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Record keeping practices and tax compliance of SMEs[1]

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Abstract

This paper reports upon a research project which was designed to explore the relationship between the record keeping practices of small businesses[5] and their potential exposure to tax and related business compliance problems. It was hypothesised that these problems might include increased tax audit exposure (combined with the potential for adverse tax audit outcomes where record-keeping practices are poor), higher tax compliance costs, and greater liquidity and cash flow problems that cause difficulties in remitting taxes collected on behalf of the Australian Taxation Office (ATO) which can lead to business failure.

The paper examines these issues and suggests that although there are a number of links between small business record keeping practices and tax compliance issues, these links are neither as straightforward nor as strong as the initial hypotheses might have suggested. The research used a mixture of qualitative (focus group) and quantitative (survey) methodologies and involved more than 500 small business owners and managers, over 300 tax practitioners[6], and a small number of ATO auditors.

Overall, the
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seriously hampered. It is hypothesised that greater costs are likely to be incurred in preparation of materials, clarifying, locating and delivering information, and general stress on owners dealing with such issues. Taxation compliance is unlike other regulatory requirements as it is often thought to provide positive externalities to the business in the form of greater information and management control, thereby reducing the actual costs of compliance attributable to the tax system. The extent to which quality record keeping further reduces this cost is part of the focus of this study.

Liquidity issues

The failure to adequately manage cash flow as a result of poor record keeping has often been listed as a cause of small business failure. As long ago as the early 1930s, empirical research by Corstvet in the USA concluded that "inadequacy of records seems in all but the largest of businesses to be one contributing factor making toward failure" (1935, pp. 61-62). Similar conclusions have been derived more recently in Australia (see, for example, Productivity Commission, 2000). However, the importance of managing liquidity in a business extends beyond cash flow management, and encomp

The research used a mixture of qualitative and quantitative methodologies and involved tax practitioners, small business owners, and ATO auditors. The methodology that was originally proposed identified three distinct phases. The first phase was to comprise two focus groups of up to 12 tax practitioners in total, designed to obtain a practical benchmark for small business record keeping. It was proposed that phase two would consist of surveying small business clients of the focus group practitioners (8 from each practitioner, making 96 in total), in order to map the relationship between record keeping and compliance risk as perceived by both advisers and their clients. The third phase was to examine compliance risks from the ATO perspective, and ensure triangulation of the data, comparing the expectations of ATO officers, practitioners and small business taxpayers.

The original research design was altered as the project progressed as a result of both practical and theoretical constraints. The primary changes related to the data collection from practitioners and the sample selection of small businesses.

Following the first focus group, a necessary change in methodology was identified. It was decided that the second focus group would be replaced by a broader survey of practitioners. This change was made for a number of reasons. Firstly, the information from the first focus group was particularly comprehensive, providing useful background information for the project. However, the participant practitioners expressed a reluctance to offer clients for phase two, an important motivation for the focus group, because of client confidentiality. Secondly, while the information was useful as background information and provided the necessary practical insights for the project, the outcomes were not easily quantifiable.

As a result, it was decided to replace the second focus group of practitioners with a survey of 300 practitioners, drawn from the CPA Australia database.

As a flow-on effect, the small business sample, rather than being sourced from the lists of practitioners' clients, was accessed via a commercially available database. Consequently, the sample size of SMEs was increased from 96 to 500 to ensure reasonable population coverage.

The following paragraphs outline the research design more fully.

The Focus Groups

Focus group research is based on facilitating an organised discussion with a group of representative individuals. Discussion is used to bring out insights and understanding in ways which simple questionnaire items may not be able to tap. The focus groups served the additional purpose of acting as a 'cognitive laboratory' for the development of ideas and items for inclusion in the survey instruments in subsequent phases.

An initial focus group was conducted with accountants from a Sydney CPA discussion group. Its objectives were:

- To establish CPA practitioners views on the benchmarks that they considered appropriate for effective record-keeping practices for small business taxpayers;
- To identify their perceptions of the relationship between small business record-keeping and compliance risk (as evidenced by higher exposure to ATO audit, increased compliance costs, cash flow and liquidity problems, and any other compliance issce2O98 2604ac50.375 1124i8210.910.6.755r62va10272.10277 Tm(m)iti 10.98 0 0 1

- To provide information useful for the design of a survey instrument to be used with small business taxpayers who may be their clients (in Phase 2); and
- To enlist their help in identifying up to 100 small business taxpayers prepared to assist in the survey phase.

