayer compliance

### 3.    RESEARCH METHOD

The study was conducted using secondary data from DJP D.I Yogyakarta. The population of this study is all taxpayers in the DJP D.I Yogyakarta in 2010-2013 who reported their Annual Tax Return Report and were included in BBM (Benchmarking Behavioral Model) corresponding to the Circular of the Directorate General of Taxationation-SE-40/PJ/2012 as many as 1,586 taxpayers. Samples were chosen using purposive sampling (Table 2). Total final sample in this study was 416 samples consisting of 104 Taxpayers for 4 years.

**Table 2. Criteria and Sampling Stages**

| No. | Criteria | Number of Samples |
|---|---|---|
| 1. | Taxpayers in BBM and report their Annual Tax Return in 2010-2013 | |
| | a.   Taxpayers in BBM non-bank or financial sector | 1,586 |
| | b.   Report Annual Tax Return | 1,163 |
| 2. | Taxpayers in KLU rank 4 with highest payable Tax Income and the most available X2 data | |
| 3. | Payable Tax Income available and circulation of business | 546 |
| 4. | Data of taxpayers available at least in the last 4 years | 446 |
| 3. | Normal data availability, profit is not negative | 104 |

Source: Data processed

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**Table 3. Variable and Measurement**

| Variable | Code | Size |
|---|---|---|
| **1. Independent Variable** | | |
| **a. Financial Performance (X1)** | | |
| 1) Circulation of Business | X1.1 | total sales revenue (turnover) WPI in year t in units of Rupiah |
| 2) HPP | X1.2 | COGS (Cost of Goods Sold) are all of the costs incurred to acquire goods sold at WPI in year t in units of Rupiah. COGS is calculated with the following formula: COGS isinitial merchandise inventories + net purchases - ending inventory. |
| 3) Business cost | X1.3 | business costs are costs incurred to implement the company's principal operations of WPI in year t in units of Rupiah. |
| 4) Salary | X1.4 | salary costs are costs incurred for employee salaries WPI in year t in units of Rupiah |
| 5) Depreciation cost | X1.5 | depreciation cost is the cost incurred for equipment, buildings, and fixed assets in the year WPI t in units of Rupiah |
| 6) Other input costs | X1.6 | costs outside the cost of production, business cost, and cost outside business WPI in year t in units of Rupiah |
| **b. Tax Administration System (X2)** | | |
| 1) Examination | X2.1 | dummy/binary (1= has never been examined, 0= has ever been examined) |
| 2) Clarification / calls | X2.2 | dummy/binary (1= has never got any calls, 0= has ever got any calls) |
| 3) The value of clarification / calls | X2.3 | $\frac{\text{The Value of Calls per Clarification Wpi}_{year\,t}}{\text{Total Payable Tax}_{year\,t}} \times 100\%$ |
| 4) Objections | X2.4 | dummy/binary (1= has never submitted objections, 0= has ever submitted objections) |
| **2. Mediating Variable** | | |
| **Optimal Tax Reporting (Y1)** | | |
| 1) Benchmarking Gross Profit | Y1.1 | $\frac{\text{Gross Profit}_{year\,t}}{\text{Gross Profit Optimal}_{year\,t}}$ |
| 2) Benchmarking Operational Profit | Y1.2 | $\frac{\text{Operational Profit}_{year\,t}}{\text{Operational Profit Optimal}_{year\,t}}$ |
| 3) Benchmarking Net Profit | Y1.3 | $\frac{\text{Net Profit}_{year\,t}}{\text{Net Profit Optimal}_{year\,t}}$ |
| **3. Dependent Variable** | | |
| **Tax Compliance (Y2)** | | |
| 1) Effective tax rate (ETR) | Y2.1 | $\frac{\text{Total Amount Paid for Tax}_{year\,t}}{\text{Profit before Tax}_{year\,t}} \times 100\%$ |
| 2) Corporate Tax to Turn Over Rasio (CTTOR) | Y2.2 | $\frac{\text{Payable Corporate Tax}_{year\,t}}{\text{Turnover}_{year\,t}} \times 100\%$ |
| 3) Delay in annual tax return report | Y2.3 | Annual Tax Return Report is not delivered or delivered not in accordance with the specified time limit. Annual Tax Return Report delay is measured from the variable dummy / binary (1 = punctual, 0 = late). |
| 4) Fine | Y2.4 | $\frac{\text{Fine}_{year\,t}}{\text{Total Payable Tax}_{year\,t}} \times 100\%$ |

The corporate financial ability is measured by the corporate financial performance (the performance of revenues and costs). The willingness of taxpayers is encouraged by the examination and appeals by the tax administration system. Behavior of optimal tax reporting is done through a method of benchmarking performance (Kalirajan, 2000). Taxpayer compliance is measured from Effective Tax Rate (ETR), Corporate Tax to Turnover Ratio (CTTOR), Annual Tax ReturnReport delays and fines.

