

Tax Evasion by Small and Medium Sized Enterprises (SMEs) and the Role of Forensic Accounting: The Malaysian Perspective

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Submitted for the Degree of Doctor of Philosophy

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The Wisdom of Adam Smith

“The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.”

“Every tax ought to be so contrived as both to take out and keep out of the pockets of people as little as possible, over and above what it brings into public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the following four ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business, which might give maintenance, and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds, which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade tax, it may frequently ruin them, and thereby put an end to the benefit which community might have received from the employment of their capitals” ... “The [tax] law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment too in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people that they are beneficial to the sovereign.”

The Wealth of Nation, Book 5, Chapter 2, Part 2: “Of Taxes”, maxims II & IV.

ABSTRACT

The aim of this research is to identify and define the characteristic behaviour of and factors that influence taxpayers in small and medium-sized enterprises (SMEs) when they either evade tax or comply with tax law. The study also attempts to assess the extent of tax evasion by SMEs in Malaysia. In addition, another concern is also to explore both the actual and potential role of forensic accounting with the focus on improving current enforcement strategies for deterring tax evasion by SMEs. The research findings will contribute to the current limited literature on the tax compliance of SMEs and forensic accounting, especially with respect to Malaysia.

Using a multi-method approach, the results of this thesis suggest that the extent of tax evasion by SMEs in Malaysia is both widespread and frequent. The findings also indicate that the offences tend to be deliberate evasion without any sophisticated tax-planning scheme. Understatement of gross profit and overstatement of expenses other than the cost of goods sold are the most frequently used methods. The fact that most taxpayers are unlikely to be detected and penalised by the tax authority is also another factor shaping tax evasion by SMEs. Most SMEs are heavily reliant on tax practitioners to guide them to comply with their income tax matters and will remain with the same tax practitioner in general; however, there is a tendency for some to switch tax practitioner for whatever reason they think fit.

Forensic accounting is a field that encapsulates all other areas in the use of accounting for investigative purposes. Forensic accounting is a relatively new discipline in Malaysia; however, the awareness of forensic accounting by tax practitioners and IRB (Inland Revenue Board Malaysia) personnel is strong. The techniques used in forensic accounting are not new to the IRB; however, the IRB personnel need further exposure to and training in these techniques. The finding indicates a lack of sophisticated planning in tax evasion by SMEs in Malaysia. Despite this, forensic accounting technique could be added to the existing tools necessary to bring about the successful investigation and prosecution of those involved. The study was carried out at a time of change for the IRB.

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This dissertation is the result of the support and efforts of many people. Thanks are due to the Government of Malaysia and the management of Malaysia Inland Revenue Board (IRB) for the scholarship, making this study possible.

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On a more personal note, a good deal of family cooperation is needed to complete this dissertation and in addition to the patience of my wife, Azian, who has given the gift of love, and selflessly provided every possible form of support imaginable. Not a day has passed that I have not been lifted and inspired by her sense of humour, her laughter and her beautiful spirit. I would like to commend my children, Daniel and Deanna for their understanding and maturity.

My research is and always will be a part of my own inner journey in which I create and discover who I am and what my truths are. Thank you to all those who have helped me, or have walked part of the way with me, in discovering this inner journey, what turned out to be a most challenging and stimulating adventure in scholarship.

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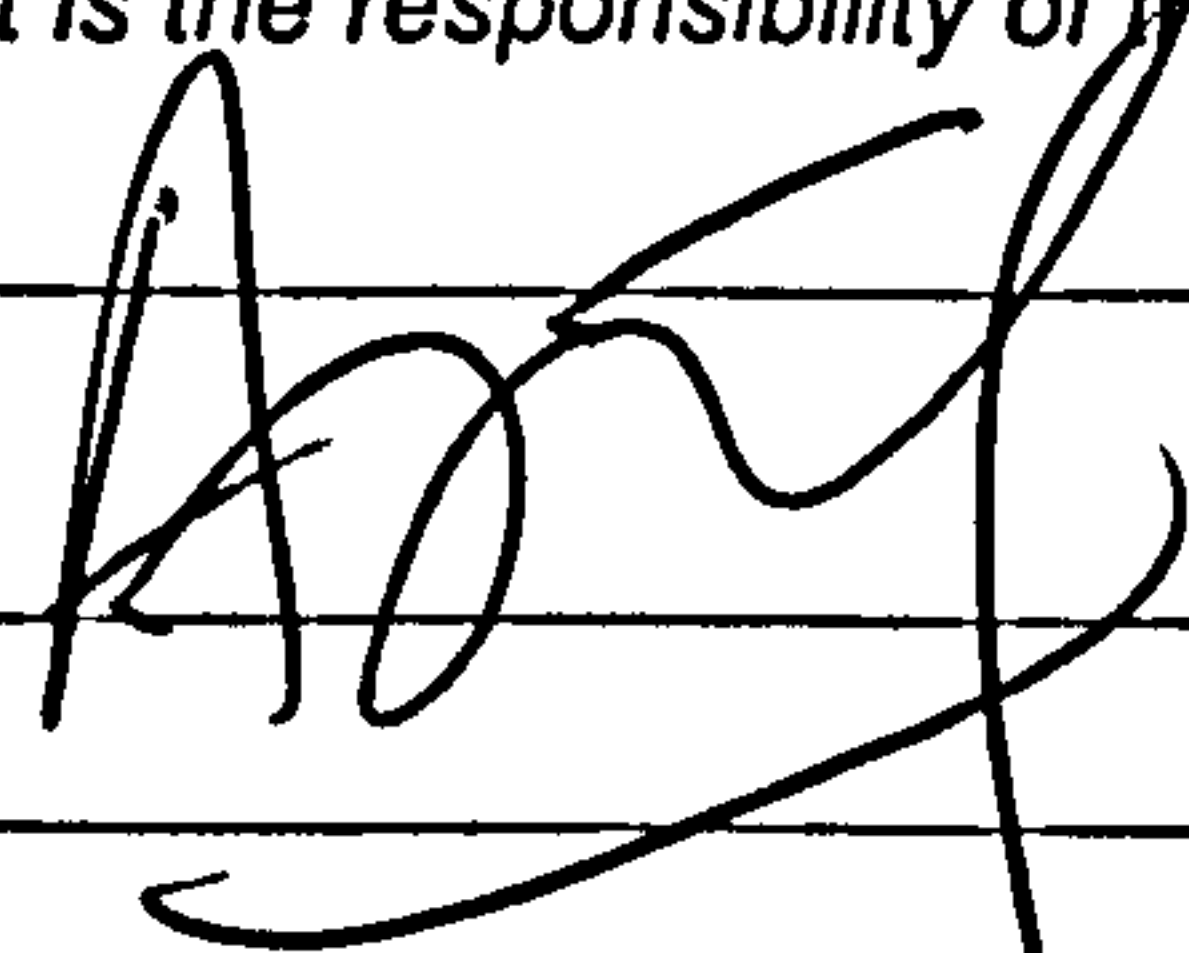
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LIST OF ABBREVIATIONS

All. E.R	All England Review
ALJR	Australian Law Journal Report
Ch D	Chancery Division
CLR	Commonwealth Law Review
DGIR	Director General of Inland Revenue
ITA 1967	Income Tax Act 1967
IRB	Inland Revenue Board
IRD	Inland Revenue Department
IRS	Internal Revenue Service
MIA	Malaysia Institute of Accountants
MIER	Malaysian Institute of Economic Research
OECD	Organisation for Economic Cooperation and Development
SAAR	South Africa Appeal Review
SAS	Self Assessment System
SME	Small and Medium Enterprises
SGATAR	Study Group on Asian Tax Administration and Research
Q.B	Law Reports, Queen's Bench Division (England)

CHAPTER 1

INTRODUCTION

Taxation is a game and tax evasion is a genuine sport in making a profit. One should not, however, look for the winners in this game.

Editorial: CATA Newsletter (June, 1990)

1.1 Preliminaries

Tax evasion is presumably as old as the history of taxation. Webley *et al.* (1991:1) pointed out that “*taxation and evasion have always gone together and income tax evasion...is as old as taxation*”. Many questions still remain, and probably will for as long as taxes exist. Income tax evasion *per se* is thus not a modern problem. According to Tanzi and Shome (1993), Plato commented on this phenomenon in his writing over two thousand years ago. Despite this lengthy existence, the only surprise is how little attention this phenomenon has received, especially in Malaysia until recent years, probably due to its sensitive nature. Very little theoretical or empirical research has been conducted in Malaysia, with the majority of studies undertaken in developed countries such as the United States and Australia. This study is being undertaken to make a contribution to filling this gap.

Since the introduction of the self-assessment system (SAS) in Malaysia in 2001^{1.1}, awareness of tax evasion has escalated. The realization that taxpayers with similar incomes often end up paying very different taxes because of different opportunities for tax evasion has led the government and the tax authorities to be concerned about the implications of tax evasion. As a developing country, it is very important for Malaysia to increase its revenue so as to foster its economic growth. Therefore, an increase in revenue through a reduction of tax evasion is one of the options available for achieving higher revenue. Thus, the government is concerned with tax evasion for two principal reasons (Cowell, 1990:45); it

^{1.1} The SAS of taxation is operative in Malaysia for companies' files with effect from the year of assessment 2001. The system has been introduced gradually to cover different categories of taxpayers: businesses, partnerships and cooperatives in the year of assessment 2003, and finally individual / salaried groups in the year of assessment in 2004.

harms the interest of the general public, and it harms the means by which the state can look after the interests of the general public.

According to Cowell (1990), the interests of the general public are broadly represented by goals for achieving social justice and efficiency in pursuing economic policy. Yet the activity of tax evaders may frustrate the pursuit of each of these two objectives. In terms of social justice, the rich may be more able to avoid tax while the poor have to pay their share, which offends one's sense of distributional justice as the principles of equity are being violated. In terms of efficiency, the administrative cost of enforcing taxes can be increased by uncertainty caused by the game of *'hide and seek'* in dealing with these tax evaders.

Evasion can also have a major impact on the structure of prices and incomes and can distort the effectiveness of any macroeconomic policy. It can erode the tax base and in some circumstances make the effect of alterations in tax rates indeterminate and unpredictable. The apparent elasticity of the labour supply and public revenue with respect to tax rates may have less to do with conventional factors such as work disincentives than with the inducement to conceal income and productive activity. The observed unemployment figures may be unreliable indicators of the economy's performance if a substantial proportion of workers are in the black economy.

Income tax has become one of the main sources of revenue for the Malaysian Government. In the year 2001, RM40.136 billion (£6.4 billion)^{1,2} of taxes were collected, whereas for 2002 this figure was forecasted to increase to RM43.932 billion (£7.01 billion) and by 2003 it was forecasted to reach RM48.043 billion (£7.66 billion) (Economic Report, 2002-2003). This represents approximately 50 per cent of the total revenue of the Federal Government of Malaysia. For the year 2001, the biggest contributors to the collected income tax were the incorporated businesses, which made up about 52.53 per cent of the total tax collected (Inland Revenue Board, Annual Report, 2001).

^{1,2} £1 = approximately RM6.2699, based on the yearly average foreign exchange rates from IRB available at <http://www.hasilnet.org.my>.

In 2001, RM397.3 million (£63.36 million) were collected as back taxes from 748 investigation cases as compared to the years 1999 and 2000, where back taxes collected from the taxpayers for their various evasion schemes were RM407.36 million (£64.18 million) (688 cases) and RM428.14 million (£68.29 million) (672 cases) respectively (Inland Revenue Board, Annual Report). As there has been no obvious improvement in the process of collecting back taxes by the IRB, these figures suggest that the problem of taxpayer non-compliance is getting worse.

1.2 Motivations and purpose of the study

The motivations of the study are based on a recognition of the severity of the evasion problem, and the concomitant need for an increased understanding of the phenomenon and the problems associated with the activities of SMEs, since little, if anything, concerning this issue is yet known in Malaysia. In Cowell's (1985:163) view, *like pornography, the subject of tax evasion seems to arouse a mixture of outrage, guilty curiosity and incredulous admiration. It is in area about which one knows little but suspects much, and which perhaps one simply ignores in the majority of economic and social activities. One has held one's own personal experiences (minor, of course) or word-of-mouth accounts concerning the practice, and one's led to believe that there are people who are involved in it in a big way, yet one is not entirely clear how to fit it into the general pattern of life's above-board experiences. Official statistics are rare and it is not clear whether they should be believed anyway.*

Rice (1992) pointed out that despite the fact that corporation or business tax evasion has accounted for an increasingly large portion of total evasion, it has to date attracted nearly no scholarly analysis as compared to individual income tax evasion^{1.3}. One reason for such an imbalance in the development of this research direction is that the conceptual difference

^{1.3} Evidence from US tax, reformed in 1986, slowing the growth of individual income tax evasion, however not for corporate income tax. The IRS estimated ratio of the corporate tax gap to the gap for individual filers increased from more than 20 per cent through the early 1980s, to about 40 per cent in the 1990s (Rice, 1992:125-126). No precise figure available for Malaysia, however the fact that the increase in the collection of back duties cases are indicative of the tax evasion.

in an evasion decision between an individual and a business is hard to capture analytically. The reason is connected with the fundamental dilemma about empirical research on tax compliance; how much faith to place in the ability of financial audits to uncover and to accurately measure accurate corporate activity. Since corporations have strong incentives to avoid disclosing misconduct, any tax compliance data will invariably suffer from substantial measurement errors (Rice, 1992:126). Another reason is that essentially no corporate income tax compliance data has previously been made available to researchers, either in Malaysia or other countries, with the exception of the United States^{1.4}.

The purpose of this study is to present and analyse findings concerning the tax evasion activities of SME taxpayers in Malaysia, in an attempt to gain an insight into and explore possible influences on the phenomenon of tax evasion and the role of forensic accounting. The aim is to identify and define the characteristic behaviour of SME taxpayers and factors that influence SME taxpayers as well as the extent of tax evasion in Malaysia. In addition, another concern is to explore the actual and potential role of forensic accounting with the aim of improving current enforcement strategies in deterring tax evasion by SMEs. Most studies in Malaysia (for example, Wallschutzky and Singh, 1995; Kasipillai, 1998; Kasipillai, 2000) have explored the overall relationship between taxpayers' characteristics and taxpayers' compliance but none have focussed on SMEs^{1.5}.

In general, SMEs are susceptible to offences that result in compliance gaps (the difference between tax receipts based on voluntary reporting and what the tax authority views as the correct amount of tax due) and loss of revenue (Silvani, 1992). According to Tekper (2003), many SMEs do not voluntarily register and so widen the gap between actual and

^{1.4} Data became available for the first time in US in the mid 1970s as a result of extensive litigation under the Freedom of Information Act by Susan B. Long (Long and Swingen, 1991). Aggregate as well as individual data level Taxpayer Compliance Measurement Program (TCMP) data files (except those individual level data used in Discriminant Function (DIF) development) were released along with all internal analyses and reports. Prior to this litigation, the IRS had generally withheld even aggregate TCMP statistics, not only from the public but also from Congress and its government auditors. The same scenario applies in Malaysia, whereby data is still not made available to outside researchers and even the files of the investigation cases are completely withheld from the government auditors.

^{1.5} A recent study by Mottiakavandar *et al.* (2004) explored the compliance level of small businesses (sole proprietors and partnerships) with regard to their demographic profile and determined the level of taxpayers' knowledge of general tax laws. See Chapter 3 for literature review.

potential taxpayers at the early stage of the tax effort. Those who register often fail to keep adequate records, file tax returns or settle their tax liabilities promptly. When SMEs choose to evade taxes, they typically use unsophisticated methods. SMEs generally lack internal accounting and tax experts; consequently, they often rely more on outside professionals to deal with tax and accounting issues.

The attention given to SME taxpayers in Malaysia reflects the fact that SMEs are understood to represent an important breeding ground for large, profitable, tax-paying employers of the future and they experience high growth rates in comparison to large enterprises in the country's economic growth process and plans (Bank Negara Malaysia, 2003). In Malaysia, SMEs contribute an average of 50 per cent of the revenue collected by the tax authority each year (Inland Revenue Board, Annual Report 2001); SMEs currently represent more than 92 per cent of the total number of established businesses in the economy (Bank Negara Malaysia, 2003).

There is no universally agreed definition of an SME. According to the International Labour Organization, no single definition can capture all of the dimensions of 'small' or 'medium' business size, nor can it expect to reflect the differences between firms, sectors or countries at different levels of development. In this research, SMEs will be broadly defined to include directors of SMEs, management of SMEs, sole proprietors, partnerships and businesses within the Ministry of International Trade and Industry's definition of Small and Medium-Sized Industry Development Corporation (SMIDEC) by being companies having the following characteristics: (1) turnover of less than RM 25 million, (2) employee number not exceeding 150, (3) companies incorporated under the Companies Act 1965, including those registered under the Registrar of Business.

Findings by Bank Negara Malaysia (2003) indicate that 88 per cent of SMEs are family-owned businesses with 72 per cent being private limited companies. Directors, managers and owners are included in the scope of the SME category to reflect the practice of the tax authority of including SME entrepreneurs (owners, directors and managers) in most of the

back duty cases of the private companies, where a means test/net worth analysis is examined and unreported income is taxed and a penalty imposed.

1.3 Research questions

Due to the lack of current information about tax evasion by SMEs and forensic accounting in Malaysia, this research is an exploratory study. The less developed a research area, the more likely that an exploratory study design should be used (Adam and Schraneveldt, 1991). Since it is an exploratory study, it will be less structured, which permits the researcher to seek new insights. This does not, however, mean that it has lost its sense of direction or focus. Adam and Schraneveldt (1991) argued that the researcher must be constantly adapting, willing to change and open to revelations from the data. The flexibility inherent in exploratory research does not mean an absence of direction to the inquiry, rather the flexibility means that the focus is initially broad and becomes progressively narrower as the research goes on.

The research is carried out with three important areas of interest. First, to determine the existence, extent and impact of tax evasion by SME taxpayers in Malaysia so as to provide a better understanding of the subject matters. Second, to explore both the actual and potential role of the forensic accounting technique in detecting tax evasion. Third, to make some recommendations for improving the tax policies and tax administration with regard to the loopholes in the Malaysian income tax system, especially in deterring the tax evasion by SMEs. Thus, this study broadly addresses the following research questions:

(1) Gain insight into the extent and impact of tax evasion by SMEs in Malaysia.

(a) To what extent do SMEs commit tax evasion in Malaysia?

(b) What are the impacts of tax evasion by SMEs?

(2) Gain an understanding of cases of tax evasion by SMEs in practice.

(a) What are the characteristics of tax evasion by SMEs in Malaysia?

(i) Is tax evasion by SMEs in Malaysia cyclical or repetitive in nature?

(ii) Is tax evasion by SMEs in Malaysia characteristically deliberate (intentional) or accidental (unintentional) in nature?

(iii) What are SMEs' relationships with tax practitioners?

(b) What are the factors influencing tax evasion by SMEs in Malaysia?

(c) What are the approaches and methods used in tax evasion by SMEs in Malaysia?

(d) What are the roles of tax practitioners?

(3) To explore both the actual and potential role of forensic accounting in relation to tax evasion.

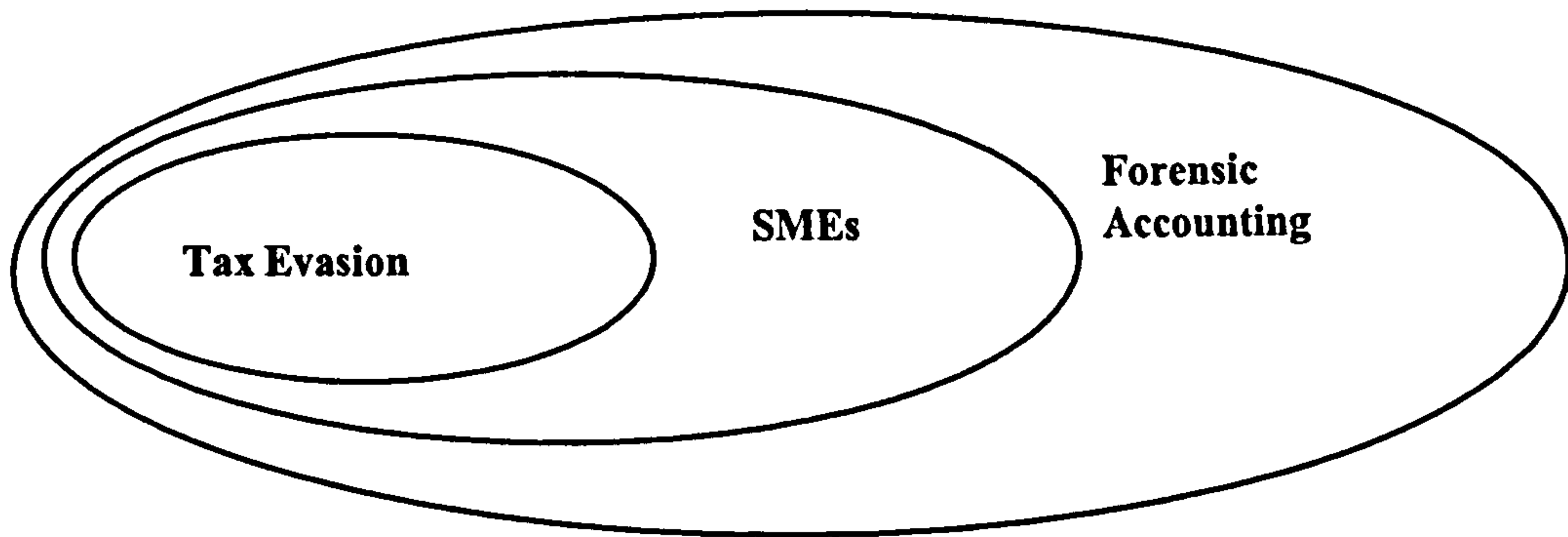
(a) What are the forensic accounting techniques for detecting tax evasion?

(b) To what extent can forensic accounting be relevant in detecting tax evasion by SMEs in Malaysia?

In addition, another concern is also to make recommendations for improving the tax system and current enforcement strategies, especially in deterring tax evasion by SMEs.

The broad objective of this study is, therefore, to study, examine and investigate the perceptions and expectations of different groups in society (SME taxpayers, tax practitioners, and IRB personnel) on the tax evasion by SMEs and forensic accounting – especially the extent and characteristics of tax evasion by SMEs, including factors influencing and approaches used by SMEs, the role and character of tax practitioners, the probability of detection, current methods used to detect tax evasion, methods of settlement, perceptions of the role of forensic accounting, and other possible ways forward. Figure 1.1 indicates the variables studied.

Figure 1.1
Imaginative framework of the study



1.4 Importance of the study

The main contribution of this research is the evidence concerning the preliminary analysis of tax evasion by SMEs in Malaysia. Whilst gaining an understanding of the existence, extent and the factors that influence compliance is an interesting exercise in itself, the research also attempts to locate ways that could possibly increase compliance, and thus increase revenue.

The findings of the research will give the government and IRB insight into future strategies to focus on the SME sector. The identification of the existence and extent of the evasion could enhance their knowledge and may be able to provide a base for a course of action to deal with tax evasion behaviour more effectively and efficiently. It is also believed that the findings of this study have relevance to other governments that will no doubt recognise the similarities that may exist and evaluate the suggested strategies accordingly.

To date, not much research material in published form is available for Malaysia, especially with regard to tax evasion by SMEs and the role of forensic accounting techniques. Hence, this research will fill a gap in the literature, especially in terms of the Malaysian perspective on tax evasion by SMEs and the role of forensic accounting.

1.5 Structure of the study

The opening chapter sets out clear objectives for this thesis, coupled with the direction of the research questions. It introduces the area of study, motives and the significance of the study.

Chapter 2 introduces the subject of Malaysian taxation. The Malaysian tax system is discussed, beginning with its history and then reviewing the current state of affairs. The importance of the Inland Revenue Board in Malaysia is described, together with its impact on tax compliance over recent years. The issue of tax compliance and tax evasion is also addressed, along with how it is affecting compliance behaviour in Malaysia.

To address the relationship between evasion and forensic accounting it was necessary to review both the evasion and forensic accounting literature. Chapters 3 and 4 discuss the subject matter critically. Chapter 3 is the first of the two literature review chapters. This chapter is devoted to a discussion of tax evasion, outlining the issue to date so as to develop an appropriate background for the research. The first section discusses conceptual issues dealing with the characteristics of the related ideas of tax evasion and tax avoidance. Next, the chapter reviews the behavioural studies, which suggest that the decision to evade taxes is sufficiently complex to merit the distinction between intentional and unintentional tax evasion and the description of tax evasion characteristics as either cyclical or repetitive in nature. The chapter also looks at the key studies that have been conducted to date in respect of SMEs. In addition, the issue of tax practitioners and how their role influences taxpayers as a whole is subsequently discussed. The chapter also discusses the issues of methodology with respect to research on tax evasion.

Chapter 4, the second of the two literature review chapters, seeks to examine the role of forensic accounting, tracing its origins, definition and significance in the taxation world and reviewing the current status in Malaysia with regard to the use of techniques or methods for detection by tax authorities. Unfortunately, the evidence from academia is scant.

Chapter 5 discusses in a broad context the methodological perspective of the research and statistical issues with a view to selecting and formulating an appropriate research framework for this study. The chapter begins with an overview of the research methodologies and a justification of the research design for the current study by outlining the research framework for data collection, data analysis and validation of research findings.

A multi-method approach is adopted, drawing on the strengths of both the quantitative and qualitative method and analysis. The quantitative method uses a randomised mail survey of SME taxpayers and tax practitioners, made possible with the co-operation of the Inland Revenue Board of Malaysia (IRB) and the Malaysian Institute of Accountants (MIA). The qualitative component was based on file data/actual case analyses from IRB documents and the views of IRB personnel that were expressed in the open-ended comments. Using different sources and methods strengthened each type of data collection and minimised the weaknesses of any single method. This helped in producing a more authoritative piece of research by increasing the strength of the research design.

Chapter 6 focuses on the findings based on the questionnaire surveys of tax practitioners and SME taxpayers (see Appendix I and II for the respective questionnaires). The first section encompasses the administrative aspect of the survey with an analysis of the response rate and non-response bias and reliability test. The chapter continues with the analyses, and interprets and summarises the tax practitioner survey results. The following section presents the SME survey results.

Chapter 7 presents the results obtained from the analyses of the actual cases taken from the Inland Revenue Board of Malaysia (IRB). Given the confidentiality requirements surrounding tax data due to the secrecy provision of section 138 of the Income Tax Act 1967, only certain data was made available for the analysis. The aim of the chapter is to establish an understanding of the practices within the IRB and SMEs with regard to tax evasion. Each section analyses data obtained from corresponding files with respect to the methods of detection and settlement by the IRB, approaches/methods used by SMEs for

evading taxes, and the degree of culpability. The information was gathered using a formatted sheet so as to ensure the systematic consistency of the collected data (see Appendix III).

Chapter 8 discusses the data drawn from open-ended questionnaire (see Appendix IV) responses from IRB personnel. The chapter examines the perceptions of IRB personnel on IRB stances and practical overviews of tax evasion by SMEs. It begins with a general view of tax evasion and SMEs followed by the current views on how the IRB emphasizes and recent trends in deterring tax evasion. Next the chapter explores the forensic accounting perceptions of the IRB personnel. The chapter also looks at their perspective on the recommendations and improvements suggested by the IRB.

Chapter 9 examines the research findings from the questionnaire survey, file data/actual cases and the opinions of IRB personnel. The chapter triangulates all of the results obtained within the context of the research questions. Due to its relatively recent emergence in Malaysia and as it has been the subject of numerous overviews by practitioners (mostly outside of Malaysia) rather than in the academic literature, discussions and implications on forensic accounting will, to a very large extent, fall back on the literature review in Chapter 4. Assumptions and limitations of the study are also highlighted so that observations are interpreted within a defined context.

The final chapter, Chapter 10, provides a summary of this study, conclusions obtained from conducting this study and an evaluation of the research. The first section presents a brief summary of the study. The next section provides conclusions obtained from conducting this research. Subsequent sections will focus on an evaluation of the research, i.e. recommendations to deter tax evasion by SMEs and suggestions for possible further research to yield more contributions to the on-going effort to learn more about tax evasion, especially by SMEs, and forensic accounting.

CHAPTER 2

THE EVOLUTION OF THE MALAYSIAN INCOME TAX

It is one of the empirical certainties of history that no structural society has ever arisen without taxation. The power of taxation is one which is particularly liable to abuse, either in the hands of an individual autocrat or of a sectional oligarchy such as may wield the sceptre of authority even under the forms of modern Parliamentary system; but without the power no Government, as we understand the term, is possible.

Isaacs J in R v Barger (1908) 6 CLR 41

2.1 Introduction

This chapter describes the Malaysian tax system, beginning with its humble history and then reviewing the current state of affairs. The role of the IRB is discussed, as is the impact it has had on tax compliance in recent years. Finally, the chapter also highlights the issue of tax evasion and how it is affecting compliance behaviour in Malaysia.

2.2 The Malaysian tax system

2.2.1 Historical background

There is no precise period when income tax was imposed in Malaysia. Income tax was, however, instituted by the head of the state or Sultan (King) in the civilization of the Sultanate era in the early sixteenth century; this tax was collected from individuals but the revenue so gained only benefited the royal family and nobility. Tax gathering of this nature continued intermittently until the early twentieth century: the British had made the Malayan peninsula part of the British colonies in the late nineteenth century.

According to Heasman^{2.1}, a bill 'for imposing a Tax on Income' was introduced by the Straits Settlements (comprising Singapore, Malacca and Penang) Legislative Council in 1910. The bill was so strongly opposed that it was withdrawn at its second reading in January 1911.

^{2.1} Appointed by the Secretary of State for the Colonies to advise the Malayan Government on the subject of Income Tax in 1946.

No further public reference to income tax appears to have been made until June 1916, when, in the course of a debate in the Legislative Council on a motion to make contributions towards Imperial War Expenditure, a proposal was put forward to supplement the contributions by means of the proceeds of an income tax. Toward this purpose, the War Tax Ordinance was introduced and remained in force up to the year 1919. In 1920, the War Tax Ordinance was converted to an income tax, which was re-imposed in 1921 and 1922. The proceeds continued, wholly in 1920 and partly in 1921, to be used for war purposes, however, but when in 1922 it was proposed to retain the tax as an income tax pure and simple for the general revenue purpose of the Colony, public agitation brought about its removal. This resulted in the premature repeal of the income tax in that year until 1940.

The first modern income tax was introduced during 1941 in the Federated Malay States (as Malaysia was then known) in order to pay the expenses of the Second World War. At this time, the Federated Malay States only comprised four of the British Protected States of the Malayan Peninsula. Although the tax was to be renewed in 1942, apparently the bill, which had been prepared and passed, never became law, as the Japanese occupied the Malayan Peninsular from 1942 to 1945. After the Malayan Peninsular was liberated, the nine British Protected States and two remaining British Colonies of the Malayan Peninsular were united to form the Malayan Union in 1946.

Subsequently, an income tax was introduced in the Malayan Union in order to raise revenue for reconstruction of the country after the Second World War. A report regarding the practicability, administration and draft legislation for an income tax was provided by an advisor appointed by the British Secretary of State for the Colonies (R.B. Heasman, 1947). The income tax, known as Income Tax Ordinance 1947, was introduced in the Malayan Union, still under British protection, in 1947, and has remained part of Malaysian law ever since. The provisions of the ordinance were based on the Model Colonial Territories Income Tax Ordinance 1922, which had been designed for the British Colonies. As such, common traits exist to this day in the tax legislation of Malaysia and Commonwealth countries (for example Singapore, India, Australia and South Africa).

The Malayan Union became the Federation of Malayan in 1948 but did not secure independence from Britain until 1957, when it became an independent nation. The

Federation of Malaya was expanded in 1963 to include the two British colonies of Borneo (Sabah and Sarawak only) and the British colony of Singapore (which thereby gained their independence from the British) forming the Federation of Malaysia, although Singapore separated in 1965. The Ordinance survived these changes, even though the states admitted to the Federation in 1963 brought their own income taxes with them.

The income tax laws of the Federation of Malaysia, however, were unified in 1967 to become a single statute, which remains the basis of the present Malaysian income tax system. This was in the form of the Income Tax Act of 1967, which came into effect in January 1968. The Act actually consolidated the three laws of income taxation which were then in existence, the Income Tax Ordinance 1947, which was only applicable in Peninsular Malaysia, the Sabah Income Tax Ordinance 1956, which was applicable only in Sabah, and the Sarawak Inland Revenue Ordinance 1960, which was applicable only in Sarawak.

2.2.2 The philosophy and rationale of taxation

Taxation in its various forms has existed since mankind began organising itself into civilised communities. The Organisation for Economic Co-operation and Development (OECD) (1992:29) defined the tax as the compulsory, unrequited payments to general government. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payment.

Most tax scholars believe that for a tax system to work there has to be some consensus and consent on the part of the taxpayers. They believe that if taxes are compulsory, people need to feel that they have some say when decisions are taken to change them.

In terms of a need for taxes, Wilkinson (1992:5) argued that real taxation is necessary to reduce the private sector claims on an economy's resources so that they can be released for use by the public sector in a non-inflationary way. This is the allocation role of taxation. The market does not provide certain essential goods, or either over or under provides, so the public sector must correct this misallocation and taxation is one half of the process, while public spending and provision is the other half. Taxes are also used to redistribute

income and for Keynesian macro-economic policy, they have a role to play in the management demand in the economy.

The philosophy and rationale for the collection of tax in Malaysia is similar to that adopted in most of the countries in this world. When the Governor General of the Straits Settlement of the Malay States first mooted the idea of establishing a modern taxation system in the then British Colony Malaya, it was with the feeling that it was the moral obligation of the colonial government to develop the country into an advanced, civilised region. In this respect, income tax system is seen as a means to generate income for the purpose of spending by the government to meet expenses for development of education, health, roads, transport and the like (SGATAR, 1984). The Income tax system in Malaysia is also based on the philosophy of the distribution of wealth, whereby a portion of people's income is made available to the government through the collection of taxes from the public. The revenue collected is then distributed amongst the public in ways such as providing support to pensioners, the unemployed, the sick and other welfare beneficiaries. In fact, the practice is intended to reduce the inequalities of income between income earners while at the same time not victimising any group of the public (MIER, 1989).

In theory, the Malaysia tax system has integrated income taxes with *Zakat*^{2.3}. This is based on the tax statute that allows zakat payment to be credited against income tax. The system is, however, still deficient in that the assessment and timing of collection are not parallel. Effort is being made to appoint the IRB as the official *amil*^{2.4} or zakat collectors, to be paid fees amounting to as much as one eighth of the total collection, though this will need some reconciliation of the law since zakat is governed by the state government under the Islamic Councils headed by the Sultan.

^{2.3} Muslims are required to pay a flat rate of 2.5 per cent of their income/wealth to the Islamic Religious Councils. Administration of the Zakat system is governed by the Sultan as the head of the religious councils in each state.

^{2.4} A person who is authorised to collect zakat.

2.2.3 Types of taxes

The types of taxes imposed by the Malaysian Government can be divided into two broad classifications, direct and indirect taxation. The responsibility to administer direct taxation lies with the Director General of the Inland Revenue Board (DGIR), while the Director General of the Royal Customs and Excise Department administers indirect taxation.

Tax revenue continues to be the main source of income for the Malaysian Government as the country continues to experience rapid growth. In 2001, 52.5 per cent of the total Federal Government revenue was from direct taxes, the remainder being indirect taxes and non-tax revenue^{2.2} (Table 2.1).

Table 2.1
Federal Government of Malaysia Revenue (2001)

	RM (£) billion	Percentage
Direct taxes	41.8(6.67)	52.5
Indirect taxes	19.4(3.09)	24.4
Non-tax revenue	18.4(2.93)	23.1
Total revenue	79.6(12.69)	100

Source: IRB Annual Report (2001)

Corporate income tax is the largest source of direct taxes in Malaysia, followed by petroleum income tax. In 2001, corporate income tax constituted 51.6 per cent of total direct taxes (Table 2.2).

^{2.2} Non-tax revenue includes royalties from the petroleum sectors, collection from licences, permits, road tax and registration fees.

Table: 2.2**Source of Direct Taxes (2001)**

	RM (£) billion	Percentage
Corporate Income Tax	21.6(3.45)	51.6
Petroleum Income Tax	9.9(1.58)	23.6
Personal Income Tax	8.4(1.34)	20.1
Other Direct Tax	1.9(0.30)	4.7
Total Direct Tax	41.8(6.66)	100

Source: IRB Annual Report (2001)

Direct taxes collected in 2001 amounted to RM41.8 billion (£6.66 billion) compared to RM29.1 billion (£4.64 billion) in 2000, an increase of approximately 30.4 per cent (Table 2.3), this being largely due to more efficient and effective programmes comprising payment schemes, tax assessment and debt management (IRB, Annual Report, 2001). This amount accounts for 52.9 per cent of the Federal Government income for 2001, thus illustrating the importance of direct taxes to the Government.

Table 2.3**Trend in Revenue Collection from Direct Taxes* (1991 - 2001)**

Year	RM (£) Billion	Percentage to Govt. Fund
1991	13.2(2.11)	38.9
1992	15.4(2.46)	39.2
1993	17.2(2.74)	40.9
1994	20.1(3.21)	41.0
1995	22.6(3.60)	45.0
1996	25.8(4.11)	45.7
1997	30.5(4.86)	48.2
1998	29.9(4.77)	46.8
1999	27.1(4.32)	47.8
2000	29.1(4.64)	45.9
2001	41.8(6.66)	52.9

Source: IRB Annual Reports (Various years)

* Direct taxes include non tax revenue

2.2.4 *Basis of income tax in Malaysia*

The basis of income taxation in Malaysia is limited by the principle of territoriality or derived scope. Income is only assessed if it is derived from Malaysia or remitted to

Malaysia from overseas^{2.5}. Resident companies are not chargeable for income tax with respect to foreign sourced income^{2.6}. Non-resident are liable for tax only with respect to income having a source in Malaysia^{2.7}. The income tax rate has been on a steady downward trend since 1987, for corporate income tax rates from 40 per cent to the current 28 per cent. This rate is applied with respect to the taxable income of both resident and non-resident companies. However, certain incomes of non-resident companies are subject to a withholding tax, for example interest, royalties, rents, and service and management fees. Withholding tax rates vary between 10 per cent and 15 per cent and may be further reduced under a double tax treaty^{2.8}. Resident individuals are subject to income tax at graduated rates, ranging from zero per cent to 28 per cent, on their chargeable income within the relevant range. A non-resident will, however, be taxed at a fixed rate of 28 per cent on his/her chargeable income.

Section 3 of ITA 1967 imposes income tax upon any person on income accruing in or derived from Malaysia. A person includes a company, a body of persons or a corporation sole^{2.9}. While income is not precisely defined in ITA 1967, section 4 sets out six sources of income chargeable to tax, as per Figure 2.1. The sources include profits from business; in this case, Malaysia uses a net income concept, generally based on financial statements. Income derived under section 4 is referred to as "gross income". Gross income is adjusted under Chapter 4 of Part III; section 33 providing for certain deductions (including the deduction of expenses wholly and exclusively incurred in producing taxable income) and section 39 for specific non-allowable deductions. Other expenses may be deducted if considered ordinary expenses of trading. Income after allowable deductions and certain

^{2.5} ITA 1967 s. 3.

^{2.6} ITA 1967 s. 3C. An exception exists in the case of banking, insurance and air or sea transport operations. With respect to such operations, residents may be assessed on their worldwide income (whether remitted to Malaysia or not); ss. 54(2), 60B and 60C. However, various incentives may be available with respect to such operations.

^{2.7} ITA 1967 Schedule 6 Part I paragraph 28 exempts non-residents with respect to foreign sourced income.

^{2.8} Withholding tax is generally imposed by ITA 1967 ss 109 – 109B. Withholding tax rates are set out in Schedule 1 Parts II and V and based on gross payments. In the case of contract payments to non-residents or services rendered in Malaysia, the withholding tax is not a final tax. Non-resident contractors will need to file a tax return and set tax withheld against any tax assessed; s 107A.

^{2.9} ITA 1967 s. 2.

capital allowances granted under Schedule 3 is referred to as “statutory income”. All sources of statutory income are aggregated and certain other amounts deducted (including provision for losses) to arrive at “total income”. Finally, taxable or chargeable income equals total income less certain personal reliefs.

In addition, tax is also chargeable on special classes of income under section 4 of the ITA, 1967: (1) amounts received by non-residents in consideration of services rendered in connection with the use of property or rights belonging to or the installation or operation of any equipment purchased from that non-resident; (2) amounts received by a non-resident in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; and (3) rent or other payments (excluding film rentals subject to film hire duty) to a non-resident under any agreement or arrangement for the use of any moveable property.

Personal income tax is imposed on individuals either employed in their capacity or as individuals operating businesses as sole proprietors and also as partners in any partnerships. Under the ITA, income that is subject to tax not only includes business and employment income but also unearned income such as rent, dividends, interest, royalties and premiums.

Figure 2.1

Chargeable Income under section 4 of Income Tax Act 1967

Section 4(a)	Gains or profits from a business, for whatever period of time carried out;
Section 4(b)	Gains or profits from an employment;
Section 4(c)	Dividends, interest or discounts;
Section 4(d)	Rents, royalties or premiums;
Section 4(e)	Pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs;
Section 4(f)	Gains or profits not falling under any of the foregoing paragraphs.

Source: Income Tax Act 1967

2.2.5 Tax collection and administration problems

Under the previous system, at the end of accounting year, every taxpayer was responsible for preparing the necessary documents required by the law, completing a tax return,

calculating the tax liabilities and submitting the return to the IRB. The IRB assessed the reported information on every return to determine the amount of tax that should be paid by taxpayers and a Notice of Assessment was issued. Taxpayers were obliged to settle their tax liabilities within 30 days of the issuance of the Notice of Assessment. However, if taxpayers failed to submit their returns, the IRB was empowered to determine those taxpayers' chargeable incomes according to their best judgement and make an assessment accordingly^{2.10}.

The assessment functions of the IRB are subdivided into three broad categories: (1) assessment based on tax returns without any queries; (2) assessment made after some form of field audit or desk audit - written queries are made and taxpayers are expected to respond in writing before assessments are raised and reviewed; and (3) investigation of cases on a selective basis.

The self-assessment system (SAS) has now been implemented in Malaysia; the implementation occurred in stages up to the year 2004, when it became fully operational^{2.11}. Under the SAS, taxpayers are expected to comply voluntarily with their obligations under the tax law. The concept of taxpayers protecting themselves by making full and correct disclosure in lodging their returns is no longer possible; rather, taxpayers are expected to determine their taxable income, compute tax payable and submit tax returns to the IRB. For the IRB, this is a shift in focus away from the examination of returns and the computation of tax liabilities to reviewing, auditing and investigation work.

The broad rationales for the SAS of taxation in Malaysia include the following factors (Singh and Bhupalan, 2002): (1) to improve compliance by taxpayers; (2) to speed up the assessment process; (3) to reduce compliance cost; and (4) to facilitate collection of taxes. Each of these factors naturally follows from the others. Where taxpayers are tax compliant, this would invariably result in a swifter assessment process, which would in turn reduce both the taxpayer's and the tax authority's compliance and administrative costs. The end result would facilitate swifter and easier collection of taxes by the authorities.

^{2.10} ITA 1967 ss. 90(2)

^{2.11} See footnote 1.1

2.3 The Inland Revenue Board of Malaysia (IRB)

Organisational changes were made with effect from 1st March 1996 when the tax authority in Malaysia became a statutory board (previously known as Inland Revenue Department [IRD]). The aim of converting the IRD to the IRB was to give the latter more autonomy and flexibility of operation. Such a move was aimed to improve the quality and effectiveness of income tax administration in Malaysia, for which the IRB became responsible under the overall direction of the Ministry of Finance. The purpose of the IRB, according to the Inland Revenue Board of Malaysia Act 1995 (ACT 533), is to act as an agent of the Government and to provide services in administering, assessing, collecting and enforcing payment of income tax, real property gains tax, estate duty, stamp duties and such other taxes as may be agreed between the Government and the Board; to advise the Government on matters relating to taxation and to liaise with the appropriate ministries and statutory bodies on such matters; to participate in or outside Malaysia in respect of matters relating to taxation; and to perform such other functions as are conferred on the Board by any other written law.

The IRB's strategies plan for compliance set out two objectives to achieve voluntary compliance. The first strand of their approach to encourage voluntary compliance was to make the system easy for the public to understand and aimed to minimise opportunities for error or abuse. The second strand was aimed to help taxpayer accuracy. The IRB continue to be guided by the principles laid down in the Taxpayer Charter when dealing with the public. These principles were later endorsed by key themes, which guided their management planning (set out in IRB) and their compliance strategy.

The other theme of the IRB compliance strategy was to deter and tackle tax evasion. The task was entrusted to the Investigation and Intelligence Division of the IRB. The Director General of the Inland Revenue, who is directly assisted by the four Deputy Director Generals, heads the Investigation and Intelligence Division.

The general operations of the IRB are highly decentralised and there are currently 36 branch offices located throughout Malaysia, headed by State Directors, carrying out the operational functions of the IRB. Most branches have an Investigation and Intelligence

Centre and depending on the size of the branches and the concentration or density of taxpayers, are staffed by experienced officials.

The IRB perceives that the tax law places a number of important obligations on the public. Clearly the fairest and most efficient way of running the tax system is for everyone to meet his or her obligations voluntarily and in full. There are, however, some who do not, either deliberately or through error or misunderstanding. Where this occurs, the IRB acknowledges that it has a duty to the majority to take suitable actions to put matters right. The IRB also has a responsibility to demonstrate to others who may be considering evading their proper liabilities that the risk of evasion is not worth taking.

2.4 Compliance activity

Roth (1989a:2) pointed out that compliance with reporting requirements means that the taxpayers file all required tax returns at the proper time and that the returns accurately report tax liabilities in accordance with the regulations applicable at the time the tax returns are filed. Under this definition, both underreporting and overreporting are forms of non-compliance. Misclassification that does not affect the reported tax liability is not treated as non-compliance.

The policy of the IRB is to achieve as far as possible voluntary compliance with the ITA 1967. The ITA 1967 provides for varying penalties, fines and periods of imprisonment for tax evasion in order to demonstrate that understatement of income does not pay in the final analysis. The penalties also provide compensation to the government for having been deprived of revenue due to deferred tax payment. As mentioned earlier, the special task of investigating or monitoring suspected cases of tax evasion is entrusted to the Investigation and Intelligence Unit. The main objective of an income tax investigation is to trace understatement or unassessed income by examining books of accounts and other primary records or documents. The initial task of an investigating officer is to establish that the income in the taxpayer's books is taxable and that the evader has failed to declare it in the tax returns. The officer would then have to obtain all evidence to show that the omission is wilful with intent to evade.

In determining whether or not to investigate, it is clear that the powers vested with the DGIR must be used for the purposes of the ITA, 1967. Nevertheless, there are several factors that the DGIR would take into account. According to Kasipillai (1998) and from experience, it has been noted that several factors are taken into account. The DGIR would take into account the cost to the taxpayers as a whole of having resources tied up and expended in a normally prolonged detailed investigation. A heavy-handed approach would attract an adverse response from certain taxpayers with vested interests. The DGIR would also have to demonstrate that certain persons are not above the law of the land. Press releases highlighting tax evasions are necessary to ensure that the public believes that taxpayers, irrespective of their status, comply with the law as it stands. The cost and likely benefits to raise revenue are also considered by the DGIR. The upgrading of computers and the use of sophisticated hardware have raised efficiency and reduced the cost and time factors in carrying out investigation work. Such a move has had the effect of increasing the productivity of the investigating staff and boosting revenue.

It has become increasingly clear that non-compliance with income tax regulations seriously impairs the capacity of the government to raise public revenue. Tax evasion is, however, extremely difficult to investigate. Nevertheless, analysts have relied upon divergence between income and expenditure estimates of Gross Domestic Product (GDP) as a measure of the extent of tax evasion. A recent study by Schneider and Enste (2000) estimated that between approximately 38 and 50 per cent of GNP escapes legitimate taxation in Malaysia^{2.12}. Kasipillai (2000) used the monetary demand approach of Tanzi (1983) to develop a plausible estimate of the size of the hidden economy and the extent of tax evasion in Malaysia for the period 1971 to 1994. Estimates of the size of this tax evasion range from 8.7 per cent of the GNP in 1980 to a low of 3.7 per cent in 1993, with tax evasion accounting for an average of just over 20 per cent of actual income tax collected over that period.

^{2.12} The study was based on the average of 1990-1993 using the physical input (electricity) and currency demand approach. The study assumed that world economic activity and electricity consumption appears to correlate relatively closely. A percentage increase in electricity consumption indicates a similar percentage increase in economic activity. Thus, electricity consumption can be used as a proxy measurement for the size of the economy. By subtracting the size of the official economy from the estimated size of the economy based upon electricity consumption, an estimate of the size of the tax evasion/underground economy can be obtained.

Some critical views by way of background to the extent of tax evasion are worth mentioning. Although precise figures are difficult to obtain, the following are indicative of the problems of tax non-compliance in Malaysia.

- The total number of taxpayers investigated in 1991 and 2001 were 429 and 748 respectively. The 2001 figure reflects an increase of approximately 43 per cent compared with 1991. However, the back duty taxes and penalties collected in 2001 relative to 1991 were greater by 47.1 per cent (Table 2.4).
- In 2001, 33.5 per cent of 2.85 million tax returns issued to taxpayers were not returned (IRB, Annual Report, 2001). While this fact does not necessarily imply non-compliance (for example, there may have been duplication of files or taxpayers may have passed away), some non-compliance may be indicated.

Table 2.4
Additional tax and Penalties Recovered (1996 - 2001)*

Year	No. of cases settled	RM(£) Million
1991	429	207.1(33.0)
1992	341	267.8(42.7)
1993	454	210.2(33.5)
1994	485	251.1(40.1)
1995	504	261.4(41.7)
1996	504	426.1(67.9)
1997	514	509.8(81.3)
1998	609	362.1(57.7)
1999	688	407.4(64.3)
2000	682	428.1(68.3)
2001	748	397.3(63.4)

Source: IRB Annual Report, Various Issues

*These are the back duties taxes cases only.

- In 1996, fines imposed by the court for failure to furnish tax returns were RM826,377 (£131,800), reflecting a decrease of RM140,525 (£22,412) from the year 1995 (Table 2.5). However, the compound fees collected in 1996 were RM4,874,331 (£777,417.66), reflecting an increase of RM1,097,403 (£175,027.19) or a 29 per cent increase from

1995^{2.13}. The substantial increase in compound fees collected, averaging 26 per cent annually over the four-year period up to 1996, indicates the seriousness of the IRB's efforts to curtail tax evasion^{2.14}.

Table 2.5
Number of cases prosecuted and compounded*

		1992	1993	1994	1995	1996
No. of cases prosecuted		5,463	5,242	4,421	3,847	2,976
No. of cases compounded		9,680	12,036	11,541	14,634	15,980
Total		15,143	17,278	17,278	18,481	18,856
Penalties imposed by Court	RM	895,856	933,654	1,280,055	966,902	826,377
	(£)	142,882	148,910	204,158	154,213	131,800
Compounded fees	RM	1,883,751	2,382,313	2,260,005	3,776,928	4,874,331
	(£)	300,443	379,960	360,625	602,878	777,790
Total	RM	2,779,607	3,315,967	3,900,060	4,743,928	5,700,708
	(£)	443,325	529,123	622,326	756,981	909,653

Source: IRB Annual Report (1992 to 1996)

* These are non-compliance cases such as failure to file a tax return; failure to pay taxes which are due and related document not submitted by the lodgment dateline

Whatever the extent of tax non-compliance, according to Cowell (1990) it must be studied as a growing part of economic activity that is not recorded in official accounts of national income, national expenditure or national output. To that extent, it conceals the volume of national economic activity, the distribution of income, and the distribution of factors of production between activities according to the ease or difficulty of tax non-compliance. What must also be taken into account is the attitude of citizens as employers or employees, spenders, producers and consumers, and all of these will be influenced by their attitude to the extent to which they distributed between legal/illegal and the moral/immoral aspects of tax non-compliance.

