

## ANTECEDENTS OF TAX AUDITORS' AGGRESSIVENESS IN JUDGMENT WHEN SETTLING TAX AUDITS: A CONCEPTUAL MODEL

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**Accepted date:** 23 July 2018

**Published date:** 19 September 2018

**To cite this document:** Yusof, N. A. M., & Wah, Y. B. (2018). Antecedents of Tax Auditors' Aggressiveness in Judgment When Settling Tax Audits: A Conceptual Model. *International Journal of Accounting, Finance and Business*, 3(13), 59-70.

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**Abstract:** *In the self-assessment system, tax audit has become a routine job for tax auditors. In completing tax audits, tax auditors frequently challenge with different tax issues, complexity and ambiguity of tax laws, poor commitment from taxpayers, poor record keeping and limited manpower, as well. Such stressful working day experiences are believed can contribute stress to the tax auditors. Tax auditors also need to rely on their domain knowledge in judgment and decision making. This paper proposes a conceptual model that links domain knowledge, stress and culpability factors in predicting tax auditors' aggressiveness in judgment when settling tax audits. The culpability factors consist of the size of the audit adjustment, the duration years involved with erroneous, the presence of tax agent and the taxpayer financial strength. The proposed conceptual model can provide insights to the policy makers and Inland Revenue Board of Malaysia especially in managing stress among tax auditors. This study has merit that proposed a conceptual model in predicting the aggressiveness of tax auditors' judgment in settlement of tax audits. It adds to the literature by exploring the applicability of Culpability Theory in context of Malaysian setting. For future research, validating the proposed model through questionnaire survey is suggested.*

**Keywords:** *Domain Knowledge, Job Stress, Culpability Theory, Judgment/Decision Making and Tax Auditors*

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### Introduction

The implementation of the self-assessment system (SAS) has posed great challenges to taxpayers, tax practitioners, and tax authority in many jurisdictions around the world, such as New Zealand, Australia and United Kingdom, as well as Malaysia. In SAS, taxpayers need to compute their own taxes, file tax return and make full payment in a timely manner. As a result, most taxpayers sought tax practitioners for help. In SAS, the task of the tax authority is to enforce tax compliance by conducting a tax audit and penalty will be imposed when intentionally noncompliance is found. In Malaysia, after the implementation of SAS, tax auditors focused

more on desk audits and field audits. The Inland Revenue Board of Malaysia (IRBM) reported that the number of resolving audited corporate tax cases has increased progressively in every year. For instance, in 2016, 73,054 corporate tax audited cases were finalized by the IRBM as compared to 49,654 cases in 2015 (IRBM, 2016). The increase in the number of finalizing tax audited cases, somewhat indicate that there is an increase in tax noncompliance among corporate taxpayers. However, Khadijah and Pope (2010) reported that an increase in the number of finalizing tax audited cases possibly due to more resources has been allocated in tax audit activities.

With regard to a tax audit, the implementation of SAS has made tax audit as a routine job for tax auditors. Two types of tax audit have been conducted that are desk audits and field audits. In completing tax audits, the tax auditors frequently challenge with different tax issues, complexity and ambiguity of tax laws. Besides, they also need to cope with poor commitment from taxpayers, poor record keeping, inadequate resources and limited manpower, as well. Such working day experiences are believed can contribute stress to the tax auditors and might influence their judgment and decision at work in conducting a tax audit. Due to higher stress, erroneous judgment will be issued in order to quickly resolve the tax audited cases. As a result, inaccurate additional taxes and penalties will be imposed not only on noncompliant taxpayers, but to the compliant taxpayers, as well. Hite and Sawyer (2000) argued that taxpayers and tax practitioners more interested to know the decisions made by tax auditors on assessment of penalty.

