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## An Exploratory Study Of Malaysian Tax Auditors' Enforcement Regulatory Styles

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### Abstract

Since the implementation of the self-assessment system in 2001, tax audit has become a major compliance program used by the Inland Revenue Board of Malaysia (IRBM). From 2002 to 2010, the IRBM finalised 4,486,946 audit cases and collected RM11,050.3 million of additional taxes and penalties (IRBM, 2002–2010). However, the public often conveys frustrations when dealing with the IRBM auditors. Tax agents perceive that IRBM auditors have the intention or aim of finding fault in order to impose penalties for incorrect returns or understated income, were not happy with taxpayers' explanations, abused their power by issuing additional tax assessments, and closed cases without being able to explain their reasons to taxpayers (Choong and Lai, 2009; Choong *et al.*, 2012). However, there is no published study on IRBM auditors in conducting audit programs and communicating with the public. This study explores the IRBM auditors' enforcement regulatory styles. It adopts grounded theory methodology, which analyses tax auditors' actual beliefs and experiences in resolving audit settlement disputes. Consistent with enforcement regulatory theory, the analysis of data shows that tax auditors apply different enforcement regulatory styles—firm, explain and educate, bargaining and threatening. This study also has identified 'avoiding' as tax auditors' enforcement regulatory style when dealing with the public. The results of this study further the call for more studies on tax auditors' behaviour because their behaviour is so intimately intertwined with taxpayers' compliance and tax administration efficiency.

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### 1. Introduction

Tax auditors are a tax authority's 'public face' (OECD, 2006). They are the ones who implement the audit policy, interact with the different behaviours of taxpayers and determine audit outcomes (Bahl and Bird, 2008; Long and Swingen, 1991). They possess a great deal of discretionary power; in many instances, tax auditors are in effect prosecutor, judge and jury in tax assessments matters (Roberts, 1995). Tax auditors' tasks might become complicated when audit issues encroach on the grey area separating evasion and acceptable tax avoidance—for example, the issue of transfer pricing (Reynolds, 2007) and lack of audit evidence due to a paperless system (Gilbert *et al.*, 2001). These issues require tax auditors to understand

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taxpayers' business intentions and use suitable audit strategies in determining the correct amount of tax. In Malaysia, the public often conveys frustrations when dealing with Inland Revenue Board of Malaysia (IRBM) auditors.

## 2. Review of Literature

### 2.1 *The public's perceptions of the IRBM auditors*

In regular meetings between the IRBM and members of the Chartered Tax Institute Malaysia (CTIM), the CTIM made several complaints to the IRBM regarding its auditors (CTIM, 2003). The CTIM claimed that the audit process conducted by the IRBM auditors lacks transparency and consistency. Moreover, the CTIM perceived that the IRBM's tax auditors do not carry out tax audits in a professional manner, adopt different treatments for the same subject matter, refuse to accept commercial justification even when supporting documents are provided, lack accounting and business knowledge, and are unable to provide convincing rationale for tax audit adjustments (CTIM, 2003). Findings from empirical studies by Choong and Lai, 2009, and Choong *et al.*, 2012, supported the CTIM's complaints. They found that tax agents felt the tax audit process took too long to finalise. The main problems faced by tax agents were that tax auditors were not happy with taxpayers' explanations and that taxpayers had to provide tax auditors with various documents that were not used or reviewed. Tax agents believed that tax auditors intend to find fault to impose penalties for incorrect returns or understatements of income during the tax audit. The studies also reveal several tax audit weaknesses, particularly regarding the tax audit approach, audit processes and tax auditors' competency and mentality (Choong *et al.*, 2012; Choong and Lai, 2009).

A study by Isa and Pope, 2011, found that corporate taxpayers perceived IRBM tax auditors as being more interested in finding fault and penalising a company for wrongdoing than helping them comply with tax law. Complaints from the public and negative perceptions of Malaysian tax auditors signify that it is imperative for the IRBM to address issues regarding tax auditors' efficiency to gain the public's respect and confidence. One particular aspect that needs attention is tax auditors' enforcement regulatory behaviour, which this study aims to explore.

### 2.2 *Enforcement regulatory styles*

Enforcement regulatory style can be defined as the general approach assumed by enforcement officials in the course of performing their regulatory duties (Bardach and Kagan, 1982; Hawkins, 1984; Reiss, 1984). Originally, two major styles were discerned: legalistic (also sometimes called deterrence); and conciliatory (sometimes called cooperation) (Kagan, 1994; Reiss, 1984). The legalistic style is based on coercion and compulsion and is concerned primarily with the application of punishment for breaking a rule and doing harm (Bardach and Kagan, 1982; Hawkins and Thomas 1984). The punishment acts to deter regulatees from violating the law (Becker, 1986; Gunningham, 1987; Kagan, 1994). In contrast, the conciliatory style relies primarily on techniques of education, advice, persuasion and negotiation (Hawkins, 1984; Hutter, 1989). It is fostered when the agent and the regulatee understand each other better and work together towards compliance. This suggests a role for agent discretion and using persuasive methods rather than sanctions (Kagan and Scholz, 1984; Reiss, 1984). Early research largely followed this dichotomy.