^{2.13} More recent data has not been made available by the IRB in the Annual Reports.

^{2.14} Compounding fees refers to the DGIR's powers to charge a person a certain amount of money as deemed fit, thus absolving the need to resort to the courts.

In terms of the causes of tax non-compliance, these are disputable. They range from a supposed general degeneration in moral standards to the increase in rates of taxes since the Second World War to meet expenditure that is evidently increasingly not approved by taxpayers. Taxpayers filing income tax returns are classified as non-compliant if they either underreport income or exaggerate deductions. Taxpayers also vary in terms of the opportunities available to them to conceal income or declare unwarranted deductions without risking detection.

2.5 Summary

This chapter has examined at the development of taxation in the Malaysian tax system, the current state of affairs and its administration, and the importance of the IRB to the Government in collecting revenue. Following this brief account, which is intended to give a basic understanding of the nature of the tax system, the IRB's role and the issue of tax evasion and how it affects compliance behaviour in Malaysia, the next chapter focuses on a literature review so as to develop the appropriate background for this research.

CHAPTER 3

UNDERSTANDING TAX EVASION

Three things in life are definite: Death, Taxes and Mankind's pursuit to evade both

Klepper and Nagin (1989)

3.1 Introduction

Chapter 3 is the first of the two literature review chapters and is devoted to the discussion of tax evasion, outlining the issue to date so as to develop the appropriate background for the research. This discussion will help to establish a structure for the current study and identify findings of previous studies relevant to the study being undertaken. The opening section of the chapter discusses conceptual issues dealing with the characterisation of the related ideas of tax evasion and tax avoidance. The chapter then reviews behavioural studies that suggest that the decision to evade taxes is sufficiently complex to merit the distinction between intentional and unintentional tax evasion. The chapter continues with a review of cycles and the repetition process in determining the nature of tax evasion. Understanding the process is essential for understanding the nature of tax evasion as well as the nature of the entire auditing/investigating function of the tax authority. The chapter then looks at key studies that have been undertaken to date in respect of SMEs, and highlights essential considerations. The later part of this chapter describes the role of tax practitioners and their decision-making processes, and highlights certain factors associated with the influence of tax practitioners on compliance activities. A number of methodological considerations are also raised in the following section, so that past studies and the present study can be put into context and compared without bias. Finally, a summary remarks of the chapter is provided.

3.2 Tax Evasion: Background and definition

According to Franzoni (1998), probably no aspect of tax compliance has escaped at least preliminary scrutiny. It is a major concern for all governments, and analytical investigation of tax evasion can be traced as far back as the work of one of the

pioneers of 'law and economics', Cesare Beccaria (1764)^{3.1}. The modern analysis of tax evasion was introduced in 1972, when the seminal article by Allingham and Sandmo (1972) was published. They applied the economic theory of criminal behaviour by Becker (1968) on law enforcement to taxation using modern risk theory that describes the decision on whether and to what extent to evade taxes^{3.2}. This model has since been the basis for subsequent economic literature concerning tax evasion.

3.2.1 *What is tax evasion?*

The notion of tax evasion could be expected to seem quite evident, but this is not actually the case. There are many grey areas where the dividing line is not clear and sometimes the tax authorities may inappropriately characterise particular cases as either evasion or avoidance (Slemrod and Yitzhaki, 2000). It should be emphasized that tax evasion differs from such concepts as tax avoidance. The Oxford English Dictionary defines evasion as *the action of evading or escaping as by artifice or contrivance, escape, dodging, prevarication, shuffling, excuse or subterfuge*, while avoidance is defined as *to keep oneself from or refrain from*. In general, most tax literature refers to tax evasion as the underreporting of taxable income with the intention to escape taxes. Taking advantage of tax law by exploring loopholes in the law is described as tax avoidance.

In the absence of a statutory definition, the literature often distinguishes between tax evasion and tax avoidance. The two most illustrative and elucidating ideas from the literature are arguably those of Kay (1979, 1980) and Cowell (1990).

^{3.1} Cited in Franzoni (1998). Detailed article "Of Crimes and Punishments" available online at http://www.constitution.org/cb/crim_pun.htm.

^{3.2} Allingham and Sandmo were primarily interested in whether higher tax rates generate more or less compliance. Their answer, while intuitive, illustrates the difficulties and subtleties of studying tax compliance (Andreoni *et al.*, 1998). Becker outlined his premise that people decide whether to commit a crime by a comparison of benefits and costs.

Kay (1980:136) pointed out that *evasion is concerned with concealing or misrepresenting the nature of a transaction; when avoidance takes place the facts of the transaction are admitted but they have been arranged in such a way that the resulting tax treatment differs from that intended by the relevant legislation...the incidence of evasion is therefore a function of the mechanisms by which tax is assessed and collected and the extent to which they can be controlled or monitored: the incidence of avoidance is a function of the tax base and depends on the extent to which legislation is successful in expressing the underlying economic concepts. Avoidance depends on the base, evasion on the assessment procedures.* However, Kay also argued that there still remains the area of transaction, which lies in between the two – the intention or reason for the taxpayer's action as perceived by the tax authority. This is bound to create difficulties for the tax authority and offers scope for distortion and misrepresentation of activities by taxpayers.

Cowell (1990) considered three approaches in distinguishing tax evasion from avoidance. First, the legal distinction between the two is unambiguous: tax avoidance is any legal method of reducing one's tax liability, while tax evasion is an illegal means of not paying tax or reducing one's tax liability. Second, the moral distinction is regarding what is legal to be moral and what is illegal to be immoral. The tax authorities' and taxpayers' judgements will then be to interpret the other's intentions – one side to enforce the law and the other side to try to reduce their tax liability. It can sometimes be argued that certain types of avoidance are just as morally wrong as evasion and therefore should be treated in the same way as evasion. Third, evasion and avoidance are just two arbitrary segments of a continuum that stretches from innocent tax planning to outrageous fraud^{3.3}. Cowell, however, pointed out that the legal distinction differs in specification and interpretation from country to country, moral views are difficult to translate from vague generalities to specific concepts of economic analysis, and the continuum thesis may be pressed almost to the point of vacuity.

^{3.3} Since taxation is not always precise, Seldon (1979:4) introduced a term tax "avoision" so as to explain further the blurring between tax avoidance and evasion and the loss of definition between the legal and moral. It is tax minimisation with elements of both avoidance and evasion practised by the taxpayer who has difficulty in equating the legal with the moral and illegal with the immoral.

Lewis (1982), however, pointed out two major distinctions within tax evasion itself that need to be looked at; namely evasion by commission versus evasion by omission and that between intentional and unintentional evasion (this will be discussed in a later section). Evasion by commission requires some positive actions on the part of the taxpayer, for example claiming deductions for non-existing expenditure. However, evasion by omission requires a negative action on the part of the taxpayer, such as not reporting all income or a certain amount of taxable income. These give rise to the differences between intentional and unintentional evasion. Thus, the actual tax assessed may depend on the income the taxpayers choose to report, which may not necessarily be the same as their true legally taxable income, so long as they go undetected or where no actions are taken by the tax authorities.

A certain degree of disagreement not only persists about the dividing line but also concerning the extent of tax evasion. Estimations of the extent of tax evasion have been indirect and open to a great deal of error, as there are no best or accepted approaches, with each approach having its own specific strengths and weaknesses (Lewis, 1982). Thus, interpretation must be cautious depending on the technique adopted and the country, as the size, causes and consequences of tax evasion vary (e.g. Tanzi and Shome, 1993; Andreoni, 1998; Schneider and Enste, 2000).

In Malaysia, the ITA, 1967 spells out, under section 114, the following actions of a person^{3.4} as wilful evasion of tax; namely, if the person omits from a tax return any income that should be included, makes a false statement or entry in a tax return, gives a false answer (oral or written), prepares or maintains false accounts or records, falsifies accounts or records, or makes use of any fraud (section 114 will be discussed in more detail in Chapter 4).

Further, under section 113 of the ITA, 1967, any person making incorrect returns by omitting or understating any income is considered to be committing an offence

^{3.4} Section 2 of ITA 1967 defines a person to include a company, a body of persons and a corporation sole.

unless the taxpayer satisfies the court that an incorrect return or incorrect information was made or given in good faith.

The Malaysian taxpayers, however, are at a disadvantage when their actions come very near to the dividing line between tax evasion and tax avoidance. It appears that the Director General of the Inland Revenue (DGIR) has been given the discretion to draw the elusive line that divides tax avoidance and tax evasion. Under section 140 of the ITA, 1967^{3.5}, the DGIR has the power to disregard certain transactions where he has reason to believe that any transaction has the effect of altering the incidence of tax which is payable, relieving any person from any liability to pay, or evading or avoiding any liability to pay tax. The DGIR appears not only to have the power to act against tax evasion, but he seems also to have the power to act even against tax avoidance (Section 140(1)(c)). The principle established on this legislation is that all transactions must be carried out for *bona fide* commercial reasons or in the ordinary of a business. Nevertheless, the actual tax assessed may depend on the income the taxpayers choose to report, which is not necessarily the same as their true legally taxable income (Reinganum and Wilde, 1985), so long as they go undetected or where no actions are taken by the tax authority.

3.2.2 *Factors influencing taxpayer behaviour in evading taxes.*

There is no easy answer to what influences a taxpayer to evade taxes. Ahsan (1995) outlined the following factors as significantly influencing tax evasion in developing countries:

Rationality. People are assumed to be rational decision makers if they are able to perceive the feasible set of alternative courses of action and then to choose the one that is expected to give them the maximum level of utility. Rational tax evaders

^{3.5} Section 140 of ITA 1967 states that where the DGIR is of the opinion that any transaction has a direct or indirect effect of:-

- (a) *altering the incidence of tax payable or suffered by any person;*
- (b) *relieving any person from any liability which would otherwise have arisen to pay or make a return;*
- (c) *evading or avoiding any duty or liability which is imposed or would have been imposed on any person;*
or
- (d) *hindering or preventing the operation of the Act in any respect.*

maximise certain things; expected net income after taxes and penalties, or utilities thereof. The traditional expected utility approach to tax evasion decisions is based on the comparison of these benefits and the costs of the crime for the evader. In other words, a rational individual compares the expected utility of the benefits from successful tax evasion with the prospect of being detected and having to bear the consequences (Alm *et al.*, 1992c). Under this premise, to pass up any gainful evasion opportunity would simply violate the axioms of choice, and hence would be irrational. The decision to evade taxes is always made under uncertainty. If someone decides to evade taxes, there is a risk of being detected and punished. The tendency of people to take risks varies between individuals, and therefore people may react very differently in similar decision-making situations. People can be categorised roughly into three groups according to their attitude towards risk taking: (i) risk averse, (ii) risk neutral, and (iii) risk loving. If someone makes his decisions purely on the basis of the expected utility of different alternatives, he is risk neutral. Usually it is assumed that most people are risk averse in their decisions, and therefore they require a higher level of expected utility in order to take risks. Because of this, highly risk-averse individuals are not very likely to evade taxes for fear of punishment.

Psychological Elements. There is a feeling in many quarters that taxpayers differ in the sense of stigma attached to evasion and follow-up investigation, charges and penalties. A survey of the literature on attitudes also reveals that evasion is more likely among those who feel that they pay an unfairly high level of taxes (Witte and Woodbury, 1985). Resistance to paying taxes has been argued to reflect the taxpayer's doubt that public revenue has a visible and concrete social or national objective (Herschel, 1978). Taxpayers' views on this subject would vary, presumably depending on their income and wealth as well as their political orientation.

Administrative and Legal Aspects. Complex tax laws or codes can add to the burden of compliance with the law and encourage evasion. Long and Swingen (1988) outlined five general propositions for the role of legal complexity in shaping taxpayer compliance. First, legal complexity is a causal factor of first rank with a

major influence upon the taxpayer. This proposition was tested by using IRS official estimates from its TCMP survey against defined complexity measures. It was found that legal complexity accounted for approximately 40 per cent of the variation in the incidence of reporting errors. Second, legal complexity reduces taxpayers' ability to comply by making the task more difficult and expensive, while reducing taxpayers' willingness to comply by reducing the moral force of the law. Third, legal complexity impacts upon compliance both directly and indirectly by mediating the role played by other variables. For example, complexity mediates the impact of structural opportunity as well as the role played by tax practitioners in the compliance process. Unintentional tax reporting errors arise because legal complexity reduces taxpayers' ability to comply by making the task more difficult and expensive. Because complexity acts to remove the restraints taxpayers feel about obeying the law simply because it is the law, wilful tax cheating can be expected to increase where the opportunities to escape detection are the greatest. Fourth, complexity is multidimensional, rather than unidimensional; thus, its specific effects vary depending upon which of its components dominate. Fifth, legal complexity complicates the measurement of non-compliance, helping to determine what is defined as non-compliance and by whom. Results have suggested that legal complexity is a significant cause of taxpayer non-compliance. It reduces taxpayers' ability to comply by making the task more difficult and expensive, while reducing taxpayers' willingness to comply by diminishing their understanding of and ultimately their respect for legal requirement.

According to Ahsan (1995), however, this is probably true of marginal cases where the amount evaded is small. More significant perhaps is the power of the wealthy to block tax measures or to fight administrative procedures in dealing with evasion, which would create a moral effect on the general population. Herschel (1978) believes that knowledge of widespread corruption and a conspicuous lifestyle of senior policymakers in the country may signal the mismanagement of public funds and hence induce resistance to comply with tax laws.

Role of Specific Taxes. Evidently the scope for evasion depends on the specific tax instrument and how the taxable base is defined. The latter may also dictate the

collection procedures. In developing countries, which are primarily dominated by agriculture and non-formal service sectors, an income tax would be especially difficult to enforce.

In a recent paper, Webley (2004) provided an overview of robust empirical findings that recur in relation to both individuals and business. According to him, the main reasons for non-compliance behaviour can be categorised as:

Equity. The perceived fairness of a taxation system is important, with taxpayers' behaviour influenced by two perceptions: that the system treats them unfairly compared to others, and that the government is seen as providing too little with the revenue it collects. Evidence from a telephone survey carried out with a sample of 426 Swedish male adults by Warneryd and Walerud (1982) shows that those agreeing with the statement *The Swedish tax system is unjust* and disagreeing with the statement *Taking into consideration what the citizen gets from the state, our taxes are too high* were much more likely to admit evasion than those with opposite opinions.

Opportunity for tax evasion. Opportunity has been reported as the most significant explanatory factor in non-compliance behaviour. However, it is unclear whether those who are predisposed to non-compliance seek to work where there are more opportunities to evade. According to Webley (2004), for people who pay tax through a pay-as-you-earn system (for example in the UK, Malaysia etc.), where the employer withholds the tax due each month and adjusts the amount withheld as necessary over the year, there is no opportunity to under-declare income and rather limited opportunity to overstate or invent deductions, since there are only a small number of allowable deductions for employees. On the other hand, a self-employed individual has many more opportunities to conceal income or declare unwarranted or inflated deductions. This pattern – where greater opportunities are associated with self-employment – is true in most countries, as found out from Vogel's (1974) Swedish respondents, where 39 per cent of those who received income not taxable at source admitted evasion, compared to only 21 per cent of those where tax was withheld. Webley *et al.* (1991), in a series of experiments where participants had to

run a shop and take a wide variety of decisions, found that opportunity consistently emerged as an important factor. Here greater opportunity consisted simply of being able to make more kinds of deductions for expenses.

Individual differences. Those who do not comply tend to be male, younger, egotistical, and have positive attitudes towards tax evasion and negative attitudes towards taxation authorities. There is also some evidence to suggest that education about the taxation system has a direct impact on reducing the propensity to evade. According to Webley (2004), one might predict that non-compliers tending to be younger may be a cohort effect or there may be a genuine change in people's behaviour as they become older on two grounds: first, people may become more integrated into society as they age and therefore be more willing to contribute, and second, the consequences of being caught evading taxes may also become severe, both in social and economic terms – back auditing is obviously more threatening the more years one has been non-compliant. The fact that evaders are more likely to be male reflects the generally greater tendency of males across the board to engage in criminal acts. In Malaysia, until recently women had very limited interactions with the tax authority, as it was the husband's responsibility to complete a joint tax return. Weigel *et al.* (1987) suggest that some individuals may be characterized by egoistic tendencies, while others may exhibit strong identification with community responsibilities and thus be less motivated to avoid taxes owed. In other words, the more egoistic an individual, the less likely they will be as a taxpayer to comply with rules and laws when compliance conflicts with their interests. In the context of tax education, Eriksen and Fallan (1996) and Mottiakavandar *et al.* (2003) (based on Norwegian and Malaysian participants, respectively) have shown that increases in tax knowledge have a direct impact on people's attitude to their own evasion and on the perceived fairness of the tax system, which suggests that there is a role for education in reducing the propensity to evade tax.

Social norms. If a person believes that non-compliance is widespread they are much more likely not to comply themselves. Studies indicate that an effective measure in reducing non-compliance behaviour is to ensure that taxpayers have an accurate understanding of the compliance behaviour of others. Wenzel (2001b) carried out a

field experiment on a random sample of 1999 Australian taxpayers. Respondents were randomly assigned to one of four groups: injunctive norm feedback, descriptive norm feedback, survey only with no feedback, and control condition. All respondents other than the control group took part in a survey and three weeks after the survey, the first two groups received feedback. The injunctive norm respondents were told, 'on average, respondents held the strong personal view that one should be honest in one's tax matter...(though most)...thought that most people would hold these views to a lesser degree...Most people actually agree that honesty, responsibility and truthfulness are important when paying taxes'. In the descriptive norm group, the text concentrated on the difference between average taxpaying behaviour and the perceived taxpaying behaviour of the average person. At the end of the tax year, it was possible to see if these manipulations had had an impact on actual taxpaying behaviour – which they had. There was a significant reduction in claims for non-work-related expenses among those in the injunction norm feedback group. This finding suggests that not only do social norms play an important role in tax non-compliance, but also that they are amenable to manipulation, and that ensuring that taxpayers have an accurate understanding of the behaviour of others is important.

Dissatisfaction with revenue authorities. There is a positive correlation between belief by taxpayers that the revenue authority is inefficient or unhelpful and the likelihood of their non-compliance (Vogel, 1974; Wallschutzky, 1984; Elffers, 1991; Webley *et al.*, 2001). This correlation also applied to small business (Adams and Webley, 2001). However, it is unclear just how potent this is compared to other factors.

3.2.3 *Deliberate (intentional) and accidental (unintentional) evasion*

Tax evasion is a form of taxpayer behaviour, as is compliant reporting. The psychology literature points out that attitudes and intentions influence behaviour. Ajzen and Fishbein (1977:889) believe that *attitudes are held with respect to some aspect of the individual's world, such as another person, a physical object, behaviour, or a policy.* Behaviour consists of one or more purposes/intentional

actions and the prediction of behaviour from attitudes assumes a rational consistency between behaviour and attitudes. The attitude – behaviour relationship has four elements: action, target, context and time. The behavioural criterion is the action that is always performed with respect to a given target, context and point in time.

Bagozzi (1981:608) introduced a more complete behavioural construct in that *attitudinal reactions might at times be more complex in nature. This would especially be expected as the intricacy and/or ambiguity of an attitudinal act increases, as the meaning of the act rises in saliency and in the number of consequences for that person and as the cognitive complexity and information processing abilities of a person expand.*

In the Bagozzi model, attitudes influence intentions directly and affect behaviour through their influence on intentions. Intentions are defined as the subjective probability that an individual will perform a given behaviour. The rationale of the intervening variable is that intentions guide goal-directed behaviour and are at an intermediate level of abstraction between concrete actions and abstract attitudes.

In the context of taxation, Kidder and McEwen (1989:48) believe that the definition of non-compliance is far too narrow, which could explain the weak relationships found in empirical studies linking non-compliance to various independent variables. They presented a typology of non-compliance that highlights the rich complexity of tax behaviour. They present six variables or clusters of variables believed to influence compliance: these are coercion or the threat thereof, self-interest, habit, legitimacy and fairness, informal social pressure, and the level of knowledge about rules. The typology assumes that a single variable dominates the compliance decision but that it is not necessarily the only variable affecting compliance. Taxpaying behaviour is described as follows:

Procedural non-compliance. This results from failing to comply with the rules relating to form and schedule usage and the timing requirements related to filing.

Unknowing non-compliance. This results from ignorance regarding the complex, changing and sometimes ambiguous rules – for example, not reporting taxable benefits from employment.

Lazy non-compliance. This results from a failure to keep accurate records and usually relates to income earned but not recorded. The lack of records is the main impetus for underreporting.

Asocial non-compliance. This fits the classic definition of a ‘tax cheater’, who wilfully underreports taxable income and expends time and effort during the year reducing income visibility and hiding an audit trail.

Symbolic non-compliance. This results from perceived unfairness and inequities in the tax law and an unfavourable disposition to the uses to which taxes are put. Includes tax protestors and petty evaders.

Social non-compliance. This develops in the context of a pattern of social or economic relationships in which non-compliance is taken for granted or explicitly endorsed.

Brokered non-compliance. This takes place on the advice of a tax consultant who assures the taxpayers that a specific form of evasion is highly unlikely to be detected.

Habitual non-compliance. This emerges over time as the taxpayer establishes a pattern of reporting income and deductions. Initial instances of brokered or lazy non-compliance might evolve into habitual non-compliance.

Kidder and McEwen (1989:64) concluded that the state of knowledge in the field would be best served by an initial emphasis on taxpaying behaviour and then on tax-enforcing behaviour. They argued that by identifying a particular behaviour, it might be possible to target enforcement strategies to that particular behaviour, thus reducing the likelihood of unintended side effects of the strategies (not just

increasing marginal compliance but also preserving and reinforcing current levels of compliance).

Carroll (1989:254) explicitly recognises that the timing element of the attitude - behaviour relationship is important. He combines timing and skill to describe evasion as being of either a high level or a low level:

Even when the taxpayer defines the appropriate behaviour as cheating rather than compliance, this cheating can also be done in a planful, high level way or a reactive, low-level way. An auto mechanic could have made a 'standing decision' to look for ways to avoid paying taxes owed...Given such a decision to avoid paying taxes where possible, the more planful, top-down strategies call for assessing overall amounts or percentage to hide, types of transactions to avoid recording and other goals and rules. A less planful mode is simply to look out for good opportunities, such as customers who pay in cash and have frequent transactions so that they are known to be 'safe' and are unlikely to keep track...An even less planful mode is to come to the end of the year with a few shoeboxes full of records and some bills to pay. Several 'trial balances' may be attempted and a strategy constructed at that time for balancing safety and need or for meeting a target tax amount.

The Kidder and McEwen typologies appear to relate to the context element of the attitude - behaviour relationship. Carroll's focus on the level of planning, however, appear to relate to the timing element that seems to be captured by Klepper and Nagin (1989), who developed a theory of line-item compliance behaviour and tested their model using Taxpayer Compliance Measuring Program (TCMP)^{3.6} data in the US. Their premise is that compliance is a line-item decision. The perception of the probability that a line item will be audited is assumed to be a function of both the

^{3.6} TCPM is a detail studies of the American taxpayer conducted on a roughly three years cycle by the IRS and based on a 'line by line' audit of a stratified random sample of 45,000 to 55,000 tax returns since 1965. These audits yield an IRS estimate of the taxpayer's true income, which allows IRS to calculate income tax evasion. However, TCMP data have some serious and well recognised deficiencies: the audits do not detect all underreported income, non-filers of tax return are not often captured, honest errors are not identified, and final audit adjustments are not included.

dollar amount and percentage of the misstatement. They predict that the dollar value of the misstatement will increase as the true dollar value of the line item increases, but that the percentage misstatement will decrease.

Klepper and Nagin (1989) also predict that the risk of detection of a line item is an increasing function of non-compliance on that line item and non-compliance on all other line items. Their empirical results show that the greater the amount of income not subject to information reporting, the smaller the percentage of non-compliance on deduction items, *ceteris paribus*. Klepper and Nagin (1989:18) term the gravitation towards an avenue of evasion the 'substitution effect', which refers to the interrelationship of non-compliance across the line items. The substitution effect causes taxpayers to gravitate away from relatively inferior evasion opportunities. As overstatement of deductions is relatively easily detectable during an audit, taxpayers with relatively large amounts of unverified income would tend to underreport the income rather than overstate deductions.

The intention element of Bagozzi's model appears to be captured by Carroll (1989:238), who interprets the Contingent Process Model of Payne in a compliance decision as follows^{3.7}:

1. Assess money in pocket (if high, no crime; if low, go to step 2)
2. Assess certainty of success (if low, no crime; if high, go to step 3)
3. Assess amount of gain (if low, go to step 4; if high go to step 5)
4. Assess risk (if high, no crime; if low, go to step 5)
5. Commit crime – a process with sub-steps involving the planning and execution of the crime.

^{3.7} According to Payne (1973), the model was an explanation of the results obtaining in a study of preferences among paired duplex gambles. The hypothesised decision strategy was presented in the form of a process model involving two stages: an evaluation stage followed by a choice stage. The model assumed that the subject first considers the probability relationship within the gamble in a pair. If $P_w < P_i$, the gamble with the lower P_i is chosen. If $P_w > P_i$ within each gamble in a pair, an attempt is made to maximise the $\$w$. In the case where the amounts are equal within a pair, P_w may be used as a secondary criterion, and the gamble with the greater P_w chosen. For pairs of gambles where $P_w = P_i$, there are alternative paths which can be taken in the model, possibly corresponding to two types of subjects. These types of pairs of gambles may be treated as if they were pairs of gambles in which $P_w > P_i$ or as if they were pairs of gambles in which $P_w < P_i$ [where P_w = probability of winning, P_i = probability of losing, and $\$w$ = amount to win].

According to Carroll, the above decision process is not optimal because it lacks a thorough consideration of alternatives and information in comparison with utility theories, and a formal combination of information into an assessment of each alternative. He does, however, conclude that the process is responsive to the environment and possibly highly effective.

The attitude - behaviour relationship and behaviour tax literature therefore suggest that the following dichotomy of tax evasion is plausible:

Intentional Evasion. The intention to evade tax exists early in that fiscal year and the taxpayer takes pre-planned steps to hide an audit trail and/or obtain fraudulent supporting documents. The level of evasion is dependent upon opportunity and taxpayer skill and motivation (Carroll 1989: 256).

Unintentional Evasion. This unintentional evasion corresponds closely to Cowell's (1985:25) description of self-declaration in that *the person spends the year garnering his income in the usual way and at the end of the year may play the game of cheat-the tax-man by falsifying the tax returns on his declared income.*

The essential difference between intentional and unintentional evasion is the timing of the evasion actions. Differences in the timing of the evasion actions could be due to differences in taxpayer opportunities, skills and motivation, thereby causing a taxpayer to be more amenable to one form of evasion behaviour. Unintentional evasion encompasses lazy non-compliance, symbolic non-compliance and perhaps the habitual non-compliance typologies of Kidder and McEwen (1989).

Carroll (1989:256) believes that the level of non-compliance is a function of three factors, opportunity, skills and motivation, and that deliberate tax cheating occurs when the skill factor is sufficiently high to be able to take advantage of opportunities to cheat. Unintentional evasion permits a lower level of skill than does intentional evasion and the primary motivation occurs while the tax return is being prepared.

3.2.4 *Cyclical or repetitive process*

The tax literature has not fully explored whether tax evasion constitutes a cyclical or repetitive process. Understanding the difference between cycles and repetition is essential for understanding the nature of tax evasion, as well as the nature of the entire enforcement function of the tax authority, so as to detect or deter tax evasion.

In general, a cycle pertains to recurrence of similar elements or events. Terms such as substitutes, exchangeable, similarities and equivalents apply to cyclical processes. On the other hand, repetition refers to constancy of identities or non-substitutability and singularities in recurrences. In psychological terms, repetition and the repeated differ since the former pertains to the process of recurrence and the latter refers to the common identified elements in each episode (Deleuze, 1994). Without this identity, no repetition exists. Terms such as sameness, non-substitutes, identity and non-exchangeable are used quantitatively to describe repetitions. As Deleuze (1994:1) explains:

To repeat is to behave in a certain manner, but in relation to something unique or singular which has no equal or equivalent. This is the apparent paradox of festivals: they repeat an unrepeatable. They do not add a second and a third time to the first, but carry the first time to the 'nth' power.

In the general traditional business cycle, economic crime was more prevalent in times of booms or economic growth because it could be 'afforded' and controls were perhaps not as tight as they could have been. It is thought that control was then tightened in times of bust or recessions as savings had to be made whenever possible. However, it is also thought that businesses are more likely to commit economic crimes as a recession occurs, to disguise financial problems within a company.

In the context of taxation, the tax evasion decision-making process is very dynamic (e.g. Andreoni *et al.*, 1998; Engel and Hines, 1999). Many of the economic models of tax evasion examine it as a static decision that is made in one period of time. This

is often not the case, because in reality people may continue to evade taxes for many years. This means that when the evader continues to evade taxes, he takes the risk that the crimes that are committed earlier will also be detected. As the evasion continues, the expected level of sanctions keeps increasing.

The tax enforcement mechanism gains the attributes of a repetition when the same personnel, procedures and methods are used from one year to another. Upon detecting this pattern, the tax evaders can adjust their tax evasion acts around the repetitious enforcement activities to evade detection.

3.2.5 *Probability of detection / audit*

According to Jackson and Milliron (1986), the probability of detection is the probability that non-compliance will be discovered and that the tax authority will seek to rectify the deviance. Most broadly, discovery could be accomplished by all means available to the tax authority, for example computerised checks of filed tax returns for obvious errors, computer matching of third-party reports and all levels of audits. This is one of the few factors that impact compliance which governments have some degree of control over. The critical question is the extent to which raising the probability of detection will reduce tax evasion.

In general, the theoretical and empirical perspective assumes that the effects of detection probabilities are clear; higher detection probabilities discourage tax evasion, as reviewed by Jackson and Milliron (1986), Fischer *et al.* (1992) and Richardson and Sawyer (2001)^{3.8}, which tabulated the results of earlier studies that addressed the effects of the probability of detection on compliance. The table is methodology-based in that the results are separated for survey studies, experimental studies, analytical studies and regression modelling. Generally, the survey, analytical and regression methodologies found that the probability of detection positively affects compliance, while the experimental approaches were inconclusive as to the effect of the audit probability on compliance. The taxpayer, however,

^{3.8} Richardson and Sawyer (2001) reviewed findings of the key tax compliance factors, including detection probabilities, from the point where Jackson and Milliron's (1986) research ended in 1985; the research follows on from that point, Richard and Sawyer's (2001) research covering the period 1986 to 1997. A

cannot perceive the probabilities of detection objectively, and therefore the decision to evade taxes is made on the basis of their subjective perception of the detection probability. One possible reason for why the majority of people pay their taxes compliantly is that they may overestimate the probability of detection. Selected research results concerning the probability of detection/audit and taxpayer compliance and the result of its effect are discussed below.

Allingham and Sandmo (1972) model taxpayer behaviour on the basis that it conforms to the Von Neumann-Morghenstern axioms for behaviour under uncertainty. The decision variable is the level of declared income under conditions of a flat tax rate, an audit probability, and a penalty function on undeclared income. The taxpayer reports so as to maximize expected utility. The mathematical result is that an increase in the probability of detection will always lead to a large income being detected. Srinivasan (1973) analysed the same reporting decision, and concluded that *ceteris paribus*, the optimal proportion by which income is understated decreases as the probability of detection increases.

Vogel's (1974) survey of Swedish taxpayers, stratified by source of income, was conducted to learn about taxpayers' attitudes and perceptions with respect to income tax evasion. Respondents were asked to assess the likelihood that tax authorities would successfully detect non-compliance if they chose to evade taxes. Additionally, they were asked whether they had a better than average chance to evade taxes without detection. Nearly half of the university-educated respondents thought that they would not be detected if they chose to evade taxes, while only 22 per cent of blue-collar workers thought that their evasion would be detected, and females estimated a higher probability of detection than did males.

In a US study, Mason and Calvin (1978, 1984) conducted two independent surveys in 1975 and 1980 and examined the relation between perceived detection probability and evasion behaviour. In the 1975 survey, the dependent variable, tax evasion, was constructed by using a dichotomous measure of three type of evasion; failure to file a tax return, overstatement of deductions and underreporting of income. A fourth type of evasion, reporting unearned tax credits, was included in the 1984 survey. They concluded that the

detailed literature review solely on detection probability and taxpayer compliance was undertaken by Fischer *et al.* (1992).

belief that non-compliance would not be detected was positively correlated with admitted non-compliance in the two surveys.

In another US study, Scholtz (1989) stated his belief that there is general agreement that an increase in the number of IRS examiners will generate increased revenues in excess of the direct costs of the increase in manpower. However, he also believes that certain social constraints restrain such an approach from being adopted. First, one negative effect of an increase in enforcement is the social cost associated with a more visible IRS, and a national distaste for increases in the size of government bureaucracy. An increase in examiners would also cause increased costs for the taxpaying population as a consequence of attending to the requirement of the revenue agents. Second, in a time of spending stringency, it would be politically unwise to appropriate more to the IRS for the audit process, while at the same time reducing spending on socially desirable programmes. Scholtz (1989) furthermore believes that the most obvious benefits of increased enforcement are that revenue can be raised from evaders, and others deterred from evading, due to an increased threat of detection. The revenue argument is most persuasive when enforcement is targeted directly at large-scale evaders. It is important to preserve the notion of fair enforcement so that the current levels of voluntary compliance can be maintained. Scholtz's argument against high levels of enforcement is, in summary, that it is contrary to the American belief in individual freedom, and that an aversion to coercive state powers pervades the political culture.

Alm *et al.* (1992a, 1992b, 1992c), in a series of experimental economics studies, found that an increase in the audit rate promoted compliance; however, they noted that the differences in compliance rates across sessions with varying enforcement policies were not large. Further, when there is uncertainty about the audit rate, the effect on tax compliance depends critically on the presence and structure of public goods. In their second study (1992b), an experimental approach to estimate taxpayer response to various policy changes, they examined the effect of an income endowment, paid from taxes on voluntarily reported income, thus dependent upon the tax payments of all taxpayers. The experimental results showed a higher compliance rate (ratio of declared income to actual income) with higher income endowments, fine rates and audit rates. There was also a higher compliance rate

associated with the payoff received from the public goods (paid for by all taxpayers). They concluded that government should pursue a range of approaches to promote compliance.

In a third study, Alm *et al.* (1992c) employed a similar design to compare actual compliance behaviour to predict levels of compliance based on an expected-utility model that assumes risk-neutral behaviour. Subjects received an income endowment, paid taxes on voluntarily reported income, faced a penalty on taxes evaded and received a public good dependent upon the tax payment of all taxpayers. They found that compliance increased (in a nonlinear fashion) as detection probability increased. They also noted that the level of compliance was higher than predicted by expected-utility theory when audit was low (2 per cent). They suggested that the result is consistent with the overweighting of low audit probabilities or extreme risk aversion. Even when audit probability was zero, there was a modest level of compliance. Risk-averse behaviour, however, did not occur in all conditions of the experiment; at high levels of audit probability, subjects exhibited risk-seeking behaviour.

In summary, it appears that the literature, in which different methods of research on detection probability have been employed, seems to suggest a positive relationship between detection probability and taxpayer compliance, and lower taxpayer perceptions of detection probability were generally associated with non-compliance behaviour. Government should therefore pursue a range of approaches to promote compliance (Jackson and Milliron, 1986; Fischer *et al.*, 1992; Alm *et al.*, 1992c), as its influence has important tax policy implications.

3.3 What does past research reveal about tax evasion by SMEs?

This section reviews SME literature with a particular emphasis on tax evasion and compliance. A summary of relevant studies on tax compliance issues among SME taxpayers is presented in Figure 3.1. These studies are discussed in more detail below.

In a US study, Hite *et al.* (1992) explored the issue of tax compliance among SMEs. Using a nationwide mail questionnaire of 300 sample responses, the findings demonstrated that one in every five SMEs was either underreporting income or overreporting deductions. The

Figure 3.1: Summaries of studies on tax compliance among SMEs.

Authors/ Organisation (year)	Participant	Method (analytical tools)	Issues explored	Major Findings
Ahmed and Sakurai , (2001)	2040 random sample of Australian taxpayers	Survey questionnaires	Compares small business worldview, demands and experiences with those of other groups of people.	Small business more likely to owe money to tax office, perceived a discrimination against them, oppose spending tax dollars on state welfare, value competence in business and admit a lack of competency in doing tax returns.
Coleman and Freeman (1994)	Small business owners in Australia	Interviews and focus group session (qualitative analyses)	Attitudes towards tax payment and Tax Office	Small business tend to see their relationships with the tax office as adversarial and use their accountant as a primary source of informations. They regard themselves as honest but accept barter and cash payment as business practices.
Coleman and Freeman (1997)	Four types of small business (professional, blue collars, retailers and rural) in Australia	Interview and focus group session (qualitative analyses)	Attitudes towards tax payment and Tax Office, influence of social norm on such attitudes	Most respondents support the idea of paying tax and voluntary compliance is related to the individual cultural background. Motives and forms of non compliance activities vary across the four groups.
Dorstein (1976)	2500 small business taxpayers in Israel	Data were gathered from the income tax file division	Effect of the control system of tax authority and detection ability on compliance	High efficiency of the tax authority and low opportunity to cheat tax are major determinants of compliance.
Erard (1997)	883 SMEs Canadian businesses nationwide	Survey questionnaires (Probit analysis)	Perceived cost of complying with federal and provincial corporate income capital taxes.	Perceptions vary substantially among SMEs. Whether actual compliance costs are substantially higher is not certain because different respondents may apply different standards of reference when classifying their cost as high or low.

Authors/ Organisation (year)	Participant	Method (analytical tools)	Issues explored	Major Findings
Hite, Stock and Cloyd (1992)	300 small businesses in the USA	Self report survey questionnaire (descriptive statistics, correlation and chi-square)	Motivation behind the use of a tax practitioner and personal variable such as age, gender.	Motivations for small business individuals to use a tax practitioner are to have the tax return prepared correctly and to reduce the likelihood of penalties.
Joufaian and Rider (1998)	8341 small business taxpayers from farm, proprietorship or rental real estate in the USA	1985 and 1988 IRS taxpayers' compliance measurement program data (Tobit estimate)	Effect of differential taxation on voluntary compliance.	The tax liability on proprietorship income under US tax law is higher than the tax liability on the same level income from rental real estate. This differential taxation treatment is found to affect the voluntary reporting compliance by small businesses.
Kirchler (1999)	117 small / medium sized firms in Austria	Survey questionnaires (correlations)	Perceived loss of freedom, attitudes towards tax evasion, moral beliefs, and tax avoidance.	Perceived restriction of freedom was related to favourable attitude towards tax evasion, low tax morale and a tendency to reduce/avoid tax.
McKerchar (1995)	200 small businesses in Australia	Self report survey questionnaires (descriptive statistics)	Sources of tax information, level of knowledge, education, age, length of time in business, turnover range and industry.	An accountant is seen as their primary source of information, non-compliance may be unintentional - resulting from their lack of awareness of taxation matters.
Mottiakavandar et al. , (2003)	312 SMEs in Malaysia	Interview and questionnaires. (descriptive statistics)	Compliance level of SMEs and level of taxpayers' knowledge on general tax laws. Demographic profile - gender, age, race, education and income level were examined.	All variables had a significant relationship with amount of the tax knowledge. Taxpayers with higher income and education level have higher amount of tax knowledge than the lower level. Gender had a significant relationship with attitude towards own compliance and age with intention to comply.

Authors/ Organisations (year)	Participant	Method (analytical tools)	Issues Explored	Major Findings
Noble (2001)	SMEs in New Zealand	Interview and focus groups sessions (qualitative analysis)	Perception of the tax system, tax evasion and motivations for tax evasion.	SMEs perceived the tax system unfair and tax compliance cost is too high. Cash jobs are generally seen as socially acceptable and encouraged from industry peers.
Plamondon & Associates Inc. (1996)	6 specialist panel comprised partners of accounting firms that specialise in small business.	Panel discussion (Qualitative analyses)	Nature and extent of incremental compliance costs, specific irritants in the system and revenue neutral initiatives that the government could take to improve and simplify the for Canada's SMEs.	Incremental cost for most SMEs to be \$200 to \$500. the proper functioning of small business deduction; tax planning that focusses on income splitting and reorganisation of share capital; clearly legitimate claims for R & D credits not being made; the use of estimating techniques to comply with non or partial deductibility of expenditure; the complexity of provisions concerning company vehicles; and the high level of professionalism and level of assistance given to small business by Revenue Canada.
Rice (1992)	TCMP data of 30,000 corporate of US	Econometric model	Determinants of small corporate tax compliance	Public disclosure of information about a corporation operation tend to encourage better tax compliance. High profit companies may take advantage of their greater ability to underreport income without being audited, whereas managers of profits performance falls short of its industry norm may resort to non compliance as a means of saving cost. The marginal tax rate is associated with negatively with compliance.

Authors/ Organisation (year)	Participant	Method (analytical tools)	Issues explored	Major findings
Sigala, Burgoyne and Webley (1999)	23 taxpayers (both self employed and employed at the organisations) in UK	Interviews (qualitative analyses)	Tax communication with others in the same occupation, social norms within occupational groups.	A social norm is evident which favours cash payments in particular occupational groups, such as small business taxpayers. Compared to others, these taxpayers tends to communicates more with each other about their tax situations, mainly to seek opportunities to reduce income tax and/or to finds correct information.
Wallschutzky (1984)	1000 individuals (500 non evaders and 500 convicted evaders) in Australia.	Questionnaires survey (descriptive statistics)	Employment status and tax evasion	Evaders tends to be small business individuals.
Wallschutzky and Gibson (1993)	12 small business in Australia	Interviews (qualitative analyses)	Concerns and problems of small business and perceptions towards tax office.	The main concern for small business is cashflow, instead of tax compliance. Cashflow problems affect the payment of their taxes on time. Small business individual have negative perceptions towards the tax office.

Source: Ahmed and Sakurai (2001) and relevant literature

most commonly addressed factors associated with such non-compliance were an absence of third party reporting of their income and a perceived lower probability of detection. They also addressed questions of SMEs' motivations for using tax practitioners and final reporting decisions about ambiguous tax items. The results suggested that preparing tax returns correctly and reducing the likelihood of penalties were the most important reasons for using tax practitioners. The study also noted that SMEs were in favour of being in control of their own tax situations and making decisions concerning final reporting.

In another US study, Joulfaian and Rider (1998) used quantitative analysis of IRS data (TCMP) from 1985 and 1988 to examine the compliance pattern of small businesses. Their research was specifically focused on the effects of differential taxation treatment on voluntary compliance by proprietorships, farms and rental real estate activities; for example, proprietorship income is subject to self-employment tax whereas rental income is not. The average amount by which income was understated was 26.6 per cent for proprietorship income, 30.2 per cent for farm income and 11.9 per cent for rental income. There was a very clear pattern in the data: the probability of tax evasion is positively correlated with tax rate, independent of the level of income. They concluded that the way in which tax obligations are framed through law and administrative practices are important in explaining the pattern of non-compliance. This finding also supports the notion that underreporting of income is positively correlated with tax rates.

Another researcher, Rice (1992), with the help of the IRS Compliance Analysis Group, analysed small corporate tax compliance micro-data in the US. The data set was a stratified random sample of approximately 30,000 small corporations. He developed an econometric model to test several propositions about the determinants of tax compliance. The study concluded that an increase in a small corporation's 'transparency', or public disclosure of information about a corporation's operation, tends to encourage better tax compliance. This conclusion is based on findings that compliance is positively associated with being publicly traded^{3,9} and with belonging to a highly regulated industry, and that corporations whose operations are shielded from view through their dealings with a tax haven country demonstrate very poor compliance. This result also shows that a firm's profitability exerts

two opposing compliance effects. Managers of a corporation whose profit performance falls short of its industry norm may resort to non-compliance as a means of shaving costs. In contrast, high profit corporations may take advantage of their greater ability to underreport income without being audited. These related implications are derived from findings that deviations from the sample's median industry profit rate correspond positively with tax compliance, while deviations from the sample-wide median profit rate correspond negatively. Rice also concluded the marginal tax rate is associated negatively with compliance, although a reduction in the marginal tax rate would cost the government one dollar in revenue for every 5.3 cents it could raise via enhanced compliance. Poor compliance is also associated with corporation size and with being located in IRS-identified poor compliance regions. Rice, however, found no clear association between compliance and service industries or the use of an outside CPA for tax return preparation.

In Israel, Dornstein (1976) explored the capacity of the tax authority to check the accuracy of SME taxpayers' information. The data were derived from the taxpayers' files in the Income Tax division of self-employed taxpayers. Two sets of hypotheses were formulated and tested based on the proposition that a person's compliance with norms is a function of his/her basic orientations towards these norms, and of the control system related to norm compliance^{3.10}. In general, the findings revealed that in a situation where non-compliance is highly detectable and the tax authority has high control in detecting non-compliance, tax compliance tends to be higher. This emphasised the importance of the taxation control system in detecting non-compliance, specifically when the declared income was lower than the actual income.

^{3.9} According to Rice (1992), TCMP data broadly divide into small corporations with assets less than US\$1 million and medium-sized corporations with assets between US\$1 million to \$10 million. In the US, a corporation having a least US\$4 million can be publicly traded on the American Stock Exchange.

^{3.10} According to the author, the basic orientation is the degree to which taxpayers identify with the norms and consider them legitimate, whether he is favourably or unfavourably disposed toward them. These views are shaped by a number of factors, among which are the taxpayers' past and present socio-cultural experiences, their ideological predisposition toward the state and their experience in dealing with bureaucratic and governmental institutions. The sets of indices chosen for the test were socio-cultural background, length of stay in the country and age. As regards the control system, income as the economic factor involved in payment of income tax, efficiency of control and official records as the amount and quality of control by the tax authority were considered.

In Austria, Kirchler (1999) investigated the SME taxpayers' attitudes to paying tax. The study highlighted the fact that SMEs were more likely to perceive paying tax as limiting their freedom to make financial decisions about their own income. Further, this restriction of freedom was positively related to favourable attitudes towards tax evasion, lower tax morale and a tendency to act in ways to avoid paying taxes. The study concluded that reducing and avoiding tax was a way of escaping the perceived loss of freedom.

Two studies in Canada explored SME taxpayers' perceptions about the cost of complying with corporate income and capital taxes (Erard, 1997b; Plamondon & Associates Inc., 1996). The study by Plamondon & Associates (1996) focuses on the nature and extent of incremental compliance cost, specific irritants in the system, and revenue-neutral initiatives that the government could undertake to improve and simplify the system for Canada's entrepreneurs. The data was generated primarily from a discussion panel of six accountants who were dealing exclusively with small businesses. The panel observed the following: the proper functioning of SMEs deduction; tax planning that focuses on income splitting and reorganization of share capital; clearly legitimate claims for research and development credits not being made; the use of estimating techniques to comply with non or partial deduction of expenditures; the complexity of provisions concerning company vehicles; and the high level of professionalism and level of assistance given to small businesses by revenue authority.

Erard's (1997b) study of Canadian SMEs revealed that the vast majority of them relied on outside professional assistance to comply with their corporate income taxes and capital taxes, in contrast to the other taxes they faced. Erard noted that although the availability of outside tax assistance undoubtedly reduced the overall income tax compliance burden for these firms, the high cost of this assistance was nonetheless the most commonly reported source of compliance problems by respondents. Record-keeping requirements, the complexity of information requested and the lack of co-ordination among governments were also commonly cited sources of concern.

Sigala *et al.* (1999) used an in-depth, semi-structured interview to question 23 British employed and self-employed taxpayers in various occupations. The study points to factors discouraging tax communication and proposes social norms as an alternative way of

investigating social influence on taxpaying behaviour. According to them, there is an 'occupational norm' among certain occupational and industrial groups that favours non-compliance by not reporting cash-in-hand payments.

Two Australian studies explored SMEs' perceptions of the tax authority (Coleman and Freeman, 1994; Wallschutzky and Gibson, 1993). Wallschutzky and Gibson (1993) noted SMEs' non-compliance was due to the unavailability of the necessary information from the tax authorities. Coleman and Freeman's (1994) findings highlight the fact that the inaccessibility of the tax authority is at least partly responsible for a failure to instil an appropriate business ethic among SMEs despite their willingness to establish a cooperative relationship with the tax authority. The tax authority is seen as being neither sympathetic nor co-operative in their dealings with SMEs' concerns and problems (Coleman and Freeman, 1994). Such a lack of good communication and support by the tax authority is likely to lead to bitterness in SMEs that will result in tax evasion.

In another Australian study, Ahmed and Sakurai (2001) reviewed what we know about small business taxpayers. Using a large sample of 2000 respondents, Ahmed and Sakurai contrasted a sample of small business taxpayers (who were self-employed, in partnerships or owning a business) with those employed by private companies and those employed by a non-profit or government organization. The small business taxpayer placed a greater value on achievement and success and opposed government spending on minorities. With regard to tax issues, they were more likely to owe money to the tax office, to be incompetent in doing tax returns, to acknowledge paying less tax themselves and to believe that others are dishonest in paying tax.

A recent study in Malaysia on SMEs by Mottiakavandar *et al.* (2003) analysed the compliance level of SMEs (sole proprietors and partnerships) and also determined the level of taxpayers' knowledge of general tax laws. Survey data was collected from 312 respondents who participated in an interview and responded to a questionnaire. Demographic profiles of the respondents, such as gender, age, race, education and income level, were examined to determine the level of compliance among SMEs. The results of this study suggested that all variables had a significant relationship with the amount of tax knowledge. Taxpayers with a higher income and education level have a higher amount of

tax knowledge than those with a lower income and education level. Gender had a significant relationship with their attitude towards their own compliance and age had a significant relationship with intention to comply.

In general, the literature discussed suggests that SMEs are likely to have more opportunities to participate in tax evasion and some common themes have emerged. Most of the results addressed issues such as that SMEs scored quite highly on honesty, had an adversarial relation with the tax authority and perceived the tax to be unfair (see Figure 3.1 for a tabulated summary of related studies). Further evidence suggests that SMEs not only lack a precise understanding of tax matters, but also lack confidence in keeping financial records, and importantly, do not view taxation as a priority. In order to overcome such problems, there have been suggestions that education and persuasion should be given priority. These findings provide an opportunity to further explore a selection of issues covered by these studies from a Malaysian perspective. The recent study on Malaysian SME taxpayers (Mottiakavandar *et al.*, 2003) only explored the level of tax knowledge and taxpayers' own perceptions of paying income tax.

3.4 The role of the tax practitioner

Hasseldine and Bebbington (1991) pointed out that the analysis of the tax evasion problem needs to take into account the activity of the tax practitioners. It has been suggested that tax practitioners can play a central role in the transmission and translation of legal rules and their meaning for the taxpayer. The role of tax practitioners is an ever increasing research issue as more and more taxpayers turn to third parties in order to facilitate their tax assessment. Roth *et al.* (1989a:178) observed that tax practitioners play a central role in the whole system of tax compliance, both from the point of view of the taxpayer and in respect of the definitions of acceptable levels of tax compliance that tax authorities adopt. They state *greater knowledge about the relationship between tax practitioners and taxpayer compliance could offer one of the most promising areas for improving compliance...to the extent that practitioners can be encouraged to foster compliance in their clients, enforcement resource could be concentrated on the most problematic areas.* Erard (1993:163) pointed out that taxpayers often find it advantageous to seek assistance from experts in response to complex social rules and obligations, as *experts may facilitate*

compliance with social rules and obligations by reducing their clients' legal uncertainties and by lowering the time and anxiety costs associated with compliance. He argued that tax practitioners possess the means to exert an extraordinary influence on the tax compliance process since their knowledge of tax law and enforcement procedures far exceeds that of the ordinary taxpayer.