In Canada, there is an example of error in judgment made by a tax auditor. The case is found in *John Marsden vs. Canada Revenue Agency* (Anonymous, 2010). The Canadian tax auditor suspicious against a memo written by one of Marsden's employees. She thought that she has found evidence of undeclared business income. Due to her lack of experience in investigating cases, the case took Marsden about five years and thousands of Canadian dollars before he was ultimately vindicated (Anonymous, 2010). This case provides a clear message on the importance of quality of the judgment and decision making in tax auditing. This is because a deficiency in judgment and decision making has a great impact on the taxpayer. Whilst, for tax practitioners, not only they need to face with penalty charges if they has been found to make and gives incorrect information (Income Tax Act, 1967, 2006), but also threats of losing potential clients due to bad reputation image. Meanwhile, for the federal government, inaccurate judgment and decision making will cause government fails to collect back additional taxes and penalty which has been owed by the errant taxpayers. Thus, this means that the tax auditors view of compliance decisions in tax auditing directly will influence both taxpayers and tax practitioners and indirectly affect the federal revenue collection.

The important of judgment and decision making in daily work over a few decades results a large amount of literature on auditing, accounting and management accounting (Trotman, Tan, & Ang, 2011). Theorists and researchers contribute to the comprehensive information regarding judgment and decision making by conducting theoretical, experimental and empirical research. Review of past studies show that previous research (Bobek & Hatfield, 2004; Magro & Nutter, 2012; Roberts, 1998; Trotman et al., 2011) on judgment and decision making focuses on tax accountants/professionals. Given the importance of tax auditors' role in the tax compliance process, surprisingly, very little research has been directed at how tax auditors make a judgment and decision. Tax auditors need to judge and make a decision on settlement of tax audit whether or not the taxpayers has fully complied with tax laws and whether to close the tax audited cases with/without adjustments. Since the tax auditors view of compliance decisions draws from tax audit is of interest for both taxpayers and tax practitioners (Roberts, 1995), thus, research is

needed to investigate the judgment and decision making on settlement of tax audit by tax auditors. Long and Swingen (1991) argued that:

“Failure to subject tax collectors to serious study has resulted in an artificial treatment of their role in past compliance theories, undermining our ability to understand not only the government’s behaviour, but the behaviour of all parties since their conduct is so intimately intertwined”.

Interestingly, although tax auditors play major roles in the compliance process, yet little studies are currently available on how tax auditors made a decision; i.e., the decision to settle the tax audited cases with/without adjustment and penalties. Prior studies revealed that researches focusing on tax auditors are limited. In the United States, except for Roberts (1995), two studies conducted in New Zealand by Hite and Sawyer (1998; 2000) and the recent study conducted in Thailand by Prachsriphum and Chuchuea (2011), at the time of study, there is little known studies conducted against tax auditors’ judgment and decision making. The similar case observes in Malaysia.

To date, in Malaysia, research on tax auditors has been neglected. The evidences from the auditing literature shows that most current research tends to focus on dysfunctional behavior (Halil, Malcolm, & Zubaidah, 2012) and audit judgment performance (Mohd-Sanusi & Mohd-Iskandar, 2007) of auditors at public audit firms. Furthermore, except for Malaysian real cases published by CCH Asia Pte Limited (CCH, 2012), the IRBM did not make publicly available any cases which involve erroneous in judgment by tax auditors. Hite and Sawyer (1998) stated that such information is believed as privileged information. Therefore, this paper aims to address this issue by investigating the factors which may influence on tax auditors’ judgment and decision.

This paper was guided by the model developed by Roberts (1998) which has five major factors associated with tax accountants’ judgment and decision making: (1) individual psychological factors such as domain knowledge and years of experience; (2) environmental factors such as the probability and magnitude of tax savings; (3) task inputs such as the complexity and ambiguity of tax laws; (4) processing factors such as time pressure and decision aid availability; and (5) task outputs such as compliance research and planning advice. Even though the scope of tax accountants and tax auditors are different, but there are some factors that might be associated with tax auditor decision making. Besides, this study also used a theory of taxpayer negligence which was introduced by Robert (1995) as a theoretical framework. Roberts (1995) developed a series of 16 cases which contained four factors tested (i.e., the education level of taxpayer, the size of the audit adjustment, the number of years involved with evasion and whether or not the taxpayers was represented by a CPA. He found that the size of the audit adjustment followed by the education level of taxpayer had the largest effect on the IRS revenue agents to assess a negligence penalty and representation by the CPA had the least impact. He also suggested that instead of examined each factor in isolation; the factors could be grouped and examined as a single factor. However, the weaknesses in Roberts (1995)’s study is that he omitted other contributing variables such as psychological factors (e.g., gender), task input factor (e.g., ambiguity and complexity of tax laws) and processing factors (e.g., stress) which might influence revenue agents’ assessment.

