

# CHAPTER 1

## INTRODUCTION

### 1.1 Background of the Study

Malaysia has been known to have a tax system introduced by early Malay rulers as early as before the year 1910 (Kasipillai, J., & Shanmugam, M, 1995). Since then, the tax system was improved and became complete and comprehensive until the present day. When Malaysia has achieved its independence on 31st August 1957, the Customs and Excise Department was reshuffled to meet the needs of an independent Malaya. Customs and Excise Department administration was assigned under the Ministry of Finance and led by a Customs and Excise Comptroller the Finance Minister.

In 1972, a revenue legislation called the Sales Tax Act 1972 was declared in the Government Gazette as Malaysia Law Act 64 and implemented on 29th February 1972. This tax, known as Sales Tax, was imposed on all imported and local products, except those exempted under Sales Tax (Exemption) Order 1972, or were produced by manufacturers exempted from being licensed under Sales Tax (Licence Exemption) Order 1972. Accordingly, in 1975, the Government introduced yet another law called the Service Tax Act 1975. This enabled the Department to collect service tax from business premises that provided services and goods which were taxed under the Second Schedule, Service Tax Regulations, 1975.

On 1st April 2015, Goods and Services Tax (GST) has been introduced by the Malaysian government to enhance the efficiency and effectiveness of the existing taxation system. However, on the 1<sup>st</sup> September 2018, the government reinstated Sales

Tax and Services Tax (SST) to replace GST which was abolished. SST consists of two separate taxes governed by different measures namely Sales Tax Act 2018 and Services Tax Act 2018. It is to minimize inherent weaknesses associated with the previous SST and to increase tax efficiency.

## **1.2 Royal Malaysian Customs Department (RMCD)**

In Malaysia, the tax system can be divided into two categories, which are direct taxes and indirect taxes. Direct taxes such as income tax, real property gains tax and petroleum income tax have been administered by Malaysia Inland Revenue Board, whereas tax authority Royal Malaysian Customs Department (RMCD) has administered indirect taxes such as Sales and Services Tax (SST) and customs duties.

The RMCD is an organization responsible for collecting revenue and facilitating trade through the enforcement and compliance of the law. The RMCD has several divisions and each division has different types of roles to manage indirect taxes, enforcement, audit compliance and management. These departments are Customs Division, Sales and Services Tax (SST) Division, Enforcement Division, Compliance Division, Management Services & Human Resources Division.

The responsibility of the Compliance Division in the RMCD is to plan and conduct a systematic audit of the licensees/importers, to ensure that the tax/customs duties are collected accurately and to provide advice regarding customs matters. The main responsibilities of the Compliance Department are planning and performing systematic, efficient and effective audits on the registrants and businesses, as well as ensuring that the customs duties and taxes are collected accurately with the detection and prevention of potential fraud, tax evasion and tax avoidance.

Tax auditors in the RMCD are assigned in the Compliance Division. It is aligned with the main responsibility of the division, which is to perform tax audit. Data from January to December 2019 have shown that the RMCD at present has about 500 tax auditors from several different grades and ranks.

### **1.2.1 Tax Audit in RMCD**

According to OECD (2006), tax audit is a way to detect non-compliance and to assess compliance in an organization. It is carried out to ensure that information contained in the tax return is accurate and according to the tax laws and regulations (Enofe et al., 2020). In ensuring the compliance with the rules, RMCD prepares the framework to ensure that the auditing tasks can be performed in a systematic, transparent, and fair manners to the auditees. The purposes of the tax audit in RMCD are to assess the level of compliance, provide advice and guidance to auditees and ensure that the tax has been paid correctly.

The management has set the Key Performance Indicators (KPIs) for every tax auditor to perform two full tax audits every month and two verification audits per month. In 2017, every tax auditor must serve at least fifteen verification GST audits per month, and in the year 2018 and above, SST audits must be performed on at least two files each month.

Standard Operating Procedures (SOP) prevent any tax auditors from performing any field audit without a member of the staff accompanying them. It is prohibited to visit the auditees' premises by the auditor himself or herself. The completion period of an audit depends on the records' completeness and auditee's cooperation. A tax audit can be evaluated up to six years from the date on which the tax was due and payable.

However, the time limit does not apply to fraud cases.

