

Towards Developing IT-based Tax Fraud Detection Models – The Need for Reform in the Tax Audit/Investigation Process

Gholam Reza Zandi^a, Siti Normala Sheikh Obid^{b*}, Rashedul Hasan^c, Al Seddig Alshali Ruhoma^d, ^{a,d}Business School, Universiti Kuala Lumpur, Malaysia, ^bIVY Academy, Malaysia, ^cSenior Lecturer, Nilai University, Malaysia, Email: ^{b*}drctnormala@gmail.com

Tax fraud is considered to be a global phenomenon affecting both developed and developing countries. It affects all sectors of a state, and can take different forms and methods which are illegal or immoral. Statistics show that tax evasion and fraud in developed countries ranges from 5% to 25%, while it is 30% to 40% in developing countries. In Malaysia, taxpayers abused the Inland Revenue Board Malaysia (IRBM) and fraudulently obtained about RM 47 billion in the last two years alone; the government also lost about RM 1.4 billion after the failure of 20 companies to pay their taxes (Sabin, 2015). There are several methods and tools to detect and limit tax evasion activities, such as statistical models, logistic regression, as well as neural networks. Recent research on fraud detection has been much more varied in the methods studied, such as the detection of fraud using analytical techniques or data mining methods, with a particular focus on computer intelligence-based techniques. Another means of detecting tax evasion is cross checking official sales and purchase accounts. The purpose of this study is to develop a tax fraud detection index as a mechanism to assist tax auditors detect fraudulent corporate reporting and to prevent tax evasion. This study focuses on integrating the development of index with the online tax reporting system to develop a convenient system for both taxpayers and tax auditors. Using semi-structured interviews with IRBM, external auditors and academic experts, as well as opinions from taxpayers, are used to discover/explore potential information of disclosure. Content analysis of transparency in tax reporting using TFDi has been adopted after access to sample tax fraud case files.

Key words: *Tax, Fraud, Detection, Fraud Triangle, Compliance.*

Introduction

Tax noncompliance has always been a major concern for all tax administrators, more so in self-assessment environments, where there is dependency on voluntary compliance (Faa and Gioak, 2008). Since 1990, researchers have tried to explain why people should pay taxes when the chances of being audited are low, or the penalties are very small (SNS Obid, (2004), Mohdali and Pope, (2014). Tax audits are conducted to ensure the essence of the Self-Assessment System (SAS) is being implemented. In Malaysia, IRBM officials utilise a street survey approach by visiting the premises of particular business premises during tax audits (Fatt and Ling, (2010). Another means of detecting tax evasion that is used by tax officials is cross-checking official sales and purchase accounts. The amount of concealed income unearthed during tax audits clearly indicates that there is widespread tax noncompliance in Malaysia and the quantum of tax lost through tax noncompliance is quite high (Yusof, Ling and Wah, (2014).

The lack of a workforce often restricts the ability of tax authorities to conduct an audit for corporate taxpayers. The controversy over tax auditor's role in fraud detection begins with the argument that an audit should be done by a competent, independent, individual and involves the collection and assessment of evidence to decide and report on the degree of correspondence between the information and certain established areas (Arens, Elder and Beasley, 2003). The advancement of technology has allowed the top management of companies to conceal the extent of tax fraud which leads to the erosion of investor confidence and a decrease in tax collection. Most corporate frauds result from the misconduct of managers, who commit tax fraud either for personal interest or organisational reasons.

Only a limited number of studies have focused on corporate tax fraud in Malaysia (Said, Abidin and Nassir, 2013; Juahir, Norsiah and Norman, 2010; Khadijah and Pope, 2010; Yusof and Lai, 2014). None have attempted to develop an index for tax fraud detection. Within auditing research group, Daniele (1992), and Leinicke, Rexroad, & Ward (1990) found the beneficial usage of computer fraud auditing and highlighted examples where computers have played an important role in cost-effective detection activities.

There have been studies in a Malaysian context that focus on the importance of TAIF towards improving tax compliance. Taxpayer uncertainty about the proportion of evaded tax that an audit will detect increases compliance for taxpayers with a positive index of absolute prudence, provided that they believe that the fraction of evaded tax that will be detected if an audit is undertaken, multiplied by the gross penalty rate, is at least equal to one (SN Obid (2004), Snow, S. and Jr., 2005), & Siti Obid and Abdi Rahman (2011). This research aimed at developing TDFI using TAIF and IRMB by integrating it with an online self-assessment system. In developing the conceptual framework, references are made to secondary sources,

together with a semi-structured interview with scholars, taxpayers and regulators, to gain opinions and suggestions that will be translated into the draft index. In validating the draft index, the study has invited panel experts and academics to confirm the proposed index.

