The Administration & Economic College Journal
For Economics & Administration & Financial Studies
Vol.14,N2, P P.27 - 43
ISSN PRINT 2312-7813
ISSN ONLINE 2313-1012
مجلة كلية الإدارة والاقتصاد للدراسات الاقتصادية
والإدارية والمالية
المجلد ١٤، العدد٢ حزيران ٢٠٢٢ ص ص٢٧-٤٣

A Proposed Approach to Increase the Effectiveness of Internal Control in Reducing Tax Evasion in Companies

م.م عبد المهدي عبد الحسن المنصوري*   أ.م.ظفر ناصر حسين *

Abstract

This paper aims at shedding the light on the role of the internal control in reducing tax evasion and fraud at some companies and the contribution of taxes to state resources. Taxes are a funding and multi-purpose tool used to maximize resources and provide services by the government. This study introduces this problem and the role of internal control in its remedy. After introducing the concepts of tax and tax evasion, the researcher introduces some solutions to reduce tax evasion. The researcher indicates that tax evasion is a global phenomenon and rife in countries where control systems are still incomplete. The problem of tax evasion and means of tax evasion and its combat, internal control, as well as the use of preventive means to prevent tax evasion are not enough since this phenomenon has worsened and the means of tax evasion has diversified. The researcher reached to the conclusion that lack or ineffective internal control can make the internal control system face some problems that makes it unproductive, and this will be reflected on the state treasury.

*جامعة بابل – كلية الادارة والاقتصاد

The researcher made some recommendations including the necessity to reactivate the role of internal control in companies by developing a code of honor and adhering to rules adopted by this code, as well as creating an effective system of governance that adopt these rules. Finally, there should be legislation in place to criminalize tax evasion by imposing strict punishment on tax evaders and manipulators of a company who manipulates or covers up companies’ profits.

Introduction

For decades, societies have faced a harmful phenomenon that hinders the state's spending policy. It negatively affects the state's efforts to meet its expenditures through various sources of revenue, including taxes. The phenomenon of tax evasion has become a nightmare forming an obstacle to the strengthening of public financial resources and deploying them to satisfy public needs. This is particularly the case in countries in which taxes are an important resource in extending the public treasury. Being a legal concept, revenue of financial tax needs to be performed in such a way that the law guarantees it. Therefore, any reluctance to abide by them generates multiple negative cases that could harm the interests of the state and society. Since the latter aspires to enjoy more services that the state seeks to achieve or provide, these are to be provided by means of taxes. If they are not paid on time, it will be difficult to create such services. Eventually, the harmony that should be available between the state and society will be lost.

Research problem

Taxes are considered an important financial revenue for the state, and evading their payment is a hidden violation that is rather difficult to detect or control. Hence, the treatment of evasion can be achieved by identifying the loopholes and outlets to be addressed. The internal control, through its professional responsibility, is responsible for reducing this dangerous phenomenon. This is why these units need to develop their internal control systems, so as to be able to reduce these practices to the lowest possible extent. The current study aims to achieve this aspect.

Research aims

This research aims to:

1- Develop a specific concept of tax and tax evasion, and explain its causes and effects on society and the state.
2- Develop the internal control system in order to raise its efficiency to prevent this phenomenon.

Research Significance

The research derives its importance from the significance of the issues it deals with. In this case, it is the concept of tax evasion in companies and how to reduce it through the development of the internal control system. These are responsible for increasing efficiency and providing control, as this course is important in financing the state budget and covering its expenses.

Tax Concept

The tax is one of the important resources that the state relies on to cover the expenses included in the general budget. However, this resource is depleted as the phenomenon of evasion increases in society. Eventually necessitating attention to the tax evasion problem that is inherent in the tax systems. It is impossible to determine the value of the taxes that are evaded annually. To find a way to combat this problem, it is necessary to identify the concept of tax evasion, its forms, and identify the factors behind it, followed by analysing the serious effects it inflicts on the economy of the country.

Before discussing the concept of tax evasion, it is first necessary to define the concept of tax. Based on the fact that the problem of evasion mainly stems from the expansion of the role of taxes in economic and social life, it has become one of the important economic tools responsible for addressing many economic and social problems.