This paper attempts to investigate the effect of two individual psychological factors as introduced by Roberts (1998) which are domain knowledge and processing factor (i.e., stress) and contextual

factors; i.e., the size of the audit adjustment, durations involved with erroneous, the presence of the tax agent and the financial strength in relation to tax auditors' judgment and decision making. The authors believed that evidence from the tax audited cases itself (contextual factors) might influence on tax auditors' judgment and decision making. Unlike Roberts (1995), this paper focuses on judgment and decision making by tax auditors in settlement of tax audit on whether to close the tax audited cases with/without adjustment and penalties at the IRBM level.

### **Tax Auditors' Judgment and Decision Making**

The SAS relies on honesty and voluntary compliance among taxpayers to compute and pay their own tax liability. Marshall, Smith, and Armstrong (1997) claimed that the SAS will lead taxpayers to file their annual tax return with honestly and voluntarily. Nevertheless, a study done by Mohd Nor, Ahmad, and Mohd Salleh (2010) reported that the use of the SAS without a proper monitoring mechanism can provide opportunities for taxpayers to commit misstatements in the financial report for the purpose of lowering the profit. In turn, their tax liability can be reduced. As a result, greater voluntary compliance cannot be achieved.

In order to enhance voluntary compliance in SAS regime and to ensure fairness among taxpayers, tax administrators have conducted a tax audit. Tax audit aims to ensure that taxpayer has prepared tax return correctly, declared and paid the right amount of income in accordance with tax laws and regulation. The task of tax auditors is to judge and decide whether the taxpayers has correctly prepared their tax returns and fully complied with tax laws in closing the tax audited case. The tax audited case will be closed with/without adjustment and penalties or may be the case will be referred to the Investigation Department if the tax auditors suspicious of wilful noncompliance. Roth, Scholz, and Witte (1989) defined tax compliance as "...filling all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the Internal Revenue Code, regulations and court decisions applicable at the time the return is filled".

Libby (1981) as cited in Trotman et al. (2011) explained that the judgments are an important input for decisions. Judgment refers to the process of estimating outcomes and their consequences (e.g. the likelihood of a material misstatement, risk assessment, estimate of an account balance, estimates of future cash flows), whereas, decision making involves an evaluation of these consequences which leads to a choice among the alternatives (e.g. Qualify/not qualify audit report, invest/not invest).

Practically, in Malaysia, the major challenges such as timeframe which required tax auditors to settle the audit case within three months, poor recordkeeping especially from small-medium enterprise, technical issue among multinational companies, poor commitment from taxpayers (Zainal Abidin, M.Y, personal communication, August 7, 2012) are believed can influence the tax auditors' decision making which can lead to an erroneous judgment. Besides, such stress and problems are believed can influence the process of gathering and evaluating the evidences of tax auditors in settling the tax audited cases. The settlement of tax audited cases could be at three levels. Firstly, at the IRBM level, whereby the taxpayer agrees with the tax auditors' proposed final tax adjustments. Second level is at the Special Commissioners of Income Tax, whereby the taxpayer who does not agree with the tax auditors' proposed final tax adjustments will appeal at this stage. The final level is whereby both parties either tax authority or taxpayer who does not satisfied with the decision of the Special Commissioners of Income Tax may apply to have the case heard at the High Court and Court of Appeal. In this paper, tax audited case is assumed to

be closed at the IRBM level. Thus, in general, tax auditors' judgment and decision making can be conceptualized as their confidence that they did not make quick decisions, having considered and processed all relevant information before deciding whether to close the tax audited cases with/without adjustment and penalties at the IRBM level.