### 1.2.2 RMCD as Collector for Government Revenue

The government of Malaysia has collected income revenue through taxation to finance government expenditure and boost the country's economic development (Asmuni et al., 2017). The revenue collected is also used to lessen the inequality of the income groups in Malaysia. However, there are problems in managing income through taxation and these problems have always been researched for a few decades. Rahul, (2015) and Thaçi and Gërxhaliu, (2019) emphasized that an organized tax system requires both direct and indirect taxes. It is essential for a country as it is linked to the overall economy. As such Malaysia has a good taxation system because it has both direct and indirect taxes.

Malaysia's federal government's total revenue can be seen in Table 1 (Ministry of Finance Malaysia, 2019). It shows that direct tax is the main source of federal government's revenue whereas the percentage of more than 50% is from the total revenue. Nonetheless, the indirect tax in 2019 has seen a drop of 1.8% due to the implementation of a new tax regime which is Sales and Services Tax (SST).

**Table 1.1:** Total Revenue of the Federal Government of Malaysia 2018 & 2019

Classification of Revenue	2018		2019	
	Amount (RM million)	Percentage %	Amount (RM million)	Percentage %
<b>Tax Revenue</b>	174,700	73.9%	176,152	67.3%
-Direct Tax	133,474	56.4%	135,068	51.6%
-Indirect Tax	41,226	17.5%	41,084	15.7%
<b>Non-Tax Revenue</b>	61,760	26.1%	85,662	32.7%
<b>TOTAL REVENUE</b>	236,460	100.0%	261,814	100.0%

Sources: (Ministry of Finance Malaysia, 2019)

The Malaysian government depends on the revenue to finance its expenditure and boost the country's economic development (Asmuni et al., 2017). Furthermore Ling et al. (2016) mentioned that most economic experts claimed that heavy dependence on a direct tax would have an adverse effect on the nation's financial position. As shown in the table 1, Malaysia heavily relies on the direct tax revenue which is more than 50% from the total revenue. Therefore, to sort out the imbalances, improving the indirect tax revenue collection seems to be an important study to enhance the country's revenue as mentioned by Rahul (2015) that direct and indirect taxes should be balanced with each other.

### 1.3 Problem Statement

KPMG Malaysia Fraud Bribery and Corruption Survey (2013) reported that Malaysian organizations in public and private sectors indicate that many respondents believe that the quantum of fraud has increased over the past three years and has become more sophisticated. According to Hashimzade et al. (2010) fraud action and non-compliance can be detected through auditing resources. There is always tax non-compliance existing, where it can jeopardize the government's revenue. Deloitte Malaysia (2017) stated that the Director-General of the RMCD was reported as saying that the government has lost more than RM100 million due to fraudulent claims. Thus, tax authorities will perform tax audit exercises through tax field audits, which is a common procedure to detect tax non-compliance (Ser, 2013).

Business that are reluctant to declare and to pay the required taxes may result to an increase in number the of tax avoidance, evasion, and fraud, that could lead to the revenue leakage of Malaysian government. To overcome the problem, RMCD has put the effort to increase the indirect tax collection by reducing the tax avoidance, evasion,

and fraud through the efficient performance of tax auditors in the tax audit process. One of the efforts is by setting high KPIs and targets by the RMCD's management for the tax auditors in performing tax audit. Hence, tax auditors need to be at the top of their performance. Since there are quite big number of businesses (registrants) under the RMCD authority, the difficulty of monitoring and auditing increases and the performance efficiency has become a crucial concern.

Public service officers need to deliver efficient and effective services through creative and innovative thinking. Thus, tax auditors play a critical role in the effectiveness of tax audits, and they have to ensure the success of the tax audit objectives (Nadiah et al., 2018).

Chaiwong (2012) named five factors that influenced the inefficiency of auditing programs by tax auditors. They are management's policy and encouragement, completeness of operating and information systems; understanding and acceptance from auditee, knowledge, skill, human relations; and relationships between the internal audit unit and other units.

Although the tax auditors play a critical role in educating the taxpayers on voluntarily compliance, studies focusing on the tax auditors' performance along with their efficiency and competency in their role are still limited, at least in specific for the case of RMCD.

The only study on the tax auditors' performance in Malaysia was conducted by Nadiah et al. (2017) who have researched on the factors that may influence the performance of tax auditors in IRBM. The factors include knowledge and understanding, skills, commitment, teamwork, organizational independence, achievement orientation, audit quality, sustainability, and innovation. Hence, a similar strand of study is also beneficial and important to be conducted from the RMCD

perspective to determine the factors that might influence the efficiency of tax audit specifically on indirect taxes.