There are many concepts for tax fraud. Sandmo and Allingham, (1972) defined tax evasion as an attempt by the taxpayer to get rid of the tax burden and the lack of a legal obligation to enforce it. While Myles (2000), defined tax evasion as the taxpayer not paying state taxes on income or wealth or any other tax revenue (e.g. consumption or importation), or reducing the amount of these taxes through the use of illegal methods such as fraud, deception and bad faith. Yo Yitzhaki (2000) refers to tax evasion as the efforts of taxpayers to avoid taxes in an illegal way. Tax evasion usually involves hiding the actual status of the taxpayer's income in a deliberate manner, vis-à-vis the tax authorities reducing the value of taxes, including providing inaccurate tax reports, such as declaring profits below their real value. Nwachukwu (2006), stated that tax evasion is used by sole proprietorships and other entities such as trusts, to evade taxes by illegal means. Therefore, tax evasion is usually a deliberate act of taxpayers to distort or conceal the fair and equitable position of their income from the respective tax authority so as to minimize their tax liability.

Tax Fraud: The Malaysian Evidence

Tax revenue is vital for any government as it is one of the most needed financial resources for a country to accomplish its' objectives (C.M.M. Lopesb, A.C. Borrego, 2016). There are many types of taxes and with the expansion of their scope; there is a serious phenomenon arising in taxation, called tax evasion. Tax evasion is a threat to the taxpayers who do not comply using the direct methods and evade tax indirectly. In many countries, the public is increasingly concerned with issues of tax evasion and economic fraud, which prevent the state from realizing the goals of their economic and social policy (Maumita Bhattacharya, and Jarrod West, 2015). There is proven evidence that tax evasion is very severe in developing countries and transition economies (Bhattacharyya et al., 2011). Taxation laws in most countries state that tax is a compulsory financial contribution, by individuals and businesses, to the government, for it to achieve specific objectives (A.C. Borrego, C.M.M. Lopesb, 2016). Many countries around the globe are very concerned about the issues of tax evasion and economic fraud.

Tax evasion and economic fraud prevent the state from realizing the goals of its' economic and social policy (Maumita Bhattacharya, and Jarrod West, 2015). Tax evasion is a form of economic crime and the consequences are serious, as it results in the loss of revenue for the government. Jia (2002) estimated that 444.6 billion yuan is lost through fraud, i.e. 35.11% of the total tax revenue of 1266.6 billion yuan in 2000. Statistics have shown that tax evasion and fraud in western industrialized countries is between 5%-25% and between 30%-40% for

developing countries (Franrom, 2000). This clearly shows that there are more cases of tax evasion in developing countries than in the industrialized economy. The Greek economy is estimated to have 40% of its GDP as prone to tax evasion. Moreover, the Italian tax authorities reported that 15% of its' economic activities were not declared. According to Murphy (2011), total world tax evasion exceeds 3.1 trillion US dollars or 5.1% of global GDP. Through this, the widespread consequences of fraud can be seen.

In Malaysia, taxpayers have "cheated" the Inland Revenue Board Malaysia (IRBM) of about RM 47 billion in the last two years. They "beat" the national tax collection system by understating their taxable income, or by simply not reporting it. Sabin (2015) claimed that IRBM was expected to collect ~RM139 billion in 2014, but only collected ~RM 120 billion. In 2015, stranded taxpayers refused the IRB's target of RM 145.2 billion. He also claimed that that there had been a constant fiscal deficit of 20% in the country in recent years. Farhana, Syed & Nokman (2017) added that the government also lost about RM 1.4 billion after the failure of 20 companies to pay their taxes (Farhana Syed Nokman, 2017).

Recent Advances in Fraud Detection: Big Data and Accounting Research

Glover and Aono (1995) proposed a new fraud detection paradigm by integrating corporate culture and industry traits into the traditional audit risk model, to develop a more proactive integrated model to prevent and detect fraud. Looking through the cases of Fortune 500 companies, the study noted that a firm's culture permeated through hiring practices, promotion and training, which led to fraudulent reporting and resulted in the company filing bankruptcy. Similar suggestions were provided by Pashev (2007) while exploring the VAT fraud prevention mechanism for Bulgaria. Pashev (2007) concluded that the possible solutions are through the field of optimising risk management and the application of the principle of joint liability, rather than through tighter controls in the conduct of business. The study also mentioned two broad categories of VAT fraud, firstly the use of traditional tax evasion systems and secondly, the abuse of tax returns through factious transactions and tenders. In addition to fraud, corruption and specifically bribery, have been reported to be rapidly increasing and having a significant impact on businesses (Kapardis and Papastergiou, 2016).

