

A STUDY ON THE EFFECT OF TAX AND STATUTORY COMPLIANCE COSTS ON SMALL AND MEDIUM ENTERPRISES (SMES)

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Abstract - This study investigates the impact of tax and statutory compliance costs on the financial performance of SMEs using a three-year dataset. Analysis reveals a very strong positive correlation between compliance costs and both profitability ($r = 0.993$) and revenue ($r = 0.968$), indicating that regulatory burdens scale as businesses grow. Regression results (Adjusted $R^2 = 0.984$ for profit; $R^2 = 0.000$) confirm these costs as significant predictors of financial outcomes. While compliance ensures transparency, high procedural costs can strain operational efficiency, especially during revenue instability. The paper recommends simplified tax processes and digitalization to optimize SME performance.

I. INTRODUCTION

Taxation and compliance are significant for Small and Medium Enterprises (SMEs), as they are required for the smooth operation of the business, financial transparency, and contribution to country's growth. Tax implies income tax, Goods and Services Tax (GST), and other taxes. Taxes are derived by calculating tax liabilities, maintaining records, and filing returns. Statutory compliance involves adherence to tax laws, accounting, audits, and regulatory legislations. In addition, costs are incurred towards professional fees and procedural processes. The analysis of involved costs helps to understand the impact on the financial performance and profitability of SMEs, and this forms the main focus of this report.

II. OBJECTIVE OF THE STUDY

- Identify and classify the various tax and statutory compliance costs incurred by small and medium Enterprises (SMEs).
- Examine the proportion of tax and compliance costs relative to SMEs' total revenue and profit.
- Analyze the trend and pattern of taxation and statutory compliance costs over a specified period.
- Assess the impact of tax and compliance costs on the overall financial performance of SMEs.

III. BACKGROUND OF THE STUDY

The role of SMEs for economic growth is significant; however, tax and regulatory compliance have become significant issues for SMEs. SMEs are required to comply with GST, income tax, and other regulatory requirements. As a result, there are additional costs of professional fees, software costs, and administrative costs. The costs of regulatory compliance have increased over time and are a challenge for SMEs. In this study, financial information of 3 SMEs for a period of 3 years will be used to understand the impact of compliance costs on financial performance.

IV. JUSTIFICATION OF THE STUDY

This study highlights the rising costs of regulatory compliance and on how SMEs are impacted by these costs. Exploring existing studies related to this topic it was noted that there is a scarcity of studies on the impact of compliance costs on financial performance. Due to increasing regulatory environment SMEs are impacted by these costs and are faced with challenges. This study aims to bridge the existing gap in the literature and help understand the relationship between compliance costs and financial performance, including profitability, liquidity, and solvency.

V. REVIEW OF LITERATURE

- **Chibaya and Kurauone (2022)** emphasized the role of tax education and simplified systems in improving SME compliance rates.
- **Lestary et al. (2021)** examined behavioural drivers, finding that while tax socialization and understanding significantly impact compliance, perceived tax fairness does not.
- **Shakkour (2020)** analysed VAT compliance in Jordan, identifying that structured compliance costs and frequent audits are significant determinants of firm behaviour. This study addresses the identified literature gap by using objective financial data and statistical tools to measure the direct effect of these costs on SME profitability.

VI. METHODOLOGY

- **Research Design:** This study employs an analytical research design to examine the relationship between taxation/statutory compliance costs and SME financial performance indicators.
- **Sampling Technique:** A stratified sampling technique was utilized to categorize SMEs based on size and specific business characteristics.
- **Data Sources:** Data was collected from secondary sources, including audited financial statements, P&L accounts, and company records related to compliance expenditures.
- **Sample Size and Period:** The study analyses a sample of 3 SMEs over 3 financial years, resulting in 9 distinct observations to identify trends and patterns.

VII. DATA ANALYSIS AND INTERPRETATION

This study evaluates the financial performance of three selected SMEs over a three-year period (2023–2025) using ratio analysis to determine their operational health and stability.

VIII. STATISTICAL FINDINGS

1. RATIO ANALYSIS

- i. **Profitability Ratio-** These ratios measure the success of the firms in generating returns relative to their revenue and compliance burdens.

a) Gross Profit Ratio

Years	firm 1	firm 2	firm 3
2023	81.00%	68.00%	-20.80%
2024	84.00%	69.00%	-23.10%
2025	83.00%	73.20%	33.00%

Interpretation

Firm 1 has a slight improvement from 81% to 84% and a slight decline to 83%, Firm 2 indicates steady improvement from 68% to 73.2%, while Firm 3 has a deeper decline into negative from -20.8% to -23.1% before a sharp improvement to 33% in 2025.

b) Net Profit Ratio

Years	firm 1	firm 2	firm 3
2023	81.00%	68.00%	-20.80%
2024	84.00%	69.00%	-23.10%
2025	83.00%	73.20%	33.00%

Interpretation

Firm 1 rises from 81% to 84%, dipping slightly to 83%, Firm 2 has a steady increase from 68% to 73.2%, and Firm 3 falls from -20.8% to -23.1% before rising significantly to 33% in 2025.

c) Operating Profit Ratio

Years	firm 1	firm 2	firm 3
2023	0.82%	6.81%	-17.20%
2024	0.84%	6.90%	-2.31%
2025	0.80%	7.32%	0.23%

Interpretation

Firm 1 indicates a slight improvement from 0.82% to 0.84%, then a slight drop to 0.80%, while Firm 2 indicates consistent improvement from 6.81% to 7.32%. Firm 3 indicates a significant improvement from -17.20% to -2.31% and then to 0.23% in 2025.