The focus group of eight participants covered issues relating to small business and tax agent concerns about record keeping requirements and practices. The information gained from this group was used to develop the practitioner and SME surveys.

The second focus group comprised eight officials from the ATO engaged in audit and SME tax compliance. Its objectives were:

- To establish the views of Tax Officers involved in SME and Cash Economy[8] compliance activities on the benchmarks that they consider appropriate for effective record-keeping practices for small business taxpayers;
- To identify their perceptions of the relationship between small business record-keeping and compliance risk (as evidenced by higher exposure to ATO audit, increased compliance costs, cash flow and liquidity problems, and any other compliance issues that may arise);
- To compare those views with the views of tax practitioners and small business taxpayers (which have been obtained through focus groups and by survey).

This focus group was conducted as the last phase in the project on 30 November 2004. The focus group was held at the ATO Hurstville office, and covered a range of questions regarding the ATO experience of SME record keeping and their opinions on the linkage between record keeping and compliance issues. The information which resulted from the group was then compared to that provided from other sources.

Each focus group used an external professional moderator to facilitate (but not dominate) discussion, and each was attended by two members of the research team. The Atax researchers acted primarily as observers in the process, although an opportunity was given for the research team to pose specific questions or make specific comments at the end 71.e8 0 0 10.98 142.92169 371.0604278 333.14093 Tw 10.98 0 0 10.98 3

The Mail Surveys

The mail survey methodology has been widely used in compliance costs and related studies. It is chosen primarily because it is the most cost-effective way of reaching a large number of targeted individuals residing in a wide geographical area. The research team was able to identify a stratified random sample of the population of both SMEs and practitioners. Further, respondents have the opportunity to complete the questionnaires at a time and place suitable to them, including access to historical information. There is also less risk of the interviewer/researcher influencing responses.

Questionnaire design and testing

The survey instruments were designed to meet the following objectives:

- User friendliness: The questions were kept short and language simple wherever possible to encourage legibility and maximise response rate.
- Administrative simplicity: A3 paper was folded to make an A4 booklet to minimise the amount of collating and stapling of the questionnaires. Data entry number boxes were employed to facilitate ease of data capture.
- Comprehensiveness: the number of questions was kept to a minimum to encourage responses. However, a larke

Respondents also had an opportunity to add any comments that they did not feel were otherwise covered in the survey, and to

Representativeness

One important aspect of survey methodology is to ensure, so far as possible, that those who respond to the survey (the effective sample) broadly reflect the categories of those taxpayers who were surveyed (the mail out sample). The SME survey was drawn from a commercia

  - the SME operating a cash business;
  - inconsistencies in financial performance between periods; and
  - adjustments to prior returns.
- Liquidity concerns around SMEs concentrated on general cash flow management. Most notably, the collection of taxes, which had to be remitted to the ATO at some point in the future, was causing major cash concerns. In particular, because of the unsophisticated nature of their record keeping, the taxes collected were being spent as business income, and when it came time to remit the money to the ATO, it wasn't available. The removal of Prescribed Payment System was a significant shock to many SMEs.

The issues raised above were subsequently incorporated, in an objective manner, into the relevant questionnaires, to test the validity of the opinions expressed.

Tax Officer Focus Group

The tax officer focus group aimed to canvas the opinions of tax officials who have routine contact with a variety of SMEs across Australia. In general the results confirmed those of both the previous focus group, and the surveys.

Some of the broad findings of the focus group included:

- Tax changes were just a small part of the compliance issues of small business. The tax officers considered that changes in workers compensation, superannuation etc were equally important in the additional compliance burdens they placed on small business. Further, tax changes such as the GST were seen as creating positive externalities (such as improved management control) to the business, which workers compensation and superannuation record keeping does not.
- According to the ATO officers, the most important factor in a record keeping system was its appropriateness to the business. The system required for effective record keeping depends on legal structure, business nature, number of transactions1.4l41 Tm(e, bu

- There was a perception that compliance costs have increased because of the increased audit activity. ATO officers indicated that, particularly since the introduction of the GST, the number of SME audits has been increasing rapidly. This results in further compliance costs imposed on small businesses as they need to spend time documenting and answering audit questions.
- The effect of poor record keeping on liquidity was considered to be felt throughs i

Almost 90% of respondents used either a computerised (65%), or partly com

all accounting reports. A chi-squared test revealed that this difference was not statistically significant (p = .808).

