

# COMPLIANCE COSTS OF MALAYSIA'S SMALL AND MEDIUM ENTERPRISES

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*Abstract* : This study presents compliance costs of Malaysia's Small and Medium Enterprises (SMEs) for the income tax assessment year 1998. These estimates obtained from a representative population using personal interviews suggest that the level of compliance costs, which are made of computational and planning costs is substantially greater for SMEs compared to public listed companies. For instance, the average tax paid by the SMEs is merely one-eleventh of the taxes paid by a typical listed firm. The compliance cost of listed firm is only three times that of the compliance costs of a typical SME. This indicates that the compliance cost is three and a half times more regressive for an average SME. The study is particularly significant for Malaysian taxpayers (including SMEs) as the self-assessment system will be implemented in stages, commencing with companies, in 2001.

*Key Words*: Compliance costs; Small and Medium Enterprises; Income tax rate.

*ABSTRAK*: Kajian ini adalah berkaitan kos-kos pematuhan Industri Kecil dan Sederhana (IKS) untuk tahun taksiran 1998. anggaran0anggaran berkenaan kos pematuhan ini diperolehi daripada sample yang mewakili IKS dengan menggunakan kaedah temubual. Dapatan menunjukkan bahawa tahap kos pematuhan yang terdiri daripada kos perancangan dan pengiraan adalah lebih tinggi untuk IKS berbanding dengan syarikat-syarikat yang disenaraikan. Sebagai contoh, Pada puratanya cukai yang dibayar oleh IKS hanyalah satu persebelas daripada syarikat yang dibayar oleh syarikat yang tersenarai. Kos pematuhan syarikat tersenarai ialah 3 kali ganda kos yang dialami oleh IKS. Ini menunjukkan bahawa kos pematuhan adalah tiga setengah kali lebih regresif untuk mana-mana IKS. Kajian ini adalah penting untuk golongan pembayar cukai (termasuk IKS) memandangkan sistem taksiran diri akan dilaksanakan secara berperingkat-peringkat mulai 2001 untuk syarikat.

## 1. Introduction

Tax compliance cost studies has become popular in other countries since the early 1980s. The impact of these studies is such that revenue authorities in advanced and even some developing countries are beginning to be cautious about changing tax systems without first estimating how new policies could affect compliance costs whenever tax rates or tax systems are proposed to be changed. This has the cumulative effect of introducing caution to the

government's urge to impose new taxes. Significant studies of compliance costs include Slemrod and Sorum (1984); Sandford (1989); Pope and Fayle (1990), Blumenthal and Slemrod (1992), Ariff *et al.* (1997) and Cheung *et al.* (1999). Several of these studies covered small and medium sized companies in Australia, the U.S. and the U.K while the last two covered large companies in Asia.

The tax system of Malaysia has changed significantly over the last 15 years and is still continuing to change fast with the introduction of the self assessment system in stages commencing with companies from 2001 taxable year. The only study on compliance costs of firms in this country reported some useful findings relating to public listed companies, which are large firms. The results of that study (Loh *et al.* 1996) suggest that compliance cost of listed firm is high and that the cost is regressive. This study is about compliance costs of small and medium enterprises (SMEs) in Malaysia. For policy formulation purposes, one needs to carefully research both SMEs and large listed firms. Studying the compliance costs of the SMEs, it is hoped, will provide new information on the regressive nature of their tax costs. As a matter of policy, SME's costs should not be permitted to become so high as to discourage SMEs from engaging in risk-taking entrepreneurial activities, which are essential at the early stage of development of the economy.

The findings on large public listed firms (see Loh *et al.*, 1997) reveal income tax compliance costs of Malaysian companies are higher for smaller companies than for larger companies. This suggests compliance costs are regressive in nature in Malaysia as in other countries. By extending the findings of this study, it can be predicted that the compliance costs per unit of revenue of a small-medium enterprise will be higher than that of the listed firms. Since a vast majority of firms is not listed in formal exchanges, it is, therefore, an important research question to obtain estimates and confirm this hypothesis about compliance costs

incurred by SMEs. The total number of firms listed in the stock market as at 1 May 1999 was about 470 (Main Board) and 210 (Second Board). However, the total number of listings of SMEs in the Yellow Pages of the telephone directory and MITI's directory alone is many times the number listed on the exchange. Hence, the experience of SMEs in this regard merits a separate study. The motivation of this study, therefore, is to produce comparative statistics for this vast majority of firms.