The intermediary place of the tax practitioners between the Government and the taxpayers confers an important role on them in the tax collection problem. As a consequence, they are well placed to exert a strong and direct influence on the attitudes of taxpayers themselves regarding payment of taxes and to tax compliance generally (Jackson and Milliron, 1986; Hite *et al.*, 1992; Erard, 1993; Tan, 1999). This influence is perceived in a tax system in which the government audit and collection resources are limited.

3.4.1 Tax practitioner client relationships

The absence of regulatory control over who can prepare a tax return in Malaysia allows the taxpayers to have the choice of either preparing the tax returns themselves or engaging a tax practitioner to assist them. With the increasing complexity of tax law and the uncertainty surrounding many tax issues, there is an increasing tendency for more taxpayers to seek assistance from tax practitioners. In the United States, approximately 60 per cent of all tax returns are professionally prepared (Newberry *et al.*, 1993; Erard, 1993). Seventy two per cent of Australian taxpayers sought professional assistance to prepare tax returns (Marshall *et al.*, 1997). No data is yet available for Malaysia.

Roth *et al.* (1989a) identified three principal services provided by tax practitioners in the US to their clients. These were (1) return preparation, (2) tax advice, and (3) risk advice. As a tax return preparer, the tax practitioners are expected to collect all necessary information from taxpayers and to complete returns with all the required forms and schedules. For the second function of tax advice, the tax practitioners need to apply their knowledge of tax regulations to advise clients on favourable but legal interpretations of the regulations and are expected to make use of their extensive knowledge of tax laws, discretion and diligence on their clients' behalf. Risk advice, the third function of tax practitioners, emphasises their knowledge of tax agency administrative practices, detection probabilities and sanctioning

practices, rather than a knowledge of tax regulations. This is merely to advise clients what to report with regard to that which is least likely to be challenged and the type of income that is likely to be ignored by the tax agency. It was reported that effective advocacy varied across each service. The nature of a tax practitioner's client base was an important factor in determining the stance that the practitioners were likely to adopt. Generally speaking, client expectations provided a strong incentive for practitioners to adopt an aggressive stance.

Hite and McGill (1992), using an experimental design, examined US taxpayer demand for an aggressive tax posture from their tax practitioners. They manipulated three factors: tax practitioner's recommendations regarding an ambiguous deduction (deduct or not deduct), probability of audit (high or low) and severity of sanction (severe or mild). Taxpayers appeared to prefer conservative advice; they displayed a reliance on their tax practitioners, particularly on their professional advisors (CPAs and lawyers). They found that the role of tax professionals in compliance might be different from previous research, suggesting that clients demand aggressive tax advice. Their findings suggest that taxpayers, on average, do not have a preference for aggressive tax advice. These findings are strengthened by the tendency of the taxpayers to terminate the tax practitioner when they disagreed with the advice. The extent of the advice given by the tax practitioner may influence the taxpayer's tax compliance behaviour. Hite and McGill (1992:399) argued that *professional experience and tax education inculcates potential tax advisors with prevailing professional culture of aggressive tax planning. It is possible that taxpayer purchase tax expertise and reporting aggressiveness as a package but would purchase just the tax expertise if it were available. A tax advisor's aggressive posture may be independent of a client's wishes and based on a misinterpretation of the client's demand for tax minimisation.*

Hite *et al.* (1992) examined why small business owners in the US use tax practitioners, how compliant they are and if they prefer to make reporting decisions about ambiguous tax items themselves. The study found that 64 per cent of the sample felt that tax practitioners should ask clients to make final reporting decisions about claiming items. They concluded that tax practitioners should let taxpayers decide whether to report the ambiguous items, given the high percentage of small business owners that want to be involved in making reporting decisions about ambiguous items. In other words, the taxpayers were in favour of being in control of their own tax situations and making decisions for final reporting.

Further evidence concerning the relationship between client expectations and the tax practitioner's role in tax compliance was provided by the empirical studies of Klepper and Nagin (1987). They noted that there were several factors that influence taxpayers into engaging tax practitioners to prepare their tax return. These include: (1) to save time, (2) to benefit from the expertise on the legal requirements involved, and (3) to identify strategies for reducing tax liability within acceptable tolerances for risk. They hypothesised that the constraints placed on tax practitioners by tax laws and professional ethics led practitioners to play a dual role in the tax compliance process. Specifically, they hypothesised that paid tax practitioners were (1) more compliant on return items for which there was little ambiguity concerning the legal requirements, and (2) were less compliant on return items where there was substantial legal ambiguity about reporting requirements. Results based on 1979 TCMP data indicate that compliance on paid tax practitioners' returns was relatively lower for items that involved ambiguity or were subject to imputation. It was concluded that the net influence of tax practitioners on compliance was a declining function of the legal ambiguity of return line items but was an increasing function of the incidence of unequivocal legal breaches on that line item.

Schisler (1995) conducted a laboratory experiment to provide exploratory evidence regarding the role of the tax practitioner in tax compliance compared to taxpayers, using two samples of 125 evening MBA students and 127 'Big 6' CPAs in the US. The samples were asked to answer questions concerning the role of tax practitioners as compared to taxpayers in compliance. Equity or fairness perceptions, aggressiveness and consensus were compared between the samples. The findings indicated that tax practitioners exhibited a higher degree of consensus than the taxpayers and the taxpayers had significantly lower equity or fairness perceptions of the tax system and were more aggressive (especially in tax due/under-withheld situations) than the tax practitioners on the same ambiguous tax issues.

Another researcher, Tan (1999), used an experimental method similar to Hite and McGill's survey on taxpayers' preference for type of tax advice based on New Zealand taxpayers. Three independent variables were manipulated in the experimental design: tax practitioner's recommendations (to claim or not to claim) regarding an ambiguous item, probability of audit (high or low) and type of sanction (mild or severe). Tan concluded that the taxpayers, who were predominantly small business owners, agreed more with the advice

given by their tax practitioners. The extent of their reliance on the tax practitioner's advice, therefore, indicates that they could be influenced in their tax compliance decisions even though there is a greater preference by taxpayers for conservative advice. Though these results are in conflict with Schisler (1995), they seem to agree with Hite and McGill (1992) using US data.

Sakurai and Braithwaite (2001) examined Australian taxpayers' perceptions of their ideal tax practitioners, using a random sample of 2040 people selected from the Community Hopes, Fears and Actions Survey^{3.11}. Of three kinds of tax practitioners sought by Australian taxpayers, the most popular is the 'low risk', 'no fuss' tax practitioner who is honest and risk averse. Second is the creative accountant, the aggressive tax planning type, and here the taxpayer is looking for a tax practitioner who is well networked and knows what tax offices check for at particular times, and lastly there is the cautious minimisation of tax, where tax practitioners identify opportunities to minimise tax.

3.4.2 *Decision processes of tax practitioners*

Given the importance of tax practitioners to the tax system, several studies have analysed tax practitioners' willingness to recommend aggressive tax positions to clients in hypothetical tax scenarios. Kaplan *et al.* (1988a) researched the tax reporting decisions of professional tax practitioners in the US. They carried out an empirical examination of the decisions of professional tax preparers. It was hypothesised that for ambiguous tax matters: (1) recent outcome information would influence the reporting recommendations of tax practitioners, and (2) the amount of tax experience would interact with situational economic variables to influence the reporting recommendations of tax practitioners. On non-ambiguous tax matters, it was hypothesised that (1) situational economic variables would affect recommendations made by tax practitioners, and (2) neither recent outcome information nor years of experience would influence the recommendations made by tax practitioners. The results obtained generally support the hypotheses. Since the taxpayers

^{3.11} Community Hopes, Fears and Actions Survey is a snapshot of the beliefs, attitudes, values and motivations held by Australian citizens in relation to the Australian tax office, the tax system, Australian democracy and taxpayers in 2000, which was a national tax survey conducted by the Centre for Tax System Integrity at The Australian National University.

sought the tax practitioners because of presumed expertise, tax practitioners could be expected to exert significant influence over taxpayers. Tax practitioners could also have the opportunity to enhance or dampen a taxpayer's propensity to be aggressive.

In another US study, Ayres *et al.* (1989) found that the regulatory framework in which CPAs operate allows them to interpret the tax law more to the taxpayer's benefit than those who are not CPAs. The CPAs were observed to help their clients exploit the grey areas of the law and thereby reduce compliance. The researchers used a set of five ambiguous tax cases to examine the willingness of tax practitioners to offer aggressive tax advice. Two of the cases involved a question of deductibility, one involved classification of income and two involved recognition of income. They argued that the economic theory of regulation^{3.12} would predict a result such as that tax practitioners permitted to offer enhanced services through the right to practise before the IRS would have some degree of protection from penalties as well as negotiating power not afforded to practitioners not authorised to practise before the IRS. That is, if tax practitioners can effectively argue that there was reasonable support or substantial authority for a position, penalties will not be assessed. In contrast, tax practitioners who are not authorised to practise before the IRS are placed in a difficult position if their clients are audited. These clients must either go to the audit themselves and justify a position which they may not be prepared to argue or take the tax practitioner along as an adviser. This belief has led the IRB to insert an additional clause into the new provision in respect of a person who assists in or advises with respect to the preparation of any tax return in Malaysia. Under this new provision, a person will be guilty of an offence if his/her advice or assistance in preparing the tax return results in an understatement of another person's tax liability. This will not apply if the tax practitioners exercise reasonable care in the course of providing the advice or assistance.

LaRue and Reckers (1989) also examined the decision processes of tax practitioners with regard to their role as advisors to taxpayers. They hypothesised that several decision factors

^{3.12} According to Ayers *et al.* (1989), the economics theory of regulation asserts that regulation exists to benefit the regulated parties. In the area of tax practice, the CPAs fall into the regulated group of tax preparers and are able legally to offer clients a broader range of services than can preparers without professional certification. Regulation of this service allows these practitioners to interpret the law more to the benefit of the taxpayer, further increasing the value of the regulated practitioner's services to the client and, thus, the total profitability.

would influence professional tax practitioners' decision processes. Factors that were manipulated were probability of audit (detection), size of tax saving, the overpayment/underpayment year-end tax status of the client and the experience of the tax practitioner as a tax advisor. The study examined the influence of the subject's descriptive variables such as level of experience, age of the subjects and the subject's perception of the fairness of the tax system. They found significant effects between experience, saving and fairness but no significant effects between payment status, audit probability and age. They argued that their findings attest to the complexity of influences potentially engaged in the professional's decision-making process.

Newberry *et al.* (1993) examined selected factors influencing the decisions made by professional tax practitioners in the US. Their experiment was conducted using six tax case scenarios with 107 experienced tax practitioners who were CPAs. The results reflected that there was a significantly greater likelihood that tax practitioners would sign tax returns containing a large deduction associated with an ambiguous tax issue (but only in relation to existing clients) and a lesser likelihood if tax practitioners' penalties were communicated with high enforcement intent. Their study provides evidence that tax sanctions against practitioners can significantly influence the decision-making process.

Schmidt (2001) examined the extent to which taxpayers agree with aggressive tax advice under a variety of conditions. This research extends prior taxpayer aggressiveness research (Hite and McGill, 1992) by applying prospect theory and the theory of regulation. The study reports the results of an experiment that used a nationwide, random sample of US taxpayers where the subjects read a scenario that involved an ambiguous tax situation in which their professional tax practitioner advises an aggressive advice position. The subjects then stated the degree to which they agreed with the aggressive advice. The experiment manipulated prepayment positions (refunds versus balance-due) and tax practitioner type (CPA versus non-CPA) between subjects. The results showed that taxpayers are more likely to agree with aggressive advice when they are in a balance-due prepayment position and when they use CPAs as their tax preparers.

In considering the ethical behaviour of the tax practitioners, Marshall *et al.* (1998) examined Australian tax practitioners' perceptions of the ethical judgements in which they practise, within the context of an income tax system based on the self-assessment principle. Using a self-administered mail questionnaire, the research identified and ranked ethical issues in terms of perceived frequency of occurrence and importance to tax practitioners. The findings indicated that inadequate technical competence, failure to make reasonable enquires/conduct research, continuing to act for a client where there is incorrect information and conflicts in distinguishing between tax planning and tax avoidance emerged as the important issues. Although acknowledging the potential for unethical action in tax practice, the tax practitioners considered that they carried out their professional activities within an ethical environment.

Cruz *et al.* (2000) also investigated professional tax practitioners' ethical judgements and behavioural intentions in cases involving client pressure to adopt aggressive reporting positions. The multi-dimensional scale (MES)^{3.13} was used to measure the extent to which a hypothetical behaviour was consistent with five ethical philosophies (moral equity, contractualism, utilitarianism, relativism and egoism). Samples of 67 tax practitioners' responses to three cases involving client pressure to adopt an aggressive tax return position were examined in order to evaluate tax practitioners' ethical judgements and behavioural intentions. It was found that the respondents supported the existence of all dimensions of the MES other than egoism. Regressions of ethical judgements and behavioural intentions on the MES dimensions indicated that the moral equity dimension, followed by the contractualism dimension, most heavily influenced ethical decision-making. In contrast, the utilitarianism and relativism dimensions were only related to ethical judgements and behavioural intentions in isolated instances. They also indicated that perceptions of the general morality or fairness of an action or the extent to which an action is consistent with an individual's duties or contractual obligations are the primary determinants of ethical judgements and behavioural intentions.

^{3.13} According to Cruz, the MES provides insights into the philosophies or rationales that underlie ethical judgement. Use of this scale is based on the premise that individuals use more than one rationale in making moral judgements, and that the significance of these rationales differs among problem situations.

In summary, the literature has documented that the extent to which tax practitioners meet the special needs of taxpayers depends on a number of factors. Cruz *et al.* (2000) and Marshall *et al.* (1997) argued on the basis that tax practitioners have their own codes of practice that may shape their responsiveness to taxpayers' needs. Tax practitioners are also operating in a competitive market and their survival may depend on their capacity to do what taxpayers ask them, be it legal, illegal, or on the margins of legality (Sakurai and Braithwaite, 2001). In general, the literature suggests that tax practitioners play a dual role, as clarified by the findings of Kleeper *et al.* (1991). In ambiguous tax situations, tax practitioners tend to recommend aggressive positions; in unambiguous tax situations, they tend to enforce tax law.

3.5 Methodological considerations

Tax compliance research is subject to certain constraints. Data on the extent of evasion may be confidential or not completely reliable. The confidentiality and disclosure of tax returns and information provisions in the tax law (in the case of Malaysia, Section 138 of the Malaysian Income Tax Act 1967) expressly prohibits the IRB from making personal/business data available to the public. Tax evasion is also seen as socially undesirable and a punishable offence and self-reports of evasion are open to question (Hite, 1988; Elffer, 1991). Access to data is therefore restricted by both parties to the taxation process.

Under these constraints, tax compliance research has evolved into five streams, delineated on methodological grounds as noted by Jackson and Milliron (1986) and Richardson and Sawyer (2001): surveys, experiments, analytical models, regression analysis, and process tracing. They, however, argued the need for robust research methodology in conducting research in tax compliance/evasion activity: '*too often...the research plan is inadequate to support the research objective*' (Jackson and Milliron, 1986: 146), thereby casting doubt on the validity of the research findings.

3.5.1 Survey research

Surveys remain a popular research method amongst tax researchers (Jackson and Milliron, 1986; Richardson and Sawyer, 2001). Generally, surveys have studied beliefs, opinions, attitudes and behaviour through interviews, questionnaires, panel discussion groups or telephone interviews by selecting a sample of people either to find out about the status quo or to discover interrelations among available of interest (Jackson and Milliron, 1986:146). As can be seen in Figure 3.1, only a few studies have used self-report survey methodology (for example Hite *et al.*, 1992; Kirchler, 1999; McKerchar, 1995). Most of the studies have been limited to interviews and focus groups to gather information about tax matters from SMEs.

A critical aspect of surveys is defining the population of interest and selecting an unbiased sample that is representative of the population. After the sample is selected, it is important to link them back to known communities or taxpayer characteristics to provide some objective measure of the representatives of the respondents. However, where the scope of the survey is limited to a few clearly defined variables, especially if these variables can be related to a conceptual base and a suitable population is available for testing, the survey can appear to represent a viable course for tax compliance research studies.

Obtaining adequate response rates and samples is also another important aspect of survey research. Although some studies have achieved response rates in excess of 50 per cent, the average response rate has remained around 30 per cent, with a low of 5.5 per cent (Richardson and Sawyer, 2001). Low response rates not only introduce potential non-response bias into the survey but also contribute to relatively small sample sizes in the studies. Non-response bias and small sample sizes limit the degree of confidence in a study's research findings.

Another critical aspect of surveys concerns the honesty and validity of survey responses. The two studies by Elffers (1991) in the Netherlands provide the strongest evidence that validity problems may exist with survey measures of taxpayer non-compliance. He tested the validity of survey measures of non-compliance by comparing the responses of survey participants to actual tax return data held by the revenue authority for those same taxpayers.

The results showed that the two different measures of non-compliance were almost completely unrelated. He suggested that the failure of the survey measure of non-compliance to correspond with the return-based measure might have been the result of taxpayer self-presentation concerns.

3.5.2 Experimental research

These studies are designed to attempt to control and manipulate the influential independent variables, though it appears that no past studies have achieved the relatively complete and strict control generally associated with laboratory experiments. The strength of this approach is the ability to control and manipulate the variables of interest, but the major weaknesses are that hypothetical choices may not accurately reflect the choices that would be made in actual situations and the instruments may lack construct validity or may fail to present critical thresholds. Thus, the findings in experimental studies should be relied on as indicators of directionality of choice rather than of absolute choice (Grasmick and Scott, 1986; Alm, 1991).

During the experimental procedure, it is important for the experimenter to control subject preference; the conditions for this to be achieved are outlined in Alm (1991: 582). If these conditions are not met, results should be interpreted with caution. Other methodological problems include experimental realism and the concern that hypothetical taxpayer behaviour cannot be generalised to actual taxpayer behaviour (Hite 1988:449).

Nevertheless, despite the limitations of this approach, external validity can be improved by increasing the realism of the experiment, focusing particularly on the use of realistic parameter values and representative subjects (Jackson and Milliron, 1986). Friedland, Maital and Rutenberg (1978) introduced the experimental approach for studying tax evasion but their work suffered from a lack of realism, since the subjects were instructed always to maximise net income and the probability of detection and the penalty rate were given.

3.5.3 *Analytical research*

Jackson and Milliron (1986) pointed out that part of the tax-oriented research literature concerning the probability of detection, sanction and the tax rate involves attempts to model these variables analytically. The early analytical models (Allingham and Sandmo, 1972; Kolm, 1973; Srivivasan, 1973; Yitzhaki, 1974) generally viewed the taxpayer as being a perfectly amoral, utility-maximizing person making the reporting decision solely on their risk profile (Jackson and Milliron, 1986). Furthermore, the models assumed that the higher the level of taxation, the greater the tendency to evade taxes. These models have been criticised as being too simplistic to capture the tax evasion decision (Mork, 1975; Pencavel, 1979; Dean *et al.*, 1980; Lewis, 1982; Schmidt and Witte, 1984).

Improvements to the earlier models saw economic models adopt relaxed assumptions to comprehend the impact of the diminishing marginal utility of money and utilise more sophisticated techniques of analysis in an effort to improve the validity of the models (Richardson and Sawyer, 2001). For example, these models considered the labour supply under uncertainty (Cowell, 1985), strategic audit selection by the tax authority (Graetz, Reinganum and Wilde, 1986; Reinganum and Wilde, 1986; Beck and Jung, 1989; Klepper and Nagin 1989; Cronshaw and Alm, 1995), uncertainty regarding the taxpayer's income level (Beck and Jung, 1989), different levels of taxpayer risk aversion (Beck and Jung, 1989) and non-monetary penalties (Klepper and Nagin, 1989).

Richardson and Sawyer (2001) commented on the difficulty of finding the right balance between simplicity and complexity within the economic models, as the models generally failed to find an equilibrium. Bardsley (1994) argued that a good economics model is one which is complex enough to be relevant, yet simple enough to be understood.

3.5.4 *Regression modelling*

Regression modelling uses actual audit data. The most detailed data are based on the American Taxpayer Compliance Measurement Program (TCMP). TCMP is conducted regularly by the IRS and is based on a 'line by line' audit of a sample of 45,000 to 55,000 tax returns. Generally, these studies seek to detect relationships between demographic

variables and tax return characteristics and the extent of evasion (Clotfelter, 1983). From a practical perspective, access to this data is limited, and from a theoretical perspective the true correlation is between the detected level of evasion and the variable studies. Weaknesses with the data are that detected evasion is less than actual non-compliance, and may be accidental and not deliberate. Furthermore, the TCMP database excludes non-filers (Alm, 1991:581). When empirical data is used to test theories, Kinsey (1986:406) concluded that when the empirical data does not support a model, it is not clear whether the failure to confirm these theories is due to faulty theory, faulty measurement or both.

Other data used in the regression analysis is amnesty data, originally used by Crane and Nourzad (1990). The main advantage of this data source is that it contains information on taxpayers who evade tax through the non-filing of tax returns. Amnesty data, however, is not a perfect source of information on non-filers, as those taxpayers who do not participate in the amnesty are excluded.

3.5.5 Process tracing

Process tracing has been developed and tested by Carroll (1989, 1992). The method is founded on the principle that taxpayer compliance is a process rather than a one-off action. The method involves observing taxpayers while they carry out their tax activities so that insights into the compliance process can be obtained. The method was trialled by Carroll (1992), where a group of 100 volunteers were asked to keep a tax diary over the course of a year, recording any tax-related thoughts or activities. At the conclusion of the trial, Carroll (1992) concluded that the process was time consuming and the resulting diaries inconsistent in quality and difficult to code.

In summary, given the range of methodologies available, it would seem that significant results should have been achieved to date. Roth *et al.* (1989a:247) concluded otherwise; ... *There is little scientific evidence on which to base policies to encourage compliance, and there are few mechanisms in place for systematically accumulating more.* Richardson and Sawyer (2001) believe the state of tax compliance research to be one of development or transition as it strives to move towards maturity rather primitive as described by Jackson and Milliron (1986). Therefore, progress in tax compliance research has depended upon

refining current methodological approaches for conducting research. Chapter 5 discusses the research methodology used in this study so as to increase the level of understanding of SME taxpayer behaviour through focusing on perceptions of taxpaying (SMEs and tax practitioners) using survey instruments, analysis of actual cases and opinion from the tax authority. Combining these methods may lead to a richer understanding of the phenomenon under investigation. By incorporating multiple modes of analysis into the design, additional insights may be revealed that would otherwise remain undiscovered via a single methodological approach.

3.6 Summary

Clearly, there is considerable diversity in the behaviour of SME taxpayers motivated by a myriad factors with regard to tax evasion. This ambiguity could possibly be due to the methodological approaches that have been adopted in the particular research studies. All social science methodologies have their strengths and weaknesses and it is important to be sensitive to their limitations and thus select the methodology that is appropriate for the research goals.

Previous research also indicates that there is a role for tax practitioners in tax compliance activities and the extent to which tax practitioners meet the special needs of the taxpayers depends on a number of factors. The question as to whether they side with the revenue authority or their client is much less well documented.

The following chapter will review the issue of forensic accounting. Unfortunately, evidence concerning forensic accounting from academic research is still scant, yet it has been addressed within endless series of professional articles, texts and websites, all of which have provided a technically competent account of the profession as a particular mode of expertise boasting specific characteristics and producing identifiable effects.

CHAPTER 4

FORENSIC ACCOUNTING

All truths are easy to understand once they are discovered, the point is to discover them

Galileo Galilei

4.1 Introduction

This is the second of the two literature chapters and it highlights recent literature pertaining to the prominence of forensic accounting through tracing its origins, definition and significance in the taxation world. Unfortunately, evidence concerning forensic accounting collected by academics is still scant^{4.1}. It has, however, been addressed within numerous series of professional articles, texts and websites, all which have provided a technically competent account of the profession as a particular mode of expertise boasting specific characteristics and producing identifiable effects (for example, Dykeman, 1982; Bologna and Lindquist, 1995; Rosen *et al.*, 1999; Brennan *et al.*, 2001).

4.2 An Overview of Malaysian Financial Accounting and Reporting Practices

4.2.1 A Historical Perspective

The origin of financial reporting in Malaysia cannot be traced precisely but it must have existed at the time when businesses were first established as a separate legal entities. The first documented financial reporting regulations, however, were those of the Companies Ordinances (and amendments) of 1940, 1946 and 1956, before Malaysia (then Malaya) achieved her independence on 31 August 1957. These Ordinances played an important role in statutory regulations on financial accounting and reporting, until they were repealed by the establishment of the Malaysian Companies Act in 1965. The Act formally established the reporting requirements, rules and regulations on accounting in Malaysia.

^{4.1} Academic literature emphasizes the examination of current coverage and the future direction and role of forensic accounting education [see e.g. Rezaee *et al.*, 1996, 1997; Carnes *et al.*, 2001]

Under the Companies Act, 1965, the Ninth Schedule, specifies the disclosure requirements in the financial statements of Malaysian companies. The Act remained relatively unchanged until in 1985 when it was amended to incorporate a revised Ninth Schedule which contains a more comprehensive disclosure requirements and specifically requires that a statement of source and application of funds be an integral part of the financial statements in addition to a profit and loss account, a balance sheet, and the accompanying notes to the accounts. The Companies Act's main concern is that the accounts should be true and fair. It does not, however, state explicitly how this true and fair view should be judged and neither does the Act make reference to the accounting standards issued by professional bodies. Thus, in practice and in the absence of an accepted accounting framework for financial reporting in Malaysia, companies tend to use the Act as the absolute disclosure requirements rather than as minimum requirements. Empirical studies by Tan *et. al.* (1990) and Tan and Chew (1996) have shown that the extent of voluntary disclosure practices among Malaysian companies is very low, even among listed companies. It is not surprising that there were many accounts preparers in Malaysia who believed that disclosures should be strictly in accordance with those by the Act (and approved accounting standards) and nothing more (cited in Tan, 2000).

The development and advancement of financial accounting and reporting was also overseer by the accounting profession. The Malaysian Association of Certified Public Accountants (MACPA) a private sector accounting body was established in 1958 as a company limited by guarantee that regulates the practices of its members who carry the title of certified public accountant (CPA). The first accounting guidance issued by the MACPA was in 1968 and it dealt with a specimen company accounts. Items in that Specimen Company accounts (apart from being drawn up so as to comply with the requirements of Ninth Schedule of the Companies Act 1965), were also largely influenced by the practices then in United Kingdom and Australia. This mainly because most of its members were either trained in the United Kingdom or Australia, or had professional qualifications from accounting bodies in those two countries. After been admitted as a member of the International Accounting Standards Committee (IASC) in 1978, the MACPA began to adopting International Accounting Standards. In 1984, the first Malaysian Accounting Standards (MAS) was issued. The process of adoption of IASs and development of MASs continued until 1997 when the Malaysian Accounting Standards Board (MASB) was established.

Another accounting body known as the Malaysian Institute of Accountant (MIA) was established in 1967 under the Accountants Act, 1967. Although established under the statute, the MIA operates largely as a private sector accounting, and its regulations cover the practices of the whole accounting profession in Malaysia. After its establishment, it remained inactive and only concentrated mainly on registration of accountants in Malaysian until 1987, its operations were activated to that of a national accounting body.

4.2.2 Reporting Requirements by Type of Enterprise

The reporting requirements of an enterprise depend on the form of business organization it takes. A business enterprise in Malaysia may take the form of:

- A sole proprietorship
- A partnership; or
- A company incorporated under the companies Act, which can be –
 - a private company (Sdn Bhd)
 - an unlisted public company (unlisted Bhd)
 - a listed public company (listed Bhd)

For a non-incorporated enterprise (for example sole proprietorship or partnership), its reporting requirements are:

- To comply with the Approved Accounting Standards in the preparation and presentation of its financial statements; and
- To submit its financial statements to the Director General of Inland Revenue for the purpose of determining assessable income under the Income Tax Act

No other external reporting or submissions are required. The financial statements also do not need to be audited, unless its own constitution requires that the financial statement to be audited.

For a private company, its reporting requirements are:

- **To comply with the Approved Accounting Standards in the preparation and presentation of its financial statements;**
- **To comply with the Companies Act – financial statements must be audited, should reflect a true and fair view and should be submitted to the Registrar of Companies within 6 months of its financial year-end; and**
- **To submit its financial statements to the Director General of Inland Revenue for the purpose of determining assessable income under the Income Tax Act**

For an unlisted public company, all the reporting requirements of a private company stated above are applicable. In addition it has to comply with:

- **the securities commission's corporate disclosure policy concerning high standards of disclosure and dissemination of information. It does not, however have to comply with the SC's guidelines which relate to listed public companies;**
- **If it is a bank or financial institution licensed under Banks and Financial Institutions Act (BAFIA), it must comply with the Central Bank's guidelines.**

For a listed public company, its reporting requirements are more extensive as it has to comply with:

- **The Approved Accounting Standards**
- **The Companies Act**
- **The SC's guidelines**
- **The KLSE Listing Requirements**
- **The Income Tax Act**
- **The Central Bank's guidelines if it is a bank or financial institution**

A listed public company should submit:

- **Quarterly financial statements to the SC and the KLSE**

- Other interim and periodic financial reports to the SC
- the final audited financial statements to the SC, the KLSE, the ROC and the Director General of Inland Revenue; and
- Financial statements that have been drawn up to show a true and fair view and are in compliance with Approved Accounting Standards.

4.3 The question of origins: Tracing the history of the forensic accounting

Nurse (2002) claimed that the current prominence of forensic accounting masks the fact that the discipline's roots can be traced back more than 5,000 years. According to Nurse, archaeological findings, dating between 3300 and 3500 BC, have revealed the habit of the world's first accountants or scribes in Mesopotamia and Egypt, who recorded commercial transactions onto damp clay tablets or papyrus. A scribe would then enfold the original document in a thin clay envelope. If the outer tablet was tampered with later, it would trigger an investigation. Egyptian bookkeepers were careful to prepare meticulous records since any irregularities found by the royal auditors were punishable by fine, mutilation or even death.

Nurse (2002) also pointed out that during India's Maurya period (321-184 BC), records indicate the inclination to go beyond accuracy and accountability, addressing issues of criminality. Kautilya's *Arthashastra* (science of material wealth), the earliest known treatise on accounting concepts, had already given detailed instructions on check and balance accounting and auditing and lists at least 40 different types of embezzlement. Kautilya also considered the punishment for accountants failing in their duties, be it by deliberate fraud, incompetence or negligence (Bhattacharya, 2002).

In Scotland, the chartered accounting profession was only established in the nineteenth century and at this time a close relationship existed between lawyers and accountants. The two professions frequently belonged to the same associations and most lawyers offered clients accounting services. Accountants, in turn, incorporated the duties of expert witnesses into their general services rendered. An 1824 circular, announcing the accounting practice of one James McClelland of Glasgow, states that he will make 'statement for laying before arbiters, courts or council' (Nurse, 2002).

During these early years, legal work comprised a substantial portion of the accountant's services. When in 1854 the Edinburgh Society of Accountants petitioned Queen Victoria for a royal charter, it argued over the relationship between accounting and law. It stated that *'the business of the accountant is not confined to the Department of Actuary, it also ranges over a much wider field in which considerable acquaintance with the general principles of law is quite indispensable'*. By the early twentieth century, chartered accountants had increased their accounting services and court appearances reduced to a fraction of their overall business. It could therefore be argued that rather than a new speciality within accounting, *modern day forensic accounting represents a return to accounting roots* (Nurse, 2002).

The discipline of forensic accounting also gained prominence during the trial of the notorious gangster, Al Capone. Eliot Ness, an agent with the Prohibition Bureau during the 1930s, has earned a permanent place in the annals of American crime fighting for his efforts to convict Al Capone, yet Ness was only one of a team responsible for terminating Capone's career. In fact, it was an accountant with the Internal Revenue Service, Elmer Irey, who played the key role in pursuing Capone for tax evasion. Irey was, in effect, America's first high-profile forensic accountant. The team of investigators, dubbed 'the silent investigators', used their superior investigative and analytical skills to piece together an irrefutable chronicle of Capone's financial malfeasance (Nurse, 2002).

The first person to use the phrase 'forensic accounting' in print was probably Maurice E. Peloubet in 1946 (Crumbley and Apostolou, 2002). At that time, Peloubet was a partner in the public accounting firm of Pogson, Peloubet & Co. in New York. Peloubet (1946:459) stated that *'during the war both public accountant and industrial accountant have been and are now engaged in the practice of forensic accounting'*.

Peloubet (1946:460) noted that forensic accounting was only practised in the courtroom, and that the preparation of financial statements has some but not all of the characteristics of forensic accounting. As the number and power of administrative and regulatory agencies increase, the accountant finds himself *'more involved in what is essentially a type of forensic practice'*. The preparation of data for and the appearance before such agencies 'as

a witness to facts, to accounting principles or to the application of accounting principles is essentially forensic accounting practice rather than advocacy’.

4.4 What is forensic accounting?

Thornhill (1995) pointed out that the discipline of forensic accounting is relatively so new that, up to now, there has been no formal definition accepted as the standard. Random House College Dictionary defines the term ‘forensic’ as *“pertaining to, connected with, or used in the courts of law or public discussion and debate”*. Accounting is *“the system of recording and summarising business and financial transaction and analysing, verifying and reporting the results”*. Thus, it can be emphasised that forensic accounting is closely connected to the legal process and has the potential to be involved in proceedings in the civil and criminal courts.

According to the myriad of professional texts, manuals and publications that have emerged in recent years, forensic accounting refers to the application of accounting methodologies, techniques and expertise, and to the analysis and representation of issues, facts, and circumstances of consequence to various legal matters and proceedings. In other words, it is accounting work executed according to a particular standard of law and with the intention of supporting specific legal claims. The significance of this intersection of accounting and law as a defining feature of forensic accounting is argued by Rosen *et al.* (1999:92):

Forensic accounting and forensic accounting investigation involve the investigation of financial transactions and the accounting for such transactions so that the results can be of used in a civil or criminal litigation proceeding...The forensic accountant is usually needed to clarify, uncover and verify the facts in a case and may also be required to quantify disputed financial issues based on the facts of various circumstances by using a variety of methods of interpretation.

Along the same lines, Bologna and Lindquist (1995:42) also argue that forensic accounting involves:

... the relation and application of financial facts to legal problems. Forensic accounting evidence is oriented to a court of law, whether that court is civil or criminal. Furthermore, with its orientation to courts of law, the quality of the work forensic accountants must attain is subject to public scrutiny if the matter goes to trial.

The management of the intersections between business, accounting and law encompasses three specific forms of forensic accounting work. They may be broadly classified in a combination of (1) investigative, (2) analytical, and (3) adjudicative (Crumbley, 1990; Zysman, 2000; Rezaee *et al.*, 1992; Williams, 2002) aspects. The investigative dimension involves the collection and preliminary analysis of both financial and non-financial forms of information pertaining to a particular case. The analytical dimension involves the conversion of these informational inputs into more formal analyses and conclusions with respect to issues of responsibility, cost and potential avenues of legal resource through a forensic accounting report. The first two dimensions are primarily oriented to the question of what is happening within the particular case, the adjudicative dimension involves the participation of forensic accounting experts (forensic accountants) in the actual facilitation or delivery of particular adjudicative outcomes or solutions. This may take a variety of different forms ranging from the provision of advice to legal counsel in support of formal civil litigation and/or criminal prosecution, to the actual delivery of testimony as an expert witness. The critical dimension of the expert witness role is the investigation, analyses and conclusions in a format that is both suitable to the desired legal framing and which may be readily understood and digested by the various participants in the legal process, including judges, juries and other lawyers – who are often unfamiliar with complex accounting and financial matters (Dykeman, 1982). In visualising these legal issues, forensic accounting experts rely not only on their original reports but also on a variety of court schedules, exhibits and visual aids, which they are responsible for producing and communicating within the context of judicial proceedings. In summary, the involvement of forensic accounting experts in the legal process is extremely broad and encompasses a number of distinct professional functions.

Williams (2002) summarised forensic accounting as a unique and highly specialised form of professional expertise founded upon well developed and technically sophisticated accounting logics, methodologies, and competencies. It is also supported by the qualities of

independence, objectivity and neutrality. It is through these attributes that forensic accounting experts are able to transverse the categories and frameworks of business, accounting, economics and laws, while rendering judgements which are interpreted and institutionalised as legitimate, authorised and ultimately authoritative in nature. All of this is of course framed in terms of an investigative mentality, integrity and sense of ethical commitments, which stand in stark contrast to the structural conformity attributed to the traditional accounting function.

4.5 Role of forensic accounting in establishing tax evasion

One of the measures taken by tax authorities in developed countries (for example, the United States and the United Kingdom) for combating tax evasion practice is to make tax evasion a crime. The framework of forensic accounting fitted neatly into reforming the procedure of deterring tax evasion for the Malaysian tax office with the introduction of criminal tax investigation as opposed to the existing system of civil penalties.

In the Malaysian context, wilful evasion of tax is an offence under section 114 of the Income Tax Act 1967. This section prescribes the particular elements and acts that constitute the offence. For proceedings against a person under section 114, being criminal in nature, criminal law applies. As this is a statutory offence, the enforcement authorities must therefore examine what the "*mens rea*" (the guilty mind) and what the "*actus reus*" (the acts) are when constituting the offence prescribed by the law (IRD, 1989; Wise, 2000). The *actus reus* must be tied to *mens rea* and the enforcement authorities must prove the existence of *mens rea* in court. Obviously, each case will be decided on its own facts. To prove or disprove the *mens rea*, counsel will generally rely upon the work of the enforcement authorities, mostly based on the forensic accounting methods, who will testify as to whether the taxpayer established a scheme to evade tax.

4.5.1 Section 114 Income Tax Act 1967

Section 114 of the Income Tax Act, 1967 states the following:

“114(1) Any person who wilfully and with intent to evade or assist any other person to evade tax:

- (a) Omits from a return made under this act any income which should be included;**
- (b) Makes a false statement or entry in a return made under this Act;**
- (c) Gives a false answer (orally or in writing) to a question asked or request for information made in pursuance of this Act;**
- (d) Prepares or maintains or authorises the preparation or maintenance of false books of account or other false records;**
- (e) Falsifies or authorises the falsification of books of accounts or other false records;**
or
- (f) Makes use or authorises the use of any fraud, art or contrivance,**

shall be guilty of an offence and shall on conviction be liable to a fine not exceeding ten thousand Malaysian Ringgit or to imprisonment for a term not exceeding three years or to both, and shall pay a special penalty of treble the amount of tax which has been undercharged in consequence of the offence or which would have been undercharged if the offence had not been detected.”

“114(2) Where in any proceedings under this section it is proved that a false statement or false entry (whether by omission or otherwise) has been made in a return furnished under this Act by or on behalf of any person or in any books of account or other records maintained by or on behalf of any person, that person shall be presumed until the contrary is proved to have made that false statement or entry with intent to evade tax.”

4.5.2 Mens rea of section 114 of Income Tax Act 1967

The expression *mens rea* refers to the state of mind of the individual (IRD, 1989; Wise, 2000). In section 114, the *mens rea* is one of the prescribed acts that must have been carried out with the intention to *“wilfully and with intent to evade or assist any other person to evade tax”*.

In tax evasion conviction, the prosecution must therefore prove beyond reasonable doubt that the accused taxpayers “wilfully” committed one of the acts prescribed in the section 114 (paragraph (a) to (f) above) and that it was committed with the particular intention of wanting to evade tax.

4.5.2.1 “Wilfully”

The term “wilfully” has been considered and defined in several decided cases. In the case of Senior (1899) 1 Q.B. 283 at 290, Lord Russel of Killowen described the term as:

... ‘wilfully’ means that the act is done deliberately and intentionally, not by accident or inadvertence but that the mind of the person who does the act goes with it...

In the case of Ianella vs. French (1967-1968) 41, ALJR 389 at 393, Barwick J. stated:

Wilful connotes intention and knowledge...the word contains in its connotations elements of purpose

Windeyer J. (41 ALJR 389:399) in the same case expanded this interpretation as follows:

If the word ‘wilfully’ be given the meaning and effect that it thinks it has in this context, then an honest mistake as to the existence of any element to the offence is a defence’

Napier C.J., in the case of Davies vs. O. Sullivan (No.2) 1049 S.A.A.R 208, stated:

the nature meaning (of the term wilfully) is that the act was done intentionally, not by accident or inadvertence but so that the mind or will of the actor goes with the act...

The interpretations seem to suggest that where, for example, a false statement was made through careless or inadvertent omission, that act is not ‘wilful’. The particular acts, however, must be committed deliberately rather than by accident. The taxpayer concerned must have intended, seen from the natural consequences of his acts or omission, to evade tax.

Yet it is difficult to prove the state of an individual's mind at a given time. In relation to this, Bowen L.J., in *Edington vs. Fitzmaurice* (1885) 29 Ch.D 459, stated:

... the state of a man's mind is as much a fact as the state of his digestion. It is true that it is very difficult to prove what the state of a man's mind at a particular time is; but if it can be ascertained, it is as much a fact as anything is

The state of a man's mind is to be gathered from the acts and conduct of the person concerned and can be proved by circumstantial rather than direct evidence. A person may of course testify as to his intent, but if his acts and conduct are shown to be at variance and are inconsistent with the intent he swears to, his own testimony in his own favour would ordinarily obtain very little credit.

4.5.2.2 Intention

Tax authorities must prove that the taxpayers have intended the effect mentioned in section 114 before a conviction of tax evasion. Intention has been defined in *R.V. Mohan* (1975) 2 All.E.R 93 at 200 as:

A decision to bring about, in so far as it lies within the accused power, a particular consequence, no matter whether the accused designed that consequences were of his act or not

Intention is not the same as motive. What is important is the purpose of the act or omission. The effect is also relevant. Motive is the reason why; purpose is the aim or objects or end view. Under section 114, the motive of the taxpayer in omitting to include income which ought to be included is therefore irrelevant.

4.5.2.3 Wilfully with intent

Wilfully with intent means the doing of an act with the knowledge that certain consequences will follow. It does not mean recklessly or negligently, which mean the doing of an act thoughtlessly without regard to consequences. It is the foreknowledge of the act coupled with the desire for it and that it exists in idea before it happens in fact.

Two situations must be understood, i.e. the state of mind of one who commits an act because he/she desires it to produce a particular result and one who, when he/she commits an act, is aware what it is likely to produce but is prepared to take the risk that it may do so in order to achieve some other purpose.

Viscount Dilhorne, in *Hyam vs. DPP* (1974) 1 All.E.R. 41, stated:

A man does an act with a number of intentions. If he does it deliberately and intentionally knowing that when he does it, it is highly probable that (the consequence) follow, I think most people would say and be justified in saying that whether other intentions he may have had as well he at least intended that (particular consequence)

Lord Diplock in the same case added:

What is common... is willingness to produce a particular evil consequence ... in my view this is the mens rea needed to satisfy a requirement whether imposed by statute or existing common law that in order to constitute the offence with which the accused is charged he must have acted with intent to produce a particular evil consequence...

Therefore, intention need not be one's specific aim or target. So long as it is highly probable that a tax can be undercharged by reason of any device used by the taxpayer, it may amount to evasion. The court will in each particular case have to take the whole circumstances of the case.

4.5.3 *Actus reus*

With respect to the *actus reus*, the tax authority will need to provide the necessary tools to demonstrate whether or not there was tax evasion or at least an attempt thereof. In this respect, the tax authority will examine primary evidence, including books of accounts and other accounting records of the taxpayer, third party documents and statements or representations obtained from potential witnesses.

Documentary forensic accounting evidence is presented in court in two forms:

1. Primary, which includes individual accounting documents in original form, obtained directly from the taxpayer or other parties; and
2. Secondary, which includes schedules, exhibits, summaries, graphs and charts, which are based on the original source documents. While this evidence may not in and of itself be evidence, it has been admitted to assist the trier of fact in understanding the primary evidence.

Section 114(1) identifies six categories of acts, which if committed would constitute the offence of tax evasion. Assisting a person to commit any of the acts is itself an offence. Professionals who prepare tax returns or tax computations based on data supplied by their clients can also be charged under section 114. In such a situation, however, by virtue of section 114(2), there is a presumption that the taxpayer is to be held equally liable.

The Income Tax (Amendment) Act, 1999, however, introduced a specific provision in respect of a person who assists in, or advises with respect to the preparation of any return with the introduction of SAS. Under this provision, a person will be guilty of an offence if his/her advice or assistance in preparing the tax return results in an understatement of another person's tax liability. This will not apply if the tax practitioner exercises reasonable care in the course of providing the advice or assistance.

4.5.3.1 Non-reporting of income [section 114(1)a]

The paragraph of this section reads; *'Omits from a return made under this act any income which should be included'*.

The elements that constitute an offence under this section are; (1) there must be an omission from a return; and (2) the omission was 'income' which should have been included.

Whether there is 'omission' or not is a question of fact and that omission must relate to '*income which should be included*'. Income is not defined in the Act. Section 4 of the Act, however, sets out the classes of income on which tax is chargeable and any concealment of income from any of the sources mentioned in section 4(a) to (f) can be legally constructed as omission to include income which should have been included in the return.

4.5.3.2 False statement [section 114(1)b]

The paragraph of this section reads; '*Makes a false statement or entry in a return made under this Act*'.

The provision deals with fraudulent misrepresentation in a return made under the Act. A return is not defined in the Act, but it is submitted that a return made under the Act means a return in the prescribed form as detailed in section 77(1). The Director General is also empowered to compel a taxpayer to provide complete information by giving him a notice and that notice may specify the kind of return that is sought (section 78(a)).

To sustain a charge, firstly the taxpayer must wilfully with intent make an untrue statement. It may be made (1) knowingly, (2) without belief in its truth, or (3) recklessly or indifferently or carelessly as to whether the statement is true or false. It is submitted that if either of the above is proved, the taxpayer must be held to have made the statement or entry falsely.

4.5.3.3 False answers [section 114(1)(c)]

The paragraph of this section reads; '*Gives a false answer (orally or in writing) to a question asked or request for information made in pursuance of this Act*'.

The paragraph covers a situation where misleading, deceptive, inaccurate or untrue replies are given by the taxpayer when responding to queries and requests for information by the IRB. It may relate to oral responses as well as to those made in writing. Where a response is in oral form, such responses should be supported by some other form of evidence, for example in writing, or taped recordings, so as to avoid unnecessary problems in court.

4.5.3.4 False accounts and records [section 114(1)(d) and (e)]

The paragraphs of this section read; *'Prepares or maintains or authorises the preparation or maintenance of false books of account or other false records'* and *'Falsifies or authorises the falsification of books of account or other false records'* respectively.

There is a statutory duty for every trader to keep such books and records as may be necessary to enable an adequate return to be made (Section 82 of the Act). Any person preparing or maintaining or authorising such preparation or maintenance having false books or records of account are liable to be charged under this section. Tax evasion by this category of people is that there is an understatement of income supported by incorrect accounts or an understatement of income supported by false accounts.

The only difficulty here is what happens if the taxpayer confesses that he did maintain two sets of books, as claimed by Tighe (1985) (cited in Rice, 1992) in the United States, that many businesses maintain two sets of accounts in order to evade taxes. By this practice, the firm keeps two sets of accounting books, one that records all the real values of revenue and cost that are used for management and another that has the false accounting information which is used for tax purposes. This is a question of evidence and intention must therefore be proven.

4.5.3.5 Fraud, art or contrivance [section 114(1)(f)]

The paragraph of this section reads; *'Makes use or authorises the use of any fraud, art or contrivance'*.

This is a sweeping provision and covers situations envisaged by earlier paragraphs. It is an all-embracing provision, which sums up the underlying basis of tax evasion.

Fraud is a human phenomenon, which can take many forms and may be the basis for either a civil action or a criminal charge (Comer, 1985). According to the Auditing Practising Board (1995), fraud comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by

one or more individuals among management, employees or third parties. It is the obtaining of pecuniary advantage by deceitful means and an act of deliberate cheating which involves trickery and cunning methods to fool the tax authority. This includes, among others:

- (a) Manipulation of figures, falsification or alteration of records or documents. Forgery or sham transactions to evade tax.
- (b) Suppression or omission of the actual substance of a particular transaction. The twisting of facts and concealment of material information from tax authorities.
- (c) Recording of transactions which in fact are in substance non-existent.
- (d) Exaggeration of outgoings, disbursements, expenditures or other payments howsoever described.
- (e) Distorting facts about assets and liabilities.
- (f) Malicious cover-up action of any sort with intent to evade tax.

4.6 Forensic accounting techniques in proving undeclared income

The criminal tax investigators must gather evidentiary documents, interview potential witnesses and piece together the elements that are necessary to prove that a crime was committed by tying the *actus reus* to the *mens rea*. Because *mens rea* relates to fraudulent intent, it must be demonstrated that there was a pattern of evasion sufficient to establish that it was an oversight by the taxpayer.

In order to prove that there is a substantial amount of additional tax due and that there was a wilful attempt to evade it, the correct taxable income in excess of that reported must be established. This is done by the direct approach, which involves proof of specific items relating to sales, expenses etc., or the indirect approach, which is based upon circumstantial evidence relating to the taxpayer's income.

With respect to the direct method, the tax authority attempts to establish that the taxpayer's transactions during the taxation year are not accurately reflected in the income tax returns, and the taxpayer is thereby wilfully understating income tax liability. This involves probing missing income by pointing to specific items of income that do not appear on the tax return. The evidence may include admissions of the defendant, the defendant's books and records,

bank records, the testimony of inside witnesses (e.g. the defendant's employees and ex-spouse), the testimony and documentation of witnesses engaged in the transactions which have been reported inaccurately and the testimony of the defendant's accountant.

When direct methods prove unproductive and the tax authority has a reasonable indication that there is a likelihood of unreported income, indirect methods may be employed. The indirect methods use economic reality and financial status techniques in which the taxpayer's finances are reconstructed through circumstantial evidence. The methods commonly used^{4.2} by tax authorities for proving unreported income are as follows: (1) net worth method; (2) expenditure; (3) bank deposits; (4) percentage mark-up; (5) units and volumes; and (6) Benford's law.

In Malaysia^{4.3}, there is no statutory provision expressly authorising the IRB to use whatever method necessary in determining unreported income in cases where the taxpayer maintains no records or the financial records are inadequate and unreliable. It is the responsibility of the IRB to seek out and counter evasion where it is known or thought to exist.

4.6.1 Net worth method

The net worth method was first used in the US in 1931. It was developed by the Internal Revenue Service of the United States (IRS) to prove the income tax evasion of Al Capone. The method involves the collection and examination of the taxpayer's personal and business records to obtain particulars of assets and liabilities for establishing lifestyle, a long process which entails a study and verification of the detailed movement of the taxpayer's assets. The tax authority will compare increments in wealth with known income on a calendar year basis to determine whether there has been any omission or understatement of income, which is shown by discrepancies in the comparisons.

^{4.2} Commonly used by developed countries, for example the US, the UK, Canada and Australia. The Malaysia tax authority has also used indirect methods, especially the net worth method, since 1947 with the introduction of investigation activities.

^{4.3} In the United States, Treasury Regulation 1.446 authorises the IRS to use whatever method necessary in determining unreported income.

Figure 4.1 illustrates an example of the calculation of the net worth method.

