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An integrative model in predicting corporate tax fraud

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Abstract
Purpose – This paper aims to present an integrative model in predicting corporate tax fraud.
Design/methodology/approach – This paper is grounded on three theories, namely, the theory of reasoned action, theory of planned behaviour and the "Fraud Diamond Theory".
Findings – By integrating these three theories, this paper proposes that individual cognitive factors, fraud diamond factors and organizational factors such as normative and control factors influence managers to commit corporate tax fraud.
Practical implications – Practically, the proposed integrative model enables the government and tax authority to understand on why corporate managers engage in corporate tax fraud. It will also allow them to devise practical methods and strategies to prevent the corporate managers to engage in tax fraud.
Originality/value – This study has merit that proposed an integrative model in predicting corporate tax fraud. Research on corporate tax fraud has been the subject of limited investigation; hence, this study contributes to the tax compliance literature by proposing an integrative model to study corporate tax fraud in a Malaysian tax setting. Future studies can be conducted to test the proposed integrative model in examining the circumstances of managers' intention to commit corporate tax fraud.

Keywords Theory of planned behaviour, Theory of reasoned action, Corporate manager, Fraud diamond theory, Tax fraud

Paper type Conceptual paper

1. Introduction

In general, individual taxpayers engage in tax frauds out of personal interests or for self-gain. However, unlike individual taxpayers, most corporate tax frauds are due to the misconducts of their managers. Corporate managers commit tax frauds either for personal interest and/or organizational reasons (e.g. to maintain stock price and stakeholders' interest). Corporate managers tend to evade tax and/or deliberately commit tax frauds through the manipulation of financial statements such as under-reporting revenues and overstating expenses. Beasley *et al.* (2010) stated that the

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Committee of Sponsoring Organizations of the Treadway Commission found that 89 per cent of corporate fraud cases in US public companies were associated with the chief executive officer or chief financial officer. In a similar vein, in Malaysia, two former executive directors of Transmile Group Berhad were charged in court for reporting misleading statements (Rita Benoy, 2011).

A review of tax compliance literature found that majority of prior studies focused on individual taxpayers. In contrast, there are limited empirical studies conducted on corporate taxpayers. This is alarming as corporate income tax plays crucial roles in the federal revenue collections. For example, in Malaysia, 80 per cent of the total tax collection came from the corporate sector (Anonymous, 2011). While the Ministry of Finance reported that the Malaysian corporate sector contributed 44 per cent out of RM76.2 billion of tax collections to the federal government in 2010 (Economic Report, Ministry of Finance, 2010). The importance of corporate income tax to the federal government, and the pervasiveness of corporate tax frauds prompted the need to examine the managers' intention to commit corporate tax fraud. This is because the behaviour of the manager(s) would significantly influence the corporate tax compliance decision. By understanding their intention to engage in corporate tax fraud, not only will it provide answers as to why corporation engaged in tax fraud but also can provide insights to the tax authorities to develop strategies to prevent, predict and detect corporate tax frauds. However, past studies that examined tax compliance in the Malaysian setting focused mostly on individual taxpayers, for example, Jeyapalan and Hijatullah (2006) and Loo *et al.* (2009).

At the time of this study, only a few studies had been conducted to determine corporate tax fraud in Malaysia, for example, Juahir *et al.* (2010), Khadijah and Pope (2010) and Zainal Abidin *et al.* (2010). However, none of these three studies did any investigation on the factors and reasons that influence the managers' intention to engage in corporate tax fraud. In essence, research on corporate tax fraud has been the subject of limited investigation. In addition, Chan and Mo (2000) argued that evidences of tax fraud based on individual taxpayers cannot be generalized to cover corporate taxpayers. The behaviour of corporate managers may or may not be similar as compared to that of individual taxpayers. Hence, this study aims to propose and develop an integrative model to explain and predict corporate tax fraud.

The paper is organized as follows. Following Section 1 as an introduction, Section 2 examines the relevant theories, followed by the development of an integrated model. The last section presents the theoretical contribution and future research consideration.

2. Literature review

A review of literature from the socio-psychology discipline found that past studies used *either the* theory of reasoned action (TRA) or the theory of planned behaviour (TPB) to examine the behavioural intention. The primary focus of TRA is behavioural intention to carry out the behaviour. According to Fishbein and Azjen (1975), behavioural intention is derived from two parallel cognitive processes that are known as attitude toward a behaviour and subjective norm.