## **2. Small and Medium Scale Enterprises**

SMEs form the backbone of any business community with an estimated 45,000 of these enterprises playing a significant role in the economy. Their share of revenue is about 15 per cent of total revenue of the manufacturing sector. They are regarded as the driving force of the economy (Chan 1999). Three-quarters of 2,039 Malaysian manufacturing firms are classified as SMEs. Furthermore, manufacturing SMEs contribute around 20 per cent of the total output of all manufacturing sector, underscoring the dominance of the larger manufacturing firms. Larger manufacturing firms depend on the crucial services of these SMEs as their suppliers. A study of SMEs would, therefore, provide information to tax planners on how compliance costs may be maintained at low levels if the costs are regularly estimated. For any policy on this key issue of entrepreneurial promotion, the planners need to base their decisions on compliance cost figure, which are not currently available. Companies too would like to know what is their average cost in this regard, and how that compares with their larger enterprises. They may even be able to manage the controllable part of their compliance costs, if they knew what these are.

## **3. Objective and Significance of Study**

This study concentrates on estimating the average compliance costs of unlisted small and medium enterprises in Malaysia. It will add new findings to those

documented in the earlier studies of larger firms. Other objectives are to analyse the composition of the compliance cost estimates for SMEs and compare them with figures reported for Malaysian listed firms and foreign companies. The interpretation of the results too will provide a basis for policy formulation by the relevant government authorities affecting small and medium enterprises. Other companies including multinationals, which are not listed, would benefit from the findings of this study.

Before examining these firms, it is imperative to identify what SMEs are, and describe the problems associated with their definition. If special treatment is given to promote these firms as the backbone of the economy by the government, the definition becomes crucial. These firms then would have obvious incentive to be included in that category.

◆ **Definition: SMEs**

According to the Ministry of International Trade and Industry (MITI), small and medium industries (SMIs) are defined as "companies with employees not exceeding 150 with an annual sales turnover not exceeding RM250 million": (SMI Directory, 1999). This new and liberal definition has been adopted by MITI since 1998. Therefore, Malaysian-owned companies satisfying both criteria would qualify to apply for the financing facilities, a government incentive, allocated for SMIs. In this paper, the acronyms SMIs and SMEs are used interchangeably. The primary aim of the new definition is to encourage expansion of existing industries and simultaneously to create a new breed of SMEs that would add value to the manufacturing chain. Promotion of such companies will encourage SMEs to be more efficient and become resilient in times of recession.

◆ **Government Support**

As SMEs play an important role of providing support services to larger industries, particularly in manufacturing sector, the government provides various finance facilities to encourage their active participation to promote economic growth. The financial facilities are provided via the following funds:

- ◆ Industrial Technical Assistance Fund (ITAF),
- ◆ Rehabilitation Fund for Small and Medium Industries (RFSMI),
- ◆ Technology Acquisition Fund (TAF), and
- ◆ Commercialisation of R &D Fund.

In 1998, the government allocated RM2.5 billion to the SME fund to encourage new investment in selected sectors, namely manufacturing, agro-based, and special services industries. This fund will directly encourage exports and initiate the growth of new industries, particularly start-ups in high technology sectors, so it is claimed.

**4. Corporate Income Taxation and Compliance Costs**

This section covers the concepts and definitions relating to compliance costs of companies.

**Concepts and Definitions**

Prior studies (Slemrod and Sorum 1984; Sandford 1989; and Blumenthal and Slemrod 1992) define compliance costs as those relating to the costs of conforming to the mandatory requirements of a tax regime involving the preparation and submission of timely tax returns in accordance with the relevant tax laws in force in a country. Compliance costs, therefore, are costs associated with the number of hours spent for preparing tax returns, administrative expenses, and any money spent on tax

professional assistance.<sup>2</sup> These costs can be categorized into *internal* and *external* costs.

◆ **Internal costs**

Internal costs arise from time costs of staff of company spent on maintaining and preparing information for professional advisers, completing tax forms and dealing with revenue authorities on matters pertaining to inquiries, objections and appeals.

◆ **External costs**

External costs arise from payments to acquire the services of lawyers, accountants, and investment advisers from outside the company. The companies to comply with the tax law and regulations, including filing annual tax returns with the Inland Revenue Board (IRB), may seek these services. Compared to the internal costs, external costs are more easily recognisable and quantifiable. Internal costs are more difficult to quantify since it involves fairly subjective apportionment of overhead and other costs. Time spent by the internal staff for preparing the annual tax returns is very subjective and therefore difficult to quantify. Nevertheless, methods have been devised by other researchers including Ariff *et al.* (1997) in computing internal costs of companies, and this study employs the same method to compute compliance costs of SMEs.