Figure 4.1: The Net Worth Method

Year One	Year Two
Assets	Assets
Less: Liabilities	Less: Liabilities
Equal: Net Worth	Equal: Net Worth
	Less: Net worth in year one
	Equal: Net worth increase
	Add: Non deductible expenditure
	Less: Non taxable income
	Equal: Corrected taxable income
	Less: Reported taxable income
	Equal: Unreported taxable income

The determination of non-deductible expenditure may not be easy. Barson (1986:98) made the following suggestions for determining expenses:

For that you need to go into the checking and savings accounts of individuals and depending on the extent of the accuracy of the records involved, you may have to make certain assumptions. Interview the parties involved and reconstruct their standard of living, making some educated guesses as to what they spend on such mundane expenses as food, clothing and various other elements of living that often leave little or no residue financial trail. Be as thorough as possible in as much as you are on less stable ground (even though the ultimate result may be very supportable ones) than if you had come up with proof in the form of actual cash deposits that were not reconcilable to reported income.

According to Wise (2000) and Crumbley *et al.* (2003), the net worth method is useful where; (1) the taxpayer keeps no books or records; (2) the taxpayer does keep books and records, but (a) they are not available, (b) they are incomplete, (c) refuses to produce them; (3) another indirect method of proving income was applied, and the net worth method is used to corroborate it.

The typical defences to the net worth method may include: (1) the calculation of the opening net worth and the closing net worth merely includes the discovery of assets already

owned; (2) increases in net worth are from non-taxable sources, such as gifts, loans and inheritances; (3) the use of erroneous accounting procedures to calculate net worth; (4) the holding of assets or funds as a nominee; or (5) an opening net worth of substantial cash on hand which failed to be considered.

4.6.2 Expenditures method

The expenditure method (also referred to as source and application of funds method) is similar to the net worth method in that the relationships among income, personal expenditures and increases/decreases in the taxpayer's assets are the same under both methods. The method is based on the theory that if the taxpayer's expenditures during a given period exceed reported income and the source of such expenditure is unexplained, it may be inferred that such expenditures represent unreported income.

The defence against this method is similar to that argued in the net worth case outline above.

Figure 4.2 gives an example of the calculation of undeclared income using the expenditures method.

Figure 4.2 : The Expenditure Method

	Year
Total	Expenditure
Less:	Total non taxable source
Equal:	Adjusted gross income
Less:	Allowable deduction
Less:	Exemption
Equal:	Corrected taxable income
Less:	Reported taxable income
Equal:	Unreported taxable income

4.6.3 *Bank deposit method*

The bank deposit method looks at the funds deposited during the years. This method attempts to reconstruct gross taxable receipts rather than adjusted receipts. Figure 4.3 shows the general formula for determining taxable income using the bank deposit method.

Figure 4.3: Bank Deposit Method

Total Deposit
Add: payment made in cash
Subtotal
Less: Non Income deposits and items (loan, gifts, etc)
Total receipts
Less: Business expenses and cost
Net income from the business
Less: Deductions and exemptions
Taxable Income

The main defence in bank deposit cases is that the amount of the deposits indicates prior accumulated funds and that no current receipts are involved; that the deposits reflect, in whole or in substantial part, non-income items, income items attributable to other years or duplicates of current income already accounted for by the taxpayer.

4.6.4 *Percentage mark-up method*

The percentage mark-up method is used mainly in connection with retail operations. The income statement is restructured using such mark-ups, mark-downs or gross percentages based on the industry averages. This is done using the taxpayer's own records such as price list, sales invoices, purchases invoices, freight in and custom duties and so forth, which are reviewed and the percentage mark-up is calculated where such documents provide a reasonable basis.

Due to the subjectivity involved with respect to factors considered in the calculation, for example type of merchandise, the geographical location, the size of the taxpayer's business

operation, the relevant period, and so forth, it may be difficult to prove what the real income of the operation is.

4.6.5 Unit and volume method

This method involves multiplying the number of units sold by the selling price per unit, which determines or verifies the gross receipts. The gross profit margin can then be applied to determine the gross profit of the business before overhead expenses.

4.5.6 Benford's law

Benford's law has been promoted as providing the tax authority with a tool that is simple and effective for the detection and proving of tax evasion. The law is based on a peculiar observation that certain digits appear more frequently than others in data sets, as noted by Simon Newcomb (Nigrini, 2000)^{4.4}. Newcomb calculated that the probability that a number has any particular non-zero first digits (zero is not a valid first number, but it is a valid second or later digit) is:

$$P(d) = \text{Log}_{10}(1 + 1/d)$$

Where: d is a number 1, 2 ...9, and

P is the probability

^{4.4} Newcomb observed that library copies of books of logarithms were considerably more worn out in the early pages, which dealt with low digits, and progressively less worn on the pages dealing with higher digits. He inferred from this pattern that fellow scientists used those tables to look up numbers which started with the numeral one more often than those starting with two, three and so on. He concluded that more numbers exist which begin with the numeral one than with larger numbers. He however provided no theoretical explanation for the phenomena that he described. Then, almost 50 years later, Frank Benford, a physicist, also noticed that the first few pages of his logarithm books were more worn than the last few. He came to the same conclusion that Newcomb had arrived at years prior; that people more often looked up numbers that began with low digits rather than high ones. Benford also posited that there were more numbers that began with the lower digits. He tested his hypothesis by collecting and analysing the data from 20,000 observations from data sets such as rivers, atomic weight of elements and numbers appearing in *Reader's Digest* articles (cited in Durtschi *et al.*, 2004). He found that numbers consistently fell into a pattern with low digits occurring more frequently in the first position than larger digits, which later became known as Benford's law.

Using the formula, the probability that the first digit of a number is one is about 30 per cent while the probability the first digit a nine is only 4.6 per cent. Table 4.4 shows the expected frequencies for all digits 0 through 9 in each of the first places in any number.

Table 4.4
Expected frequencies based on Benford's Law

Digit	1st place	2nd place	3rd place	4th place
0		0.11968	0.10178	0.10018
1	0.30103	0.11389	0.10138	0.10014
2	0.17609	0.19882	0.10097	0.10010
3	0.12494	0.10433	0.10057	0.10006
4	0.09691	0.10031	0.10018	0.10002
5	0.07918	0.09668	0.09979	0.09998
6	0.06695	0.09337	0.09940	0.09994
7	0.05799	0.09035	0.09902	0.09990
8	0.05115	0.08757	0.09864	0.09986
9	0.04576	0.08500	0.09827	0.09982

Source: Nigrini, 1996

Formulas for expected digital frequencies:

For first digit of the number:

$$\text{Probability}(D_1 = d_1) = \log(1 + (1/d_1)); d_1 = (1,2,3...9)$$

For second digit combinations:

$$\text{Probability}(D_2 = d_2) = \sum_{d_1=1}^9 \log(1 + (1/d_1 d_2)); d_2 = (1,2,3...0)$$

For two digit combinations:

$$\text{Probability}(D_1 D_2 = d_1 d_2) = \log(1 + d_1 d_2)$$

$$\text{Probability}(D_2 = d_2 | D_1 = d_1) = \log(1 + d_1 d_2) / \log(1 + (1/d_1))$$

Where:

D_1 represents the first digit of a number

D_2 represents the second digit of a number, etc.

Nigrini (2000) illustrated a simple scenario so as to understand the law. Consider a city with a population of 1,000,000. It will have to double in size before the first digit is a '2', in other words it needs to grow 100 per cent. For the first digit to be '3', it only needs to grow 50 per cent. To be a '4' the population must only grow 33 per cent and so forth. This explains why '1' will consistently be a first digit that is much further from other digits.

Thus, the observed finding is that smaller values of the first significant digits are much more likely than larger values.

According to Durtshi *et al.* (2004), most accounting-related data can be expected to conform to a Benford distribution, as shown in the proof by Hill (1995)^{4.5}. Such is the case because the typical accounts consist of transactions that result from combining numbers (for example accounts receivable, which is the number of items sold [which comes from one distribution], multiplied by the price per item [coming from another distribution]). Benford analysis will reveal various underlying peculiarities in an account but not all accounts shown not to conform to the law will be fraudulent. Not conforming, however, should raise some level of suspicion. Figure 4.4 summarises when it is appropriate to use Benford's Law, and when to use caution.

^{4.5} Hill's proof relies on the fact that the numbers in sets that conform to the Benford distribution are second-generation distributions, that is, combinations of other distributions. If distributions are selected at random and random samples are taken from each of these distributions, then the significant digit frequencies of the combined sampling will converge to Benford's distribution, even though the individual distributions may not closely follow the law. In other words, combining unrelated numbers gives a distribution, a law of true randomness that is universal.

Figure 4.5
When Benford's Law is or is not likely useful

<i>When Benford's Law is likely Useful</i>	<i>Example</i>
Sets of numbers that result from mathematical combination of numbers - Result comes from two distributions	Accounts receivable (no. sold * price) Accounts payable (no. bought * price)
Transaction-level data- No need to sample	Disbursements, sales, expenses
On large data sets - the more observations, the better	Full year's transactions
Accounts that appear to conform to Benford Law - When the mean of a set of numbers is greater than the median and the skewness is positive	Most sets of accounting numbers
<i>When Benford's Law is not likely to be useful</i>	<i>Example</i>
Data set is comprised of assigned numbers	Cheque numbers, invoice numbers, zip codes
Numbers that are influenced by human thought	Prices set at psychological thresholds (\$1.99), ATM withdrawals
Accounts with a large number of firm-specific numbers	An account specically set up to record \$100 refunds
Accounts with a built in minimum or maximum	Set of assets that must meet a threshold to be recorded
Where no transaction is recorded	Thefts, kickbacks, contract rigging

Source: Durtschi et al. (2004)

According to Nigrini (1996), in general, when the actual proportion of low digits exceeds the expected frequencies under Benford's law, this indicates that the numbers have been manipulated downwards. Conversely, when the actual proportion of high digits exceeds the expected frequencies, this indicates that the numbers have on average been manipulated upwards^{4.6}.

^{4.6} Nigrini developed a Distortion Factor (DF) Model that quantified the extent of unintentional tax evasion. Tax returns on the U.S. IRS Individual Tax Model Files were analysed. The analysis based on the digital frequencies indicated that low-income taxpayers practise unintentional tax evasion to a greater extent than high-income taxpayers.

4.7 Summary

This chapter has highlighted the origins, definition and the significance of forensic accounting in taxation with some illustrations of the different methods commonly used by tax authorities in proving income tax evasion.

Forensic accounting represents a return to accounting roots rather than a new speciality within accounting. It is seen as a field that encapsulates all the other areas in the use of the accounting framework for investigation purposes. The use of forensic accounting techniques, together with knowledge and skills in other investigation methods, will enhance the investigation and the enforcement officers' ability to investigate and prosecute those involved in tax evasion and criminal acts.

The following chapter introduces methodological considerations with respect to this study. The chapter also highlights the importance of certain statistical techniques relevant to this study, as well as a number of tests to signify the validity and reliability of the adopted research process.

CHAPTER 5

RESEARCH METHODOLOGY

...if the research is worth doing, then one is likely to be dealing with a problem which is not fully understood, and for which the ideal course of investigation cannot be charted in advance with any certainty.

Easterby-Smith et al. (2002:13)

5.1 Introduction

There appear to be a number of methodologies for conducting tax evasion research, as discussed in Chapter 3 (section 3.5). Hasseldine and Zhuhong (1999:98) noted that the research method employed and the inherent trade-offs in the research would have consequences for the validity and robustness of the results. Jackson and Milliron (1986:146) identified the need for this as they commented that too often answers to interesting questions are indeterminate because the research plan is inadequate to support the research objective, thereby casting doubt on the validity of the research findings. The quest for valid research methodology remains a vital aspect of tax compliance research and the aim of this chapter is to outline and justify the research method employed in this study.

This chapter presents an overview of the methodological perspective of the research and statistical issues with a view to selecting and formulating an appropriate research framework for this study into tax evasion. The chapter begins with a discussion of the philosophy of research and research methods in general. This is followed with the choice of and justifications for the research method in the current study. Then a comprehensive description is provided for each of the research strategies adopted by outlining the research framework for data collection: reliability and validity issues are also discussed. Next is a brief orientation to the statistical procedures used to analyse the data. Finally, a summary section concludes the chapter.

5.2 Research and research methods

There is no consensus in the literature on how research should be defined. One reason for this is that research means different things to different people. From the many different

definitions offered, however, there appears to be agreement that: (1) research is a process of enquiry and investigation; (2) it is systematic and methodical; and (3) research increases knowledge (Remenyi *et al.*, 1998).

Buckley *et al.* (1975:28) suggested that the definition of research requires the satisfaction of the conditions that: (1) it be an orderly investigation of a defined problem; (2) appropriate scientific methods be used; (3) adequate and representative evidence be gathered; (4) logical reasoning be employed in drawing conclusions on the basis of the evidence; (5) the research be able to demonstrate or prove the validity or reasonableness of the conclusions; (6) the cumulative results of research in a given area yield general principles or laws that may be applied with confidence under similar conditions in the future.

Research is conducted in the spirit of inquiry, which relies on facts, experience and data, concepts and constructs, hypotheses and conjectures, and principles and laws, all of which are commonly used but easily confused concepts in science. Figure 5.1 (abstracted from Buckley *et al.*, 1975:29) illustrates how these concepts of research together form a symbolic and rational system of inquiry. Additionally, they constitute the language of research, enabling precision in the use of words and communication among those concerned.

Figure 5.1
Basic elements of scientific research methodology

Laws	Verified hypotheses; used to assert a predictable association among variable: can be empirical or theoretical
Principles	A principle is a law or general truth which provides a guide to thought or action
Hypotheses	Formal propositions which, through untested, are amenable to testing; usually express in casual terms
Conjectures	Informal propositions which are not stated in a testable form, nor is a casual relationship known or even necessarily implied
Concepts and Constructs	Concepts are inventions of the human mind to provide a means for organising and understanding observations; they perform a number of functions, all of which are designed to form logical and systematic relationship among data
Facts	Something that exists, a phenomenon that is true or generally held to be true
Data	The collection of facts, achieved either through direct observations or through garnering from records; observation is the process by which facts become data

Source: Buckley *et al.* (1975:28-29)

Remenyi *et al.* (1998) defined research methodology as the procedural framework within which the research is conducted. They further argued that there are many factors to be considered when choosing an appropriate research methodology, with the topic to be researched and the specific research questions being the primary drivers. The important thing is that the form of inquiry adopted in any investigation should not be shaped simply by a commitment to particular research methods for their own sake, but should be logically consistent and appropriate given the aims of the research and the values and assumptions that lie behind it (Hooper and Powell, 1985).

5.3 Schools of thought

Research falls into two main areas, namely qualitative research and quantitative research. Patton (1990) views the former as concentrating on words and observations to express reality and attempts to describe people in natural situations. In contrast, the quantitative approach grows out of a strong academic tradition that places considerable trust in numbers that represent opinions or concepts.

Patton (1990) also noted that philosophers of science and methodologists have been engaged in a long-standing epistemological debate about how best to conduct research. The debate centres on the two fundamentally different and competing schools of thought or inquiry paradigms: (1) positivism; (2) phenomenology. Positivism uses quantitative and experimental methods to test hypothetical-deductive generalisations. Among the major implications of this approach are the need for independence of the observer from the subject being observed and the need to formulate the subject hypotheses for subsequent verification. Positivism searches for causal explanations and reduces the whole to the simplest possible elements in order to facilitate analysis (Remenyi *et al.*, 1998; Easterby-Smith *et al.*, 2002). Phenomenological inquiry, however, uses qualitative and naturalistic approaches to inductively and holistically understand human experience in a context-specific setting. This latter approach tries to understand and explain the phenomenon, rather than search for external causes or fundamental laws (Remenyi *et al.*, 1998; Easterby-Smith *et al.*, 2002). This picture is set out in Figure 5.2 (Silverman, 1998).

Figure 5.2
Two school of science

Approach	Concepts	Methods
Positivism	Social structure Social facts	Quantitative Hypothesis testing
Phenomenological	Social construction Meanings	Qualitative Hypothesis generation

Source: Silverman (1998)

Although the distinction between the two paradigms may be very clear at the philosophical level, as Burrell and Morgan (1979) argue, when it comes to the use of quantitative or qualitative methods and to the issues of research design the distinction breaks down (Bulmer, 1988). This is due to different researchers exhibiting different preferences and leaning toward one direction or style of research. Moreover, the range of methods of data collection represented does not divide easily into quantitative and qualitative. Filstead (1979) views quantitative and qualitative methods as being more than just differences between research strategies and data collection procedures. These approaches represent fundamentally different epistemological frameworks for conceptualising the nature of knowledge, social reality and procedures for comprehending those phenomena.

In research design, therefore, it is crucial to be cognisant of the methodological paradigm debate in order to appreciate why decisions regarding methods can be controversial. Guba and Lincoln (1994:116) stated that “Paradigm issues are crucial; no inquirer, we maintain, ought to go about the business of inquiry without being clear about just what paradigm informs and guides his or her approach”.

Patton (1990:39) advocates “a paradigm of choices” as a way out of the dilemma. “A paradigm of choices rejects methodological orthodoxy in favour of methodological appropriateness as the primary criterion for judging methodological quality.” The paradigm of choices recognises that different methods are appropriate for different situations. This issue then becomes not whether one has uniformly adhered to prescribed canons of either positivism or phenomenology but whether one has made sensible method decisions given the purpose of the study, the questions being investigated and the resources available

(Bulmer, 1979; Morgan and Smircich, 1980). Remenyi *et al.* (1998) summarised the main differences between the positivist and the phenomenological viewpoints based on the work of Easterby-Smith *et al.* (1991), as shown in Figure 5.3.

Figure 5.3
Key features of positivist and phenomenological paradigm

Theme	Positivist Paradigm	Phenomenological Paradigm
Basic beliefs	The world is external and objective Observer is independent Science is value free	The world is socially constructed and subjective Observer is part of what is observed Science is driven by human interest
Researcher should	Focus on facts Look for causality and fundamental law Reduce phenomena to simplest elements Formulate hypotheses and test them	Focus on meaning Try to understanding what is happening Look at the totality of each situation Develop ideas through induction from data
Preferred method in the research	Operationalising concepts so that they can be measured Taking large sample	Using multiple methods to establish different views of the phenomena Small samples investigated in depth or over time

Source: Easterby-Smith (1991)

Patton (1990:69) further points out that a main concern confronting researchers is the polarisation of views held by each paradigm, "...it is this aspect of paradigms that constitutes both their strength and their weakness – their strength in that it makes action possible, their weakness in that the very reason for action is hidden in the unquestioned assumptions of the paradigm". Figure 5.4 provides a view of a summary of some of the strengths and weaknesses of the two research paradigms.

Thus no one research method is superior to another and each research method has its own unique ways to collect and analyse data, and each strategy has its own particular strengths and weaknesses. It is the appropriateness of the method of investigation to the specific study being undertaken that is the main concern in a particular research study. Therefore, construction of a logical research process is of paramount importance in order to lend credence to the research findings (Wallance, 1971).

Figure 5.4
Comparison of strengths and weaknesses

Approach	Strengths	Weaknesses
Positivist (Quantitative paradigm)	<ul style="list-style-type: none"> they can provide wide coverage of the range of situations they can be fast and economical where statistics are aggregated from large samples, they may be of considerable relevance to policy decisions 	<ul style="list-style-type: none"> the methods used tend to be rather inflexible and artificial they are not very effective in understanding processes or the significance that people attach to actions they are not very helpful in generating theories because they focus on what is, or what has been recently, they make it hard for policy makers to infer what changes and actions should take place in the future
Phenomenological (Qualitative paradigm)	<ul style="list-style-type: none"> data gathering methods seen as more natural rather than artificial ability to look at change processes over time ability to understand people's meaning ability to adjust to new issues and ideas as they emerge contribute to theory generation 	<ul style="list-style-type: none"> data collection can be tedious and require more resources analysis and interpretation of data may be more difficult harder to control the pace, progress and end points of research process policy makers may give low credibility to results from qualitative approach

Source: Easterby-Smith et al. (1991:33)

5.4 Choice of research strategy

From the discussion of these schools of thought, it is apparent that both the qualitative and quantitative methods have differing strengths and weaknesses. McGrath (1982), in his study of research choices, makes it clear that there are no ideal solutions, only a series of compromises. Cronbach (1982:239) has observed that, “designing a study is as much art as science...it is an exercise of the dramatic imagination.” Patton (1990:13) also expressed the same view: “research, like diplomacy, is the art of the possible”. Thus, a mixed approach of quantitative and qualitative research methods would be the most appropriate in order to avoid their respective weaknesses. This may provide complementary data sets, which together give a more complete picture than can be obtained using either method singly, as justified below.

As suggested by Jackson and Milliron (1986), Hasseldine and Zhuhong (1999), and Richardson and Sawyer (2001), mixed approaches hold promise to improving tax compliance/evasion research. Jackson and Milliron (1986:146) commented that with research in tax compliance, too often the research plan is inadequate to support the research objective. Richardson and Sawyer (2001:200) observed that research studies in tax compliance have been criticised for their conflicting research results obtained when different research methods are used in the same study. It is possible that these discrepancies are the result of different research methods measuring different types of non-compliance; however, this is merely speculation at this point in time. They further argued that the finding that different research methods yield different results underlies the need for triangulation. Without such an approach, results will always be method dependent and any conclusions reached can be no more than provisional.

Moreover, combining these methods may lead to a richer understanding of the phenomenon being studied, especially when investigating human behaviour and attitudes (Patton, 1990; Easterby-Smith *et al.*, 2002), and thus improve the validity of the data. By incorporating multiple modes of analysis into the design, additional insights may be revealed that would otherwise remain undiscovered via a single method approach.

The advocates for mixed approaches (for example, see Jick, 1979; Das, 1983; Denzin, 1989; Tashakkori *et al.*, 1998; Creswell, 2003) argue that neither paradigm alone (quantitative only or qualitative only) will provide a deep understanding of the subject being studied, but together, the two offer the potential to inform and complement each other. Using different sources and methods strengthens each type of data collection and minimises the weaknesses of any single method. This helps in producing a more authoritative piece of research by increasing the strength of the research design. Das (1983:311) stated that, “...*qualitative and quantitative methodologies are not antithetic or divergent; rather they focus on the different dimensions of the same phenomenon. Sometimes, these dimensions may appear to be confluent: but even in these instances, where they apparently diverge, the underlying unity may become visible on deeper penetration...The situation contingencies and objectives of the research would seem to play a deceive role in the design and execution of the study*”.

Denzin (1989:307) also noted that *“by combining multiple observers, theories, methods and data sources, (researchers) can hope to overcome the intrinsic bias that comes from single methods, single observers and single theory studies”*.

In the context of developing countries, Bulmer and Warwick (1993) argued that multi-method approaches are important, especially for social science research; one reason being that it can be very hard to locate and find research data in a specific field due to bureaucracy. A second reason is that in a developing country, due to cultural orientation, people are not used to expressing their opinions frankly; they have a tendency to say what the other person wants to hear.

A number of research strategies are available for conducting research. According to Yin (1994), a research strategy should be chosen as a function of the research situation. Each research strategy has its own specific approach to collecting data and analysing empirical data and therefore each strategy has its own advantages and disadvantages. Although each strategy has its own characteristics, there are overlapping areas which bring complexity to the process of strategy selection. In order to avoid gross mismatches between the desired outcome and the chosen strategy, Yin (1994:4) put forward three criteria for choosing a certain type of research strategy. These are *(1) the type of question posed; (2) the control over actual behaviour elements; and (3) the degree of focus on historical or contemporary events*.

Figure 5.5 shows the outcome of the intersection between most common research strategies and the three conditions identified by Yin (1994). However, in this thesis, the choice of strategy as a principle research technique is based on the contention that it was the most appropriate and efficient means available for addressing the research questions.

Based on the research questions proposed in this study (see Chapter 1, section 1.3), the research strategies of a questionnaire survey, analysis of file data/actual cases and group interviews were to be used to obtain information on the areas identified for the research (see section 5.5 and 5.6 for a detailed discussion). A group interview, however, was not conducted due to unforeseen circumstances. As a fallback method, the semi-structure

questions intended for the group interview were later distributed as an open-ended questionnaire.

Figure 5.5
Research strategies versus characteristics

Strategy	Form of research question	Requires control over behaviour events?	Focuses on contemporary events?
Experiment	How, Why	Yes	Yes
Survey	Who, What*, Where, how many, how much	No	Yes
Archival analysis	Who, what*, where, how many, how much	No	Yes/No
History	How, Why	No	No
Case studies	How, Why	No	Yes

Source: Yin (1994:17)

* 'what' questions, when asked as part of an exploratory, pertain to all five strategies

The questionnaire was designed to gain a general insight into how the different SME taxpayers and tax practitioners in Malaysia perceived the situation in relation to tax evasion and forensic accounting. The results from the questionnaire survey would further provide a contemporary opinion on top of the case file analysis and opinions from IRB personnel. Whatever the case, the author believed that they would provide a justification and explanation of the tax evasion by SMEs and forensic accounting in Malaysia.

Having identified the choice of strategy to be taken, the discussion from here on will therefore focus primarily on methodological issues relating to the chosen strategies for data collection, data analysis and validation.

5.5 Quantitative component

5.5.1 Introduction

According to McKerchar (2001), a common weakness of quantitative studies on tax evasion/compliance has been the inability to generalise the findings to the broader population, because the researchers have had to work independently of the tax authority and

thus have been unable to study random samples of taxpayers. This present study, however, was given permission to use the tax authority's (Inland Revenue Board, Malaysia) database to address this weakness, but within a limited coverage so as to ensure taxpayer privacy and not to contravene the tax law (Section 138, Income Tax Act 1967^{5.1}). Given this opportunity, the desire to reduce bias in as many forms as possible, and the nature of information to be collected, a mail survey questionnaire was determined to be the most practical and reliable method of data collection.

By definition, a questionnaire is a set of questions as an instrument of research for data collection (Oppenheim, 2000). In this study, the questionnaire was the main instrument through which data was accumulated. A mailed questionnaire survey was adopted, as the approach is judged a suitable, economical, effective and a reliable means of obtaining the primary data and also desirable for investigating sensitive attitudes or behavioural patterns. Questionnaires can also obtain quantitative and qualitative data. Mailed questionnaires also allow researchers to obtain a larger sample with wide coverage and allow the respondents to complete the questionnaire in their own time. However, it is recognised that mailed questionnaires are subject to response bias.

5.5.2 Questionnaire design

In order to gain complete coverage of the research questions, two sets of questionnaires (see Appendix I and II) were designed to collect data from SME taxpayers and tax practitioners. By addressing the related questions to these two groups, it was possible to draw on each subject's opinions, experience and specialist knowledge of tax laws, tax evasion and the impact on both of the technical aspects of the legislation, and the impact that the administration of the tax system has on tax evasion by SMEs.

^{5.1} Section 138 of the Act provides that every classified person shall deal with classified material as confidential. Therefore, there is a duty of confidentiality with regard to the information obtained about the affairs of taxpayers. A classified person is defined to include not only IRB officials, the Auditor General and his officers, but also any person advising or acting for a person who is or may be chargeable to tax, and any employee of a person so acting or advising who had access to classified material. Therefore, a duty of confidentiality is imposed on professional advisers such as accountants and lawyers. Classified material means any return or other document made for the purposes of the Act and relating to the income of any person or partnership and any information which comes to the notice of a classified person in his/her capacity as such.

Considerable attention was given to developing clear, unambiguous and useful questions aimed at answering the research questions; this included conducting two pilot studies. The first was with fellow doctoral students within the university, colleagues from Edinburgh University and selected academic staff of the Accounting and Finance Division of Heriot-Watt University. The second piloting stage was done using a non-random representative sample of the tax practitioners and SME taxpayers at the researcher's hometown in Malaysia.

The development of the questionnaire was carried out in four phases:

Phase 1: Literature review: To determine the appropriate concepts to be included, the design of the research framework, which served to guide the desired information and specify the relationships to be investigated

Phase II: Question Development: Questions were developed both from previous studies and original ideas, and were modified to suit the conditions and background of the largely different Malaysian respondents so as to ensure that responses were not so much a reflection of their business acumen as of their cultural background. The purpose of this stage was to evaluate whether respondents understood and correctly interpreted the meaning of the questions and whether the range of response alternatives was sufficient. Sentence structure for the questions was short and simple in order to avoid ambiguity.

As the area of taxation, and especially tax evasion, is sensitive in nature, most of the questions in the questionnaire were generally indirect, such as:

(Question 2.3, Appendix 1):

Image yourself in this situation: One of your clients has been paid RM100,000 in cash for work that was done outside the regular job. As a tax practitioner which action would you take in reporting that income to IRB? – this will indirectly answer the research question concerning the characteristics of tax evasion and whether it is deliberate or accidental in nature.

(Question 2.7, Appendix 11)

Do you have any other interest in other SME businesses (associate, subsidiary or wholly-owned company, including sole proprietorship etc.) – indirectly translated the likelihood that inter-company transactions exist in the approach and method used in the tax evasion.

The answers tended to be more honest than from direct questions. There were also some questions, however, that did adopt the direct approach as to whether the respondent had evaded taxes and, if so, to what degree: as argued by Lewis (1982:140), “*why not just ask respondents whether they evade tax or not? If they admit it, ask them how much this amounts to and perhaps even why they do it? What could be simpler?*”

Phase III: Questionnaire development: Piloting and administering a complete questionnaire at this stage allowed further evaluation of individual items as well as of the questionnaires as a whole.

Phase IV: Questionnaire revision: This phase incorporated the responses from phase III in order to revise particular questions.

The questionnaire not only had to cater for educated individuals, but also for those who have a low level of literacy. Where possible, questions were shortened in order to reduce confusion and ambiguity. Questions were also worded so as not to be misleading about the purpose of the question. The aim was to try and ensure that respondents could respond without feeling that they were giving wrong answers. This included translation of the questions into the local language (Bahasa Malaysia) for the benefit of respondents not English educated.

To ease and save respondents' time in completing the questionnaires, as well as achieving uniformity among respondents' answers, most of the questions adopted a closed format. Even though closed format questions are difficult to design, they simplify the collection and analysis of data and make the task easier for the researcher (Remenyi *et al.*, 1998). Further advantages of well-developed closed questions are evident when the questionnaire is long or people's motivation to answer is not high, as the questions are easy and quick to answer. Closed questions are also easy to code and classify by respondents, thus avoiding

misclassification. Open-ended questions, however, were also included in asking further opinions of the choices made by the respondents. Open-ended questions are important in allowing the respondents to say what they think (Oppenheim, 2000).

A category termed 'other (please specify)' was also adopted to allow for unanticipated responses, so that if the available categories were not the chosen answer, then the respondents would be in a position to make their own choice of answer to the question. The type of closed format questions used included: (i) Likert-style formats, with rating scales of 1 to 5 for respondents to indicate their responses to the question; (ii) semantic differential formats, where the format consists of choosing adjectives to present the two extremes of a continuum and asking the respondents to tick between the two extremes; (iii) Yes and No format to obtain the respondents' general opinions about the main subject matter.

So as to maximise the response rate, each mailed questionnaire was accompanied by a covering letter (attached inside the questionnaire) stating the survey objectives, assuring the confidentiality and anonymity of the responses, giving the approximate deadline for respondents to complete the questionnaire and providing a stamped, addressed reply envelope. In addition, a support letter from the author's supervisor was also included to introduce the researcher and stating the importance of the research.

5.5.3 Sample construction

The sample was restricted to SME taxpayers and tax practitioners, as mentioned in the questionnaire design (paragraph 5.5.2). SME taxpayer and tax practitioner databases were provided by the IRB. The SME taxpayer population comprised two databases of non-tax evaders (general database) and SME tax evaders (from the Investigation and Intelligence Division database for the year 2000). The population differed in at least two important respects; first, the population of 'tax evaders' consisted of those who had evaded tax and who had been caught and penalised for doing so. Secondly, the population of the 'non-tax evaders' group was based on those whose names appeared on the main IRB database. This group was likely to include both evaders and non-evaders, though the number of evaders in this group was unknown.

The database was provided with limited content – only data with the full names and addresses of the taxpayers was provided. This has generally been the case to ensure taxpayer privacy and to prevent contravention of the tax law (section 138, Income Tax Act, 1967). However, the general database may not represent the true population since the actual number of the population supposed to be registered as taxpayers is unknown. The IRB database, however, provides substantial evidence as a representative of the population for the research. Furthermore, most of the literature argues that an accessible population is one that meets the established criteria and is easily accessible, considering the constraints of time, money and research availability. Babbie (2001:195) argued that a “*properly drawn sample provides information appropriate for describing the population of element that compose the sampling frame – nothing more*”.

The general database provided by the IRB was already stratified according to the file categories of ‘P’ for partnership, ‘OG’ for businesses which include sole proprietors and SME entrepreneurs (owner, director and management), and ‘C’ for SMEs registered under the Company Act 1965. So as to minimise cost and time, a probability sample was used, namely, a stratified random sample. A probability sample is one in which each person in the population has an equal, or a least a known probability of being selected. Stratified sampling is a modification of simple random sampling which is able to produce a more representative and accurate sample. The main reason for using probability-sampling methods is to permit the use of a variety of statistical tools to estimate the precision of the samples. The sampling technique used is termed stratified disproportionate sampling. Once the strata are determined, the selection of a sample from each stratum is dictated by analytical considerations.

The tax practitioner database consisted of tax practitioners practising according to the provisions of Section 153(3) of the Income Tax Act 1967 - (i) Section 153(3)a: a professional accountant authorized by or under any written law to be an auditor of companies; (ii) Section 153(3)b: any other professional accountant approved by the Minister; (iii) Section 153(3)c: any other person approved by the Minister on the recommendation of the Director General.

The IRB database formed the sampling frame except for the sample of tax practitioners practising under Section 153(3)a, which was drawn from the database of the Malaysian Institute of Accountants (MIA - an association of professional accounting bodies in Malaysia), since the MIA is the controlling body of professional accountants in Malaysia.

A nationwide sample of 750^{5.2} was selected, consisting of 400 SME taxpayers (250 non-tax evaders and 150 tax evaders) and 350 tax practitioners (200, 100 and 50 in each category of tax practitioner under sections 153(3)a, 153(3)b and 153(3)c respectively). Each of the categories was distinguished by using different coloured questionnaire covers - blue for non-tax evaders, orange for tax evaders, white for tax practitioners practising under section 153 (3)(a), red for those practising under section 153(3)(b) and yellow for those practising under section 153(3)(c).

The sample size obtained is likely to have an effect on the degree of accuracy of the sample and the extent to which there is variation in the population with regard to the key characteristics of the study. What must be remembered is that the size of the population from which the sample is drawn is largely irrelevant for the accuracy of the sample (Oppenheim, 2000). In this study, the final sample size was a compromise between cost, accuracy and the ensuring of sufficient numbers for meaningful analysis and results.

5.6 Qualitative Component

5.6.1 Introduction

To identify and understand better the actual factors underlying the research agenda (in this study, tax evasion by SMEs and the role of forensic accounting), one of the major

^{5.2} Determination of sample size for the survey was based on the sample size calculator created by Creative Research Systems (retrieved at <http://www.surveysystem.com/sscalc.htm>) with the confidence level of 95% and confidence interval of 5%. The formula used in the sample size calculator was:

$$\text{Sample size} = \frac{Z * (p) * (1 - p)}{C}$$

Where: Z = Z value (e.g. 1.96 for 95% confidence level)

P = percentage picking a choice expressed as decimal (0.5 used for sample size needed)

C = confidence interval, expressed as decimal (e.g. 0.04 = ± 4)

determinants was the need to be able to study actual data/cases rather than rely upon data from taxpayers' memories (Hite, 1988; Elffers 1991a; McKerchar 2001). The critical factor here was that reliance on recall was considered unsuitable, as taxpayers that had been evading tax would not honestly report whether they had reneged on their taxes. Further, the analysis of actual data/cases would facilitate the evaluation of the appropriateness of certain aspects of the quantitative design.

The file data/actual cases analysis and opinions from the IRB personnel involved in the deterring of tax evasion (Investigation and Intelligence Division/Centre personnel) appeared to be the most appropriate qualitative design.

5.6.2 File data/Actual cases

The file data/actual cases analysis is the collection of data undertaken by reviewing the settled convicted tax evaders' files from the Investigation and Intelligence Division, which is entrusted to investigate suspected cases of tax evasion. The purpose of file data/actual cases analysis is to draw analytical generalisations about the practices within the IRB and SMEs with regard to tax evasion. Again, given the confidentiality requirement of the data due to the secrecy provision of tax law (Section 138, Income Tax Act 1967), only certain data were made available for the analysis. A systematic approach in drawing the data from the file was adopted so as to ensure that the appropriate and correct information would be extracted by using a pre-designed, tabulated format sheet (see Appendix III). The area of interest was the characteristics and methods employed by SME taxpayers in their tax evasion schemes, methods used by the IRB in detection and settling of the cases, and the degree of culpability.

From a total population of 609 and 649 for the years 1997 and 2001 respectively, samples of 200 files based on IRB records were reviewed between April and June 2003 (100 files for each year, i.e. 1997 and 2001) by using systematic random sampling. The sample size here did not play an important role as the analysis was able to show the pattern or trend within tax evasion by SMEs. The data was then linked with further findings from the quantitative method. The selected years were chosen because they represented the latest financial crisis in the Asian region in the second half of 1997 and when the economy of the

country started to recover in 2001. This period significantly reflects business cycles, which consist of phases of peak, subsequent recession, trough and finally recovery, which repeat ad infinitum. Table 5.1 represents the percentage changes in GDP in Malaysia from 1996 to 2002.

Table 5.1
Percentage changes in GDP in Malaysia, 1996 - 2002

Year	1996	1997	1998	1999	2000	2001	2002
GDP	10	7.5	-7.5	6.1	8.3	0.4	4.2

Source: Bank Negara Malaysia, Annual Report (2002)

5.6.3 *Opinion from IRB personnel*

The initial survey instrument for the collection of this data was supposed to be a group interview with IRB officers using semi-structured questions. However, due to unforeseen circumstances, the group interview could not be conducted. The semi-structured questions (with a slightly revised format, see Appendix IV) were later distributed to all fifteen heads of the Investigation and Intelligence Centre of the IRB of Malaysia as an open-ended questionnaire. This fallback method to collect data from the IRB personnel received an encouraging response, with 8 replies.

Through this fallback method, it was possible to draw upon the subjects' specialist knowledge of tax laws, tax evasion and the impact that the technical aspects of both the legislation and the current administration of the tax system have on tax evasion. This method also allowed an exploration of the degree to which forensic accounting and its underlying assumptions were gaining acceptance and use within the organisation. The method is justified because, as argued by Marsh (1982:66), "*...There is no obvious alternative to survey research in most situations. If you cannot intervene in the social world yourself, and you are chary of drawing very strong or general conclusions from those quasi experimental situations where others have, you are forced back to considered variations as it occurs*".

5.7 Triangulation

Denzin (1978:291) broadly defines triangulation as *the combination of methodologies in the study of the same phenomenon* and the process is important in ensuring the validity of the research work. Triangulation thus denotes the use of different techniques of collecting data for a single research project.

According to Croll (1986:176), *“triangulation is a data conformation technique in which data are strengthened where the same results are produced by different procedures...it also served to give greater depth to the data and gives the researcher a greater understanding”*. Bennett and Thaiss (1967:307) supported the argument that *“human reality must be apprehended by a variety of viewpoints, not by one alone because this very reality is always in part a construct, always in part an image and only by encouraging difference in perspective and approach can one obtain the needed richness of imagery and consequently theory”*. Jick (1979:602) described the advantages of such techniques in that they *“improve the accuracy of the researcher judgements by collecting different kinds of data bearing on the same phenomenon”*.

Jick (1979:603) sees blending and integrating a variety of data and methods, as triangulation demands, as a continuum, ranging from simple to complex designs. ‘Scaling’ or ‘quantification of qualitative measures’ is at the simple end, and the complete, ‘holistic’ and contextual portrayal of the unit(s) is at the complex end (see Figure 5.6).

Figure 5.6

A continuum of triangulation design

Scaling....	Reliability...	Convergent Validation...	Holistic (or Contextual) Description
Simple Design			Complex Design

Source: Jick (1979:603)

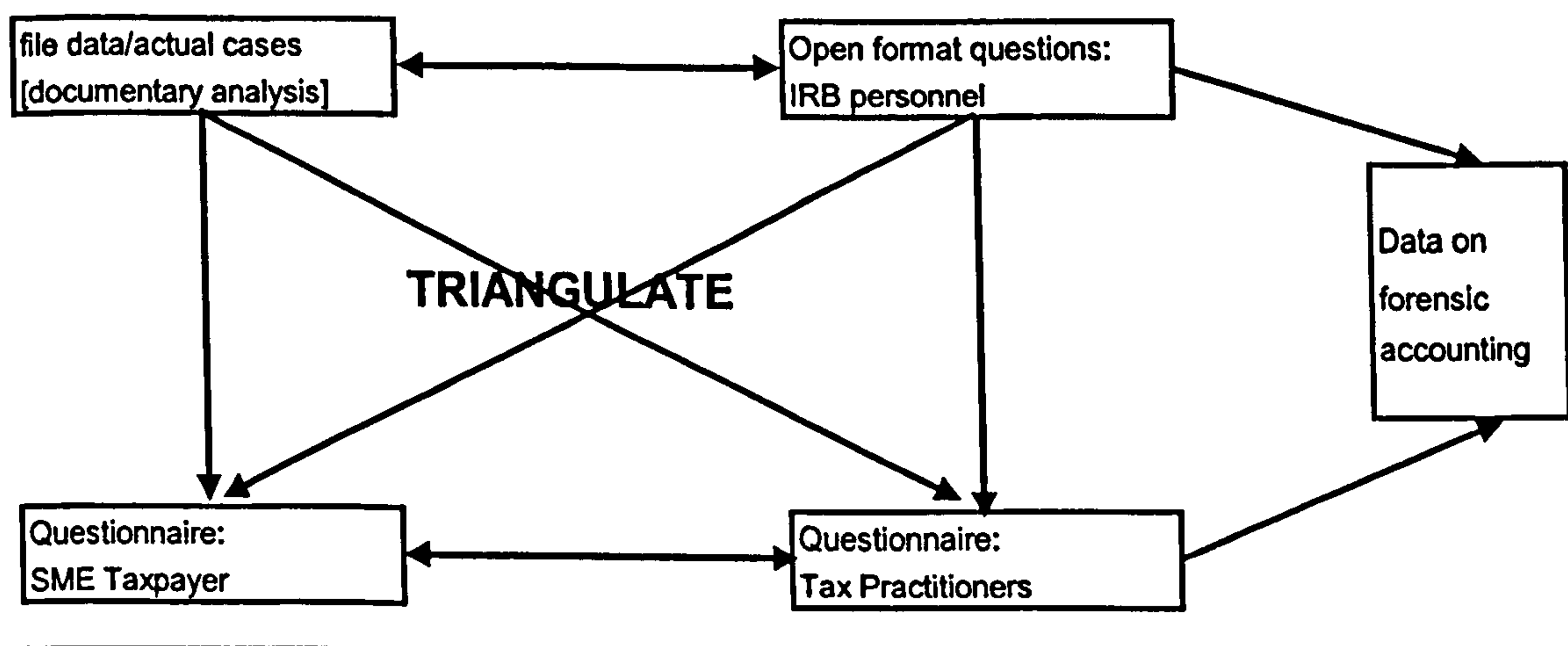
Testing ‘reliability’ and ‘convergent validation’ (or the use of complementary methods) occupies the second and third place on his continuum. In the sense of ‘holistic’ design, triangulation may be used not only to examine the same phenomenon from multiple

perspectives, but also to enrich our understanding by allowing new or deeper dimensions to emerge. Jick went on to illustrate the advantages and effectiveness of triangulation as “*The effectiveness of triangulation rests on the premises that the weaknesses in each single method will be compensated by the counter-balancing strengths of another. Although each method has assets and liabilities, triangulation purports to exploit the assets and neutralize, rather than compound, the liabilities*”.

Jick (1979:608) also stated that “*Triangulation provides researchers with several important opportunities, it allows researchers to be more confident of the results, ... it can stimulate the creation of inventive methods; new ways of capturing a problem to balance with conventional data collection methods... the triangulation may also help to uncover the deviant or off quadrant dimension of a phenomenon*”.

In line with the above arguments, the findings from the questionnaire survey, file data/actual cases and opinion from IRB personnel are corroborated to give a comprehensive understanding of the issue. This helps in producing a more authoritative piece of research by increasing the strength of the research design. Figure 5.7 shows a diagrammatic representation of the triangulation of information.

Figure 5.7
Diagrammatic representation of the triangulation of information



5.8 Reliability and validity issues

The questions of reliability and validity have to be addressed before a piece of research can be accepted. In this study, measures were taken to ensure that the study was both reliable and valid by employing a number of different research methods.

5.8.1 Reliability

Reliability is the extent to which a test or procedure produces similar results under constant conditions on all occasions (Yin, 1994). Another definition, by Simon and Burstein (1985), states “...reliability is essentially repeatability - if it comes up with the same result in the same circumstances time after time, even employed by different people”. In other words, if another researcher uses the same method on the same group, the same result will be obtained.

To look at the reliability of the data collected and consistency of the item, the Cronbach reliability estimate was used (see Chapter 6 for the result). The coefficient alpha is suitable for items that are not scored as right or wrong: the response simply indicates where one stands on the continuum of the given scale. If all the variation in observed scores is due to errors of measurement, the reliability coefficient will be zero. If there is no error of measurement, the reliability coefficient will be one. With regard to its use, Nunnally (1967:210) stated, “*coefficient alpha is the basic formula for determining the reliability based on internal consistency...even if other estimates of reliability should be made for particular instruments, coefficient alpha should be obtained first ... the coefficient alpha sets an upper limit to the reliability test.*”

Cronbach’s alpha varies between 0 and 1 inclusive, with the higher numbers indicating greater reliability. According to Bagozzi (1994), for exploratory research, a score of 0.6 is desirable, although values greater than 0.70 are preferred.

5.8.2 Validity

De Vaus (1991) asserted that validity means in essence that a theory, model, concept or category describes reality with good fit: *“A valid measure is one which measures what it is intended to measure. In fact, it is not the measure that is valid or invalid but the use to which the measure is put...the validity of a measure then depends on how we have defined the concept it is designed to measure”*.

The measure of validity is often considered under either internal or external validity (Yin, 1994; Gill and Johnson, 1991). Internal validity refers to whether or not what are identified as the causes actually produce what has been interpreted as the effect or response, and checks whether the right cause and effect relationships have been established. Thus, internal validity is the issue of establishing theoretical territory that goes with the defined construct and ensuring consistency between it and other recognised constructs. External validity, on the other hand, refers to the extent to which any research findings can be generalised beyond the immediate research sample or setting in which the research took place. External validity is often subdivided into two: (1) population validity, which concerns the extent to which it is possible to generalise from the sample involved in the research to a wider population; and (2) ecological validity, which concerns the extent to which it is possible to generalise from the actual social context in which the research has taken place and the data has been collected to other contexts and settings.

From the above discussion, it can be seen that the basic difference between reliability and validity (internal) is that reliability deals with the data collection process to ensure the consistency of the results, while validity focuses more on the way such results support the conclusions. The above deliberation, however, refers to the traditional evaluation criteria of validity and reliability that are governed by the convention of the quantitative research paradigm. Although early qualitative researchers felt compelled to relate traditional notions of validity and reliability to procedures in qualitative research, later researchers (Miles and Huberman, 1994; Yin 1994; Easterby-Smith, 2000) developed their own criteria in the qualitative research paradigm. Miles and Huberman (1994) concentrated on improved and rigorous techniques for data gathering and analysing as the best way to enhance credibility and acceptance. Yin (1994) identified the following as essential to establishing validity and

reliability in qualitative research: (1) establish a chain of evidence; (2) have the draft study report reviewed by the key informants; (3) the use of a single research exploratory design by establishing a causal relationship, using a single case explanatory design, and specifying the unit of analysis; (4) develop a formal research study framework, which typically has the following sections - an overview of the study project (objectives, issues, topic being investigated), field procedures (credentials and access to sites, sources of information), research study questions (specific questions that the investigator must keep in mind during data collection, and a guide for the research report (outline, format of the narrative).

Reliability and validity issues can be interrelated. A study can be merely reliable but cannot be valid without first being reliable. Kirk and Miller (1986:20) asserted that, "*it is easy to obtain perfect reliability with no validity at all...perfect validity, on the other hand, would assure perfect reliability, for every observation would yield the complete and exact truth*". Therefore, the use of both quantitative and qualitative methods in this study may help towards developing a more reliable and valid generalisation, as discussed earlier.

5.9 Statistical techniques

There are a number of statistical techniques that can be used to explain research data (from the questionnaires). The following section highlights those statistical techniques that have been used in this study. The statistical package adopted in this case is the Statistical Package for the Social Sciences (SPSS) for Windows version 11.

5.9.1 Descriptive statistics

Statistics such as frequency, percentage, mean, median and standard deviation were used to describe and summarise sets of the data received from the respondents. The uses of these statistics include describing the characteristics of the sample and checking variables for any violation of the assumptions underlying the statistical techniques that address specific research questions. These give the readers 'a picture' of the data collected and used in the research.

5.9.2 *Bivariate analysis*

This analysis concentrates on explaining the variance that the researcher observes in single variables in the descriptive statistics. The usual way to examine a relationship between one variable and another is in the context of a table, known as cross tabulation or sometimes a contingency table, which includes both variables.

5.9.3 *Mann-Whitney U test*

The Mann-Whitney U test is a non-parametric test that is used to test the difference between two independent groups of sample data. This test is the non-parametric alternative to the *t*-test for independent samples. Instead of comparing the means of the two groups, as in the case of the *t*-test, the Mann-Whitney U test actually compares medians. It converts the scores of the continuous variable to ranks across the two groups. It then evaluates whether the ranks for the two groups significantly differ. As the scores are converted to ranks, the actual distribution of the scores does not matter.

This statistical technique is used to test for non-response bias within the questionnaire survey in this study. Wallace and Mellor (1988:136) pointed out that this non-parametric test might be more efficient and more appropriate. The parametric (*t* or *F*) tests require a variety of strong assumptions, the main ones being that (i) the samples are drawn from independent normal populations with equal variances, and (ii) the scores under analysis result from measurement in the strength of at least an interval scale (Siegel, 1956:31).

5.9.4 *One-way analysis of variance (ANOVA)*

ANOVA involves one independent variable, which has a number of different levels. These levels correspond to the different groups or conditions. Analysis of variance is so called because it compares the variance between the different groups with the variability within each of the groups. An *F* ratio is calculated, which represents the variance between the groups divided by the variance within the groups. A large *F* ratio indicates that there is more variability between the groups than there is within each group. This analysis is used to

assess the degree of agreement within the scale questions (Likert scale) in the questionnaire.

5.10 Summary

This chapter has provided a detailed account of the methodological issues that have been considered and implemented with regard to this study. The research methodology can be characterised as a combination of quantitative and qualitative strategies via the triangulation technique so as to gain insights and results and to assist in making inferences and in drawing conclusions. Detailed processes and methods for utilising the questionnaire survey, analysis of file data/actual cases from the IRB and opinions from IRB personnel were also described. Finally, the chapter detailed reliability and validity issues and data analysis techniques utilised in the study.

The following three chapters will discuss the results obtained from the collected data. The questionnaire results are detailed in the next chapter, followed by a discussion on the analysis of file data/actual cases from the IRB files in Chapter 7. Chapter 8 examines the perceptions, drawn from open-ended questions, of IRB personnel of the IRB's stance on and practical overview of tax evasion by SMEs. These results will then be linked together and discussed in the context of the research questions in Chapter 9.

CHAPTER 6

QUESTIONNAIRE SURVEY RESULT

6.1 Introduction

Chapter 6 reports the results obtained from the surveys of tax practitioners and SME taxpayers (see Appendix I for the tax practitioner questionnaire and Appendix II for the SME taxpayer questionnaire). The first section encompasses the administrative aspect of the surveys with the analysis of response rates, non-response bias and reliability testing. The next section of the chapter analyses, interprets and summarises the tax practitioner survey results and the following section presents the SME survey result. Each section analyses the data obtained from corresponding sections of the questionnaire and is delineated as such. A summary at the end of each of the sections outlines the main points of that section.

