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# EFFECTS OF TAX AUDIT OUTCOME ON BUSINESS PERFORMANCE: A CASE OF IRINGA MUNICIPALITY

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## ABSTRACT

This study is an attempt to determine the effect of tax audit outcome on business performance; a case of Iringa Municipality. Specifically, it examined the effect of Penalties and tax refund on business performance in Iringa Municipality. The study included a sample of 63 observations from 75 audited companies in Iringa Municipality. A case study was employed where simple random sampling technique was used to collect quantitative data. The data was analysed by linear regression model using ordinary least squares estimator. The findings show that penalties have a negative relationship with the business performance, while tax refund has a positive relationship with the business performance. The co-efficient of determination, the adjusted $R^2$ was to 0.861, which shows that the independent variables explain about 86.1% of the variation in the dependent variable. The study concludes that both two variables, that is, penalties and tax refund affect business performance as hypothesized in the model. The study recommends that penalties should be reduced to audited companies because they negatively affect business performances. Moreover, tax should be reasonably estimated from audited companies so as to avoid overpayments of tax by taxpayers. When collected taxes are more than the estimated amount, reimbursement to the company should be done effectively and on due date so as to trigger business performances of audited companies in Iringa Municipality.

### INTRODUCTION

Tax is a contribution exacted by the state. It is a non-penal but compulsory and unrequited transfer of resources from the private to the public sector, levied based on predetermined criteria. The classical economists were in view that the only objective of taxation was to raise government revenue. However, with the changes in circumstances and ideologies, the aim of taxes has also been changed (Kirchler, 2015). Thus, today taxation is one of the important elements in managing national income, in both developed and developing countries. Tax is defined as 'a compulsory levy, imposed by government or other tax raising body, on income, expenditure, or capital assets, for which the taxpayer receives nothing specific in return' (Lymer and Oats, 2015). However, not all payments to government are considered tax payments: for example, charges, and other levies are paid to obtain a specific service and are not strictly tax payments.

Tax administrations carry out audits so as to verify that the taxpayer has complied with provisions of the tax legislation (OECD, 2016). A tax audit is an investigation made by the tax authority to verify the accuracy of tax returns and attempt to detect non-compliance behaviour and activities (Kirchler, 2017). However, the role of an audit in a modern tax administration goes beyond verifying a taxpayer's reported obligations and detection of discrepancies between taxpayer's declarations and supporting documentation. According to the Federation of Tax Administrators in Ethiopia (undated), the audit program of a revenue body performs several important roles that, when effectively carried out, can make a significant contribution to improved administration of the tax system. The efficiency and effectiveness of a revenue body's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.

It has never been easy to persuade all taxpayers to comply with the requirements of a tax system. Tax compliance is likely to become a more significant aspect of tax policy as most of the old problems remain and new considerations are raised by developments such as self- assessment, the emergence of the global economy and development of technology. These factors have policy implications about the way the tax system should be administered. One risk with self-assessment is the temptation to rely on a harsher enforcement regime. It has been alleged from time to time, for example, that the revenue authorities have sometimes relied on eager enforcement or excessively corrective methods of securing compliance with their self-assessed income tax system (Payne, 2018). However, there seems to have been signs of fundamental change in the approach of some tax agencies with respect to taxpayers. On the other hand, given the actual low rates of audit and rather mild Penalties it is argued that deterrence cannot account for the generally high levels of compliance (Alm, et al., 2015).

Recently many poor countries have become preoccupied with improving tax systems. For instance, Tanzania amended the tax laws with new provisions and procedures to assist the taxpayers in complying with self-assessment process to reduce tax evasion, thereby increasing the revenue generated through tax; for example, the government replaced the sales tax with Value Added Tax (VAT). Furthermore, the United Republic of Tanzania is trying to improve its tax administration capacity which encompasses tax audit as one of its components (Misrak, 2017).

Tax audit is a critical and significant component of the compliance activities of tax administration by means of proper use of enforcing tax laws. It is conducted by audit staff to the selected taxpayers of whether he/she has been correctly declaring the tax liabilities, including a review of taxpayer's systems, books of accounts and other related information. It may include cross checks of taxpayer's records and taxpayer's suppliers' information or with other government departments sources of information. Its effectiveness and efficiency must be guaranteed by means of proper procedures and application of modern audit tools and techniques (OECD, 2016).

A tax audit is one of the most sensitive contacts between the taxpayer and a revenue body, the presence of an auditor in a taxpayer's private dwelling or business premises, coupled with the exploration of private and business issues and the gathering of information from taxpayers' books and records, or just the disruption of day-to-day workflow, represents a burden on the taxpayer (OECD, 2016).

