



**INFORMATION NOTE**

## Strengthening Tax Audit Capabilities: General Principles and Approaches

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Forum on Tax Administration's  
Compliance Sub-group

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# TABLE OF CONTENTS

<b>ABOUT THIS DOCUMENT</b> .....	<b>4</b>
<i>Purpose</i> .....	4
<i>Background</i> .....	4
<i>Caveat</i> .....	4
<i>Inquiries and further information</i> .....	4
<b>SUMMARY</b> .....	<b>5</b>
<b>INTRODUCTION</b> .....	<b>6</b>
<i>Managing and improving compliance</i> .....	6
<i>Focus of this note—small and medium-sized businesses</i> .....	6
<i>Providing a snapshot of current practice</i> .....	7
<b>1 THE ROLES OF THE TAXPAYER AUDIT PROGRAM</b> .....	<b>8</b>
<i>The roles of the taxpayer audit program</i> .....	8
<i>What is an audit?</i> .....	9
<i>Types of audits</i> .....	9
<i>The audit context—administrative assessment versus self-assessment</i> .....	10
<i>Key audit characteristics</i> .....	11
<b>2 LEGAL FRAMEWORKS</b> .....	<b>12</b>
<i>Why have legal frameworks?</i> .....	12
<i>Taxpayers' record keeping obligations</i> .....	13
<i>Giving tax officials access to taxpayers' books and records</i> .....	14
<i>Giving tax officials access to third party information</i> .....	15
<i>Obtaining information from other national revenue bodies</i> .....	15
<i>Powers of revenue bodies to amend returns</i> .....	16
<i>Sanctions for non-compliance</i> .....	16
<i>Formal statements of taxpayers' rights and obligations- an audit context</i> .....	17
<b>3 ORGANISATION &amp; MANAGEMENT OF THE TAXPAYER AUDIT FUNCTION</b> .....	<b>18</b>
<i>Organization of tax audit operations</i> .....	18
<i>Resources for the tax audit function</i> .....	19
<i>Strategic management and the audit function</i> .....	19
<i>Operational management</i> .....	21
<i>Who conducts the Audit?</i> .....	23
<i>Scope of Audit</i> .....	23
<i>Other case management factors</i> .....	24
<i>Publicity as leverage for Audit</i> .....	25
<i>Performance objectives and measurement</i> .....	26
<i>Outcome Measures</i> .....	30
<i>Evaluation of audit activities</i> .....	31
<b>4 AUDIT TECHNIQUES</b> .....	<b>33</b>
<i>Key principles</i> .....	33
<i>Audit support tools</i> .....	34
<i>Audit Planning</i> .....	36
<i>Pre-contact Analysis &amp; Case Selection methods</i> .....	37
<i>Examination Techniques</i> .....	40
<i>Use of indirect methods to verify income</i> .....	42
<i>Working papers</i> .....	44
<i>Finalising the Audit</i> .....	44

<b>5</b>	<b>AUDIT WORKFORCE MANAGEMENT ISSUES .....</b>	<b>46</b>
	<i>Competency / capability models.....</i>	<i>46</i>
	<i>Identifying the required competencies .....</i>	<i>47</i>
	<i>Assessing competencies .....</i>	<i>49</i>
	<i>Improving competencies and addressing capability gaps .....</i>	<i>50</i>
	<i>Recruitment.....</i>	<i>51</i>
	<i>Training and development .....</i>	<i>53</i>
	<i>Initial training .....</i>	<i>53</i>
	<i>Ongoing training and development .....</i>	<i>53</i>
	<i>Mentoring and coaching programs.....</i>	<i>54</i>
	<i>Accreditation models .....</i>	<i>55</i>
	<i>Job rotation and/or placement programs .....</i>	<i>55</i>
	<i>Career paths, grading and promotion systems .....</i>	<i>55</i>
	<i>Knowledge-sharing initiatives.....</i>	<i>56</i>
	<i>Knowledge tests .....</i>	<i>57</i>
	<i>Measuring cost benefits of competency improvement programs .....</i>	<i>57</i>
	<i>Incentives to participate in competency improvement programs .....</i>	<i>57</i>
	<i>Performance management and motivation.....</i>	<i>58</i>
	<i>Remuneration .....</i>	<i>58</i>

# ABOUT THIS DOCUMENT

## Purpose

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This information note, prepared by the Forum's Compliance Subgroup, focuses on audit programmes and the conduct of individual audits. It identifies common key features of effective audit activity found in a wide variety of tax administrations and outlines the principles underpinning these characteristics.

Preparation of this note was assisted greatly by the contribution of revenue bodies in Australia, Canada, France, New Zealand, United Kingdom, and United States.

## Background

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Since its establishment in July 2002, the Forum on Tax Administration (FTA), a subsidiary body of the OECD's Committee on Fiscal Affairs (CFA), has operated with the broadly stated mandate ... *to develop effective responses to current administrative issues in a collaborative way, and engage in exploratory dialogue on the strategic issues that may emerge in the medium to long term.* To carry out this mandate, the Forum's work is directly supported by two specialist Sub-groups: Compliance and Taxpayer Services (previously e-services)—that each carry out an agreed program of work.

The Compliance Sub-group provides a forum for members to share experiences and knowledge of compliance approaches in OECD member countries to progress good practice in compliance activities and administration, both domestically and internationally. Specifically, the Sub-group is expected to: 1) periodically monitor and report on trends in compliance approaches, strategies and activities; 2) consider and compare member compliance objectives, the strategies to achieve those objectives and the underlying behavioural compliance models and assumptions being used; 3) consider and compare member compliance structures, systems and management and staff skills and training; and 4) create and maintain best practice papers and discussion papers on emerging trends and innovative approaches.