Ajzen (1985) stated that personal factor which is one's attitude towards behaviour, is an evaluation of the positive or negative outcome when carrying out an intention based on the behaviour. Attitude towards behaviour is determined by two features: salient beliefs and outcome evaluation. Thus, if a person believes that his/her performing

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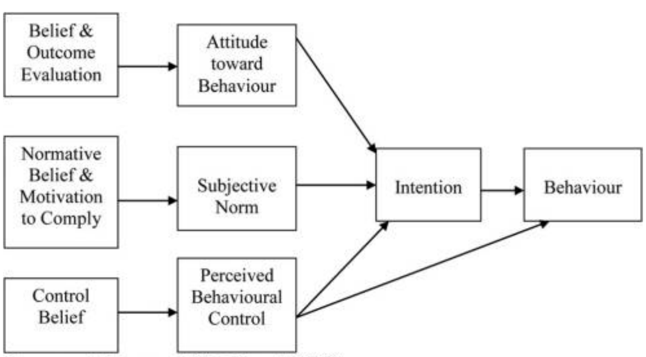
behaviour will lead to a positive outcome, he/she will take a favourable attitude toward performing the behaviour and vice versa. The second factor is subjective norm. Ajzen (1991, p. 188) defined subjective norm as "the perceived social pressure to perform or not to perform the behaviour". The social pressure includes "what significant others (e.g. friend, family, co-worker) think one should do, and one's motivation to adapt to their views" (Bobek *et al.*, 2007). Both attitude and subjective norms have direct influence on, and the intention is a direct antecedent of behaviour. Hence, in taxation setting, corporate managers' compliance with tax laws is a deliberate act that could be sufficiently explained and predicted by his/her behavioural intention.

In tax compliance literature, few studies have used TRA to explain or predict the managers' intention to commit corporate tax fraud. The two constructs of TRA, i.e. attitude towards the behaviours and subjective norm are relevant to the study context as both components have been proven to be important determinants of intention. These two constructs affect the corporate managers' compliance intention towards tax laws. However, the application of TRA in this study is limited because the intention to commit corporate tax fraud is executed at the organization level. Therefore, TRA cannot account for other factors such as control factors which are relevant in organizational decision-making. In addition, TRA does not consider other factors, in particular, the fraud diamond factors such as opportunity, incentive/pressure and capability which may be relevant to explain fraud behaviour.

Researchers noted that one of the greatest limitations of TRA is it assumes behaviour is under volitional control. Sheppard *et al.* (1988) claimed that TRA is not accurate whenever the behaviour requires knowledge, skills and resources. To overcome this deficiency, Ajzen (1985) extended TRA by taking a degree of control over the behaviour into account and developed TPB. As portrayed in Figure 1, TPB extends TRA by including an additional construct that is perceived behavioural control.

Ajzen and Madden (1986) defined perceived behavioural control as "the person's belief as how easy or difficult performance of behaviour is likely to be". It is believed that a person's desire to implement the behaviour become stronger when he/she has significant resources, opportunity and specialized skills. Perceived behavioural control is determined by the total number of accessible control beliefs that can be accumulated through experience with the behaviour, second-hand information about the behaviour,



Source: Ajzen and Madden (1986)

Figure 1.
Theory of planned behaviour

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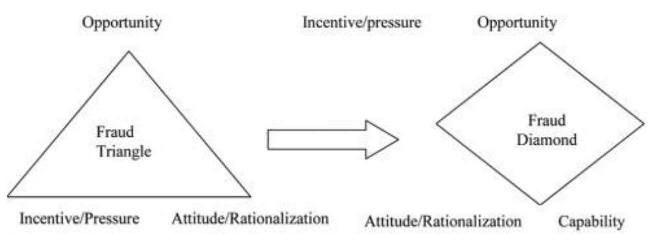
the experiences of acquaintances and friends and by other factors that increase or decrease the perceived difficulty of performing the behaviour (Ajzen, 1991).

TPB has been successfully validated in socio-psychology studies (Ajzen, 1991; Ajzen and Madden, 1986) and applied in various fields such as in the ethical decision-making (Carpenter and Reimers, 2005; Cohen *et al.*, 2010), health studies (Bozionelos and Bennet, 1999) and intention to use e-filling (Ramayah *et al.*, 2009). Past studies show that although TPB has been adapted to taxpayer compliance such as Efebera *et al.* (2004) and Bobek *et al.* (2007), it has not been specifically applied to study the managers' intention of corporate tax fraud. However, Armitage and Conner (2001) claimed that TPB is a useful model in predicting intentions and behaviours. Despite the usefulness of TPB as a predictor of intentions and behaviour, nevertheless, Armitage and Conner (2001) found that TPB only accounted for 27 per cent of the variance in behaviour and 39 per cent in intention from their meta-analytic review. Hence, TPB still need other constructs to predict individual behaviour accurately.

