eJournal of Tax Research

Volume 3, Number 2 December 2005

CONTENTS

146 Editorial Announcement

147 Obituary – The Honorable Justice D. Graham Hill
Patrick Gallagher

151 Commodity Tax Reforms In A Many Consumers Economy: A Viable Decision-Making Procedure
Fabrizio Bulckaen and Marco Stampini

170 Trans-Tasman Tax Reform: The Real Story
David G. Dunbar

206 The Determinants of Malaysian Land Taxpayers' Compliance Attitudes
Nor Aziah Abdul Manaf, John Hasseldine and Ron Hodges

222 The Attitudes of Tertiary Students on Tax Evasion and the Penalties for tax Evasion – A Pilot Study and Demographic Analysis
Ken Devos

274 Taxing Non-Fixed Trusts
Elaine Abery

288 Record Keeping Practices and Tax Compliance of SMEs
Chris Evans, Shirley Carlon and Darren Massey

335 Book Review – Global Challenges in Tax Administration
Dale Pinto

Atax
UNSW
Faculty of Law

© Atax, The University of New South Wales
ISSN 1448-2398

eJournal of Tax Research (2005) vol. 3, no. 2, pp. 288-334

Record keeping practices and tax compliance of SMEs[1]

Chris Evans[2], Shirley Carlon[3] and Darren Massey[4]

Abstract

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

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

Overall, the research showed that there was some dissonance between perceptions and reality. All of the key stakeholders – SME owners/managers, practitioners and ATO auditors – perceived (to varying degrees) direct relationships between poor SME record keeping practices and adverse tax compliance outcomes. But those perceptions were not always confirmed by the evidence of actual behaviour. Poor record keeping did not, of itself, necessarily lead to a higher vulnerability to audit (though once audited SMEs with poor records were more likely to suffer adverse audit outcomes). Nor did poor record keeping necessarily translate to higher compliance costs (though the data were ambivalent). Nor, finally, did poor record keeping necessarily lead to liquidity and cash flow problems.

The outcomes of the project suggest that further and more detailed research is required to explore these complex relationships. The current project was ambitious in its scope, and was ultimately limited in its findings by its reliance on the self-assessment of the quality of record keeping practices by SMEs themselves. Further research should be narrower in focus. For example, separate projects should investigate each of the three compliance relationships (audit; compliance costs and liquidity) with record keeping practice. In addition, future research should seek more objective measures of the quality of SME record keeping practice, utilising evaluations by advisers (as originally intended in this project) and by the researchers themselves.

[1] This research was funded by CPA Australia under the Small Business Research Grant Scheme 2004. The authors acknowledge the financial support for the project provided by CPA Australia. Views expressed in this article are those of the authors and not necessarily those of CPA Australia.

[2] Professor of Taxation and Director, Atax, UNSW.

[3] Lecturer in Taxation and Accounting, Atax, UNSW.

[4] At the time that this project was undertaken, Darren was a Research Assistant at Atax, UNSW. He is now an analyst with the Reserve Bank of Australia.

[5] Defined as an independently owned and operated business employing fewer than 20 people (ABS, 2002). The terms 'small business' or 'SME' (small and medium size enterprises) are used interchangeably throughout this paper.

[6] Selected from CPA Australia members who provide tax and accounting services to the small business sector. The terms 'CPA Australia members', 'advisers' and 'practitioners' are used interchangeably throughout this paper.

BACKGROUND

> *An appropriate record-keeping system can determine the survival or failure of a new business. For those already in business, good record-keeping systems can increase the chances of staying in business…(Cordano, 1991, p. 2).*

Small businesses play a pivotal role in modern industrial economies. There were 1,233,200 private sector small businesses operating in Australia in 2000-01, representing 97% of all businesses (ABS, 2002). Small businesses generate significant employment and output. In Australia the small business sector employed 3.6 million people in 2000-01, or 49% of all private sector employment (ABS, 2002). The contribution of the small business sector to GDP in that year was more than AUD$160,000 million, or 30% of GDP (Industry Tourism Resources, 2002). The small business sector plays such an important role that the Prime Minister has referred to it as the "the engine room of the Australian economy" (Howard, 1997, p. iii).

However, small businesses face many different compliance obligations, including occupational health and safety, workers' compensation and other employment legislation, licensing requirements, local council planning and a host of other regulatory responsibilities. Taxation is by far the most critical in terms of resources expended. It has been estimated that taxation accounts for roughly two thirds (or 141 hours per annum) of all time spent on compliance activities by small businesses in Australia (Small Business Deregulation Task Force, 1996, p. 12). Company and personal income tax accounted for half of the compliance time spent on tax matters in 1996, and other tax issues such as the operation of employee withholding tax (currently PAYG but formerly PAYE), Wholesale Sales Tax (WST)[7], Fringe Benefits Tax (FBT), payroll taxes and other tax types accounted for the other half.

The introduction of the GST and changes to the collection and remittance of withholding and related taxes considerably exacerbated the tax compliance problems encountered by the small business sector. As a result the record keeping requirements of small businesses have been the focus of even more public attention since 2000. The ATO has suggested that poor record keeping is one of the major causes of tax compliance problems for small business, particularly in relation to Business Activity Statements (BAS) and related returns. Businesses that make calculation and systems errors, use accounting packages incorrectly, or make coding errors are in danger of failing ATO audits (CPA Australia, 2003b, p. 10). Additionally, there is the real possibility that poor record keeping can cost SMEs dearly through non-intentional non-compliance, either through over-payment of tax or because refunds due are missed (McKerchar, 2003). It has also been suggested anecdotally that poor record keeping can translate into higher compliance costs, both in terms of increased fees to advisers and greater use of scarce small business proprietor time in sorting out taxation issues.

Tax compliance issues therefore loom large for small businesses in Australia. In recent years, considerable research has been undertaken into tax issues that affect the small business sector (Tran-Nam and Glover, 2002; Warren, 2003). That research has identified a number of key concerns that have been expressed by small business. Overwhelmingly, the sector is concerned at the complexity and ever-changing nature

[7] Wholesale Sales Tax was replaced with the Goods and Services Tax (GST) from 1 July 2000.

of the tax system and the excessive burden of 'red tape' that it imposes upon small businesses. Closely allied to this is a concern with compliance issues – with 'getting things right and not falling foul' of the ATO, with not incurring penalties or being audited. This concern also feeds into the problem of excessive compliance costs, as taxpayers are obliged to spend more of their limited time on complying with their taxation obligations, and/or pay more to their tax advisers (see, for example, Evans, Pope and Hasseldine, 2001).

In addition, research indicates that small businesses have an on-going problem with cash flow issues. Their liquidity is constantly impacted by the tax system – and in particular by the arrangements under which they are required to pay their own tax liabilities and hand over taxes collected on behalf of others (PAYG etc).

In spite of this public attention and research, there has, to date, been little work done in Australia in measuring the benefits or potential costs of the failure to implement or operate an adequate record keeping system. In short, in a large literature in the area of tax and small business compliance, there is no academic work that directly evaluates the impact of small business record keeping on compliance risk, whether in the form of increased audit exposure, higher compliance costs, liquidity/cash flow issues or other compliance problems.

In a recent Discussion Paper CPA Australia has recognised the need for better information and sound empirical evidence on which to base small business policy (CPA Australia, 2003a, p.3). The overall objective of this research project, therefore, was to provide such empirical evidence about the relationship between the record keeping practices of small businesses and their exposure to greater problems relating to tax compliance.

At the outset of the research project it was hypothesised that small businesses with effective record keeping systems and practices would encounter fewer compliance problems than businesses with poor record keeping systems. The compliance problems encountered by SMEs with poor record-keeping practices would typically include:

- increased exposure to the risk of ATO audit and adverse outcomes (monetary penalties and time costs) as a result of such audits;
- higher than average compliance costs; and
- liquidity and cash flow problems that can, for example, cause difficulties in remitting taxes collected on behalf of the ATO.

This research project was therefore designed to evaluate the extent to which such observations could be confirmed by empirical evidence. In so doing it was hoped that it would help to establish the positive steps that tax practitioners (and particularly CPAs) could undertake to assist clients to minimise compliance risks and burdens.

Tax compliance issues for small businesses (and other businesses) are impacted by the actions of three major sets of players: the owner/manager; the external accountant/adviser, and ATO officers. This project sought the views of each of these sets of players, to gauge their independent opinion on the sorts of relationships outlined above. The following sections more fully explore these relationships.

Audit exposure and audit outcomes

Conceptually, the link between poor record keeping and audit exposure may be either direct, or indirect. The indirect relationship refers to the possibility that without accurate records, firms are more likely to come to the attention of tax authorities through late filing, conspicuous or abnormal financial ratios, seeking amended assessments etc. The direct relationship considers the hypothesis that while susceptibility to tax audit may be independent of the quality of the record keeping practices of the business, once selected for audit, SMEs with poor record keeping practices face higher probability of an amended assessment than those with better record-keeping systems and processes in place.

The ATO has become increasingly active in the records management of small businesses. The introduction of the GST in 2000, and other changes resulting in quarterly reporting, has meant that both the components of a record keeping system and the frequency of update have become critical in ensuring SMEs meet their tax obligations. In addition, the record keeping requirements of the GST have impacted on the cash economy, driving some elements into the tax system, and others further underground. Consequently, those businesses which previously operated outside the tax system have now found their record keeping ability to be somewhat short of tax office expectations.

