

# Internal Control System and Tax Compliance: An Empirical Analysis

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The Government Treasurer plays an important role in fulfilling the tax obligations of a government agency. However, this role must also support an adequate internal control system. This study determines the relationship between the internal control system and the tax compliance of the Government Treasurer in Indonesia. This research is an analytic study using an internal auditor and treasurer of 11 Legal Entity Universities as respondents to examine the perceived tax compliance in Indonesia's government. The results showed that an internal control system has no relationship with tax compliance. This result is contrary to the Committee of Sponsoring Organizations' Theory (1992), which states that a good internal control system will affect the compliance of its employees. Rather than focussing only on the importance of the rational and analytical deliberation of an internal control system in influencing their tax compliance, the current paper shows that strategic responses establish the basis for understanding taxpayers' compliance. Our respondents are treasurers who work at a Legal Entity University who have different governance from other university types, so this research can be considered to have more value than previous research.

**Keywords:** *Internal Control System, Tax Compliance, Legal Entity University.*

## Introduction

Internal control is considered a management tool in the preservation of the assets and property of the organisation and its continuing. It contributes in achieving the general objectives, such as achieving the best possible profitability and protecting the rights of shareholders through the application of a strict system that includes control procedures implemented on the administrative and financial functions to verify the legitimacy and legality and efficiently in the actual implementation of the company's activities, and ensures

that all sections are committed with the legislations that govern the implementation of tasks by a pre-planned correct methodology (ALHARBI, 2017).

Internal controls give reasonable, not total confirmation to an entity's management and board of directors that the organisation's goals will accomplish. The probability of accomplishment is influenced by impediments inalienable in all frameworks of internal control (Hayes, 2005). All government ministries and organisations ought to enhance the adequacy of internal control systems, internal audit function, and organisation commitment because they improve good governance (Suyono & Hariyanto, 2012). Moreover, a successful internal control framework can provide information to management about the firm's advancement, or absence of advancement toward the accomplishment of their destinations (Vijayakumar & Nagaraja 2012).

Puttick (2001) states that internal controls are an arrangement of hierarchical strategies and sanction internal processes (internal controls) created by organisations to accomplish essential management targets of guaranteeing that the business works faultlessly. He further clarified that a business is said to be running easily if they find themselves able to stick to the management policies, to secure the organisation assets, and set up a framework that would stop and eradicate the manipulation of the accounting information.

Organisations are tasked with providing proper risk prevention practices and effective internal controls for operations, finance, human resources, strategy, and legal to ensure all corporate compliance obligations are met. To greatly improve organisational compliance from the front line to the executive ranks, internal controls should be standardised and automated with workflow management systems.

Ultimately, strong internal controls provide:

- Compliance with organisational policies
- Compliance with laws and regulations
- Protection against waste, fraud, and inefficiency
- Reduced organisational risk
- Reporting accuracy and consistency across business units and departments
- Documented evidence of compliance or non-compliance for internal auditing
- Management controls

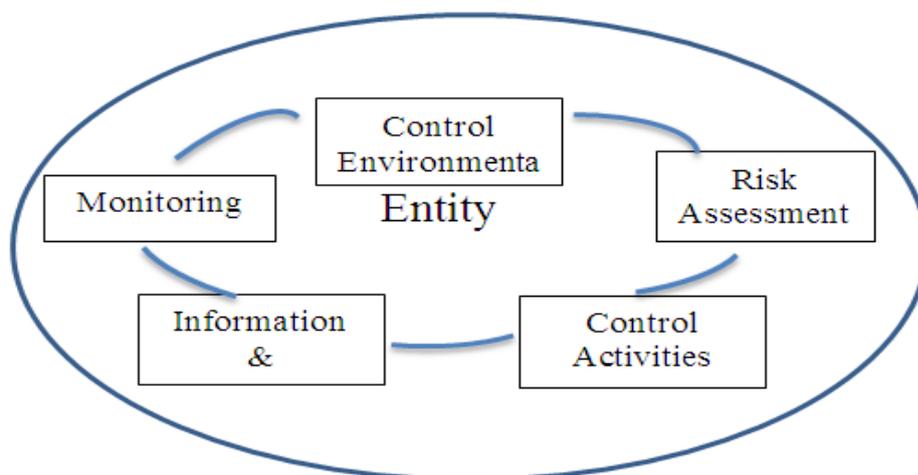
Regardless of industry, the compliance function is responsible for ensuring that the company's policies and procedures are designed to comply with applicable laws and regulations, and ensuring that those policies and procedures are followed. Integrity provides a consistent, secure, auditable workflow for any compliance system and enforces consistent

processes to match the policies and procedures within your organisation or department. As compliance regulations continue to increase in both number and scope, the automation of compliance workflows has become critical. This is applicable whether you need to comply with Sarbanes-Oxley, ISO Standards, the Gramm-Leach-Bliley Act, HIPAA, SEC, FINRA, OCC, internal security protocols, incident management or any other compliance requirements. This study focusses on how internal control systems can affect the compliance of employees in meeting tax obligations.