### ***Domain Knowledge and Tax Auditors' Judgment and Decision Making***

Tax auditors rely on their domain knowledge of tax laws to evaluate taxpayer information and to come out with a decision in settlement of tax audits. According to Bonner (1990), domain knowledge represents information stored in long term memory about how to make decisions in a particular task domain, including which cues are relevant and how those cues should be evaluated. O'Donnell, Koch, and Boone (2005) proposed two dimensions of domain knowledge that are procedural knowledge and outcome expectations which are believed can influence tax auditors' judgment and decision making. According to O'Donnell et al. (2005), the procedural knowledge represents the familiarity with the process for evaluating a particular tax compliance issue. This procedural knowledge is acquired through task experience (Spilker, 1995). On the other hand, the outcome expectation represents the opinion about whether the decision can be defended if challenged during an audit (O'Donnell et al., 2005). This outcome expectation was developed through a combination of two factors that were (1) base rate expectations about the likelihood that a particular tax compliance position can be defended and (2) client specific information acquired during the task (O'Donnell et al., 2005).

Research in auditing provides evidence that procedural knowledge and outcome expectations are associated with performance in tax - related tasks. For example, Bonner and Walker (1994) found that a measure of procedural knowledge related positively to performance in a ratio analysis task. In addition, Spilker (1995) found procedural knowledge enhance tax researchers' ability to select relevant key words at a time-restricted task. Likewise, in tax professionals' study, O'Donnell et al. (2005) found that professionals with more procedural knowledge favour less aggressive compliance recommendations. In tax auditing, the timeframe to complete an on-site examination is between two to three days. Thus, procedural knowledge helps tax auditors to look for relevant information and evidence during a limited audit timeframe. Besides, in terms of examination of records, procedural knowledge consists of the rules that guide the tax auditor's search and evaluate for relevant cues in arriving at the accurate judgment and decisions. To investigate the effect of procedural knowledge on the ability of tax auditors in settlement of tax audit, the following hypothesis was proposed:

*H<sub>1</sub> (a): Tax auditors with more procedural knowledge will have a lower preference to close tax audited cases with adjustment and penalties.*

The second dimension of domain knowledge is the outcome expectations. Reckers, Sanders, and Wyndelts (1991) argued that tax professionals bring base-rate expectations to a decision task as part of their domain knowledge. Mueser, Cowan, and Mueser (1999) further added that this base rate expectation is brought into working memory and integrated with client-specific information when processing activities activate links to memory structures that contain relevant knowledge. According to Nelson (1993), once the processing activated, base-rate knowledge about the success of previous decisions will influence on an individual preference for making similar choices again. In settlement of a tax audit, based on their past experience, tax auditors will finalize the tax audited cases with adjustments and penalties when they found evidence that favor to tax authority. Based on the tax auditors' domain knowledge which acquired through their own experience and heard from their peer experiences in tax audit, it is believed that the outcome

expectations will influence on the judgment and decision making by tax auditors. The outcome expectations is whereby the tax auditors certain that the final tax adjustments proposed to the taxpayer can be defended if challenged by the taxpayer either at the Special Commissioners of Income Tax or at the High Court and Court of Appeal. Past studies on tax professionals (e.g., Kaplan, Reckers, West, & Boyd, 1988; Newberry, Reckers, & Wyndelts, 1993; O'Donnell et al., 2005) found that positive outcome expectations will increase professional's preference for recommending the aggressive position. Therefore, pertaining to tax auditors, this paper hypothesised that:

*H<sub>1</sub>(b): Tax auditors with outcome expectations will have a higher preference to close tax audited cases with adjustment and penalties.*

### ***Stress and Tax Auditors' Judgment and Decision Making***

Judgment/decision making and stressful events are central features of tax auditors' duty. In Malaysia, tax auditors need to cope with three months audit timeframe for settling the audited cases. At the same time, tax auditors also need to achieve the target. For instance, in 2014, tax auditors need to conduct both desk and field audit about 12% from 567,662 active corporate files (IRBM, 2014). The IRBM report shows that tax auditors managed to achieve the target by conducting tax audit about 17.4% from 567,662 active corporate files. These job events are likely to induce stress that may effect on the quality of how a tax auditor's work is carried out. Parker and DeCotiis (1983, p. 161) defined job stress as "a particular individual's awareness or feelings of personal dysfunction as a result of perceived conditions or happenings in the work setting".