Sandford, *et al.* (1989) further classified compliance costs into computation and planning costs.

◆ **Computation costs**

According to the researchers, computation costs arise from compiling and maintaining relevant information on a periodic basis to prepare mandatory

information required by the revenue authorities. Therefore, computation costs cannot be avoided by the companies and are non-discretionary in nature.

◆ **Planning costs**

Planning costs, on the other hand, are discretionary since they are related to tax minimizing efforts of a company to manage its tax-related matters, which among others involve efforts to mitigate, and legally avoid taxes. Planning costs are avoidable since these costs are subject to the discretion of the management.

**SAS and Initial Compliance Costs**

The implementation of a self-assessment system (SAS) commencing in year 2001 is predicated as a fair and honest reporting of tax liability. It requires taxpayers to maintain appropriate records to exercise reasonable care in the reporting and submission of returns affecting their tax liability. The new measures necessitate taxpayers to incur initial costs in addition to their regular compliance costs. Thus, compliance costs could also be categorised into initial irregular costs and regular costs.

◆ **Initial costs**

Initial costs may have two elements: costs relating to implementation of new tax law and cost linked with the learning process. When a significant change is made to an existing assessment system, as in the case of Malaysia's SAS, new compliance costs would be incurred. Not only is the current year basis of assessment is replaced with the preceding year as from 1 January 2000, SAS too would be implemented in stages in ensuing years. When major changes are made to the assessment system, it is prudent for taxpayers to get things right the first time, or at least as accurate as humanly possible. Preparing for the new tax system may necessitate a sizeable amount of initial irregular costs. On the other hand, the initial costs of complying with the tax provisions will lead to lower costs in the future as the taxpayer gets used to understanding the issues

pertaining to the new amendments. These are costs associated with the learning curve.

#### ◆ **Regular costs**

Regular or on-going compliance costs are costs incurred by taxpayers, who are used to the tax systems. Taxpayers to comply with the requirements of the law incur such costs periodically.

### **5. Review of Literature**

Most of the early studies relating to compliance costs concentrated on individual taxpayers (Wicks 1966; Slemrod and Sorum 1984; Martin 1944.). Following these studies, researchers in Australia, Singapore, UK and the USA examined compliance costs of public corporations and companies. Pope *et al* (1991) investigated the compliance costs of public companies in Australia and they estimated the overall mean compliance costs per public company at A\$62,604 (RM 143,989). Ariff *et al.* (1995) undertook a similar study in Singapore and their mean compliance cost estimate was over S\$78,396 (RM 172,471) for a company. A second Singapore study (Ariff, Ismail, and Loh 1997) estimated the average compliance costs to be S\$54,615 (RM 120,153). Another study in Malaysia of public listed companies estimated the average compliance costs per company to be RM68,836 (Loh *et al.* 1995)

In a comprehensive UK study by the University of Bath on compliance costs, Sandford (1990) noted that compliance costs for small traders started to rise in the mid-1980s. This was due mainly to heavier penalties imposed by revenue authorities on small businesses for not complying with tax regulations. As a result, many small businesses had to hire accountants to file their tax returns. Getting professional help meant extra financial burden for the taxpayers. This obviously led to an increase in their compliance costs.



Similar studies had been carried out in the USA by Slemrod and Blumenthal (1996). The findings of their survey of 1,329 large corporations revealed that corporate compliance costs amounted to US\$2 billion for 1995 (the average is US\$1.505 million). As a fraction of the revenue raised, corporate compliance costs were found to be lower than for individual income tax. The findings of this study also revealed that the cost-to-revenue ratio was higher for state corporate tax systems than for the federal tax system, reflecting the non-uniformity of the state tax systems. Furthermore, most of the respondents were of the opinion that the Tax Reform Act 1986 made the United States tax system more complex, resulting in higher compliance costs. Likewise, for UK companies, Sandford (1989) estimated the average compliance costs to be £10,980 (RM 69,174) for companies with turnover of more than or equal to £10 million (RM6.3 million). Among several studies that investigated compliance costs in the corporate sector, costs of complying with corporate taxation were highest for Australia companies.

## **6. Research Methodology**

The following section covers the data collection and preparation of survey questionnaire.