6.2 Response rates and non-response bias

Mearns and Braithwaite (2001) noted that any response rate is typically related to the size of the questionnaire and the mode of delivery (in this study normal mail [equivalent to the 2nd class mail in the UK] was used). Following two mailings^{6.1} and after the deadline for responding to the questionnaire had passed, the response achieved an unadjusted response rate of 21.75 per cent for SME taxpayers and 17.14 per cent for tax practitioners (Table 6.1). When adjusted using the formula described by de Vaus^{6.2} (1992), a response rate of 24.9 per cent for the SME taxpayers and 19.7 per cent for tax practitioners were obtained. Such response rates are typical for mail surveys (Kanuk and Berenson, 1975; Oppenheim, 2000) and not unusual in taxation studies, where it has been argued that tax surveys cannot be expected to achieve more than a 30 to 40 per cent response rate (Wallschutzky, 1984).

^{6.1} Following an interval of 14 days from the initial posting, a short reminder letter was sent to all respondents to encourage them to respond as soon as possible.

^{6.2} Response Rate = $\frac{\text{Number returned}}{\text{N in the sample} - (\text{Ineligible} + \text{Undelivered})} * 100$

Another interesting feature of the data in Table 6.1 is that approximately 13 per cent (95 samples) of the samples were not delivered to the address the questionnaire was sent to. This finding is somewhat surprising given that the sample was drawn from an active IRB and MIA database, which, it was assumed, would be up-to-date.

Table 6.1
Response rate of the survey

	Taxpayer			Tax Practitioners			Overall
	Non Evader	Evader	Overall	Sec153(3)a	Sec153(3)b	Sec153(3)c	
Population	1.6m	631	2.2m	17,300	364	666	18,300
Questionnaires mailed	250	150	400	200	100	50	350
Usable response	62	25	87	35	17	8	60
Undelivered	30	20	50	20	15	10	45
Unadjusted Rate	24.80%	16.70%	21.75%	17.50%	17%	16%	17.14%
Adjusted Rate	28%	19%	24.90%	19%	20%	20%	19.70%

Questionnaires sent to a random sample of a population will typically yield biased results arising from the fact that not all will return the questionnaire. This will create two main problems; a reduction in the sample and bias in the study. In order to attain a reasonable sample size, a large initial sample could be created. However, this serves only to produce the designed sample size, it does not address the problem of non-response bias. Increasing the sample size does not ensure a representative sample of various groups if some groups systematically do not respond.

The main concern about non-response is the risk that it will differ between respondents with regard to the survey variables, in which case the survey estimate based on the respondents alone will be a biased estimate of the overall population. The concern is not so much the bias itself, but the difficulty in understanding what the bias is and to what extent it occurs. However, there are a wide variety of practices and methods for dealing with the non-response problem through various statistical techniques for minimising its influence in the analysis. As the survey in this study is confidential and anonymous, the possibility of obtaining information to enable adjustments for bias is ruled out.

Wallace and Mellor (1988) outlined three types of test that can be carried out on questionnaire non-responses. The surrogate method involves a comparative analysis of responses by date of receipt. This method requires that returned questionnaires bear the

dates of completion or, in the absence of this, questionnaires are coded as they are received. The second method involves comparing the profile of respondents with known characteristics of a sampled population. The third method also involves the comparison of the characteristics of respondents with the non-respondents from the sample (in terms of geographical location, date of birth, sex, type of qualification).

The difficulty of gaining independent records of the population or the sample frame that can provide a more definite picture of the characteristics of the non-respondents means that the latter two methods are not so regularly used by researchers as the surrogate method. It would be impossible to carry out either of these latter two methods with respect to this study, as there is no way of knowing who responded and who did not due to enforced confidentiality and anonymity. This study will use the surrogate method to test the non-response bias. The surrogate method attempts to construct a measure of non-response bias that will be based on the presumption that late responders are reasonable surrogates of non-respondents.

Wallace and Mellor (1988) also suggested a non-parametric test (Mann-Whitney) as an appropriate test to this set of investigation. They argued that parametric tests require a variety of strong assumptions, the main one being that (1) the samples are drawn from independent normal populations with equal variances, and (2) the scores under analysis result from measurement in the strength of at least an interval scale.

Using the surrogate method, Table 6.2 shows the result of the non-parametric test (Mann Whitney) using specified variables for SME taxpayers (non-tax evaders) for the first and the last 10 respondent questionnaires. Significant differences are only noted in Q1.4g with a significance level of $p = 0.008$ (z value is -2.645). In general, it can be inferred that there appears to be no statistically significant difference between early and late respondents for this group.

Table 6.2
Result of the non response bias test SME taxpayers (non tax evader)

<u>Variable</u>	<u>z value</u>	<u>Sig (2 tailed)</u>
Q1.1a	-1.630	0.103
Q1.1b	-0.187	0.851
Q1.1c	-0.312	0.755
Q1.1d	-0.041	0.967
Q1.1e	-0.764	0.445
Q1.4a	-0.659	0.510
Q1.4b	-1.501	0.133
Q1.4c	-1.501	0.133
Q1.4d	-1.364	0.172
Q1.4e	-1.629	0.103
Q1.4f	-1.198	0.231
Q1.4g	-2.645	0.008
Q1.5a	-1.153	0.249
Q1.5b	-1.009	0.313
Q1.5c	-1.744	0.081
Q1.5d	-0.736	0.461
Q1.5e	-0.648	0.517
Q1.5f	-0.622	0.534
Q1.5g	-0.965	0.335

For the tax evader responders (Table 6.3), the same procedure as for non-tax evaders was used. The results of the Mann Whitney test also show that no significant difference exists between early and late respondents. Significant differences were only noted in Q1.4e (z value = -2.134, sig. level = 0.033) and Q1.5c (z value = -2.285, sig. level = 0.022).

Table 6.3
Results of non response bias test SME taxpayer (tax evader)

<u>Variable</u>	<u>z value</u>	<u>sig (2 tailed)</u>
Q1.1a	-1.378	0.168
Q1.1b	-1.453	0.146
Q1.1c	-1.000	0.317
Q1.1d	-1.395	0.163
Q1.1e	-0.350	0.726
Q1.4a	-1.071	0.284
Q1.4b	-0.530	0.596
Q1.4c	-0.944	0.345
Q1.4d	-0.559	0.576
Q1.4e	-2.134	0.033
Q1.4f	-0.587	0.557
Q1.4g	-0.042	0.967
Q1.5a	0.000	1.000
Q1.5b	-0.376	0.707
Q1.5c	-2.285	0.022
Q1.5d	-1.902	0.057
Q1.5e	-1.023	0.306
Q1.5f	-0.640	0.522
Q1.5g	0.000	1.000

With regard to the tax practitioner survey, a similar method and Mann Whitney test procedure was also carried out. All of the results for tax practitioners show no significant difference between early and late respondents. Table 6.4, Table 6.5 and Table 6.6 show the results for tax practitioners practising under section 153(3)(a), section 153(3)(b) and section 153(3)(c) respectively.

Table 6.4
Result of the non response bias test
Tax Practitioner (section 153(3)(a))

<u>Variable</u>	<u>z value</u>	<u>Sig (2 tailed)</u>
Q1.9a	-1.826	0.068
Q1.9b	-1.400	0.161
Q1.9c	-0.175	0.861
Q1.9d	-0.640	0.522

Table 6.5
Result of the non response bias test
Tax Practitioners section 153(3)(b)

<u>Variable</u>	<u>z value</u>	<u>Sig (2 tailed)</u>
Q1.9a	-1.000	0.317
Q1.9b	-1.000	0.317
Q1.9c	-1.000	0.317
Q1.9d	-1.181	0.238

Table 6.6
Result of non response bias test
Tax Practitioners section 153(3)c

<u>Variable</u>	<u>z value</u>	<u>Sig (2 tailed)</u>
Q1.9a	-1.423	0.155
Q1.9b	-2.013	0.044
Q1.9c	-1.512	0.131
Q1.9d	-1.323	0.186

It can be concluded that there appear to be no significant differences between early and late responders for the SME taxpayers and the tax practitioners. Bearing in mind the assumption when using the surrogate method, that the late responders are representative of non-responders, the test concluded that non-response bias is not significant. Therefore, it was not necessary to carry out any adjustment to the responses received.

6.3 Reliability test

In this research, most of the questionnaire questions have been treated as a measure in assessing the attitude of the respondents. Each question is a measurement of a particular variable. Thus the concept of reliability and validity has been applied in order to assess the performance of the measure.

There are two aspects to consider when testing scaled responses; unidimensionality and reliability. This is known as item analysis. A unidimensionality scale is one in which each item measures the same underlying concept. The way to work out whether the responses for

a particular item reflect the response for other items is to calculate a correlation coefficient between the respondents' scores for the item with the score for the rest of the scale. The coefficient is termed the item-to-item scale coefficient. If the coefficient is less than 0.3, then the item is dropped from the scale.

To assess the reliability for each item on a scale, it is possible to calculate item-to-item correlations. This compares the consistency of a response for an item to each other scale item. The index is given by the alpha statistic. If the alpha statistic is at least 0.7, the scale is deemed reliable.

Figure 6.7 and Figure 6.8 show the results of the scaled items in response to questions relating to the moral acceptability of tax evasion in business practices for the non-tax evaders and convicted evaders respectively. The items are signified as Q1.4A to Q1.4G. The alpha for the scale justifies the reliability (0.7), as do the unidimensionality coefficients for individual items.

Table 6.7
Reliability test for SME taxpayers (non tax evaders) responses to questions relating to moral acceptability of involving tax evasion.

Item-total Statistics				
	Scale mean if item deleted	Scale variance if item deleted	Corrected item total correlation	Alpha if item deleted
Q1.4A	12.1290	24.3437	0.7531	0.9535
Q1.4B	11.9355	23.1761	0.8158	0.9484
Q1.4C	11.9194	22.623	0.9179	0.9402
Q1.4D	12.0645	23.5695	0.8701	0.9445
Q1.4E	11.9516	22.8665	0.9285	0.9395
Q1.4F	11.9516	23.8829	0.8344	0.9473
Q1.4G	11.9516	22.8993	0.7891	0.9519
Reliability Coefficients				
N = 62	Reliability coefficient = 7			
Alpha =	0.9539			

Table 6.8**Reliability test for SME taxpayers (tax evaders) question relating to business practices**

Item total statistics

	Scale mean if item deleted	Scale variance if item deleted	Corrected item total correlation	Alpha if item deleted
Q1.4A	15.4000	9.8333	0.7307	0.862
Q1.4B	15.4400	10.3400	0.6168	0.8774
Q1.4C	15.0800	10.9433	0.6031	0.8787
Q1.4D	15.3600	10.49	0.8172	0.8553
Q1.4E	15.1600	9.8067	0.7458	0.8598
Q1.4F	15.1600	10.89	0.7203	0.8661
Q1.4G	15.2000	11.0833	0.5623	0.882

Reliability Coefficients

N = 25

Reliability Coefficient = 7

Alpha = 0.8855

The scaled responses for the questions relating to the proportion of SMEs practising such business practices was also deemed reliable with alpha above 0.7 for the SME taxpayers, as shown in Table 6.9.

Table 6.9**Reliability test for SME taxpayers questions relating to proportion of SMEs practising such business practices**

Taxpayer	No. of responses	Cronbach's Alpha
Non tax evader	62	0.8573
Tax evader	25	0.9126

A similar test was also conducted with the tax practitioner questionnaire for the scaled responses. The items are signified as Q1.9A to Q1.9D, relating to the effectiveness of the method used in detecting tax evasion. Alpha is calculated as being above 0.7 for each of the three groups, which is deemed reliable (Table 6.10).

Table 6.10**Reliability test for the tax practitioners questions relating to the effectiveness of the methods used in detecting tax evasion**

Tax Practitioners	No. of responses	Cronbach's Alpha
Sec 153(3)a	35	0.7628
Sec153(3)b	17	0.8609
Sec153(3)c	8	0.8889

The difficulty in assessing the validity of attitude questions is the lack of criteria. A group of people with known attitude characteristics are required (criterion group) so that it is possible to see whether or not the chosen question can discriminate between them. In order to assess the validity of this research, careful attention must be given to studying conceptualisation and the way in which data are collected, analysed and interpreted, as this will help to generalise the findings.

6.4 Tax practitioners survey result

6.4.1 Respondents' background

Respondents were asked to provide personal details in Part III of the questionnaire (Appendix I). With respect to some of these items, response categories have been combined in order to facilitate statistical analysis. The results are shown in Table 6.11. Approximately two-thirds of the respondents were below 50 years old and almost 94 per cent were male practitioners. Over 60 per cent of the respondents were Chinese, followed by Malays (38 per cent) and Indians (2 per cent). More than 51 per cent were members of local professional bodies, less than 7 per cent have overseas professional qualifications and the rest hold themselves to be tax practitioners under Section 153 of the Income Tax Act 1967. The sample is thus a fair composition of tax practitioners concurrently registered with the Ministry of Finance to act as tax practitioners. Two-thirds of the respondents have more than 10 years' experience in taxation, while another 30 per cent have between 5 and 10

Table 6.11
Demographic characteristics of the tax practitioner

	Percentages			Overall
	Sec153(3)a	Sec153(3)b	Sec153(3)c	
(a) Age				
<50	62.9	47.1	100	63.3
>50	<u>37.1</u>	<u>52.9</u>	<u>0</u>	<u>36.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(b) Gender				
Male	94.3	94.1	87.5	93.3
Female	<u>5.7</u>	<u>5.9</u>	<u>12.5</u>	<u>6.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(c) Ethnicity				
Malay	22.9	41.2	100	38.3
Chinese	74.3	58.8	0	60.0
Indian	<u>2.9</u>	<u>0</u>	<u>0</u>	<u>1.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(d) Member of Professional Bodies				
MIA/MACPA	88.6	0	0	51.7
ACCA/CA	11.4	0	0	6.6
Sec 153 of ITA 1967	<u>0</u>	<u>100</u>	<u>100</u>	<u>41.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(e) Experience				
<5 years	0	0	12.5	1.7
Between 5 to 10 years	22.9	29.4	62.5	30.0
> 10 years	<u>77.1</u>	<u>70.6</u>	<u>25</u>	<u>68.3</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(f) No of SMEs Client				
< 100 clients	17.1	35.3	62.5	28.3
100 to 500 clients	45.8	64.7	37.5	50.0
> 500 clients	<u>37.1</u>	<u>0</u>	<u>0</u>	<u>21.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
(g) Location				
Western	57.1	58.8	50	56.6
Eastern	8.6	17.6	0	10.0
Northern	14.3	5.9	12.5	11.7
Southern	11.4	11.8	37.5	15.0
East Malaysia	<u>8.6</u>	<u>5.9</u>	<u>0</u>	<u>6.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

years and less than 2 per cent have 5 years or less experience in tax matters. The mean length of tax experience is approximately 10 years. The data implies that respondents are fairly familiar with the tax law and its administrative system.

The size of practices can be regarded as medium compared to the number of SME clients the tax practitioners serve, with 50 per cent of them having 100 to 500 clients. The geographical breakdown is appropriate, based on the business/economic setting of the country. Most of the practices are located in the western region (56 per cent), followed by the southern (15 per cent), northern (11 per cent), and eastern regions (10 per cent) and East Malaysia (7 per cent).

6.4.2 Existence and extent of tax evasion in SMEs

Responses indicated that SMEs do evade tax (Table 6.12). Question 1.1 related to the respondent's opinion toward the existence of tax evasion in SMEs. Only a small proportion of the respondents (15 per cent) did not perceive the existence of tax evasion within SMEs. To quantify these responses, the respondents were asked to estimate the extent of the involvement of SMEs in tax evasion in Question 1.2. Overall, the results suggest that the problem of tax evasion among SMEs is serious in Malaysia: approximately 52 per cent of the respondents believed that more than 50 per cent of SMEs evade tax.

These responses, however, must be viewed in the context of the fact that one-third of the respondents are former IRB staff (tax practitioners practising under Section 153(3)b) and may have a biased view of tax evasion by SMEs based on their previous exposure and experience within the IRB handling SME cases.

Table 6.12**Tax practitioners' perceive the existence and extent of SMEs involvement in tax evasion**

Q1.1: In your opinion, do most of SMEs evade tax?

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Yes	88.6	94.1	50.0	85.0
No	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q1.2: To the best of your ability, please estimate the percentages of SMEs that evade tax in Malaysia

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
< 25% of SMEs	5.7	17.6	37.5	13.3
25%-50% of SMEs	31.5	5.9	0	20.0
50%-75% of SMEs	45.7	64.7	12.5	46.7
>75% of SMEs	5.7	5.9	0	5.0
Not applicable*	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

* Responses perceived SMEs do not evade tax.

6.4.3 Characteristics of tax evasion in SMEs

Questions 1.5, 1.6 and 1.7 identified the characteristics of tax evasion by SMEs. The results are presented in Table 6.13. Over 48 per cent of respondents indicated that tax evasion is not cyclical in nature within SMEs. By contrast, only 5 per cent perceived otherwise and approximately one-third of them responded 'do not know' (Q1.5).

Table 6.13

Tax practitioners' perceived the characteristics of tax evasion by SMEs

Q1.5: Is tax evasion cyclical in SMEs? Cyclical means it happens within a specific period or circumstances for example once in ten years.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Yes	8.6	0	0	5.0
No	42.9	76.5	12.5	48.3
Do not know	37.1	17.6	37.5	31.7
Not applicable*	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q1.6: Is tax evasion a repetitive action by some SMEs? Repetitive means a yearly affair done by SMEs.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Yes	40.1	70.6	0	43.3
No	11.4	5.9	0	8.3
Do not know	37.1	17.6	50.0	33.3
Not applicable*	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.1</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q1.7: Which is the most likely period that SMEs will evade taxes.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Early stage	8.6	0	0	5.0
High inflation	0	0	0	0
Economic boom	5.7	11.7	0	6.6
Economic downturn	2.9	0	0	1.7
All the time	71.4	76.5	50.0	70.0
Other	0	5.9	0	1.7
Not applicable*	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

On the other hand, tax evasion was perceived to be repetitive in nature by more than 40 per cent of the respondents. Another 8 per cent believed it not to be repetitive and one-third indicated 'do not know' (Q1.6).

To understand these responses further, respondents were asked to identify the likely period over which SMEs would evade tax (Q1.7). Almost 70 per cent of the

respondents were of the opinion that SMEs evaded taxes all the time, an interesting finding given that if they are caught, they are at greater risk of incurring substantial penalties for past evasions: the IRB is empowered under section 91 of ITA, 1967 to raise assessment beyond the prescribed time limit (6 years) where tax has been lost due to fraud, wilful default or negligence on the part of the taxpayer. Alternatively, this result indicates that the characteristic of SME tax evasion is that it is repetitive in nature.

6.4.4 Factors influencing tax evasion by SMEs

Question 1.4 asked tax practitioners to identify the most common factor from a list of factors that may lead to tax evasion and related manipulation in SMEs in Malaysia. An overall average of 57 per cent of the respondents viewed an incompetent, corrupt and inadequately staffed tax administration as the most common factor that may lead to tax evasion and related manipulation in SMEs (Table 6.14).

Table 6.14

Tax practitioners' view on the most common factor influencing tax evasion in SMEs

Q1.4: The following are the factors which may lead to tax evasion and related manipulation in SMEs. Please indicate one factor which you think is the common factor that may lead to tax evasion and related manipulation in SMEs in Malaysia.

	Percentages			Overall
	Sec153(3)a	Sec153(3)b	Sec153(3)c	
Loopholes in tax system	8.6	5.9	0	6.7
Wrong accounting concept/principle	8.6	5.9	0	6.7
Incompetent, corrupt and inadequately staffed tax administration	60.0	58.8	37.5	56.7
Unable to enforce prevailing tax code	2.9	0	12.5	3.3
Unwilling to enforce prevailing tax code	2.9	0	0	1.7
Other	5.7	23.5	0	10
Not applicable*	11.4	5.9	50	15
Total	100	100	100	100
<i>N</i>	35	17	8	60

* Responses perceived SMEs do not evade tax.

The dimensions associated with the provision of law (loopholes in the tax system, unable and unwilling to enforce prevailing tax code and the professional standard) were regarded by tax practitioners as the least influential on tax evasion by SMEs.

In practice, these categories are not mutually exclusive because tax practitioners' training and experience allows them to take and justify the position.

6.4.5 Role of tax practitioners

Tax practitioners acting on behalf of the taxpayers are involved in certain decision-making processes. The decision is governed by whether the practitioner takes an independent, pro-taxpayer or pro-tax authority stance with regard to their professional decision process. Questions 2.3 and 2.5 identified stances that influenced tax practitioners in terms of siding with their client or the tax authority.

Responses indicated that tax practitioners do show commitment towards the tax authority. Question 2.3 looked at the possible responses concerning tax practitioners' appropriate action in reporting the income received from outside of the regular job of a client. Over 98 per cent of the respondents preferred to declare it in the most advantageous manner within the law (Table 6.15). This acknowledges that the tax practitioners have a duty to perform for their client within the boundaries of tax laws. It is in the interest of the taxpayers to comply. It can also be seen as being in the interest of the tax practitioners (self-interest) to ensure that clients do comply and this interpretation can be perceived as a pro-tax authority stance.

Table 6.15

Tax practitioners' response to the action that will be taken in reporting income

Q2.3: Imagine Yourself in this situation: One of your client has been paid RM100,000 in cash for work done outside the regular job. As tax practitioner which action would you take in reporting that income to IRB

	Percentages			
	Sec153(3)	Sec153(3)b	Sec153(3)c	Overall
Not declare it	0	0	0	0
Declare only a portion of it	0	0	0	0
Declare it in the most advantageous manner within the law	100	94.1	100	98.3
Declare as advised by client	0	0	0	0
Others	<u>0</u>	<u>5.9</u>	<u>0</u>	<u>1.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Question 2.5 raised the issue of clients not accepting advice on an issue of disclosure. Approximately 88 per cent of respondents would refuse to continue to act on behalf of such a client (Table 6.16). Again, this suggested a positive attitude of tax practitioners towards the IRB in assisting the board to enforce tax laws.

Table 6.16

Tax practitioners' response to non acceptance of advice on an issue of disclosure

Q2.5: What action do you think tax practitioner should take, if client does not accept advice on an issues of disclosure.

	Percentages			
	Sec153(3)	Sec153(3)b	Sec153(3)c	Overall
Inform IRB	0	0	12.5	1.7
Refuse to complete the tax return	2.8	0	0	1.6
Refuse to act as an agent	88.6	88.2	87.5	88.3
Fill in incorrect return but inform IRB	0	5.9	0	1.7
Other	<u>8.6</u>	<u>5.9</u>	<u>0</u>	<u>6.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

The large numbers of respondents saying that they would declare cash earnings in the most advantageous manner within the law and would refuse to act as an agent seemed contrary to view of the fact that tax practitioners may play a negative role in the tax compliance process as there is evidence that tax practitioners appear to be

exploiters of the law (e.g. Kaplan *et al.*, 1988a; Ayers *et al.*, 1989; Erard, 1990). This may also be true with regard to the cultural orientation of developing countries; people are not used to expressing their opinions frankly and they have a tendency to say what other people want to hear (Bulmer and Warwick, 1993). If these responses are a true indication, tax practitioners are not prepared to go out of their way to aid taxpayers, but are happy to help within the boundaries of tax law.

6.4.6 *Tax practitioners professional ethics and integrity*

Two questions (Q2.1 and Q2.2) addressed tax practitioners' professional ethics and integrity. Question 2.1 looked at the possibility of tax practitioners accidentally or deliberately understating SMEs' profit so that their clients would pay less tax (Table 6.17). Over 80 per cent of respondents perceived that they were involved in such activities, about 12 per cent felt that no such involvement existed and approximately 7 per cent stated 'prefer not to reply'.

Table 6.17

Tax practitioners' perceptions of the accidental or deliberate understatement of SMEs profit

Q2.1: Do you think tax practitioners, whether due to client pressure or for what ever reasons, accidentally or deliberately understate their client profit so that they have had to pay less income tax

	Percentages			
	Sec153(3)	Sec153(3)b	Sec153(3)c	Overall
Yes	80.0	88.2	75.0	81.7
No	8.6	11.8	25.0	11.6
Prefer not to reply	<u>11.4</u>	<u>0</u>	<u>0</u>	<u>6.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q2.1(b): To what extent (in percentage) do you think, tax practitioners accidentally understate SMEs profits.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
< 10% of tax practitioners	77.1	64.6	62.5	71.7
10% - 25% of tax practitioners	2.9	11.8	0	5.0
25% - 50% of tax practitioners	0	5.9	12.5	3.3
50% - 75% of tax practitioners	0	5.9	0	1.7
>75% of tax practitioners	0	0	0	0
Not applicable[*]	<u>20.0</u>	<u>11.8</u>	<u>25.0</u>	<u>18.3</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q2.1(c) To what extent (in percentage) do you think, tax practitioners deliberately understate SMEs profit.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
< 10% of tax practitioners	8.5	11.8	12.5	10.0
10% - 25% of tax practitioners	14.3	5.9	37.5	15.0
25% - 50% of tax practitioners	28.6	64.6	25.0	38.3
50% - 75% of tax practitioners	25.7	5.9	0	16.7
> 75% of tax practitioners	2.9	0	0	1.7
Not applicable[*]	<u>20.0</u>	<u>11.8</u>	<u>25.0</u>	<u>18.3</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

* Responses with answers 'no' and 'prefer not to reply'

The majority of the respondents (72 per cent), however, believed that the involvement of tax practitioners in accidentally understating SMEs' income/profit was less than 10 per cent. By contrast, between 25 and 50 per cent of tax

practitioners were perceived to be deliberately involved in understating SMEs' income/profit. One possible explanation is that tax practitioners are trying to keep their clients happy in order to keep their business.

Question 2.2 looked at the possible involvement of tax practitioners' perceptions of accidental or deliberate overstatement of SMEs' income/profit (Table 6.18). Over 78 per cent of the respondents were of the opinion that tax practitioners were involved in such activities. Tax practitioner involvement, however, was perceived to be less than 10 per cent. One possible explanation for overstatement is that most SMEs with low paid-up capital and resources need financing. In order to obtain funding, their financial statement needs to show them to be a creative altered to show a going concern, with good income and profit and paying a fair share of tax. This approach is possible because currently the tax law in Malaysia does not require the accounts of the smaller SMEs (for example self-employed, sole proprietorship and partnership) registered with Registrar of Business to be audited except those which are incorporated under the Companies Act 1967.

Table 6.18

Tax practitioners' perception of the accidental or deliberate overstatement of SMEs profit

Q2.2: Do you think tax practitioners, whether due to client pressure or for whatever reason, accidentally or deliberately overstate their client's profit so they have to pay more tax.

	Percentages			
	Sec153(3)	Sec153(3)b	Sec153(3)c	Overall
Yes	68.6	88.2	100	78.3
No	28.6	11.8	0	20.0
Prefer not to reply	<u>2.8</u>	<u>0</u>	<u>0</u>	<u>1.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q2.2(b) To what extent (in percentage) do you think, tax practitioners accidentally overstate SMEs profit?

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
< 10% of tax practitioners	65.7	76.4	87.5	71.6
10% - 25% of tax practitioners	2.9	11.8	0	5.0
25% - 50% of tax practitioners	0	0	12.5	1.7
50% - 75% of tax practitioners	0	0	0	0
> 75% of tax practitioners	0	0	0	0
Not applicable*	<u>31.4</u>	<u>11.8</u>	<u>0</u>	<u>21.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Q2.2(c) To what extent (in percentage) do you think, tax practitioners deliberately overstate SMEs profit?

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
< 10% of tax practitioners	57.2	23.5	50.0	46.7
10% - 25% of tax practitioners	0	17.6	37.5	10
25% - 50% of tax practitioners	11.4	41.2	0	18.3
50% - 75% of tax practitioners	0	5.9	12.5	3.3
> 75% of tax practitioners	0	0	0	0
Not applicable*	<u>31.4</u>	<u>11.8</u>	<u>0</u>	<u>21.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

* Responses with answer 'no' and 'prefer not to reply'

6.4.7 Approaches used by SMEs in evading tax

The related prior research indicated that there are various ways for SMEs to evade tax. Question 1.6 detailed four methods understood to be the most common in

generating tax-evaded income in SMEs, as listed in Table 6.19. The survey respondents believed (45 per cent) overstatement of expenses (other than cost of goods sold) to be the most common method used for SMEs' tax evasion schemes. This was followed by understatement of gross profit (30 per cent) and complete suppression of gross profit (8 per cent). The possible explanation as to why the overstatement of expenses is common in generating tax-evaded income in SMEs could be because it is the easiest and simplest method to use.

Table 6.19

Tax practitioners' response to the approaches used to evade tax

Q1.3: The following are understood to be common methods for generating tax evaded income in SMEs. Which do you think is the most frequently used in generating tax evaded income in SMEs in Malaysia.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Complete Suppression of GP	8.6	11.8	0	8.3
Understatement of GP	22.9	52.9	12.5	30.0
Overstatement of expenses (other than cost of goods sold)	57.1	23.5	37.5	45.0
Understatement of asset (including property and inventories)	0	0	0	0
Others	0	5.9	0	1.7
Not applicable*	<u>11.4</u>	<u>5.9</u>	<u>50.0</u>	<u>15.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

* Responses perceived SMEs do not evade tax.

6.4.8 Probability of detection by IRB

Question 2.4 asked the respondents' views towards the chances of being caught by the IRB. Over two thirds of the respondents believed that there was less than a 50 per cent chance that tax evasion activities would be detected by the IRB (Table 6.20). In other words, respondents believed the chances of being caught by the IRB are 50/50.

Table 6.20**Tax practitioners' view on the chances of being caught by IRB**

Q2.4: What do you think the chances are that your client will be caught by IRB if they/
tax practitioner reported less/none of the income in Q2.3.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
None	5.7	0	0	3.3
Less than 25 %	14.3	17.6	25.0	16.7
Between 25% to 50%	57.1	70.6	75.0	63.3
Between 50% to 75%	20.0	0	0	11.7
More than 75%	<u>2.9</u>	<u>11.8</u>	<u>0</u>	<u>5.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	18	7	60

The number of SMEs' clients being investigated/audited by the IRB may further explain this view. The majority indicated that less than 10 clients on average had been investigated/audited per year over the last five years (Table 6.21). As such, a small percentage of the SMEs were investigated/audited by the IRB each year and this could be less than 1 per cent. This view further suggests an incompetent, corrupt and inadequately staffed tax administration to be one of the main factors influencing tax evasion by SMEs.

Table 6.21**Tax practitioners' response on the number of clients investigated/audited on average per year over the last five year.**

Q2.6: How many of your SME clients have been investigated/audited by IRB on average per year over the last five years.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
None	37.1	23.5	12.5	30.0
Less than 10	60.0	76.5	75.0	66.7
10 - 50 clients	2.9	0	12.5	3.3
More than 50 clients	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

6.4.9 *Methods used by IRB in detecting tax evasion by SMEs*

Respondents were presented with a set of four methods that had been identified as the common methods for detecting tax evasion (Q1.9). Respondents were asked to rate the effectiveness of the methods using a Likert scale of “1” (very poor) to “5” (very good). Table 6.22 compares the means of the responses concerning four common methods used by the revenue authority. The respondents were of the opinion that all the methods were good with all of the means nearing 4. However, capital statement/net worth analysis (overall mean response of 3.80) was viewed by the respondents overall as the most effective way to detect tax evasion.

Table 6.22

Tax practitioners' view on the common methods for detecting tax evasion used Revenue

Authority

Q1.9: The following are the common methods for detecting tax evasion used by the Revenue Authority. How would you rate the effectiveness of the method in detecting tax evasion.

	Mean response			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Analytical Review/Ratio analysis	3.89	3.71	3.38	3.77
Capital Statement/Networth Analysis	3.80	3.88	3.63	3.80
Income Reconstruction	3.66	4.00	3.63	3.75
Digital analysis using Benford's Law	<u>3.51</u>	<u>2.76</u>	<u>3.50</u>	<u>3.30</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

The mean response of individual response on the scale of 1= very poor to 5 = very good.

6.4.10 *Tax practitioners' perception of forensic accounting*

Questions 1.10 and 1.11 addressed the issue of forensic accounting, and respondents were asked to assess their understanding and opinions of the techniques involved in detecting tax evasion by SMEs. More than 78 per cent of the respondents claimed to have either a ‘fairly good’ and ‘good’ understanding of forensic accounting. It is of note that approximately 20 per cent stated that they had a poor or non-existent understanding of what forensic accounting was all about (Table 6.23). At the other end of the scale, about 2 per cent identified themselves as being very well equipped with knowledge of forensic accounting.

Table 6.23**Tax practitioners' response to the understanding of forensic accounting techniques**

Q1.10: What is your understanding of forensic accounting?

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
None	0	5.9	0	1.7
Poor	17.1	17.6	25.0	18.3
Average	54.3	64.7	62.5	58.3
Good	28.6	5.9	12.5	20.0
Very good	0	5.9	0	1.7
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

Despite the relatively high percentage of respondents who claimed themselves to have a 'fairly good' or 'good' understanding of forensic accounting, most respondents (95 per cent) were not aware or perhaps not knowledgeable at all about other methods^{6.3} of detecting tax evasion more successful than forensic accounting techniques (Table 6.24). The remaining 5 per cent claimed that there was a better way to detect tax evasion by SMEs; unfortunately, none of them made any comments or suggestions about this method. The possible explanation is that forensic accounting is either still new to them or not widely available in Malaysia or, if it is available, the tax practitioners may not have undergone formal training to enable them to fully understand the concept of forensic accounting.

Table 6.24**Tax practitioners' response to the other mean of detection better than forensic accounting technique?**

Q1.11: In your opinion is there a better way to detect tax evasion by SMEs other than forensic accounting techniques.

	Percentages			
	Sec153(3)a	Sec153(3)b	Sec153(3)c	Overall
Yes	2.9	5.9	12.5	5.0
No	31.4	11.8	25.0	25.0
Do not know	<u>65.7</u>	<u>82.4</u>	<u>62.5</u>	<u>70.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	35	17	8	60

^{6.3} Most tax practitioners were quite familiar with the indirect methods of proving unreported income used by the tax authority, for example net worth/capital statement, expenditure, bank deposits or percentage mark-up.

6.4.11 Focus group outcomes

The tax practitioners and SMEs focus group

The primary purpose of the tax practitioners and SMEs focus groups were to assist in identifying issues in the SMEs and tax practitioners questionnaires (see Chapter 5, section 5.5.2 and 5.5.3 for further details). The principal outcomes of the analysis of the data are summarised in Figure 6.1.

Summarising, the tax practitioner survey suggested that SMEs did evade tax and it is estimated that more than 50 per cent of SMEs are involved. Analysis also revealed that tax evasion by SMEs is repetitive in nature and takes place mostly through overstatement of expenses (other than cost of goods sold), which was the most common method used in tax evasion schemes.

The results further revealed an incompetent, corrupt and inadequately staffed tax administration to be the major factor influencing tax evasion by SMEs, which is supported by the probability of detection by the IRB, which is less than 1 per cent annually. Tax practitioners, however, believed that all of the methods and approaches used by the IRB are good with capital statement/net worth analysis being viewed as overall the most effective method of detecting tax evasion.

Tax practitioners also perceived themselves as pro-tax authority, acting within the law and without any factors influencing their decision-making. They, however, admitted that some of them do accidentally or deliberately understate or overstate profit for their clients so that they will pay more or less tax.

The conception and knowledge of forensic accounting among the tax practitioners is perceived to be 'average' by the majority. The current techniques of forensic accounting used by the IRB are considered to be the most effective way to detect tax evasion by SMEs.

Figure 6.1

Outcomes of Tax Practitioners and SMEs

Research Questions	Tax Practitioners	SME Taxpayers	Comments
Extent and existence of tax evasion by SME in Malaysia	<p>Perceived SMEs do evade tax (Table 6.12)</p> <p>More than 50 per cent of SME evade tax</p>	<p>Strong agreement with 3 statement about tax evasion by SMEs (Table 6.26)</p> <p>Split in opinion with 60 per cent believed between 25 to 50 per cent of SME evade tax (Table 6.27)</p>	<p>SMEs do evade tax. The situation is serious i.e widespread and frequent</p>
Characteristics of tax evasion by SMEs in Malaysia: Cyclical vs repetitive	<p>Repetitive in nature, occur all the time (Table 6.13)</p>	<p>Repetitive in nature, occur all the time. (Table 6.28)</p>	<p>Repetitive and deliberate in nature.</p>
Deliberate vs accidentally	<p>Deliberately in nature with the involvement between 25 per cent done by tax practitioners (Table 6.17 & 6.18)</p>	<p>Deliberately in nature with 25 to 50 % of SMEs (Table 6.31 & 6.32)</p>	
SME tax practitioner relation	<p>Good working relationships (Table 6.15)</p>	<p>Good working relationships Heavy reliance on tax practitioners (Table 6.29)</p>	<p>A contribution that practitioners make to SMEs in giving them confidence that their tax matters are under control and that their tax-paying behaviour is lawful.</p>

Research questions	Tax Practitioners	SME Taxpayers	Comments
Factors influencing tax evasion by SMEs in Malaysia	Incompetence, corrupt and inadequately staffed tax administration (Table 6.14) Low detection rate by IRB support the above argument (Table 6.20)	Burden of paying tax is too great. Low probability of detection by IRB. (Table 6.40)	Suggest IRB is ineffective in the present tax collection as a result it is unlikely that tax cheaters will be caught and penalised.
Method use in evading tax by SMEs in Malaysia	Overstatement of expenses (Table 6.19)	Understatement of gross profit (Table 6.33) No sophisticated tax painning scheme involved (Table 6.34, 6.35 & 6.36)	Easiest and simplest method to used. No sophisticated tax planning scheme involved.
Role of tax practitioners	Perform duty within the boundaries of tax law pro taxpayers (Table 6.15 & 6.16)	Heavily reliance on tax practitionera. Most had never switched accountant/practitioners (Table 6.29)	As for the practitioners a positive perceptions toward tax law but it may be difficult to prove. Heavily reliance on practitioner may influence the level of tax evasion.
Role of Forensic accounting	New to them, not widely yet available - need to undergone training to enable them fully understand the concept	N/A	Need further exposure before fully understanding the concept of forensic accounting

Research Questions	Tax Practitioners	SME Taxpayers	Comments
<p>Other Observation: Evasion not restricted to a particular source of income</p>	<p>Most familiar with the indirect method of proving unreported income - capital statement</p>	<p>Various respondents believed they evade tax Highly concentrated in particular SMEs</p>	<p>Prima facie SMEs evade tax</p>

6.5 SME taxpayer survey result

6.5.1 Respondents' background

Some of the personal details provided in Part III of the questionnaire (see Appendix II) have been combined in order to facilitate statistical analysis. Table 6.25 provides a profile of the respondents. The respondents represent a total of 87 SME taxpayers, 62 from the general population, i.e. the group presumed to be SME non-tax evaders, and 25 convicted SME tax evaders. The classification of compliance behaviour, that is, whether the respondent is deemed a non-tax evader or convicted evader, was indicated by the colour of the questionnaire, which was set at the design stage: blue for non evaders and orange for tax evaders.

Two-thirds of the respondents were below 50 years old with over 90 per cent being male proprietors. They represented a fairly evenly spread ratio of ethnic groups, comprising Malays (43 per cent), Chinese (50 per cent) and Indians (7 per cent). Fifty four per cent of them have had a tertiary education and 46 per cent compulsory schooling/college education.

The majority of the respondents are in a position of control in the SMEs. Approximately 45 per cent are company directors and more than 39 per cent are self-employed. The average turnover for the respondents was less than RM10 million per year. Over 80 per cent of the sample employed fewer than 50 employees. The geographical breakdown of the respondents is appropriate according to the economic setting of the country with most of the economic activities being located in the western region (48 per cent), followed by the southern (17 per cent), northern (14 per cent), and eastern regions (11 per cent) and East Malaysia (8 per cent).

Table 6.25**Demographic characteristics of the SMEs taxpayers**

	Percentages		
	Non evaders	Evaders	Overall
(a) Age			
< 50	83.8	76.0	81.6
> 50	<u>16.2</u>	<u>24.0</u>	<u>18.4</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(b) Gender			
Male	90.3	92.0	90.8
Female	<u>9.7</u>	<u>8.0</u>	<u>9.2</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(c) Ethnicity			
Malay	46.8	32.0	42.5
Chinese	43.5	68.0	50.6
Indian	<u>9.7</u>	<u>0</u>	<u>6.9</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(d) Education			
Compulsory schooling/college	48.4	40.0	46.0
First degree and above	<u>51.6</u>	<u>60.0</u>	<u>54.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(e) Profession			
Professional	43.5	28.0	39.1
Partner in a partnership	9.7	12.0	10.3
Company director	38.7	60.0	44.9
Employee	<u>8.1</u>	<u>0</u>	<u>5.7</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(f) Average turnover per year			
< 10 millions	85.4	72.0	81.6
10 - 25 million	<u>14.6</u>	<u>28.0</u>	<u>18.4</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(g) No. of employee			
< 50	82.2	76.0	80.5
> 50	<u>17.8</u>	<u>24.0</u>	<u>19.5</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
(h) Business category			
Self employed	45.2	32.0	41.4
Non self employed	<u>54.8</u>	<u>68.0</u>	<u>58.6</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>

Table 6.25 (continued)

Demographic characteristics of the SME taxpayers

	Percentages		
	Non evaders	Evaders	Overall
(i) Location			
Western	51.6	40.0	48.3
Eastern	9.7	16.0	11.5
Northern	14.5	16.0	14.9
Southern	19.4	12.0	17.2
East Malaysia	<u>4.8</u>	<u>16.0</u>	<u>8.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

The sample provided a relatively representative cross section of the population. The only bias that was observed was an under-representation of female entrepreneurs, where married female entrepreneur taxpayers currently are filed under the husband's tax file^{6.4}.

6.5.2 General views and extent of tax evasion in SMEs

The SME taxpayers were asked to indicate their agreement or disagreement, on a five-point Likert scale of "1" (strongly disagree) to "5" (strongly agree), with each of five statements regarding tax evasion by SMEs in Malaysia, as listed in Table 6.26. This table also sets out the means and significance level for the responses of the non-tax evaders and convicted evaders who supported the statements. The mean responses to these statements were greater than 3.5 for both groups of respondents with no significant differences, indicating strong agreement in the views on tax evasion by SMEs in Malaysia^{6.5}.

The strong agreement with such statements as "*Tax evasion is common in Malaysia*", "*There is nothing morally wrong with paying less tax*" and "*Tax*

^{6.4} Under the Malaysian tax system, only one file is opened for a married couple, even though a married woman is assessed separately on her income from all sources. The wife has to file the income under the husband's tax return. However, a married woman may elect for aggregation of her income with that of her husband if she finds it beneficial in terms of a lower tax liability.

^{6.5} ANOVA, was used to test for differences in responses between non evaders and evaders.

evasion is a form of gambling” is evidence to suggest that the existence and problem of tax evasion is serious in Malaysia (at least in the perceptions of the respondents).

Table 6.26
Taxpayers' view on tax evasion by SMEs

	Mean response			F value	Sig
	Non evaders	Evaders	Overall		
Q1.1: To what extent do you agree with the following statement about tax evasion?					
Tax evasion is common in Malaysia	3.92	3.96	3.93	0.057	0.811
Tax evasion is a fraud committed against the government	3.90	4.08	3.95	1.342	0.250
Tax evasion is justified if the tax system is unfair	3.85	3.92	3.87	0.163	0.688
There is nothing morally wrong with paying less tax than the proper amount	3.56	3.68	3.60	0.415	0.521
Tax evasion is a special form of gambling: gambling for extra income in light of the likelihood of detection and the imposition of penalties	3.82	3.76	3.80	0.136	0.731
<i>N</i>	62	25	87		

The mean response is the individual response on a five point scale of 1= strongly disagree to 5 = strongly agree

It is also worth highlighting the strong agreement (overall mean response of 3.95) with the statement of *“Tax evasion is a fraud committed against the government.”* On the basis of this view, both groups of respondents perceived some positive attitude towards tax ethics and a perception of fairness in taxation. It is quite surprising to observe the positive attitude among tax evaders. Presumably they want to present an image of themselves as honest and also want to regard themselves as honest, perhaps resulting from their experience with the IRB after being found out and penalised for income tax evasion.

In order to quantify the seriousness of the perceptions, the respondents were asked to estimate the extent of SME involvement in tax evasion (see Q1.6, Table 6.27). About two third of the respondents in both groups believed that ‘between 25 to 50 per cent’ of SMEs do evade tax. In contrast, only 2 per cent are of the view ‘less than 25 per cent’ and approximately 36 per cent believed ‘more than 50 per cent’ of

SMEs are evading tax. There was a split opinion in the overall perception by the SME taxpayers and tax practitioners (Table 6.12, Q 1.2) with regard to this estimate; however, the extent of the perceived involvement of SMEs indicates that the problem of tax evasion among SMEs is serious.

Table 6.27

Taxpayers' estimation of SMEs involvement in evading tax

Q1.6: In your opinion, to what extent (in percentage), if any, do you think that SMEs are evading tax.

	Percentages		
	Non evaders	Evader	overall
Less than 25%	1.6	4.0	2.3
Between 25% to 50%	53.2	76.0	59.8
Between 50% to 75%	41.9	20.0	35.6
More than 75%	3.2	0	2.3
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

6.5.3 Characteristics of tax evasion in SMEs

One question (Q1.8) was posed to identify the likely period over which SMEs would evade taxes. As can be seen from Table 6.28, both groups of respondents believed that tax evasion by SMEs will take place all the time. This view is consistent with the results obtained from the tax practitioners (Table 6.13). It indicates that tax evasion by SMEs is repetitive in nature.

Table 6.28

Taxpayers' response to the likely period SMEs will evade taxes

Q1.8: In your opinion, which is the likely period in which SMEs will evade taxes?

	Percentages		
	Non evaders	Evader	Overall
Early stage	4.8	8.0	5.7
High Inflation	3.2	0	2.3
Economic boom	9.7	0	6.9
Economic downturn	6.5	12.0	8.0
All the time	75.8	80.0	77.1
Other	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

6.5.4 Relationship with tax practitioners

The relationship with tax practitioners was addressed through three questions (Q2.1, Q2.2 and Q2.3). The respondents were asked who kept their accounting records/books, who dealt with tax matters and whether they had ever switched accountants/tax practitioners in dealing with tax matters.

Questions 2.1 and 2.2 asked SME taxpayers whether or not they relied on each of the following in keeping their accounting documents and dealing with tax matters for their business: (a) Self; (b) Spouse/partner; (c) Friends; (d) Employee; (e) Accountant/Tax practitioners. The frequency of use of each possible source is summarised in Table 6.29.

A majority of evaders (64 per cent) whereas about half (50 per cent) of non evaders relied on their accountants/tax practitioners to keep their accounting documentation; about one third of respondents kept their own. Notably less involved in the keeping of accounting documentation were the employees (12.6 per cent) and spouses/partners (1.1 per cent). Both group tended to be more heavily relied on their accountants/tax practitioners in keeping their accounting records. The extent of their reliance on their accountants/tax practitioners, therefore, indicates that they can be influence in their tax compliance decision. These results are consistent with research undertaken in the Australia context (Marshall *et al.*, 1997) showing that taxpayers place a heavy reliance upon tax practitioners.

Table 6.29

Taxpayers' response on tax administration

Q2.1: Who keeps the accounting records/books of your business?

	Percentages		
	Non evaders	Evader	Overall
Self	37.1	20.0	32.2
Spouse/partner	1.6	0	1.2
Friends	0	0	0
Employee	11.3	16.0	12.6
Accountant/tax practitioners	50.0	64.0	54.0
Not applicable	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.2: Who deals with tax matters for your business?

	Percentages		
	Non evaders	Evaders	Overall
Self	25.8	8.0	20.8
Spouse/partner	1.6	0	1.1
Friends	0	0	0
Employee	1.6	0	1.1
Accountant/Tax practitioner	71.0	92.0	77.0
Not applicable	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.3: Have you ever switched accountant/tax practitioners in dealing with tax matter.

	Percentages		
	Non evaders	Evaders	Overall
Yes	12.9	56.0	25.3
No	62.9	32.0	54.0
Prefer not to reply	4.8	12.0	6.9
Not applicable	<u>19.4</u>	0	<u>13.8</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Both groups (92 per cent of evaders and 71 per cent of non evaders) also used accountants/tax practitioners in helping them to deal with tax matters with the IRB (see Q2.2, Table 6.29). This finding implies a complexity in the tax law and, as a result, the tendency of SME taxpayers to seek assistance and advice from

accountants/tax practitioners. This view also implies that tax practitioners play dual roles; giving advice to their clients and helping to enforce tax laws. Klepper *et al.* (1991), however, established that tax practitioners do assist the government to enforce tax laws when it is unambiguous but at the same time assist taxpayers to exploit the tax law when it is ambiguous. The extent of SMEs' reliance on the tax practitioners as their advisors, therefore, indicates that they can be influenced in their tax compliance decisions (Tan, 1999).

In analysing the results for switching accountants/tax practitioners, both groups expressed that they had never switched accountants/tax practitioners in dealing with tax matters (Table 6.29; Q2.3). There is, however, a tendency to switch accountants, for some reason that has not been raised by this research, as perceived by the convicted tax evaders. This implies that both groups willing to terminate their tax practitioner's services. Evaders, in particular, justified their actions although there is no clear evidence to indicate that this occurs when their desire for advice is not met. Prior research (Hite, 1992; Tan, 1999; Sakurai and Braithwaite, 2001) has shown that taxpayers would switch or terminate their tax practitioners if they disagreed with the advice given or if they had been investigated for tax evasion: it was even likely that the tax practitioner would stop dealing with them if he/she thought they fitted the profile of a tax evader.

6.5.5 *Taxpayers' integrity*

Three questions were asked to assess the integrity of SME taxpayers. The first question presented respondents with a scenario of a case (Q 2.4). The scenario asked the respondent for the appropriate action to be taken if they were being paid RM100,000.00 in cash for work done outside their regular job. By far the greatest number of respondents indicated that they would declare the income in the most advantageous manner within the law (Table 6.30). This response suggests that both groups of SME taxpayers have a positive perception towards the tax law; however, it may be difficult to prove whether truthful answers were given, as discussed earlier in the context of the tax practitioners' views on the same issue (paragraph 6.4.5).

Table 6.30**Taxpayers' response on the action that will be taken in reporting the income to IRB**

Q2.4: Imagine yourself in this situation: You have been paid RM100,000 in cash for work that you have done outside your regular job. Which appropriate action would you take to report it.

	Percentages		
	Non evaders	Evader	Overall
Not declare it	8.1	4	6.9
Declare only a portion of it	1.6	8	3.4
Declare it in the most advantageous manner	87.1	88	87.4
Declare it but off set by GP or expenses	<u>3.2</u>	<u>0</u>	<u>2.3</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Tables 6.31 and 6.32 show respondents' perceptions of whether SMEs are involved in tax evasion and whether their involvement was either accidentally or deliberately understating or overstating their income/profit so as to pay less or more tax than they should. These were assessed by two questions – Q2.5 and Q2.6.

When examining the responses to part 1 of Q2.5 (Table 6.31) and Q2.6 (Table 6.32), it is clear that there was a perception that SMEs do accidentally or deliberately understate or overstate their income/profits. The respondents generally tend to agree that SMEs accidentally or deliberately understated their income/profits. One implication of this response is that both groups believed SMEs had more opportunity to evade tax.

Both groups believed the actual percentage of SMEs involved in such activities to be less than 10 per cent. Further findings showed that almost half of respondents indicated that between 25 and 50 per cent of SMEs deliberately understated their profits and two third of the respondents perceived that less than 10 per cent of SMEs deliberately overstated their profit.

