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# The Managerial Benefits of Tax Compliance: Perception by Small Business Taxpayers

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## Abstract

Research undertaken in 2006 – 2007 investigated the perception of managerial benefits of tax compliance by small business taxpayers. Survey data from a sample of 300 small business taxpayers and responses to semi-structured interviews of owner-managers were examined. The study found that a majority of small business taxpayers recognised that tax compliance activities led to better record keeping and to an improved knowledge of their financial affairs. However, there seemed to be a general reluctance by respondents to accept the idea that benefits could be derived as a result of complying with tax. The findings of this study are important as it is the first research that systematically investigated managerial benefits and their perception by small business

The main difficulty with managerial benefits is that even though the concept itself is rather straightforward, the reality of managerial benefits can be elusive because it is dependent on how the accounting information generated by tax compliance activities is valued by business owner-managers and used in business decisions. Hence, the actual realisation of managerial benefits by the firm will be closely related to the perception that owner-managers have about the usefulness of the information generated by record keeping activities.

Research undertaken in late 2006 and early 2007 compared accounting practices in businesses exposed to the record keeping requirements of the tax legislation, with accounting practices in firms of similar size that had no tax compliance obligations. The primary purpose of that study was to investigate the nature of managerial benefits generated as a result of tax compliance activities, and to identify the conditions in which these benefits may be derived. In addition, the researcher sought to examine what managerial benefits were perceived by owner-managers and contrast this perception with managerial benefits actually realised.

The study deliberately focused on small businesses for two main reasons. Firstly, managerial benefits resulting from tax compliance activities are more likely to arise in small organisations where accounting information systems are relatively undeveloped. Secondly, since previous research has indicated that the burden of tax compliance costs is felt more acutely by small businesses, it is possible that managerial benefits, if they exist and are significant, make this burden more sustainable.

This remainder of this article is structured as follows. Section 2 examines the empirical evidence on managerial benefits, and reviews the previous literature that has discussed the concept of managerial benefit. The methodology adopted for this research is described in Section 3 and the research outcomes are presented in Section 4. A discussion of the results follows in Section 5 while Section 6 concludes the article by identifying the limitations of the study and making suggestions for further research.

## 2. PREVIOUS LITERATURE

### 2.1 Significance of managerial benefits in small businesses

Two studies, the Sandford, Godwin, Harck and Butterworth 1981 Value Added Tax (VAT) study and the National Audit Office (NAO) 1994 VAT survey have attempted to quantify managerial benefits. Both studies relied on estimates provided by owner-managers of the benefits they received. In the Sandford et al study, respondents were asked to give values to managerial benefits, while the 1994 NAO study proposed an overall estimation of managerial benefits.

The report from the NAO valued the overall managerial benefits generated by compliance with VAT in the United Kingdom (UK) at £149m (\$312m), representing nine per cent of gross tax compliance costs.<sup>7</sup> The value of managerial benefits relative

<sup>5</sup> The report published by the National Audit Office in 1994 largely relied on the valuation undertaken by Sandford.

<sup>6</sup> N The exchange rate used for the conversion of Australian dollars is the 1994 average rate.

<sup>7</sup> National Audit Office, HM Customs and Excise, *Cost to Business of Compliance with VAT Requirements* (Her Majesty Stationery Office, 1994), 20.



Additional empirical evidence on the perception of managerial benefits by business taxpayers is available from research on tax compliance costs undertaken in New Zealand and Australia in the 1990s. Nearly 50 per cent business owners surveyed in New Zealand in 1991 agreed that their paper records were better kept as a result of complying with GST obligations, and 31 per cent said that there was useful cash collected.<sup>9</sup> In Australia in 1995, Evans et al found that only a small majority of small business taxpayers agreed that the requirements of the federal tax system helped them to improve their record keeping. There was an even lower level of agreement that managerial benefits were derived in the form of improvements to internal controls.<sup>10</sup> Higher rates of managerial benefit perception were reported by a study commissioned by CPA Australia in 2003: over 75 per cent of small business owner-managers indicated that they were using financial information produced from the record keeping system to manage the business and 73 per cent agreed that compliance obligations acted as an incentive to keep up-to-date records.<sup>11</sup>

In conclusion, even though the evidence on managerial benefits is extremely patchy, there is some indication that a significant proportion of small businesses perceive that they are deriving benefits from tax compliance in the form of improved record keeping. The degree of perception and the amount of benefits perceived seemed to be influenced by the size of the business and the activity sector.