### **(i) Questionnaire Design**

The questionnaire was divided into four parts (referred to as Sections 1, 2, 3 & 4). Section 1 (General Information) elicited data on the characteristics and nature of the business as well as the number of people employed by the company. Section 2 (External Costs) contained questions relating to costs of employing with external advisers to handle taxation matters of the company. Information about the breakdown of the estimated fees for tax return preparation work, advisory and planning

costs was elicited from respondents. Section 3 (Internal Costs) obtained data on time spent on tax affairs by managers, accounting staff and computer officials and the amount as well as proportion of fees paid to each group. Finally, Section 4 (Other Matters) was designed to elicit respondent's opinion on ways to improve rapport between IRB and companies: these investigated whether IRB's views have been sought on specific issues. This section also examined the extent to which companies were prepared for the self-assessment system<sup>3</sup> and the impact of the new system on compliance costs.

## **(ii) Survey Questionnaire**

The survey instrument solicited information regarding the following: general information on the characteristics of the company, information on external and internal costs, and aspects of the tax system covering opinions, constraints and suggestions for the improvement of the tax system.

## **(iii) Data collection**

The researchers conducted the personal interviews, as SMEs normally do not readily respond to mailed questionnaires. Interviews were held with the accountants and the finance managers of the companies selected in this study. The survey population was taken from the directory of SME companies obtained from the Ministry of International Trade and Industry. Total numbers of SMEs for the whole from the MITI directory was 10,400. However, only SMEs located in the northern region were selected for this study. A total of 253 such SMEs were used as respondents in this study. The cluster sampling method was employed in this study, as the population frame from the whole of Malaysia was very large. In view of the highly technical nature of study, it was decided the

use of a smaller but representative population using personal interviews would yield higher response rate as well as more reliable responses. A total of 67 SMEs responded favorably to our request to participate in this study providing a response rate of 26.5 percent.

Reliability analysis was carried out in this study and various sections were found to be reliable and valid after certain questions, which were unclear eliminated. Based on Cronbach's Alpha, the overall reliability coefficient scores obtained for the questionnaire was 0.80. Generally, the above reliability coefficients indicate that there is a high level of consistency in the responses given by the respondents. Reliability coefficients of 0.65 and above are considered more than acceptable for most behavioral science application (Nunnally , 1978). To test for validity, tax professional views were gathered in designing the questionnaires. Discussions were also held with fellow academics pertaining to the design of the survey instrument and the method adopted in this study.

**(iv) Pilot Study**

A pilot study was carried out earlier among 12 SMEs located in the Northern region of West Malaysia to test for reliability and validity of the survey instrument. Personal interviews were conducted with finance managers or accountants of companies. Every step was taken to ensure that the final survey instrument was clearly understood by the respondents.

**(v) Data Analysis**

A total of 73 SMEs responded to our request to participate in this study. Six returned questionnaires were not useable as the information provided was unreliable, leaving 67 favorable responses, thereby, providing a

response rate of 22.3 percent. The response rate was low, as the nature of study is such that most respondents normally dislike divulging detailed tax matters of their company.

The returns were classified into three groups (1,2 and 3) based on turnover of the SMEs to facilitate comparison of compliance costs within group-size. Group 1 comprised of companies with turnover of less than RM5 million; Group 2, sales turnover between RM5 million to RM50 million; and Group 3, sales turnover exceeding RM50 million. Descriptive statistics such as the mean values of varying cost item were used to test for significant differences in compliance costs among various groups of companies. By regressing compliance costs on turnover values, past compliance cost studies on public listed companies has shown that the absolute amount of compliance cost is higher for larger firms (Pope *et al.*, 1991 and Ismail *et al.*, 1996).

## 7. Research Findings

The general characteristics of the companies are summarised in Table 1. Turnover of the SMEs ranged from RM600,000 to RM466 million (US\$ 157,894.74 to US\$70 million) with 21 companies having sales turnover of less than RM 5 million; 38 with between RM5 million and RM50 million; and the rest more than RM50 million [See Table 1, item (a)]. Majority of the companies were from the manufacturing sector (37); followed by commerce or trading (8) and construction and property development (7). The remainder of the companies included business activities such as financial, insurance and service industries and computer firms [See Table 1, item (b)];