According to Cleaves *et al.* (2012, p.44), financial performance can be measured in financial development, comparison with other companies' financial condition, and ratio analysis. This study uses panel data, so it can evaluate the development of financial performance (comparative financial statement analysis) as well as performance comparisons between companies (common size financial statement analysis). This study uses a model of efficiency and performance (Hanlon and Heitzman, 2010) to estimate the performance of input (circulation of effort and expense) for estimating the output performance (profit). Therefore, the

regression model can also be a model of analysis of the ratio (efficiency). Directorate General of Taxation (2012) uses a circulation attempt to predict the profit ratio consisting of the ratio of GPM, OPM, PPM, and NPM. According to Wagner (1960), there are three indicators in measuring the tax base of income taxes, namely income (circulation of business), as well as expenses and assets (property), so that the cost indicators can also be used to estimate the optimal profit other than the circulation of business.

Data analysis and processing techniques used are Structural Equation Modeling (SEM) approach and GSCA (Generated Structured Component Analysis) method. Indicators that have outer loading with the sign corresponding to the variable value and has a value of ≥ 0.3 (rounding off) and or significant, are selected as an indicator of the relevant variables. The outer loading value indicates the degree of strength of the indicator as a measurement of latent variables. The greater the outer loading indicates the relevant indicator is getting stronger as a measure variables. Structural models (inner model) are evaluated by looking at the value of coefficient parameters of the connectivity between the latent variables. Testing of structural models (inner model) is made after the relationship model built in this study corresponds to the data observed and to overall goodness of fit model. The purpose of testing the structural relationship model is to determine the relationship between the latent variables in this study. GSCA model outputs and structural model testing are done by looking at the estimated value of structural path coefficients and the value of the critical point (t-statistic) significant at α 0.05. The model fit test in this case is a test of structural models (inner model). The structural model is evaluated by observing the R-square ($R^2$), FIT, and Afit. Hypothesis testing in GSCA is done using t-test, by applying bootstrap resampling method. The size of sample bootstrap that equals to 100, then it meets the argument of the central limit, so the hypothesis testing on GSCA does not require the assumption of normal distribution of data. The hypothesis is proven if CR > 1.96 and p under 0:05. If the results indicates the value mentioned, then the influence between exogenous variables on endogenous variables are significant and vice versa.

## 4. RESULTS OF ANALYSIS

*4.1 Outer Loading*

In this study, the measurement on the variable Financial Performance is reflected through six indicators, namely circulation of business (X1.1), HPP (X1.2), business cost (X1.3), salaries (X1.4), depreciation costs (X1 .5), and other input cots (X1.6). Table 4 shows that that all the indicators have a value of outer loading with a positive sign (+), have a value of ≥ 0.3 (rounding off), and are significant. Indicator of circulation of business (X1.1), HPP (X1.2), business cost (X1.3), salaries (X1.4), depreciation costs (X1 .5), and other input cots (X1.6) all made as an indicator of financial performance variables (X1). This means that the variable Financial Performance (X1) has been able to set up or explained by circulation of business, HPP, business cost, salaries, depreciation costs, and other input cots. Circulation of business is the most significant indicator that can be used to measure the financial performance of the company. The higher the circulation of business shows good financial performance, conversely the lower the circulation of business shows poor financial performance.