## Caveat

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Each revenue authority faces a varied environment within which they administer their taxation system. Jurisdictions differ in respect of their policy and legislative environment and their administrative practices and culture. As such, a standard approach to tax administration may be neither practical nor desirable in a particular instance. The documents forming the OECD tax guidance series need to be interpreted with this in mind. Care should always be taken when considering a country's practices to fully appreciate the complex factors that have shaped a particular approach.

## Inquiries and further information

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Inquiries concerning any matters raised in this note should be directed to Richard Highfield (Head, CTPA Tax Administration and Consumption Taxes Division), phone +33 (0)1 4524 9463 or e-mail (richard.highfield@oecd.org).

## SUMMARY

1. The taxpayer audit function plays a critical role in the administration of tax laws in all member countries. In addition to their primary role of detecting and deterring non-compliance, tax auditors are often required to interpret complex laws, carry out intensive examinations of taxpayers' books and records, while through their numerous interactions with taxpayers operating very much as the "public face" of a revenue body. These factors, as well as the sheer size of the audit function in most revenues bodies, provide a strong case for all revenue bodies paying close attention to the overall management of the tax audit function.
2. This note focuses on audit programmes and the conduct of audits:
  - The important roles played by tax audit activities.
  - The legislative framework required to underpin effective audits.
  - How the audit function is organized and managed.
  - The audit techniques and support tools that can be used.
  - How the overall performance of the audit program can be improved by specific strategies and actions to enhance the competency of audit officials.
3. The note does not purport to be an authoritative and comprehensive guide on how audit activities should be conducted. Rather, it draws together information supplied by member countries through various information gathering activities (e.g. surveys and workshops) conducted over the last three years and presents an array of facts and observations that may assist member countries improve the efficiency and effectiveness of their audit activities.
4. The note is accompanied by two companion notes that provide more specific facts, guidance and case study examples:
  - Strengthening Tax Audit Capabilities: Auditor Workforce Management—Survey Findings and Observations (October 2006).
  - Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Methods (October 2006).
5. Additional documents published in October 2004 concerning tax audit activities may also be of interest to readers:
  - Managing and Improving Tax Compliance (October 2004).
  - Audit Case Selection Systems (October 2004).
  - Use of Random Audit Programs (October 2004).
6. **Revenue bodies are encouraged to examine this and the related companion documents to identify new approaches and opportunities for strengthening their tax audit activities.**

# INTRODUCTION

## Managing and improving compliance

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7. The primary goal of a revenue body's compliance activity is to improve overall compliance with their tax laws, and in the process instil confidence in the community that the tax system and its administration are fair. Instances of failure to comply with the law are inevitable whether due to taxpayers' ignorance, carelessness, recklessness and deliberate evasion, or weaknesses in administration. To the extent that such failures occur, governments, and in turn the communities they represent, are denied the tax revenues they need to provide services to citizens.
8. Historically, most taxpayer-driven failures or compliance risks have been addressed nearly exclusively in terms of regulatory enforcement through an audit-based approach. In more recent times, revenue administrators have come to realise that the factors underlying taxpayers' compliance behaviour in any specific risk area are varied and often complex, and are unlikely to be treated successfully with a 'single action' strategy, particularly one based exclusively on regulatory enforcement action such as audits.<sup>1</sup> This particular development is dealt with in considerable detail in the accompanying guidance note 'Managing and Improving Tax Compliance' published in late 2004.<sup>2</sup>
9. Nevertheless, audits remain a major tool for tackling non-compliance and in revenue bodies in most OECD countries constitute the largest deployment of resources for administration of the laws. This paper outlines some general principles underpinning successful audit regimes as part of a revenue body's overall compliance risk management process.

## Focus of this note—small and medium-sized businesses

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10. The main focus of this guidance note is on audits carried out on small and medium sized enterprises (SMEs) due to their risk of under-reporting their tax liabilities for both direct and indirect taxes.
11. Definitions of an SME vary between countries but a useful definition can be found in the companion paper in this series *Use of Random Audits* (where they are described as 'Small & Midsize Businesses'):

*A small and midsize business is any for-profit commercial entity that does not exceed a given asset or turnover threshold. SMEs can include sole proprietorships, partnerships, trusts, and corporate forms of organisation. They include individual return filers who have income from self-employment, even if self-employment income is not their primary source of income.*

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<sup>1</sup> Various terms such as examination, control, and inspection, as well as the term 'audit', are used by revenue bodies to denote the routine review (conducted either by field or correspondence inquiry) of returns filed by taxpayers to verify reported tax liabilities. In this note, the term 'audit' is used in the place of all such terms.

<sup>2</sup> This guidance note encourages revenue bodies to pay greater attention to understanding the factors that shape taxpayers' behaviour and to employing a multi-faceted approach to the treatment of non compliance; an approach that focuses on understanding the underlying causes for non-compliant behaviour rather than merely treating the symptoms.

12. SMEs represent a high risk taxpayer segment in all countries for a variety of reasons. They are relatively large in number and their incomes are not fixed and often very hard to verify using third-party information sources. In addition, their operating structures and arrangements can lack the well-developed processes for record-keeping, independent audit of accounts and cash handling typically seen in larger businesses, which help to minimise risks of under-reporting tax liabilities.