However, in reality, approaches to enforcement are far more subtle, with enforcement styles being mixed and multifaceted. A closer inspection reveals several underlying elements that combine to become enforcement styles (Ayres and Braithwaite, 1992; Kagan, 1994; May and Winter, 1999). Hence, the newer scholarship addressing enforcers' behaviour pays attention to different modes of public action at the front lines of service delivery. Scholars argue that auditors often make choices on the spot about the best mode of action

to produce the desired set of behaviours from a target individual or group (May and Wood, 2003). Lo *et al.*'s (2009) analysis of enforcement regulatory literature yields five major enforcement style elements:

- *Formalism*. This element refers to adhering to rather rigid legal requirements and can be expressed through firm implementation deadlines, specific environmental standards linked to clear penalties and a reluctance to consider mitigating circumstances (i.e., cost–benefit considerations) (Braithwaite *et al.*, 1987; Gormley, 1998; Hawkins, 1984; Kagan, 1994).
- *Coercion*. This element stresses the force of law, and is manifested in a strong propensity to impose—or signal the imposition—of non-compliance sanctions (Hawkins, 1984).
- *Education*. This element emphasises the law's communicative function, seeing the potential for using education of regulated enterprises and the public as a means to inculcate responsible behaviour (Kagan and Scholz, 1984; May and Winter, 1999; Scholz and Gray, 1997).
- *Prioritisation*. This element indicates pragmatic enforcement that tries to obtain the most effective result within the given contextual constraints and while reconsidering the circumstances. Such enforcement requires prioritising regulatees and violations that inform the use of scarce enforcement resources (Bardach and Kagan, 1982; Gray and Scholz, 1991; May and Winter, 1999).
- *Accommodation*. This element emphasises reconciling the demands of key stakeholders in enforcement regulation. In doing so, enforcement agents consider the opinions of, for instance, political leaders and their constituencies (Frank and Lombness, 1988; Hutter, 1989; Scholz *et al.*, 1991; Wood, 1988; Wood and Waterman, 1991).

In their purest form, none of these style elements is likely to be effective on its own, as each have advantages and limitations. Enforcement regulatory styles are also difficult to control because they are multidimensional (Gormley, 1998). For example, formalism allows for reducing discretionary administration in the interests of preventing corruption, enhancing deterrence, promoting equity or empowering the public (Bardach and Kagan, 1982; Gunningham *et al.*, 1992; Langbein, 2002), but can easily become counter-productive to the extent that it arouses hostility or otherwise frustrates cooperation (May and Winter, 1999). Further, an entirely persuasive approach is threatened by cooperation, overindulgence and amoral calculators who take advantage of leniency by breaking rules; an entirely deterrent approach can cause decreased involvement with regulation, inefficiency due to time-consuming lawsuits, deteriorating relationships between enforcers and the regulated, and withholding of information from the regulated (Bardach and Kagan, 1982; Hawkins, 1984; Potoski and Prakash, 2004; Vaughan, 1990). Therefore, enforcement style elements are neither mutually elusive nor independent. Regulators usually adopt a combination of elements to perform regulatory control.

### 3. Research Gaps and Aims

Despite of the public's negative perceptions, scholars have given little attention to IRBM auditors' behaviour, particularly their enforcement regulatory styles. Strict approaches might fail to deal with different compliance behaviour and tax administration complexity. Further, a bureaucratic and rigid application of procedures, regardless of circumstances, can lead to inefficiencies and taxpayer resistance (IRS, 2008). They should treat taxpayers respectfully and courteously, work to achieve favourable outcomes and remain neutral in decision making to ensure they are fair and promote future compliance (Stalans and Lind, 1997). However, there is no published study on IRBM auditors' enforcement regulatory styles. Studies on tax auditors' enforcement regulatory styles are extremely important to deal with any disputes over tax liability fairly, efficiently and quickly and to ascertain if an assessment is correct and practicable (Mann, 2005). Hence, this study aims to explore the IRBM auditors' enforcement regulatory styles.

#### 4. Research Methodology

This study adopts a qualitative grounded theory methodology by Glaser, 1998, and Strauss and Corbin, 1990. Grounded theory relies on the people in a particular environment to explain what is happening to them instead of the researcher assuming that they know what is or 'ought to' be happening (Glaser, 1978, p. 11). Grounded theory is best adopted for this study, since it is exploratory in nature and there is little existing literature on the study's topic (Bouma and Ling, 2004; Charmaz, 2006).