Compliance costs of running a small business

The costs associated with complying with various statutory taxation obligations have been covered in studies in Australia (for example Evans, Ritchie, Tran-Nam and Walpole, 1997) and overseas (see, for example Sandford, Godwin and Hardwick, 1989, in the UK; Sandford and Hasseldine, 1992, in New Zealand; Slemrod and Venkatesh, 2002, in the USA). All such studies point to the significance (in absolute and relative terms) of these compliance costs, and to their regressivity – they impact disproportionately upon the small business sector. In Australia, for example, the compliance costs faced by a small business taxpayer with a turnover of $100,000 per annum is likely to be in the order of 25 times higher per $1,000 of turnover compared to the compliance costs of a business with a turnover of $10 million (Evans, Ritchie, Tran-Nam and Walpole, 1997, p. 81).

There has also been considerable debate on how best to reduce such costs (see, for example, Sandford, 1995; Evans, Pope and Hasseldine, 2001). However, the extent to which poor record keeping impacts upon these costs has not yet been examined to the same extent. The essential hypothesis here is that poor record keeping will have a significant impact on both the internal costs (essentially the time of the business owner and the time and monetary cost of other resources utilised on tax compliance within the business) and external costs (usually the fees to advisers) in complying with tax regulatory obligations.

With the increasing regulatory burden on businesses, ranging from superannuation, workers compensation to taxation, these costs are increasingly being felt by small businesses without the skills or knowledge to comply with the legislation. The ability of small business to cope with the increasing demands of business on their time means that their ability to keep adequate and accurate records will be fundamental to their ability to discharge their regulatory obligations.

For businesses without accurate records, the ability to accurately assess their superannuation requirements, insurance premiums, and tax obligations can be

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

Liquidity issues

The failure to adequately manage cash flow as a result of poor record keeping has often been listed as a cause of small business failure. As long ago as the early 1930s, empirical research by Corstvet in the USA concluded that "inadequacy of records seems in all but the largest of businesses to be one contributing factor making toward failure" (1935, pp. 61-62). Similar conclusions have been derived more recently in Australia (see, for example, Productivity Commission, 2000). However, the importance of managing liquidity in a business extends beyond cash flow management, and encompasses issues such as the availability of finance, and debtor and creditor management. Such issues are at the core of successfully operating a small business, and the extent to which good record keeping systems assist in minimising liquidity risks is also examined in this project.

Research into the causes of business failure often identifies that tax issues play a significant role in this process. For example, a UK Department of Trade and Industry study of business failures in early 1999 indicated that the most frequent cause of business bankruptcy among the 1,412 cases reported by the Official Receiver was a failure to deal with income tax/corporation tax/VAT affairs (about 20% of the cases) (DTI, 2000). Similar results were identified in the USA in a longitudinal study of non-farm business bankruptcies in the mid 1990s (Sullivan, Warren and Westbrook, 1998).

Australian data on business failures do not separately identify tax as a catalyst of the failure, but given the similar legal and business environments, it is unlikely that the Australian experience would differ significantly from that in the UK and USA. In addition Australian research does indicate that "failure to keep proper books" is one of the ten major causes of business failure, although it only accounted for 2% of business related bankruptcies in 1998-99 (Productivity Commission, 2000, pp. 50-51).

The next section of this paper identifies the research design that was employed to test the hypothesised relationships between record keeping practice and compliance outcomes (Section 2). The paper then discusses the outcomes of the focus groups and surveys that were conducted (Sections 3 and 4), before drawing conclusions together in Section 5.

RESEARCH DESIGN

As has been noted, the aim of the project was to establish the relationship between record keeping practices and various tax compliance issues faced by the small business sector. The focus of the project was to obtain some qualitative and quantitative data that would facilitate a conclusion about the impact of poor record keeping on compliance issues of small business. In particular, the relationship between record keeping and audit, compliance costs, and liquidity concerns was examined.

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

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

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

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

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

The following paragraphs outline the research design more fully.

The Focus Groups

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

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

- To establish CPA practitioners views on the benchmarks that they considered appropriate for effective record-keeping practices for small business taxpayers;
- To identify their perceptions of the relationship between small business record-keeping and compliance risk (as evidenced by higher exposure to ATO audit, increased compliance costs, cash flow and liquidity problems, and any other compliance issues that may arise);

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

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

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

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

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

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

Each of the sessions lasted approximately two hours, and was deliberately kept small in order to allow plenty of scope for deeper discussion than would have been possible had more participants been involved. It was decided that it would be inappropriate to audio or video record any of the proceedings, and this adoption of 'Chatham House rules'[9] encouraged greater freedom of expression than might otherwise have been the case. Notwithstanding this, it was made clear at the outset that the research team wished to take notes, and no participants objected to this. The identity of participants has remained confidential to those present at the focus group.

Participants (with the exception of the moderator) were not paid for their involvement, but all were happy to volunteer their time.

The principal outcomes of the focus group discussions are detailed in Section 3.

[8] Both are ATO business lines dealing with small business

[9] This is where the researchers were free to use the information received but neither the identity of the individuals nor the geographical location of the CPA practitioners participants were to be disclosed.

The Mail Surveys

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

Questionnaire design and testing

The survey instruments were designed to meet the following objectives:

- User friendliness: The questions were kept short and language simple wherever possible to encourage legibility and maximise response rate.
- Administrative simplicity: A3 paper was folded to make an A4 booklet to minimise the amount of collating and stapling of the questionnaires. Data entry number boxes were employed to facilitate ease of data capture.
- Comprehensiveness: the number of questions was kept to a minimum to encourage responses. However, a large amount of relevant quantitative and qualitative data needed to be collected. There were therefore a total of 48 questions in the SME survey and 37 in the practitioner survey.

Using the input from the focus group study and informed by the academic literature in the area, two survey instruments were developed – one for SMEs with the required turnover and employee limits, and one for tax practitioners (CPA Accountants) who indicated SMEs were a significant focus of their practices.

Copies of the questionnaires are not included in this paper, although the detailed tables of results in Appendix A (SMEs) and Appendix B (practitioners), also include the actual questions that were used in the surveys.

The SME questionnaire had six identifiable parts:

1. Demographic and background information – questions about the business owners, the legal structure of the business, the length of time that the business had operated, the number of employees and turnover, and a self assessment of the quality of the record keeping practices of the business.
2. Record keeping details – questions about the types of records maintained by the business, together with other elements of the business record keeping practices.
3. Audit – this section explored issues relating to the business's audit history, including frequency, type of audit, and audit outcome.
4. Compliance costs – businesses were asked to estimate the internal and external costs associated with various record keeping activities.
5. Liquidity – this section explored issues relating to the liquidity history of the firm, covering any recent cash crises, the causes of previous cash crises, and ability to obtain finance based on records.
6. Attitudinal questions – participants were asked to respond on a five-point Likert scale to a range of questions relating to their attitudes towards the relationship between record keeping and various factors.

Respondents also had an opportunity to add any comments that they did not feel were otherwise covered in the survey, and to indicate the time that they had taken to complete the questionnaire.

The practitioner questionnaire followed substantially the same format as the SME survey in order to facilitate comparisons. Questions related to their small business clientele.

The questionnaires were sent out to a small number of SMEs and tax practitioners for pilot testing. No major comments were received as a result of this testing, and the research team's estimates of the time taken to complete each questionnaire were found to be accurate. However, some minor changes of wording of several questions in the tax practitioner questionnaire took place.

Sample selection

The participants of the SME survey were selected from a commercially available database. The tax practitioners sample was drawn from the CPA Australia membership database. The following parameters were placed on the selection:

- For the SME survey, small businesses were identified as having less than 21 employees (ABS definition) or turnover less than $10 million p.a (ATO definition). There was no restriction on age of the business, location, or industry. A sample size of 500 was identified, with an expected response rate of 30%[10].
- For the practitioner survey, tax practitioners on the CPA Australia membership database who identified an area of practice interest as small and medium enterprises were selected. A sample size of 300 was identified, with an expected response rate of 30%.

Response rates

The response rates for each of the two surveys are contained in Table 2.1. The SME survey achieved a response rate of 28%, while the response rate for the tax practitioner survey was 44%[11]. Both rates were considered satisfactory in the light of the target response rate of 30% that had been set for each survey at the outset of the project.

TABLE 2.1 RESPONSE RATES: TAXPAYER AND TAX PRACTITIONER SURVEYS

	SMEs	**Tax practitioners**
Gross sample	497	300
Out-of-frame responses	32	2
Net sample	465	298
Useable responses	129	130
Response rate	**28%**	**44%**

The out-of-frame responses were forms that were returned undelivered or where the respondents indicated they were no longer part of the target sample.

[10] A 30% response rate was chosen for two reasons. Firstly this is comparable to prior studies, and secondly, a 30% response rate supports generalization to the population.

[11] The inclusion of a token gift for half (150) of the practitioner sample population resulted in a response rate of 53%. For those who did not receive the gift, the response rate was 34%.

Representativeness

One important aspect of survey methodology is to ensure, so far as possible, that those who respond to the survey (the effective sample) broadly reflect the categories of those taxpayers who were surveyed (the mail out sample). The SME survey was drawn from a commercial database, with identified selection criteria to ensure a representative sample of the population. In particular, characteristics such as business age, legal structure, operating industry, age of owners etc were identified so that they sample was broadly consistent with the Australian SME population.

The demographic information relating to the SME survey (Appendix A) indicates that the broad parameters that might be expected of small business respondents were satisfied. More particularly, respondents were generally representative of businesses in the small business sector in that they were predominantly drawn from secondary and service industry sectors, the businesses were operated mainly by middle aged and older citizens, they generally employed a relatively small number of people, and the turnovers ranged across all categories up to $10 million.

The respondents to the SME survey included a number of businesses (19) which, at the time of completing the survey, had more than 20 employees. However, because of the selection criteria provided to the data supply agent, their turnover was less than $10 million. Given the vagaries of employment trends in small business, the research team conducted further analysis on this sub group, and concluded that their responses were not statistically distinguishable from the remainder of the sample. As a result, the responses of those 19 businesses were included in the analysis.