First: Defining the tax and its characteristics

Economists and financial scholars differed in clarifying the legal nature of the tax, as many of them described it as “the requirements of the authority exercised by the state over its subjects”. Another definition of tax is “a non-punitive compulsory financial deduction determined by the state and obligating the natural and concerned persons to perform it for the state permanently and without special consideration. This is to enable the state to carry out its economic, social and political functions” (Khader, 2008: 32).

Tax features

1. Tax is the withholding of cash:

Taxes used to be imposed in form of agricultural crops and others as a result of the lack of a monetary economy. This is accompanied with a number of issues such as the high costs of collecting and storing it. After the use of money as a general measure of values, and as a means for the payment of debts, the tax has started to be collected in cash as a general rule. However, it may be paid otherwise on a small scale in some countries (Abdul Ghafour, 2008:29).

2. Tax is obligatory

The state, through its bodies, collects the tax according to established rules. It is imposed by law and according to specific rules, as the individual has no choice in paying the tax. On the contrary, he is obligated to pay it regardless of his willingness. The same evasion of paying the tax fell under the penalty of punishment, and the state obtained its right to seize the taxpayer’s money using forced execution methods, because the tax owes a privilege over all the taxpayer’s money (Abu Hashish, 2010: 17-18).

3. Tax is an obligation without consideration

The taxpayer who pays the tax does not obtain a benefit of his own, for there is no connection between the private benefit that accrues to the taxpayer and the tax. The individual pays the tax as a member of a certain group. This does not mean that the taxpayer does not benefit from it, in fact the individual benefits from the services of public utilities as a citizen, and benefits from his presence in the midst of a group that is provided with security, stability and justice (Al-Ali and Kadawi, 1989: 42).

4. The purpose of taxes is to achieve a public benefit

The tax is one of the important sources of public revenue, so it enables the state to achieve its goals. The outcomes represent a permanent and main goal, because it provides the state with the resources it needs to meet its expenses and increase its burdens. The latter is necessary to achieve public benefits for society. It also achieves an economic and social balance between the rights of the public treasury and the rights of individuals (Nased, 2000: 120). Traditionally the state must use the revenue to achieve economic, social and political goals through the availability of two basic conditions, namely the abundance of tax revenue, and the impartiality of the tax (Abu Hashish, 2010: 19).

5. The tax is imposed according to the taxpayers' ability to pay

In order to achieve the principle of justice, each individual should contribute according to his ability to pay, taking into account the personal circumstances of the taxpayer. No discrimination may occur in terms of tax treatment between taxpayers who have equal ability to pay (Al-Azzawi, 2002: 3). This aspect will be further discussed later on through the use of the rules and standards to which the tax is subject.

Second: The basic rules of tax

The writer and economist Adam Smith is the first to set the rules of tax, in his famous book (The Wealth of Nations). To this day, these rules are still the standard by which the validity of taxes and the integrity of the tax system are measured as a whole. This book is called the "tax constitution" (Bseisu, 1950:193).

1. The rule of justice and equality:

The idea of justice in its modern context requires exempting low-income earners from paying the tax in relation to the subsistence limit, which is the minimum standard of living. It is also required to take into account family burdens in proportion to the standard of living in the community, imposing the tax at different rates according to different levels of income (Al-Mayahi, 1014: 19).

2. A suitable rule:

It means that the tax is collected from the taxpayer when he obtains his income. The appropriate time for the owners of salaries and wages to collect the tax is the time of obtaining the income, which is monthly (Al-Batriq, 1987: 87).

3. The rule of certainty:

It means that the tax should be clear and well-known in terms of its amount, the date of its payment, and the manner of this payment, so that the tax is far from arbitrariness and transgression (Al-Ali and Kadawi, 1987:51),

4. The base of the economy:

The essence of this rule is economizing tax collection, which means keeping the expenses of tax collection to a minimum. The tax whose collection expenses exceed its revenue as a result of employing a large number of employees, should better not be imposed (Al-Sakban, 1972: 163).