### **Providing a snapshot of current practice**

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13. The objective of revenue bodies may be constant—optimising revenue collections under their law and increasing the levels of voluntary compliance in ways that instil community confidence—but the means to achieving it are not. Revenue bodies should seek to develop innovative and co-operative approaches to understand the market place, and devise their approaches accordingly.
14. This guidance note offers a practical insight into the principles underpinning successful tax audit programmes. It is not a prescribed plan. It is designed to assist revenue bodies to examine and improve their audit programmes. (NB: This paper does not cover processes leading to prosecution where the audit has identified criminal or other illegal activities.)

# 1 THE ROLES OF THE TAXPAYER AUDIT PROGRAM

## KEY POINTS

- The audit programme of a revenue body performs a number of important roles that, effectively carried out, can make a significant contribution to improved administration of the tax system.

## The roles of the taxpayer audit program

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15. The audit programme of a revenue body performs a number of important roles that, effectively carried out, can make a significant contribution to improved administration of the tax system. These roles are described briefly hereunder:
- **Promote voluntary compliance:** The primary role of the audit program is to promote voluntary compliance by taxpayers with the tax laws. It seeks to achieve this by reminding taxpayers of the risks of non-compliance and by engendering confidence in the broader community that serious abuses of the tax law will be detected and appropriately penalized.
  - **Detect non-compliance at the individual taxpayer level:** By concentrating on major areas of risk (e.g. unreported cash income) and those individual taxpayers most likely to be evading their responsibilities, audits may bring to light significant understatements of tax liabilities, and additional tax revenue collections.
  - **Gather information on the “health” of the tax system (including patterns of taxpayers’ compliance behaviour):** The results of normal audit activity may provide information on the general well-being of the tax system. Audits conducted on a random basis can assist overall revenue administration by gathering critical information required to form judgments on overall levels of tax compliance—that over time can be used to identify trends in overall organizational effectiveness—and to gather more precise information that can be used to inform decision-making on future compliance improvement strategies, to refine automated risk-based case selection processes, and even support changes to tax legislation.
  - **Gather intelligence:** Audits may bring to light information on evasion and avoidance schemes involving large numbers of taxpayers that can be used to mount major counter-abuse projects.
  - **Educate taxpayers:** Audits can assist clarify the application of the law for individual taxpayers and to identify improvements required to record-keeping and thus may contribute to improved compliance by taxpayers in the future.
  - **Identify areas of the law that require clarification:** Audits may bring to light areas of the tax law that are causing confusion and problems to large numbers of taxpayers and thus require further efforts by the revenue body to clarify the laws’ requirements and/or to better educate taxpayers on what they must do to comply into the future.



16. Given the broad range of roles to be performed a revenue body's audit program typically entails the largest allocation of a revenue body's total staff resources. From this perspective alone, the audit program represents a sizeable strategic investment that dictates the need for sound management policies and practices.

## What is an audit?

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17. A tax audit is an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations. Tax audits are often more detailed and extensive than other types of examination, such as general desk checks, compliance visits/ reviews or document matching programmes. There are, of course, exceptions to this rule. Conditions and approaches vary from country to country.
18. Generally, an audit will examine the issues seen as most significant to achieving an accurate assessment of a taxpayer's tax liability. Typically, these issues will include any indications of significant unreported income (for example, as may be suggested by a very low ratio of net/gross business income ratio computed from a taxpayer's return) or potentially over-claimed deduction items that may be apparent from an examination of a taxpayer's tax return and other information. As well as income tax returns and other reporting, this includes supporting documents, which the taxpayer should normally have. In the case of business audits, national law often requires a business to obey certain bookkeeping and accounting standards. The audit may also involve physical enquiries, such as the inspection and examination of goods in stock, premises etc.
19. Audit periods, frequency and coverage differ from country to country.

## Types of audits

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20. ***Audit scope and intensity:*** Audits can vary in their scope and the level of intensity to which they are conducted. For this reason, various terminology have evolved to describe different types of audit activity:
  - *Full audits* – The scope of a full audit is all-encompassing. It typically entails a comprehensive examination of all information relevant to the calculation of a taxpayer's tax liability for a given period. The objective is to determine the correct tax liability for a tax return as a whole. In some countries full audits are carried out as part of random audit programs that are used to gather data on the extent, nature and specific features of tax compliance risks, for compliance research purposes and/or the development of computerised audit selection formulae. Given their broad scope, full audits are typically costly to undertake—a substantial program of full audits will require considerable resources and reduce the rate coverage of taxpayers that could otherwise be achieved by a more varied mix of audit types.
  - *Limited scope audits* – Limited scope audits are confined to specific issues on the tax return and/or a particular tax scheme arrangement employed by the taxpayer. The objective is to examine key potential risk areas of non-compliance. These audits consume relatively fewer resources than full audits and allow for an increased coverage of the taxpayer population.
  - *Single issue audits* – Single issue audits are confined to one item of potential non-compliance that may be apparent from examination of a taxpayer's return. Given their narrow scope, single issue audits typically take less time to perform and can be used to review large numbers of taxpayers involved in similar schemes to conceal non-compliance.
21. In practice, the scope and nature of any audit activity undertaken for a particular taxpayer will depend on the available evidence pointing to the likely risks of non-

compliance and a taxpayer's prior history. Extensive audit inquiries may also be justified simply because a taxpayer's financial and /or business activities are unusually complex.