The practitioner sample was drawn from the CPA Australia database, from those members who identified themselves as having a small business focus. Consequently, as expected, the respondents were typically from sole practitioners or small partnered firms. The respondents generally had a significant proportion of clients in the small business sector, and from a reasonable spread across primary, secondary and service industries.

Non-response bias

Despite the satisfactory response rates and degrees of representativeness achieved in the surveys, it is still important to consider whether there is any “response bias” in the study (and – if there is – to attempt to identify its extent and impact). Response bias arises if there are systematic differences in some key areas between respondents and non-respondents. Testing for non-response bias establishes whether, if non-respondents had responded, the outcomes of the survey would have been substantially changed. While there are a variety of methods available to test for non-response bias, the research team decided to employ a wave analysis.

Wave analysis is a process which identifies respondents’ answers to certain central questions in the survey by reference to the point of time that they answered the survey. Analysis is then conducted to determine whether responses to key selected questions changed significantly from period to period. The procedure assumes that those who return surveys in the later part of the response period are ‘almost non-respondents’.

A wave analysis was conducted on both the SME and the practitioner survey respondents. For the purposes of the analysis, responses were divided into two waves:

those who responded early in the survey process, comprising the first 70% of respondents, and those who responded later (the remaining 30%).

The questions selected for analysis were:

- Questions 11, 34 for SMEs.
- Questions 11, 23 for practitioners.

For SMEs, these questions examined to what extent respondents were exposed to audits or liquidity concerns, and their attitude to record keeping. For practitioners, the wave analysis tested for differences in attitude to record keeping and perceived link between record keeping and audit.

A chi-square test revealed that, at the 5% level of significance, there was no statistically significant difference between the perceptions of early and late SME respondents. For the practitioners, no difference between mean responses for the link between record keeping and audit was found at the 5% level. Similarly, there was no statistical difference between the main reasons for record keeping. In summary, the outcomes of these tests for non-response bias strongly suggest the absence of any such bias in the responses to either survey.

FOCUS GROUP OUTCOMES

The Practitioner Focus Group

The primary purpose of the tax practitioner focus group was to assist in identifying issues for inclusion in the SME and practitioner questionnaires. Issues raised in the focus group, listed from the most general and widely agreed upon to the more specific, and based on practitioner knowledge and experience, are detailed below.

The outcomes of the practitioners focus group were:

- SMEs were generally not interested in accounting or record keeping for the small business. Most SMEs saw such activities as a waste of time, rather than an essential part of operating a small business.
- The use of computerised accounting packages did not improve client records. In many cases, the lack of knowledge or understanding by the client resulted in just as many errors as a paper based system.
- Increasing fees to dissuade clients with poor record keeping practices was widely used, as was requiring up-front payments from those clients whose records would require a significant amount of work. There was a general consensus that those with poorer records incurred higher accountancy costs than those with good records.
- Most SMEs were concerned with the cash balance as an indicator of business health. This ‘indicator’ has been corrupted following the introduction of the GST, whereby some of this cash belongs to the tax authority rather than the business.
- Many of the practitioners had turned away clients who had poor record keeping, suggesting that they were ‘not worth the hassle’. They believed such clients then went to unregistered accountants or tax agents. This point was also raised by one respondent to the practitioner survey.
- Factors that were believed to increase the business exposure to tax audit varied, and included:

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

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

Tax Officer Focus Group

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

Some of the broad findings of the focus group included:

- Tax changes were just a small part of the compliance issues of small business. The tax officers considered that changes in workers compensation, superannuation etc were equally important in the additional compliance burdens they placed on small business. Further, tax changes such as the GST were seen as creating positive externalities (such as improved management control) to the business, which workers compensation and superannuation record keeping does not.
- According to the ATO officers, the most important factor in a record keeping system was its appropriateness to the business. The system required for effective record keeping depends on legal structure, business nature, number of transactions and competency of the owner/manager. One-size fits all systems such as MYOB and QUICKEN were not necessarily the most appropriate responses to client needs. There was a general consensus that a basic level of bookkeeping was necessary to effectively run a small business.
- Tax officiers suggested that the use of specific types of non CPA or ICAA qualified practitioners by small businesses with poor records put such businesses at a disadvantage when dealing with the ATO. In particular, those with poor record keeping who had been turned away from CPAs or CAs were often referred to lesser qualified practitioners precisely when they most needed the skills of fully qualified professionals. This suggests the existence of a 'quality trap' and a 'spiral effect', whereby those with poor record keeping skills were likely to compound their problems when they are forced to rely upon a less competent external adviser.
- The accuracy of returns was considered the most likely cause of audit. Mistakes in industry classification, errors in figures, and 'typos' on returns were likely to raise the interest of officials. Further, claiming refunds, or having ratios outside industry norms were also considered to add to audit vulnerability. The somewhat random nature of audits meant there was a perceived indirect link between record keeping and business audit.

- There was a perception that compliance costs have increased because of the increased audit activity. ATO officers indicated that, particularly since the introduction of the GST, the number of SME audits has been increasing rapidly. This results in further compliance costs imposed on small businesses as they need to spend time documenting and answering audit questions.
- The effect of poor record keeping on liquidity was considered to be felt through a number of channels. Most notably theft, poor stock control, debtor and creditor issues, and general financial management were believed to be the primary transmission mechanisms through which poor record keeping affected liquidity.
- Tax officials suggested that cultural differences have been a problem in ensuring tax compliance of small businesses. Those who have recently migrated or have language barriers find it difficult to comply with tax law, resulting in greater compliance costs for such business. The extent to which such issues are present Australia-wide should be taken in the context of the Hurstville population. Census data reveals that Hurstville has a significant migrant population (55% born overseas), and only 37% of the population speak English at home (ABS, 2001). This suggests that the revenue authority has significant work to do with people of non-English speaking background to ensure compliance.

The views taken from each of the focus groups are further explored in later sections of this paper.

SURVEY OUTCOMES

This section summarises the major outcomes of the two surveys, and uses the data provided in the surveys to examine the relationship between record keeping and various compliance issues faced by the small business sector.

SME Survey

The data provided from the 129 SME respondents provides a rich source of qualitative and quantitative information about the nature of the relationship between record keeping and the various compliance risks that are the subject of this project. Details of specific survey responses for all questions for the SME survey are contained in Appendix A.

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

- two thirds of the SME respondents came from the service sector, with 22% from the secondary sector, 7% from the primary sector and 4% did not specify (Question 1: Appendix A);
- just over 60% of respondents were private companies, with the balance roughly equally divided between partnerships (14%), trusts (11%) and sole traderships (9%) (Question 3);
- respondents tended to be well established businesses (71% had been in operation for more than ten years), but there was a sprinkling of newly established (9% had been in operation for up to five years) and ‘middle-aged’ businesses (19% had been in operation for six to ten years) (Question 4);
- the surveys were predominantly completed by the business owners (74%) or by managers (17%) (Question 5);

- only 21% of the persons completing the surveys were aged 45 or under, and none were under 30. The surveys were predominantly (four out of five) completed by persons who were over 45 (and 13% were 60 or over) (Question 6);
- over 90% of the businesses had employees, and 58% had more than five employees (Question 7);
- more than three quarters of the SME respondents had an annual GST inclusive turnover of between $500,000 and $10,000,000 (Question 8).

Overall, therefore, the authors are satisfied with the spread and representativeness of the captured sample of SME respondents.

Record keeping

The respondents to the SME survey were generally satisfied with the quality of their business records, with over 72% rating (on a self-assessment basis) the quality of those records 8 out of 10 or better (on a scale of 10, where 1 is poor, 5 is average and 10 is excellent). Only 12% of respondents rated the quality of their business records as 5 or less (Question 9). This outcome was reinforced later in the survey, with 95% of respondents either agreeing or strongly agreeing that they were confident in the accuracy of their record keeping systems (Question 39), and 94% of respondents either agreeing or strongly agreeing that they were confident that they have the necessary record keeping systems in place to comply with the taxation law (Question 40). In addition, 99% of the SME respondents responded in the negative to the question: "Has an accountant or other professional refused you as a client on the basis of your record keeping?" (Question 13).

General business management was seen as the most important reason for keeping records (by 58% of respondents), followed by compliance with tax law (23%). Record keeping for profitability information and keeping track of the debtors and creditors rated lowly at 5% each. Thirty two per cent of respondents considered that compliance with the tax law was the second most important reason for keeping business records.

The emphasis that SMEs placed on the value of record keeping for general business management was interesting, as it appeared to contrast quite significantly with earlier research in related areas. For example, in an investigation of compliance costs relating to the 1994-95 fiscal year, Evans et al (1996: pp. 93-94) had established that business taxpayers saw the financial statements prepared for the business as overwhelmingly useful and used for tax purposes: 76.5% of respondents had indicated that this was the case, and only 16.1% indicated that the primary purpose of the financial statements was for internal management use.

The contrast, however, is not quite as surprising as might initially be thought. This research related to the base business records, not to financial statements such as the Profit and Loss Statement or the Balance Sheet. SMEs were clearly more likely to relate the former to their ongoing business management than would be the case with their financial statements, usually prepared externally and necessarily after the close of the year.

No respondents considered bank requirements the main reason or the second most important reason for record keeping, possibly as a consequence of the introduction of 'low doc' loans (Questions 11 and 12).

Almost 90% of respondents used either a computerised (65%), or partly computerised (23%) record keeping system, and only 5% used only a paper based system (Question 10). However, just 37% of those who used a computerised record keeping system did so on the advice of an external adviser (Question 21). Further, just over half of the businesses set up the program and chart of accounts themselves (Question 22). Almost all (94%) believed that the computerised system saved them money (Question 25), but only 35% actually experienced a decrease in external agent costs as a result of computerisation (Question 27).

Three out of four respondents maintained their business record keeping systems in house; 9% used a CPA/CA or other accountant to maintain the business records, and a further 9% used a bookkeeper (Question 14).