**Table 1**  
**Profile of Respondents**

Characteristics	No. of companies
<b>(a) Turnover in RM million.</b>	
Group 1: <i>Less than 5</i>	21
Group 2: <i>Between 5 and 50</i>	38
Group 3: <i>More than 50</i>	8
<b>(b) Main Business Activity.</b>	
Construction and Property Development	7
Commerce/Trading	8
Computer/Software/IT	1
Financial, Insurance, Real Estate and Business Service	4
Manufacturing	37
Transport, Communication and Storage	1
Others	9
<b>(c) Estimated Tax Liability.</b>	
Less than RM100, 000	17
RM100, 000 - RM499, 999	15
RM500, 000 - RM 1 million	5
More than RM 1 million	9

The statistics on the estimated taxes payable are given under item (c) of Table 1. The tax liability by each company range from estimates lower than RM100,000 to those exceeding RM1,000,000. Only 46 companies out of 67 gave an estimate of their tax liability for year of assessment 1998. The others did not reveal their estimated tax liability. The average tax paid by the companies in the study is RM571,149 (US\$ 2,170,366.2) with a range of RM 3,472 to RM 3,300,000. The average tax per company paid by each listed companies determined in an earlier study (Loh *et al.* 1997) was estimated as RM 6.5 million (US\$ 1.7 million) in 1999 exchange rate. The average tax of an SME carried out in this study is therefore one-eleventh of the average tax paid by a listed firm. This is our estimate of the order of the SMEs tax liability under current laws.

**Table 2**  
**Dollar Compliance Costs per RM1, 000S Sales Turnover**

<b>Groups</b>	<b>Year of Assessment 1998</b>
	<b>RM</b>
1	629,715
2	771,072
3	70,830
<b>Average</b>	<b>21,964</b>

The average per firm compliance cost of SMEs is RM21,964 (US\$5,780) using 1999 exchange rate (see Table 2). The average for the listed firms reported in the cited study was RM68, 836 (US\$ 27,100). The relative compliance cost of SMEs is therefore around one-third that of the much larger listed companies. This seems to indicate the regressive nature of compliance costs. The internal compliance cost constitutes 75 per cent of the total cost while the external cost stood at 25 per cent. For listed firms (Loh *et al.*, 1997) the external cost was reported to be 72 per cent of the total (Loh *et al.*, 1997). This suggests that the components of compliance cost (comprising of internal and external costs) are not similar to both SMEs and listed companies in Malaysia. The SMEs do not spend more on external advice as in the case of listed companies but rather rely heavily on their own staff to comply with the tax laws. In addition to the above costs, 10 companies stated that they had to incur additional costs in submitting the company income tax requirements for financial year 1998. These additional costs were incurred to handle tax audit inquiries, stamping of documents, appeals against Scheduler Tax Deductions for employees and others.

**Table 3**  
**Regression of compliance costs on Sales Turnover of companies**

Intercepts	Slope coefficient	R-Squared	F-Ratio
2.053E-04	6.978	.000	.001
20.422	-3.165E-03		

The slope parameter of 6.978 suggests that it is not statistically significant. In this study, the respondents were small and medium enterprises (SMEs) and since they were in a homogenous group, the analysis of the data suggests that the compliance costs do not significantly vary among them (see Table 3).

### 7.1 Computational and Planning Costs

Table 4 shows the breakdown of compliance cost into computation and planning component:

**Table 4**  
**Breakdown of Compliance Costs by Size**  
**(% Of Compliance Costs)**

Group	Computation		Planning		Total RM
	RM	%	RM	%	
1	498,734	79	130,981	21	629, 715
2	302,258	39	468,814	61	771,072
3	67,304	95	3,526	5	70, 830
<b>Average</b>	<b>12, 960</b>	<b>59</b>	<b>9,005</b>	<b>41</b>	<b>21965</b>

The average computation cost was RM12,960, which amounted to 59 percent of average total compliance costs. This ratio incurred by Malaysian SMEs varies with the 50 percent incurred by Singapore public listed companies (Ismail *et al.* 1996) and 45 percent incurred by Australian companies (Pope *et al.* 1991). Malaysian listed companies, on

the other hand, incurred 61 percent computation costs (Loh *et al.* 1997). The average planning costs per company in this study was RM9,005 that is 41 percents of the average total compliance costs of RM21,964. This proportion is not strictly comparable with the 50 percent incurred by Singapore public listed companies or the 45 percent incurred by Australian companies. The difference could be due to any of the following: complexity of tax system, scope for tax planning, stage of development of economy, and size of the company.