## 2.2 The concept of managerial benefits

The concept of managerial benefits was first introduced by Sandford et al in the 1981 VAT study and further discussed in a further publication a few years later.<sup>12</sup> Sandford argued that the effect of complying with tax may not always be detrimental, as individuals who complete the tax return and file the necessary information, may at the same time be encouraged to engage in more efficient management of their financial affairs. These benefits are likely to be more significant in the case of businesses (hence the terminology of “managerial benefits”) as compliance with the tax system will force the business owner to introduce a more efficient financial information system.<sup>13</sup> Sandford described managerial benefits from compliance with VAT in this manner:<sup>14</sup>

“[...]It is clear that there are continuing and not inconsiderable cash benefits from the better record keeping which is necessary to comply with VAT requirements. It is not possible to put a realistic value on these benefits but they are an important offset to the compliance costs of some of the smaller businesses.”

<sup>9</sup> C Sandford and J Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Institute of Policy Studies, 1992), 96-97.

<sup>10</sup> Evans, Ritchie, Tam-Nam and Walpole, above n 3, 131-133.

<sup>11</sup> CPA Australia, *Small Business Survey Program: Compliance Burden* (CPA Australia, 2003), 17.

<sup>12</sup> Sandford, Godwin, Hardwick and Berworth, above n 8, 90; Sandford, Godwin and Hardwick, above n 2, 13.

<sup>13</sup> Sandford, Godwin and Hardwick, above n 2, 13.

<sup>14</sup> *Ibid*, 118.





### 2.3.2 Savings on other costs

Where tax compliance encourages taxpayers to prepare their accounts internally or at least to do their own bookkeeping, there will be potential savings on accountancy and audit fees.<sup>28</sup> Strictly speaking, savings on other costs should not qualify as managerial benefits as they do not result in additional information that will lead to better business decisions. However, since the costs associated with hiring an external accountant are essentially related to the acquisition of accounting or managerial information, it can be contended that savings on these costs constitute a managerial benefit.

The essence of Sandford's proposition was, that where businesses set up their records in-house for tax compliance purposes, they will not have to hire an external accountant to prepare their financial reports, or at least they will save on accountant time. This proposition assumes that the entity would still prepare accounts either for external parties or for internal purposes even if it did not have to comply with tax laws. Prior research in Australia indicates that assistance with tax related matters was the main reason why a majority of small business taxpayers sought the services of an accountant.<sup>29</sup> In other words, only a small percentage of small businesses would use the service of an accountant if there was no compliance, and therefore there seems to be a limited number of cases where savings on accountancy fees would be realised as a result of tax compliance.

Nevertheless, savings may also be realised where business taxpayers are obtaining additional services for which they would otherwise have to pay, had they not hired an accountant for tax compliance reasons. Empirical evidence suggests that many accountants or other tax advisers were providing a variety of business services incidentally to tax related activities.<sup>30</sup> In Australia, accountants often assist their clients with compliance tasks for third parties other than the Australian Tax Office (ATO). Many accountants also offer general business advice, financial planning and business plans,<sup>31</sup> and are an important source of support in the selection and installation of computer software as well as the training of internal staff.<sup>32</sup>

Even where accounting practitioners charge their clients for these additional services, it is reasonable to expect that the fees would have been higher if the services had been provided separately from tax compliance activities. The main reason for this is that the accountant will be able to perform different tasks for the same client with increased productivity. Economies will be achieved because in most cases a common base of information (accounting records) is used for both tax compliance and other business



situation where the AIS generates an abundance of information but that information is not used in business decisions, no benefit will result. Three factors are likely to

#### 2.4.2 Owner-managers' perception of accounting information usefulness

The effectiveness of accounting information usage depends in large part on the perception that the decision maker has of the usefulness of that information. Even where accounting information possesses all the required qualities and attributes to make it useful, usage can only be effective if owner-managers recognise that the information will assist them in running their business.