A well-designed tax audit needs a risk-based audit program and application of standardized technology to determine the type of audit, procedures, and duration of audit to achieve its objective. However, according to regional revenue authority's tax audit strategies, review results indicate well designed risk-based tax audit is not in place.

Evidence shows that there are several factors affecting tax audit outcome in business performance not only in developing countries but also in the most developed world; such factors like penalties, tax refund, accumulated tax, audit attributes and organizational independence affect tax audit outcome on business performance (Mihret & Yismaw, 2017; and Cohen & Sayag, 2018). However, tax laws differ from country to country and cannot be applied uniformly because of shortage of qualified tax auditors, resource allocation, audit selection systems, audit strategies and audit manuals, audit scope, monitoring and performance evaluation system, motivation schemes, information technology, integrity of audit staff, and taxpayers' attitude and knowledge about tax audits.

Moreover, while similar studies have been done in several Tanzanian tax regions, there is no concrete evidence of such studies in Iringa. For that matter, this motivated the researcher to assess whether the above-mentioned variables affect business performance.

Tax audit helps revenue authority to achieve its objectives, and making sure there is indirect drive for voluntary compliance and directly generate additional tax collections. Tax audit helps tax authorities to reduce the tax gap between the tax due and tax collected. Although the Tanzania Chamber of Commerce, Industry and Agriculture (TCCIA) issued suggestions and opinions on regulations and directives in different periods to improve the tax audit, the performance of tax audit is very low by the following factors:

From the year 2018/19 audit performance of the revenue records shows that the numbers of files submitted by taxpayers were 760 but only 330 files, which is 43% files were audited, and in 2019/20, 187 files were submitted but only 75 files, which is 40% were audited. Moreover, the performances of audit for past three years 2017/18, 2018/19 and 2019/20 were 43%, 40% and 22% respectively (Mihret & Yismaw, 2017). Thus, it seems that the audit coverage performance is 35% while the remaining 65% are unaudited files. Previous studies such of Mihret & Yismaw, (2017) and Cohen & Sayag, (2018) found that factors like penalties, tax refund, audit attributes and organizational independence affect tax audit outcome on business performance.

Many researches have been done in both developing and developed countries. However, tax laws differ from country to country and cannot be applied uniformly because of qualified tax auditors, resource allocation, audit selection systems, audit strategies and audit manuals, audit scope, monitoring and performance evaluation system, motivation schemes, information technology, integrity of audit staff, and taxpayers' attitude and knowledge about tax audits. Moreover, while similar studies have been done in several Tanzanian tax regions, there was no concrete evidence of such studies in Iringa. For that matter, this motivated the researcher to determine whether if the above-mentioned variables affect tax audit outcome on business performance in Iringa municipality.

## LITERATURE SURVEY

Contingency Theory

This study adopted the Contingency Theory to explain and to interpret the findings on effect of tax audit outcome on business performance. This is due to the existing contingent factors which bond structures that produce and process auditing information. The theory states that there is no best way to organize a corporation, to lead a company, or to make decisions, instead, the optimal course of action is contingent (dependent) upon the internal and external situation (Betts, 2017). Furthermore, Luder (2015) Contingency Model of Government Accounting Innovation is adopted to explain specific individual factors' values and characteristics as well as contingent factors that can influence auditing information. These values are subject to change and are shaped by the influence of internal and external firm pressures. The Contingency Theory has been in existence since 1960s, and is a dominant, theoretical, rational and an open system model at the structural level of analysis of an organization's performance (Betts, 2017).

The theory emphasizes how contingent factors such as technology, size of an organization and the environment affect the design


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and functioning of organizations. According to Galbraith (2018), Contingency Theory is based on two primary assumptions. The first is that there is no one best way of organizing and the second is that any way of organizing is not equally effective. In addition, the Contingency Theory assumes that proper decision-making procedures depend on the importance of the decisions, decision quality, decision acceptance and amount of relevant information possessed by decision-makers and subordinates as well as the probability that subordinates will accept the decisions or try to make good decisions work (Chalu, 2017). Penalties and tax refund emerge as the primary contingency variables that can explain the effect of tax audit outcome as technical activities to be used on business performance process upon which change is subjected to firm's internal and external pressures.