## Literature Review

In 1992, the Committee of Sponsoring Organizations (COSO) defined internal controls as a process, and rightly so, because an internal control system is not an end in itself but a means to an end. Internal control is defined as a “process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: Effectiveness and efficiency of operations, Reliability of financial reporting, Compliance with applicable laws and regulations” (COSO, Internal Control-Integrated Framework, 1992). Again, the Basel committee on banking supervision defined internal controls “as a process effected by the board of directors, senior management, and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within the bank” (Basle, 1998).

**Figure 1.** Integrated Internal Control Framework for an Organisation (COSO)



A system is a set of interrelated and interdependent components that interact in a way to achieve a set goal. These components or sub-systems are inter-dependent, and the failure of one component leads to the failure of the whole system. An organisation is a complex system that is divided into various sub-systems (units, divisions, departments, etc.) and hence

requires a system of controls over units, divisions, departments, etc., for its effectiveness and survival. An effective internal control system is an integrated system with interrelated components, supporting principles and attributes. Harvey and Brown (1998) identified the control environment, accounting system, and control procedures as the major components of internal controls (Harvey & Brown, 1998). According to Grieses, an internal control system available to a firm consists of management oversight and the control culture, risk recognition and assessment, control of activities and segregation of duties, information and communication, and monitoring activities, and correcting deficiencies (Grieses, 2000). The paper adopts COSO's 1992 integrated internal control framework. The COSO was commissioned in the nineteen-eighties by the National Commission on Fraudulent Financial Reporting (the Treadway Commission) to identify the factors that caused fraudulent corporate financial reports and make recommendations. It has since developed to become a thought leader in enterprise risk management (ERM), internal control, and fraud deterrence (Amudo & Inanga, 2009). In 1992, COSO published a landmark report on internal control: Internal Control-Integrated Framework, referred to as "COSO". The framework classifies an organisation's internal control system into five integrated components that must be built into business processes across the entire entity, in its efforts to achieve objectives. The components are: control environment, risk assessment, control activities, information and communication, and monitoring activities.

An internal control system is an integrated system merged with management processes to achieve overall organisational goals. For an organisation to achieve its organisational objectives, then the five control components of the control environment, risk assessment, control environment, information and communication, and monitoring, must be integrated into management processes across the entire organisation (subsidiaries, divisions, units). Like the body system, the internal control components and business processes must interact ceaselessly for a healthy, effective internal control system. The seamless and collaborative interaction of an internal control system with business processes is a prerequisite for the effectiveness of an internal control system. Control objectives and measures that are derived from the monitoring and assessment of risks must be integrated into operational business units and business practices (PricewaterhouseCoopers, 2007) through an effective information and communication control component that ensures a smooth flow of information to personnel responsible for internal controls across the entity.

Glance (2006) provided that an internal control system refers to "the local government process and procedure that is been established with the aim of objective achievement". Section 125 of IAG (2008) stipulated that "local government should provide a sound system of an internal control system which should assist toward the achievement of an objective". Similarly, the internal control system also serves as a process that guides an organisation towards achieving its established objectives (Amudo & Inanga, 2009; Baltaci & Yilmaz,

2006; Jokipii, 2010). From the above definition of an internal control system, it can be understood clearly that it regards the provision that will assist in the achievement of objectives. Therefore, for the purpose of this study, effective internal control system refers to the effective control measures established by an organisation to safeguard their assets and ensure the reliability of records, both financial and non-financial, as well as compliance with relevant policies and procedures that will ensure the achievement of organisational objectives. In this context, the local government should ensure that their internal control system is well established to assist internal audits towards the objective achievement of the organisation.

Similarly, the quality of an organisation internal control system has a significant impact on the accuracy of management guidance. Likewise, firms that disclose ineffective internal controls system have a larger tendency of experiencing management errors in their operation than those firms that report an effective internal control system (Feng, Li, & McVay, 2009). Therefore, it is the responsibility of the management of an organisation to ensure that an effective internal control system is put in place that will ensure the achievement of organisational established objectives. This is because the establishment and supervision of effective internal control systems are the responsibility of management, not auditors (Changchit, Holsapple, & Madden, 2001). At the same time, an effective internal control system is a fundamental driver towards earnings quality (Church & Schneider, 2008). In the same vein, an effective internal control system has an essential role to play in a firm's success (Jokipii, 2010). In line with the above issue, an effective internal control system could also play an important role in the effectiveness of internal auditors, particularly at the local government level.