Computation cost for SMEs in Malaysia was 1.5 times the average planning cost of RM3,1753.7 reflecting that a typical company used more resources to keep routine cost data associated with tax audit, withholding tax costs, payment to staff, and advisers to complete returns, and costs related to tax objections, inquiries, and appeals. Computation costs of Group 3 companies amounted to 95% of the average total compliance costs. This compares with Group 1 companies computation costs, which amounted to 79% of the overall average and 39% for Group 2.

The difference in computation costs between Group 1 and Group 3 companies and between Group 2 and Group 3 were not statistically significant, whereas the differences between Group 1 and Group 2 companies was only marginally significant ( $p > 0.08$ ).

The smaller companies, on average, spent almost less than one-third of their compliance cost on tax planning activities compared to 61% in the case of Group 2 companies, and five percent of Group 3 companies. This probably reflects the complex nature of the business activities of larger companies with more diversified investment opportunities and financing



patterns, which require special tax considerations, for example, development tax offsets and computation of capital allowances.

The results also indicate that there are no significant differences in planning costs among the group of companies. This means that companies in the three categories spend almost an equal amount on tax planning irrespective of their size.

## 7.2 Internal and External Costs

A breakdown of internal and external costs is presented in Table 5.

**Table 5**  
**Breakdown of Compliance Costs by Sources of Costs**  
**(% Of Compliance Costs)**

Group	Internal		External		Total (RM)
	RM	%	RM	%	
1	428,845	77.2	126,570	22.8	555,415
2	578,013	75.5	187,837	24.5	765,850
3	31,200	47.4	34,650	52.6	65,850
<b>Average</b>	<b>15,493.403</b>	<b>74.8</b>	<b>5,209.806</b>	<b>25.2</b>	<b>20,703.209</b>

One quarter (25%) of total costs was incurred by all SMEs for use of external advisors compared to 72% incurred by listed companies as revealed in Loh *et al.* study. Ninety-two percent or 62 of the companies in the sample had the assistance of external professional advisers to handle their tax matters (see Table 6). The main reason for 41.8 percent of the respondents in using external advice was to handle routine income tax affairs while the remaining nine percent of the respondent were to undertake tax planning, and other tax matters.

**Professional Advisors**  
**Table 6**  
**Employ external advisor**

Professional advisors	Frequency	Percents
Yes	62	92.5
No	5	7.5
<b>Total</b>	<b>67</b>	<b>100</b>

The other reasons for using external advisors were to undertake income tax planning (10.4%), to handle routine, tax matters (29.9%) and other related matters (1.5%) (Refer Tables 7 and 8).

Since a majority of the companies in the sample are in Group 1, this finding suggests that smaller companies are more likely to employ external advisors to prepare their tax returns and that these advisors probably handled other routine matters pertaining to corporate tax. SMEs spent about 75% of total compliance costs on internal resources to comply with tax laws rather than on external advisors.

**Table 7**  
**Source of External Advisor**

Source	Frequency	Percent
Accounting Firm	61	91.0
Legal Advisors	-	-
Merchant Bank	-	-
Others	1	1.5
<b>Total</b>	<b>62</b>	<b>92.5</b>

**Table 8**  
**Purpose of Seeking External Advisor**

<b>Professional advisors</b>	<b>Yes</b>	<b>No</b>
To handle routine income tax affairs	54 (80.7%)	-
To undertake income tax planning	7 (10.4%)	-
Other tax related matter	1 (1.5%)	-
<b>Total</b>	<b>62 (92.5%)</b>	<b>5 (7.5%)</b>

The breakdown of computation costs into internal and external components across companies in the various groups is found in Table 9.

**Table 9**  
**Breakdown of Computation Costs into Internal and External Costs**  
**(% Of Computation Costs)**

<b>Group</b>	<b>Internal (RM)</b>		<b>External (RM)</b>		<b>Total</b>
	<b>RM</b>	<b>%</b>	<b>RM</b>	<b>%</b>	
1	409,664	82	89,070	18	498, 734
2	168,836	56	133,422	44	302, 258
3	28,704	43	38,600	57	67, 304
<b>Average</b>	<b>9,062.75</b>	<b>70</b>	<b>3,896.90</b>	<b>30</b>	<b>12,959.65</b>

Thirty percent of the total computation costs of all companies pertained to costs arising from payment to external agents, thus the internal costs was 70 percent. The proportion of external costs of Group 1 companies was 18 percent, 44 percent for Group 2 and 57 percent for Group 3. This finding is consistent with the responses made by the smaller companies in our sample presented in Table 1.