Whereas the maintenance of the business record keeping system was predominantly (74%) dealt with in-house, accounting and tax reports, as might be expected, were usually prepared outside the business. Cash statements were prepared for about two thirds of the businesses, and profit and loss and balance sheet statements were prepared for more than 80% of businesses (Question 17). About 40% of these accounting reports were prepared in-house, with the majority prepared by external accountants, tax agents and bookkeepers. Only 16% of tax reports (for example, the BAS or annual returns) were prepared in-house (Question 18).

Only one out of three SMEs thought that the time dedicated to record keeping exceeded the benefits (Question 38), but 69% still considered that the record keeping requirements of small business were too time-consuming (Question 41). This ambivalence was further confirmed by the fact that roughly equal numbers agreed and disagreed with the statement that "Required record keeping (eg the BAS) helps me manage my business more effectively" (Question 42).

In summary, therefore, the results of the survey is that the SMEs were satisfied with the quality of their records, which they kept primarily for general business purposes (and incidentally for tax purposes). Those records were more likely than not to be computerised and maintained in-house, and – despite concerns about the time that had to be spent on them – most businesses could see the value of the record keeping exercise. Although the basic business record keeping system was more likely than not to be set up and maintained in-house, preparation of accounting reports was primarily entrusted to external professionals. Tax reports were even more likely to be externally prepared.

Audit Risk

The research project hypothesised at the outset that the nature of the record keeping practices of the business could impact on tax audit risk in two ways. In the first place there was the possibility of a relationship between record keeping and exposure to audit. More specifically, those businesses with poor record keeping practices might be perceived as 'inviting' or leaving themselves open to a higher potential **exposure** to audit by the ATO than those with good record keeping practices. Secondly, it was considered that, once selected for audit, businesses with poor record keeping practices would be more vulnerable to adverse audit **outcomes** than those with good record keeping practices. Each of these hypotheses is examined in turn.

Audit exposure-

Roughly half of the respondents agreed with the statement that "Good record keeping reduces the likelihood of ATO audit". Less than 20% disagreed with this sentiment, while about one third remained neutral or unsure on the issue (Question 44). This would suggest that, on balance, small businesses are more likely to perceive a strong relationship between record keeping practice and exposure to audit than not. The evidence from the remainder of the survey, however, failed to provide data to support this conclusion.

Most respondents (63%) had not been the subject of an ATO audit. Roughly one third of businesses had undergone an ATO audit, with 20% of the total respondents having suffered an audit in the past three years (Question 28). Field audits were the most common types of audit for those who had been exposed to a tax audit (70%), although 18% had undergone a desk audit and 12% a telephone audit (Question 29). The nature of the audits varied considerably, although most (40%) were GST-focused. Income tax was the principal focus of 21% of those audited, Fringe Benefits Tax featured as the main focus in 12%, PAYG/Withholding was also 12%, and Capital Gains Tax was 7% (Question 32).

The 20% of SME respondents (27 businesses) who had been exposed to an audit in the last three years were grouped into a separate cohort to establish whether their responses differed to any statistically significant extent from the responses given by the cohort who had not been subject to audit (81 businesses). For the purposes of this testing the 12 businesses that had been audited, but not in the last three years, were excluded.

The two cohorts were first tested to establish if there were any clear or distinct differences in how they rated the quality of their record keeping practices. Table 4.1 summarises the outcome.

TABLE 4.1 RECORD KEEPING QUALITY AND AUDIT EXPOSURE

	Cohort not audited (n=81)	**Cohort exposed to audit (n=27)**
Mean rating of the quality of business records	7.8	8.3

The cohort of businesses that had been subject to recent audit rated the quality of their business records slightly higher (on the basis of mean scores) than those that had not been audited. This may indicate the impact of a 'recency' or 'educative' effect, whereby those that had been audited were able to feel more confident in the quality of their record keeping practices than those who had not. For some of the audited cohort this confidence may have stemmed from the fact that there were no adverse outcomes as a result of the audit – their existing practices were vindicated. For those businesses that had encountered adverse outcomes, they may have felt greater confidence as a result of improvements to the record keeping practices subsequently made as a direct or indirect consequence of the audit.

Table 4.2 compares the preparation of accounting reports between those businesses that had been exposed to audit in the previous 3 years, and those who had not been audited. Those businesses that had been exposed to audit were more likely to prepare

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

TABLE 4.2 PREPARATION OF ACCOUNTING REPORTS AND AUDIT EXPOSURE

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

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

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

The hypothesis of a link between record keeping and audit exposure is therefore not statistically supported. Some evidence does point to minor differences in preparation of accounting reports and a difference in attitudes to record keeping, but overall it appears that differences in record keeping practice do not lead to greater or lesser likelihood of exposure to an ATO audit.

Audit outcomes-

The next consideration is of a direct relationship between record keeping practices and the audit outcome for those businesses that have been selected for audit. Selection for an audit can be based on a number of factors, including industry, turnover, random selection etc. The direct link implies that once an audit has taken place, those who have poor record keeping have a greater likelihood of receiving an amended (increased) assessment.

As noted above, roughly one third (29%) of SME respondents had been the subject of an audit, predominantly involving GST (40%) and income tax (21%). Only 20% (eight respondents) had received an amended assessment as a result of the audit. One quarter of the amended assessments involved a decrease in tax payable, while three quarters involved an increase in tax liability (Question 30). It should be noted that the deliberate policy of the ATO in the early years following the implementation of the GST was to use audits as an educational rather than penal tool. This may help to

[12] Being Compliane with tax laws, general business management and keeping track of debtors and creditors.

explain the relatively small number of SMEs who experienced an amended assessment as a result of the audit.

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

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

TABLE 4.3 PREPARATION OF ACCOUNTING REPORTS AND AMENDED ASSESSMENT

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

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

Compliance Costs

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

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

Participants were also asked to estimate the annual internal and external costs associated with various tax reporting requirements of the business (Question 33). Comparisons were made on the basis of how respondents self assessed the quality of the records and the costs (internal and external) that they reported. Subsequent

analysis focused on the relationship of the types of records that were prepared in-house and externally, again related to costs of compliance.

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

TABLE 4.4 RECORD KEEPING QUALITY AND INTERNAL COMPLIANCE COSTS

	Self reporting 8 – 10 (n=93)		**Self reporting < 8 (n=36)**	
	Mean $	**Median $**	**Mean $**	**Median $**
BAS / GST	10298	4000	6283	3500
Tax Returns	11010	4000	2808	2000
Payroll	5615	2500	5721	3500
FBT	3841	2000	1803	1000
Other Taxes	3959	2500	4000	5000

Table 4.5 compares the external costs of record keeping, again based on a comparison between those with 'better' record keeping practices and the rest. Once again, those who claimed that the quality of their record keeping practices was 'better' (in the range of 8-10) appeared to pay more in external tax compliance costs than those with lesser quality record keeping practices.

The results suggest that the initial hypothesis is not proven – those with poor record keeping practices actually appear to suffer lower compliance costs than those with better record keeping practices. Intuitively one can see grounds for supporting this outcome: quality comes at a price, and that price involves both the costs of internal time and labour in setting up and maintaining quality record keeping processes, the costs of software etc and the costs of engaging quality external professionals. It should therefore not be entirely surprising that those businesses that apparently have better record keeping practices pay a higher price for them.

TABLE 4.5 RECORD KEEPING QUALITY AND EXTERNAL COMPLIANCE COSTS

	Self reporting 8 – 10 (n=93)		**Self reporting < 8 (n=36)**	
	Mean $	**Median $**	**Mean $**	**Median $**
BAS / GST	3237	2540	2950	3000
Tax Returns	7236	4000	5342	3750
Payroll	3284	950	833	500
FBT	1517	1000	807	325
Other Taxes	2350	1900	1375	750

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

TABLE 4.6 RECORD KEEPING ELEMENTS AND COMPLIANCE COSTS

	Internal all 3	**Internal <3**	**External all 3**	**External <3**
	Median $	**Median $**	**Median $**	**Median $**
BAS / GST	4500	1200	3000	1500
Tax Returns	3000	1000	4500	4000
Payroll	3000	4000	885	500
FBT	1400	2000	1000	100

The evidence for increased compliance costs as a function of the record keeping elements is mixed. In short, there is no consistent relationship between median estimates for report preparation between those who have a more comprehensive record keeping system than those who do not.

Liquidity Risk

The final area that was examined related to the relationship between record keeping practice and exposure to liquidity problems – and in particular to cash flow problems that cause difficulties in remitting taxes collected on behalf of the ATO. SME respondents acknowledged the likelihood of a strong correlation in two of the attitudinal questions in the survey (Questions 43 and 46). Ninety per cent agreed with the statement that "There is a strong relationship between poor record keeping and business failure", and 84% agreed that "Good record keeping helps to ensure that cash crises are avoided". As with the other areas, however, there was a marked difference between what SMEs thought and what the evidence of their behaviour actually showed.

Over half the respondents (62%) had suffered a cash crisis at some time (Question 34). Late payment by debtors was the most commonly stated primary cause (34%), followed by "Other" (25%) and "ATO/Tax obligations" (15%) (Question 35). "ATO/Tax obligations" was the second most important cause that was cited (22%) (Question 36).

Only 1% of respondents had been refused finance or credit because of a lack of business records.

In order to examine the impact of record keeping on liquidity, those respondents who had suffered a cash crisis in the last three years were separated from the rest of the respondents. The record keeping practices of each group were then compared. As expected, when compared to those who had not had a recent cash crisis, those that had:

- self assessed the quality of their record keeping at a lower level than the average;

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

Table 4.7 outlines the difference in preparation of accounting reports between those businesses that had experienced recent liquidity problems, and those that had not. Businesses without liquidity problems were more likely to have prepared (or have had prepared for the business) such accounting reports, with the exception of debtors and creditor reports. A chi-squared test revealed, however, that these differences were not statistically significant (p = .918).