The evolution of big data has captured the interest of both academics and professionals and is traced by Bumblauskas, Nold, Bumblauskas, & Igou (2017) through a chronological review of related literature. Fredrick Winslow Taylor (1911) played an important role in the evolution of big data with his famous work "The Principles of Scientific Management". Big data is an ambiguous and flexibly defined term that is often associated with the collection and analysis of "large" data sets (Bumblauskas *et al.*, 2017). Gartner cited in Arnaboldi, Busco, & Cuganesan (2017) defined big data as high-volume, high-velocity and high-variety



information assets that demand cost-effective and innovative forms of information processing for enhanced insight and decision making.

The definitions incorporate the three basic elements of big data including volume, velocity and variety. In the context of big data, volume refers to the magnitude of data, while velocity relates to the rate of data generation and processing requirements, and variety is the type of data that refers to the possibility of dealing with both structured and unstructured data.

Research has examined the role of visualisation and narratives in corporate reports that make the relationship between intangible resources and organisational value visible (Cuganesan and Dumay, 2009). Accounting practitioners may seize the opportunity to balance enthusiasm and rigour in using big data due to having a long tradition in fitting and checking data to achieve business value (Ma and Tayles, 2009). However, the abundance of already available data and pressing deadlines, may force accountants to become reluctant in processing the large volume of big data collected from various sources. Secundo, Vecchio, Dumay, & Passiante (2017) provided a multi-level conceptual framework that contributed to the Intellectual Capital (IC) literature in light of the emerging paradigm. The framework addresses the main motivations, objectives and opportunities to incorporate big data into Information and Communication Technology (ICT) strategy and practices.

Detection of Tax Evasion and Indicators

The difficulty in detecting tax evasion activities is a challenging issue for most tax authorities. Due to this problem, public investment will be negatively affected if the government cannot detect tax evasion activities, and a fiscal shortfall will result from the loss of tax revenue. Different approaches have been used by tax offices to prevent tax evasion, such as criminalizing actions from simple non-compliances, such as a deliberate failure to properly file a tax return. Other countries may apply criminal sanctions at a higher threshold, where the deliberate non-compliance with a tax obligation is accompanied by aggravating circumstances, such as if the amount of the tax exceeds a certain threshold, if the offense is repeated, income is actively concealed, or when documents or evidence are deliberately falsified. Alternatively, countries may set a very high threshold for classifying tax crimes, such as for-profit organized crime, or tax evasion with particularly aggravating circumstances. Common examples are presented in Table 1.

Table 1: Common Examples to Tax Evasion

Category	Examples
Non-compliance offences (may apply irrespective of intent or result)	<ul style="list-style-type: none"> ● Failure to provide required information, documents or returns ● Failure to register for tax purposes ● Failure to keep records ● Keeping incorrect records ● Making a false statement ● Non-payment of a tax liability
Intentional tax offences	<ul style="list-style-type: none"> ● Destroying records ● Deliberate failure to comply with tax law to obtain financial advantage ● Evading tax or receiving refunds by fraud or illegal practices ● Intentional reduction of tax using false documents, fictitious invoices ● Counterfeited or forged documents to reduce tax <ul style="list-style-type: none"> ● Intentionally, or by gross negligence, providing misleading information in a tax return to obtain a tax advantage ● Fraudulently obtaining refund / credit ● Theft from or defrauding the government ● Obstructing an official of the tax authority
Specific offences	<ul style="list-style-type: none"> ● Accessory offences ● Entering an arrangement that would make person unable to pay tax ● Committing tax evasion as member of a gang ● Commercial commission of tax evasion ● Illegal use of zappers or sale suppression software ● Identity theft

In general, there should be a comprehensive tax compliance strategy covering the full range of compliance, ranging from voluntary compliance to avoidance, involuntary non-compliance, serious crime and tax evasion. However, the specific strategy would be based on the legal system, legislative environment, policy and overall law enforcement structure of each country. Table 2 presents the range of actions and behaviours that can be taken to improve compliance.

Methodology

The study was designed to provide an explicit review of tax fraud detection through selecting and analysing relevant documents. Documents that dealt with various aspects of tax fraud are chosen in this study. Based on the extensive review of selected literature, this study was able to provide a description and evaluation of the current body of knowledge on tax fraud

detection. The study believes that a semi-structured interview will be the best approach to obtain comments, clarifications and suggestions from scholars on the proposed items. The details of the experts are in Table 5.