22. **Periods under examination:** Audits can focus on one financial year or accounting period, or be extended to cover multiple fiscal periods. An audit can focus on specific parts of the taxpayer's activities (such as sales, goods in stock etc), specific incidents or transactions or activities (such as those carried out in a branch or subsidiary), or specific tax obligations. An audit can vary in its level of detail. Sometimes the taxpayer's affairs are examined in detail and in other situations, subject to the level of risk perceived, merely superficially.
23. **Location of audits:** Tax audits can be conducted in different locations. Sometimes there is a need to carry out the audit at a taxpayer's business premises; in other situations, the books and records required to complete an audit can be collected by, or sent to, the revenue body and the audit work performed in the office. Tax audits can be categorised as 'field audits' or 'office or desk audits' on this basis.
24. Given that audits can vary in terms of their scope and intensity revenue bodies should have a clear policy on the types (and numbers) of audits to be conducted, and the circumstances in which specific types of audits are to be carried out, so that audit officials (including managers) understand what is expected of them. More is said on this in Part 3.

## **The audit context—administrative assessment versus self-assessment**

25. The scope of audit activities varies across member countries, in part as a result of the system of assessment in place. There are two generally accepted systems of tax assessment applied by OECD countries—administrative assessment and self-assessment. In around half of OECD countries, administrative assessment is employed to varying degrees in the administration of personal income tax and corporate profits/income tax. All countries administer VAT under self-assessment principles.
26. Assessment systems operate on the principle that all tax returns should be subject to a degree of technical scrutiny before a formal assessment is sent to the taxpayer. In practice, however, much of the scrutiny previously undertaken by technical staff has been replaced in many countries by the use of automated screening techniques to identify returns requiring scrutiny before a formal assessment is issued. To the extent that there is some level of scrutiny carried out by technical officers, it ranges in practice from a very cursory examination of some tax returns to a more in-depth examination where further inquiries may be made with taxpayers (sometimes by correspondence) before a formal assessment is issued. Even countries that operate administrative assessment regimes complement these arrangements with a formal program of post-assessment audits. However, in practice such programs tend to be conducted on a smaller scale than is the case in countries only applying self-assessment principles.
27. In countries where self-assessment principles are applied, returns are typically accepted as filed in the first instance (with the exception of returns containing mathematical errors or clearly erroneous deductions) and, for income tax, a formal assessment/ notice confirming/advising the tax liability is sent to the taxpayer before any inquiry. A sample of returns is selected for post-assessment audit, generally applying computer-based risk selection techniques and/or manual screening processes. Large scale matching programs may also be mounted on a post –assessment basis for the major categories of income (i.e. wages, interest, and dividends).

28. Since virtually all tax returns are accepted as filed without technical scrutiny when applying self-assessment principles, it is essential for the system to be supported by a reliable automated audit case selection system using risk-based screening techniques. Typically, such systems are developed using risk-based criteria derived from analyses of completed audit cases and are regularly updated to take account of the results of audit activities and to reflect important changes in the behavioural patterns of taxpayers. Examples of risk identification models and approaches are described in the companion note 'Audit Case Selection Systems' issued in 2004.
29. As systems of administrative assessment and self-assessment have evolved over time in many countries there is something of a fine-line in practice between their features and relative efficacy.

## **Key audit characteristics**

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30. Compliance regimes operate within the unique legal, cultural and administrative background of individual member countries. Nevertheless, there are a number of common pre-requisite features and requirements that need to be in place to ensure a good level of effectiveness and efficiency from audit activities and to support continuous improvement. They are:
  - A comprehensive legal framework, including an appropriate regime of sanctions.
  - Well-defined organizational and management processes, including a comprehensive performance measurement framework.
  - Well-defined audit techniques and adequate support arrangements; and.
  - Adequate human resource management and development programs.
31. The following chapters describe prerequisite features and requirements in greater detail.

## 2 LEGAL FRAMEWORKS

### KEY POINT

- The efficiency and effectiveness of a revenue body's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.
32. The efficient and effective conduct of audit activities requires that a revenue body's audit and investigation staff have appropriate powers of access to information held by the taxpayer and other parties so that taxpayers liabilities reported in their returns can be properly verified or, in the absence of returns, be accurately established. There should also be an appropriate regime of sanctions to punish and deter non-compliance.
33. For these reasons, revenue bodies require a set of powers and sanctions in the legal framework supporting the conduct of tax administration activities that includes the provision of adequate powers for obtaining information and an appropriate regime of sanctions covering the various offences that may arise. In practice, this legal framework may be set out separately in the laws governing each tax administered or, preferably for ease of legislative maintenance, in a single comprehensive law on tax administration that provides a common set of provisions covering all taxes.

### Why have legal frameworks?

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34. A tax audit is one of the most sensitive contacts between the taxpayer and a revenue body. The presence of an auditor in a taxpayer's private dwelling or business premises, coupled with the exploration of private and business issues and the gathering of information from taxpayers' books and records, or just the disruption of day-to-day workflow, represents a burden on the taxpayer and may be seen by some as an unwarranted intrusion into their affairs. Notwithstanding this, tax audits remain the only effective method for ascertaining additional facts or verifying provided information.
35. Legal frameworks are essential to provide integrity in the way tax administrations carry out audits and to ensure that taxpayers' rights are properly protected. As such, in many jurisdictions the taxpayer may request a review of any proposed assessments or an explanation of the audits techniques used and adjustments being proposed. This request may be made to the revenue body or an independent third party body.
36. This chapter of the guidance note briefly describes the key elements of such a legal framework as it relates to the audit function. These are:
- Taxpayers' record-keeping obligations.
  - Giving tax officials access to taxpayers' books and records.
  - Giving tax officials access to third party information sources.
  - Obtaining information from other countries' revenue bodies.
  - Powers of revenue bodies to amend returns.
  - Sanctions for non-compliance.