Tax evasion

First: The concept of tax evasion

Tax evasion is defined as "the violation resulting from concealment, distortion, or falsification of information submitted to the tax administration with the aim of reducing tax amounts, or concealing a previous violation" (Amin, 2000: 148). The concept of tax evasion can be studied from several aspects, including the economic, legal, ad accounting aspects. Despite the differences in terms of nomenclature, they fall into one content as it is a dangerous phenomenon that must be followed up and limited.

Economic evasion

Tax evasion is defined as "the taxpayer's attempt to completely or partially get rid of his legal obligation to pay the tax due on him, using various legally illegal means" (Abdul Ghafour, 2008: 16). Evasion is one of the dangerous social phenomena that work to harm the national economy. It stands as an obstacle to the state in implementing its fiscal policy and achieving its economic and development goals through a decrease in the tax revenue of the public treasury, which leads to the state's inability to meet its public expenditures (Qasim, 2003: 88).

Legal evasion

It means “the taxpayer gets rid of his legal obligation to pay the tax due on him wholly or partially by following fraudulent methods that violate the law” (Al-Khasawneh, 2010: 224). Another explanation is “every act and omission that is in violation of the established rules for organizing and protecting the economic policy of the state if it is stipulated that it be criminalized in the penal code, or in special penal laws” (Al-Nuaimi, 2004: 12).

Accounting evasion

The Finance Book defines tax evasion as “a tax violation resulting from concealment, distortion, or forgery of information submitted to the tax administration with the aim of reducing the amount of tax, or concealing a previous violation, by not registering the taxpayer in the income taxpayer system, or the registered taxpayer's failure to submit its declaration annual tax return to the tax administration” (Amin 2000: 148).

Through the three aspects, the main characteristics of evasion can be identified as follows (Al-Rawi, 2008: 92):

- The taxpayer is not obligated to pay the tax despite the existence of the law.
- Decreased tax proceeds regardless of whether the evasion was total or partial.

- It is a violation of one of the tax rules, which is the rule of justice between those charged with paying taxes to cover the state's public expenditures.

Second: The causes of tax evasion: There are a number of reasons that lead to tax evasion, the most important of which are:

1. Factors related to economic conditions:

There are reasons related to the economic conditions of the state, as it is noted that in the event of a recession, the state's need for material resources increases to try to save the economy and eliminate unemployment. However, the state of depression, on the other hand, means a decrease in income, and thus the inability of individuals to pay taxes (Ibrahim, 2010: 42-43).

2. High tax rates:

The increase in the tax rate leads to the taxpayer evading from paying the tax, because the incentive to evade depends on the tax rate based on the gains from evasion are determined as a percentage of the evaded income, and tax evasion on income (Al-Rawi, 2008: 21).

3. State spending policy:

There is a lack of tax sense among individuals and a lack of awareness of the importance of their tax performance, and the benefit that this reflects to the whole society. This represents a reason for evasion, and whenever the state performs its full role towards individuals, these people feel the value of the contribution they make (Kaddoura, 2012: 127).

4. Legislative reasons:

Legislative reasons are one of the most important reasons for tax evasion, and the reason for this is the lack of tax legislation. Tax legislation in Iraq suffers from a large number of legislations related to taxes and fees, and this may be due to the legislator's desire to update laws and regulations and make them keep pace with all that happens in economic conditions. However, the enormity of these legislations constitutes a weak point, and thus is a reason for tax evasion (Ibrahim 2010: 41),

Third: The effects of tax evasion

1. Economic effects

The most important effects of tax evasion from the economic point of view are summarized as follows (Ibrahim, 2003: 42-43):-

> "Tax evasion constitutes one of the important obstacles to achieving economic and social development, which is one of the main objectives of the state. Exaggerated tax evasion, and these activities may not be beneficial to society, yet individuals tend to invest in them, due to the possibility of tax evasion."

2. Financial implications

Tax fraud leads to damage to the state's public treasury, so that the state misses an important part of the financial resources. Tthis results in the state's public spending to the fullest, and the state becomes unable to perform its basic duties towards its citizens (Nasser, 2004: 17).

3. Social Effects:

The tax is one of the tools through which the state intervenes in order to reduce the disparity between the different social classes, and to achieve a kind of social justice. The progressive tax is applied by most countries to achieve tax justice and reduce disparities between the classes of society (Al-Najjar: 2003: 53).