TABLE 4.7 LIQUIDITY PROBLEMS AND PREPARATION OF ACCOUNTING REPORTS

	No liquidity problems in last 3 years (n=76)	**Liquidity problems in last 3 years (n=60)**
Cash Statement	68%	63%
Profit and Loss	90%	83%
Balance Sheet	87%	75%
Debtors and Creditors	77%	81%

Record keeping elements (Cash Statement, Invoices or Bank Statements) showed greater homogeneity in terms of preparation across the two groups. Consequently, no statistical difference was found between the two groups (p = .881).

A further aspect of the record keeping elements was the frequency of preparation of those records. The timeliness of the information was thought to be directly related to the usefulness of such reporting. Chi-Squared tests between frequency of reporting and liquidity issues, however, showed no statistically significant difference between the groups.

The empirical evidence, therefore, does not support a direct link between record keeping and liquidity issues. The research team also explored, however, the information content of record keeping. This is to acknowledge that preparation of reports may not prevent a cash crisis, as many of the causes were beyond the business's control, but reports may make it easier to identify the cause.

It was established that those respondents who listed "Debtors and creditors" as the main cause of the cash crisis had a greater likelihood of preparing debtors and creditor reports (95% versus 70%). A chi-squared test showed this to be statistically significant (p = .024). In addition those respondents who listed "ATO / Tax Obligations" as the principal cause of the cash crisis were more likely to view compliance with tax law as the main reason for record keeping (40% versus 22%).

These results suggest that the information content in reports may help a business pinpoint issues or concerns (such as late payment by debtors), but if the problem is external to the business, the reports are unlikely to be helpful in resolving the problem.

Tax Practitioner Survey

The tax practitioner survey also produced very useful qualitative and quantitative data from 130 respondents relating to their perceptions and experience of SME record keeping practices and exposure to the various compliance risks. Details of specific

survey responses for all questions for the tax practitioner survey are contained in Appendix B.

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

- just over two thirds (68%) of the responses came from self-employed sole practitioners, and just over a quarter (27%) from partners in practice. The partners were predominantly (80%) from partnerships with four or fewer partners (Questions 1 and 2: Appendix B);
- the GST inclusive turnovers of the respondents' practices were generally less than $1 million (88%). The practice turnovers for roughly a quarter were less than $100,000; for a further quarter were between $100,000 and $250,000; and for just over one third were between $250,000 and $1 million (Question 3);
- the number of clients in the practices ranged from less than 100 (16%), through 101 to 250 (15%) to more than 1,000 (22%). Nearly half (46%) had between 251 and 1,000 clients (Question 4);
- roughly three quarters of the clients of the respondent practices were classified as small business clients, and they came from the full range of business sectors and levels of turnover (Questions 5, 6 and 7).

Once again, the research team was satisfied with the relevance, coverage and representativeness of the practitioner respondents.

Record Keeping

Practitioners were asked a series of questions that related to their perceptions of the record keeping practices of SME clients. The first of these (Question 8) sought information on the number of potential clients that practitioners had turned away as a result of perceived poor record keeping practices within the business. Only 51 of the 130 respondents (39%) had never turned a client away on such grounds. Most (52%) had turned away between one and five clients per year, and 8% had turned away more than five annually. This tends to reinforce the notion of the existence of a 'quality trap' that was identified in the earlier practitioner focus group, and may contribute to a downward spiral effect that sees those businesses with poor records forced to engage lesser qualified professionals for their tax compliance obligations.

"Accuracy" and "simplicity" were perceived by practitioners to be the most important characteristics of a record keeping system (Questions 9 and 10). These two attributes were seen as significantly more important than the "comprehensiveness" and the "timeliness" of the record keeping system. Despite the perceived importance of the accuracy of the records, and despite the large percentage of practitioners who advised small business clients on their record keeping systems (95%: Question 12), nearly one third of practitioners (32%) were not confident or were unsure of the accuracy of their clients' record keeping systems (Question 29).

Nonetheless, nearly 80% of practitioners were confident that their clients' record keeping systems were sufficiently adequate to comply with tax obligations (Question 30). Further, some 71% believed that tax-induced record keeping (such as BAS obligations) improved the management of the business (Question 32). Confirming this, over 60% (79 out of 130 practitioners) considered that reporting obligations under the BAS/GST regime improved the management of the small business, and

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

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

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

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

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

Audit risk

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

Being in a 'cash economy' industry was viewed as the most important factor in increasing the risk of audit (116 respondents), followed by more than average deductions (103 respondents). Being in the simplified tax system was seen as the least

likely of a number of factors to increase the risk of a small business being exposed to a tax audit (only 4 respondents) (Question 22).

Practitioners considered that, once exposed to an audit, small businesses were most likely to suffer an amended assessment (presumed to be adverse) as the result of poor advice from their agent, followed by the tax evasion or fraud of the SME (Question 24). Other reasons that were offered included a lack of awareness of the legislation, clerical error and insufficient evidence of the claim, but these were not scored as high as the first two mentioned factors.

Compliance Costs

More than four out of five practitioners believed there was a positive relationship between good record keeping and lower compliance costs (Question 35), although only 68% quantified this as a strong relationship in Question 14.

Interestingly, the estimates of compliance costs given by practitioners (Question 25) were significantly below those indicated by SMEs – in some cases up to ten times less. It appears that estimating the costs associated with compliance with tax law is difficult for both practitioners and SMEs. There is a wide variation in estimates not only within groups, but also across the two cohorts. It is likely that the costs fall somewhere between the two estimates, with SMEs overestimating the costs incurred, and practitioners underestimating the amounts they charge clients. Both estimates[13] showed significant variation, however, with some facing/charging very high costs, and others relatively low.

Further information about practitioners' views on SME compliance costs were derived from Question 18 of the survey, which related to perceived benefits of computerisation of SME record keeping for practitioners and SMEs themselves. Less than 40% of practitioners believed that computerisation of client record keeping either reduced bills or saved time for the majority of their clients. In contrast, nearly two out of three practitioners perceived that such computerisation saved the practitioner time so far as the majority of clients was concerned. In short, computerisation may not reduce client compliance costs (time or money) directly, though it may reduce practitioner time (which is not necessarily passed on to the client in reduced bills).

These attitudes to computerised records contrast with those expressed in the SME survey, where 94% of SMEs believed a computerised system saved them money.

Liquidity Risk

Three out of four practitioners supported the view that "there is a strong relationship between poor record keeping and small business failure" (Question 33), and 70% agreed that "good record keeping helps to ensure that cash crises are avoided by small business clients" (Question 36). Eighty five per cent assessed a similar relationship between good small business client record keeping and improved cash flow management as medium to strong (measured as between 3 and 5 on a scale of 5, where 1 indicated no relationship and 5 indicated a strong relationship) (Question 14).

However, "poor record keeping" was not identified as one of the primary factors causing cash crises for clients (Question 26). It ranked fourth out of five factors, being

[13] Refer Appendix A SME survey Question 33 and Appendix B CPA practitioner survey Question 25 where the mean and medians are reported.

rated behind "late payment by debtors" (ranked highest), "ATO/tax obligations" (second highest) and "general business downturn" (third). Only "pressure from creditors" was rated less significantly than poor record keeping in causing SME cash crises.

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

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

CONCLUSIONS

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

Record keeping

A number of recurrent themes relating to record keeping practices emerged in the process of the project. Two of these – the value of the record keeping process in general, and the benefits of computerisation of record keeping practice – are explored in greater detail here.

The value of record keeping for the business

The initial focus group conducted with tax practitioners suggested that SMEs were generally not interested in record keeping, seeing such activities as a waste of time rather than an essential part of operating a small business. There was some support for this view from the larger group of practitioners that was surveyed. Just under half of that practitioner group tended to suggest that the effort put into record keeping by the SME sector did not – on the whole – produce commensurate benefits for the business. But a small majority of practitioners did consider that the benefits of record keeping (for SMEs) outweighed the costs (to SMEs). Overall, the combination of these sentiments suggested a fairly restricted view by practitioners of the value of record keeping to the business itself.

But this was not the whole picture as seen through the prism of practitioners. They considered that the primary purpose for SME record keeping was tax compliance related rather than an essential part of business management. But there was still an indirect impact of good record keeping practice on the business – many practitioners conceded that these tax reporting obligations could actually help to improve business management.

This somewhat indirect view of the value of business record keeping was not shared by the SME sector itself. It is true that the owners and managers of the small businesses were concerned at the amount of time and effort that they had to expend on maintaining record keeping systems. But, by a factor of about two to one, they saw the value of their record keeping systems as an essential tool in the business management process, with tax compliance a secondary outcome. And roughly half of them went

further and recognised that even those tax reporting obligations helped them manage the business more effectively.

This view of the possibility of positive externalities that SMEs could derive from record keeping and tax reporting was a theme that was also touched upon in the focus group conducted with ATO auditors. These tax officials were aware of the growing compliance burden imposed upon SMEs (and not just as a result of tax obligations), but also recognised that good record keeping practices, in part induced by tax obligations, could lead to improved management control for the SME.

Computerisation of record keeping

The practitioner focus group had also suggested that the use of computerised accounting packages did not improve client records. It was suggested that a lack of knowledge and understanding by many clients resulted in just as many errors as were occurring in paper based systems. The focus group view may reflect the types of businesses of their clients, many of who were trades people, who were perceived to be less au fait with computerised packages than other clients.

The 130 practitioners who responded to the survey did not endorse this view. Most believed that computerised record keeping practices improved the accuracy of the records for the majority of their clients, although there was a significant minority that did not share this view. Notwithstanding this, a very large majority of practitioners not only strongly urged their clients to adopt computerised record keeping practices, but most also set them up for the clients.