The Cue Utilization Theory by Easterbrook (1959) as cited in Choo (1995) suggested that the relationship between stress and judgment performance is an inverted U function. Easterbrook (1959) argued that higher stress will result progressive reduction in the range of cue utilization in mind. Choo (1995) found that there is a progressive reduction in the range of cues used as stress increases which can result in poor judgment performance. Review of past studies also found that stress may have negative effects on the quality of auditor works. For example, Choo (1986) found that excessive stress has a detrimental effect on auditor's performance. In Malaysia, a study by Halil, Zubaidah, and Malcolm (2010) revealed that auditor resorts to some dysfunctional activity to cope with time budget pressure. These arguments show that stress did effect on judgment/behavior of auditors. In tax auditing, in order to meet time deadlines to finalize tax audited cases and to achieve the employer target, it is believed that there are some tax auditors who make quick decisions to impose additional taxes and penalty without being able to justify the reasons (IRBM, 2006). Their aim is to quickly close the cases. Therefore, this paper hypothesised that:

*H<sub>2</sub>: Tax auditors will have a higher preference to close tax audited cases with adjustment and penalties when the level of stress is higher.*

### ***Culpability Factors and Tax Auditors' Judgment and Decision Making***

Given the limited research on tax auditors, little theory exists to explain the tax auditor's behaviour; so much of this paper is exploratory. Thus, this paper will review the Culpability

Theory<sup>1</sup> as developed by Roberts (1995) to investigate the determinants of tax auditors' judgment and decision making.

### ***Size of the audit adjustment***

The first factor under the Culpability Theory is the size of the audit adjustment. Roberts (1995) explained that the size of the audit adjustment referred to the dollar magnitude of the error determined by the revenue agent. He further explained that there is more likelihood that the revenue agent will assess a negligence penalty when they found that the larger amount of audit adjustment relative to actual gross income. When the size of audit adjustment is large, it is believed that the error was due to intentional. In his study, Roberts (1995) found that size of the audit adjustment had the largest single impact on the decision to assess a negligence penalty. Ho and Wong (2006) agreed that the amount of income omitted largely influence the penalty level. Therefore, this paper hypothesises that:

*H<sub>3</sub>: Tax auditors will have a higher preference to close tax audited cases with adjustment and penalties when the size of the audit adjustment is larger.*

### ***The Duration Involved with Erroneous***

The Culpability Theory believed that taxpayers already aware the existence of error when the number of years over which the error occurred (Roberts, 1995). His study found that revenue agents will be more likely to assess a negligence penalty when the underpayment occurs in more years. Ho and Wong (2006) supported the findings reported by Roberts (1995), that is long duration of noncompliance does carry substantial weight in deciding the penalty rate. Thus, the fourth hypothesis is:

*H<sub>4</sub>: Tax auditors will have a higher preference to close tax audited cases with adjustment and penalties when the duration involved with erroneous is longer.*

### ***The presence of tax agent***

The last factor in Culpability Theory is the representation of the tax agent/practitioner. Prior studies agreed that tax agent are enforcers of unambiguous issues, but the exploiters of ambiguous issues (Klepper & Nagin, 1989). In Culpability Theory, this theory believed that taxpayers who are represented by tax agent do have some knowledge of their tax responsibilities, but deliberately ignored it. This theory hypothesized that taxpayers who employ tax agent will be deemed more culpable than taxpayers who prepare and represent themselves. Roberts (1995) found that the representation of the chartered public accountant had the least impact on Revenue Agent in assessing a negligence penalty. Hite and Sawyer (1998) supported the findings by Roberts (1995) which is returns prepared by tax professionals were the least likely to be audited. Consistent with that, Nichols and Price (2004) found that the final tax assessment is significantly less for taxpayers with representation during an Internal Revenue Service audit. These three findings signalled tax agent as enforcers of unambiguous issues, rather than as exploiters. Based on these arguments, the fifth hypothesis is proposed:

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<sup>1</sup> The authors exclude one of the Culpability Factors, which is taxpayer education level because when surveying tax auditors who are conducting tax audits, corporate taxpayer normally appoint tax agent/practitioner in preparing their tax return of assigning it to their tax manager or tax department. Based on past literature, this paper extends the Culpability Theory by including the financial strength of the taxpayer.