These results provide some evidence that SMEs do accidentally or deliberately understate or overstate profits; however, overall SMEs tend to deliberately

understate profits. Understanding this phenomenon could help the IRB to shape and manage its compliance programme in a strategic way. Kidder and McEwen (1989:64) concluded that the state of knowledge in the field of tax evasion would be best served by an initial emphasis on taxpaying behaviour and then on tax enforcing behaviour. It may be possible to target enforcement strategies to the particular behaviour, thus reducing the likelihood of unintended side effects of the strategies.

Table 6.31

Taxpayers' perceptions of the accidental or deliberate understatement of SMEs profit

Q2.5: Do you think SMEs/taxpayers for what ever reasons, ever accidentally or deliberately understate their profit and pay less tax than they should.

	Percentages		
	Non evaders	Evaders	Overall
Yes	87.1	100	90.8
No	8.1	0	5.7
Prefer no to reply	<u>4.8</u>	<u>0</u>	<u>3.5</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.5(b):To what extent(in percentage) do you think, SMEs accidentally understate the profit?

	Percentages		
	Non evaders	Evaders	Overall
< 10%	62.9	68	64.4
10% - 25%	16.1	20	17.2
25% - 50%	8.1	12	9.2
50% - 75%	0	0	0
>75%	0	0	0
Not applicable[1]	<u>12.9</u>	<u>0</u>	<u>9.2</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.5(c):To what extent(in percentage) do you think, SMEs deliberately understate the profit?

	Percentages		
	Non evaders	Evaders	Overall
< 10%	6.5	4	5.7
10% - 25%	6.5	8	6.9
25% - 50%	43.5	48	44.8
50% - 75%	27.4	40	31
>75%	3.2	0	2.3
Not applicable[1]	<u>12.9</u>	<u>0</u>	<u>9.2</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

[1] Responses with answer 'no' and 'prefer not to reply'

Table 6.32

Taxpayers' perceptions on the accidental or deliberate overstatement of SMEs profit

Q2.6: Do you think SMEs/taxpayers for what ever reasons, ever accidentally or deliberately overstate their profit and pay more tax than they should.

	Percentages		
	Non evaders	Evaders	Overall
Yes	82.3	88	83.9
No	17.7	12	16.1
Prefer no to reply	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.6(b):To what extent(in percentage) do you think, SMEs accidentally overstate the profit?

	Percentages		
	Non evaders	Evaders	Overall
< 10%	77.4	88	80.5
10% - 25%	3.2	0	2.3
25% - 50%	1.6	0	0
50% - 75%	0	0	0
>75%	0	0	0
Not applicable[2]	<u>17.7</u>	<u>12</u>	<u>16.2</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q2.6(c):To what extent(in percentage) do you think, SMEs deliberately overstate the profit?

	Percentages		
	Non evaders	Evaders	Overall
< 10%	72.6	64	70.1
10% - 25%	6.5	16	9.2
25% - 50%	43.2	8	4.6
50% - 75%	0	0	0
>75%	0	0	0
Not applicable[2]	<u>17.7</u>	<u>12</u>	<u>16.1</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

[2] Responses with answer 'no' and 'prefer not to reply'

6.5.6 Approaches used by SMEs in evading tax

Question 1.9 details four approaches that are understood to be the most frequently used in generating tax evasion by SMEs (Table 6.33). Both groups perceived the understatement of gross profit to be the most frequently used method, followed by an overstatement of expenses other than the cost of goods sold, in contrast with the view of the tax practitioners (Table 6.15).

Table 6.33**Taxpayers' view on the most frequently used method in generating tax evaded income in SMEs**

Q1.9: The following are the methods for generating tax evaded income in SMEs. Which do you think is the most frequently used in generating tax evaded income in Malaysia.

	Percentages		
	Non evaders	Evaders	Overall
Complete suppression of GP	12.9	12	12.6
Understatement of GP	58.1	40	52.9
Overstatement of expenses (other than cost of goods sold)	27.4	44	32.3
Understatement of asset (including property and inventories)	1.6	0	1.1
Other	0	4	1.1
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

The difference is perhaps explicable, no one methods is proven effective in camouflaging tax evasion.

The focus of another three questions (Q2.7, Q2.8 and Q2.9) was to identify SMEs with the potential to use additional methods (for example, inter-company transactions or transfer pricing) in tax evasion schemes. Table 6.34 shows that most of the SMEs (82 per cent) do not have any other interest either through direct or indirect shareholding (including in sole proprietorships or partnerships). Only 15 per cent indicated that they had other interests but with fewer than 5 businesses (Table 6.35).

Table 6.36 shows that the majority of respondents (approximately 98 per cent) also had no dealing with tax haven countries. These responses imply that the respondent SMEs were not in a position to apply a sophisticated tax-planning scheme in evading tax.

Table 6.34**Taxpayers' response on the interest in other SMEs business**

Q2.7: Do you have any other interest in other SMEs business (associate, subsidiary or wholly owned company including sole proprietorship, partnership etc.)

	Percentages		
	Non evaders	Evaders	Overall
Yes	12.9	20.0	14.9
No	82.3	80.0	81.6
Prefer not to reply	<u>4.8</u>	<u>0</u>	<u>3.5</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Table 6.35**Taxpayers' response to the number of business interest in SMEs**

Q2.8: Please indicate the number of business that you have interest in either through direct or indirect shreholding including sole proprietor, partnership etc.

	Percentages		
	Non evaders	Evaders	Overall
< 5	11.3	20.0	13.8
6 to 10	1.6	0	1.1
More than 10	0	0	0
Not applicable	<u>87.1</u>	<u>80.0</u>	<u>85.1</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Table 6.36**Taxpayers' response on SMEs dealing with tax haven countries**

Q2.9: Have you any dealing with tax haven countries?

	Percentages		
	Non evaders	Evaders	Overall
Yes	1.6	0	1.1
No	96.8	100	97.8
Prefer not to reply	<u>1.6</u>	<u>0</u>	<u>1.1</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	89

The survey also raised the issue of business practices (Questions 1.4 and 1.5). Question 1.4 asked the respondents to rate business practices based on their moral acceptance using a 5-point scale of "1" (Not at all acceptable) to "5" (Perfectly

acceptable). Table 6.37 compares the means and shows any significant differences in the responses of the respondents to seven situations regarding business practices in generating tax-evaded income. Both non-evaders and convicted evaders were quite clear in their view that all of the stated lists of business practices were not at all morally acceptable (overall mean response less than 2.5). This again implies that both groups show some positive attitude to tax ethics. However, there were some significant differences where convicted evaders were more accepting of these practices as being morally acceptable, probably due to their previous actions.

Table 6.37

Taxpayers views on the morally acceptable business practices.

Q1.4: Which of the following business practices would you regard as morally acceptable?

	Mean response			F value	Sig
	Non evaders	Evaders	Overall		
Not filling tax return	1.85	2.40	2.01	7.54	0.007
Not reporting full income	2.05	2.36	2.14	2.143	0.147
Reporting main income, but not some other income	2.00	2.72	2.25	10.004	0.002
Overstating business expenses	1.92	2.44	2.07	7.781	0.007
Being paid cash for a job and not reporting it on tax return	2.03	2.64	2.21	9.066	0.003
Non disclosure of fact to the tax practitioners	2.03	2.64	2.21	10.82	0.001
Writing off personal expenses as business expenses	2.03	2.64	2.20	6.786	0.011
<i>N</i>	62	25	87		

The mean response of individual response on the scale of 1=not at all acceptable to and 5= perfectly acceptable

The respondents regarded these unacceptable practices (Q1.5) to be quite widely used, with the mean responses from both groups greater than 3 (Table 6.38).

Table 6.38**Taxpayers views on the involvement of SMEs in morally acceptable business practices.**

Q1.5: In your opinion what proportion of SMEs do the following?

	Mean response			F value	Sig
	Non evaders	Evaders	Overall		
Not filling tax return	3.31	3.32	3.31	0.006	0.937
Not reporting full income	3.53	3.44	3.51	0.408	0.525
Reporting main income, but not some other income	3.47	3.72	3.54	3.937	0.050
Overstating business expenses	3.29	3.76	3.43	9.454	0.003
Being paid cash for a job and not reporting it on tax return	3.44	3.52	3.43	0.289	0.593
Non disclosure of fact to the tax practitioners	3.31	3.48	3.46	1.365	0.246
Writing off personal expenses as business expenses	3.47	3.60	3.51	1.13	0.291
<i>N</i>	62	25	87		

The mean response of individual response on the scale of 1=none, 2= few, 3= half, 4= most and 5=all

6.5.7 Factors influencing tax evasion by SMEs

The related prior research on tax evasion indicates that there are various factors influencing tax evasion. In this study, the respondents were asked to identify from a list the most important factors determining why SMEs do or do not pay the right amount of tax (Q1.2 and Q1.3 in Table 6.39). The results are shown in Table 6.39.

Table 6.39

Taxpayers' response to why SMEs do and do not pay the right amount of tax

Q1.2: The following is a list of some of the main factors why SMEs do not pay the right amount of tax. Which do you think is the most importance factor.

	Percentages		
	Non evaders	Evaders	Overall
Burden of paying tax is too great	51.6	72.0	57.5
Everyone else fiddles their tax	14.5	16.0	14.9
Inefficiency of tax administration	14.5	4.0	11.5
Complicated of the tax law	11.3	8.0	10.3
Tax system is unfair	8.1	0	5.8
Other	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

Q1.3: The following is a list of some of the main factors why SMEs do pay the right amount of tax. Which do you think is the most important factor.

	Percentages		
	Non evaders	Evader	Overall
The threat of fine/penalties	19.4	16.0	18.5
The threat of being caught	3.1	20.0	8.0
To avoid audit/investigation	59.7	52.0	57.5
Think other people are honest in paying their tax	11.3	8.0	10.3
Believe in paying their fair share	6.5	4.0	5.7
Other	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

More than half of the respondents believed that *'the burden of paying tax is too great'* as the most important factor determining why SMEs do not pay the right amount of tax (see Q1.2, Table 6.39). In contrast, almost 60 per cent of the respondents indicated that *'to avoid audit or investigation by IRB'* is the most important factor that influences SMEs' decisions about whether to pay the right amount of tax (see Q 1.3, Table 6.39).

It is interesting to note (given that respondents could only tick one answer) that none of the negative reinforcements such as *'threat of fines/penalties'* and *'threat of being caught'* were seen as major factors having an effect on SMEs in paying the right amount of tax. Looking more closely, these categories are not mutually

exclusive: perhaps the respondents were thinking of the threat of being caught if one is audited. It is a fact that of those audited by IRB, a large fraction is subjected to penalties and fines.

6.5.8 *Probability of detection by IRB*

Several scholars have established that most taxpayers would evade tax because it is unlikely that the evaders would be caught and penalised by the tax authority (e.g. Allingham and Sandmo, 1972; Alm *et al.*, in a series of experimental studies, 1992a, 1992b, and 1992c). When examining the responses to Question 1.7, it is clear that both non-tax evaders and convicted evaders believed that their chances of being caught were quite low (Table 6.40). Over 87 per cent of the non-evaders and 76 per cent of convicted evaders thought the chances of SMEs getting caught by the IRB were only between 25 and 50 per cent. Whether this is an accurate estimate or not is hard to gauge. However, evidence from the IRB's annual report reveals that a minuscule fraction of tax returns is audited. The case is, however, similar to that in the US where, according to Anderoni *et al.* (1998), in the mid 1990s, 1.7 per cent of tax returns were audited.

It is also worth highlighting the higher percentage of responses in the 50 –75% category by the convicted evaders. This may be attributable to the fact that they have been caught, making them more likely to think that they would be detected. One possible explanation given by the survey respondents for these perceptions of a low probability of detection could be the existence of an incompetent and inadequately staffed tax administration.

Table 6.40**Taxpayers' response on the chances of the likelihood SMEs being caught by IRB**

Q1.7: In your opinion, to what extent (in percentage), if any, do you think tax evading SMEs are caught by IRB.

	Percentages		
	Non evaders	Evaders	Overall
None	0	0	0
< 25%	8.1	8.0	8.0
Between 25% to 50%	87.1	76.0	83.9
Between 50% to 75%	4.8	16.0	8.1
> 75%	0	0	0
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	62	25	87

6.5.9 Focus groups outcomes

The Tax Evaders and Non Tax Evaders

The taxpayers focus groups aimed to canvas the opinions, experience and the impact that the administration of the tax system has on tax evasion by SMEs (see Chapter 5, section 5.5.2 and 5.5.3 for further detail). Figure 6.2 summaries the principal analysis of data from the SMEs focus groups.

In summary, the SME taxpayer survey suggests that there is evidence to support the assumption that SMEs do evade tax, and that this evasion is thought to be widespread and frequent in Malaysia. The proportion of SMEs evading tax, however, is less than 50 per cent. SME taxpayers also believe that it takes place all the time. *'The burden of paying tax is too great'* is considered to be the most important factor for why SMEs do not pay tax and *'to avoid audit or investigation by the IRB'* is the factor most influencing them to pay the right amount of tax.

The results of the SME taxpayer survey also revealed the understatement of gross profit to be the most frequently used method by SMEs in evading tax, followed by overstatement of expenses (other than cost of goods sold). SME taxpayers employed no additional or sophisticated tax-planning scheme. They considered that the probability of detection by the IRB is only between 25 and 50 per cent.

The results also suggest a heavy reliance by taxpayers upon accountants/tax practitioners in relation to book keeping and dealing with tax matters. There is also a tendency among SMEs to switch or terminate the tax practitioners.

The following chapter discusses the results obtained from file data/actual cases from the IRB's investigation files.

Figure 6.2
Outcomes of Tax Evader and Non-Tax Evader

Research Questions	Tax Evaders	Non-Tax Evaders	Comments
Extent and existence of tax evasion by SME in Malaysia	Strong agreement with the mean response on a five point scale [of 1 (strongly disagree) to 5 (strongly agree)]above 3.6 which suggest the existence and problem of tax evasion is serious (Table 6.27)	Strong agreement with the mean response on a five point scale [of 1 (strongly disagree) to 5 (strongly agree)]above 3.5 which suggest the existence and problem of tax evasion is serious (Table 6.27)	SMEs do evade tax. The situation is serious i.e widespread and frequent
Charateristics of tax evasion by SMEs in Malaysia: Cyclical vs repetitive	Take place all the time, indicates repetitive in nature (Table 6.28)	Take place all the time, indicates repetitive in nature (Table 6.28)	Repetitive and deliberate in nature.
Deliberate vs accidentally	Deliberately in nature with the involvement between 25 to 50 % of SMEs (Table 6.31 & 6.32)	Deliberately in nature with 25 to 50 % of SMEs (Table 6.31 & 6.32)	
SME tax practitioner relationship	Good working relationships More than half switched practitioners in dealing with tax matters (Table 6.29)	Good working relationships Two third never switched tax practitioners (Table 6.29)	Implies that both groups willing to terminate their tax practitioners services. Evaders in particular, justified their actions although there is no clear evidence

Research questions	Tax Evaders	Non-Tax Evaders	Comments
Factors influencing tax evasion by SMEs in Malaysia	Burden of paying tax is too great (Table 6.39) To avoid audit/investigation by IRB as to why they paid right amount of tax. (Table 6.39) Low probability of detection by IRB. (Table 6.40)	Burden of paying tax is too great (Table 6.39). To avoid audit/investigation by IRB as to why they paid right amount of tax. (Table 6.39) Low probability of detection by IRB. (Table 6.40)	Surprising as the lowest tax rate is only between 2 to 28 per cent. Advantageous to evade tax as it is unlikely that tax cheaters will be caught and penalised
Method use in evading tax by SMEs in Malaysia	Overstatement of expenses (other than cost of goods sold) [Table 6.33]	Understatement of gross profit (Table 6.33)	No sophisticated tax planning scheme involved
Taxpayers integrity	Declare tax in the most advantageous manner (Table 6.30)	Declare tax in the most advantageous manner (Table 6.30)	Positive perception toward tax law but it may be difficult to prove whether truthful answers were given
Role of Forensic accounting	N/A	N/A	

CHAPTER 7

ANALYSIS OF DATA ON CASE FILES

7.1 Introduction

This chapter discusses the results obtained from the analysis of the 200 actual cases taken from the IRB's files. Given the confidentiality requirements surrounding tax data due to the secrecy provision of section 138 of the Income Tax Act 1967, 'parallel' files (files consisting of the final report of the cases and administration procedure for settlement) at the Investigation and Intelligence Division were analysed. Only certain data were made available for the analysis.

The aim of this chapter is to establish an understanding of the practices within the IRB and SMEs with regard to tax evasion. Each section analyses data obtained from the files with respect to the methods of detection and settlement by the IRB, approaches/methods used by SMEs for evading taxes and the degree of culpability. The information was gathered using a formatted sheet to ensure systematic and consistent data collection (see Chapter 5 for a detailed discussion and Appendix III for a sample of the worksheet).

7.2 Method of detection of SME tax evasion by Inland Revenue Board

The main activity carried out by the IRB to counter tax evasion is investigation work. As revealed by the actual cases, the IRB has not set any criteria as to which areas of taxpayers' affairs would be examined to confirm the accuracy of the accounts or tax returns submitted, but it is logical to assume that the following areas would be the subject of scrutiny: calculation of capital allowances and verification of source documents such as sale and purchase agreements, conformation of deductibility of legal and professional fees, valuation of closing stock for the previous year, heavily qualified auditor's report, and so forth. This assumption is logical because the detection procedure is undertaken manually and is based almost entirely on the subjective judgement of the IRB staff concerned and the director of the Investigation and Intelligence Centre, according to the guidelines and procedures of the

IRB. The guidelines and procedures are outlined in the IRB Audit and Income Tax Back Duty Manual, which is strictly confidential.

The IRB undertakes substantial precautions to maintain the secrecy of their detection procedures; however, taxpayers and tax practitioners are nonetheless assumed to know the rules of the procedures and should therefore be able to be aware of the detection strategy (Anderoni *et al.*, 1998; Reinganum and Wilde, 1985). In the real world, however, taxpayers seem to possess quite poor knowledge of the audit function. Tax practitioners are considered to have a better knowledge of the factors that trigger an investigation compared to taxpayers, but Anderoni *et al.* (1998) suspect that there is substantial heterogeneity of beliefs even among this group: for example, some may actually be willing to overreport the tax liability if doing so would result in a significant reduction in the chance of being detected – whereby an audit is triggered if and only if reported income is too low or below norm.

Based on the data gathered, the conventional methods used by the IRB in detecting tax evasion can be grouped into three categories: (1) accounting/intelligence gathering; (2) third party information; and (3) related cases information. Table 7.1 shows that financial accounting analysis and intelligence information gathering have been the most commonly and widely used methods of detecting SME taxpayers' tax evasion. Financial accounting analysis uses financial ratio or analytical review to interpret the financial data of the business.

Table 7.1
Method of detection by Inland Revenue Board

	Percentages		
	1997	2001	Overall
Accounting/Intelligence	66	83	74.5
Third party information	18	3	10.5
Related cases information	16	14	15
Total	100	100	100
<i>N</i>	100	100	200

In general, the IRB employs two methods to gather intelligence information. First, general intelligence information gathering consists of physical surveillance, information from mass media including electronic media, and information from government agencies. These methods, however, as noted by Wallschutzky and Singh (1995), are not the most efficient that the revenue authority can use to detect tax evasion, as shown by the experience of developed countries (for example Australia, Canada and the United States), where computers are used to select cases for audit/investigation with the view to generating more scientific and risk-based selection criteria. Second, primary intelligence methods are used, including examination, analysis and interpretation of accounts submitted over the years, reviews and analysis of asset accumulation, house and business premises surveillance, and minimal undercover work to ascertain cash sales system.

File data also indicates that third party information is the least significant of that used for the detection of tax evaders. Third-party information consists of the allegations made by an informer with regard to tax evasion. Information given is deemed to have been offered voluntarily, to be accurate and specific and to be supported by documentary evidence. It is possible that the informer will be able to show how evasion of tax has been committed, as all information is given merit in consideration of reward (if the informer has asked for it) at the discretion of the Director General of the Inland Revenue. Unfortunately, this has never been made public due to the secrecy provision of section 138 (1) of the Income Tax Act.

As Table 7.1 shows, there has been a drastic drop in the use of third-party information, from 18 per cent in 1997 to 3 per cent in 2001. One possible explanation for third party information being comparatively less popular could be due to the information and allegations usually being vague and exaggerated. The IRB, however, does not ignore the information completely, since more than 10 per cent of cases were detected by using it.

The nature of the information in existing investigation cases or settled cases (i.e. related cases information) is also considered by the IRB as a resource in detecting tax evasion. This information may either lead to the discovery of new taxpayers or the detection of other taxpayers involved in tax evasion. The degree of usable information is again based on the subjective judgement of the IRB staff concerned. Fifteen per cent of the cases noted were detected using this method.

7.3 Methods of settlement by the IRB

The nature and extent of an SME's evasion varies from case to case to such an extent that the scope of enquiry is largely individual and usually no two cases are alike. Thus, in most cases, the evasions are not restricted to a particular source of income and it is necessary to conduct a review of, or to investigate the whole of, a taxpayer's financial affairs. Therefore the nature of investigation and the amount of work required will depend upon the circumstances of the case.

Nevertheless, the methods employed by the IRB, i.e. the techniques, fall into well-defined operations, a standardised, logical and systematic approach, the files are kept in an orderly manner and the work is easily followed if the necessity for a review arises at a later stage. This development of techniques involves the proper usage of forms or individual sub-files to categorise the progression to the achievement of a conclusion. Without this, the staff would find themselves drifting in an aimless way, dealing with items in a piecemeal way, and endless delays would ensue.

As Table 7.2 shows, the accounting basis approach is the most common and widely accepted technique employed by the IRB to determine any understated income of SME taxpayers. This method is frequently used in the case of companies, especially where understatement of income is more prevalent, such as with private companies or family owned companies. One possible explanation in using the accounting basis approach may be due to the variety of tools it has to estimate the underreporting of income.

Table 7.2
Method of settlement by IRB

	Percentages		
	1997	2001	Overall
Capital statement/Networth method	32	13	22.5
Accounting method	67	86	76.5
Other	1	1	1
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	100	100	200

Further analysis of the file data showed that where complete bookkeeping records are available, a proper investigative accounting procedure was employed to determine the issues of evasion. This includes the matching concept and ratio comparison to the business norm based on internal data. However, where the accounting record is incomplete, an income reconstruction approach was employed by preparing receipts and payments accounts based on either bank statements or cash analysis, which may include business and private transactions, and ascertaining any discrepancies.

The 'Rosette Principle'^{7.1} is also applied as a basis for computing the omitted income of other years of assessment. Where the IRB discovers one discrepancy in an account, such a discrepancy can form the basis for computing a prior or succeeding year's omitted income.

The capital statement/net worth method is also frequently used as an appraisal of the wealth accretion of the owners of SMEs: sole-proprietors, directors of companies, partners in a partnership or even salaried employees (for example, salaried employees having substantial unquoted shareholdings in the companies, etc.) related to the company's cases. Initially, the capital statement/net worth method involves the collection and examination of the taxpayer's personal and business records to obtain particulars of assets and liabilities and for establishment of the lifestyle of the taxpayer. The purpose is to ensure that, as far as possible, all relevant facts are brought to light. It provides both a computation of the taxpayer's true income and a test as to its accuracy.

To do so, the IRB compares increments in wealth with known income on an annual calendar year basis to determine whether there has been any omission or understatement of income, shown by discrepancies in the comparison. The rationale behind this measure is that if SME taxpayers have understated their income, it would invariably benefit the owners who would have used this understated money to acquire landed properties and other assets.

^{7.1} The principle was based on the case of *Rosette Franks Ltd v. Dick* (36 T.C. 100) in which the dicta of the case is as follows: "It is perfectly true that this is only one incident... but it was open to the commissioners to conclude that this was not merely an isolated transaction but showed the kind of thing which was going on and they were entitled to come to the conclusion...that there must be other similar incidents and therefore that the accounts of the company could not be relied upon to show the whole of the trading profit of the company".

This view is confirmed in the Malaysian case of *UGH v. DGIR* (1974) 2 MLJ 33.

Although different, these two methods of approach used by the IRB seem complementary and frequently supplement one another, especially in the case of partnerships. Understatement of partnership income is brought to light by an investigation of the private wealth of individual partners using either capital statements or means tests. Evidence unexplained increases in such private wealth point to understatements in partnership accounts and would enable the IRB to investigate the business accounts.

7.4 Methods used by SMEs in evading tax

There are various methods for evading tax used by SMEs. The choice of method would depend on the opportunity available and the requirement of the SME taxpayer. Table 7.3 categorises five common methods (including 'other') for tax evasion by SMEs. Understatement of gross profit is seen as the most commonly used technique, rather than overstatement of expenses (other than costs of goods sold), as a way of evading tax^{7.2}.

The underreporting of sales and overstating of purchases are noted as the largest adjustments in SMEs' tax evasion schemes to understate their gross profit. Common approaches used in underreporting sales involve omitted cash sales and omitted sales for which cheques received are paid into private accounts. Overstating purchases include fictitious purchases supported by false invoices and inflated invoices covering an element of personal drawing.

Such an approach is possible because currently, smaller SME taxpayers (businesses that are registered with the Registrar of Business) need not have their annual accounts audited with their tax returns. Only limited companies are required to submit audited accounts (which is mandatory for all companies incorporated under the Companies Act, 1965). This could, in most cases, lead SME taxpayers to present accounts which may be incorrect with understated sales, overstated purchases or stock adjustments leading to either a zero or a low tax liability.

^{7.2} Only the main method is considered in each case based on the highest amount of tax evaded by the taxpayers. They could use single or mixed methods in their approach to evade tax.

The Director General of the IRB under section 82(5)^{7.3} of the Income Tax Act, however, may require audited accounts to be produced by these SME taxpayers if the accounts or records produced are insufficient for ascertaining taxable income. A taxpayer who contravenes this section is guilty of a statutory offence and will be subject to a penalty.

A unique approach that uses two sets of accounts was noted in two SMEs. With this practice, SMEs keep two sets of accounting books, one that records all the real values of revenue and cost that are used for internal control, and the other having false accounting information, which is used for tax or other purposes. By doing so, SMEs essentially separate tax evasion and internal control as two independent decision-making problems.

Table 7.3
Method used by SMEs taxpayers in evading tax*

	Percentages		
	1997	2001	Overall
Complete suppression of gross profit	1	0	0.5
Understatement of gross profit	44	41	42.5
Overstatement of expenses (other than cost of good sold)	24	43	33.5
Understatement of assets (including property and inventories)	0	0	0
Others	31	16	23.5
Total	100	100	100
<i>N</i>	100	100	200

*Only the main method is considered in each case based on the highest amount of tax evaded by the taxpayer. They could use single or mixed methods in their approach.

Another area of concern for the IRB is the form in which assets are held. These assets are generally held in the form of landed properties and shareholdings in nominees' names and holding foreign assets. Of equal importance is retaining deposits in foreign banks. The IRB generally finds it more difficult to detect assets of tax evaders held overseas, even though the DGIR has wide discretionary powers to obtain information from any source on their

^{7.3} The Director General, if he is of the opinion that any accounts or records produced by any person to the Director General for the purpose of ascertaining the income of a person are insufficient or inadequate for that purpose, may by notice under his hand require that person to produce, in respect of any period or periods specified in the notice and within a time so specified (that time not being less than thirty days from the service of the notice), accounts audited by a professional accountant together with a report made by that accountant which shall contain, in so far as they are relevant, the matters set out in section 174(1) and (2) of the Companies Act 1965.

own or a third party's economic circumstances under section 78 or 79 of ITA 1967, as the Act is not applicable outside Malaysia^{7.4}.

7.5 Degree of culpability

There can be no hard and fast rule for determining the appropriate penalty for any offence, but since tax offences are truly factual, their characteristics feature – e.g. repeat themselves - regularly (see Chapter 3, section 3.2.4). The IRB categorises the culpability of the offence into three simple divisions according to the main characteristics of any case:

- (1) *innocent error or mistake* - cases where there has been no offence and consequently the question of culpability does not arise, for example calculation error in addition/subtraction;
- (2) *negligence or culpable carelessness* – this can arise where a statement of income (whether on a statutory return form, a non-statutory form, a repayment claim form, or in the form of accounts) sent to the IRB is found to contain some error or omission whereby a loss of tax has occurred; and
- (3) *deliberate evasion or fraud* – falsification deliberately planned with the clear intention of deceiving and cheating the IRB by, for example, the omission, manipulation or invention of figures or other records.

The analysis of the file shows approximately 99 per cent of the offences to be in the category of deliberate evasion with another one per cent (3 files) being negligence or culpable carelessness (Table 7.4). As the information in the file does not constitute complete data on who committed the offences, it can be argued that the SME taxpayer remained responsible for the act of evasion either by themselves or through their agent. The

^{7.4} Section 78 of ITA provides the power to call for specific returns and the production of books, accounts and other documents for examination by the DGIR as well as any such information or particulars that are deemed necessary by the DGIR in order to determine the chargeability to tax or the tax liability of a person. Section 79 of ITA 1967 allows the DGIR to require any person to provide to the IRB a statement containing particulars of all bank accounts, saving and loan accounts, deposits and so forth as well as all assets possessed by the person, spouse and dependant children.

general rule is that the taxpayer should sign the tax return even though a tax agent may have prepared it. However, where it is not practicable for the taxpayer to sign the tax return, the agent may sign it provided the tax agent has the authority to do so. Where the tax return is made by or on behalf of any person, it is deemed to have been made by that person or on his or her authority unless the contrary is proved (section 88 of ITA, 1967). Therefore, where the tax return is prepared by an authorised agent and signed by the taxpayer, it is deemed that the taxpayer is aware or cognisant of the contents. The tax practitioners can commit evasion on behalf of a client if they knowingly prepare and send incorrect accounts, computed together with the tax return to the IRB.

Table 7.4
Degree of culpability

	Percentages		
	1997	2001	Overall
Innocent error or mistake	0	0	0
Negligence or culpable carelessness	1	2	1.5
Deliberate evasion	<u>99</u>	<u>98</u>	<u>98.5</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	100	100	200

7.6 The nature of tax evasion by SMEs

According to section 91(1) of the Income Tax Act, any assessment, including an additional assessment, must be issued within 6 years (previously 12 years) from the chargeable period. Section 91(3), however, empowers the Director General to raise assessment beyond the prescribed time limit where tax has been lost due to fraud, wilful default or negligence on the part of the taxpayer. However, judicial pronouncements categorically state that there is an initial onus on the IRB to establish fraud, wilful default or negligence on the part of the taxpayer resulting in tax being lost. Once the IRB succeeds in discharging this burden, the onus shifts to the taxpayers to demonstrate that the assessments disputed are excessive or erroneous.

As Table 7.5 shows, most of the taxpayers have been investigated for a period of more than ten years. This could be due to the emphasis accorded to the above sections 91(1) and

91(3). Alternatively, it could also be indicative of the characteristics of tax evasion, which is repetitive in nature and takes place at all times in SMEs: there tends to be a continuous pattern associated with tax evasion, the effect of which is to reduce tax liability.

Table 7.5

The number of years investigation period reviewed by IRB

	Percentages		
	1997	2001	Overall
Between 1 to 5 years	15	30	22.5
Between 6 to 10 years	25	52	38.5
More than 10 years	<u>60</u>	<u>28</u>	<u>44.0</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>
<i>N</i>	100	100	200

For a more realistic and practical flavour to the nature of tax evasion by SMEs in Malaysia an illustrative example in three case study are presented as follows.

CASE STUDY 1

The principal activity of the company is selling stationery. The case was referred for investigation by the Assessment Branch, Kuala Lumpur. The Assessment Branch sought to clarify with the company a sum of RM114, 493 written back to the 2001 Profit and Loss Appropriation Account but failed to make any headway. There was also some general allegation by an informer concerning cash withdrawals in the year 2000.

Apart from the examination of the company's record, a capital statement covering the period from 1995 to 2001 was also issued to the Managing Director/Owner of the company. This was done because the books of account of the business, the sole proprietorship predecessor of the subject business were not available as they were said to have been destroyed by the flood which took place in Kuala Lumpur few years back. Throughout the course of investigation, the Managing Director/Owner of the business contented that all the irregularities detected by the IRB were in fact genuine book keeping errors caused by his staff rather than the products of his intention to evade taxes. Whether this contention is true or otherwise is a matter of opinion.

Examination of the books of account of the business noted specific cash sales omission and failure to account for certain rebates on purchases and damage claims, some of those irregularities detected are probably a product of bad book keeping compounded by the carelessness of the company's auditors. The following are good examples: -

The RM114, 443 written in the 2001 Profit and Loss Appropriation Account

The adjustment was made merely to write off the total differences between the Creditors and Debtors Control Accounts and the subsidiary accounts of both debtors and creditors detected while the 2000 accounts were being prepared. The company's representatives contended that the differences arose because of the following book keeping error:

- (1) Setting off balances in the debtors and creditors subsidiary accounts without such set-offs being recorded in the main control accounts;
- (2) Cash sales being posted to the debtors columns of the cash book and the total then posted to the control accounts;
- (3) The balances brought forward from the previous years being taken up twice, i.e. the net balances of the debtors and creditors after set-off being accounted once and again the balances of such accounts before set-off being accounted for.

The absence of records pertaining to years prior to 2000 made the investigation into the exact nature of the RM114, 493 written back almost an impossible task. The bulk of the amount was made up of RM56, 200 said to be amount due to X company appearing in the creditors ledgers and another RM54, 390 was said to be difference in debtors balance brought forward from previous years in relation to the Statistical Department. The precise nature of the RM56, 200 proved to be an exercise in futility, while RM54, 390 appear to be the difference between the amount owed by a particular debtor as appear on a list of debtors at 31.12.2000 (which was extracted for audit purposes and filed among the auditors' working papers) and the actual balance as per the debtors ledger. The latter indicated a balance of RM204, 714 at 31.12.2000 whereas the former listed it as RM150, 324.

Since neither the company's representative nor the company's auditors made any effort to prove by objective evidence that the RM114, 493 (admittedly a sum total of various

errors) does not affect the income figure in any year, IRB bring it in for tax. Such being so, the one question has to be decided is whether it is the company or the owner that should bear the tax. It has been agreed that since the RM114, 493 probably related to the period before the company was incorporated, it is logical that the proprietor of the predecessor of the company should bear the tax. This amount has been reflected in the capital statement of the owner.

Overstatement of purchases of RM117, 134

This arises from the following journal entry put through at the end of 2001:

DR:	Purchases	RM117, 113
CR:	X Company	RM56, 200
	Y Company	RM 6, 634
	Debtors Transfer	RM54, 390

The above items were part of the RM144, 493 mentioned in example above. The company's representatives explained that the above adjustment was meant to reverse some of the RM114, 493 written off to the 2000 Profit and Loss Appropriation Account that was done pending further investigation by the company. The debiting of the purchases Account has the unfortunate effect of inflating purchases of 2001 by that amount. The correct account, which should have been debited, in the first place is the Profit and Loss Appropriation Account.

Omission of Government Debtors Balances of RM88, 699 as at 31.12.2001

On examining the auditors' working papers for 2001 accounts, it was noted that the whole list of Government Debtors balances which amounted to RM88, 699 failed to find their way to the balance sheet for the year ended 31.12.2001 despite the fact that the individual items on the list had been ticked by the auditors with the related debtors accounts.

No explanation was given either by the auditors or the company except that an adjustment of RM108, 000 debiting the Debtor Control and crediting Sales had

subsequently been put through in 2002 to rectify this. The investigation and from the result of circularisation with various Government Departments, it appeared that: -

- (1) as far as could be ascertained, there was no omission of sales to Government Departments;
- (2) the 2001 balance sheet was able to be reconciled in spite of the omission of the RM118, 000 because there were compensating understatements of creditors as well as overstatements of debtors. The net result of this is an understating credit of about RM90, 000.

The adjusting entry of RM108, 000 in 2002 if in fact intended to bring back the RM88, 699 omitted in 2000 would have the consequence double counting sales.

The allegation with regard to cash withdrawals appear to be justifiable because from the investigation reveals that cash payments purported to be either for cash purchases or cash expenses but without adequate supporting external documentary evidences. The Owner/Managing Director, however insisted that they were expanded for genuine business purposes. It was after some haggling that a comprise of adding back 60 per cent of them for tax purpose was reached.

CASE STUDY 2

This case arose from an informer who brought in over 2,000 chits alleged to have been issued by the doctor as a means of evading tax. An inspection of the doctor's clinic and his house was made and the following were found:

1. A cash count difference of RM56.00 - between cash-in-hand and recorded takings on that day during which the doctor was at the dispensary for only about two hours.
2. There was an amount of RM2,999.00 - found in the house which was explained as comprising of—

Doctor's personal cash	RM1,000.00
Daily takings on the 1 st and 2 nd January 2002	
And some granny's praying money which totalled	RM1,999.00

3. Certain fees in a number of history cards, which were apparently omitted or understated.

On the basis of the discrepancy of cash takings found on the day of inspection, assessments were raised to protect the Revenue while further enquiry was made into the doctor's affairs. Instead of co-operating with the Revenue with a view to arrive at a settlement, taxpayer engaged a lawyer, Mr.W.E. to represent him and both he and his lawyer took the attitude that they would oppose any step by the Revenue to compute income believed to have been understated. Instead of furnishing relevant information required by the Revenue, taxpayer and his lawyer took every opportunity to fish out information so as to enable them to cover up every point that they think the Revenue might have against them.

On the basis of the assessments, it was made in accordance with the cash count taken on the day of the inspection. The main crux of the case, however, depend on the large number of chits in the Revenue's possession with the informer's assistance, it was ascertained that the doctor had systematically used the chits for fees which he intended to omit from his Tax Returns and an analysis of the chits showed that his understatement of income had been very much more than the additional assessments raised. It should be noted that the chits available are not a complete set, which might have been issued by the doctor for the days concerned as the informer did have easy access to all of them.

While the investigation was still in progress and the Revenue was still awaiting for information relating to taxpayer's assets and liabilities taxpayer's lawyer persistently pressured the Revenue to refer the case the Special Commissioners citing sub-section (2) of section 102 of the Income Tax Act 1967.

From the very outset of the case, taxpayer has taken the stand that he has never made use of chits to evade tax and the only chits he used were for his free patients i.e. patients whom he treated without charge. Although shown the chits he has denied that any of the chits were his and this stand was maintained right up to the date of the hearing. It was during the hearing that the taxpayer and his lawyer became aware that the Revenue possessed far more chits than the original thought they could cover, which were the few chits shown to them at the commencement of the investigation. During the hearing, the Chairman of the special

Commissioners asked the appellant whether he could “ match “ some of the chits produced by the Revenue and his patient cards (the taxpayer had explain in the course of giving evidence that sometimes chits were used when cards were not available and the particulars from the chits had been transcribed to the cards subsequently). Taxpayer had replied that he could if he were given the chance to look at the chits in conjunction with his patient cards.

The main feature of the chits is that except for a very few, all the rest do not bear any name or address of the patient. Due to the time lapse between the date of issue and the present date it would be virtually impossible to match the chits with the patient cards even assuming that taxpayer’s story is true. But the true position is that whatever prescription written on the chits and the charges there on will not be written on the patient cards and this is the scheme whereby taxpayer omitted his income.

In a desperate attempt to cover this point and to satisfy the Special Commissioners, taxpayer had copied some of the particulars of the chits which had been handed in as exhibits. It is now known that the taxpayer and/or his employees have written the particulars of these chits on to at least 3 of the patient cards, which were in taxpayer’s possession. The relevant cards have been tendered to the Special Commissioners and it is apparent that the particulars from the chits had been respectively transcribed recently on to the above - mentioned cards. This is fraud of the most blatant kind and unless action is taken against the taxpayer and whoever is responsible for this fraudulent action, our work will be seriously affected in all future cases. Action against the taxpayer will also be a deterrent in all future investigation cases.

It was proposed that:

- (1) An application be made to the Special Commissioners to have the relevant exhibits examined by the Chemistry Department:
- (2) A detailed examination of the relevant cards prescriptions, related illnesses of the patients, etc. are undertaken with the help of medical assistance, if necessary, with a view of initiating prosecution proceedings for which Head Office’s approval is sought.

Before the hearing was adjourned, the Chairman of the Special Commissioners directed that the appellant or his representatives be allowed to examine all the chits in the Revenue

in order to enable to match the chits with the patient cards. This directive was given despite Revenue pointed out that such an arrangement will give appellant an opportunity to “manufacture” evidence and undermine the Revenue’s position. As it is imperative to protect the Revenue, permission to retain all the taxpayer’s patients’ cards was made when they call to examine the chits in the Revenue’s possession. This is a drastic step which will give rise to strong protests but it was absolutely necessary if Revenue are to prevent the tax evader from making a mockery of the law in general and the Income Tax Act in particular.

CASE STUDY 3

The case was taken up purely on the basis that Mr. K was (and still is) a well-known person in Taiping, Perak. Accretion of assets at annual rests from 1990 to 2002 was adopted as basis for review from the very beginning.

Mr.K’s assets comprise principally of shares in private limited companies, shares in partnerships and a couple of sole proprietorships business viz. GSH and TH Ice Factory. GSH was converted into a limited company in 1999. Mr.K made substantial gifts to his children throughout the period under investigation. Consequently net assets left in Mr. K’s name amounted to only RM259,085 in 1992: the highest of which was in 1999 when the total was RM540,085.

Numerous current accounts maintained with the various companies, businesses and partnerships and constant transfers of funds from one to another coupled with frequent gifts, have somewhat complicated the review exercise. However all these transactions have been sorted out and verified.

The following items:

(a) Claim of Turf Club Winning \$53,556/-

Although Revenue implicitly accepted the amount in 1993, credited to Mr. K’s current account with GSH and some confirmatory slips were produced, these were rejected as being insufficient despite strong objections by the taxpayer. As a compromise, however, the

lottery winnings were allowed in 1991 but the same amount was spread over the period from 1991 to 2002 (i.e. RM4,463 each year) and were treated as gambling expenses in each of these years (taxpayer's tax rate is almost the same).

(b) 'Gifts' debited in the accounts of GSH

Mr. K could not regard these as gifts as the children who received these 'gifts' were shown in the accounts as debtors.

These 'so called' gifts should correctly be loans. If they are to be regarded as gifts Mr. K's current account with GSH should be debited thereby reducing the balance of Mr.K's current account. This however is not what happened and it is not correct therefore to treat the items listed as gifts.

The capital statement was accordingly adjusted. As the business had considerable sums charged as overdraft interest in the accounts, a proportion of these are disallowed.

c) Personal and Private Expenses

The estimates were grossly excessive and were revised to a more realistic figure. It was pointed out that taxpayer stays at 88, Barrak Road, which is a shop house.

d) Terms of payment and penalty

Terms of payment consists of an initial payment of RM80,000 (a cheque has been issued) and 15 monthly instalments of RM20,000. The instalments may appear to be a habit protracted but it take into consideration taxpayer's financial position and the nature of his assets. Most of his assets as indicated before consist of shares in private limited companies and partnerships and these are not readily saleable. Moreover, the settlement has exceeded his net worth by about RM120,000 and his liquidity position is a virtual zero.

The penalty of about 57% is adequate in view of the excellent co-operation taxpayer (through his son) had given towards a settlement of the case.

7.7 Other observations

According to Allingham and Sandmo (1972), the probability of detection and penalties are the two main policies backed tools available to the revenue authorities to eradicate tax evasion. Hence, these two main areas were explored; (1) estimating percentage of SME taxpayers detected by the IRB; and (2) the percentage of penalties imposed by the IRB.

7.7.1 *Estimating percentage of SME taxpayers detected by IRB.*

Estimating the percentage of tax evaders being caught by the IRB is an indirect way of measuring the rate of detection. However, without complete data, the only fallback method to determine the percentage of SME taxpayers detected by the IRB will be comparing the number of SME cases finalised to the total number of registered SME taxpayers.

Table 7.6 indicates a very small proportion of SME taxpayers that evade tax are detected by the IRB. As the table shows, less than one per cent is detected. Nevertheless, it should be noted that between 1997 and 2001, the number of cases finalised increased by approximately 1.18 times, whereas the number of registered SMEs had also increased by 1.27 times. This may indicate a higher level of detection, as the number of cases finalised has increased. On the other hand, it might also indicate that tax evasion within SMEs is becoming serious, as measured by the cases finalised.

Table 7.6
Estimated percentages of SMEs taxpayers detected by IRB

Year	No. of registered SMEs (million)	No. of SMEs cases finalised	Percentages of detection %
1997	1.1	485	0.04
2001	1.4	572	0.04

Source: IRB Operation Division and Investigation and Intelligence Division reports.

7.7.2 *The percentage of penalties imposed by IRB*

The adequacy of the penalty structure may affect the rate of tax evasion within SMEs. If it is not properly enforced, the objective of deterring tax evasion behaviour might not be achieved.

Data gathered are summarised in Table 7.7. From the table, it can be seen that the average penalty imposed is in the region of 58 per cent of the amount of tax which has not been charged or has been undercharged. The high penalty imposed by the IRB emphasises that the penalty acts as a vehicle to improve compliance among SME taxpayers. This reliance on penalties has been based on the relation specified in deterrence theory. The theory assumes that there is a perceived likelihood of apprehension and that there is a severe but fair penalty for the offence (Rossi and Grasmick, 1985). However, there is the possibility of a backlash effect, as argued by Schmolders (1970:302): *Taxation according to the legal definition of ability to pay is realised to a fair extent but at the price of an intensive confrontation with tax enforcement and control...The logical consequence of such relatively coercive tax enforcement technique is the high degree of alienation between citizens and the state and between the penal code and the code of penalties in case of tax fraud. This alienation, in turn, negatively influences the willingness to cooperate with tax authorities.*

Currently, the severity of the penalties varies with the nature of the offence and the amount of the penalty is frequently based on the discretion of the Director General of the IRB (as the law only stipulates maximum penalties). Similarly, if a taxpayer has been successfully prosecuted in court, the court has the discretion to determine the total fine to be imposed. Furthermore, the Director General also has the power to compound offences before the case is due for prosecution in court. In practice, the maximum amount is usually not imposed. This may have some drawbacks for the Malaysian penalty provision in general, particularly the fact that the maximum penalties are in fixed currency amounts: as argued by Wallschutzky and Singh (1995), (1) over time, they lose their real significance as they are eroded by inflation, and (2) it might not be possible to adequately discriminate between large and small offences.

Table 7.7**The percentage of penalty imposed on SMEs tax evaders**

Year	No. of cases finalised*	Amt. Of additional tax* RM(million)	Amt. Of penalty imposed* RM(million)	Penalty imposed %
1997	100	15.6	9.2	58.9
2001	100	12.4	7.2	58.1

Source: Investigation and Intelligence Division

* Based on the number of file reviewed

Clearly, if compliance is to be affected by SME taxpayers' perceptions of IRB enforcement activity, they need to be aware of the level of that activity. It should also be that SME taxpayers perceive that activity to be of such a level that it puts them at risk. The IRB should therefore be seen to be having a greater presence in this type of enforcement activity. Not only must they do more, they must be seen to be doing more.

7.8 Summary

This chapter has highlighted the analysis of file data of actual cases with regard to tax evasion by SMEs. Analysis has revealed that detection procedures were undertaken manually and based entirely on the subjective judgement of the IRB personnel concerned, which is not efficient. Most of the techniques adopted for settlement are complementary and frequently supplement each other between accounting basis and capital statement/net worth analysis.

The understatement of gross profit is the most common and most widely used method by SMEs to evade tax. The underreporting of sales and overstating of purchases were noted as the largest adjustments in the SMEs' tax evasion schemes. Analysis also revealed the offences to have the characteristics of deliberate evasion, which takes place all the time. The IRB also emphasised the rate of penalty as a vehicle to improve compliance among SMEs, as the rate of evasion detection is very small.

The following chapter describes the opinions of the IRB personnel drawn from the open-ended questions and identifies further characteristics of tax evasion within SME taxpayers.

CHAPTER 8

PERCEPTIONS OF INLAND REVENUE BOARD STAFF

8.1 Introduction

The initial survey instrument for the collection of this data was supposed to be a group interview with IRB officers using a semi-structured questionnaire. However, due to unforeseen circumstances, the group interview could not be conducted. The semi-structured questions (with a slightly revised format, see Appendix IV) were, however, later distributed to all fifteen heads at the Investigation and Intelligence Centre of the Inland Revenue Board of Malaysia as an open-ended questionnaire (see Chapter 5 for a detailed discussion). Eight completed open-ended questionnaires were returned.

Drawing from the responses to the open-ended questionnaire from IRB personnel, this chapter examines the perceptions of IRB personnel of the IRB's stance on and practical overview of tax evasion by SMEs. It begins with general views on tax evasion and SMEs. This is followed by the current view on how the IRB emphasises detection, civil settlement tools and the recent trends in deterring tax evasion. The next section explores the perception of forensic accounting of the IRB personnel. The chapter also looks at the recommendations and improvements suggested by them. Finally, the chapter concludes with a summary.

8.2 General view on tax evasion and SMEs

The perceptions of tax evasion and SMEs were assessed through the focal argument in most of the literature (Ahsan, 1995; Silvani, 1992; Terkper, 2003) that tax authorities in developing countries, including Malaysia, are handicapped in their fight against tax evasion by at least three elements, namely: (1) an incompetent, corrupt and inadequately staffed tax administration set up; (2) poor information gathering and processing technology beset by weak accounting practices; and (3) a legal system that is both unable and unwilling to enforce the penal and civil aspects of the prevailing tax code. It is further believed that

against this backdrop, high tax rates, especially within a graduated schedule, add impetus to evasion practices.

Generally, most of the respondents believed the above factors as major handicaps to deterring tax evasion. Although some of the respondents were not of the opinion that IRB personnel are incompetent or that the IRB is inadequately staffed, many thought that they were. As one respondent put it:

Inadequate or incompetent staff? Need I say more? With the current staff strength in the investigation centre, striking (winning) a lottery is a lot easier than getting investigated, especially in the Klang Valley.

Respondents also perceived that IRB staff were not properly trained. They argued that there was no comprehensive training programme for the IRB personnel, especially in tax audit and investigation. The respondents noted further that IRB personnel were supposed to learn through experience. One respondent put it:

There is no comprehensive training programme for the investigation officers, unlike other countries like the United States and Japan. They are supposed to pick up the tricks of the trade as they go along, so to speak...and there is a need to set up special training similar to that of IRS special agents and Japanese NTA.

All respondents directly stated that corruption is not a factor among IRB personnel. They suggested ample evidence. They emphasised the following reasons: (1) the IRB has been rated the second least corrupt government agency by Transparency International's Malaysian Chapter ^{8.1}; (2) the corporate culture of honesty and highly ethical values inculcated by British Colonials are generally still intact but there is no guarantee this will be so in the near future if this issue is not addressed by the management; (3) there are ample checks and balances in the audit and investigation process; and (4) there are fairly sound standards of tax audit and investigation systems and procedures which are generally adhered to. For example, one respondent remarked:

^{8.1} Transparency International is a global non-governmental organisation devoted to combating corruption. Its mission is to create change toward a world free of corruption.

Corrupt? From experience the first thing that comes to the mind of businessmen/SMEs is to bribe their way to settle the case. They eventually learn we are not corruptible like other enforcement agencies. I am not saying the IRB is perfectly clean but the general perception is that the IRB is doing superbly in this respect

Almost all of the respondents were of the opinion that the legal system seems to be quite adequate in the enforcement of criminal or civil provisions to serve as a deterrent and as a compliance tool. They further argued that failing to institute criminal proceedings against tax evaders probably contributed to the rampant tax evasion, especially among the SMEs. With the criminal division being set up recently and the management seriously committed to criminal enforcement, taxpayers will definitely have to rethink their tax lodgement activities.