The SMEs also saw the value of such systems, with virtually all of them identifying that there were savings to be made as a result of their introduction and maintenance. Most businesses had either fully computerised or hybrid (paper based and computer based) systems in place and had little reason to doubt their value and their efficacy.

The relationship between record keeping and tax audit

At the outset of the project it was hypothesised that there was a direct link between the quality of SME records and the likelihood of audit by the ATO. The research has identified that the link is by no means as straightforward or certain as was anticipated.

The initial focus group with practitioners did not identify poor record keeping – per se – as a cause of selection for audit by the ATO. Rather, such factors as the operation of a cash business, inconsistent financial performance and adjustments to prior returns were considered to be far more likely to lead to audit. These observations were ultimately confirmed in the tax auditor focus group, and a number of other factors were also put forward, none of which was directly related to the quality of the underlying records.

The surveys of both the practitioners and the SMEs also failed to confirm that the quality of records was a key variable in determining exposure to audit, either in a direct or indirect fashion. What the surveys did confirm was that both practitioners and SMEs generally perceived that there was a direct relationship between poor small business record keeping practice and probability of tax audit, but that this perception was not confirmed by the evidence available (which primarily related to a small number of SMEs who had undergone an audit in recent years).

While the direct and indirect links between record keeping and audit exposure were not found, there was some evidence (albeit based on a rather small sample of SMEs)

of a direct relationship between record keeping and an amended assessment or other adverse audit outcome. The results suggested that once selected for audit, the probability of an amended assessment was related to the quality of record keeping. It was also apparent that having experienced an audit did induce an attitudinal change in affected businesses. Those that had been the subject of a recent audit generally rated tax obligations as a more important reason for record keeping, and were more likely to prepare (or to have prepared) accounting records.

The evidence also suggested that while the threat of audit did not induce improved record keeping activities, exposure to an actual audit may lead to a subsequent improvement in records. Consequently it is considered that the recent increase in audit and compliance activity by the ATO is likely to improve record keeping of small businesses over time. From the viewpoint of practitioners, therefore, their ability to improve the record keeping systems of small businesses can have a dramatic impact if the client is selected for audit.

The relationship between record keeping and compliance costs

It was also hypothesised at the outset of the project that there was a direct relationship between record keeping practice and compliance costs. Simply stated, it was considered that poor records were more likely to lead to increased compliance costs.

Some support for the initial hypothesis was gleaned at the practitioner focus group. Participants indicated that accountants widely used the practice of increasing fees to dissuade clients with poor record keeping practices, and there was a general consensus that SMEs with poorer records incurred higher accountancy costs than those with good records. Each of the surveys also showed that there was a perception of a direct relationship between poor record keeping and higher compliance costs: a large majority of practitioners and a majority of SMEs shared this view of a positive correlation.

Interestingly, however, analysis of the data from the survey revealed that there was no direct relationship between poor record keeping and increased compliance costs. Rather, the compliance costs varied independent of the quality of the business records. This may suggest that practitioners are not as successful as they think in using price (the fees they charge) to deter poor record keepers. It may also suggest that there are other, countervailing, forces at work to break the direct relationship between record keeping and compliance costs. For example, those SMEs with poor records may actually save resources (the value of their internal time) as a result of not maintaining good records. Given that the time spent by business owners and managers is a significant component of compliance costs[14], this may have the effect of causing lower compliance costs where poor record keeping practices prevail.

These results do suggest an ongoing uncertainty about just how much complying with legislative requirements actually costs a business, both internally and externally. There was wide variation in estimates of internal and external costs from SMEs, and these differed substantially from those provided by practitioners. This leads to a suggestion that key stakeholders are often unaware of the quantum and composition of business tax compliance costs.

[14] Studies by Evans et al (1997) and Pope et al (1994) suggest that the internal costs of SME proprietors represent between 65% and 70% of total compliance costs.

The results also point to the need for surveys dealing with compliance cost issues to be very carefully constructed. In retrospect it is possible that the compliance cost questions in these surveys were too general in nature to be able to provide reliable estimates of the actual costs incurred by SMEs. Other surveys (for example, Evans et al, 1996; 1997) have focused solely on compliance costs and have been able to carefully obtain reliable estimates that have highlighted both the significance and the regressivity of compliance costs for the small business sector. The current survey may well have sacrificed a compliance cost focus in order to achieve its broader objectives.

The relationship between record keeping and liquidity

The final relationship between record keeping and compliance outcomes that was explored in the project related to liquidity and cash flow management, particularly as this related to the capacity of the business to properly account for tax withheld from various sources and due to the revenue authority. It was hypothesised that those SMEs with poor record keeping practices would be more exposed to liquidity issues than those with better quality records.

In the initial focus group, practitioners indicated that most SMEs were concerned with the cash balance as an indicator of business health. They also suggested that SMEs with unsophisticated record keeping practices were encountering cash flow problems as a result of spending cash that then needed to be remitted to the Tax Office. The ATO auditor focus group confirmed that there was evidence that SMEs were encountering cash flow difficulties as a result of poor record keeping practices.

Both SMEs and practitioners overwhelmingly confirmed the perception of a strong relationship between poor record keeping and liquidity problems in the surveys. Once again, however, that perception was not matched by underlying data derived from the surveys. In short, no strong or direct relationship between poor record keeping and cash flow problems was identified.

The main cause of liquidity concerns of small businesses, as indicated by both SMEs and practitioners, was the late payment by debtors. However, the preparation of creditors and debtors reports was considered the least useful accounting report by SME respondents. The evidence suggests that such reports provide information content only, as they highlight a problem external to the business. Despite identifying the cause of the cash crisis, such reports do not necessarily provide a workable solution. SMEs remain, in some cases, at the mercy of their debtors.

Proper and timely debtor management may be able to reduce the incidence or severity of the cash crisis in a small business. SMEs that are more proactive in recovering debts as they become outstanding may find they are able to improve their cash flow management. Advisers should be actively encouraging and guiding businesses on debt recovery options. It is clear that by the time such debts become lodged in the debtors and creditors reports, it is already too late for some to be recovered.

In summary, therefore, this research showed that there was some dissonance between perceptions and reality so far as the relationship between record keeping and a range of broad tax compliance issues is concerned. All of the key stakeholders – SME owners and managers, practitioners and ATO auditors – perceived (to varying degrees) direct relationships between poor SME record keeping practices and adverse tax compliance outcomes. But those perceptions were not always confirmed by the evidence of actual behaviour. Poor record keeping did not, of itself, necessarily lead to

a higher vulnerability to audit (though once audited SMEs with poor records were more likely to suffer adverse audit outcomes). Nor did poor record keeping necessarily translate to higher compliance costs (though the data were ambivalent). Nor, finally, did poor record keeping necessarily lead to liquidity and cash flow problems. In each case, however, the stakeholders were able to identify the positive value that professional advisers can bring to the systems and practices of record keeping that businesses adopt. The benefits that good record keeping practices can bring were evident throughout the research in a number of direct and indirect ways.

Further and more detailed research is required to explore the complex relationships that exist between record keeping and tax compliance outcomes. The current project was ambitious in its scope, and was ultimately limited in its findings by its reliance on the self-assessment of the quality of record keeping practices by SMEs themselves. Further research should be narrower in focus. For example, separate projects should investigate each of the three compliance relationships (audit; compliance costs and liquidity) with record keeping practice. In addition, future research should seek more objective measures of the quality of SME record keeping practice, utilising evaluations by advisers (as originally intended in this project) and by the researchers themselves.

REFERENCES

Australian Bureau of Statistics, *Census Data 2001 First Release*, available from http://www.abs.gov.au, and accessed via the Hurstville Council Website http://www.hurstville.nsw.gov.au/default.asp.

Australian Bureau of Statistics, (2002), *Small Business in Australia*, AusStats: 1321.0, 23 October 2002.

Cordano, D. (1991), *Record Keeping in Small Business*, US Small Business Administration FM 10: Washington DC.

Corstvet, E. (1935), "Adequate Records as an Element in Business Survival", *The Accounting Review*, September, pp. 49-63.

CPA Australia, (2003a), *Small Business Survey Program: Compliance Burden*, April.

CPA Australia, (2003b), *Small Business Policy: Where to from here?* Discussion Paper (November).

Department of Trade and Industry, (2000), *Bankruptcy: A Fresh Start*, The Insolvency Service: London.

Evans, C. Pope, J. and Hasseldine, J. (eds) (2001), *Tax Compliance Costs: a Festschrift for Cedric Sandford*, Prospect: Sydney.

Evans, C. Ritchie, K. Tran-Nam, B. and Walpole, M. (1996), *A Report into the Incremental Costs of Taxpayer Compliance*, Commonwealth of Australia: Canberra (November).

Evans, C. Ritchie, K. Tran-Nam, B. and Walpole, M. (1997), *A Report into Taxpayer Costs of Compliance*, Commonwealth of Australia: Canberra (November).

Howard, J. (1997), *More Time for Business: Statement by the Prime Minister*, Commonwealth of Australia: Canberra (24 March).

Industry Tourism Resources, 2002, *Annual Review of Small Business*, Commonwealth of Australia: Canberra.

Insolvency and Trustee Service Australia, (2004), *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act*, http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/about+us->publications->annual+reports?opendocument.

McKerchar, M. (2003), *The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers*, Australian Tax Research Foundation: Sydney.

Pope, J. Fayle, R. and Chen, D. (1994), *The Compliance Costs of Companies' Income Taxation in Australia*, Australian Tax Research Foundation: Sydney.

Productivity Commission, (2000), *Business Failure and Change: An Australian Perspective*, Staff Research Paper, available at http://www.pc.gov.au/research/staffres/bfacaap/.