The following procedures represent the minimum included in a proposed approach to increase the effectiveness of internal control, with the purpose of reducing tax evasion in companies

The main features

First: Controls for the management methodology: To reduce manipulation practices in companies, the internal control system must have the following:

1- The basic duty of the administration is to protect the rights of the unit and its development in the long term. The administration must be firm, because this will be reflected in the extent of the commitment of the unit's members to the established control instructions.
2- Separation of duties, i.e. a party that authorizes operations and records them must be separated, and the assets related to them must be kept. This separation contributes to reducing the possibilities of manipulation or committing corrupt practices.
3- The auditor who has practiced accounting work for a period of no less than two years must be appointed.
4- Holding periodic meetings on outstanding issues and other developments.
5- Setting standards for internal control in a manner that is appropriate to its environment and its application.
6- Rotating jobs and positions for each specific period, while restricting their broad powers to reduce chances of manipulation.
7- The existence of fundamental approvals for the various activities and operations that take place in the unit.

8- It evaluates the performance of internal control annually, and this is done by other similar control bodies.
9- The audit officer is evaluated and a renewal or exemption is recommended based on the evaluation results.
10- Work of integration between the internal control system and the external control.

Second, an appropriate control environment

1- The administration defines the unit's goals and approves strategies to achieve these goals through a planning process that includes all audit work to ensure that the performance achievements are reviewed according to the work plans and that the necessary measures are taken.
2- Integrity and Moral Values: The administration must lay the foundation stone for an environment that enjoys high morals and integrity, provided that the administration is the first to abide by it and set an example in this. In this ethical document, it must include the penalties for its violation, and these penalties must be graded in severity with the size of the violation.
3- Establishing rules and procedures regulating operations with related parties, whether between the unit and its employees or the parties related to them.
4- Clear control systems that prevent employees from exploiting the internal information in the unit for their own benefit or for the benefit of other people.
5- The unit must have written policies that cover all its various activities and are circulated at all administrative levels and reviewed regularly to ensure that they include any amendments or changes that occurred to laws, instructions, economic conditions and any other matters.

6- Participation of management in supervision. The effectiveness of oversight over work within the unit increases as the degree of management participation increases.

7- The Internal Audit Department provides a sufficient number of qualified human cadres, who are trained and rewarded appropriately, and the Audit Department has the right to obtain any information and contact any employee. It also has all the powers that enable it to perform the tasks entrusted to it as required, and the unit documents the tasks and powers Audit management responsibilities.

8- Transparency, the element of transparency must be available to increase the effectiveness of oversight within the unit, and transparency means allowing access to documents and reducing the level of confidentiality on the information on which fraud is based.

9- Accountability, the control environment must have a system of accountability. Accountability is one of the most important concepts that seek to ensure justice and integrity and to achieve effective oversight in the unit as it helps reduce fraud to the lowest level. Everyone must be held accountable at all administrative levels, so that there is an actual action to be taken regarding the performance of the requirements of a particular role within the framework of the work to be accomplished.

10- The unit is required to follow a fixed accounting policy such as the depreciation method, the cost of the asset, and the inventory valuation.

Third: Effective internal audit

1- The structure of the internal control systems is reviewed by the internal auditor and the external auditor, at least once annually.
2- Survey: The internal auditor can detect corrupt practices and manipulation by making some surveys in case he suspects the existence of such cases. The survey is written so that a sphere of safety and confidence is ensured for being reported and processed, because some information cannot be discovered using audit procedures.
3- Any material weaknesses are to be disclosed in the internal control systems (i.e. a material weakness is a clear point or group of weaknesses that results in the possibility of not being able to prevent or detect an incorrect statement with a fundamental effect).
4- A report from the external auditor stating their opinion on the executive management’s evaluation of the effectiveness of the internal control and control systems.
5- Use of information technology: The internal auditor can use electronic computers to save time and effort in conducting test operations and discovering any fraudulent practices that may have occurred.
6- Follow-up: In order for the internal control system to maintain its effectiveness, a continuous evaluation and follow-up of the quality of its performance must be carried out, to determine the adequacy of the internal controls for control and to carry out corrective measures and their effectiveness by discovering fraudulent practices and modifying them to achieve the objectives of control and the objectives of the unit.
7- The Internal Audit Department submits its reports to the highest administrative body affiliated to it without any external interference.