The breakdown of costs from tax planning activities incurred from internal and external resources by group is presented in Table 10.

**Table 10**  
**Breakdown of Planning to Internal and External Costs**  
**(% Of Planning Costs)**

Group	Internal (RM)		External (RM)		Total
	RM	%	RM	%	
1	517,245	96	23,500	4	498,734
2	588,950	92	49,735	8	302,258
3	31,630	91	3,100	9	34,730
<b>Average</b>	<b>16,982.46</b>	<b>94</b>	<b>1139.33</b>	<b>6</b>	<b>18,121.79</b>

Only six percent of planning expenditure comprised of fees paid to external advisers for their service in formulating tax planning. The external component of the planning costs for large companies was only nine percent compared to four percent for smaller companies.

### 7.3 Additional Analysis

We also calculated compliance costs as a percentage of tax revenue.

**Table 11**  
**Percentage of Compliance Costs to Tax Revenue**

Group	Estimated Tax Revenue (RM)	Compliance Costs (RM)	Percentage of Costs to Tax (RM)
1	1,775,843	555,415	.313
2	16,262,172.48	765,850	.005
3	8,013,639.48	65,850	.0008
<b>Average</b>	<b>566,304.33</b>	<b>2,070.302</b>	<b>0.004</b>

Sanford (1989) showed that United Kingdom companies, on average, incurred compliance costs comprising 2.2 % of total tax revenue. Pope *et al.* 1991 estimated the compliances costs of Australian public companies' income taxation in 1986/87 at between 11.4 and 23.7% of public companies' tax revenue. The results for Singapore were an average of 0.4% for all companies for the year of assessment 1995 (Ismail *et al.* 1996). Hence the Malaysian results of 0.004 percent (that is, 0.313%, 0.05% and 0.0008%, respectively, (for Groups 1,2 and 3) appear to be comparable to the Singapore results, again with the proviso that the size differences are not controlled. The results are lower than those of the developed countries of Australian and United Kingdom, highlighting the complexities of the tax system in these countries. An alternative plausible explanation is that the companies in Sanford (1989) and in Pope *et al.* (1991) samples are smaller, and if the regressively principles holds, one might expect higher percentage of compliance costs to tax revenue than reported on unadjusted basis.

The findings also indicate that larger SMEs use accounting firms and legal advisers as their main sources of external advice. Accounting firms were sought mainly to undertake accounting, secretarial and tax return preparation work. The main reasons for seeking external advice were to handle routine income tax affairs and to undertake income tax planning. External assistance was also sought by these companies because the depth of technical knowledge particularly in specialized areas was not readily available within the firm and also because it was more cost-effective.

#### **8. Perception of the SMEs towards IRB**

The open-ended responses to qualitative questions elicited interesting comments. The findings reveal considerable convergence of views among

respondents with respect to their impression about IRB and its staff. Some frequently mentioned responses were:

- (i) "IRB staff are not very helpful."
- (ii) "IRB personnel maintained strict confidentiality on taxpayer's records."
- (iii) "Difficult to access IRB staff over the telephone."
- (iv) "Tax return forms are not processed quickly."

A general concern is the absence of IRB tax rulings on specific issues. The respondents want the IRB to be more transparent suggesting that tax rulings should be readily made available when sought by taxpayers<sup>4</sup>. Some respondents pointed to IRB's pathetic attitude towards time management that is queries raised were seldom responded promptly.

The respondents replied the following towards other additional (non-staff) costs in submitting their income tax requirements for financial year 1998:

- i. Time taken by directors to meet with their tax consultants for clarifying on annual tax matters
- ii. Accounting firm does not charge separately, lumped-up for the year and a Real Property Gains Tax (**RPGT**) matters.
- iii. Meeting with the IRB for certain issues such as absence of provision on doubtful debts.

When asked whether the corporate income tax system could be improved, the respondents suggested include the following:

- i. Introduce user-friendly tax assessment form.

- ii. Establish a specific units where public and private can be made IRB before taxpayers submit their returns.
- iii. Capital allowances and losses to be utilized for all sources.
- iv. IRB should send rules and guidelines periodically. Need for specific tax rulings by IRB. Very difficult to approach IRB for decision in advance.
- v. IRB should conduct regular seminars at affordable prices to clear up any current tax issues.
- vi. Allow companies to select monthly installment or half yearly payment at the end of each of six-month period of the basis period.

These suggestions could be considered in making policy decisions by IRB.