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**Table 4. Outer Loading Indicators for Research Variables**

| Indicators | Outer Loading | CR |
|---|---|---|
| Corporate Financial Performance | | |
| X1.1 | 0.912 | 83.00* |
| X1.2 | 0.821 | 45.81* |
| X1.3 | 0.862 | 32.97* |
| X1.4 | 0.834 | 34.82* |
| X1.5 | 0.689 | 18.84* |
| X1.6 | 0.585 | 16.20* |
| Tax Administration System | | |
| X2.1 | 0.920 | 36.63* |
| X2.3 | 0.579 | 10.81* |
| Optimal tax reporting | | |
| Y1.2 | 0.968 | 12.09* |
| Y1.3 | 0.376 | 2.892* |
| Taxpayer compliance | | |
| Y2.1 | 0.667 | 7.82* |
| Y2.2 | 0.285 | 4.68* |
| Y2.3 | 0.883 | 38.85* |
| Y2.4 | -0.328 | 2.33* |

Note: * = significant at α 5%
Source: Secondary data processed with GSCA, 2015

Measurement of the Tax Administration System in the process of examining the indicators is reflected through four indicators of examination (X2.1), clarification (X2.2), value of appeals (X2.3), and objections (X2.4). Evaluation on outer model or model of measurement can be seen from outer loading value of each indicator ofTax Administration System. The test results of measurement show only two indicators of examination (X2.1) and the value of appeals (X2.3) which can be used in testing the model. Clarification (X2.2) and objections (X2.4) have a weighting factor values smaller than 0.3 and are not significant, so they are not used as an indicator of the Tax Administration System (X2). On the other hand, the value of CR (Critical Ratio) shows that the most powerful indicators to measure tax administration system is examination or appeals as it has the highest value of 18.76 significant at α95% (1.960).

Optimal Tax Reporting is reflected through three indicators of gross profit (Y1.1), operational profit (Y1.2), and net profit (Y1.3). Evaluation on outer model or model of measurement can be seen from outer loading value of each indicator of Optimal Tax Reporting wherein Y1.1 weighting factor value < 0.30. Table 4 shows that only two (2) indicators are significant as a measure of Optimal Tax Reporting (Y1). Benchmarking Gross Profit (Y1.1) has a weighting factor value smaller than 0.3 so it is excluded as an indicator of Optimal Tax Reporting variable (Y1). Benchmarking Net Profit (Y1.3) has a weighting factor value of 0269 and if rounded off 0.3 so it meets the criteria. This variable then only has two (2) indicators, namely Benchmarking Operational Profit (Y1.2) and Benchmarking Net Profit (Y1.3).

Taxpayer Compliance measurement is reflected through four (4) indicators, namely Earning Tax Ratio (Y2.1), CTTOR (Y2.2), the late submission of Annual Tax Return (Y2.3) and Fine (Y2.4). All indicators have a weighting factor value (outer loading) of ≥ 0.3 (rounding off) and is significant. Indicators of Effective Tax Rate (ETR) (Y2.1), Corporate Tax to Turnover Ratio (CTTOR) (Y2.2), the late submission of Annual Tax Return (Y2.3) and Fine (Y2.4) are all used as indicators of Taxpayer Compliance (Y2). Weighting factor of Fines (Y2.4) is **negative** (-), indicating that if the higher the fines given to taxpayers, the higher their non-compliance will be. Based on analysis of data, viewed from the estimated value of outer loading for each indicator, the most important indicator for Taxpayer Compliance is the late submission of Annual Tax Return. The analysis shows the highest factor loading by 0.883, so the indicator is able to explain the variable Taxpayer Compliance (Y2) better than other indicators.

*4.1 Testing on Structural Model (Inner Model)*

GFI value of 0.992 is greater than the cut-off value of 0.90; it indicates that the model is good. The model can be used to explain the results of hypothesis testing. FIT value of 0449 shows that the model can explain the influence of Company Financial Performance and Tax Administration System to the Optimal Tax

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Reporting and Taxpayer Compliance by 44.9%, where the balance of 50.1% is determined by other variables that have not been included into the model and error component.

**Table 5. Goodness of Fit Model**

| FIT Model | Value |
|---|---|
| FIT | 0.449 |
| AFIT | 0.446 |
| GFI | 0.992 |
| R-Square X1, X2 → Y1 | 0.224 |
| R-Square X1, X2, Y1 → Y2 | 0.419 |

Source: Secondary data processed with GSCA, 2015

The coefficient of determination (R-square) obtained from the variable Financial Performance (X1) and Tax Administration System (X2) to variable Optimal Tax Reporting (Y1) is 0.224 soOptimal Tax Reporting (Y1) can be explained by Financial Performance (X1) and Tax Administration System (X2) as much as 22.4% and the remaining 77.6% is influenced by other variables not included in the research. The coefficient of determination (R-square) obtained from Financial Performance (X1), Tax Administration System (X2), and Optimal Tax Reporting (Y1) towardTaxpayer Compliance (Y2) is 0419, so it can be said that Financial Performance (X1), Tax Administration System (X2), and Optimal Tax Reporting (Y1) can be explained by Financial performance (X1) as much as 41.9% and the remaining 58.1% is influenced by other variables outside the research model.