#### **1.4 Research Objectives**

1. To identify factors influencing tax auditors' characteristics that affect the performance efficiency of tax audit.
2. To discover factors of auditees' attributes that affect the performance efficiency of tax audit in RMCD.
3. To determine factors of the organizational management of RMCD that affect the performance efficiency of tax audit.

#### **1.5 Research Questions**

1. What are the factors influencing tax auditors' characteristics that affect the performance efficiency of tax audit?
2. What are the factors of the auditees' attributes that affect the performance efficiency of tax audit in RMCD?
3. What are the factors of the organizational management of RMCD that affect the performance efficiency of tax audit by tax audit?

#### **1.6 Scope of Study**

This study focuses on the tax audit of indirect taxes in Malaysia. Therefore, the study is based on the perceptions of the RMCD's tax auditors in conducting the indirect tax audit on the taxpayers or businesses (auditees). According to the internal circular in RMCD, there are approximately 500 tax auditors in RMCD. The questionnaires are distributed to tax auditors in various RMCD stations across

Malaysia covering of large and small stations. The results of this study represent the whole issues on the performance of tax auditors in RMCD.

### **1.7 Significance of the Study**

The lack of study performed on the performance of the RMCD's tax auditors, has provide the opportunity of, this study is to address and explore the level of performance efficiency of RMCD's tax auditors on performing the tax audit and to identify the issues and aspects that affects their performance efficiency in general based on their perceptions as tax auditors.

By identifying factors affecting the performance efficiency of RMCD's tax auditors in conducting tax audit, it is expected that it would upgrade and improve their performance efficiency and would enhance the enforcement of the RMCD on the compliance of taxpayers and businesses with the laws and regulations and prevent leakage in the revenue of the government.

This study is significant to emphasize the decision and policy making by the management of RMCD to minimize the non-compliance of laws and regulations, and the evasion of tax by businesses or taxpayers; as well as to increase the government revenue. When tax auditors are efficient in performing tax audit, more taxpayers or businesses can be audited, and would increase the collection of government revenue. Overall, the revenue can be used to finance the expenditure that benefits the Malaysian citizens and to further spur the economy of the country.

## **1.8 Definition of Terms**

### **1.8.1 Tax Audit**

Tax audit is an examination of taxpayers' business records and financial activities to ensure that taxpayers have totalled their tax payable in accordance with the current tax laws and regulations (Isa and Pope, 2011). A tax audit is an inspection of whether or not a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations (OECD, 2006). According to the Inland Revenue Board Malaysia (IRBM), tax audit is a checking of taxpayer's business accounts and financial activities to discover that the taxes reported and paid are correct and are in compliance with the corresponding laws and regulations.

### **1.8.2 Tax Auditor**

In this thesis, the tax auditors refer to the officer employed in RMCD and who conduct tax audits for businesses. In this paper, the tax auditors comprise of the government auditors specifically those employed with the RMCD. They conduct tax audits for companies, especially those suspected of tax evasion or fraud. As mentioned earlier in this chapter, tax audit is an examination on the business records and financial activities of taxpayers to ensure that the amount of tax reported and paid is accurate with tax laws and regulations (Oyedokun, 2016).

### **1.8.3 Efficiency**

Efficiency is defined as doing something which takes the least amount of time, money, or effort (Goldsmith, 2012). Therefore, when something is efficient, it produces an outcome using as little time, material, effort, or energy as possible. In this

study, the study of performance efficiency of tax auditors refers to the achievement and completion of the targeted (KPI) audit tasks earlier or within the time given.

### **1.9 Organization of Thesis**

Focusing on the issue of the performance efficiency of the RMCD's tax auditor, this chapter discusses the background of the study, the emergence of the problems, the objectives and scope of this study. The following chapter, Chapter 2, will explain about the independent variables as well as the dimensions on each variable and its relationships with the independent variables. The hypotheses and the conceptual research framework will be developed in that chapter. Next, Chapter 3 will explain the research design, the population and sample, and how data would be collected for this study.

Furthermore, Chapter 4 will explain the analysis of the research findings from the data collection and the results. The last chapter which is Chapter 5 will discuss the recommendations, limitation of the study and directions for future research.