## **9. Conclusions and Recommendation**

An important area of tax research during the last two decades has been the issue of costs to taxpayers in complying with their taxation obligations. As for Malaysia, the issue of compliance costs is more significant now for a number of reasons. First, there is increased consciousness of the vital role of SMEs to the general economy. Several governments such as those in Australia, Malaysia and Thailand see small and medium companies as the vehicle for greater economic growth as well as the means to create more employment opportunities. The US economy has found that the 1993-1999 fast growths in employment are actually being generated by SMEs. Secondly, tax systems appear to increasingly become more complex either due to major amendments being made to existing law or new assessment systems being introduced as in the case of Malaysia. This study is particularly significant for Malaysian taxpayers, as the SAS will be implemented, commencing with companies, in 2001. Compliance costs are expected to significantly increase, particularly during the initial stages of the new assessment era, when companies are getting things right the first time or as correct as humanly possible. The implementation of SAS in Malaysia will result in

transfer of costs from administration (Revenue Board) to compliance (taxpayers). Thirdly, there is an increasing outcry by the public for more government accountability. Although there will be a shift in costs from the revenue authorities to taxpayers once SAS is introduced, government accountability indicates that there should be an overall reduction in economic costs.

Interesting preliminary findings have been obtained in this initial study before proceeding with the final study. The average tax paid by the SMEs is one-eleventh of the taxes paid by a typical listed firm. The compliance cost of listed firm is only three times that of the compliance costs of a typical SME. This suggests that the compliance cost is three and a half times more regressive for an average SME. The average tax paid by an SME is RM 855,381. Therefore, SME's compliance cost is approximately four per cent of the tax liability. That is, compliance cost amounts to four cents in a dollar of tax paid. For the listed firm, the comparison is: the compliance cost is 1.1 per cent of the taxes paid, again confirming the four-fold regressive ness of tax compliance costs in Malaysia.

Finally, an important aim of this study is to gather research data to assist in formulation of realistic proposals for tax reforms that would result in an overall reduction in compliance costs for both small and large firms. The proposals may hinge on measures that could be introduced by the government that will lower costs of SMEs in adhering to the requirements of the tax provisions. Tax simplification should be an essential element in the tax reform agenda. A rigorous tax education programmed too must be extended to private business enterprises.



## ENDNOTES

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1. Small and Medium Enterprise are generally labour intensive and they lack information technology and knowledge of automation. SMEs, therefore, have not become competitive enough to increase their share of the output even though they form three-fifth of the number of firms in manufacturing. With larger particularly foreign manufacturing firms using them as contractors, the rate of technological knowledge is increasing steadily.
2. According to Evans *et al.* (1998), 'pure' compliance costs are costs directly incurred by taxpayers in meeting the requirements of the tax law. These include taxpayers' own labour, unpaid helper and internal staff costs, costs of external advisers, and incidental or overhead costs such as specific travel, stationery, postage and computer use incurred by taxpayers. Psychic and social welfare costs as well as administrative costs borne by taxation authorities are, however, excluded.
3. Under the Official Assessment System (OAS), all return forms were checked for arithmetical accuracy, computation of tax payable and full disclosure of taxable income. Such a system was perceived to be an ineffective and inefficient approach to ensure compliance with tax law. The OAS approach was also perceived to be inconsistent with IRB's policy of encouraging voluntary tax compliance.
4. The Inland Revenue Board issued Public Rulings 1/2000 to 6/2000 on 1 March 2000. Public Rulings are listed below:

Ruling Number	Name of Ruling
1/2000:	Basis Period for a Non-Business Source.
2/2000:	Basis Period for a Business Source (Companies & Co-operatives).
3/2000:	Basis Period for a Business Source (Individual & Persons other than Companies & Co-
4/2000:	operatives).
5/2000:	Keeping Sufficient Records (companies & Co-
6/2000:	operatives).
	Keeping Sufficient Records (Individuals & Partnerships).
	Keeping Sufficient Records (Persons other than Companies & Co-operatives)

Ruling No. 1/2000 provides a brief outline of basis period for non-business sources. Rulings No. 2/2000 and No. 3/2000 provide numerous examples to illustrate application of specific tax law relating to basis periods. Rulings 4/2000 to 6/2000 illustrates what constitutes sufficient records to different business entities and the consequences of failing to maintain sufficient records.

The Inland Revenue Boards is expected to issue more public rulings in the future. Such as move would minimise ambiguous interpretation of tax law.

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