**Tabel 6. The Results of Hypotheses Testing**

| No | Relationship between Variable | | Path Coefficient | CR | p | Note |
|---|---|---|---|---|---|---|
| H1 | Corporate Financial Performance (X1) | Optimal Tax Reporting (Y1) | 0.473 | 4.65 | 0.000 | Significant |
| H2 | Tax Administration System (X2) | Optimal Tax Reporting (Y1) | -0.098 | 0.67 | 0.503 | Non-Significant |
| H3 | Corporate Financial Performance (X1) | Taxpayer Compliance (Y2) | -0.066 | 1.09 | 0.276 | Non-Significant |
| H4 | Tax Administration System (X2) | Taxpayer Compliance (Y2) | 0,647 | 9,93 | 0.000 | Significant |
| H5 | Optimal Tax Reporting (Y1) | Taxpayer Compliance (Y2) | -0.031 | 0.51 | 0.610 | Non-Significant |

Source: Secondary data processed with GSCA, 2015

Here is the illustration of hypotheses testing results in a form of a path diagram.

**Figure 2.A Path Diagram of Hypotheses Testing Results**
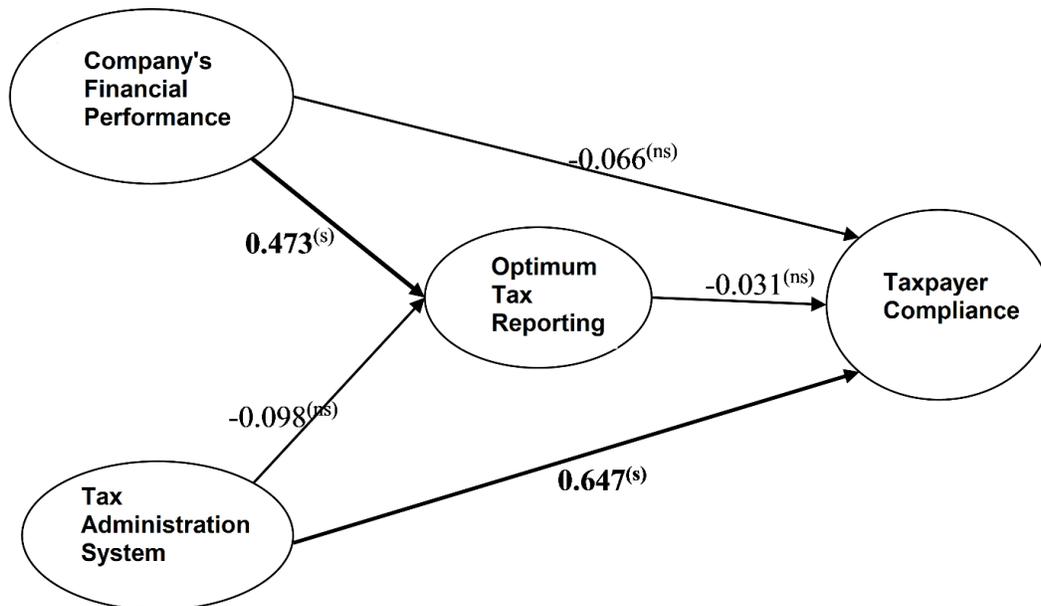


Source: Secondary data processed with GSCA, 2015

Corporate Financial Performance has significant effect on Optimal Tax Reporting. GSCA results in path coefficient of 0.473 and p-value of 0.000 (significant), so the hypothesis is accepted. Path coefficient is positive; it means that the better the financial performance, the more optimal tax reporting will be, and the vice versa.

Tax administration system does not significantly influence Optimal Tax Reporting. GSCA results in path coefficient of -0.098 and p-value of 0.503 (non-significant), so the hypothesis is rejected. This indicates that a good or bad system of tax administration does not affect optimal tax reporting.

Corporate Financial Performance does not significantly influence Taxpayer Compliance. GSCA results in path coefficient of -0.066 and p-value of 0276 (non-significant), so the hypothesis is rejected. This indicates that the level of financial performance does not affect taxpayers compliance.