The Effect of Penalties on Business Performance

Nzioki and Peter (2014) studied on the "Analysis of Factors Affecting Business Performance in Real Estate Sectors in Nakuru Town, Kenya". The study used explanatory research design. A sample size of 60 real estate investors was used. Data was collected using structured questionnaire, and analysed quantitatively using descriptive analysis. The study found that higher Penalties/fines simply reduce the pace of business performance thus encouraging tax evasion. Therefore, business performance was strongly affected by the number of penalties/fines than by audit probabilities. Thus, Penalties have a negative effect on business performance, thus the higher the penalty the greater discouragement for potential business investors.

Oladipupo and Obazee (2016) studied on "The Impact of Penalties on Business Performance among SMEs in Nigeria" 50 small and medium enterprises were involved using a survey research design. The data obtained from questionnaire were analysed using Ordinary Least Square estimator. The researcher used a linear regression model. The results showed that interest and penalties imposed have negative significant impact on business performance. Thus, the study shows that interest and penalty imposed have lower tendency to promote business performance. Thus, the government should impose a moderate interest penalty to small and medium scale business owners for the mutual benefits of the governments and taxpayers.

Eliamini (2018) studies on "Factors Influencing Business Performance in Small and Medium Enterprises (SMEs) in Dodoma Municipality, Tanzania". The study employed survey design. The questionnaire, interviews and Focus Group Discussions were used to collect data from 50 respondents. Data analysis was undertaken using descriptive and content analysis. The study found that the behaviour of the business owner is likely to be influenced by Penalties for fraud, benefits of evasion and detection probability. The implication here is that when the auditors impose more Penalties to companies, few businesses will have chance to grow.

Mahenge (2018) studied on the "Effect of Tax audit outcome in Private Sector in Tanzania". The researcher used a descriptive survey design, where 50 tax audited companies were involved. Primary data were collected through questionnaire, while secondary data were collected through documentary review. All data were analysed using descriptive analysis under SPSS version 23 and presented in tables and figures. Study findings revealed that penalties and fine highly affect the company after tax audit conducted. To ensure business performances, taxes should be paid accordingly on due date.

The Effect of Tax Refund on Business Performance

Richupan (2017) studied on "Relationship Between Tax Refund and Business Performance in Gandhi". The study employed a cross-sectional design and primary data was collected from 50 taxpayers whereby regression model was used to analyse data. The researcher used a linear regression model. Data were analyses using ordinary least square technique. The study found that the existence of positive benefits increases the profitability on the business, without direct coercion. Although most taxpayers cannot assess the exact value of tax refund, they receive from the government in return for taxes paid, it can be argued that they have general impressions and attitudes concerning their own and others' terms of trade with the government, although, tax refund has a positive effect on business performance.

Shenkute (2018) studied on "Factors Affecting Taxpayers Business Performance in Ethiopia". The study employed a cross-sectional design; both primary and secondary data was collected from 60 taxpayers and analyzed using descriptive analysis by the aid of Statistical Package for Social Sciences (SPSS V.20). The study was conducted with the aim of identifying the major hindrances of tax collection from taxpayers in Ethiopia. The findings revealed that tax refund; interest and tax education are the major factors influencing business performances in Ethiopia.

Otaro, et al., (2016) conducted research on "Effects of Tax on Business Performance in Kenya". A case study was adopted and descriptive analysis was employed to analyze data from 75 taxpayers. The study aimed at identifying the major sources of tax revenue in Kenya. The study revealed that tax refund and penalty or fine affect the performance of the business of taxpayers in complying with their tax payments.

Makule (2018) examined "The Relationship between Audit Quality and Tax Collections in Tanzania". A cross sectional study analysis of companies listed on the Dar-es-Salaam Stock Exchange was carried out. A sample of twenty (20) audited financial reports of these companies for the period ending 2017 was selected using the simple random sampling technique. The data collected for the variables were subjected to descriptive statistics analysis. Findings indicated that as the quality of tax audit increases, the business performance improves and as the tax refunds increases, business performance improves. It was therefore recommended that auditors should strive for audit quality to ensure taxes are paid well.

## METHODOLOGY

The study included a sample of 63 observations from 75 audited companies in Iringa Municipality. A case study was employed where simple random sampling technique was used to collect quantitative data. The data was analysed by linear regression model using ordinary least squares estimator.

## RESULTS & DISCUSSION

Multiple Regression Analysis

Multiple linear regression analysis was used to determine how independent variables (penalties and tax refund) affect the dependent variable (business performance) whereby 63 observations were used. According to Weiers (2015), a multiple regression analysis is an analysis that involves one dependent variable and two or more independent variables. In other words, it is an analysis of association in which the effects of two or more independent variables on a single, interval-scaled dependent variable are investigated simultaneously (Zikmund, 2015).