Most respondents expressed the opinion that there are fairly good information gathering systems in the IRB but they are done manually, not integrated, not technology enabled and not centralized. So as not to lose out on vital sources of resource materials for effective tax evader detection, efforts are being made to address this issue but it is still in the infancy stage. As one respondent summarised it:

Information gathering, processing and disseminating has never been our forte.

The respondents acknowledged that tax evasion is commonly attributed to high tax rates (e.g. Allingham and Sandmo, 1972; Srivivasan, 1973). Some, however, commented that even with decreasing tax rates over the years in Malaysia, tax evasion is still rampant, especially among SMEs. They viewed the suggestion that a low tax rate equals low tax evasion is but a myth. This view was perhaps accurately summed up by Graetz and Wilde (1985:359), as follows:

The myth that high marginal tax rates cause non-compliance is the most pervasive of all. In fact, that lowering tax rates will induce greater compliance is a claim supported neither by the theory of tax compliance nor by empirical evidence.

In general, the theoretical literature shows that tax rates have an ambiguous effect on compliance depending upon taxpayers' attitudes toward risk, audit selection criteria etc. (e.g. Allingham and Sandmo, 1972; Srinivasan, 1973; Yitzhaki, 1974). Unfortunately, the empirical literature reports mixed results as well (e.g. Clotfelter, 1983; Pommerehne *et al.*, 1992; Alm *et al.*, 1993; Joulfaian *et al.*, 1998). The ambiguity of the compliance response to an increase in marginal tax rates is also observed for small corporations. Rice (1992) finds tax rates have a small effect on income underreporting.

One respondent expressed the belief that a pivotal issue is the taxpayer's perceptions and attitudes and the perceived idea that '*the gain far outweighs the risk*' could be the factor underlying tax evasion by SMEs in Malaysia. Two respondents said that:

I think our tax rate is comparable or even lower than other Asian countries. Whatever the rate it is I think Malaysians still don't like to pay tax. It is the catch me if you can attitude...I think it is the lack of tax education

The current Malaysian tax rate is comparable or lower than other tax regimes in this region; yet tax evasion cases continue to surface in multitudes. Malaysian tax rates in the 1970s and 1980s were punitive; going by logic alone, tax evasion should be on the decline but this is not so, why? It boils down to taxpayer perceptions and attitudes.

The respondents believed that as far as SMEs are concerned, business survival and realisation of capital outlay is of the utmost importance, thus, responsibility toward proper compliance with tax laws is seldom taken seriously by SMEs. They further argued that it rested on a matter of perception and attitude; payment of due taxes is not considered a national duty or responsibility, which indicates that tax education plays a vital role in changing the perception notions. The general perception in the culture of paying '*minimal or reasonable*' tax to the government and the political reality and consideration '*what I will get back in return for my tax contribution*' were also associated with SME tax evasion.

One respondent further made the point that the external auditor of SMEs is usually not of the highest repute (not among the big four auditors). The lack of a stringent application of

auditing standards by these auditors for fear of losing clients has seen SMEs become the sector with the highest incidence of tax evasion. As he put it:

It is worth noting that the auditors engaged by SMEs are usually not of the highest repute, i.e. not among the big 4 auditors. Sometimes the auditors just put their signature on the accounts knowing that the actual account/audit was done by unqualified accountants/auditors.

Some personnel also recounted their experiences as an illustration, indicating that most SMEs are family owned and managed and therefore the decision to evade taxes is easily made, probably due to loose or non-existent internal controls in the accounting system. SMEs are also companies with low paid-up capital and their sources of finance are limited. Tax evasion is one way of obtaining funds and to reduce the level of the debt equity ratio.

8.3 Current practice perspective

Responding to the current detection and civil settlement tool used, IRB personnel evaluated that it has not changed much from the expatriate days when the investigation techniques were first introduced. The new tools simply complement the old ones. In the written words of two respondents:

Don't see any new tools replacing old. Criminal prosecution is on the way to complement the old.

Afraid to change 'old tool' or experiment with something new.

The respondents noted the following tools in ascertaining evaded income and tax computation of tax undercharged: (1) the net worth method; (2) accounts examination; (3) business economics method; and (4) bank deposit method. These tools are basically part of the forensic accounting technique for detecting fraud. One respondent even commented that he preferred these tools and worked the way he always had. He put it:

It is safe to do what you always do because you know you won't make a mistake and you won't get into trouble. Mind you, the capital statement method put Al Capone in jail for tax evasion.

The tools predominantly used in intelligence work can be categorised into two methods: (1) general intelligence method, which includes physical surveillance, information from mass media, including electronic media, and information from government agencies; (2) primary intelligence method, which examines, analyses and interprets accounts submitted over the years, reviews and analyses asset accumulation, house and business premises surveillance, and minimal undercover work to ascertain cash sales systems.

Most of the respondents believed that competence in terms of knowledge and skills is required for efficiency and effectiveness in detecting tax evasion: however, no structured training programme has yet been developed for effective training, especially for investigation personnel. The existing personnel, who possess tertiary qualifications, are from various disciplines of educational backgrounds. Even though they stated that they have received in-house training in accounts and tax law, the training programmes are not comprehensive or well tailored, thus they have to learn from experience and this could be too laborious and tedious. For example, in the US, the IRS gives agents selected for forensic investigation work two years of specialised training on how to conduct forensic investigations. During the IRS training session, IRS agents are taught various methods of proof and interview techniques. Between classes, agents return to the local office to work on some on-the-job training material under the guidance of an assigned coach who may supervise two or three trainees.

It was noted that prior to becoming a Board, the recruitment of tax officers was mainly the responsibility of the central agency of the Public Service Department of Malaysia (PSD). As such, graduates of varied disciplines were recruited as tax officers. The PSD did not discriminate in the selection of graduates partially due to the fact that many graduates were government scholars with bonds to fulfil. After becoming a Board in March 1995, the responsibility of recruitment rested with the IRB. The IRB has recognised that graduates of certain disciplines such as accounting, economics and law are advantageous to have. The IRB has also recognised that it needs to engage expertise or consultants in certain

specialised industries such as insurance, banking and finance. It is a step in the right direction, as the current staff and the new recruits will never be adequately equipped to handle investigation or audit of these specialised industries.

From the literature review, it was apparent that different governments give different emphasis to tax evasion. The file data also shows that the type and extent of evasion varies from case to case to such an extent that as a rule no two cases are alike. The IRB personnel supported the assertion that the tax evasion method used by SMEs varies from case to case. This is due to the unique nature of the business that SMEs are involved in (for example, the type of industry and location of the business entity – remote, suburban or in a township) and the prevalent opportunities for tax evasion.

It was noted from IRB personnel's experience that SMEs would evade taxes in any way that is possible by under-declaring profits all the time. Notably, inflation of cost of sales and suppression of sales/income were common methods used by SMEs to evade taxes.

There was a split in the response concerning the implementation of criminal investigation as opposed to the current civil system. Some believed that the IRB has to start somewhere and no time is better than now with the implementation of self-assessment. They were of the opinion that the results that could flow from publicity generated in a criminal tax investigation case would be manifold. As two personnel put it:

Civil tax investigation gives the impression that tax evasion is a misdemeanour only, whereas a criminal investigation has a stigma; that of a cheat, defrauder.

The introduction of criminal tax investigation was timely as it fitted neatly into ongoing discourse about reforming the procedure of detecting tax evasion, reshaping the tax system and how it is administered in the new millennium

Indeed, the IRB is in the midst of implementing criminal tax investigation, but the other half of the respondents are in doubt about its effectiveness. They argued the following: (1) a comprehensive training programme has not been developed; (2) an effective organisational

structure to drive the programme is not in place; and (3) an effective legal framework and amendments to the existing tax provision are still pending.

8.4 IRB personnel's perceptions of forensic accounting

In order to ascertain the awareness among IRB personnel in respect of forensic accounting, a brief definition of forensic accounting was given in the questionnaire:

Forensic accounting is the application of financial skill and investigation mentality to unresolved issues, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a strong knowledge and understanding of business reality and the working of the legal system. According to some of its advocates it looks beyond the numbers and deals with the business reality of the situation (Bologna, 1993).

A direct question was asked – ‘*What is your understanding of forensic accounting?*’ Responses to the question suggest that the respondents held a strong understanding about forensic accounting. For example:

It is the application of accounting and financial knowledge, within the rules of evidence, in legal problems, whether in any criminal or civil proceedings.

A method of looking for traces or evidence that points to an act, going back to the origins of an accounting entry and subsequent evolutions. In the case of SMEs, to detect acts of manipulation of accounts, which have resulted in altered states of profitability, thereby lowering the tax incidence.

Not surprisingly, the understanding of forensic accounting results in the detailed examination of the financial records by IRB personnel as commented on the techniques or methods of working in detecting and settling tax evasion by SMEs. One respondent remarked:

Basically going through books of accounts with a magnifying glass; checking every accounting entry and its corresponding entry and its impact on the profitability of the SMEs. Of course with the advent of computerised accounting the audit trail is more tedious and cumbersome but it is nothing that a good accounting background and experience cannot overcome.

The IRB personnel were of the opinion that forensic accounting is a powerful tool that could carry the detection and settling of tax evasion cases a step further. They argued on the basis that forensic accounting is more encompassing, comprehensive and intricate in respect of technique and approaches even though their current methods are essentially similar to that used in forensic accounting. Methods or techniques to be employed, however, will very much depend on the type of industry of the SMEs concerned.

8.5 Recommendations and improvements from IRB personnel

The most significant argument seems to be based on the organisational structure of the investigation function. All respondents suggested that criminal investigation should replace civil investigation, as the monitoring function of tax compliance would be carried out by field audits under the Self-Assessment System (SAS), which would be fully operational for all taxpayers by 2004. Civil investigations would be redundant.

The IRB personnel also noted further recommendations for the investigation personnel to be trained, retrained and exposed to forensic accounting techniques to improve and sharpen their investigative skills. This included specific courses designed to teach and train new investigation personnel. One of the respondents put it:

The development of human resources is a fundamental pillar of an effective tax administration. The most sophisticated tax administration system will not succeed in maximising efficiency in the absence of any well-trained, conscientious and honest tax personnel, especially in deterring tax evasion

Personnel motivation was also put forward by a few of the respondents who argued it was vitally important for job satisfaction. A lack of development and career opportunities would

have a considerable impact on their expectations. This will leave them unduly open to the temptation of moving to other jobs or even corruption.

8.6 Summary

This chapter has discussed the perceptions of IRB personnel with regard to tax evasion by SMEs, current practices, forensic accounting and improvements they would like to see. The analysis revealed that they perceived that IRB personnel were not properly trained, that there was unsystematic information gathering, and that taxpayers' perceptions and attitudes, and SMEs' business survival and realisation of capital outlay, are the factors contributing to why SMEs are regarded as the sector with the highest incidence of tax evasion in Malaysia.

The analysis also failed to reveal new tools to replace the existing tools in detecting and settling tax evasion cases. The introduction of criminal prosecution will simply complement the old tools as most of the legal provisions are within the Malaysian tax laws.

With regard to forensic accounting, although IRB personnel held a strong understanding of it, they may not have achieved this through formal training. This, arguably, means that they will be unable to meet the challenges that will be demanded by legal counsels upon the introduction of criminal prosecution in the era of the SAS.

IRB personnel also recommended some actions to be taken within the organisation, which needs improvement so as to deter tax evasion and reshape the tax system.

The following chapter will triangulate all of the findings observed within the last three chapters, i.e. Chapter 6, Chapter 7 and Chapter 8, in the context of the research questions as proposed in Chapter 1.

CHAPTER 9

DISCUSSION OF RESEARCH FINDINGS

9.1 Introduction

The last three chapters presented the results of the questionnaires from tax practitioners and SME taxpayers, the analysis of file data/actual cases, and the responses to open-ended questions from IRB personnel. This chapter triangulates all of the results obtained in the last three chapters within the context of the research questions. To a very large extent, the discussion of the implications of forensic accounting will draw on the literature review presented in Chapter 4 because of its relatively recent emergence in Malaysia. Moreover, forensic accounting has been the subject of numerous overviews in practitioners' journals (mostly outside of Malaysia) rather than the academic literature. Assumptions and limitations of this particular study are also discussed.

9.2 Existence and extent of tax evasion by SMEs in Malaysia

The first research question examined the existence and extent of tax evasion by SMEs. There is a *prima facie* case for suspecting the existence of tax evasion by SMEs in Malaysia. Based on the quantitative and qualitative appraisal from the survey, file data and IRB personnel, it is suggested that the existence of tax evasion by SMEs is serious. SME tax evasion is seen as both widespread and frequent in Malaysia. There was general agreement with three statements about tax evasion in Malaysia by the SME taxpayers^{9.1}: *Tax evasion is common in Malaysia; There is nothing morally wrong with paying less taxes; Tax evasion is a form of gambling: gambling for extra income in light of the likelihood of detection and the imposition of penalties.* These statements provide support for widespread and frequent tax evasion by SMEs in Malaysia (Table 6.26). Eighty five per cent of tax practitioners in this study perceived that SMEs do evade tax (Table 6.12).

^{9.1} The SME taxpayers were asked to indicate their agreement or disagreement with each of five statements regarding tax evasion by SMEs in Malaysia on a five point Likert scale of 1 (strongly disagree) to 5 (strongly agree). The mean responses to these three statements were greater than 3.5.

The above findings are strengthened by the evidence from the file data, which shows an increase in the finalisation of investigation cases between 1997 and 2001 by approximately 1.18 times (see paragraph 7.7.1 and Table 7.6). This finding might indicate that, notwithstanding a greater number of cases, tax evasion by SMEs is getting worse (as measured by tax and penalties recovered [see Table 2.4]). The IRB personnel in their comments also believed that the tax authority in Malaysia is handicapped in its fight against SME tax evasion.

Respondents are, however, split in their opinions about the estimation of the extent of the involvement of SMEs. Approximately 52 per cent of tax practitioners believed that over 50 per cent of SMEs do evade tax (Table 6.12). On the other hand, 60 per cent of SME taxpayers indicated that less than 50 per cent of SMEs evade tax (Table 6.27). This response, however, must be viewed with the understanding that it is based on self-reporting using the direct question, *"To the best of your ability, please estimate the percentages of SMEs that evade tax in Malaysia"* as data on the extent of tax evasion may be confidential (not available for external analysis) or not completely reliable (such as those derived from national accounting sources). Indeed, self-reported data suffer from bias: respondents may not remember, they may have misunderstood, they may have no cognisance of the issue or they may deliberately conceal the information, as has been argued by most tax literature (e.g. Hite, 1988; Elffers, 1991a). Tittle (1980), however, concluded that self-reports were generally 80 to 90 per cent accurate (cited in Hite, 1988). Most empirical investigations (e.g. Vogel (1974) has gone some way towards this aim), however, have relied on survey methodologies and respondents' verbal descriptions of their past behaviours to assess the occurrence and extent of tax evasion.

The fact that tax evasion is illegal makes it difficult to obtain reliable estimates of its magnitude. The initial findings, however, suggest that the overall perception of SME taxpayers and tax practitioners regarding SMEs is that they are seen as a high-risk segment in the Malaysian economy as far as tax evasion is concerned. This finding is congruent with those of Wallschutzky (1984), Hite *et al.* (1992) and Joulfaian and Rider (1998). The findings may have implications for the future strategies of the government of Malaysia and the IRB in focusing on this sector in order to deal with tax evasion.

9.3. The characteristics of tax evasion in SMEs in Malaysia

The evidence in the literature review has revolved around several different focal points concerning the characteristics of tax evasion and has contributed substantially to the knowledge about SMEs. This evidence provides an opportunity to explore a selection of issues and the characteristics of tax evasion covered by these studies within the Malaysian SMEs' perspective, as outlined in the research questions.

9.3.1 Are tax evasions by SMEs in Malaysia cyclical or repetitive in nature?

The anatomy of tax evasion and its dynamic content raise the question of whether tax evasion by SMEs is cyclical or merely repetitive in nature. To the best of my knowledge, this question has not been addressed in the tax literature despite its primacy in distinguishing intentional and unintentional in understanding the fundamentals of the tax system.

In this case, most of the tax practitioners and SME taxpayers are of the opinion that tax evasion by SMEs is repetitive in nature. About three-quarters of the respondents (Table 6.13 and Table 6.28) are of the opinion that tax evasion by SMEs takes place all the time. Evidence from file data (Table 7.5 and paragraph 7.6) and the IRB personnel's experience shows that an absolute majority of SMEs would evade taxes in any way possible all the time rather than in situationally based circumstances (for example, in a period of high inflation or a period of economic boom or downturn).

This finding, however, can be reconciled with Schneider and Este (2000), who argued that once taxpayers are engaged in the underground economy (UGE) (which includes tax evasion)^{9.2}, it is difficult to get them to stop (as it develops all the time according to the principle of running water; it adjusts to changes in taxes, to sanctions from tax authorities and to general moral attitudes and so forth).

^{9.2} Schneider and Este (2000) defined the UGE to include unreported income from the production of legal goods and services, either from monetary or barter transactions, by agents that are not registered or who do not pay taxes – hence all economic activities which would generally be taxable were they reported to the tax authority.

9.3.2 Are tax evasions by SMEs in Malaysia characteristically deliberate (intentional) or accidental (unintentional) in nature?

Based on the questionnaire survey (Table 6.17, Table 6.18, Table 6.31 and Table 6.32), the results reported in this study show that the respondents believe that SMEs accidentally and deliberately understate and overstate profit so as to pay less or more tax than they should, respectively. Approximately, an overall average of 13 per cent responded positively that SMEs are not engaged in the above unethical activities. The overall involvement is estimated to be approximately 25 to 50 per cent of the SMEs. Data from the actual cases/file data (Table 7.4 and paragraph 7.5) provide further evidence for the above perception, with approximately 99 per cent of the cases reviewed involving deliberately planned falsification with the clear intention of deceiving and cheating the tax authorities. The same is true of the view given by IRB personnel, which indicates that most SMEs are family owned and managed and therefore the decision to evade taxes is easily made.

In contrast, in an Australian study, McKerchar (1995) concluded that SME taxpayers may unintentionally evade tax as a result of their apparent unawareness of their taxation knowledge shortfall. This may be because of differences in cultural, political and institutional circumstances between the two countries. Apart from this, the SME taxpayers in the two countries also differed in terms of perceptions toward their tax authority regarding the effectiveness in detecting tax evasion.

A key question here concerns the remedies: if intentional tax evasion is rampant, then the solution is to ramp up enforcement. However, if a major portion of tax evasion is unintentional, than education, assistance in preparing tax returns and simplification of the tax law would be better-targeted policy responses.

9.3.3 SME - tax practitioner relationships

As in other countries, tax compliance is facilitated by the efforts of tax practitioners and other private advisors who assist SME taxpayers in tax return preparation. The results of this study indicates that most SMEs rely on tax practitioners for guidance to comply with their income tax requirements (Table 6.29). This indicates that SMEs are likely to lack the

technical knowledge to properly complete an income tax return; they may not be familiar with recent tax changes, and would in all probability find it cost inefficient to attempt to develop this expertise in house. Although the availability of tax practitioner assistance undoubtedly reduces the overall compliance burden, the high cost of this assistance is nonetheless the most commonly reported source of compliance problems by SMEs in the literature, as argued by Erard (1997b). The relationship between SMEs and tax practitioners can also be seen as a contribution that tax practitioners make to taxpayers in giving them confidence that their tax matters are under control and that their tax-paying behaviour is lawful (Tan, 1999; Hite and McGill, 1992). Erard (1993:194) views this contribution as *a socially beneficial role in reducing many of the informational and computational barriers to compliance with tax laws.*

Sakurai and Braithwaite (2001) argued that most taxpayers actively seek out tax practitioners whom they believe will aid or at least be comfortable with their behaviour. This is what is shown to be perceived by SME taxpayers in Table 6.29 (Q2.3). More than 50 per cent of the respondents claimed that they had never switched accountants/tax practitioners in dealing with tax matters. This behaviour appears to be consistent with the literature on small business firms, which indicates that although owners rely on tax practitioners for their compliance work, they also prefer someone whom they can work with or someone who communicates well and has a personal interest in them (Cameron, 1992; cited in Tan, 1999). There is, however, a tendency to switch tax practitioners for some reason that has not been raised by this research, as perceived by the convicted evaders (Table 6.29, Q2.3). Prior research (Hite *et al.*, 1992) has shown that taxpayers would switch or terminate their tax practitioners if they disagreed with the advice given, or if they had been investigated for tax evasion. It is even likely that the tax practitioner would cease to serve them if he/she thought that they fitted the profile of tax evaders. The findings hold true for this research, interpreted from Table 6.29, even though more than half of the respondents had never switched their tax practitioners.

Hite *et al.* (1992) demonstrated that taxpayers' and tax practitioners' expectations are not necessarily consistent. Taxpayers may simply want to pay the correct tax and the tax practitioners may think the correct tax is the lowest tax liability. Taxpayers expect and pay their tax practitioners to minimise their tax. Tax practitioners are operating in a competitive

market, and while tax law is sufficiently ambiguous to allow them to use the law to suit taxpayers' purpose of tax evasion or avoidance, tax practitioners will direct their professional experience and skills to exploiting legal loopholes to serve their clients' interests (Klepper *et al.*, 1991). Therefore, the decision to retain or change tax practitioner generally very much depends on the clients' working relationships with their practitioners rather than being based solely on the type of advice given. Taxpayers generally tend to be loyal to their tax practitioner if a good working relationship is maintained. These findings are quite similar to the findings in this research as shown in Table 6.17, Table 6.18, Table 6.29, Table 6.31, Table 6.32 and Table 7.4. More than half of the taxpayers had never switched tax practitioner, which seems to suggest that a good working relationship exists between taxpayer and tax practitioner, supported by the tax practitioners deliberately understating or overstating the tax liability of the SMEs so as to pay less or more tax, either at the instruction of the taxpayer or following advice sought and given by the tax practitioners. However, it can be argued that the SME taxpayers remain responsible for the act of evasion either undertaken by themselves or by their agent. The tax practitioners can commit evasion on behalf of a client if they knowingly prepare and send incorrect accounts, computations or tax returns to the tax authority.

9.3.4 Other observations

The other observation to note is that the type and extent of evasion in SMEs varies from case to case in Malaysia. Tax evasion is not restricted and appears to be highly concentrated in particular sources of income within the SMEs, as argued by Kesselman (1988) and Joulfaian and Rider (1998) in studies using US data. File data/actual cases and the IRB personnel supported the assertion that this variation is due to the unique nature of business that SMEs are involved in (for example, type of industry and location of business entity – remote, suburban or in a township) and the prevalent opportunities that exist.

9.4 Factors influencing tax evasion by SMEs in Malaysia

The questionnaire survey from tax practitioners revealed that they viewed incompetence, corruption and an inadequately staffed tax administration set up as the main factors influencing tax evasion by SMEs in Malaysia (Table 6.14). The IRB personnel, however,

view themselves as not being well or properly trained. This suggests that the IRB is ineffective in the present tax collection system. What is lacking is a comprehensive training programme for the IRB personnel, especially in tax audit and investigation: they are currently supposed to learn through experience.

Respondents, however, do not believe that corruption is a factor with IRB personnel as evidence from Transparency International's Malaysian Chapter has shown that the IRB is the second least corrupted government agency. The corporate culture of honesty and highly ethical values inculcated by British Colonials are generally still intact with ample checks and balances in audit and investigation processes. However, there is no guarantee that this will be the case in the future if these issues are not addressed by the management of the IRB.

A critical analysis of the literature suggested a positive relationship between detection probability and taxpayer compliance (see Chapter 3, section 3.2.5), i.e. the probability of being detected is so low that it is advantageous to evade tax. Alm *et al.* (1992c) argued that a purely economic analysis of the evasion gamble implies that most taxpayers would evade tax if they were rational because it is unlikely that cheaters will be caught and penalised. The perceptions of tax practitioners and SME taxpayers (Table 6.20 and Table 6.40 respectively) in this study appear to support the above notion. On average, only 10 SMEs have been investigated/audited by the IRB annually over the last five years (Table 6.21). As such, the proportion of returns detected for tax evasion by the IRB could be less than 1 per cent per year, as shown by the estimate from file data/actual cases (Table 7.6). Similar detection figures are seen in the United States (Anderoni *et al.*, 1998). What is perhaps most interesting to note is that those who evade tax had far more precise estimates of the probabilities of apprehension than the non-evaders. This fits nicely with the view that those who are active in tax evasion will have a better sense of the size of evasion than non-evaders.

Examination of file data showed that an average penalty of approximately 58 per cent was normally imposed on the amount of tax which has not been charged or has been undercharged (Table 7.7). This penalty is reasonably low compared to the statutory penalty that could be imposed under section 114 of the Income Tax Act 1967, which is treble the

amount of tax which has been undercharged in consequence of the offence or which would have been undercharged if the offence had not been detected. The DGIR also has the power to compound offences (i.e., before a case is due for prosecution in court) and the penalty imposed is also at the discretion of the DGIR. As noted in the file analysis, in practice, the maximum amount is usually not imposed.

'The burden of paying tax is too great' is seen to be an important factor influencing SME taxpayers not to pay tax. On the other hand, *'to avoid audit or investigation by the IRB'* was the main factor influencing the payment of the right amount of tax (Table 6.39). This finding is surprising, with the lowest tax rate in Malaysia being 2 per cent for personal income on the first chargeable income between RM2,500 and RM5,000, and a reduction in corporate tax to 20 per cent from 28 per cent for SMEs in the 2003 budget.

9.5 Methods used by SMEs in evading tax

The questionnaire survey showed an overall perception among the tax practitioners and SME taxpayers (Table 6.19 and Table 6.33 respectively) that the most frequently and widely used methods by SMEs in tax evasion are overstatement of expenses (other than cost of goods sold) and understatement of gross profit. Evidence from the actual cases/file data (Table 7.3) and IRB personnel further support these findings. Sole proprietorships and small corporations in the United States and Canada exhibit similar patterns, with a high percentage of all non-compliance in the form of an understatement of gross profit (Erard, 1997).

The file data further revealed that the underreporting of sales and overstating of purchases are noted as the largest adjustments in the SMEs' manipulation of accounts so as to evade tax (see paragraph 7.4). The usage of these methods practically implies that SMEs do not apply a sophisticated tax evasion scheme. This is consistent with the responses from questions Q2.7, Q2.8 and Q2.9 of the SME taxpayers' questionnaire (see Appendix II). SME taxpayers indicated that they do not have any interest in other businesses, either through direct or indirect shareholding including sole proprietorships or partnerships, and no business dealings with tax haven countries (Tables 6.34, 6.35 and 6.36). This further

limit the possibilities for the usage of sophisticated tax evasion schemes such as transfer pricing and so forth.

Moreover, this finding is supported by the existence of the current tax legislation: smaller SMEs, which are not incorporated under the Companies Act 1965 (for example, sole proprietorships/self employment, partnerships or businesses registered with the Registrar of Business), need not have their annual accounts audited with their tax returns. Therefore, SMEs will see that there is no need to invent new schemes for tax evasion, taking into account this flexible legislation. SMEs could collaborate with tax practitioners in manipulating and producing false accounts so as to pay the desired tax. The government and the IRB, however, should consider making it mandatory that the accounts of SMEs be audited before submission to the Registrar of Business and the IRB, as suggested by Wallschutzky and Singh (1995) and Mottiakavandar *et al.* (2003). Even though this measure may increase the cost of compliance for SMEs, with the implementation of this proposal, attitudes towards positive tax compliance behaviour would, however, be expected to improve.

9.6 The role of the tax practitioner

Roth *et al.* (1989a) emphasised the role of tax practitioners in tax compliance and suggested that tax practitioners are sought out specifically to discuss tax matters and they frequently affect the actual risks and rewards of compliance, transmit values and affect the costs of compliance. They affect taxpayers' tax schemes by interpreting compliance requirements and offering judgements about the consequences of various actions. Tax practitioners are, therefore, in a position to influence the level of tax evasion activities observed by the tax authority (Tan, 1999).

The perspective of tax practitioners as intermediaries is considered important for two reasons. First, tax practitioners can be pro-tax authority and calculate a tax liability that is acceptable to the Revenue in terms of legal interpretation without negotiation and is deemed acceptable by the tax authority. Second, tax practitioners can be more pro-taxpayer in terms of taking a more aggressive stance alongside their client in an attempt to reduce the tax liability further. The question addressed in this paper, however, is whether or not there

is an expectation that tax practitioners will take a stance against tax enforcement agencies and an expectation that they will do so at the expense of their professional integrity.

Based on the questionnaires (Questions 2.3 and 2.5, see Appendix 1 and Tables 6.15 and 6.16 respectively), the study provided evidence indicating that tax practitioners in Malaysia claim to have a pro-tax authority stance, with their role being to perform duties within the boundaries of the tax law and their refusal to continue to act on behalf of an SME client if the client does not accept advice on an issue of disclosure. The data suggests the contribution of the tax practitioner influences the SME taxpayer's behaviour within the boundaries of the law. It suggests that the tax practitioners play a positive role in the tax compliance process, as they appear to be enforcing the law by giving conservative advice to their client. This accords with the findings of Duncan *et al.* (1989) and Pei *et al.* (1992).

The above findings provide encouragement and support for the IRB and the government for introducing the self-assessment system (the system will be fully operational by the year 2004) as the tax practitioners seem to help to enforce the tax law. Where taxpayers are tax compliant, this would invariably result in a swifter assessment process, which would in turn reduce both the taxpayers' and the tax authorities' compliance and administrative costs. The end result would facilitate swifter and easier collection of taxes by the tax authorities.

Apparently, tax practitioners do believe that for whatever reasons, tax practitioners accidentally and deliberately understate or overstate the income/profit of SMEs so that they pay less or more than they should (Table 6.17, Table 6.18 and tax practitioners' questionnaire, Appendix I). This result can be interpreted as them being pro-taxpayer. This finding suggests that tax practitioners play a negative role in the tax compliance process, as they appear to be exploiters of the tax law (Kaplan *et al.*, 1988a; Ayers *et al.*, 1989; Erard, 1993).

Taken together, these results suggest that tax practitioners in Malaysia play a dual role depending on the tax situations. These data support the claim of Klepper *et al.* (1991) that tax practitioners are both enforcers and exploiters of the tax law, given that they have unique knowledge of tax law. This might suggest that in ambiguous tax situations, tax

practitioners tend to be exploiters of tax laws and enforcers of the law in unambiguous tax situations, as argued by Klepper *et al.* (1991) in their research findings.

Deliberate and accidental evasion further reflects the issue of the competency and honesty of tax practitioners in Malaysia. With an overall average of 80 per cent of respondents assuming that tax practitioners deliberately and accidentally understate and overstate their clients' profit (Tables 6.17 and 6.18) as so to pay less or more tax, this may indicate a general lack of importance of ethical issues within the tax practitioner profession in Malaysia. To install professionalism amongst tax practitioners and to ensure public confidence, the necessary provision (section 114A) in the Income Tax Act (Amendment) 1999 and the code of conduct was introduced by the Inland Revenue Board. The provision and the code of conduct may provide a safeguard for tax practitioners who feel pressured to develop clever strategies for evading or minimising their clients' tax obligation (Murphy and Sakurai, 2001). The provision will also protect taxpayers from tax practitioners who may misinterpret their clients' wishes or lack the ability or integrity to prepare accurate and correct tax returns. The code of conduct is expected to impinge on the ability of tax practitioners to support taxpayers' reporting positions, especially with the current self-assessment principles, and accordingly is perceived as being important in defining the tax practitioner's ethical role along the spectrum of *de facto* government agent at one end to taxpayer advocate at the other (Klepper *et al.*, 1991; Marshall *et al.*, 1998).

Klepper and Nagin (1989) noted that in 1979 about 44 per cent of all tax returns in United States were prepared by tax practitioners; yet these returns accounted for 74 per cent of all non compliance. Although no such statistics is available in Malaysia, many schemes used by SMEs, to defer or reduce their taxes, are devised undoubtedly with the help of tax practitioners (Table 7.3). Interestingly studies conducted in North America, Schisler (1994) indicates that the tax practitioners' clients may be the ones who insist on such aggressive reporting. Hite and McGill (1992), however found in their studies that taxpayers preferred conservative advice over aggressive advice as their respondents appeared to be primarily interested in filling an accurate tax return. This study found that taxpayers, who are predominantly SMEs agree more with the conservative advice given by their tax practitioners (Table 6.15, Table 6.16, and Table 6.30). Wallschutzky (1984) noted that it may in fact that all studies are relevant only for their country of origin. Despite such

cautions behaviour displayed by SMEs, tax practitioners could still exercise significant influence over their client's compliance behaviour as the latter generally tend to rely on their adviser to assist them with their tax work. Being the tax experts, it appears that the advice given by them is generally accepted as correct by their clients who are unfamiliar with the tax law. Therefore, the literature which suggests SMEs to be instigators of aggressive reporting is not strongly supported. Rather, the majority appear to be cautious taxpayers, and are primarily interested in filing a correct tax return and in avoiding serious penalties.

The apparent lack of these ethical issues may be explained by the relative newness of the provision and the standards of care within the tax profession in Malaysia. Furthermore, the IRB has been unwilling to test in the courts the statutory provisions and associated explanatory rulings of the code of conduct so as to allow authoritative guidelines to emerge. Bandy *et al.* (1993) noted that greater familiarity with the standards and code of conduct is likely to highlight the consequences for tax practitioners and lead to the adoption of less aggressive resolutions of tax law issues in ambiguous situations, as has occurred under the 'realistic possibility' standard in the United States.

In summary, the role of the tax practitioner in ethical decision-making, particularly in relation to unprofessional behaviour, raises some concerns. Even though tax practitioners see scope for abuse of the tax system, they are well in control of their professional relationships with clients. The best strategy for improving compliance is a system to give professionals the support they need to find a way to balance the competing pressures that threaten compliance, as suggested by Sakurai and Braithwaite (2001).

9.7 The role of forensic accounting

The literature on forensic accounting has been reviewed in detail in Chapter 4. This section will address the relationship between tax evasion by SMEs and forensic accounting. The literature review suggests that forensic accounting is a relatively new discipline in Malaysia. It is a field that substantially interacts with economics, finance, information systems and the law in the usage of accounting for investigative purposes. The discipline is so relatively new that, up to now, there has been no formal definition accepted as the

standard (Thornhill, 1995). As a discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the workings of the legal system. Its development, however, has been primarily achieved through on-the-job training as well as experience with investigating officers and legal counsel (Bologna *et al.*, 1995).

Evidence from the tax practitioners and IRB personnel shows that they view forensic accounting services as still not widely available or, if they are available, the practitioner may not have undergone formal and sufficient training and is thus unable to function or render all the services. They therefore need further exposure before fully understanding the concept of forensic accounting sufficiently. Tax practitioners acknowledge themselves as having a fairly good understanding of forensic accounting (Tables 6.23 and 6.24 respectively). Awareness among IRB personnel, especially those personnel involved in the investigation of tax evasion cases, with regard to forensic accounting is also strong (paragraph 8.4). Although such investigation techniques in forensic accounting are not new to them, they need further exposure (even though the findings indicate a lack of sophistication in tax evasion by SMEs) to bring about the successful investigation and prosecution of those involved in tax evasion. Knowledge of forensic accounting by IRB personnel will be a powerful addition to the investigation officers' arsenal and will enhance their ability to combat tax evasion by SMEs. This will help and contribute effectively towards the successful investigation and prosecution of tax fraud, especially the evasion and avoidance of taxes. As Brennan *et al.* (2001) pointed out, the main thrust of forensic accounting involves the financial aspects of an investigation, and encompasses all the necessary investigating expertise and experience such as interrogative skills, knowledge of the law and the rules of evidence, investigative proficiency, and interpersonal skills. Thus, in the context of the tax authority, forensic accounting can be deemed as a discipline that combines expertise in accounting together with other investigative skills to examine instances of criminal wrongdoings with regard to taxes: the findings from the investigation will form the basis for the prosecution of the suspects in the court of law.

Based on the questionnaire survey (Table 6.22), file data (Table 7.2) and the opinions of IRB personnel, the technique used by the IRB in detecting and settling tax evasion cases appears to be relatively effective with capital statement/net worth analysis viewed overall

as an effective method. This was further stressed by one of the IRB personnel, who stated that the capital statement approach put Al Capone in jail for tax evasion. The IRB bases its net worth approach on the following hypothesis: (1) a taxpayer's net worth at a point in time is the cost of all his or her assets (business and personal) minus his or her liabilities; (2) a taxpayer must have sufficient income (taxable and non-taxable) to account for (a) any increase in his or her net worth between the beginning and the end of the year, plus (b) any personal expenditure that he or she incurs during the year. Under this approach, taxable income is computed as all or part of the increase in net worth during the year, minus non-taxable income plus non-deductible personal expenses (see Figure 4.1 for summary).

In summary, awareness of forensic accounting techniques by tax practitioners and IRB personnel is strong, having acknowledged a fairly good understanding of forensic accounting. Forensic accounting could be seen as a multi-skilled or multi-disciplined area, which creates an additional challenge for one to master. Expertise in accounting alone will not suffice without the expertise in other investigative areas. Similarly, expertise in other investigative skills without the knowledge of accounting will not assist the investigating officers in uncovering fraudulent activities. Accordingly, the development has to come in stages and as a team effort as investigation is not something that can be taught and not everyone can do it.

Capital statement/net worth analysis is viewed overall as the most effective method among the various techniques used by the IRB in detecting tax evasion by SMEs. Although such forensic accounting techniques are not new to the tax authority, they however need further exposure as the type and extent of evasion by SMEs varies from case to case. Hence the area of forensic accounting should be added to the tools necessary to bring about the successful investigation and prosecution of those involved.

9.8 Assumptions and limitations of the study

There are several assumptions and limitations of this study that need to be considered in evaluating these findings so as to ensure that the results described are not misinterpreted. It is essential that all assumptions are stated and that any perceived limitations are affirmed.

This will allow the research findings to be justified in the context of these assumptions and limitations and minimise any misconstruing of the findings.

This study involves a survey of the attitudes of tax practitioners and SME taxpayers regarding their perceptions of others' behaviour with some questions asking the respondents to consider themselves in hypothetical situations. It involves a sensitive area and the researcher was not able to determine whether the respondents were sincere in providing their answers. In other words, the issue is whether the answers provided were similar to how they would behave in a real situation, as all taxpayers engaged in tax evasion activities might not wish to be identified^{9.3}. Let us look into the evidence.

The response rate was considered to be very low with an average of 20 per cent (Chapter 6). As discussed in Chapter 5, the most common problem leading to a low response rate may be the structure and phrasing of the questionnaire. There was no mention of any problems or any comments made concerning the point of the questions, and thus those who responded seem to have understood what the questions were asking them. Therefore, once the respondents decided to reply to the questionnaire, they seem to have found no difficulties in understanding and answering the questions. The questionnaire was relatively short and easy to understand, as closed questions were used (in the direct and indirect style) so as not to cause respondent fatigue. The fact that the responses received from the convicted tax evaders were fewer than from the non-evaders strengthens the conviction that the low response rate was due to the sensitivity nature of tax evasion, with which the tax evaders do not wish to be identified. Many chose not to respond: however, those who did respond may have been more likely to have given their true and honest opinion, as they were not forced to respond, and they had no incentives to do so (monetary, gifts or so forth as an added incentive for increasing response rate) other than their own interest.

The tax practitioner survey was based on a sample of 350 practising tax practitioners, approved and licensed under Section 153 of the Malaysian Income Tax Act. The sample contained 200 professional accountants 'authorised by or under any written law to be an

^{9.3} Smith (1986:78) comments that 'such extreme caution – verging perhaps on paranoia – contrasts sharply with the enthusiasm with which pub bores may appear prepared to regale even complete strangers with tediously detailed anecdotes about their transactions in the black economy and their view about taxation'.

auditor of companies' (Section 153(3) (a)), 100 from 'any other professional accountant approved by Minister of Finance' (Section 153(3) (b)), and 50 from 'any other person approved by the Minister on the recommendation of the Director General of the Inland Revenue' (Section 153(3) (c)). The bias was introduced in order to ensure that a large number of respondents would have specialist knowledge and experience, especially in forensic accounting. The tax practitioner sample was drawn from two databases – the IRB and the MIA database (sample construction is discussed in more detail in Chapter 5). It was not possible to follow up non-respondents, as the survey had ensured anonymity as well as confidentiality in order to enhance completion rates.

The SME taxpayer survey was limited to a sample of 400. The sample was constructed using the IRB database (sample construction is discussed in detail in Chapter 5). Again, anonymity and confidentiality were adopted for the SME taxpayer survey, making it impossible to carry out follow-ups. This procedure was used in an attempt to increase the response rate. Non-response bias was considered in more detail in Chapter 6.

Though permission was granted to carry out research using actual case data from the IRB, given the confidentiality requirement under Section 138 of the Income Tax Act, only certain data was made available for the analysis in comparing the results with other observations.

Again, given the confidentiality provision of the Income Tax Act, the stances or opinions expressed by the IRB personnel are their own views and should not be interpreted as representing the views of the IRB as a whole.

9.9 Summary

The chapter has presented the findings from the questionnaire survey, file data/actual cases and the opinions from the IRB personnel. The main outcomes from this chapter show that triangulation yields comparable and consistent data in the research findings between the three observations made. There was found to be a general consistency between the results. This confirms the validity of this research work. It can be interpreted that the researcher carried out the survey as prescribed for any fieldwork and also the file data/actual cases and

IRB personnel opinions strengthened the findings of the surveys. A summary of the triangulation result is presented in Figure 9.1.

The research findings suggest that the extent of tax evasion by SMEs in Malaysia is serious. SME tax evasion is seen as both widespread and frequent. The findings also indicate the offences to be in the character of deliberate evasion without any sophisticated tax-planning scheme. Understatement of gross profit and overstatement of expenses other than cost of goods sold are the most frequently used methods. The fact that most taxpayers feel that it is unlikely that they will be detected and penalised by the tax authority is also another factor shaping tax evasion by SMEs in Malaysia.

The findings also show that SMEs in Malaysia rely heavily on tax practitioners to guide them to comply with their income tax requirements and that they will in general remain with the same tax practitioner. There is a tendency, however, to switch tax practitioners for whatever reason they think fit.

In relation to the role of the tax practitioner, the results indicate that tax practitioners play a critical role in how SMEs approach tax evasion opportunities in Malaysia. They have a dual role in compliance within the tax system consistent with other findings. Tax practitioners are seen as pro-tax authority with their role in performing duties within the boundaries the tax law and refusal to continue to act on behalf of SME taxpayers if they do not accept

Figure 9.1
Summaries of triangulation result

Research questions	Questionnaires		File data	Opinion from IRB personnel
	Tax Practitioners	SME Taxpayers		
Extent and existence of tax evasion by SME in Malaysia	<p>Perceived SMEs do evade tax (Table 6.12)</p> <p>More than 50 percent of SME evade tax (Table 6.12)</p>	<p>Strong agreement with 3 statement about tax evasion by SMEs (Table 6.26)</p> <p>Split in opinion with 60 percent believed between 25 to 50 % of SME evade tax. (Table 6.27)</p>	<p>Approximately 1.18 percent increase in the investigation cases.</p>	<p>Rampant.</p>
Characteristics of tax evasion by SME in Malaysia: Cyclical vs repetitive	<p>Repetitive in nature, occur all the times. (Table 6.13)</p>	<p>Repetitive in nature, occur all the times. (Table 6.19)</p>	<p>Continuous in nature, the effect of which is to reduce tax liability. (Table 7.5)</p>	<p>Evade in any way possible all the time.</p>
Deliberate vs accidentally	<p>Deliberately in nature with the involvement between 25 to 50 % done by tax practitioners (Table 6.17 & 6.18)</p>	<p>Deliberately in nature with 25 to 50% of SME (Table 6.31 & 6.32)</p>	<p>Deliberately planned falsification with the clear intention of deceiving and cheating the tax authority (Table 7.4)</p>	<p>Deliberately - family owned and managed, easily evade due to loose or non-exist internal control in the accounting system.</p>
SME tax practitioner relationship	<p>Good working relationships.</p>	<p>Good working relationships Heavy reliance on Tax Practitioners (Table 6.29)</p>	<p>N/A</p>	<p>N/A</p>

Research questions	Questionnaires		File data	Opinion from IRB personnel
	Tax Practitioners	SME Taxpayers		
Factors influencing tax evasion by SMEs in Malaysia	Incompetence, corrupt and inadequately staffed tax administration (Table 6.14). Low detection rate by IRB support the above argument (Table 6.20).	Burden of paying tax is too great. Low probability of detection by IRB. (Table 6.40)	N/A	Perception and attitude of SME taxpayers toward the tax system and IRB.
Method use in evading tax by SMEs in Malaysia	Overstatement of expenses (Table 6.19).	Understatement of gross profit (Table 6.33). No sophisticated tax planning scheme involved (Table 6.34, 6.35 & 6.36).	Understatement of gross profit (Table 7.3).	Cost of sale and suppression of sale/income.
Role of tax practitioners	Perform duty within the boundaries of tax law i.e. pro taxpayers (Table 6.16 & 6.16)	Heavily reliance on tax practitioners. Most had never switched accountant/practitioners (Table 6.29)	N/A	Practitioners engaged by SMEs are usually not of the highest repute and sometimes bogus.
Role of forensic accounting	New to them, not widely yet available - need to undergo training to enable them fully understand the concept.	N/A	Capital statement noted as the common technique employed in determining unreported income.	Powerful tool which carry a step further in detecting and settling tax evasion cases. Methods or technique to be employed depend on the type of industry of SMEs concerned.

Research questions	Questionnaires		File data	Opinion from IRB personnel
	Tax Practitioners	SME Taxpayers		
	Most familiar with the indirect method of proving unreported income - capital statement			
Other Observation: Evasion not restricted to a particular source of income	N/A	Various respondents believed they evade tax.	Nature of investigation and amount of work depend upon the circumstances of the cases.	Unique nature of SMEs and prevalent opportunities for tax evasion.

advice on the issue of disclosure. Tax practitioners are also seen as pro-taxpayer, as they appear to be exploiters of the tax law by deliberately understating or overstating the income of SMEs so that they pay less or more tax than they should.

Awareness of forensic accounting techniques by tax practitioners and IRB personnel is strong, having acknowledged a fairly good understanding of forensic accounting. Capital statement/net worth analysis is viewed overall as the most effective method among the various techniques used by the IRB in detecting tax evasion by SMEs. Although such forensic accounting techniques are not new to the tax authority, they however need further exposure as the type and extent of evasion by SMEs varies from case to case. Hence the area of forensic accounting should be added to the tools necessary to bring about the successful investigation and prosecution of those involved.

The next chapter provides an overview of the research and the results together with conclusions and recommendations for further research. It also proposes some strategies to overcome the major weaknesses in the existing tax system noted in the research findings so as to deter tax evasion, especially in SMEs.

CHAPTER 10

SUMMARY AND CONCLUSION

*If you drive a car, I'll tax the street; If you try to sit, I'll tax your seat; If you get too cold, I'll tax the heat;
If you take a walk, I'll tax your feet*

Part of the lyrics from Taxman by The Beatles

10.1 Introduction

This chapter provides a summary of this study, conclusions obtained from conducting this study and research evaluation. The first section presents a brief summary of this study. The next section provides conclusions obtained from conducting this research. The subsequent section will focus on research evaluation, i.e. recommendations to deter tax evasion by SMEs and suggestions for possible further research.

10.2 Brief summary

The principal objective of this study was to gain an insight into and assess the phenomenon of tax evasion by SMEs and explore the role of forensic accounting in Malaysia. The SMEs make a major contribution to the Malaysian economy, accounting for about 33.3 per cent of all private sector employment and 92 per cent of all private sector business (Bank Negara, 2002). It is stressed that the existence of tax evasion will have important implications for the determination of macro-economic variables, the functioning of the national economy and the implementation of economic policy. The SME sectors are seen as having a high incidence of tax evasion in terms of voluntary tax compliance and they have more opportunities to participate in cash transactions compared to other taxpayers (Vogel, 1974; Wallschutzky, 1984; Joulfaian and Rider, 1998; Ahmed and Sakurai, 2001). There is, however, a strong voice in defence of SMEs. Coleman and Freeman (1994) and Terkper (2003) argued that SMEs are surrounded by an inefficient and unsupportive tax system, and often unnecessarily confrontational bureaucracy. The IRB, in its attempts to reduce or eradicate tax evasion through positive and negative reinforcement measures, has decided that it requires large-scale studies to be conducted in order to assess SME taxpayer behaviour and to ascertain what influences tax evasion activity. This study defines

characteristic behaviours of SME taxpayers and tax practitioners, factors affecting tax evasion activity and the role of forensic accounting.

In this research, SME is broadly defined to include directors of SMEs, management of SMEs, sole proprietors, partnerships and businesses within the definition of the Small and Medium-Sized Industry Development Corporation (SMIDEC) of the Ministry of International Trade and Industry by being companies having the following characteristics: (1) turnover of less than RM 25 million, (2) employee number not exceeding 150, (3) companies incorporated under the Companies Act 1965, including those registered under the Registrar of Business. Directors, managers and owners are also included in the scope of the category SME to reflect the practice of the tax authority of including SME entrepreneurs (owners, directors and managers) in most of the back duty cases of private companies, where a means test/net worth analysis is examined and unreported income is taxed and a penalty imposed.

This study adopted a multi-method approach (qualitative and quantitative approach), as suggested by Jackson and Milliron (1986), Hasseldine and Zhuhong (1999) and Richardson and Sawyer (2001). It was argued that by using different sources and methods, each type of data collection was strengthened and the weaknesses of any single method were minimised, helping to produce a more authoritative piece of research by increasing the strength of the research design.

The data presented was constituted by views from SME taxpayers and tax practitioners and expressed in response to a mail questionnaire, file data/actual cases from the IRB investigation files, and from IRB personnel in response to open format questions. SME taxpayers consisted of non-tax evaders and convicted tax evaders. The tax practitioners comprised individuals according to the provision of the ITA under section 153(3): (a) a professional accountant authorised by or under any written law to be an auditor of companies, (b) any other professional accountant approved by the Minister and (c) any other person approved by the Minister on the recommendation of the DGIR. By addressing the related questions to tax practitioners and IRB personnel, it was possible to draw on their specialist knowledge of tax laws and their understanding of the impact of both the technical

aspects of the legislation and the administration of the tax system concerning tax evasion. The tax authority's file data gave a further understanding of the practices within the IRB and SMEs with regard to tax evasion.

A total of 87 usable responses were returned by SME taxpayers, providing an overall response rate of approximately 25 per cent. Of the 87 SME taxpayer respondents, 62 were from the non-tax evaders group and the remaining 25 were convicted tax evaders. Usable questionnaires were obtained from 60 tax practitioners resulting in a response rate of over 19 per cent. Appropriate statistical tests were performed in analysing the data.

A total of 200 tax investigation files were reviewed for the years 1997 and 2001 and all fifteen directors in charge of the Investigation and Intelligence Centre were sent an open-ended questionnaire for their personal opinions. Eight responses were received from the IRB personnel, representing more than half of the directors of the Investigation and Intelligence Centre of the IRB.

10.3 Research findings

The results of this research as a whole have implications for future strategies of the IRB to focus SMEs sectors. The results also aid in setting the future direction and role of forensic accounting technique in detecting and deterring SMEs tax evasion. The following summaries the research findings based on the research questions addressed in Chapter 1 (Section 1.3).

10.3.1 Insight into the extent and impact of tax evasion by SMEs

10.3.1.1 *To what extent do SMEs commit tax evasion in Malaysia?*

There is a prima facie case for suspecting the existence of tax evasion by SMEs in Malaysia. The findings suggest that tax evasion by SMEs is widespread and frequent. Though there was a split opinion in the estimate of the extent of the involvement of SMEs, the majority of questionnaire respondents believed that not less than 50 percent of SMEs evaded tax. What is perhaps the most interesting outcomes is that those who evade tax had

far more precise estimates of the probabilities of apprehension than non evaders. This fits nicely with the view that those who are active in tax evasion will have a better sense of the size of evasion than non-evaders.