On the other hand, a review of literature related to criminology, the "Fraud Diamond Theory" has been used to explain why people commit fraud. Wolfe and Hermanson (2004) argued that frauds would not have occurred without the right person with the right capabilities in place. This is because even though opportunity opens the doorway to fraud, attitude/rationalization draws the individual towards it, but without the capability, fraud cannot be committed. Therefore, based on this argument, Wolfe and Hermanson (2004) extended the "Fraud Triangle Theory" by adding the capability construct and developed the four-sided "Fraud Diamond Theory". Figure 2 presents the transitions from the "Fraud Triangle" to the "Fraud Diamond Theory".

The "Fraud Diamond Theory" posits that incentive/pressure, opportunity, attitude/ rationalization and capability are present when fraud occurs. In paragraph 7 of the AICPA (2002), it stated that when incentives are given or under pressure, fraudsters tend to commit fraud. The pressures may be financial problems, work problems or personal pressures. Fraudsters tend to engage in fraud when there is an opportunity. An opportunity occurs when fraudsters are in high position in the company and when internal control and monitoring are lacking. The third component is an attitude/rationalization whereby fraudsters are able to justify his/her fraudulent act.

The last component in the "Fraud Diamond Theory" is capability. Wolfe and Hermanson (2004) explained that there were five components of capability: first, position/function. A person having a position/function within the organization may try to find an opportunity for fraud. The second component is the brain. Fraudsters are smart enough to handle and exploit the weaknesses of internal control and authorized access for personal advantage. The third component is confidence/ego. Fraudsters have



Source: Wolfe and Hermanson (2004)

Figure 2. Transitions from the "Fraud Triangle" into the "Fraud Diamond Theory"

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a strong confidence and ego that they will not be detected. The next component is related to coercion skills. Fraudsters can coerce others to commit or conceal fraud. Effective lying is the fifth component whereby successful fraudsters lie effectively and consistently. Finally, the successful fraudsters deal very well with stress. This is because fraud usually occurs for over a long period and it can be extremely stressful (Brennan and McGrath, 2007). Anyone who cannot manage stress effectively may not be able to endure the process.

In studying an individual's behavioural intention, theory-based predictor, especially cognitive factors can provide a consistent basis in explaining the factors that motivate individual's behavioural intention. Thus, this paper has reviewed the theory of reasoned action, TPB and "Fraud Diamond Theory" to highlight the similarities and fundamental differences, as well as their strengths and weaknesses to conceptualize the key constructs that can be used in explaining and predicting corporate tax fraud.

As mentioned earlier, TPB is an extension of TRA. Both theories share two identical components that are:

(1) "attitude toward the behaviour"; and
(2) "subjective norm".

However, TRA omitted a construct named "perceived behavioural control", which is an important construct in TPB. It is argued that perceived behavioural control could be a significant predictor of corporate intention because corporate decisions are made by managers who are at the top organizational level. Most studies have attempted to use TRA and/or TPB to examine unethical behaviour; very few studies utilized "Fraud Diamond Theory" to predict unethical behaviour. To overcome this gap, Cohen *et al.* (2010) integrated TPB into "Fraud Triangle Theory" to investigate corporate fraud and managers' behaviour. This paper expands Cohen *et al.*'s (2010) study by integrating TRA, TPB into the "Fraud Diamond Theory".

TRA, TPB and the "Fraud Diamond Theory", do share one similarity. The similarity is the attitude, whilst, the difference is based on a broad concept of attitude (Vanlandingham *et al.*, 1995; Cohen *et al.*, 2010). Cohen *et al.* (2010) stressed that "attitude" in the "Fraud Diamond Theory" covers three components of TPB that are:

(1) "attitudes towards the behaviour";
(2) "subjective norm"; and
(3) "perceived behavioural control".

Although the Statement of Auditing Standard 99 did mention about attitude as one of the individual's characteristics, but the Statement of Auditing Standard 99 did not specify the concept of "attitude"; the concept of "attitude" was not well explained. Cohen *et al.* (2010) argued that the examples of attitudes/rationalization as listed in the appendix of AICPA (2002) are more related to the corporate ethics instead of managers' behaviour. Because these three models shared the similar "attitude" construct, thus, the "attitude" construct in the "Fraud Diamond Theory" will be excluded to avoid double measures in this study.

The other three components of the "Fraud Diamond Theory" are incentives/pressures, opportunity and capability. These three components have not been covered either by TRA or TPB, as these components represent external stimuli for

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fraud behaviour (Cohen *et al.*, 2010). Beck and Ajzen (1991) emphasized that "opportunity" represents people's actual control over the behaviour; opportunity depends on one's intention; and on partially non-motivational factors such as time, money, skills and cooperation of others. In contrast, as implied by its name, the TPB deals with perceived, rather than actual behavioural control. Unlike the "Fraud Diamond Theory", perceived behavioural control could be separated into internal and external control factors. Internal control factor include information, personal deficiencies, skills, abilities and feeling, whilst, external factor refers to factors that exist outside of the organization that could impede the determination of corporate intention of tax fraud.