TABLE 4.2 PREPARATION OF ACCOUNTING REPORTS AND AUDIT EXPOSURE

	Cohort not audited (n=81)	Cohort exposed to audit (n=27)
Cash Statement	60%	88%
Profit and Loss	86%	92%
Balance Sheet	80%	92%
Debtors and Creditors	76%	88%

In further analysis it was identified that there was no relationship between the elements of the record keeping system (Question 16) and exposure to audit (p = .986). Further, the frequency of maintenance of such records was also proved to be not statistically significant.

When comparing what respondents viewed as the main reason for keeping records, those that had been audited were twice as likely (40% versus 20%) to view tax compliance as the main reason for record keeping. There was a statistically distinguishable difference (p = .000) between the top three reasons[12] for record keeping. This suggests that the threat of audit may not be enough to induce a change of behaviour. It is only once a business has actually been audited that the importance of tax requirements become apparent and behaviour changes.

The hypothesis of a link between record keeping and audit exposure is therefore not2072 Tm(yd11 explain the relatively small number of SMEs who experienced an amended assessment as a result of the audit.

Because of the low number of respondents with an amended assessment (n = 8), statistical tests to establish differences in the quality and nature of records for this limited cohort were not possible. Some broad comparisons from the data, however, may be indicative, though should be treated with caution.

There is a marked difference in preparation of accounting reports between those who had an amended assessment as a result of audit, and those who had none. Table 4.3 shows the relative percentages. It is clear that the cohort of businesses that received amended assessments as a result of the audit were less likely to prepare (or have prepared) basic accounting reports, particularly so far as cash statements and debtor and creditor reports were concerned.

TABLE 4.3 PREPARATION OF ACCOUNTING REPORTS AND AMENDED ASSESSMENT

	No change (n=29)	Amended assessment (n=8)
Cash Statement	89%	62%
Profit and Loss	100%	87%
Balance Sheet	100%	87%
Debtors and Creditors	96%	75%

Those respondents who had an amended assessment were almost twice as likely (25% versus 13%) to prepare their own tax reporting in-house, rather than seek the services of a professional. They were also far more likely to have their annual tax returns completed in-house than by a professional (50% versus 17%). This suggests that the use of qualified external practitioners reduces adverse audit outcomes, although the conclusion has to be treated with caution given the small numbers involved.

Compliance Costs

We initially hypothesised that businesses with poor record keeping practices would likely encounter higher taxation compliance costs than businesses with better record keeping practices. Extending the theme that emanated from the focus group, the research team examined this relationship between record keeping and compliance costs.

Initial support for the hypothesis was garnered from SME respondents' attitude to the statement that "Good record keeping reduces compliance costs of the business" (Question 45). Three times as many participants in the survey agreed with this statement compared to those who disagreed (69 respondents compared to 22). Note, however, that 30 respondents (25%) were either neutral or did not know. As a result, the 69 positive respondents represented only 57% of total responses – a majority, but not an overwhelming endorsement of the statement. These results indicate that the participants are not certain that good record keeping practices will reduce the taxation compliance costs.

Participants were also asked to estimate the annual internal and external costs associated with various tax reporting requirements of the business (Question 33). Comparisons were made on the basis of how respondents self assessed the quality of the records and the costs (internal and external) that they reported. Subsequent analysis focused on the relationship of the types of records that were prepared in-house and externally, again related to costs of compliance.

Table 4.4 compares the mean and the median internal costs associated with the various record keeping activities. Those businesses that considered that they had better quality record keeping practices (measured as a self-assessed score of 8 to 10) had higher mean and median estimates for all internal costs except for payroll and other taxes compared to those who assessed the quality of their record keeping practice as less than 8. The mean internal costs relating to payroll and to other taxes is broadly similar.

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The basis of preparation of external accounts and tax reports, namely the underlying records, together with their comprehensiveness, may help to determine the costs associated with compliance. Table 4.6 considers the principal record keeping elements (Cash Book, Invoices and Bank Statements) and their impact on record keeping. The table compares internal and external compliance costs when less than three elements are used with those respondent businesses that used all three elements. Only the median cost is cited.

TABLE 4.6 RECORD KEEPING ELEMENTS AND COMPLIANCE COSTS

	Internal all 3	**Internal <3**	**External all 3**	**External <3**
	Median $	**Median $**	**Median $**	**Median $**
BAS / GST	4500	1200	3000	1500
Tax Returns	3000	1000	4500	4000

- had generally been in business for a slightly shorter period of time; and
- had a lower business turnover on average.