## Taxpayers' record keeping obligations

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37. All audit activities rely on the books and records kept by taxpayers. Throughout the OECD the legal requirements for record keeping only vary regarding the level of detail required. This may also depend on the type or size of the business being audited.
38. Business enterprises in all member countries are obliged to keep books and records; private persons are only required to in exceptional cases. Most countries have simplified accounting requirements for small enterprises and self-employed taxpayers.
39. In countries with an assessment system, record keeping obligations are based on national Codes of Commerce to the extent they are not in contravention of specific provisions in the tax laws. Countries operating a self-assessment system tend to use specifications that are more general. They may require existing books and records to be sufficiently comprehensive for taxable income to be determined – or that the accuracy of VAT/GST due or claimed is verifiable
40. The specific requirements for VAT/GST have made it necessary for these administrations to require more detail, such as records for all goods and services delivered or purchased and separate accounting requirements for any sale to which a zero rate or an exemption applies.
41. Where levels of technological developments allow, obligations may specify or permit the keeping of electronic books and records. This is a developing area and the level of compulsion in keeping such records is dependent on the technological environment. It is clear that where business records are kept electronically, it is advantageous for the tax administration to review them electronically as this allows for a deeper and more complex review. (see Audit techniques, Chapter 5)

### **Examples: Electronic record-keeping**

Canada, France and Ireland allow electronic record keeping. No OECD country proscribes it. In the United States, original manual source records must also be retained.

In New Zealand, a record may be retained in an electronic form only if the record can be readily produced in paper form; and that paper form is a duplicate image of the original paper or other non-electronic form. If a record is received from a person in both paper (or other non electronic form) and in electronic form, the record may be retained in its electronic form only.

In December 2003, the New Zealand Inland Revenue released a standard practice statement containing guidelines on the retention of business records by taxpayers where those records are stored in electronic form or on microfiche or microfilm. The statement also contains guidelines on the information and assistance required from taxpayers when the Department requests information and requires access to those business records and the supporting background material.

42. Books and records should be recorded in the language of the country where the taxpayer has his head office or in the language of the country where the subsidiary or permanent establishment resides. There are some exceptions from this basic rule. In some cases, it is acceptable to use English or any other nationally spoken language. In general, the auditor can ask for a certified translation and the taxpayer must cover the costs of the translation.
43. Countries have a range of requirements regarding how long a taxpayer must retain records, from one year to ten years. For the majority of countries, the retention period starts after the fiscal year has ended.

44. Revenue bodies often specify additional record-keeping requirements. These may be put in place to provide evidence that supports specific parts of the tax calculation and could be vital pieces of evidence within the audit process.

#### **Examples: Record-keeping obligations**

- Details of assets including their cost of purchase, sales proceeds and depreciation expenses. This is to check that the correct deductions for these items have been claimed.
- Simplified record keeping obligations and less onerous for small businesses and low-income individuals. These cases are often lower risk, so less information is needed. In the UK, self-employed taxpayers with a turnover below £15K need only supply annual figures for turnover, expenses and profit – ‘three line accounts’.
- In New Zealand – Generally, records must be retained for a period of seven years after the end of the income year to which they relate. However, the Commissioner can also issue a notice before the expiry of the seven year period extending the record retention period by up to three years. This may occur where there has been, is, or is likely to be, an audit or investigation of the taxpayer.

### **Giving tax officials access to taxpayers’ books and records**

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45. Legal provisions should give an auditor access to all tax-relevant information during an audit. Tax-relevant information is any piece of information (such as books and records, bank statements, trade letters, contracts etc.), which is essential to determine the correct amounts of tax due. Domestic information is information kept in the home country. It must be available to the auditor during an audit at his request within an acceptable time, whether in paper form or electronically.
46. Information held abroad mostly concerns multinational enterprises (MNE’s) either as a parent company or as a foreign subsidiary. The ability to access information held abroad is subject to the provisions of the revenue body’s Double Taxation Agreements and domestic laws.
47. The legal basis to require original documentation varies from across countries. In most countries, tax auditors can return to their office with any piece of information provided by the taxpayer (e.g. to make copies).

#### **Examples: Access and information gathering powers**

In the UK, the auditor has the legal right to see the business records, but would require the permission of the taxpayer to take records away from the premises at which they were made available. The auditor does have additional powers to obtain and take away records where not made reasonably available. And in cases of fraud a search warrant issued by the court will grant access to specified records.

In New Zealand, the Commissioner of Inland Revenue and any authorised Inland Revenue officer are granted full and free access for the purposes of inspecting any books and documents together with any property, process or matter. The right of access is granted in relation to all land, buildings and places and all books and documents (as defined in the legislation).

Departmental officers, or a person accompanying them, wishing to gain entry to a private dwelling must either have the consent of the occupier or a special access warrant.

On gaining access, the Commissioner or an authorised officer may then remove any books or documents for the purpose of making copies. Copies must be made and the originals returned as soon as practicable. Any copy certified by or on behalf of the Commissioner is admissible in evidence in court as if it were the original. The owner of the book or document which the Commissioner has removed has the right to inspect and copy it at the Inland Revenue premises to which the Commissioner has removed it. This right may be exercised when the Commissioner removes the book or document to the premises and at reasonable times subsequently.

48. An auditor's ability to enter the taxpayer's premises adds value to an examination. The auditor can obtain an impression of the daily workflow and various assets used by the taxpayer to run his enterprise. Most countries allow access to the business premises. The majority of administrations require that any full audit is carried out at the business premises.