On the hand, "capability" is the unique contribution of the "Fraud Diamond Theory" which cannot be found in TRA and TPB. In the absence of capability forces, fraud would have not happened. Hence, it is argued that in a corporate setting, managers do have more capability to be involved in wrongdoings without being detected by other members in the organization. Therefore, it is argued that the inclusion of the "Fraud Diamond Theory" to TRA and TPB models would add value in predicting and explaining corporate tax fraud. The integrative model is presented in the preceding section.

3. The proposed integrative model

The lack of important integral constructs from each model motivates this study to propose one model that can predict corporate tax fraud. The incorporation of salient constructs from all models could provide a parsimonious theoretical framework which might explain a greater amount of variance in behaviour. Moreover, this integrative model includes individual level variables of cognitive factors and managers' characteristics with the organizational variables of control factors and normative factor. This integrated theoretical framework is presented in Figure 3.

The integrative model posits that the cognitive factor, normative factor, internal control factor, external control factor and Fraud Diamond factors may influence corporate managers' intention to commit corporate tax fraud. This paper postulates that positive attitudes towards the behaviour will influence higher intention of tax fraud. An individual's attitude towards the behaviour is formed from the positive and negative evaluations of tax fraud. It is believed that managers will evaluate the consequences of tax fraud once they have been exposed to the compliance activities (e.g. tax audit, street survey and seminars) and publication by the tax authority and accounting bodies and the mass media.

Normative factor or subjective norm deals with beliefs that important referents would approve or disapprove the behaviour. In the context of organization, subjective norm refers to the companies' stakeholders. Stakeholders can influence organizational decision-making, thus, pressuring organizations either to pursue or not to pursue an action based on what they perceive the sentiments of the stakeholders to be (Hill and Jones, 1992). Thus, it is argued that the presence of stakeholders could influence the managers' decision in committing corporate tax fraud.

In this context, internal control factor is examined through tax audit experience. Khadijah and Pope (2011) argued that having an unpleasant tax audit experience might lead to non-compliance behaviour in future. In contrast, if taxpayers are being

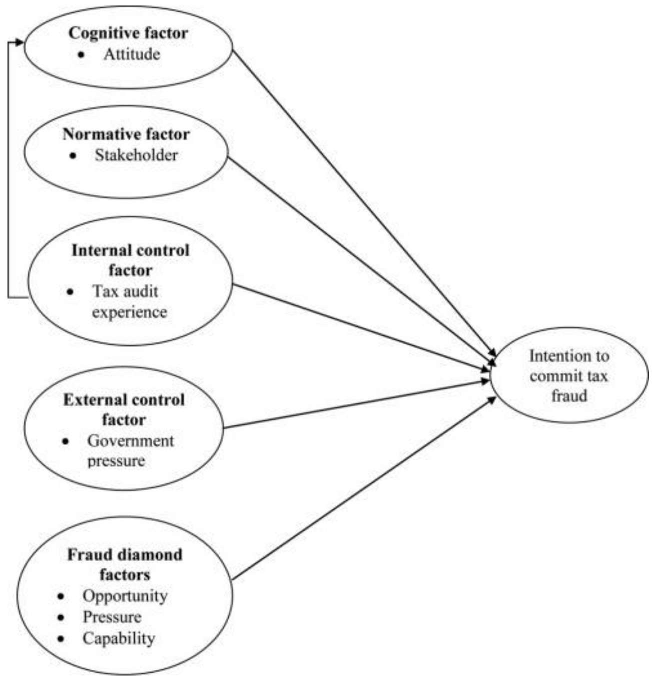

Figure 3.
An integrative theoretical framework

treated with respect during a tax audit, they will tend to have higher intention to comply with tax laws in the future (Khadijah and Pope, 2010). Meanwhile, the external control factor is determined by government pressure. It is believed that government pressure influences the corporate ethical behaviour.

Higher opportunity due to the highest position in the company, as well as weak control or oversight might influence corporate managers to engage in corporate tax fraud. It is argued that when a manager has the incentive or higher pressure, and when he/she has the capability to cover with tax fraud, the intention to commit corporate tax fraud is more likely to occur.

4. Conclusion

All three models have their own uniqueness; they share some similarities, but also some have fundamental differences. The differences can be overcome either by integrating the model or omitting a construct. By reviewing and discussing these three theories, this paper has highlighted the key constructs in each model in proposing an integrative model in explaining and predicting corporate managers' intention to commit corporate tax fraud. The proposed model integrates individual cognitive factors, organizational factors, and Fraud Diamond factors predict and explain managers' intention to commit corporate tax fraud. This integrative model can be empirically tested. Further study can be done to validate this model, by using a focus group interview and/or survey conducted on corporate managers.

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