The literature provides somewhat contradictory evidence about how small business owner-managers perceive accounting information. A few studies found that "accounting" or "financial reporting" was often seen by owner-managers as a necessary activity which had to be carried out in order to meet external requirements. In addition, many small business owners had a general perception that financial statements were costly to produce and provided little useful information because they were often "ancient history".

On the other hand, it seemed that this negative perception about accounting and financial reporting was balanced by the recognition that having a record keeping system was important, and that good records could help to manage the business. Only one out of three small business owner-managers surveyed in 2005 considered

### 2.4.3 Accounting information and business performance

Ultimately, accounting information usage will only be beneficial to the firm if it contributes to business performance. As business performance is generally considered from the two aspects of business survival and growth.<sup>48</sup>

There is only mixed evidence in the literature about the existence of a correlation between quality of record keeping and business survival. Although some authors found that poor record keeping and absence of financial controls were predictors of business failure,<sup>49</sup> the Productivity Commission in Australia reported that only 20 per cent of cases of bankruptcy could be traced to non-existent or poor quality accounting records.<sup>50</sup>

The relationship between accounting practices and business growth is even more difficult to establish because of the impossibility of tracing growth to specific factors. A number of studies have suggested that a correlation may exist between certain management accounting practices and financial effectiveness;<sup>51</sup> however other authors argue that the correlation may only be apparent as it may be mitigated by other factors such as business size.<sup>52</sup>

Although there is no conclusive evidence so far to support the proposition that sophisticated accounting practices lead to improved business performance, there is at least some indication that poor record keeping and absence of finance management may be an important contributor to business failure. Even where accounting information is not contributing directly to business decisions, it can be argued that it can be useful to the business where it contributes to the decision makers' learning and appreciation of their business environment.<sup>53</sup>

## 3. METHODOLOGY

### General approach

This research adopted a mixed methodological design including a major quantitative phase followed by a minor qualitative phase. While the possibility of developing testable hypotheses justified a dominant quantitative component, it was believed that the investigation of some aspects of the topic would be better addressed by qualitative analysis. For instance, compliance with tax obligations may be generating forms of managerial benefits that have not been identified by previous research. Moreover, the examination of the subjective attributes of managerial benefits called for an in-depth

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<sup>48</sup> Jarvis, Curran, Kitching and Lightfoot, above 44; J Maes, L Sels and F Roodhooft, 'Modelling the link between management practices and financial performance. Evidence from small construction firms.' (2005) 25(1) Small Business Economics 7.

<sup>49</sup> R Lussier and S Pfeifer, 'A cross-national prediction model for business success' (2001) 30(1) Journal of Small Business Management 22; S Perry, 'The relationship between



respondents are almost non-respondents and whether there are any differences between the responses collected from the first wave of respondents and the wave of late respondents. Three screening questions in the TCE survey and two in the TFE survey were selected for this purpose. Differences between early and late respondents were tested using an independent-sample t-test. No non-response bias was detected for either the TCE or the TFE surveys.

### 3.3 Qualitative phase: case study

The case study methodology appeared to be the best approach for the qualitative phase of this research as it allowed the collection of contextualised and meaningful information through semi-structured interviews<sup>62</sup>. The case study component involved the interviewing of 12 participants, 6 from the TCE cohort and 6 from the TFE cohort, selected among respondents who had volunteered to participate in interviews. The case study used a protocol which included sets of questions and propositions, and an interview schedule as this was expected to reinforce the reliability and stability of the data collection procedure<sup>63</sup>.

Case study participants from the TCE cohort were selected according to two criteria: business size and 'expected managerial expertise'; the latter criteria was evaluated

The main hypothesis relating to the perception of managerial benefits by TCE owner-managers (Hypothesis 4) was formulated as follows:

H<sub>4</sub>: TCEs owner-managers perceive that they are deriving managerial benefits as a result of complying with their tax obligations.