Table 2: The Range of Behavior and Measures to Enhance Compliant

Tax fraud (serious organized crime)	Combatting and preventing fraud	<ul style="list-style-type: none"> • Tax investigation and audits • Prosecution and penalties • Elimination from legal financial circles • Cooperation with the judicial system/police
Tax evasion (shadow economy, income underreporting, illegal employment)	Controls and sanctions	<ul style="list-style-type: none"> • Controls, investigations • Tax audits (risk analysis) • Prosecution and penalties • Tax collection
Tax avoidance (aggressive tax planning, avoidance models)	Monitoring and cooperation	<ul style="list-style-type: none"> • Risk management • Office and field staff controls • Official first visits • Tax collection
Tax compliance (voluntary disclosure, fulfilment of tax obligations)	Support an simplification	<ul style="list-style-type: none"> • Information and forms • Cooperation with interest groups • Horizontal monitoring • Advance rulings

Table 3: Factors influencing tax fraud

Factors	Explanations	Author and Date
Cognitive Factor	The attitude of the taxpayer toward the tax system that could affect the intention of tax fraud.	Yusof & Lai (2014)
Normative Factor	Influences from various stakeholders affecting one's choice and activities.	Abuznaid (2011)
Internal Control	Internal control factors are examined through tax audit experience.	Khadijah & Pope (2010)
External Control	Enforcement of tax laws can be an effective form of external control that could reduce the number of tax frauds committed under the self-assessment system.	Yusof & Lai (2014)

Fraud Diamond	Fraud Diamond theory provides three factors that are present when fraud occurs. These include opportunity, pressure and capability.	Wolfe & Hermanson (2004)
Religious/Ethical Obligations	Religious/ethical obligation refers to the role of religion in affecting one's choice and activities.	Amin, Rahman, Sondoh & Hwa (2011)
IT-based Tax Audit	Implementation of an audit procedure that relies on the BIG data analytical procedure to detect tax fraud from self-assessment report.	Vasarhelyi & Romero (2014)

In constructing TFDi, the route of the development is presented in Table 4.

Table 4: Route of the Development of TDFi

Process	Description	Instrument
Stage 1	Identification of the disclosure items from various sources	Initial TFDI
	a) Finalising the items by conducting a semi-structured interview with scholars.	
	b) Obtain opinions from tax payers and regulators to discover potential information of disclosure index.	
Stage 2	Identification of measurement, structure and scoring procedures	Validated TFDI
Stage 3	Assessment of validity (expert review and academics)	

Table 5: List of Scholar

Panel Groups	Panel Description	Approach\Number of panel members
Scholar (academics)	Tax background	4 panels and face –to face interview
Tax Auditor	Audit background	4 panels and face –to face interview
External Auditor	Tax background	4 panels and face –to face interview
Total		12

Apart from the confirmation of scholars, an interview session (face to face) with taxpayers and tax auditors is carried out. Taxpayers will be represented from both institutions and corporations. The questions will be prepared on an open-ended basis, and each interview session will then be recorded and transcribed. The detail of the number of interviewees of respondents i.e. taxpayers and tax auditors are given in Table 6.

Table 6: List of Respondent Groups.

Panel Groups	Panel Description	Approach\Number of panel members
Taxpayers	• Corporate taxpayers	Focus group: 2 panels
	• Executive of IRBM	Focus group: 2 panels
	• Academic (Financial reporting specialisation on disclosure index), auditing, Tax accounting and law	Focus group: 2 panels
Tax Auditors	Experience in performing tax audits	Focus group: 2 panels
Total		10

After the interview, all the possible and related information will be translated into the list before the draft of disclosure is compiled. A revised draft disclosure index will be prepared according to the recommendations and suggestions given by both groups. The final stage is to test the validity and reliability of the draft TFDi. Hence the draft disclosure index of TFDi will be reviewed by the panel of experts, who have experience in tax reporting.

Data Collection

The content analysis of transparency in tax reporting using TFDi was adopted. A formal letter was sent to IRBM requesting access to tax fraud case files. Each of the cases were examined, and the items included in the TFDi were counted.