Tax Administration System significantly influences Taxpayer Compliance. GSCA results in path coefficient of 0647 and the p-value of 0.000 (significant), so the hypothesis is accepted. Path coefficient is positive; it means that the better the system of tax administration, the higher the taxpayer compliance will be, and the vice versa.

Optimal Tax Reporting does not significantly influence Taxpayer Compliance. GSCA results in path coefficient of -0.031 and p-value of 0610 (non-significant), so the hypothesis is rejected. This indicates that optimal tax reporting does not affect taxpayer compliance.

## 5. DISCUSSION

The results of this study show that taxpayer compliance for small and medium scale business is not affected by the ability (either directly or indirectly through the optimal tax reporting), but through the willingness of the taxpayer to pay the tax that is driven by the implementation of the tax administration system (through examination and appeal). The higher the corporate financial performance (higher revenue and costs) showing higher financial ability to pay taxes is not followed by tax compliance for payment of taxes. The financial performance of the company not only describes the ability, but also the strategy, culture and information, so corporate financial performance is not always in line with corporate ability to obligations in tax payments as described in the Theory of Ability to Pay (Wagner, 1883),

The higher the corporate financial performance has only significant effect on optimal tax reporting. The higher the corporate financial performance encourages taxpayers to report actual profits, while

taxpayers with lower performance tend to report profit under the actual profit. Samples of companies are mostly medium, small, and micro scale enterprises requiring credibility of the company to raise capital from investors and lenders (such as banks) for business development. High revenue performance gives opportunity for companies to report high profits to increase the confidence of investors and creditors (Lanis and Richardson, 2011; Hoi *et al.*, 2013; Hanlon and Slemrod, 2009; and Muller and Kolk, 2012). The results of the study do not find such a tax saving measures as found in large enterprises (Davis *et al.*, 2013; Preuss, 2010). Irregularities in reporting profit as the tax base for corporate income tax by some taxpayer is not necessarily because of the tax savings behavior as occurs in large companies, but can also be caused due to the unavailability of adequate financial reports on medium, small, and micro scale enterprises.

The condition is different from the large-scale companies where profit management going on a lot. In large enterprises, irregularities in profit reporting as the tax base for corporate income tax can be due to profit management. Management can do overvalued and undervalued in reporting profit (Davis *et al.*, 2013; Preuss, 2010). In connection with the value of the company, managers tend to over value in reporting profit to enhance corporate value as to gain trust from investors and creditors to realize profits quickly; yet, in relation to tax, management will delay profit and realize loss faster to realize tax savings. Management tends to maximize profits for themselves and shareholders (stakeholders which are the most profitable).

Taxpayer compliance is more influenced by the willingness of the taxpayer to pay the tax that is driven by the implementation of the tax administration system (through examination and appeal). Implementation of the tax administration system (through examination and appeal) may encourage taxpayers to obey in tax payments (supporting the Theory of Willingness to Pay by Kahneman, Knetsch and Thaler, 1990), but has not been able to encourage companies to report the optimal tax. Implementation of the tax administration system (through examination and appeal) should be able to provide external stimulus to change attitudes, perceptions, and pressure on taxpayers to report the actual tax. These results indicate that the implementation of the tax administration system currently is only able to influence taxpayer compliance which is a formal compliance (do not delay tax return, no penalty, and suitability of tax rates with current regulations), but does not affect the compliance of material (such as optimal profit report). Activities during examination and appeal are more done in large companies where high payable income tax and non-compliance take place. Limited number of functional inspectors has led to less optimal inspection and control functions. Use of the method of accounting in the examination seems effortless due to high number of taxpayers. On the other hand, examination cannot be done in a short time. The Directorate General of Taxation should take some important things into consideration in determining tax audit policy including the shortage of human resources in the Directorate General of Taxation. Administrative system in the Directorate General of Taxation stipulates that the Account Representative is responsible for overseeing the administration of taxpayer compliance. In an effort to overcome the limitations of functional examiners, then Account Representative Materials also have limited supervision. On average, an Account Representative should supervise 500-1000 taxpayers (Iqbal and Santosa, 2015 p. 10). On the other hand, sample observation for micro, small, and medium enterprises is still limited to corporate financial statement information. This can lead to the implementation of the tax administration system which is only formal compliance but not material compliance. From the explanation above, we need a tool to facilitate the task of Account Representative in conducting supervision. Supervision is expected to be carried out thoroughly with a tool or method, which is scalable, effective, and non-subjective.