The COSO also provides the basic principles representing the fundamental concepts of effective internal control in five components of the framework (Candrea, 2006; Sudsomboon & Ussahawanitchakit, 2009). Although, Amudo and Inanga (2009) argued that the weakness of the COSO mechanism is a failure to recognise information technology as one of the major control components of an internal control system, and information technology is very crucial to the internal control framework. That is why most organisations today use information technology for authorisation, initiation, recording, and processing of transactions because it ensures the effectiveness of the internal controls system and thereby, making it six. At the same time, advancements in technology have increased the importance placed on the internal controls system (Rezaee, Elam, & Sharbatoghlie, 2001). These components must be present and functioning effectively for any internal control system to achieve organisational objectives (COSO):

**Control environment:** is the major aspect of managing an organisation. This is because it is a reflection of the attitude and the policies of management in regard to the importance of

internal auditing in the economic unit (Karagiorgos, Drogalas, & Giovanis, 2011). It influences the achievement of organisation goals (Aldridge & Colbert, 1994). However, it is the foundation for the other components of internal control and providing structure (Sudsomboon & Ussahawanitchakit, 2009). The control environment assists in reducing the level of fraudulent activities within organisational operation. Also, the quality of an entity's internal controls system depends on the function and quality of their control environment (Amudo & Inanga, 2009). Therefore, providing a proper control environment for a local government is essential to the effectiveness of their operation.

**Risk assessment:** this is the identification and analysis of relevant risks associated with the achievement of the management objectives (Karagiorgos et al., 2011). Similarly Sudsomboon and Ussahawanitchakit (2009) view risk assessment as the process of identifying and analysing management relevant risks to the preparation of financial statements that would be presented fairly in conformity with general accepted accounting principle. In this situation, management must determine the level of risk carefully to be accepted and should try to maintain such risk within determined levels. Therefore, local governments are required to frequently assess the level of risk they are experiencing to take necessary actions.

**Control activities:** these are policies, procedures, and mechanisms that ensure management's directives are properly carried out (Aikins, 2011; Rezaee et al., 2001). The proper documentation of policies and procedural guidelines in these aspects help to determine not only how the control activities are to be executed, but it also provides adequate information for an auditor's examination of the within adequacy of control design over financial management practices (Aikins, 2011). These control activities ensure that all necessary actions should be taken to address risks so that organisational objectives are achieved. An example of control activities includes the segregation of duties, the daily deposit of cash receipts, bank reconciliations and limiting access to check stock.

**Information and communication:** refers to the process of identifying, capturing, and properly communicating relevant information and within a timeframe to accomplish the financial reporting objectives (Aldridge & Colbert, 1994). However, effective communications should occur in a wider sense with information within the various sections of the organisation (Karagiorgos et al., 2011). Most of the recent literature on internal control system frameworks are concerned on information and communication as one of the internal control system components, because of their importance in influencing the working relationship within the organisation at all levels (Amudo & Inanga, 2009). Hence, such information must be communicated throughout the entire organisation to permit personnel to carry out their responsibilities concerning objective achievement.

**Monitoring:** it is usually accepted that internal control systems need to be adequately monitored to assess the quality and effectiveness of the system's performance over time. Monitoring assures that the findings of audits and other reviews are promptly determined (Karagiorgos et al., 2011). Furthermore, the monitoring of operations also ensures the effective functioning of the internal controls system (Amudo & Inanga, 2009). Hence, monitoring determines whether policies and procedures designed and implemented by management are being carried out effectively by employees.

## **Methodology**

This research uses a descriptive qualitative method with case studies at 11 Legal Entity Universities. The research describes and analyses the design of internal control system procedures that should be carried out by universities in overseeing the fulfillment of their tax obligations. The data collected is primary data and secondary data. Primary data is in the form of interviews with internal control units, and secondary data is in the form of applicable laws and regulations, and other relevant documents.

This study uses an interactive model in the analysis of interview data. Interactive models use four components of data collection, data reduction, data presentation, and conclusions or verification (Miles & Huberman, 1984; Sugiyono, 2007). The data reduction is made by coding and axial coding of the results of the interview, then copied in the form of transcripts, analysed, and given a specific code on each phrase, sentence, or paragraph based on the topic. The process of data reduction is carried out continuously throughout the study.