### **Giving tax officials access to third party information**

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49. All countries have legal provisions to support the auditor in cases where the taxpayer provides unsatisfactory information or the auditor must verify taxpayers' information using an independent or third party source. However, these provisions set limitations for auditors that can be summarised as follows:
- Protection under a professional pledge of secrecy (e.g. lawyers, public and tax accountants);
  - Protection of trade or industrial secrets; and
  - Protection of taxpayers' privacy.

Full details on information access rights in OECD member countries (and whether they extend to third parties) are provided in Table 18 of the OECD document *'Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)'*.

### **Obtaining information from other national revenue bodies**

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50. The large number of tax treaties in existence (one authority has 120 tax treaties, and the average revenue body has 58) reflect, among other things, the fundamental importance of accepted rules for exchange of information between countries for liability verification purposes. Some treaties cannot meet the international information needs relating to indirect taxes because this is not covered by the respective treaty. Other restrictions on the kind of information that may be exchanged are found with some revenue bodies while a very small number limit the scale of cases for which they will consent to an exchange of information (e.g. turnover must exceed 10,000 euros).
51. For many revenue bodies the exchange of information is organised through liaison units. These units process the requests of foreign tax authorities; supervise the restrictions on the kinds of information that may be exchanged, and in some cases, the fact that exchange can only take place in important cases.
52. The nature of audit activities is changing from working exclusively in the domestic arena to doing audits on international issues. One means of verifying information involving other countries is through simultaneous bilateral or multilateral audits. The number of these audits varies from one to ten per annum in the administrations that employ them. Three OECD countries do not have programmes for simultaneous audits. Direct or informal contact between auditors from different countries is governed by the tax treaty in place between the two countries.
53. Although a foreign auditor has no authority outside his own jurisdiction, six countries accept that a foreign auditor can carry out verification in their territory if necessary. Each of these countries has introduced conditions as to when such verifications can happen. For example, it may be necessary to have the approval of the competent authority and the taxpayer's consent, or accreditation may only be given to certain administrations.

## Powers of revenue bodies to amend returns

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54. The power to audit must be supported by a power to amend the original tax return. The general principles on which reassessment powers operate are described below.
55. The report made by the auditor at the conclusion of the audit will form the basis for any reassessment. Most revenue bodies enable taxpayers to provide comments on the audit report before the reassessment is completed, in order to raise unclear facts or different interpretations of law.
56. Similarly, the taxpayer will commonly have the right to appeal against that reassessment if agreement cannot be reached.

### **Example: Finalizing the audit**

In New Zealand, a Notice of Response (NOR) must give brief reasons why the taxpayer rejects a proposed adjustment, and specify how the proposed adjustment could be altered in order for the taxpayer to agree with it. A NOR cannot merely state that the Inland Revenue Department's (IRD) proposed adjustment is unacceptable.

If the IRD accepts all the contentions in the NOR, the agreement will be recorded and IRD will not make the proposed adjustment. If it disagrees with some or all of the contentions, it will inform the taxpayer. The dispute will then usually move to the conference stage. When a taxpayer is issued with a NOR (or at any later stage) and the tax in dispute is NZ\$15,000 or less, the taxpayer may elect that any subsequent litigation of unresolved issues be heard before the small claims jurisdiction (the Taxation Review Authority). For amounts above NZ\$15,000, the dispute will be heard in higher Courts.

57. Auditors are not usually authorised to amend assessments without the approval of other tax officers (e.g. team leader). The maintenance of integrity is the key reason given for this; ("four eyes are better than two"). However, in some revenue bodies auditors are allowed to conclude settlements, without such supervision, in defined circumstances.
58. Whilst most audits rely on an accounting system and complete books and records, auditors may occasionally use indirect methods to establish or estimate taxable income, annual taxable turnover or input tax. More detail on these methods is given in Part 5 - Audit Techniques and in the accompanying document 'Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Techniques'.
59. The legal time limits for reassessment vary from country to country. The period for ordinary cases ranges from three to eight years. A few authorities have implemented different periods for direct and indirect taxes. In one administration it is permitted to reassess for one year only, in contrast to the taxpayer's right to make reassessments over a five-year period. In cases of misrepresented information or tax fraud, the period for reassessment ends after five years (in two authorities), ten years (in nine authorities) and twenty years (in one authority).

## Sanctions for non-compliance

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60. The voluntary reporting of taxpayers' correct tax liabilities and the provision of any assistance that may be required to verify taxpayers' reported liabilities are facilitated by an appropriately structured regime of sanctions (e.g. penalties and interest, and imprisonment).
61. All revenue bodies can impose penalties for refusal or failure to furnish an answer or to provide documents or relevant papers to an auditor and without such legal



sanction it would be very difficult to conduct any effective audit activity. These sanctions affect the taxpayer and/or any third party approached for information. The levels of sanction range from monetary penalties related to the documents required to imprisonment.