The findings are also supported by other findings that optimal tax reporting has no significant effect on tax compliance. It shows that tax compliance is more on formal compliance over material compliance. Taxpayers have not reported an optimal tax (part of material compliance), which is not necessarily non-compliance (formal). This leads to optimal tax reporting has no significant effect on tax compliance. Optimal tax reporting is not only measured by the profit reported, but there is a component in a comparison that is optimal profit in the business group. This causes the indicator of profit on corporate financial performance is not necessarily aligned with the indicator variable of ETR and CTTOR on taxpayer compliance.

## 6. CONCLUSIONS
Based on the hypotheses testing, the following conclusions can be drawn:
1. The higher corporate financial performance (higher revenue and cost) is followed by Optimal Tax Reporting. The results of this study indicate that a company will report the optimal profit to increase

confidence of stakeholders such as investors, creditors, employees, and the wider community. The results of this study reinforce the enactment of Stakeholder Theory (Freeman, 1984). Stakeholder confidence is beneficial for the company for capital increase, the ease of obtaining business loans, and marketing. Behavior tax savings are not found on small and medium scale enterprises.

2. The higher (lower) the implementation of tax administration system (through examination and appeal) is not accompanied by the higher (lower) optimal tax reporting. The results of the study do not correspond with the Theory of Cognitive Behavioral Prescriptive (Ajzen and Fishbein, 1981) which explains that the external stimulus can change attitudes, perceptions, and pressure on taxpayers to report the actual tax (optimal tax reporting). The difference of these findings could be due to constraints in the capacity of examination by the tax office that implementation of the tax administration system (through the examination and appeals) only affects the formal compliance but has not material compliance (optimal tax reporting).

3. The higher (lower) of corporate financial performance is not accompanied by the higher (lower) of taxpayer compliance. The results of this study is different from the Theory of Ability to Pay (Wagner, 1883) which explains that the taxpayer compliance in paying taxes is affected by the ability of taxpayers to pay taxes. The study found that tax compliance is more influenced by the willingness than the taxpayer's ability to pay taxes.

4. The higher (lower) the implementation of the tax administration system (through examination and appeal) is accompanied with the higher (lower) of taxpayer compliance. The results of this study reinforce the enactment of the Theory of Willingness to Pay (Kahneman, Knetsch and Thaler, 1990) in explaining the tax compliance.

5. The higher (lower) of optimal tax reporting by taxpayers is not accompanied by the higher (lower) of taxpayer compliance. The results of this study are different from the Theory of Justice (Adams, 1963) which explains that the fairness of the tax system (distributive justice, procedural justice, and retributive justice) will supportcompliance. These results suggest that taxpayer compliance is more on formal compliance. Taxpayers who have not reported an optimal tax (part of the material compliance) is not necessarily non-compliance (formal). Yet optimal tax reporting does not affect tax compliance on growing business, especially medium, small, and micro scale enterprises in developing countries. The growing environmental condition is marked by the availability of limited financial information of the companies, as well as limited knowledge and understanding of financial and taxation, and developing administrative systems. This condition causes the material compliance (optimal tax reporting) is not aligned with formal compliance (tax compliance).

The results of this study have implications in explaining the theory most appropriate to describe the taxpayer compliance based on the corresponding characteristics of corporate taxpayers in developing countries. Characteristics of taxpayers in developing countries are that the high proportion of taxpayers from medium and small scale enterprises, low availability of financial information, high asymmetry of information, low enforcement of tax regulations, cultural factors, as well as promoting awareness of taxpayers (socialization and calls) compared to coercion (penalty and examination). These results provide practical implications for Tax Administration System on the importance of the development of Benchmarking Performance method to improve the audit program (inspection) and appeal more effectively and efficiently according to the characteristics of corporate taxpayers in developing countries.

This study has limitations because it has not included samples of three groups, namely small, medium, and large enterprises. Further studies may include all corporate taxpayers because the compliance behavior among the three may be different. Further studies can also expand indicators and other variables that may affect the willingness of taxpayers to tax reporting and payment of tax, such as financial penalties, rewards, service time, information systems, and public confidence in the management and use of taxpayer money.

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