The withdrawal of conclusions and verification is made based on the process of reduction and presentation of data. The conclusions are supported by valid and consistent evidence throughout the research process.

## **Results and Findings**

Based on the Legal Entity University statutes as presented in Table 1, all Legal Entity Universities have the same work units in the context of internal control. All Legal Entity Universities also have audit committees that serve as the Board of Trustees (BoT) in conducting non-academic oversight. All Legal Entity Universities have work units that carry out the audit or internal supervision function and work units that carry out the academic quality assurance functions.

**Table 1:** Work Unit in Legal Entity University

No	Univ	BoT	AS	Rector	AC	RC	IAU	AQA
1	UI	√	√	√	√	√	√	√
2	ITB	√	√	√	√	-	√	√
3	UGM	√	√	√	√	-	√	√
4	IPB	√	√	√	√	-	√	√
5	UPI	√	√	√	√	-	√	√
6	USU	√	√	√	√	-	√	√
7	Unair	√	√	√	√	-	√	√
8	Unpad	√	√	√	√	-	√	√
9	Undip	√	√	√	√	-	√	√
10	Unhas	√	√	√	√	-	√	√
11	ITS	√	√	√	√	-	√	√
<b>BoT: Board of Trustees</b>				<b>RC: Risk Committee</b>				
<b>AS: Academic Senate</b>				<b>IAU: Internal Audit Unit</b>				
<b>AC: Audit Committee</b>				<b>AQA: Academic Quality Assurance</b>				

From the results of interviews with the Internal Audit Units, two IAU role codes were obtained, including:

***Internal Control Unit as a Supervisor***

There has not been a special audit program focussed on university tax compliance, but university tax audits have always been a part of every IAU audit program. All transactions audited in any audit program include an examination of the accuracy and compliance of the university tax.

In each transaction cycle, IAU universities provide enough reasonable certainty that: (1) recorded transactions are reasonable; (2) transactions recorded are legal; (3) transactions are authorised accordingly; (4) existing transactions have been recorded; (5) transactions are valued accordingly; (6) transactions are classified accordingly; (7) transactions are recorded in a timely manner; and (8) the transaction is entered correctly into the subsidiary records and is properly summarised.

Supervision carried out by IAU in all Legal Entity Universities is good; this can be seen from the well-paid and timely payment and tax reporting of Employee Income Tax. The withholding of Employee Income Tax carried out by the Treasurer is supervised by the IAU, then Employee Income Tax deducted from the employee's income is then deposited on time. Besides, the treasurer still has another obligation, namely, to make Employee Income Tax



Cut Proof for all employees. This Proof of Cut is made at the beginning of the next tax year and is delivered directly to all employees.