The researcher conducted in-depth interviews with 49 IRBM tax auditors that explored their enforcement regulatory styles in resolving audit settlement disputes, reasoning and underpinning beliefs. The interview data were analysed using constant comparison method, which is a continuous process of identifying conceptual categories and their properties emerging from data by consistent comparison of that data. The researcher had to be sensitive, which means identifying what data is significant and assigning it a meaning. In this study, sensitivity came from the researcher's experience, the literature review and the interviewees' expressions, particularly in their repetition of the same phrases and concepts (Corbin and Strauss, 2008). Constant comparison method generates relationships, context and process, thus providing a theory that was much more than a descriptive account (Morse and Richards, 2002). The process of the data driving the theory is referred to by Glaser and Strauss (1967) as 'grounding' the theory in the data. Due to this continual 'grounding' process, the theory accurately reflects the data. The theory is not necessarily intended to stand alone, but could be related to existing theories within a field, thus—in this case—amplifying and extending current understanding of tax auditors' behaviour. To ascertain the theory, the researcher re-interviewed 15 tax auditors. No new categories emerged in the second round of interviews, indicating that the tax auditors' enforcement regulatory style is consistent with the theory.

#### 5. Findings

The analysis of findings shows that the tax auditors, as regulator enforcers, use several enforcement regulatory enforcement styles. Five enforcement regulatory styles were identified: explaining and educating; bargaining; firm enforcement; threatening; and avoiding.

##### 5.1 Explaining and educating

Explaining and educating was the prominent interaction strategy adopted by tax auditors to resolve disputes. Unlike tax investigators, who aimed to penalise non-compliant taxpayers, tax auditors aimed to educate taxpayers to encourage future compliance. This enforcement style element emphasises the law's communicative function and sees the potential of using education of the public to inculcate behaviour that is more responsible (Kagan and Scholz, 1984; May and Winter, 1999; Scholz and Gray, 1997). Patience and understanding underpin the whole strategy, which is regarded as an open-ended and long-term venture. The strategy approximates Braithwaite *et al.*'s, 1987, notion of the Diagnostic Inspectorate.

This enforcement style is consistent with the IRBM's objective of implementing self-assessment to educate taxpayers. The majority of the tax auditors interviewed asserted that main compliance issue among sole proprietors was lack of tax and accounting knowledge. Sole proprietors with small turnover, such as fishmongers and food sellers, usually had lower education levels and did not understand their tax responsibilities. In resolving disputes with these taxpayers, the tax auditors had to educate them. They also needed to clarify the purpose of their audit activities to prevent taxpayers from feeling stressed and to avoid non-cooperation.

Further, some tax auditors perceived that some taxpayers were afraid of them. As an enforcement authority, tax auditors have the power to make audit decisions and penalise taxpayers. The tax auditors

believed that taxpayers were afraid the auditors would impose high taxes and penalties. To avoid negative perceptions, some tax auditors asserted that they followed the IRBM's objective of educating taxpayers and inculcating compliance.

### 5.2 Bargaining

The majority of the tax auditors asserted that some taxpayers were not concerned about the audit issues (i.e., accrual income methods and capital allowance). Instead, their main concern was the amount of tax—they wanted to pay less. Therefore, bargaining was a suitable strategy for enhancing the possibility of ending disputes, particularly resolving incomplete records cases. Bargaining also was a suitable strategy when all others failed to obtain taxpayers' cooperation and agreement.

Bargaining was adopted by the tax auditors to compromise and seek something for both sides. While tax auditors aimed to maintain their integrity by ensuring they were bargaining within tax law and that their decisions were supported by documentary evidence, taxpayers were concerned about their amount of tax. In bargaining, tax auditors normally set the 'best alternative to a negotiated agreement' (BATNA) (Fisher *et al.*, 1992), which is 'the bottom line' amount that tax auditors will accept during bargaining. In this way, bargaining becomes less crucial because tax auditors do not compromise on the amount below the recognised limit. Tax auditors also need to understand the law to build substantial arguments and assess the likely outcomes of a court hearing, the relevant precedents issues at hand and the availability of other external standards that can support their arguments.

### 5.3 Firm enforcement

Firm enforcement means that tax auditors strictly comply with the tax rules and audit framework or do not tolerate taxpayers' requests. The interviewed tax auditors adopted this strategy when they strongly believed (and had concrete evidence) that taxpayers did not comply with tax laws. It is based on coercion and compulsion, and is concerned primarily with the application of punishment for breaking a rule and doing harm (Bardach and Kagan, 1982; Hawkins and Thomas, 1984). Firm enforcement is expected to provide greater certainty for regulatees in terms of what they are expected to do (Hawkins, 1984; Hutter, 1997) and thus help bring about social motivation to comply (May and Winter, 2007). Stringency is also eminently reasonable when the provocation is serious (Gormley, 1998).