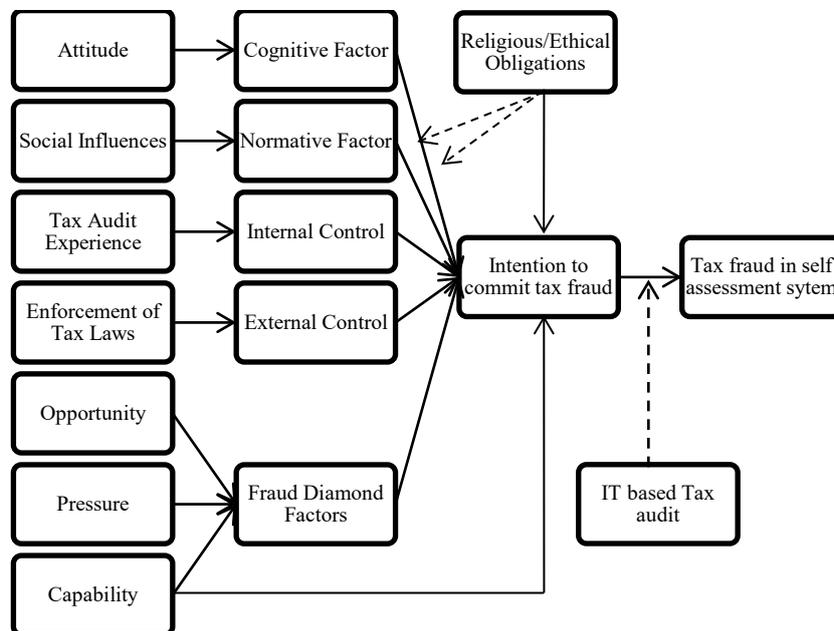
Scoring the Extent of the Transparency in Tax Reporting

The unweighted index, the binary coding system or dichotomous index, was exercised for all disclosure items. If the item was present, then the score of one (1) was awarded and zero (0) was awarded if it was not disclosed. In other words, the sum of the scores related to the extent of tax fraud in tax reports. In order to control the subjectivity in examining and scoring the reports, the reports were assessed and scored independently by two experienced researchers in disclosure studies. Any discrepancies will be discussed to obtain a consensus. The IRBM is committed to detecting, deterring and dealing with tax evasion and fraud and taking action against taxpayers or their representatives. The IRBM undertakes compliance activities, including criminal investigations and civil audits to combat fraud and tax evasion. IRBM officials use a street survey approach to visit the premises of some commercial premises during the tax audit (Fatt & Ling, 2010). Another way to detect tax evasion, that is used by tax officials, is checking the purchase accounts and official sales.

Advances in technology have made the world more dependent on financial information, and we have reached a point where such dependence is leading toward a higher level of financial

statement fraud. The introduction of online reporting systems have both merits and demerits, but a proper fraud detection system is still absent within the online self-assessment system. This paper explores tax fraud from corporate perspectives. Both theoretical and practical models of tax fraud detection were discussed. Evidence provided in prior studies indicates that there are differences in the perception of an auditor's role in corporate tax fraud detection. While the general public expects auditors to perform the additional duty to detect tax fraud, auditors, on the other hand, perceives this duty to be performed by the management through utilisation of strong internal control mechanisms. Among several theories of tax fraud detection, the fraud triangle theory was most frequently used. The proposed model presented in Figure 1 focuses on the use of IT-based tax audits and tax investigation procedures to detect tax fraud in the self-assessment system. An IT-based tax audit and tax investigation is positioned as a moderator that can influence the relationship between the intention to commit tax fraud and the actual tax fraud detected by the tax officers in the self-assessment report. The model has included several antecedents that can influence the intention to commit tax fraud based on the propositions of the TPB and FDTi. The significance of the proposed model is the introduction of Religious/Ethical obligations as a moderator.

Figure 1. Proposed IT based tax fraud detection model





Conclusion

A review of the prior literature on tax fraud revealed that a majority of the literature focused on individual tax fraud with a handful focusing on corporate tax fraud. This study provides an IT-based tax fraud detection model using the latest technology in tax audit procedures to allow tax officials to detect tax fraud in the self-assessment system. The introduction of the IT-based tax audit procedure as a mediator in the model, helps to determine the level of psychological impact it could make in the taxpayers' mind that will ultimately prevent their intention to commit tax fraud.

The majority of Government tax revenue in Malaysia comes from the corporate tax payments. Thus, the fraud detection model could provide valuable information to the IRBM authority in understanding the factors that lead to corporate tax fraud. The model also suggest solutions, by proposing an IT-based tax audit procedure which is structured on big data based data mining technology. This study is theoretical in nature and statistical evidence to validate the model will be provided in a separate paper based on a survey as part of an on-going research project. However, the integrated model presented in this paper has addressed the need to develop both proactive and reactive measures of tax fraud detection through a complete review of various frameworks that cover prevention and detection of tax fraud.

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