As in the Evans et al 1995 research, this study tried to identify the specific managerial benefits of tax compliance which were perceived or “recognised” by small business owner-managers. Yet, even where discrete managerial benefits were identified, it was necessary to ascertain whether respondents held a different opinion about the overall proposition that their business derived managerial benefits as a result of complying with tax. It was therefore resolved to measure this broad perception about managerial benefits and contrast it with the recognition of discrete benefits. Finally, this study sought to test Sandford’s findings that perception about managerial benefits was influenced by the owner-manager’s personal characteristics.

The objectives of the research led to the formulation of three secondary hypotheses.

## 4. RESULTS

### 4.1 Perception of managerial benefits by owner-managers

#### 4.1.1 Recognition of specific types of managerial benefits of tax compliance

Recognition of specific types of managerial benefits by owner-managers was measured by including attitudinal questions in the survey questionnaire. Respondents were invited to indicate their degree of agreement (rated along a five point Likert scale) with statements about six specific managerial benefits of tax compliance. The managerial benefits identified in the questionnaire were: improvement of record keeping; better knowledge of financial position; better knowledge of profitability; better monitoring of cash flows; better monitoring of trading stock; and better monitoring of debtors and creditors. A managerial benefit was deemed to be recognised where the respondent either agreed or strongly agreed with the statement.

The results (Table 2) indicate that four out of six types of managerial benefits were recognised by a majority of respondents. Thus, Hypothesis 1 was generally supported by the survey data. Nearly three quarters of all survey respondents in the TCE group agreed that tax compliance improved the quality of their record keeping, about two thirds that they had a better knowledge of their financial position and profitability, and more than half that it helped them to monitor their cash flows. Almost 50 per cent of respondents agreed that tax compliance assisted them with monitoring their debtors and creditors, but less than a third recognised a managerial benefit in the form of better monitoring of trading stocks.

TABLE 2: PERCEPTION OF MANAGERIAL BENEFITS BY SMALL AUSTRALIAN BUSINESS OWNER-MANAGERS: COMPARISON BETWEEN STUDIES

Types of managerial benefits:	This study 2006: Percentage of respondents who agreed that this was a benefit of tax compliance	Evans et al 1995:* Percentage of small business taxpayers who agreed that this was a benefit of tax compliance
Better record keeping	72	50
Better knowledge of financial position.	66	37
Better knowledge of profitability	63	37
Better monitoring of cash flows	58	34
Better monitoring of trading stock	31	15
Better monitoring of debtors and creditors	47	N/A

improvement to stock monitoring is the least recognised, with the other benefits (except improvement to credit management which was not measured by the Evans et al study) having roughly the same percentage of recognition.

The higher level of managerial benefit recognition reported by the current study might be explained by the fact that at the time of the Evans et al survey, businesses did not have to comply with GST. As discussed earlier, empirical evidence from the UK suggests that compliance with consumption taxes like VAT or GST is likely to be a major source of managerial benefits.

Nevertheless, some of the difference in the results might also be attributable to the different sampling methods used for the two surveys. Evans et al surveyed a population of taxpayers across Australia, while this study focused on the small business population of a particular regional area. Differences in demographic



TABLE 3: PERCENTAGE OF RESPONDENTS WHO RECOGNISED SPECIFIC TYPES OF MANAGERIAL BENEFITS BY TCEs; BREAKDOWN BY BUSINESS SIZE CATEGORY

Managerial Benefits:	No employee (n= 46)	1-4 employees (n=116)	•5 employees (n=119)	All TCEs (n=281)
Better record keeping	69	73		

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position									
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A close examination of the results reveals noticeable variations in the percentages across size categories. More than 48 per cent of TCEs with no employees perceived that their business derived benefits from tax compliance, while the proportion was only 31 per cent in the “1 to 4 employees” category. The “5 employees and over” category has the lowest percentage of respondents who were of the opinion that no benefits were derived from tax compliance.

Prima facie, these results appear to contradict the findings for Hypothesis<sub>4</sub> H<sub>4</sub> which showed that almost three quarters of all business owner-managers recognised at least one specific type of managerial benefit and possibly over 60 per cent recognised at least three. In addition, the percentage of respondents perceiving that benefits were derived from tax compliance appeared to be higher among non-employing entities, while the level of recognition of specific managerial benefits was generally lower in that category.