Sandford, C. (ed.), (1995), *Taxation Compliance Costs Measurement and Policy*, Fiscal Publications: Bath.

Sandford, C. Godwin, M. and Hardwick, P. (1989), *Administrative and Compliance Costs of Taxation*, Fiscal Publications: Bath.

Sandford, C. and Hasseldine, J. (1992), *The Compliance Costs of Business Taxes in New Zealand*, Institute of Policy Studies: Wellington.

Slemrod, J. and Venkatesh, V. (2002), *The Income Tax Compliance Cost of Large and Mid-Size Businesses*, A report to the IRS Large and Mid-Size Business Division, Office of Tax Policy Research: University of Michigan Business School (5 September).

Small Business Deregulation Task Force, (1996), *Working Overtime: A National Survey of the Paperwork Burden on Small Business*, Background Paper 3, Yellow Pages Small Business Index, Commonwealth of Australia: Canberra.

Sullivan, T. Warren, E. and Westbrook, J. (1998), *Financial Difficulties of Small Businesses and Reasons for their Failure*, SBA-95-0403, Small Business Administration: Washington DC.

Tran-Nam, B. and Glover, J. (2002), "Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach", *Australian Tax Forum*, Vol. 17 No. 4, pp. 499-536.

Warren, N. (ed) (2003), *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney.

APPENDIX A DETAILED TABLES: SME SURVEY

Section A BACKGROUND DETAILS

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

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

3 Identify the legal form of your business.

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

4 How long has your business been in operation?

	Number	Percent
Less than 1 year	0	0%
1 to 3 years	9	7%
4 to 5 years	3	2%
6 to 10 years	25	19%
More than 10 years	91	71%
Non-Response	1	1%

5 What is your position in the business?

	Number	Percent
Owner	96	74%
Manager	22	17%
Accountant / Payroll Officer	5	4%
Bookkeeper	4	3%
Other	1	1%
Non-Response	1	1%

6 What is your age?

	Number	Percent
Under 18	0	0%
18 – 30	0	0%
31 – 45	27	21%
46 – 60	84	65%
60 and above	17	13%
Non-Response	1	1%

7 Approximately how many full-time persons (including yourself) are employed in the business?

	Number	Percent
1	6	5%
2 – 5	47	36%
6 – 10	26	20%
11 – 20	30	23%
More than 20	19	15%
Non-Response	1	1%

8 What is the approximate annual turnover of your business (including GST)?

	Number	Percent
$0 - $100,000	5	4%
$100,001 - $250,000	10	8%
$250,001 - $500,000	12	9%
$500,001 - $2 million	40	31%
over $2 million	59	46%
Non-Response	3	2%

9 On scale of 1 to 10 (where 1 is poor, 5 is average, and 10 is excellent) how would you rate the overall quality of your business records?

	1 - 3	4 - 5	6 - 7	8 - 9	10
Number	4	11	21	68	25
Percent	3%	9%	16%	53%	19%

Section B RECORD KEEPING DETAILS

10 Which best describes your record keeping system?

	Number	Percent
Paper based system	7	5%
Hybrid system	30	23%
Computer based system	84	65%
Non-Response	8	6%

11 What do you see as the main reason for record keeping?

	Number	Percent
Compliance with tax law	30	23%
General Business Management	75	58%
Keeping track of debtors and creditors	7	5%
Profit and loss information	6	5%
Bank Requirements	0	0%
Other	2	2%
Non-Response	9	7%

12 From the list in question 11, what do you see as the second most important reason for record keeping?

	Number	Percent
Compliance with tax law	41	32%
General Business Management	25	19%
Keeping track of debtors and creditors	19	15%
Profit and loss information	30	23%
Bank Requirements	0	0%
Other	2	2%
Non-Response	12	9%

13 Has an accountant or other professional refused you as a client on the basis of your record keeping?

	Number	Percent
Yes	1	1%
No	128	99%

14 Who maintains your record keeping system?

	Number	Percent
Inhouse	96	74%
CPA/CA or other Accountant	12	9%
Tax Agent	0	0%
Bookeeper	12	9%
Other	1	1%
Non-Response	8	6%

15 In relation to question 14, why have you decided to manage financial records in this manner?

	Number
Size of the business	61
Internal expertise	58
Cost	32
Other	10

16 What are the main elements of your record keeping system and how often are they prepared/updated/reconciled?

	Never / NA		Daily		Weekly		Monthly		Quarterly		Yearly	
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
Cash Book	14	11	60	47	33	26	18	14	3	2	1	1
Invoices	15	12	52	40	40	31	22	17	0	0	0	0
Bank Statements	14	11	29	22	34	26	47	36	4	3	1	1
Non-specialised Computerised Software	59	46	25	19	16	12	16	12	9	7	4	3

17 Do you prepare, or have prepared, any of the following accounting reports?

	Number	**Percent**
Cash statement	86	67%
Profit and loss	113	88%
Balance sheet	107	83%
Debtors and creditors	102	79%
None of the above	3	2%

18 Do you use someone external to the business to prepare tax or accounting reports?

	Accounting Reports		**Tax Reports**	
	Number	**Percent**	**Number**	**Percent**
Inhouse	50	39%	20	16%
CPA/CA or other Accountant	50	39%	86	67%
Tax Agent	2	2%	12	9%
Bookeeper	12	9%	3	2%
Other	2	2%	0	0%

19 Please indicate which of the following are prepared inhouse or externally, and how often they are prepared:

	Inhouse		Externally		Weekly	Monthly	Quarterly	Yearly
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
Maintaining computerised records	109	96	4	4	87	18	3	0
BAS/GST reporting	110	91	11	9	9	40	66	0
Annual tax returns	21	18	98	82	2	3	7	100
Bank/Creditor reporting requirements	93	90	10	10	28	35	12	24
Annual reports	76	62	47	38	6	35	8	63
Payroll	104	93	8	7	63	37	4	3

20 If you use a specialised accounting package, which one do you use?

	Number	Percent
MYOB	74	63%
Quicken	11	9%
e-records	1	1%
Other	31	26%

Note, the number of people who indicated they use a computerised or hybrid system is 114. Three responses indicated they use two systems. Percentages in this section are out of 114

21 Did an external advisor (eg accountant, tax agent) advise you to use a computerised accounting system?

	Number	Percent
Yes	42	37%
No	72	63%

22 Did an external advisor set up the software package (i.e. chart of accounts)

	Number	Percent
Yes	52	46%
No	62	54%

23 Did you or your staff undertake training on the software package?

	Number	Percent
Yes	82	72%
No	32	28%

24 If yes, what was the approximate duration and cost?

	Mean	Median
Duration (hours)	21	12
Cost ($)	1143	800

25 Do you think a computerised system saves your business money?

	Number	Percent
Yes	107	94%
No	7	6%

26 Do you think a computerised system saves your external advisor (e.g. accountant, tax agent) agent time?

	Number	Percent
Yes	85	75%
No	29	25%

27 Has your external agent cost decreased after implementing a computerised system (where relevant)?

	Number	Percent
Yes	40	35%
No	74	65%

Section C AUDIT

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

	Number	Percent
Never / NA	81	63%
In the past year	16	12%
In the past 2 years	8	6%
In the past 3 years	3	2%
In the past 4 years or more	12	9%
I do not wish to answer this question	7	5%
Non-Response	2	2%

29 Please describe the type of audit.

	Number	Percent
Phone Call	6	12%
Desk Audit	9	18%
Field Audit	34	69%
Asset Betterment Assessment	0	0%
Other	0	0%

Note the number of responses (49) is greater because some had multiple types of audit

30 What was the outcome of the audit?

	Number	Percent
Decrease in tax payable	2	5%
No change in tax payable	29	74%
Increase in tax payable	6	15%
Unsure	2	5%
Non-Response	0	0%

31 What was the main cause of the outcome?

	Number	Percent
Unaware of legislation	2	11%
Poor advice from agent	0	0%
Clerical error	3	17%
Insufficient evidence of claim	4	22%
Unsure	0	0%
Other	1	6%

32 What was nature of the audit?

	Number	Percent
GST	23	40%
PAYG / Withholding	7	12%
Income tax (including company tax)	12	21%
Fringe benefits tax	7	12%
Capital gains tax	4	7%
Unsure	5	9%

Section D COMPLIANCE COSTS

33 Estimate the annual costs to the business of dealing with the record keeping and reporting requirements relating to each of the following activities

	Internal			External		
	Mean	**Median**	**Responses**	**Mean**	**Median**	**Responses**
BAS/GST	$9,137	$ 4,000	83	$3,147	$3,000	32
Annual income tax returns	$8,276	$2,500	42	$6,695	$4,000	77
Payroll	$5,646	$3,000	69	$2,234	$885	14
Fringe benefits tax	$3,266	$2,000	39	$1,306	$1,000	27
Other taxes	$3,965	$3,000	21	$2,025	$1,400	12
Other record keeping	$23,823	$10,000	55	$3,076	$2,000	19

Section E LIQUIDITY

34 Have you suffered a "cash crisis" or crises in the past?

	Number	**Percent**
1 year	32	25%
2 years	20	16%
3 years	8	6%
4 years or more	19	15%
Never	57	44%

Note: Totals add to more than 100% because some firms had cash crisis in more than 1 year

35 What do you believe was the main cause of the cash crisis?

	Number	**Percent**
Pressure from creditors	3	4%
Late payment by debtors	27	34%
ATO / Tax obligations	12	15%
Poor record keeping	1	1%
Other	20	25%
Non-Response	16	20%

36 What do you consider the second most important cause of the cash crisis from the list in question 35?

	Number	**Percent**
Pressure from creditors	10	13%
Late payment by debtors	12	15%
ATO / Tax obligations	17	22%
Poor record keeping	4	5%
Other	10	13%
Non-Response	26	33%