8- Financial reporting processes to ensure that the main information about financial and administrative matters and operations is accurate, reliable and timely.
9- Applying internal instructions, local standards and procedures, and relevant laws and instructions.
10- The unit is committed to maintaining lines of communication with the regulatory authorities, stakeholders and the public in general, by submitting a periodic summary.

Findings and Recommendations

First: the results

1- Tax evasion is a global phenomenon that spreads in underdeveloped and developed countries.
2- It affects both the society and the state in terms of covering the expenses of services rendered by the state to the society.
3- The main reason for tax evasion cases in companies is weakness and shortcomings in internal control.

Second: Recommendations

1- The role of internal control in companies must be activated so that these systems can limit these practices and thus achieve good performance for them.
2- The internal control system must contain the Code of Ethics, with the need to adhere to the rules contained in this charter, while constantly supporting it.
3- The necessity of establishing a system of governance in these units.
4- Criminalizing tax evasion practices.
5- Integration of internal and external control.

References

Books:

1- Al-Khasawneh, Jihad Saeed, Public Finance and Tax Legislation, Dar Wael for Publishing and Advertising, 1st Edition, Amman, 2010

2- Al-Sakban, Abdel-Al, Introduction to the Science of Public Finance and Public Finance in Iraq, Part One, Al-Ani Press, Baghdad 1972.

3- Bseisu, Saadi, Summary in the Science of Finance and Financial Legislation, Al-Anqat Press, Baghdad, without a year of printing, 1950.

4- Taqa, Muhammad, and Al-Azzawi, Huda, The Economics of Public Finance, Dar Al Masirah for Publishing, Distribution and Printing, 2nd Edition, Amman, 2010.

5- Abdullah Mahmoud Amin, Evaluating the Effectiveness of the Tax Accounting System for Income Tax in Iraq, PhD thesis, Al-Mustansiriya University, Iraq, 2000

6- Kaddoura, Zuhair Ahmed, The Science of Finance and Tax Legislation and Its Applications, Wael Publishing House, Amman, 2012.

7- Nasser, Murad, Tax fraud and evasion in Algeria, Cordoba House, Algeria, 2004.

8- Younis Ahmed Al-Batriq, Tax Systems, University House, Beirut, 1987.

Theses

1. Abdul Ghafour, Taha Hamid, Analysis of the Reality of Tax Evasion, and Ways to Treat It, Higher Diploma Thesis, Higher Institute of Financial and Accounting Studies, University of Baghdad, 2008

2. Al-Mayahi, Haider Muhammad Ali, Income Taxes and Their Role in Achieving Tax Justice, Higher Diploma Thesis, Higher Institute of Accounting and Financial Studies, University of Baghdad, 2014.
3. Khader, Barzan Ali, Evaluating the performance of the tax administration and its relationship to the tax outcome with the tax outcome, thesis of a higher diploma in taxation, the Higher Institute for Financial and Accounting Studies, Baghdad, 2008.
4. Al-Nuaimi, Rasha Abdul Majeed Saeed, The Phenomenon of Tax Evasion in Income Tax, High Diploma Thesis, College of Administration and Economics, University of Baghdad, 2004.
5. Al-Azzawi, Ibtisam Ali Hussein, Analysis of the Impact of Economic Factors on Tax Energy, Master Thesis, University of Baghdad, 2002
6. Al-Rawi, Orouba Muin Ayesh, the factors that lead to the evasion of income taxpayers, a higher diploma thesis, the Higher Institute for Accounting and Financial Studies, University of Baghdad, 2008
7. Qassem, Salah Muhammad Tawfiq, Income Tax Evasion in Palestine, Master Thesis, An-Najah National University, Palestine, 2003.
8. Nashed, Suzy Adly, The phenomenon of international evasion and its effects on the economies of developing countries, PhD thesis, Department of Economics and Public Finance, Faculty of Law, Alexandria University, 2000
9- Al-Najjar, Sarmad Abbas Al-Najjar, Tax Evasion and its Economic Effects in the Arab Countries, Master Thesis, College of Administration and Economics, University of Baghdad, 2003.