In summary, there appears to be some ambivalence regarding the perception of managerial benefits by small business owner-managers. While a significant proportion of respondents seemed ready to recognise specific improvements to their accounting system as a result of tax compliance, only a minority acknowledge the fact that their business derived any benefit from tax compliance activities.

## 4.2 Influence of personal characteristics on managerial benefit perception

### 4.2.1 Analysis of survey data

The relationship between managerial benefit perception and the personal characteristics of owner-manager was statistically tested using quantitative data from the survey. Three personal characteristics expected to influence managerial benefit perception were selected for the purpose of testing Hypothesis H

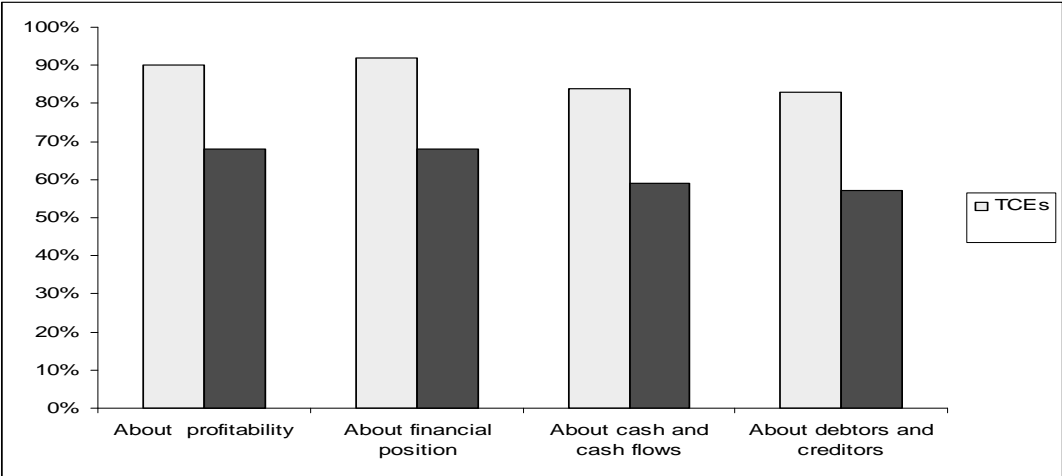
recognised" were negatively correlated (Pearson  $r = -0.154$ ); this can be interpreted as meaning that owner-managers with a lower level of education were more likely to recognise specific managerial benefits than those who were "better" educated. "Knowledge of accounting" and "Number of managerial benefits recognised" were positively but weakly correlated (Pearson  $r = 0.09$ ).

TABLE 6: R

As described in the methodology section, the expected level of managerial expertise was one of the two selection criteria for TCE participants. “Expected level of managerial expertise” was rated either high or low on the basis of two personal characteristics measured by the survey questionnaire: “Knowledge of accounting” and