*H<sub>5</sub>: Tax auditors will have a lower preference to close tax audited cases with adjustment and penalties with the presence of the tax agent/ practitioner.*

### ***The Taxpayer Financial Strength***

Generally, firm with poor financial strength will try to manipulate financial statement either by increasing revenues or reducing expenditures to improve the profit. However, a firm with unreasonably low turnover, low gross profit, low net profit and incur losses for continuous year is likely to have under-reporting its income. Spathis (2002) stated that unreasonably low profit seems to indicate that Greek companies try to manipulate financial statements to produce a lower tax liability. Spathis (2002) further added that the companies more motivated to engage in fraudulent financial statement when they are doing poorly.

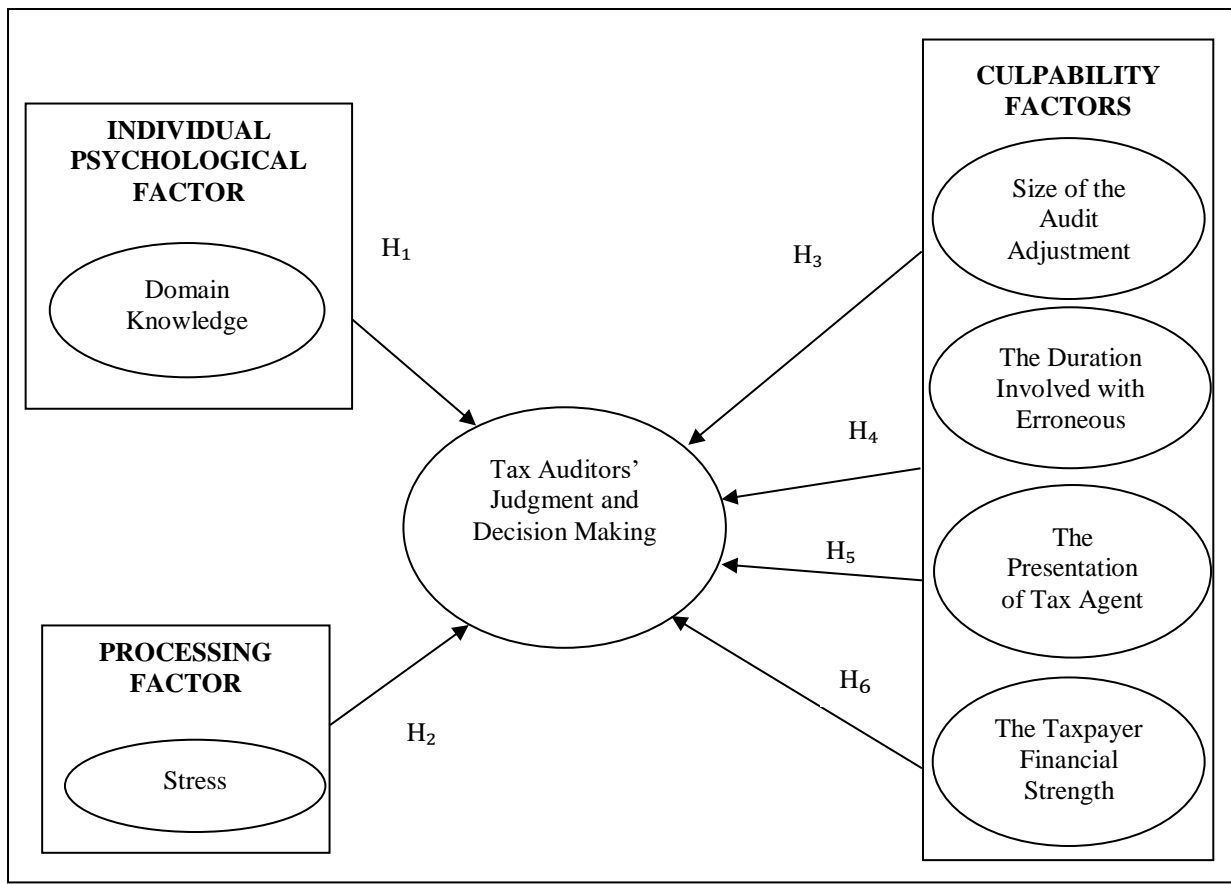
According to a Malaysian tax officer, Pang (personal communication, March 29, 2011) did mention that a company which has a financial problem and at the verge of closing down will attract tax auditors to initiate a tax audit. Tax audit will be conducted to verify the accuracy of figures and matched it with the reported figures in the financial statements. Therefore, it is reasonable to assure that a firm with unreasonable and continued poor financial performance would manipulate their financial statement in order to evade taxes. Thus, this paper will examine whether a tax auditor's judgment and decision making will be affected by a poor financial strength. Hence, the sixth hypothesis is:

*H<sub>6</sub>: Tax auditors will have a higher preference to close tax audited cases with adjustment and penalties when the taxpayer has a strength financial condition.*

Figure 1 shows the proposed theoretical model. The proposed model intends to investigate the relationship of six independent variables: size of the audit adjustment, the duration involved with erroneous, the presentation of tax agent, the taxpayer financial strength, domain knowledge and stress with a dependent variable – tax auditors' judgment and decision making. Unit of analysis of the study is the tax auditor. The population for this proposed study consists of all tax auditors at the IRBM because they are involved in tax audit and make judgment and decision in the settlement of tax audit. Indeed, prior studies that examine tax audit judgment also have used tax auditors/investigators as their sample (Hite & Sawyer, 1998; Hite & Sawyer, 2000; Prachsriphum & Chuchuea, 2011; Roberts, 1995). Since the IRBM has branches in all states and are widely scattered in term of geographical location, the proposed study will apply the stratified sampling method whereby the peninsular Malaysia will be divided into four regions and East Malaysia. A questionnaire was developed and used to collect the data. The reliability and validity of measurement will be tested. The proposed study will perform Partial Least Squares Modeling to determine the strength of the relationship between the independent variables and the dependent variable.



Figure 1 The proposed theoretical framework



## Conclusion

This paper proposes a conceptual model that links domain knowledge, stress and culpability factors in predicting tax auditors' judgment and decision making in settlement of tax audits. In completing tax audits, the authors believed that not only individual psychological and processing factors will influence the tax auditors' judgment and decision making, but also the factors derived from the cases itself. Thus, based on the Roberts' (1998) model, domain knowledge and stress, as well as, culpability factors which are the size of the audit adjustment, the duration years involved with erroneous, the presence of the tax agent, the taxpayer financial strength are expected to significantly influence tax auditors' judgment and decision making. Unlike previous studies which examines the effects of knowledge on judgment or reporting recommendations such as (Bobek & Hatfield, 2004), this paper will use two dimensions of domain knowledge that are procedural knowledge and outcome expectations. The proposed model has both theoretical and practical implications. From theoretical perspective, it adds to the literature by exploring the applicability of Culpability Theory in context of Malaysian setting. Meanwhile, for practical implication, it can provide insights to the policy makers and IRBM especially in human resource development in order to reduce stress among tax auditors. Ultimately, this could bring a great impact to the effectiveness of a tax audit. For future research, validating the proposed model through questionnaire survey rather than experimental basis is suggested.

## Acknowledgment

We would also like to show our gratitude to the Dr Lai Ming Ling, formerly from Universiti Teknologi MARA Selangor Campus for sharing her pearls of wisdom and comments that greatly improved the manuscript. We are also immensely grateful to anonymous reviewers for their useful comments and suggestions.

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