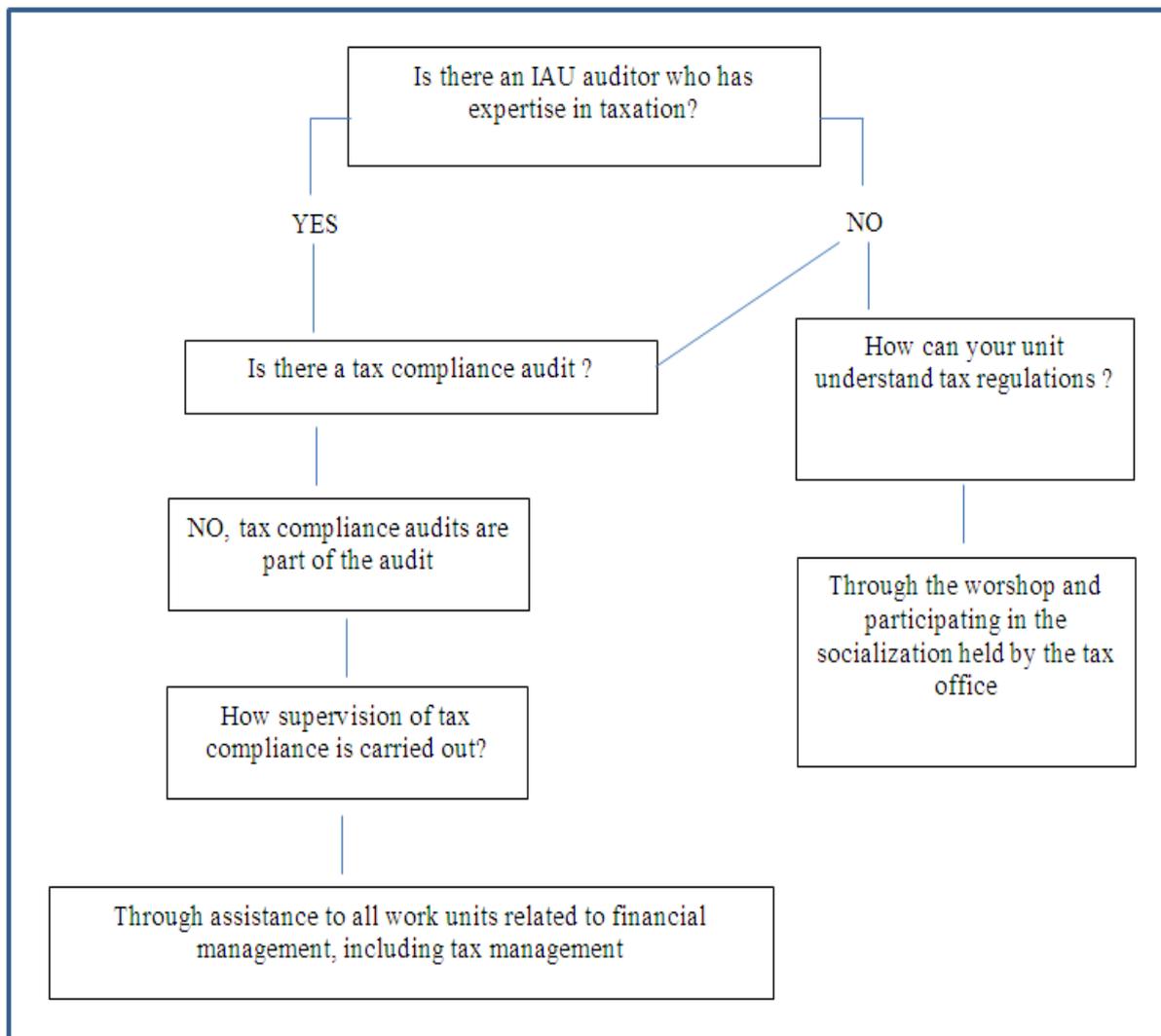
### ***Internal Audit Unit as a Consultant***

Despite the assurance role (e.g. regulatory compliance, operational auditing, financial auditing, and due diligence audits) which was traditionally performed, internal auditors still need to expand and prove their existence by demonstrating the added value they can bring to an organisation (Suhaili & Mahzan, 2012). Therefore, a new definition of IA was officially adopted by the IIA in June 1999, developed by the Guidance Task Force (GTF) where it defines the function as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations” (Nagy & Cenker, 2002, p. 130). The argument is that internal auditors possess knowledge of the company; thus, they can position themselves as consultants when there is a necessity to impart a value factor as IAs within the organisation. Therefore, in this respect, internal auditors may participate proactively, such as supporting the board and the management team through a consulting role and providing prudent advice towards business improvement, should the company be interested in venturing into new business transactions. Sarens and De Beelde (2004) also state that the definition of IA resulting in the internal auditor’s expanded roles is to support the management, audit committee (AC), the board of directors, external auditors, and other key stakeholders (IIARF, 2003; Rezaee, 2009). This has consequently raised the importance of IA as a key component towards good corporate governance practice (Spira & Page, 2003; Gramling et al., 2004).

The implementation form of the internal control depends on the complexity of the corporate structure, its legal form, the scale of activity, features of the industry segment, reasonable expediency, the attitude of management to the issue of control, and the requirements of owners. A Legal Entity University has a complex legal form and scale of activity, so the units require a lot of consultation on implementing the rules contained in the statute. To carry out consultations, work units can discuss with the IAU in person, face to face, directly during business hours, Monday to Friday from 08.00–16.00, as well as consultation through the WA Group and social media. IAU has a WhatsApp Group with all work unit management through the WhatsApp Group; IAU and work units can discuss and convey information related to financial management, including tax management.

The details of the interview results can be seen in the block diagram below:

**Figure 2.** The block diagram of the interview results



## Conclusion

This study investigates the role of IAU in fulfilling tax compliance at Legal Entity Universities. The results show that the IAU acts as a supervisor and as a consultant, and both roles are carried out simultaneously.

Realising the importance of the role of the internal audit system in order to achieve the goals and objectives of the organisation and to realise good governance, the leadership of the agency or organisation must be able to make the implementation of the internal audit system a joint responsibility, not only for the smallest work units but up to each individual.



Besides, it is worth remembering that the internal audit system is not only an effort to form administrative mechanisms but is also an effort to change attitudes and behaviour (soft factors). The existing regulation is not the end but is the beginning of the corrective step. Therefore, the implementation of SPIP is very dependent on the commitment, leadership model, and good intentions of all elements and officials and employees of government agencies.

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