Table 4.7 outlines the difference in preparation of accounting repo survey responses for all questions for the tax practitioner survey are contained in Appendix B.

Responses to the questions in Section A (Practice Background) of the survey reveal that:

- just over two thirds (68%) of the responses came from self-employed sole practitioners, and just over a quarter (27%) from partners in practice. The partners were predominantly (80%) from partnerships with four or fewer partners (Questions 1 and 2: Appendix B);
- the GST inclusive turnovers of the respondents' practices were generally less than $1 million (88%). The practice turnovers for roughly a quarter were less than $100,000; for a further quarter were between $100,000 and $250,000; and for just over one third were between $250,000 and $1 million (10.98 00.9212 Tm0n41 0 j10Tm7Tj10.98 2

57% thought that the filing of the annual tax return also improved business management (Question 21). Additionally, 60% of practitioners believed that computerised record keeping practices improved the accuracy of the records of more than half of their SME clients (Question 18).

Compliance with the tax law was identified by 60% of practitioners as the main reason for record keeping, exceeding general business management by a factor of two (Question 11). This symmetrically contrasted with the view of SMEs, who (in almost equal proportions: 58%) saw business management as the main reason for record keeping. This inevitably reflects the greater tax focus of the practitioners compared to the SME owners' and managers' focus on the business.

Almost all practitioners (95%) advised clients on record keeping systems, and then actually set up those systems for the clients (80%) (Questions 12 and 13). The number of transactions and perceived competency of the client were the primary factors that determined whether these systems were computerised (Question 15), which they tended to be for about 90% of clients (Question 16). MYOB was recommended by just over half (53%) of practitioners (Question 16), and more than half of the practitioners (58%) trained their clients in the use of those computerised programs (Question 17). Very few practitioners (9%) did not insist upon or suggest a computerised record keeping system for their small business clients (Question 16).

Practitioners were split as to whether the time spent by small businesses on record keeping exceeded the benefits, with 45% agreeing and 47% disagreeing (Question 28). Most (70%), however, agreed with the statement that "the record keeping requirements of small business are too time consuming" (Question 31).

Practitioners, in this survey, rated the profit and loss statement as the most essential of the various accounting reports for the successful management of the business, followed closely by a statement of debtors and creditors, the balance sheet and cash statement – all of which were also considered essential for successful management by the majority of practitioners (Question 19).

Audit risk

Practitioners were divided on the issue of whether there was a relationship between poor small business record keeping and the probability of audit by the Tax Office (Question 23). Roughly one in four considered there was little or no relationship (measured as a score of between 1-3 on a scale of 1-10, with 1 being no relationship and 10 being a strong relationship). About half assessed the relationship as being medium (4-8 on the scale), and only 11% saw a strong relationship between poor record keeping and probability of audit (9-10 on the scale). This ambivalence was confirmed by responses to two related questions. In Question 14, 64% of practitioners considered that good small business client record keeping reduced exposure to ATO audit; in Question 34 half of 129 practitioner respondents agreed that "good record keeping reduces the likelihood of ATO audit for small business clients". Overall, therefore, there is some reasonable support from practitioners for the nexus between poor records and increased exposure to audit, but that support is not overwhelming.

Being in a 'cash economy' industry was viewed as the most important factor in increasing the risk of audit (116 respondents), followed by more than average deductions (103 respondents). Being in the simplified tax system was seen as the least likely of a number of factors to increase the risk of a small business being exposed to a tax audit (only 4 respondents) (Question 22).

Practitioners considered that, once exposed to an audit, small businesses were most likely to suffer an amended assessment (presume rated behind “late payment by debtors” (ranked highest), “ATO/tax obligations” (second highest) and “general business downturn” (third). Only “pressure from creditors” was rated less significantly than poor record keeping in causing SME cash crises.

The number of clients refused credit due to poor record keeping (2%) (Question 27) was not dissimilar to the outcome in the SME survey, where it was 1%.

Having identified the major outcomes of the two surveys, it now remains to draw the analysis together and derive appropriate conclusions based on the outcomes of both the focus groups and the surveys. This is done in the concluding section.

CONCLUSIONS

The project sought the views and experience of the three principal stakeholders involved in tax compliance issues for the SME sector – the owners/managers of small businesses, their accountants and advisers, and the tax officials who audit the sector. It was expected that by drawing on the insights of these groups and triangulating the results a comprehensive picture of the relationship between record keeping and tax compliance outcomes could be developed. The following paragraphs outline the conclusions reached in each of the areas that were explored.