FIGURE 1: PERCENTAGE OF TCE AND TFE BELIEVING THAT THEIR RECORD PROVIDED RELIABLE AND USEFUL INFORMATION

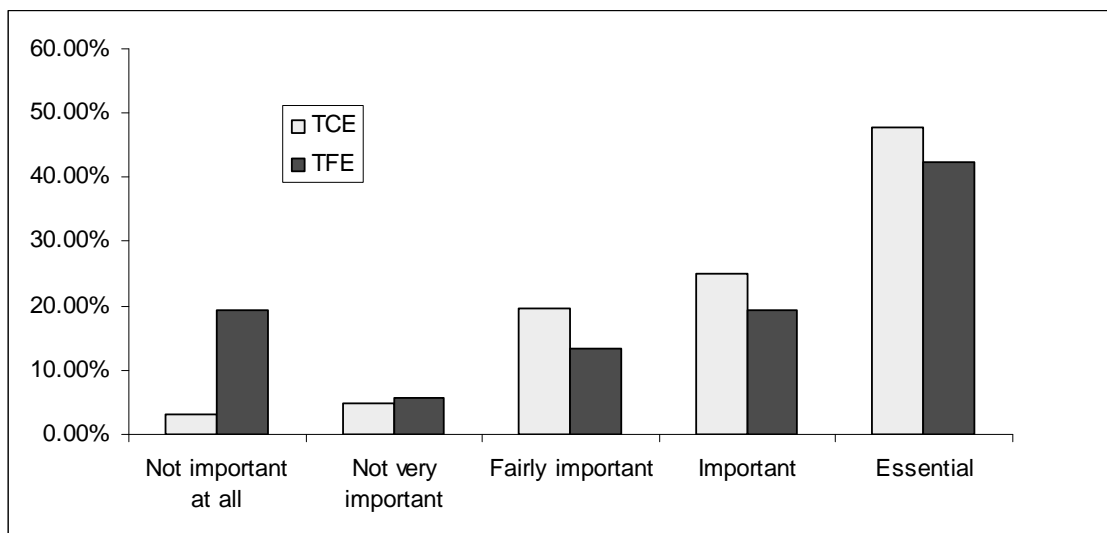


One could not make any inference about the actual quality of accounting information from this perception as very few entities either on the mainland or in Norfolk Island had their accounts audited. Yet, it seems that in the case of TCEs, the fact that accounting data was also used for tax reporting purposes was an incentive to ensure that records were accurate and up-to-date.

#### 4.3.3 How important is accounting information to owner-managers?

Survey respondents were also invited to rate the importance of accounting (financial) information for running their business. Business size was expected to be one of the factors influencing this perception. As the TCE sample contained a higher proportion of entities in the “5-19 employees” category, the comparison was limited to the “4 employees or less” cohort in both samples in order to avoid any bias in the interpretation.

FIGURE 2: PERCEPTION ABOUT THE IMPORTANCE OF ACCOUNTING INFORMATION BY TCEs AND TFEs WITH 4 EMPLOYEES OR LESS



The results reveal that overall a majority of respondents in both TCEs and TFEs considered accounting information as “important” or “essential” (Figure 2). There is also an indication that TFEs did not rate the importance of accounting information as highly as TCE: 24 per cent of TFE respondents considered that accounting information was not very important or not important at all, while less than 10 per cent of TCE respondents shared the same opinion. A Chi-square test confirmed that the difference in the distribution of ratings





accounting information with nearly 40 per cent prepared to spend more than \$2,500 per year.

## 5. DISCUSSION

### 5.1.1 Research objectives

As stated in the introduction of this article, this study had the broad aim of filling the knowledge gap on managerial benefits of tax compliance. This article discusses how managerial benefits are perceived by owner-managers. Among its different objectives, the research attempted to find answers to broad issues relating to the perception of managerial benefits. Firstly, it sought to identify which specific types of managerial benefits of tax compliance were recognized by small business owner-managers. Secondly, it sought to establish whether overall small business

reluctance to accept the idea that benefit may arise out of tax compliance. There was also the possibility that, while owner-managers recognised the fact that their record keeping and knowledge of their financial affairs had improved since they had to report for tax (mainly GST), they did not readily attribute these improvements to tax compliance. Finally, improvements to accounting records may not be seen as a benefit mainly because many owner-managers saw record keeping as a necessity (of tax compliance) rather than an advantage for the management of their business.

However, the latter argument could be put on the ground that more than 80 per cent of respondents to the TCE survey stated that they would still keep accounting records even if tax compliance obligations were removed. This is supported by the findings that more than 70 per cent of respondents indicated that they would be prepared to incur cost to acquire useful accounting information. It also emerged from survey responses that besides tax calculation, accounting information was often used for internal management purposes.

### 5.1.3 Managerial benefits perceived and realised

Sandford anticipated that discrepancies might exist between perception and realisation of managerial benefits. Some benefits might be perceived but not realised, and conversely some actual managerial benefits might not be perceived. Besides managerial benefit perception, this study also investigated the actual realisation of managerial benefits by TCEs. The comparison between the actual realisation of specific managerial benefits and their perception by owner managers is presented in Table 10.