37 Have you been refused finance or credit because of a lack of business records?

	Number	Percent
Yes	1	1%
No	128	99%

ATTITUDINAL QUESTIONS

38 Time dedicated to record keeping exceeds the benefits

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
33	28%	43	36%	8	7%	25	21%	11	9%

39 I am confident in the accuracy of my record keeping system

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
1	1%	1	1%	4	3%	51	42%	65	53%

40 I am confident that I have the necessary system in place to comply with the taxation law

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
1	1%	1	1%	5	4%	53	43%	62	51%

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

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
3	2%	24	20%	12	10%	36	30%	47	39%

42 Required record keeping (e.g. BAS) helps me manage my business more effectively

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
11	9%	44	36%	16	13%	38	31%	13	11%

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

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
0	0%	2	2%	11	9%	63	52%	46	38%

44 Good record keeping reduces the likelihood of ATO audit

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
10	8%	14	11%	42	34%	33	27%	23	19%

45 Good record keeping reduces compliance costs of the business

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
3	2%	19	16%	30	25%	50	41%	19	16%

46 Good record keeping helps to ensure that cash crises are avoided

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
5	4%	10	8%	5	4%	68	56%	34	28%

47 Poor record keeping has prevented me from obtaining an allowable deduction in the past 3 years

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	%	No.	%	No.	%	No.	%	No.	%
40	35%	40	35%	24	21%	7	6%	4	3%

Section F FURTHER COMMENTS

48

Please provide an estimate of the time taken to complete this form: Average 16 min

Identified: 50% of respondents identified themselves

Appendix B Detailed Tables: CPA Survey

Section A PRACTICE BACKGROUND

1 Are you?

	Number	Percent
A self-employed sole practitioner	89	68%
A partner	35	27%
An employee	4	3%
Other	1	1%
Non-Response	1	1%

2 If you are a partner, or an employee of a partnership, please indicate the number of partners in the practice.

	Number	Percent
2 - 4 partners	33	80%
5 - 7 partners	8	20%

3 In broad terms, what is the annual turnover of the practice (including GST)?

	Number	Percent
$0 - $100,000	35	27%
$100,001 - $250,000	34	26%
$250,001 - $1,000,000	45	35%
$1,000,001 - $2,500,000	12	9%
$2,500,001 - $5,000,000	1	1%
over $5 million	0	0%
Non-Response	3	2%

4 What is the approximate number of clients of the practice?

	Number	Percent
0 – 50	12	9%
51 -100	9	7%
101 – 250	20	15%
251 - 1,000	60	46%
more than 1,000	28	22%
Non-Response	1	1%

5 From which industry sector do your clients come?

	0	1 - 25 %	26 - 50 %	51 - 75 %	76 - 100 %	Non-Response
Primary	54	47	16	3	4	6
Secondary	14	65	41	4	3	6
Services	1	22	39	27	38	3
Other	30	22	13	5	4	54

6 What proportion of the practice's client base is comprised of small business clients (defined as clients with fewer than 20 employees or less than $10 million in turnover)?

Mean	77%
Median	99%

7 In broad terms, what proportion of your client base would fall into each of the following categories (including GST)?

	0	1 - 25 %	26 - 50 %	51 - 75 %	76 - 100 %
$0 - $100,000 pa	13	45	36	14	22
$100,001 - $250,000 pa	12	66	39	11	2
$250,001 - $500,000 pa	26	71	28	5	0
$500,001 - $2 million pa	38	77	9	1	5
over $2 million pa	76	52	2	0	0

8 How many potential clients have you refused because of poor record keeping?

	Number	Percent
None	51	39%
1 - 5 per year	68	52%
6 - 10 per year	7	5%
11 - 25 per year	1	1%
more than 25 per year	2	2%
Non-Response	1	1%

Section B ATTITUDES TO RECORD KEEPING

9 What characteristic do you consider the most important attribute of a good small business client record keeping system?

	Number	Percent
Accuracy	72	55%
Timeliness	9	7%
Simplicity	30	23%
Comprehensiveness	13	10%
Other	1	1%
Non-Response	5	4%

10 From the list in question 9, what do you see as the second most important attribute of a good small business client record keeping system?

	Number	Percent
Accuracy	29	22%
Timeliness	23	18%
Simplicity	33	25%
Comprehensiveness	31	24%
Other	0	0%
Non-Response	14	11%

11 What do you see as the main reason for small business client record keeping?

	Number	Percent
Compliance with tax law	78	60%
General Business Management	43	33%
Keeping track of debtors and creditors	1	1%
Profit and loss information	2	2%
Bank Requirements	0	0%
Other	1	1%
Non-Response	5	4%

12 Do you advise your small business clients on appropriate record keeping system?

	Number	Percent
Yes	124	95%
No	6	5%

13 Do you set up those systems?

	Number	Percent
Yes	104	80%
No	21	16%
Not Applicable	0	0%
Non-Response	5	4%

14 The following list contains some common assumptions about the benefits which result from good small business client record keeping. Please rate them on a scale of 1 – 5, where 1 indicates no relationship, and 5 indicates a strong relationship.

	No Relationship						Strong Relationship					
	1		2		3		4		5		Non-Response	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Improved cash flow management	1	1	12	9	31	24	52	40	27	21	7	5
Greater stock/inventory management	7	5	27	21	32	25	43	33	15	12	6	5
Lower compliance costs	7	5	8	6	19	15	56	43	33	25	7	5
Better access to credit	2	2	9	7	32	25	62	48	19	15	6	5
Reduced exposure to audit by ATO	7	5	13	10	21	16	51	39	32	25	6	5

15 What factors would encourage you to advise a small business client to set up a computerised record keeping system?

	Number	Percent
Turnover	50	17%
Staff levels	42	15%
Numerous transactions	97	34%
Perceived competency of client	88	31%
Other	10	3%

16 What computerised record keeping system do you insist upon or suggest for small business clients?

	Number	Percent
None	14	9%
MYOB	78	53%
QUICKEN	20	14%
e-records	7	5%
Other	29	20%

17 Do you train small business clients in the use of computerised programs?

	Number	Percent
Yes	75	58%
No	55	42%

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

	0% of clients		< 25% of clients		26% - 50% of clients		51% - 75% of clients		76% - 100% of clients		Non-Response	
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
Saves client time	12	9	29	22	31	24	36	28	14	11	7	5
Improves client accuracy	5	4	17	13	24	18	58	45	20	15	6	5
Reduces client bills	7	5	34	26	33	25	41	32	9	7	6	5
Saves you time	5	4	19	15	32	25	48	37	20	15	6	5

Section C ACCOUNTING RECORDS

19 Which accounting reports (which you may or may not prepare) do you consider essential to successful management of a small business?

	Number
Cash statement	77
Profit and loss	117
Balance sheet	84
Debtors and creditors	94

20 Please estimate the percentage of clients who prepare (or you prepare on their behalf) the above reports.

	0% of clients		< 25% of clients		26% - 50% of clients		51% - 75% of clients		76% - 100% of clients		Non-Response	
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
Cash statement	18	14	59	45	14	11	15	12	8	6	16	12
Profit and loss	2	2	16	12	14	11	24	18	72	55	2	2
Balance sheet	2	2	19	15	20	15	28	22	55	42	5	4
Debtors and creditors	13	10	37	28	22	17	27	21	21	16	10	8

21 Do you consider any of the following reports which are required by third parties (e.g. government / creditors) improve the management of a small business?

	Number
BAS/GST	79
Annual tax return	74
Bank / Creditor reporting requirements	35
Payroll	29
Other	3

Section D AUDIT

22 What factors do you think increase the risk of a small business being exposed to a tax audit?

	Number
Being in a "cash economy" industry	116
More than average deductions	103
Being in the simplified tax system	4
Fluctuating revenues/deductions	66
Refunds	40
Seeking an amended assessment	16
Other	7

23 On a scale of 1 -10, with 1 being no relationship and 10 being a strong relationship, please indicate the strength of the relationship between poor small business record keeping and the probability of audit by the tax office.

	Number	Percent
1 – 3	28	22%
4 – 6	37	28%
7 – 8	36	28%
9 – 10	14	11%
Non-Response	15	12%

24 When considering those small business clients who have been audited by the ATO, please rank (in order of importance) the following reasons that resulted in an amended assessment, from 1 to 6 (with 1 being most important).

	Mean
Unaware of legislation	3.23
Poor advice from agent	4.38
Tax evasion/fraud	3.65
Clerical error	2.23
Insufficient evidence of claim	2

Section E COMPLIANCE COSTS

25 Please indicate the average cost that you charge a small business client for preparation of the following reports.

	Average Cost		
	Mean	**Median**	**Responses**
BAS/GST	$ 455	$ 250	112
Annual income tax returns	$ 907	$ 785	116
Payroll	$ 338	$ 200	42
Fringe benefits tax	$ 398	$ 300	54
Other taxes	$ 332	$ 150	19
Other record keeping	$ 579	$ 500	44

Section F LIQUIDITY

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

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

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

Mean	6%
Median	2%

ATTITUDINAL QUESTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
4	3%	25	19%	35	27%	49	38%	16	12%

35 Good record keeping reduces compliance costs for small business clients

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
2	2%	8	6%	12	9%	79	62%	27	21%

36 Good record keeping helps to ensure that cash crises are avoided by small business clients

Strongly Disagree		Disagree		Neutral / Don't Know		Agree		Strongly Agree	
No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
3	2%	15	12%	20	16%	70	56%	18	14%

Section F FURTHER COMMENTS

37 Please add any other comments you may have about the relationship between record keeping and the probability of audit, compliance costs, and cash flow for small business clients that you do not think were covered by the survey

Please provide an estimate of the time taken to complete this form: Average 23 minutes

Identified: 48% of respondents identified themselves