62. As regards penalties relating to incorrect returns, the sanctions available typically allow for the degree of culpability of the taxpayer, as set out hereunder;
  - Understatements of liability resulting from unintended errors, ignorance or misinterpretation of facts and/or law;
  - Understatements of liability resulting from careless or reckless acts; and
  - Understatements of liability resulting from deliberate and /or fraudulent acts.
63. Other sanctions relevant to the conduct of audits normally found in the laws of member countries include 1) the failure to keep adequate books and records; 2) the failure to supply requested information relevant to the conduct of audit inquiries; and 3) causing obstruction to, preventing access of, a tax official in the conduct of official duties.
64. Table 20 of the OECD document, 'Tax Administration in OECD and selected Non-OECD Countries: Comparative Information Series (2006)', provides a brief summary of the major sanctions in place in member countries.
65. In all countries, tax evasion offences can be subjected to prosecution under criminal laws and in most cases can lead to terms of imprisonment and/or fines ranging from 50% to 600% of the evaded tax.
66. In all countries, the rights of the taxpayer are protected from the inappropriate use of penalty provisions. Revenue bodies in all countries are accountable to judicial authorities for all of the sanctions imposed administratively.

## **Formal statements of taxpayers' rights and obligations- an audit context**

67. Given the objective of an audit and the additional burden this may place on a taxpayer, it is important that there is a clear understanding of the respective roles and responsibilities of both tax officials and taxpayers from the outset of an audit. To this end, many revenue bodies have elaborated these responsibilities in formalized administrative documents (e.g. official statements of administrative practice, codes of conduct, etc.) and make them widely available. Such statements serve as a reminder to both taxpayers and tax officials of desirable modes of conduct and in this respect may have a positive influence on the behaviours of both taxpayers and tax officials. An outline of such a statement is described hereunder.

**Example: Informing the taxpayer of what an audit will entail  
Australia—'If you're subject to inquiry or audit' booklet**

This booklet tells taxpayers what they can expect if they are subject to a face-to-face inquiry or audit from the ATO. It outlines how taxpayers will be treated, what they can expect from the ATO, and what's expected of them. Specifically, it describes:

- Introduction—why audits and similar inquiries are conducted.
- The enquiry or audit process.
- What the taxpayer can expect from the ATO
- What is expected of taxpayers during an enquiry or audit
- How taxpayers should prepare for an enquiry or audit
- Arrangements for notification of an enquiry or audit
- What will happen at the start of an enquiry or audit
- What will happen during an inquiry or audit
- What will happen at the end of an inquiry or audit
- Information concerning penalties and offences
- What taxpayers can do if they wish to make a complaint

### 3 ORGANIZATION AND MANAGEMENT OF THE TAXPAYER AUDIT FUNCTION

#### KEY POINTS

- Revenue bodies with effective tax audit programs pay close attention to the way the function is organized, resourced, and managed.
- In many OECD countries, the proportion of the revenue body's overall staff resources devoted to audit and other verification activities exceeds over 30% of total staff resources.
- There has been a trend for revenue bodies to take a more strategic "top down" view of all compliance risks (including, but not limited to, the under-reporting of tax liabilities), using a more structured and systematic process to identify, assess, and prioritize compliance risks, and to determine appropriate treatment actions for the major risks identified.
- Revenue bodies should aim to achieve a balanced program of audits—one that balances 'coverage', 'audit quality', and 'overall deterrent' considerations.
- Audit operations should be underpinned by sound management practices including the use of a comprehensive set of performance measures/indicators (output and, ideally, outcomes-focused), and with close monitoring of the results and quality of operations achieved in practice.

68. This section outlines a number of important features related to the organization, staff resources, and management of the taxpayer audit function.

#### Organization of tax audit operations

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69. Revenue bodies with effective tax audit programs pay close attention to the way this function is organized, resourced, and managed. Given the importance of tax audits and the specialized skills they involve, all revenue bodies in member countries include one or more specialised departments that are responsible for all activities relating to audits of SMEs, large businesses, and other taxpayers.
70. There is no one "right" model for the organization of tax audit activities. However, from an examination of the organizational structures of revenue bodies in OECD and other selected countries there are two clear trends that can be identified: 1) use of the 'functional' model for organizing tax administration operations; and 2) the emergence of organizational groupings of functions for specific segments of taxpayers (e.g. large taxpayers):
- **The functional model:** Under the functional model, staff are organized principally by functional groupings (e.g. registration, accounting, information processing, audit, collection, appeals, etc.) and generally work across taxes. This approach to organizing tax work was introduced to enable greater standardization of work processes across taxes, to simplify computerization and arrangements for taxpayers, and to generally improve operational efficiency. Compared to the 'tax type' organizational model from which many revenue bodies have evolved, this model was perceived to offer many advantages and its adoption has facilitated many developments aimed at improving tax administration performance (e.g. providing single points of access for tax inquiries, unified system of taxpayer registration, common tax payment and accounting approaches, and more effective management of tax audit and debt collection functions.) Adoption of the functional model has seen many revenue bodies integrate the management of direct and indirect tax, especially VAT, audit work, leading to some audit officials being responsible for a range of tax types when examining taxpayers' affairs, rather than confining their inquiries to a single tax type.

- **The taxpayer segment model:** A more recent development among a small number of developed countries has been to organize service and enforcement functions principally around segments of taxpayers (e.g. large businesses, small/ medium businesses, employees, etc.). The rationale for organizing these functions around taxpayer segments is that each group of taxpayers has different characteristics and tax compliance behaviours and, as a result, presents different risks to the revenue. In order to manage these risks effectively, the revenue body needs to develop and implement strategies (e.g. law clarification, taxpayer education, improved service, more targeted audits) that are appropriate to the unique characteristics and compliance issues presented by each group of taxpayers. Proponents of the ‘taxpayer segment’ type of structure contend that grouping key functional activities within a unified and dedicated management structure increases the prospects of improving overall compliance levels. While application of the ‘taxpayer segment’ model is still in its early stages of use, many countries have partially applied this approach by creating dedicated large taxpayer divisions/ units.
71. In practice, the organizational structure of many OECD and non-OECD revenue bodies is a hybrid of the models described, a common structure being one based largely on ‘functional’ criteria, along with a dedicated multi-functional division/ office to administer the affairs of the largest taxpayers. Thus, in practice for these countries there will be a specialized audit function for large taxpayers (forming part of a large taxpayer division/office) and a separate specialized audit organization responsible for all other taxpayers. These units may in turn be organized on a specialized basis (e.g. by industry segment, and/or by tax type, issue (e.g. tax avoidance schemes)).