2. Liquidity Ratio

a) Current ratio

Firm Name	2023	2024	2025
firm 1	1.87	1.66	1.94
firm 2	1.47	1.29	1.22
firm 3	1.47	1.36	1.64

Interpretation

Firm 1 decreases from 1.87 to 1.66 and then increases to 1.94, Firm 2 continuously decreases over the years from 1.47 to 1.22, and Firm 3 decreases from 1.47 to 1.36 and then increases to 1.64 in 2025.

3. Solvency Ratio

a) Debt – equity ratio

Firm name	2023	2024	2025
firm 1	-3.31	-3.00	-1.48
firm 2	-3.00	-0.96	-1.45
firm 3	-1.48	-0.87	-2.30

Interpretation

Firm 1 has improved from -3.31 to -1.48, Firm 2 has improved from -3.00 to -0.96 and then slightly deteriorated to -1.45, and Firm 3 has improved from -1.48 to -0.87 and then deteriorated to -2.30 in 2025.

b) Debt ratio

Firm Name	2023	2024	2025
firm 1	71.00%	63.00%	72.30%
firm2	22.00%	25.70%	32.90%
firm 3	99.70%	87.90%	71.40%

Interpretation

Whereas Firm 1 declines from 71.00% to 63.00% and then increases to 72.30%, Firm 2 has a steady increase from 22.00% to 32.90%, and Firm 3 declines significantly from 99.70% to 71.40%.

4. TREND ANALYSIS

a) Revenue trend

Firm name	2023	2024	2025
Firm 1	112670437.00	104453102.00	1147800404.00
Firm 2	450512529.00	553345351.00	505281743.00
Firm 3	167920220.00	194822333.00	44853729.00

Interpretation

While Firm 1 shows a decrease from 11.27 Cr to 10.45 Cr and further increases sharply to 114.78 Cr. Firm 2 revenue increases from 45.05 Cr to 55.33 Cr but decreased to 50.53 Cr. The revenue of Firm 3 provides an increase from 16.79 Cr to 19.48 Cr and then decreased sharply to 4.49 Cr in 2025.

b) Profit trend

firm name	2023	2024	2025
Firm 1	940209.00	901637.00	1021772.00
Firm 2	35354625.00	40263872.00	35561744.00
Firm 3	545949.00	-4470280.00	51123.00

Interpretation

The profit trend of Firm 1 decreased from 9.40 to 9.02 lakh and then increased to 10.22 lakh. Firm 2 shows increased profits from 353.55 lakhs to 402.64 lakhs and then decreases to 355.62 lakh. Firm 3 profit decreases from 5.46 to a loss of 44.70 lakh and then increases to 0.51 lakh in 2025.

c) Compliance cost to revenue trend

firm name	2023	2024	2025
Firm 1	0.043	0.047	0.044
Firm 2	0.017	0.016	0.019
Firm 3	0.111	0.257	0.029

Interpretation

The compliance cost to revenue ratio of Firm 1 rises from 0.043 to 0.047 and slightly falls to 0.044. Firm 2 falls from 0.017 to 0.016 and then rises to 0.019. The ratio of Firm 3 sharply rises from 0.111 to 0.257 and then significantly falls to 0.029 in 2025.

5. DESCRIPTIVE STATISTICS

	N	Minimum	Maximum	Mean	Std. Deviation
total revenue	9	44853729.00	553345351	249848831.5556	196082457.97385
net profit after tax	9	-4470280.00	40263872	12241183.4444	18742239.80069
tax and external compliance cost	9	50000.00	88000	62666.6667	19000.00000
Valid N (listwise)	9				

Interpretation

The descriptive statistics indicate that the total revenue for SMEs varies significantly (Mean ₹24.98 Cr, Min ₹4.49 Cr, Max ₹55.33 Cr), and profitability varies significantly, with many firms experiencing losses (Min ₹-0.45 Cr, Mean ₹1.22 Cr), while tax and compliance costs are relatively stable (Mean ₹0.0063 Cr).

6. CORRELATION

The Pearson correlation analysis reveals a very strong positive linear relationship between compliance cost and profit ($*r = 0.993*$) and revenue ($*r = 0.968*$). This suggests that as the SMEs grow in terms of revenue and profitability, the compliance costs are also increasing significantly.

7. REGRESSION

The regression analysis with high explanatory value (Adjusted $R^2 = 0.929$ and 0.984 for revenue and profit, $*p = 0.000*$) suggests that compliance costs are significant factors affecting the financial performance of SMEs, and therefore, taxation and statutory compliance are closely linked with the growth and profitability of SMEs.

IX. FINDINGS

- Revenue and profit fluctuate in SMEs, and some even operate at a loss.
- Compliance costs remain stable, but a higher burden when profits are low.
- Strong correlation exists and compliance costs increase with growth.
- Regression results confirm compliance costs significantly impact SMEs.

X. CONCLUSION

The study concludes that taxation and compliance are vital for ensuring transparency and legal functioning in SMEs, and this places a huge financial burden on them, especially on smaller and less stable firms. Although compliance costs tend to increase with revenues and profitability, this is a positive aspect,

showing growth in the business, yet compliance costs also tend to decrease profitability when revenues are less stable, thus having a dual impact on SMEs.

XI. RECOMMENDATIONS/SUGGESTIONS

- Simplify tax processes to reduce compliance costs.
- Offer tax relief or support for small SMEs.
- Encourage digitalization to reduce compliance costs.
- Enhance awareness and improve financial management practices.

XII. REFERENCES

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