10.3.1.2 What are the impacts of tax evasion by SMEs?

Specific impacts are difficult to make especially as the fact that tax evasion is illegal makes it difficult to obtain reliable estimates of its magnitude. In addition, the absence of a significant effect of probability of audit and severity of penalties on SME taxpayer that it is advantageous to evade tax. There is, however, sufficient evidence to conclude that tax evasion by SMEs is a significant problem, particularly in light of community perceptions that the problem is escalating. There also appears to be a perception that there is little likelihood of detection and, in any case, that the consequences of being detected are not severe. While there is no reliable estimate of the revenue foregone, it is clear that the Malaysian community is denied the benefit of billions of ringgit each year that could be funding improvements in health, education and other government programs.

10.3.2 Understanding cases of tax evasion by SMEs in practice

10.3.2.1 What are the characteristics of tax evasion by SMEs in Malaysia?

(i) Is tax evasion by SMEs in Malaysia cyclical or repetitive in nature?

In this case, the finding indicates that tax evasion by SMEs is repetitive in nature. Experience and research (Schneider and Este, 2000) shows that SMEs would evade taxes in any way possible all the time rather than in situationally based circumstances – once engaged, it is difficult to stop them (as it develops all the time according to the principle of running water; it adjusts to changes in taxes, to sanctions from tax authorities and to general moral attitudes and so forth).

(ii) Is tax evasion by SMEs in Malaysia characteristically deliberate (intentional) or accidental (unintentional) in nature?

SMEs are thought to accidentally and deliberately understate or overstate profit so as to pay less or more tax than they should (Hasseldine and Kaplan, 1990). Similarly, Tooley (1992, cited in Tan, 1999) in his research on tax practitioner's attitudes towards taxation found that tax practitioners assert that their clients (majority are small firms) have the intention to overstate deductions or overstate incomes. The finding from this study believed the offences to be characteristic of deliberate evasion. This appears to indicate that SMEs tend to be deliberately understating the income/profit as to pay less tax than they should. In contrast, approximately less than 10 percent of SMEs are believed to be involved in accidentally or deliberately overstating their income (Table 6.17, Table 6.18, Table 6.31 and Table 6.32).

10.3.2.2 What are the factors influencing tax evasions by SMEs in Malaysia?

The findings revealed considerable variability in factors influencing tax evasion by SMEs. It appears that tax practitioner's perceived incompetence, corrupt and inadequate staffed tax administration. In contrast, SMEs taxpayers in the opinion that the burden of paying tax is too great as the factor not paying the right amount of tax and to avoid audit/investigation as the factor for paying right amount of tax. The chances of being detected and penalised by the tax authority are also another indication that SMEs evade tax.

10.3.2.3 What are the approaches and methods used in the tax evasion by SMEs in Malaysia?

There was a split in opinion with regard to the approaches used by SMEs in evading taxes with SME taxpayer perceived understatement of gross profit while tax practitioners understood overstatement of expenses other than cost of goods sold to be the most frequently used method. File data indicated that underreporting of sales and overstating of purchases are the largest adjustments in the SMEs tax evasion scheme, put through so as to understate their gross profit. This shed light on the method used by SMEs in evading tax.

10.3.2.4 *What are the roles of tax practitioners?*

The findings revealed that a considerable percentage of SME taxpayers appear to rely on tax practitioners. This is because a possibility of increasing complexity in tax law. The prevalence of the use of tax practitioners indicates that SMEs can be influenced in their tax evasion decision. This also raises some concerns regarding ethical decision-making in tax practice, particularly in relation to unprofessional behaviour in tax compliance. The study also suggested that tax practitioners in Malaysia play dual roles. Tax practitioner is seen as pro tax authority with their role in performing duties within the boundaries of the tax law and refusal to continue to act on behalf of SME taxpayers if they did not accept advice on the issue of disclosure. Tax practitioners also seen a pro taxpayer, as they appear to be exploiters of the tax law by deliberately understate or overstate income/profit of SMEs as to pay less or more tax than they should, given that they have unique knowledge of tax law.

10.3.3 Explore both the actual and potential role of forensic accounting in relation to tax evasion

10.3.3.1 *What are the forensic accounting techniques for detecting tax evasion*

By definition, forensic accounting is the application of financial accounting and investigation standards acceptable by the courts, to address issues in disputes, in the context of civil and criminal litigation (Nurse, 2002; Manning, 2000; Bologna and Lindquist, 1995).

The literature generally assumes that any detection of tax evasion by an individual or corporate automatically leads to full detection and therefore triggers penalties that are proportional to the total amount of evaded taxes. In the real world, however, tax evasion is almost never fully detected (Feinstein, 1991; Anderoni et. al., 1998) because it is either too far outside the law or completely 'off the book' (Rice, 1992). The use of forensic accounting techniques searching for tax misdemeanours by using a mixture of accounting, law, computer technology, ethics and criminology have been applied by some tax authorities to detect tax evasion. Unfortunately the respective tax authorities closely guarded the detailed methods they used.

The framework of forensic accounting fitted neatly into reforming the procedure of detecting tax evasion among SMEs for the IRB in the new millennium with the introduction of criminal tax investigation as opposed to the existing system of civil penalties. Awareness of forensic accounting among tax practitioners and IRB personnel are, in general fairly good.

Capital statement/Net worth analysis is considered as overall, the most effective method in detecting tax evasion in SMEs compared to ratio/analytical analysis, income reconstruction and digital analysis using Benford's law. However, the type and extent of evasion within SMEs varies from case to case to such an extent that mostly no two cases are alike; the accounting basis methods (ratio/analytical analysis and income reconstruction) are widely accepted by the IRB. The capital statement method is used as an appraisal of wealth accretion of the personal wealth related to the company cases by the IRB.

10.3.3.2 To what extent can forensic accounting to be relevant in detecting tax evasion by SMEs in Malaysia

Forensic accounting appears to be suitable for an adoption to detect tax evasion or other irregularities by SMEs but new techniques and tool are necessary to perform thorough investigations, especially on new types of business or industry such as the computer assisted analytical procedures using Benford's Law or Discriminant Function Formulas (DIF) currently adopted by US tax authority. While general forensic accounting procedures apply to most fields of business, the tax investigators must quickly become knowledgeable of industry-specific practices to immediately identify how to approach an investigation so as to not only avoid loss of time in the initial stages of work but also to discover information which may prove beneficial to the outcome of the cases.

10.4 Recommendations

There appears to be considerable scope for improving the tax collection practices of the Malaysian tax system so as to deter tax evasion, especially by SMEs. Drawn from the research findings of the survey questionnaires, data files and IRB personnel opinions, significant benefits could be derived from making it easy and cost effective for SMEs to

meet their obligations. In summary, the sector is characterised by ineffective mechanisms for the control of SMEs by the tax authority: the current enforcement system includes a detection probability which is low and methods of selecting cases for detection which are not efficient. Further, a heavy reliance is placed by the tax authorities on penalties and its penalties are inadequate to change the behaviour of the average SMEs.

The strategy for improvement can be broadly categorised as follows: (1) increase the probability of detection; (2) provide environments conducive to voluntary compliance; and (3) regulate tax practitioners.

10.4.1 Increase the probability of detection

One way to encourage compliance is to increase the probability that tax evasion will be detected and penalised. This can be done in two ways: (i) by structuring SMEs' taxpaying so as to make tax evasion more visible to the IRB, and (ii) by devoting more resources to detecting tax evasion.

10.4.1.1 Increasing the visibility of tax evasion

If all the information needed to correctly calculate SMEs' taxes were readily available to the IRB, tax evaders would face an enormous risk of getting caught if they attempted to evade taxes. Though the IRB has a computerised system in place to take over the manual system for some services relating to tax matters, the system is, however, not integrated, not technology enabled and not centralised (see Chapter 8, paragraph 8.2). The IRB should introduce a computerised central master file for handling tax returns and other relevant documents. Such a system could enable the IRB to systematically ascertain whether SMEs have failed to file tax returns, to check the mathematical accuracy of returns filed, and to compare the information contained in a taxpayer's return with the corresponding information filed by third parties, in order to establish a consolidated central file for each SME that is constantly updated and to streamline the classification and selection of tax returns for audit or investigation. The effectiveness of the central master file, however, depends on the quality and variety of the information reported to the IRB.

Currently, SMEs registered with the Registrar of Business are not required to submit audited accounts with their tax return. Hence the government and the IRB should consider making it mandatory that the accounts of SME businesses be audited. With the implementation of this proposal, attitudes towards positive tax compliance behaviour could be expected to improve. Moreover, with the implementation of the SAS, tax audit functions would be the main focus of the IRB.

10.4.1.2 Increasing resources for tax evasion detection

The most costly and familiar enforcement function of the tax authority is the examination or audit/investigation of tax returns to detect tax evasion. Most literature has argued that the enforcement activity should be based on appropriate selection criteria; over-extensive enforcement is impractical since any additional rise in revenue would be offset by increased administrative costs.

A good information system, using computers, would facilitate rapid detection of tax evaders. Computerisation which integrates a wide array of data would be of great significance for the IRB in adopting modern tools for detecting tax evaders, such as using computer analysis on the basis of statistical analysis. A computer-based risk analysis and case selection system, combined with a significant increase in the electronic capture of IRB data, would increase the IRB's potential to analyse data and increase the audit and investigation coverage. This would strengthen and increase the efficiency of the IRB in detection activities, which are currently dependent on the traditional methods of obtaining information from various resources manually, which is not efficient. The IRB could model the system on the *Discriminant Function Formulas* (DIF) adopted by the US tax authority. The DIF uses mathematical formulae to establish average taxes paid and weighted averages for deductions in the case of each income bracket. The averages are programmed into the computer and tax returns are thus compared with the averages.

Another computer-assisted analytical procedure uses Benford's law. Nigrini (1996) concludes that Benford's law, when used correctly, is a useful analytical tool for identifying accounts for further analysis and investigation because it does not use aggregated data, rather it is conducted on specifics using all the data available. Therefore it should assist the

IRB in their quest to detect tax evasion in financial statements so as to increase their ability. According to Nigrini (1996), Benford's law provides expected frequencies for the digits in tabulated data. The hypothesis is that the human element inherent in fabricated (fraudulent) numbers would cause the digits to deviate from the expected frequencies. He developed a Distortion Factor Model that allows the direction and extent of manipulation in a data set to be quantified. In general, when the actual proportion of lower digits exceeds the expected frequencies, the model indicates that the numbers have been manipulated downward and need further analysis and investigation, and vice versa.

The IRB should at the same time explore new training and development initiatives to support the programme of change in the organisation. This would equip them with the skills and necessary knowledge and allow them to develop more effective enforcement and prosecution procedures.

The enforcement activities should also be supported by an appeals system so as to ensure the tax officer remains within the limits of the law. This would also act as the mechanism for solving disputes, which could arise during the course of enforcement, between IRB and SMEs. The appeals structure might be integrated with the judicial system or a special tax court. However, it is recommended that the rules must be simplified and made flexible to make it easy and cost effective for SMEs to seek redress that includes representation in their personal capacity or by tax practitioners who may not be lawyers.

The IRB could also establish a special programme that uses other investigatory techniques to focus on SMEs in known problem areas, as tax evasion is not restricted and appears to be highly concentrated in a particular source of income (Kesselman, 1988; Joulfaian and Rider, 1998).

In addition, to introduce criminal penalties for evasion and other tax offences is recommended, as these are rarely imposed in Malaysia^{10.1}, even though the legal system is deemed to be quite adequate for the enforcement of criminal or civil provisions. The criminal

^{10.1} Only one taxpayer in Malaysia has been known to be sentenced to imprisonment, for one day in 1989, and a fine of RM750 (£120) for each of the offences for not submitting a tax return (Berita Harian, 1 November 1989).

penalties publicly condemn tax evasion and deter it by punishing the most egregious offenders (Roth, 1989a). On the basis of case studies of several such investigations by the IRS, they concluded that the widely publicised arrest, indictment, trial and conviction in these investigations appeared to produce at least a temporary decreases in levels of tax evasion activities.

An effective penalty regime also needs to be introduced. Penalties are generally higher under the SAS/voluntary system because of the fact that returns or computations are accepted at face value by the IRB. Any penalty regime will need to distinguish between circumstances in which SME taxpayers either intentionally or unintentionally evade taxes.

Working with other government agencies could also be of benefit in providing new information to the IRB. Integrating the information not only ensures that adequate information is gathered but also that cost is minimised by avoiding duplication and overlapping information or procedures. This would also strengthen the efforts of all of the enforcement agencies of the nation in the fight against irregularities within SMEs.

The public must also witness the serious attempts of the IRB to punish tax evaders. By publicising the imposition of penalties, the IRB would be sending a deterrent message to others who were contemplating violating tax laws that they may suffer a similar fate.

10.4.2 Provide environments conducive to voluntary compliance

Owing to the lack or inadequacy of information, especially in SMEs, the IRB can assess the taxes on the basis of notional or presumptive income rather than on the basis of the income the SMEs actually received or to which they are legally entitled, which is known as *forfait*^{10.2}. The rationale for the use of this method derives from the assumption that it is unrealistic to expect SMEs with turnovers below certain levels to keep the kind of records needed for the determinations of their actual income and that a certain proportion of tax revenue due from such business will be lost through tax evasion because the tax administration cannot make adequate verification of actual income reported in each case, given the large number of business involved (United Nations, 1997).

Under the *forfait* assessment method, the determination of taxable income is the outcome of consultations between the tax administration and taxpayers. The tax administration estimates the general expenses and incomes of taxpayers on the basis of a minimum of information provided by the latter or available in their files with the tax administration or derived from general economic data. The aim here is to determine the taxpayer's normal income, in other words, not the income which the taxpayer in fact earns in a taxable year but the amount that a business which can be compared to the taxpayer's business would normally earn on an average basis.

In general, *forfait* assessment is simple and makes it possible to carry out an assessment when this cannot be done on the basis of actual income. The method also eliminates requests for refunds and enables the IRB to use the limited number of skilled staff available to combat tax evasion. However, in order to ensure that this assessment method is applied in an effective manner, a substantial amount of general information must be assembled in advance to enable the IRB staff who make assessments by this method to become fully acquainted with the business activities of the taxpayers and hence to be capable of weighing the validity of the arguments and supporting documents submitted to them.

Currently, tax law in Malaysia requires tax deductions at source from the following income of a resident individual: salary or wages and interest. Taking into account their effectiveness in reducing the scope of tax evasion, the IRB should adopt this withholding system as extensively as possible to SMEs. Such a withholding system should not, however, impose additional costs on those people who are responsible for making deductions or who must disclose their income to the IRB. The industries that would be covered by the withholding system should be those in which compliance has been low. A greater use of withholding may lead to an increased willingness of taxpayers to submit returns, especially if deduction of tax at source results in slight overpayment.

The IRB could also consider setting up SME advisory services. The role of the advisory service would be to provide assistance with meeting tax obligations, with a view to improving voluntary compliance.

^{10.2} Forfait or methode forfaitaire originated in France.

The emphasis would be on providing information and support as early as possible in the business's life cycle, because many SMEs fail in the first two years of operation or are closed down by taxpayers so as to avoid paying the tax on their operations. Providing services early reduces the risk of tax evasion and the risk of a business failure/close down because of tax requirement.

10.4.3 Regulating tax practitioners

Tax practitioners who prepare tax returns or advise clients about tax matters provide an important component of the tax system. Since more than half of all SMEs' tax returns in Malaysia are believed to be prepared by the tax practitioners every year (Table 6.29, Q2.1 and Q2.2), they affect a much larger proportion of returns than IRB examiners. Although the final responsibility for the contents of a tax return legally rests with the taxpayer, the return is completed on the advice of the tax practitioners, who bear limited responsibility for the advice given.

As observed in this study, a significant number of the tax practitioners believe they either accidentally or deliberately understate or overstate profit/income for their clients so that they pay more or less tax than they should. One source of IRB control in this area is from its authority to administer and enforce regulations governing administrative proceedings within the IRB. Tax practitioners are more easily monitored than SME taxpayers since they are a much smaller group.

Currently, section 153 of the ITA provides for tax practitioners. Subsection 1 states that *No person holding himself out as a tax agent, a tax consultant or a tax adviser (or under any other like description) shall be permitted to act in Malaysia on behalf of any person for any of the purposes of this Act unless he is a tax agent as defined in this section.* Their duties and responsibilities are governed by the code of conduct recently issued by the IRB and they can be disciplined by a fine, the amount of which can be between RM2,000.00 and RM20,000.00, or imprisonment for not more than three years, or a fine and imprisonment, as stated in the ITA (amendment) 1999.

As a stringent measure, a further legislative provision along the lines of one in the US is proposed as follows:

The Director General of the Inland Revenue (DGIR) may reprimand or institute proceedings to suspend or disbar any tax agent who the DGIR has reason to believe violated the rules of practice. Except in certain unusual circumstances, the DGIR will not institute a proceeding for suspension or disbarment against practitioners until the facts (or conduct) which may warrant such action have been given in writing to that practitioner and the practitioner has been given the opportunity to demonstrate or achieve compliance with the rules.

10.5 Suggestions for further research

As very little research of this kind has been conducted in Malaysia, the opportunity exists to build upon this empirical work by initiating further studies and substantiating what has already been achieved and defined. Further research is necessary in Malaysia in order to gain credence and credibility such as that in developed countries. An international comparison of tax policies for the SMEs would provide opportunities to improve and eradicate tax evasion in Malaysia.

It is also necessary that future research be undertaken to assist the IRB to develop and refine more sophisticated techniques that would enable it to detect tax evasion in general. Given the increasing sophistication of such tax evasion activities, failure to develop and refine detection techniques will render the IRB less effective than they should be. Thus, developing and refining the techniques is an urgent initiative for the IRB to enhance the investigation and enforcement officers' ability to investigate and prosecute those involved in tax evasion.

Given the lack of research on corporate income tax evasion, as pointed out by Rice (1992), the methodology could also be duplicated for large corporate enterprises. This could further assist the IRB in reducing corporate tax evasion in Malaysia.

With the introduction of the SAS, most taxpayers will depend on tax practitioners for tax advice and assistance. As a consequence, tax practitioners are therefore in a position to exert a strong and direct influence on the compliance and tax administration process (Erard, 1993). It is important that Malaysian tax practitioners be constantly reminded of their duties and obligations to assist clients in paying the proper amount of taxes. Thus, another aspect of future research could be to investigate the relationships of tax practitioners to the population at large with a view toward integrating these practitioners' roles more fully into the compliance system in Malaysia.

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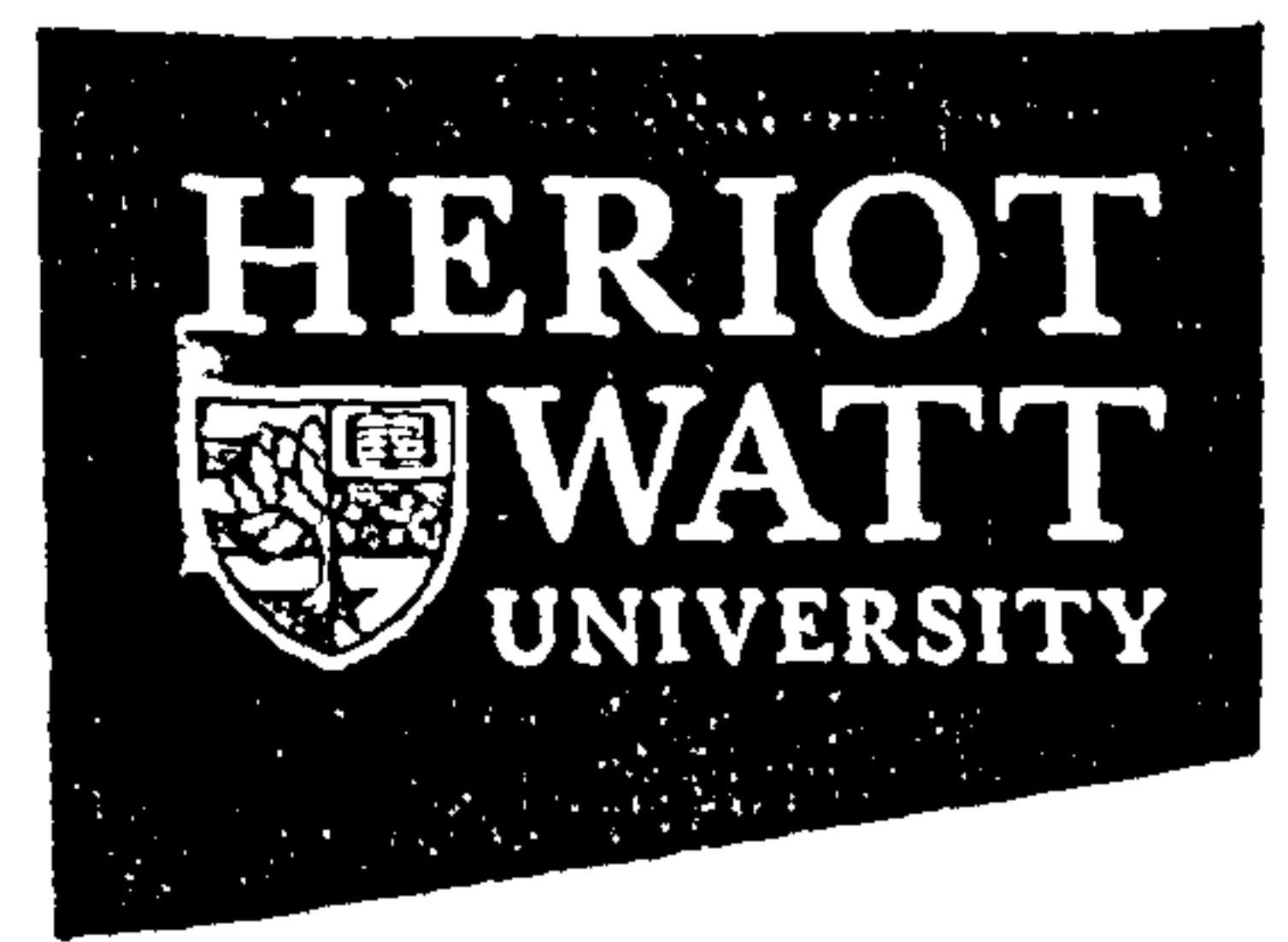
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APPENDICES

APPENDIX I
QUESTIONNAIRE SURVEY:
TAX PRACTITIONER



**TAX EVASION BY SMEs AND THE ROLE OF
FORENSIC ACCOUNTING:
A MALAYSIAN PERSPECTIVE**

QUESTIONNAIRE SURVEY: TAX PRACTITIONER

CONFIDENTIAL

TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING: A MALAYSIAN PERSPECTIVE

QUESTIONNAIRE SURVEY

PURPOSE OF THE SURVEY

The survey is carried out to crucially support a doctoral research study under the supervision of Professor Claire Marston and Professor Jim Haslam, Division of Accountancy and Finance, Heriot-Watt University. The study investigates the scope and significance of tax evasion and forensic accounting in Malaysia. Its aim is to gain insights into the extent, impact and understanding of cases of tax evasion in practice by SMEs. It also aims to explore the actual and potential role of forensic accounting in relation to tax evasion for the Inland Revenue Board of Malaysia.

You have been selected randomly as a respondent for this questionnaire. I assure you that replies are completely anonymous and will be carefully protected. It is not possible to trace any questionnaire to identify the person completing it. I would like to stress that all of the information provided will be kept strictly confidential. **PLEASE NOTE that this information will not be provided to anyone and the questionnaire will be destroyed once the research has been completed.**

I hope that you will find time from your busy schedule to complete the questions. It is very important for me. On completing, please return the questionnaire in the stamped addressed envelope provided as soon as possible.

Thank you in advance for your co-operation in support for this research study.

If you have any queries about the study please do not hesitate to contact me:

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**QUESTIONNAIRE SURVEY
TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING:
A MALAYSIAN PERSPECTIVE**

To promote common understanding of terms and concepts used in this questionnaire and to facilitate responses, a brief glossary of main terms is provided.

Definition of terms used in this study

“IRB” refers to the Inland Revenue Board of Malaysia.

“SME” (Small and Medium Enterprise) refers in this context as follows:

- Self employed people/Sole Proprietor
- Partnership
- Turnover of less than RM25 million
- Employee size not exceeding 150
- Companies incorporated under the Companies Act 1965, including those registered under the Registrar of Business.

“Tax Evasion” constitutes a breach of Income Tax Act 1967.

PART I: TAX EVASION BY SMEs AND FORENSIC ACCOUNTING

The purpose of this section is to obtain a general view on tax evasion in SMEs and forensic accounting. It is commonly believed that SMEs exhibits high rates of tax evasion and this is attributed to various factors. The questions below will enable this study to provide some insight into the phenomenon of the tax evasion and the role of forensic accounting including gauging what are the elements that effect tax evasion by SMEs and its detection in Malaysia.

Question 1.1

**In your opinion, do most of the SMEs evade tax?
Please tick the appropriate box.**

- Yes *Please explain*
- No *Please explain and go to Question 1.9*
- Do not know *Go to Question 1.9*

Please explain briefly if possible:

Question 1.2

**To the best of your ability, please estimate the percentages of SMEs that evade tax in Malaysia.
Please tick the appropriate box.**

- Less than 25%
- Between 25% to 50%
- Between 50% to 75%
- More than 75%

Question 1.3

The following are understood to be common methods for generating tax evaded income in SMEs. Please *tick one method* which you think is the most frequently used in generating tax evaded income in SMEs in Malaysia.

Complete suppression of gross profit

Understatement of gross profit

Overstatement of expenses
(other than cost of goods sold)

Understatement of assets (including
property and inventories)

Other (please specify)
.....
.....

For the most frequently used method indicated above, please briefly indicate the common approaches to its application, in your view.

Question 1.4

The following are the factors which may lead to tax evasion and related manipulation in SMEs. Please **tick one factor** which you think is the most common factor that may lead to tax evasion and related manipulation in SMEs in Malaysia.

Loopholes in tax system

Applying the wrong accounting principle /concept

Incompetent, corrupt and inadequately staffed tax administration setup.

Tax Authority unable to enforce the penal and civil provision of the prevailing tax code

Tax Authority unwilling to enforce the penal and civil provision of the prevailing tax code

Other (please specify)

.....
.....

Please explain briefly your above choice:

Question 1.5

In your opinion, is tax evasion cyclical in some SMEs? Cyclical mean it happens within a specific period or circumstances for example once in every ten year period.

Please tick the appropriate box.

Yes

No

Do not know

Please briefly explain further your answer:

Question 1.6

In your opinion, is tax evasion a repetitive action by some SMEs? Repetitive means a yearly affair done by SMEs. *Please tick the appropriate box.*

Yes

No

Do not know

Please briefly explain further your answer:

Question 1.7

In your opinion, which is the most likely period in which SMEs will evade taxes? Please *tick one period* which you think is the most common period that SMEs will evade taxes.

Early stage of the business

In a period of high inflation

The period of economic boom

The period of economic downturn

All the time

Other (please specify)

.....

Please briefly explain your above choice:

Question 1.8

Please indicate three (3) methods which in your opinion might help to deter tax evasion and briefly explain your choice.

1) Method one and briefly explain your choice:

2) Method two and briefly explain your choice:

3) Method three and briefly explain your choice:

If you have not answered the above please tick the appropriate box.

No Opinion

Other (please specify)

**TEXT BOUND
INTO
THE SPINE**

Question 1.9

The following are the common methods for detecting tax evasion used by the Revenue Authority. How would you rate the effectiveness of the method in detecting tax evasion. Please tick the appropriate box.

	Very poor	Poor	Average	Good	Very good
	1	2	3	4	5
Analytical Review/Ratio Analysis	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Capital Statement/Net Worth Analysis	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Income Reconstruction	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Digital Analysis Using Benford's Law (analysis of digit and number patterns to detect abnormal recurrences of digits, digit combinations and number patterns)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Please briefly explain your above rankings:

Question 1.10

What is your understanding of Forensic Accounting? *Please tick the appropriate box.*

[Forensic accounting is the application of financial skill and an investigative mentality, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a strong knowledge and understanding of business reality and the working of the legal system. According to some of its advocates it looks beyond the numbers and deals with the business reality of the situation].

- None**
- Poor**
- Average**
- Good**
- Very Good**

Please explain briefly if possible:

Question 1.11

In your opinion is there a better way to detect tax evasion by SMEs than forensic accounting techniques? *Please tick the appropriate box.*

- Yes**
- No**
- Do not Know**

Please explain briefly if possible. If you have answered 'Yes' kindly explain your technique.

PART II: PROFESSIONAL ETHICS AND INTEGRITY

Question 2.1

Do you think tax practitioners, whether due to client pressure or for whatever reasons, accidentally or deliberately understate their client's profit so that they have had to pay less income tax than they should. Please tick the appropriate box.

- Yes**
- No** Go to Question 2.2
- Prefer not to reply** Go to Question 2.2

If you have answered 'Yes', to what extent (in percentage) do you think, tax practitioners are involved? Please tick the appropriate box.

	Accidentally understate	Deliberately understate
Less than 10% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 10% to 25% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 25% to 50% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 50% to 75% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
More than 75% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>

Please briefly explain the approaches commonly used by the tax practitioners:

Question 2.2

Do you think tax practitioners, whether due to client pressure or for whatever reasons, accidentally or deliberately overstate their client's profit so that they have had to pay more income tax than they should. Please tick the appropriate box.

- Yes**
- No** Go to Question 2.3
- Prefer not to reply** Go to Question 2.3

If you have answered 'Yes', to what extent (in percentage) do you think, tax practitioners are involved? Please tick the appropriate box.

	Accidentally overstate	Deliberately overstate
Less than 10% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 10% to 25% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 25% to 50% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
Between 50% to 75% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>
More than 75% of tax practitioners	<input type="checkbox"/>	<input type="checkbox"/>

Please briefly explain the approaches commonly used by the tax practitioners:

Question 2.3

Imagine yourself in this situation:

One of your client has been paid RM100,000 in cash for work that was done outside the regular job.

As a tax practitioner which action would you take in reporting that income to IRB.

Please tick the appropriate action.

Not declare it

Declare only a portion of it

Declare it in the most advantageous manner within the law

Declare as advised by the client

Other (please specify)

.....
.....

Question 2.4

What do you think the chances are that your client will get caught by the IRB if they/tax practitioner reported less/none of the income above (Question 2.3).

Please tick the appropriate box.

None

Less than 25%

Between 25% to 50%

Between 50% to 75%

More than 75%

Question 2.5

What action do you think tax practitioner should take, if client does not accept advise on an issue of disclosure. Please tick the most appropriate action.

Inform IRB

Refuse to complete the tax return

Refuse to continue to act for the client

Fill in incorrect return and inform the IRB

Other (please specify)

.....
.....

Question 2.6

How many of your SME clients have been investigated/audited by the IRB on average per year over the last five years. Please tick the appropriate box.

None

Less than 10 clients

10 - 50 clients

More than 50 clients

PART III: YOU AND YOUR FIRM

Some personal information to help in classifying your response. Please tick in the appropriate box.

Question 3.1: Age

- 20 years and below
- 21 to 30 years
- 31 to 40 years
- 41 to 50 years
- 50 years and above

Question 3.2: Ethnicity

- Malay
- Chinese
- Indian
- Other (please specify)
.....

Question 3.3: Gender

- Male
- Female

Question 3.4: Member of Professional Bodies

- MIA/MACPA
- ACCA/CA
- MIT
- MATA/Agent under Sec 153 of Income Tax Act 1967
- Other (please specify)
.....

Question 3.5: Number of years of tax experience

Less than 5 years

5 to 10 years

More than 10 years

Question 3.6: Number of SME Clients

Less than 100 clients

100 to 500 clients

501 to 1,000 clients

More than 1,000 clients

Question 3.7: Location

West Malaysia:

Western Region (KL, Selangor)

Eastern Region (Pahang, Terengganu,
Kelantan)

Northern Region (Perlis, Kedah,
Pulau Pinang, Perak)

Southern Region (N. Sembilan, Melaka,
Johor)

East Malaysia:

Sabah

Sarawak

PART IV: GENERAL OPINIONS

If you have any opinions or ideas about tax evasion by SMEs and the role of forensic accounting techniques that have not been covered in this survey, please can you explain further.

**THANK YOU VERY MUCH FOR YOUR COOPERATION - IT IS MUCH APPRECIATED
PLEASE RETURN THE QUESTIONNAIRE IN THE ENVELOPE PROVIDED AS SOON AS POSSIBLE
OR NOT LATER THAN 30th April 2003**

FOR DATA ANALYSIS USE ONLY

DATE REPLY RECEIVED

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REPLY NUMBER

--	--	--

APPENDIX II
QUESTIONNAIRE SURVEY:
SME TAXPAYER

**TAX EVASION BY SMEs AND THE ROLE OF
FORENSIC ACCOUNTING:
A MALAYSIAN PERSPECTIVE**

QUESTIONNAIRE SURVEY: TAXPAYER

CONFIDENTIAL

TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING: A MALAYSIAN PERSPECTIVE

QUESTIONNAIRE SURVEY

PURPOSE OF THE SURVEY

The survey is carried out to crucially support a doctoral research study under the supervision of Professor Claire Marston and Professor Jim Haslam, Division of Accountancy and Finance, Heriot-Watt University. The study investigates the scope and significance of tax evasion and forensic accounting in Malaysia. Its aim is to gain insights into the extent, impact and understanding of cases of tax evasion in practice by SMEs. It also aims to explore the actual and potential role of forensic accounting in relation to tax evasion for the Inland Revenue Board of Malaysia.

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**QUESTIONNAIRE SURVEY
TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING:
A MALAYSIAN PERSPECTIVE**

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- Partnership
- Turnover of less than RM25 million
- Employee size not exceeding 150
- Companies incorporated under the Companies Act 1965, including those registered under the Registrar of Business.

“Tax Evasion” constitutes a breach of Income Tax Act 1967.

PART I: TAX EVASION AND SMALL AND MEDIUM ENTERPRISES (SMEs) IN MALAYSIA

The purpose of this section is to obtain a general view on tax evasion in the SMEs. It is commonly believed that SMEs exhibit high rates of tax evasion and this is attributed to various factors. The questions below will enable this study to provide some insights into the phenomenon of tax evasion by SMEs including gauging what are the elements that effect tax evasion by SMEs in Malaysia.

Question 1.1

**To what extent do you agree with the following statements about tax evasion?
Please tick the appropriate box for each statement.**

	Strongly disagree	Disagree	Uncertain	Agree	Strongly agree
	1	2	3	4	5
Tax evasion is common in Malaysia	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Tax evasion is a fraud that is committed against the government	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Tax evasion is justified if the tax system is unfair	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
There is nothing morally wrong with paying less than the proper amount (amount that one ought to pay according to the law)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Tax evasion is a special form of gambling: gambling for extra income in light of the likelihood of detection and the imposition of penalties.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....					
.....					

Question 1.2

The following is a list of some of the main factors why SMEs *do not pay* the right amount of tax. Please *tick one factor* which you think is the most important factor.

- The burden of paying tax is too great.
- They think everyone else fiddles their tax.
- Inefficiency of tax administration
- Complication of Malaysian Income Tax Law
- The tax system is unfair
- Other (please specify)

.....

Question 1.3

The following is a list of some of the main factors why SMEs *do pay* the right amount of tax. Please *tick one factor* which you think is most important factor.

- The threat of fine/penalties
- The threat of being caught
- To avoid audit/investigation by IRB
- They think other people are honest in paying tax.
- They believe in paying their fair share
- Other (please specify)

.....

**TEXT BOUND
INTO
THE SPINE**

Question 1.4

Which of the following business practices would you regard as morally acceptable?

Please indicate 1 for not at all acceptable ... 5 for perfectly acceptable.

(Tick the appropriate box)

	Not at all acceptable				Perfectly acceptable
	1	2	3	4	5
Not filing in tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Not reporting all business income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Reporting main income, but not some other income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Overstating business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Being paid in cash for a job and not reporting it on tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Non disclosure of fact to the tax agent	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Writing off personal expenses as business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Question 1.5

**In your opinion what proportion of SMEs do the following?
Please tick the appropriate box.**

	None	Few	Half	Most	All
Not filing in tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Not reporting all business income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Reporting main income, but not some other income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Overstating business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Being paid in cash for a job and not reporting it on tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Non disclosure of fact to the tax agent	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Writing off personal expenses as business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Question 1.5

**In your opinion what proportion of SMEs do the following?
Please tick the appropriate box.**

	None	Few	Half	Most	All
Not filing in tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Not reporting all business income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Reporting main income, but not some other income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Overstating business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Being paid in cash for a job and not reporting it on tax returns	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Non disclosure of fact to the tax agent	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Writing off personal expenses as business expenses	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....					
.....					
Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....					
.....					

Question 1.6

**In your opinion, to what extent (in percentage), if any, do you think that SMEs are evading taxes.
Please tick the appropriate box.**

- None**
- Less than 25% of SMEs**
- Between 25% to 50% of SMEs**
- Between 50% to 75% of SMEs**
- More than 75% of SMEs**

Please explain briefly if possible:

Question 1.7

**In your opinion, to what extent (in percentage), if any, do you think tax evading SMEs are caught by the IRB.
Please tick the appropriate box.**

- None**
- Less than 25%**
- Between 25% to 50%**
- Between 50% to 75%**
- More than 75%**

Please explain briefly if possible:

Question 1.8

In your opinion, which is the most likely period in which SMEs will evade taxes? Please *tick one period* which you think is the most common period that SMEs will evade taxes.

- Early stage of the business
- In a period of high inflation
- The period of economic boom
- The period of economic downturn
- All the time
- Other (please specify)

.....

Please explain briefly if possible:

Question 1.9

The following are the methods for generating tax evaded income in SMEs. Please *tick one method* which you think is the most frequently used in generating tax evaded income in SMEs in Malaysia.

- Complete suppression of gross profit
- Understatement of gross profit
- Overstatement of expenses
(other than cost of goods sold)
- Understatement of assets (including
property and inventories)
- Other (please specify)

.....
.....

Please explain briefly if possible:

Question 1.10

Please indicate three (3) methods which in your opinion might help to deter tax evasion by SMEs and briefly explain your choice.

1) Method one and briefly explain your choice:

2) Method two and briefly explain your choice:

3) Method three and briefly explain your choice:

If you have not answered the above question please tick the appropriate box:

No opinion

Other (please specify)

PART II: YOU AND YOUR SME

Question 2.1

Who keeps the accounting records/books of your business? Please tick the appropriate box.

- Self
 - Spouse/partner
 - Friends
 - Employee
 - Accountant/Tax Practitioner
 - Not Applicable Please explain briefly
 - Other (please specify)
-

Question 2.2

Who deals with tax matters for your business? Please tick the appropriate box.

- Self
 - Spouse/partner
 - Friends
 - Employee
 - Accountant/Tax Practitioner
 - Not Applicable Please explain briefly
 - Other (please specify)
-

Question 2.3

Have you ever switched accountant/tax practitioner in dealing with your tax matters? Please tick the appropriate box.

Yes

No

Prefer not to reply

Not applicable

Please explain briefly if possible:

Question 2.4

Imagine yourself in this situation:

You have been paid RM100,000 cash for work that you have done outside your regular job. Please tick the appropriate action that you will take.

Not declare it

Declare only a portion of it

Declare it in the most advantageous manner within the law

Declare it but offset it either by understatement of gross profit or overstatement of expenses so as to pay less tax

Other (please specify)

.....

Question 2.5

Do you think SMEs/taxpayers for whatever reasons, ever accidentally or deliberately understate their profit and pay less income tax than they should. *Please tick the appropriate box.*

Yes

No

Go to Question 2.6

Prefer not to reply

Go to Question 2.6

If you have answered 'Yes', to what extent (in percentage) do you think, SMEs are involved?
Please tick the appropriate box.

Accidentally
understate

Deliberately
understate

Less than 10% of SMEs

Between 10% to 25% of SMEs

Between 25% to 50% of SMEs

Between 50% to 75% of SMES

More than 75% of SMEs

Please explain briefly if possible and outline the approaches commonly used:

Question 2.6

Do you think SMEs/ taxpayers for whatever reasons, ever accidentally or deliberately overstate their profit and pay more tax than they should. Please tick the appropriate box.

Yes

No

Go to Question 2.7

Prefer not to reply

Go to Question 2.7

If you have answered 'Yes', to what extent (in percentage) do you think, SMEs are involved? Please tick the appropriate box.

Accidentally
overstate

Deliberately
overstate

Less than 10% of SMEs

Between 10% to 25% of SMEs

Between 25% to 50% of SMEs

Between 50% to 75% of SMES

More than 75% of SMEs

Please explain briefly if possible and outline the approaches commonly used:

Question 2.7

Do you have any other interest in other SME businesses (associate, subsidiary or wholly owned company including sole proprietorship, partnership etc.) Please tick the appropriate box.

- Yes**
- No** Go to Question 2.9
- Prefer not to reply** Go to Question 2.9

Question 2.8

Please indicate the number of business that you have an interest in either through direct or indirect shareholding including sole proprietorship, partnership etc. Please tick the appropriate box.

- Less than 5**
- 6 to 10**
- More than 10**
- Prefer not to reply**

Question 2.9

Have you any dealings with tax haven countries? (For example banking facilities etc.) Please tick the appropriate box.

- Yes**
- No**
- Prefer not to reply**

Question 2.10

Have you been audited/investigated by the IRB in the last 10 years?

- Yes**
- No**
- Prefer not to reply**

PART III: PARTICULARS OF RESPONDENT

Some personal information to help in classifying your response. Please tick the appropriate box.

Question 3.1 Business category:

- Sole proprietorship/Self employed
- Partnership
- Limited Company (Sdn. Bhd)
- Other (please specify)
.....

Question 3.2 Number of Employee

- Less than 25
- Between 25 to 50
- Between 50 to 75
- Between 75 to 100
- More than 100

Question 3.3 Average Turnover Per Year

- Less than RM5 million
- Between RM5 million to RM10 million
- Between RM10 million to RM15 million
- Between RM15 million to RM25 million

Question 3.4 Ethnicity:

- Malay
- Chinese
- Indian
- Others(please specify)
.....

Question 3.5 Gender:

- Male
- Female

Question 3.6 Age:

- 20 years and below
- 21 to 30 years
- 31 to 40 years
- 41 to 50 years
- 50 years and above

Question 3.7 Highest level of education

- Primary School
- SPM or PMR
- STPM or Diploma
- First degree and above
- Other (please specify)
.....

Question 3.8 Profession:

Professional (self employed/
Sole proprietorship)

Partner in a partnership firm

Company Director

Employee

Other (please specify)

.....

Question 3.9 Location:

West Malaysia

Western Region(KL,Selangor)

Eastern Region(Pahang, Terengganu,
Kelantan)

Northern Region(Perlis, Kedah,
Pulau Pinang, Perak)

Southern Region(N. Sembilan, Melaka,
Johor)

East Malaysia

Sabah

Sarawak

Question 3.8 Profession:

Professional (self employed/
Sole proprietorship)

Partner in a partnership firm

Company Director

Employee

Other (please specify)

.....

Question 3.9 Location:

West Malaysia

Western Region(KL,Selangor)

Eastern Region(Pahang, Terengganu,
Kelantan)

Northern Region(Perlis, Kedah,
Pulau Pinang, Perak)

Southern Region(N. Sembilan, Melaka,
Johor)

East Malaysia

Sabah

Sarawak

PART IV: GENERAL OPINIONS

If you have any opinions or ideas about tax evasion by SMEs and the role of forensic accounting techniques that have not been covered in this survey, please can you explain further.

[Forensic accounting is the application of financial skill and an investigative mentality, conducted within the context of rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a strong knowledge and understanding of business reality and the working of the legal system. According to some of its advocates it looks beyonds the numbers and deals with the business reality of the situation.]

**THANK YOU VERY MUCH FOR YOUR COOPERATION - IT IS MUCH APPRECIATED
PLEASE RETURN THE QUESTIONNAIRE IN THE ENVELOPE PROVIDED AS SOON AS POSSIBLE
OR NOT LATER THAN 10 MAY 2003**

FOR DATA ANALYSIS USE ONLY:

DATE REPLY RECEIVED

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REPLY NUMBER

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APPENDIX III
PREDESIGN TABULATED FORMAT SHEET
(FOR FILE DATA ANALYSIS)

NOTE TO DATA COLLECTION: FILE REVIEW.

As to ensure a systematic data gathering the following abbreviation is to be used in carrying out the document analysis.

HEADINGS	PARTICULARS
No.	Listing the numbers of document/file analysed.
Master Register Number (MR. No.)	A register where the sample will be base. The name of the SMEs will be replaced with the MR. No. as to camouflage the SMEs selected for the review inline with the secrecy provision of the Income Tax Act.
Business Category/ Principle Activity	<p>SMEs categorised within the research.</p> <p><i>To indicate in the column with the number provided: For example if the sample is small limited company then the code will be 5.</i></p> <ol style="list-style-type: none"> 1. Director 2. Management of SME 3. Sole proprietor/Self Employed 4. Partnership 5. Small limited company [Sdn Bhd] <p>Plus to fill in the nature of business e.g. grocery, stall trader etc.</p>
Year of investigation	List the year the case is investigated.
A:	<p>Methods of evasion used by the taxpayers:</p> <p><i>Fill in the column with the number provided. For example if the method used is understatement of gross profit by using fictitious purchases then the code will be 2:A.a</i></p> <ol style="list-style-type: none"> 1: Complete suppression of gross profit 2: Understatement of gross profit <p>A: Purchases</p> <ol style="list-style-type: none"> a. Fictitious purchases possibly supported by false invoices b. Inflated invoices covering an element of personal drawings c. Ante-dated purchases d. Private expenditure included in purchases e. Capital expenditure included in purchases f. Excessive reserves for liability g. Omitted rebates or allowances h. Lump-sum additions to total purchases

i. Others

B: Sales

- a. Omitted cash sales
- b. Omitted cash sales cheques received are paid into private accounts
- c. Sales cancelled by means of false credits notes or false written off as bad debts
- d. Post dated sales
- e. Under valuation or omission of debtors
- f. Lump sum deduction from total sales
- g. Omission of bad debts recovered
- h. Others

3: Overstatement of expenses (other than cost of goods sold)

A: Expenses

- a. Private expenditure included in expenses account
- b. Capital expenditure included in repairs
- c. Excessive reserves for liabilities
- d. Expenditure not allowed for Income Tax Purposes concealed
- e. Over statement of expenses by means of dummy or fraudulent vouchers
- f. Others

B: Wages

- a. False statements of wages in respect of particular workmen
- b. Dummy workers
- c. Personal staffs paid through the business and included in wages book e.g. domestic staff, gardener.
- d. Proprietor's drawings included in wages
- e. Others.

4: Understatement/overstatement of assets (including property and inventories) /liabilities

A. Creditors

B. Debtors

C. Cash/Bank Balances

D. Work in progress

E. Stock

F. Other

5: Other

B:	Methods used by the Revenue in settling the cases: <i>To indicate in the column with the number provided:</i> 1. Capital Statement 2. Account/Examination of books 3. Others
C:	Methods used in analysing the cases before/during Investigation. <i>To indicate in the column with the number provided</i> 1. Ratio Analysis/Analytical Review 2. Third party's information 3. Intelligence information gathering 4. Others
D:	Attitude and behaviour <i>To indicate in the column with the number provided:</i> 1. Innocent error or mistake Unintentional evasion due to technical or ruling interpretation. 2. Negligence or culpable carelessness Cases where a statement of income whether on a statutory return form, a non statutory form or in the form of an account sent to the Revenue is found to contain some error or omission whereby a loss of tax has occurred. 3. Deliberate evasion Ignorance of the law as to mislead the Revenue.
E:	Total amount of tax loss and penalties recovered
NOTES/ COMMENTS	Important points to ponder.

APPENDIX IV
PRO FORMA QUESTIONS FOR IRB OFFICERS

TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING: A MALAYSIAN PERSPECTIVE

Pro forma questions for IRB officers.

A: General View on Tax Evasion and SMEs

The focal arguments on tax evasion in developing countries in most literatures view the following as the major handicaps to the tax authority in its attempt to deter tax evasion.

- Incompetent, corrupt and inadequately staffed tax administration set-up
- A legal system that is both unable and unwilling to enforce the penal and civil provision of the prevailing tax code
- Poor information gathering and processing technology beset by weak accounting practices.
- A high tax rate with a graduated schedule which adds impetus to evasion practices

Q1. Can you briefly explain the overall context – the key problems or issues to address - with regard to the above in relation to tax evasion in the SMEs sector in Malaysia?

Q2. In your opinion, why is the SMEs sector regarded as the sector with the highest rate incidence of tax evasion?

B: Practical Overview

It is recognised that different governments give different emphasis to tax evasion. The purpose of the following questions is to obtain an overall understanding of the tools and practices framework. A comprehensive view may not be possible in all cases. Nevertheless, it is hoped that the interviewee can provide an indication of overall emphases and recent trends.

Q3. What kinds of tools are being predominantly used, and how are they being used.

3.1 For detecting?

3.2 Information gathering and processing / Intelligence work?

3.3 Settling the cases?

3.4 Are new tools being added to complement the old?

3.5 Are new tools replacing old tools?

Q4. In practice, competence in terms of knowledge and skills required for the efficiency and effectiveness in detecting tax evasion. What actions have been taken by IRB to facilitate and increase the officers' competence? Briefly explain in the following context:

- Qualification and experience of existing staff
- Use of external expertise(consultant)
- Information support adequacy
- Training program
- Other

Q5. The type and extent of evasion varies from case to case to such an extent that the scope of enquiry work is largely unique in each case especially in dealing with the SME cases. Can you briefly explain what are the characteristic and factors affecting it?

Q6. In what circumstances do you think SMEs will evade tax and what are the most common methods used to evade taxes?

Q7. Is the tax authority ready to implement criminal investigation as opposed to the current civil system? How will this help in deterring tax evasion by SMEs?

C: Forensic Accounting

Forensic accounting is the application of financial skill and an investigative mentality, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a strong knowledge and understanding of business reality and the working of the legal system. According to some of its advocates it looks beyond the numbers and deals with the business reality of the situation.

Q8. What is your understanding of forensic accounting?

Q9. Briefly explain the techniques or methods of working (detecting and settling) especially in dealing with SMEs cases?

Q10. In your opinion is there a better way to detect tax evasion by SME than forensic accounting techniques?

D: Recommendation

Q11. What improvements would you like to see?

- **Structure (organisational positing etc.)**
- **Process (technique etc.)**
- **Competence (skill deficiencies, training needs etc.)**
- **Other?**

APPENDIX V
A COVER LETTER FROM SUPERVISOR
SUPPORTING THE RESEARCH

12 February 2003

To Whom It May Concern

**QUESTIONNAIRE SURVEY
TAX EVASION BY SMEs AND THE ROLE OF FORENSIC ACCOUNTING:
A MALAYSIAN PERSPECTIVE**

Mr. Nik Abdullah Sani b. Nik Mohamed is currently a candidate in the Doctoral Studies Program in the Division of Accountancy and Finance, School of Management and Languages at Heriot-Watt University, Edinburgh, UK. He is in the middle of conducting a research survey, investigating the scope and significance of tax evasion and forensic accounting in Malaysia.

The respondents for the survey questionnaire include SMEs, taxpayers and tax practitioners. Your cooperation is requested to assist him in gathering information and data required for the research. The information provided is very much needed in order for him to complete his research. The results of the survey will provide valuable information and added knowledge about the phenomenon of tax evasion by SMEs and the role of forensic accounting especially in Malaysia.

I hope that you will take the time to complete the enclose questionnaire. I thank you for your cooperation.

Yours Sincerely,



**Professor C L Marston BSc MAcc PhD FCA CTA
Professor of Accountancy**