TABLE 10: REALISATION OF SPECIFIC TYPES OF MANAGERIAL BENEFITS AND PERCEPTION BY OWNER-

Although the relationship with the accountant was valued by many owner-managers, this was not generally perceived as a managerial benefit of tax compliance, possibly because the benefits were obscured by the fact that the main reason for hiring an accountant and paying accountancy fees was taxation. The second area of discrepancy was related to improvements in decision making. Survey responses seemed to indicate that owner-managers in TCEs were using accounting information more effectively than their counterparts in TFEs, but interviews showed that owner-managers in both TCEs and TFEs believed most business decisions were made without the support of accounting information.

However, it must be noted that while many interviewees claimed that they did not use accounting reports when making decision, they often added the comment "it is all in my head". This would suggest that even though it was impossible to link decision making with specific accounting reports, the availability of accounting information was clearly contributing to the owner-manager's knowledge about the business.

#### 5.1.4 Influence of owner-manager characteristics

In their 1981 VAT study, Sandford et al only considered the influence of the accounting training of small business owner-managers on managerial benefits perception. The outcome of their investigation was summarised as follows:

"The more the training the less the benefit perceived."

The authors explained this finding by the fact that the impact of the introduction of VAT would be higher on owner-managers whose record keeping was initially the worst than on those who were already qualified accountants.<sup>77</sup>

The analysis of quantitative and qualitative data collected by this research suggests that managerial benefits perception may be influenced by the owner-manager's knowledge of accounting, but also by the level of basic education. While it was found that owner-managers with a lower level of basic education tended to perceive more managerial benefits than those with more advanced school education, it appears that knowledge of accounting was positively related to managerial benefit perception. In other words, the more accounting training the owner-manager had received, the more managerial benefits were perceived.

The computation of correlation coefficients shows that the positive relationship between "Knowledge of accounting" and "Managerial benefit perception" was strong and significant while the negative relationship between "Level of education" and "Managerial benefit perception" was not statistically significant.<sup>78</sup> This would indicate that accounting knowledge was a far more important predictor of managerial benefit perception than the basic level of education.

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<sup>76</sup> Sandford, Godwin, Hardwick a

Factors such as time lag, cultural factors and the fact that the Sandford study only considered the impact of VAT could explain the discrepancy between the findings. Bearing in mind that the number of observations in this research was relatively small, there is clearly a need for more investigation of this aspect of managerial benefits.

## 6. CONCLUSION

Although some evidence about managerial benefits had been collected by earlier research, the findings of this study are important as it is the first research that systematically investigated the managerial benefits of tax compliance in small businesses and their perception by owner-managers. The major outcome of this research in relation to managerial benefit perception is that a large majority of small business taxpayers believed that, as a result of tax compliance requirements their record keeping had improved, and that they had a better knowledge of their financial affairs. Comparisons with the findings of previous research undertaken in Australia before the introduction of GST reveal an increased perception of these managerial benefits. Data collected from interviews also confirm that compliance with that particular tax was seen as a major incentive to upgrade the quality of accounting records. In spite of this increased awareness of specific benefits of tax compliance, only a minority of owner-managers perceived that despite the costs incurred, compliance with tax obligations generated some benefits for their business.

As in all research, this study has strengths as well as limitations that must be acknowledged.

The major limitation relates to the representativeness of the sample of small business chosen for the survey. Although the choice of a narrow sampling frame for the population of TCEs allowed useful comparisons with the TFE sample, it necessarily limited the possibility of generalisation to the general population of Australian small businesses.

Another limitation was the small size of the sample of useful responses which did not allow data analyses at sub-sample level to produce significant results. This was particularly the case when investigating the influence of personal characteristics on managerial benefit perception.

The findings of this research need to be confirmed by a large scale study which would include a wider cross-section of small businesses drawn from different areas of Australia. Such a large scale research would allow the investigation of the influence of business size and activity sector on managerial benefit perception. There is also a need of further investigation of the influence of personal characteristics on managerial perception since the findings of this research were not fully conclusive and seemed to deviate from the conclusions established by previous research. Finally, additional research is necessary to explore the extent to which tax based information is effectively used by small business owner-managers in decision making.