This strategy was also adopted when:

- Taxpayers and tax agents did not cooperate in settling disputes and closing cases. These actions delayed settling disputes and finalising cases. The tax auditors did not want to prolong settlement due to the pressure of closing cases within three months and achieving targets. Therefore, they were firm in their decisions.
- Taxpayers were audited for a second time. The tax auditors asserted that they should not tolerate re-audited taxpayers because the taxpayers should have learned from their mistakes and gained more knowledge, not only in good recordkeeping but also in accounting principles and tax laws. For example, they should know the different methods of income declaration for accounting and tax and for allowable and non-allowable expenses.

### 5.4 Threatening

Threatening is a strategy adopted by some tax auditors when they failed to end disputes through explaining and educating. Braithwaite *et al.*, 1987; Hutter, 1989; Burby and Paterson, 1993; Scholz and Gray, 1997, have

asserted that inspectors must use threats occasionally to be taken seriously and to give credibility and certainty to their expectations and the consequences of not meeting them. Tax auditors who adopted this strategy asserted that it was very effective for ending disputes with arrogant and non-cooperative taxpayers. Tax auditors threatened taxpayers by:

- informing them that more assessment years would be audited and they would have to pay more tax; or
- finalising audit cases without taxpayers' agreement, which means that taxpayers do not have the option to apply for instalment. Instalment is only given to taxpayers who agree and sign the audit outcomes. If taxpayers do not agree with the audit outcomes or sign the acceptance letter, they must pay the tax adjustment within 30 days after the additional tax notice has been issued.

### 5.5 Avoiding

When all the strategies adopted by tax auditors failed to end disputes with taxpayers, some tax auditors adopted the avoiding strategy. They avoided confronting with taxpayers; instead, they solicited help from colleagues or audit managers. This is based on two criteria:

- Ethnicity of taxpayers—some Chinese taxpayers do not speak English and Malay. In contrast, the majority of tax auditors are Malays. They do not speak or understand Mandarin and Cantonese. This makes it difficult for both parties to interact. Some of the interviewed tax auditors also believed that some of the Chinese taxpayers perceived them as having bad intentions towards them; conversely, some Chinese taxpayers believed that the auditors wanted them to pay a great deal of taxes. To avoid negative perceptions and ease communication with the Chinese taxpayers, some Malays tax auditors sought help from Chinese tax auditors.
- Taxpayers did not trust tax auditors' decisions—some taxpayers did not trust that tax auditors had conducted a proper audit process or made the correct decisions. When this happened, tax auditors solicited help from their audit managers to deal with taxpayers and close the audit cases. The interviewed tax auditors believed that when they audit managers interact with the taxpayers, disputes can easily be resolved.

## 6. Conclusions

This study sheds some light on Malaysian taxpayers' negative perceptions of tax auditors' behaviour. To say that Malaysian tax auditors are rigid and interested in finding fault is not entirely correct. This study shows that tax auditors adjust their behaviour according to the environment in which they work and the behaviour of the individuals with whom they work. Further, it would be incorrect to assume that tax auditors have fully internalised the legal framework that they have been hired to apply and enforce. They are people, and they are taxpayers, like anyone else. To lose sight of the emotional side of audit work would be to overlook an important aspect of the field audit process (Pentland and Carlile, 1996).

Consistent with enforcement regulatory literature, this study found that tax auditors apply different styles when dealing with the public. They do not use only one enforcement style, but frequently change their approach. Some tax auditors started with a firm enforcement style and then changed to a bargaining style. Firm enforcement sometimes failed to obtain taxpayers' agreement after several meetings. When the tax auditors were pressured by their managers to achieve targets and work through a backlog of cases, they changed their enforcement styles to bargaining (e.g., by eliminating insignificant audit issues or using other indirect income methods) to reduce taxpayers' tax.

This study also identifies a new enforcement regulatory style—avoiding. The data analysis shows that some tax auditors were unable to resolve disputes and finalise cases despite using different enforcement regulatory styles when dealing with the public. Due to the pressure of finalising audit cases, their main responsibility, tax auditors sought help from other auditors or managers. This shows that enforcers do not

always resolve cases themselves. They need support from others, particularly when they fail to deal with regulatees by themselves.

Tax auditors' behaviour and decisions reflect how tax law is actually implemented. The effectiveness of tax audit programs depends as much or more on tax auditors' actions and reactions to the actual tax audit environment (Bahl and Bird, 2008; Long and Swingen, 1991). Further, procedural justice theory suggests that taxpayers comply willingly if tax officials treat them in a respectful and fair manner (Tyler and Smith, 1998). Hence, there is a need for further research to confirm the findings and extend the investigation of tax auditors' behaviour to other tax audit sections or other jurisdictions.

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