4.2.1 Results of Analysis

The model used, as shown from the conceptual model, was linear, that is,

$B.P = \alpha_o + \beta_1 PT + \beta_2 TR + U$

Where, B.P = Business Performance; PT= Penalties; TR= Tax Refund

And $\beta_1 < 0$, and $\beta_2 > 0$

The estimated linear model was B.P = 2.452 – 0.541PT + 0.623TR

(3.405) (-7.191) (8.014)

$\bar{R}^2 = 0.861$, F = 192.295, and t values are in parentheses

From the economic theory, signs parameter estimates conform to the hypothesized signs.

Table 1: Output 1

| Model | | Unstandardized Coefficients B | Unstandardized Coefficients Std. Error | Standardized Coefficients Beta | T | Sig. |
|---|---|---|---|---|---|---|
| 1 | (Constant) | 2.452 | 6.055 | | 3.405 | .000 |
| | Penalties | -.541 | .584 | -.430 | -7.191 | .009 |
| | Tax refund | .623 | .605 | .531 | 8.014 | .000 |

a. Dependent Variable: Business performance

The estimated regression model indicates that a one percentage increase in penalties leads to a change of -0.541 in business performance. A one percentage change in tax refund leads to a positive change of 0.623 in business performance. All two parameter estimates are statistically significant at 5% level. However, all algebraic signs of the parameter estimate for penalties and tax refund conform to the hypothesized signs.

All t-values are greater than 2.0, therefore, according to the rule of thumb, the parameter estimates are statistically significant based on t-statistics. Moreover, they take the correct algebraic signs.

F-Statistical Test

Table 2: Analysis of Variance – ANOVA

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 27054.804 | 2 | 13527.402 | 192.295 | .006[b] |
| | Residual | 4220.837 | 60 | 70.347 | | |
| | Total | 31275.641 | 62 | | | |

a. Dependent Variable: Business performance

b. Predictors: (Constant), Penalties, Tax refund

Interpretation

This was used to test the overall significance of the regression results.

The calculated ‘F’ as shown in Table 5 is 192.295 and the critical F-value (from tables) is 4.13. Since the calculated ‘F’ is greater than critical ‘F’, the researcher rejects null hypothesis in favour of the alternative hypothesis; that is, β and $\beta_2$ are statistically different from zero implying that penalties and tax refund affects business performance in Iringa Municipality.

Table 3: Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics: R Square Change | F Change | df1 | df2 | Sig. F Change |
|---|---|---|---|---|---|---|---|---|---|
| 1 | .930[a] | .865 | .861 | 8.38733 | .865 | 192.295 | 2 | 60 | .000 |

a. Predictors: (Constant), Penalties, Tax refund

b. Dependent Variable: Business performance

Interpretation

This test was used to explain the total variations in the dependent variable i.e. business performance caused by variations in the independent variables i.e. penalties and tax refund. In the case of the regression output the adjusted $R^2 = 0.861$, implying that the model explains about 86.1% of variations in the business performance.

Also, it indicates, R coefficient is 0.930 meaning that there is a correlation of 93% between the independent variables (penalties, tax refund) and dependent variable (business performance). This shows that the independent variables (penalties and tax refund) are significant predictors of the dependent variable (business performance) in Iringa Municipality.

Summary of Hypothesis Testing

Findings of the study revealed that all two explanatory variables had significant effect on business performance as shown in Table 4 below. Whereby HA is Alternative Hypothesis

Table 4: Summary of Hypothesis Testing

| Hypothesis | Variable | Accept/reject | Significance |
|---|---|---|---|
| $H_A$ | Penalties | $H_A$ is accepted | 0.009 |
| $H_A$ | Tax refund | $H_A$ is accepted | 0.000 |

## Conclusion

Penalties and tax refund found to have significance influence on business performance as indicated from the regression results. With that logic, business performance of audited companies is affected with percentage of tax imposed for tax failure payments on due and percentage rate of reimbursement to the company. Therefore, penalties and tax refund are the good predators of business performance in Iringa Municipality.

## Recommendations

Findings revealed that penalties negatively affect business performance while tax refunds positively affect business performance. This is in line with the expectation of the study. Based on these findings, the researcher makes the following recommendations;

Penalties should be discouraged (reduced) to audited companies because they negatively affect their business performances.

Moreover, tax should be reasonably estimated from audited companies to avoid overpayments of tax by taxpayers. When collected taxes are more than the estimated amount, reimbursement to the company should be done effectively and on due date so as to trigger business performances of audited companies in Iringa municipality. However, it is strongly recommended that the tax assessment should be throughout done while increasing number of tax auditors to be able to audit all tax fine on due dates.



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