Record keeping

A number of recurrent themes relating to record keeping practices emerged in theerged in the further and recognised that even those tax reporting obligations helped them manage the business more effectively.

This view of the possibility of positive externalities that SMEs could derive from record keeping and tax reporting was a theme that was also touched upon in the focus group conduc

The results also point to the need for surveys dealing with compliance cost issues to be very carefully constructed. In retrospect it is possible that the compliance cost questions in these surveys were too general in nature to be able to provide reliable estimates of the actual costs incurred by SMEs. Other surveys (for example, Evans et al, 1996; 1997) have foull a higher vulnerability to audit (though once audited SMEs with poor records were more likely to suffer adverse audit outcomes). Nor did poor record keeping necessarily translate to higher compliance costs (though the data were ambivalent). Nor, finally, did poor record keeping necessarily lead to liquidity and cash flow problems. In each case, however, the stakeholders were able to identify the positive value that professional advisers can bring to the systems and practices of record keeping that businesses adopt. The benefits that good record keeping practices can bring were evident throughout the research in a number of direct and indirect ways.

Further and more detailed research is required to explore the complex relationships that exist between record keeping and tax compliance outcomes. The current project was ambitious in its scope, and was ultimately limited in its findings by its reliance on the self-assessment of the quality of record keeping practices by SMEs themselves. Further research should be narrower in focus. For example, separate projects should investigate each of the three compliance relationshi

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APPENDIX A DETAILED TABLES: SME SURVEY

Section A BACKGROUND DETAILS

1 From which industry sector is your main business income derived?

	Number	Percent
Primary	9	7%
Secondary	29	22%
Services	87	67%
Other	4	3%
Non-Response	0	0%

3 Identify the legal form of your business.

	Number	Percent
A sole trader	12	9%
Partnership	18	14%
Private Company	80	62%
Trust	14	11%
Other	3	2%
Non-Response	2	2%

6 What is your age?

	Number	**Percent**
Under 18	0	0%

Section C AUDIT

28 Has your business been the subject of an ATO audit?

	Number	Percent
Never / NA		

2 If you are a partner, or an employee of a partnership, placti,

8 How many potential clients have you refu refu

18 The following are some of the financial benefits that computerised systems are suggested to achieve. Can you indicate, in your experience, what percentage of small business clients achieve the listed benefit.

	0% of clients		**< 25% of clients**		**26% - 50% of clients**		**51% - 75% of clients**		**76% - 100% of clients**		**Non-Response**	
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
Saves client time	12	9	29	22	31	24	36	28	14	11	7	5
Improves client accuracy	5	4	17	13	24	18	58	45	20	15	6	5
Reduces client bills	(13)Tj/TT4 1 Tf12 0 0 cy											

Section F LIQUIDITY

26 When considering those small business clients who have had a "cash crisis" in the past two years, please rank (in order of importance) the following reasons that resulted in a cash crisis, from 1 to 6 (with 1 being most important).

	Mean
Pressure from creditors	3.67
Late payment by debtors	2.45
ATO/Tax obligations	2.72
Poor record keeping	3.26
General business downturn	3.00

27 Please estimate the percentage of small business clients that you are aware of who have been refused credit because of a lack of records.

Mean	6%
Median	2%

ATTITUDINAL QUESTIONS

28 Time dedicated to record keeping by small business clients exceeds the benefits

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
18	14%	42	33%	11	9%	37	29%	21	16%

29 I am confident in the accuracy of the majority of my small business clients' record keeping systems

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
3	2%	18	14%	21	16%	78	60%	9	7%

30 I am confident that my small business clients have the necessary system in place to comply with the taxation law

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
1	1%	11	9%	15	12%	89	69%	13	10%

31 The record-keeping requirements of small business are too time-consuming

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
4	3%	21	16%	13	10%	56	43%	35	27%

32 Required record keeping (e.g. BAS) helps small business manage the business more effectively

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
5	4%	16	12%	16	12%	69	53%	23	18%

33 There is a strong relationship between poor record keeping and small business failure

Strongly Disagree		**Disagree**		**Neutral / Don't Know**		**Agree**		**Strongly Agree**	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
3	2%	15	12%	17	13%	53	41%	41	32%

34 Good record keeping reduces the likelihood of ATO audit for small business clients

Strongly Disagree		**Disagree**		**Neutral / Don't Know**		**Agree**		**Strongly Agree**	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
4	[redacted]	[redacted]	19%	35	27%	49	38%	16	12%

35 Good record keeping redu

[redacted]