## Resources for the tax audit function

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72. Revenue bodies typically have at their disposal a finite level of resources to conduct the day to day business of revenue administration. Given the many tasks to be performed and the inevitable decisions that must be made on priorities, a process is required to determine how those resources are to be allocated. In some member countries, revenue bodies have relatively limited discretion as to how staff resources are to be spread across the various areas of work, while in others broad discretion is given to senior management on how resources are to be allocated. Regardless of how the overall budget of resources for audit work is arrived at, a key issue for the audit function is how those resources will be spread over the various segments of taxpayers. Determining how resources might best be allocated is a key element of a revenue body’s strategy for compliance improvement and is dealt with in the following section.
73. The significance of the roles played by the taxpayer audit function, as described at para.9, is evidenced in part by the relatively large proportion of staff resources devoted to this function. In many member countries, the proportion of the revenue body’s overall staff resources devoted to audit and other verification activities exceeds over 30%. Data on staff resource allocations by broad functional groupings in OECD and selected non-OECD countries can be found in the Forum’s information series *Tax Administration in OECD and Selected Non-member Countries: Comparative Information Series (2006)*.

## Strategic management and the audit function

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74. Given the relatively large amounts of staff resources available for audit work and the important roles that audits can play, audits are a key element of a revenue body’s overall strategy for achieving improved compliance with the laws. For this reason alone, the delivery of audit activities justifies a high degree of planning, monitoring and evaluation to ensure that they are contributing in an optimal way to the revenue body’s goal of improved overall compliance with the laws.

75. Until relatively recent times, the audit program of most revenue bodies was a largely “bottom-up” driven activity with the majority of individual cases for audit identified by manual and/or computer-based case selection systems and/or as part of ad hoc industry-based compliance checking projects. While this approach was and continues to be effective in identifying and treating individual cases of non-compliance, a downside is that it does not provide any assurance to administrators, in a strategic sense, that the most important risks to overall compliance, are being addressed in an optimal way. Furthermore, administrators have more recently come to recognize that the behaviours underpinning taxpayers’ compliance in many risk areas are quite complex and broad-ranging and that a more tailored and comprehensive approach is required, rather than relying wholly or substantially on audit activity.
76. In recognition of these factors, there has been a trend for revenue bodies to take a more strategic “top down” view of all compliance risks (including but not limited to the under-reporting of tax liabilities), using a more structured and systematic process to identify, assess, and prioritize compliance risks, and to determine appropriate treatment actions for the major risks identified. This practice—described by the term ‘compliance risk management’—is the subject of the FTA’s guidance note ‘Managing and Improving Tax Compliance’<sup>3</sup>, issued in late 2004.
77. In essence, this approach is intended to assist revenue bodies formulate in a systematic way their overall approach to improving compliance by answering the following sorts of questions :
- What are the key compliance risks to be addressed?
  - Which groups of taxpayers do they relate to?
  - How should these risks be treated to achieve the best possible outcome?
  - How should resources be allocated across the various functions of the revenue body to achieve the best outcome in terms of taxpayer’s compliance.

**Example: Specific compliance risk identification and its communication**

In Australia, the ATO develops an annual compliance program that gives a comprehensive description of each of the major segments of taxpayers (e.g. small and medium-sized enterprises), their tax and compliance profile, the major compliance issues to be targeted, the strategies (both of an audit and non-audit nature) that will be employed to address specific compliance risks, and the results achieved from current year activities. For example, in its 2005-06 program, the program document identifies the following risks concerning the correct reporting of liability-related information for its SME segment:

**SMEs (businesses with annual turnover of \$2 million - \$100 million)**

- Business with a large disparity between economic performance and tax paid.
- Losses- creation and utilisation;
- Capital gains tax;
- Capital management—shareholder loan arrangements;
- Service trusts—payments to associated entities;
- GST/ VAT—including large one-off or unusual transactions, incorrect refunds;
- Cash economy industries;
- Employer obligations—including withholding and fringe benefits tax;
- Superannuation obligations;
- Recent/new measures—examples are consolidations and demergers;
- Aggressive tax planning—both income tax and GST;
- Property, building, and construction industry; and
- Excise—claims for the energy grants credit scheme.

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<sup>3</sup> OECD Guidance Note, ‘Managing & Improving Tax Compliance’ (October 2004).

78. Within this context, the audit programme plays an essential and integral role:
- Audits are the primary treatment for those taxpayers that resist administrative efforts aimed at taxpayers' voluntarily reporting all of their tax.
  - Audits (and associated sanctions) serve to remind taxpayers of the risks associated with the deliberate non-reporting of liabilities, and in so doing may increase confidence across the broader population that deliberate non-compliance is being appropriately dealt with.
  - Data gathered from audit activities is an important contributor to increasing revenue body awareness and assessment of compliance risks, which is essential to devising of appropriate treatment actions.
79. Inevitably, a revenue body's overall strategy for improving compliance will require specific audit strategies. These give a context for decisions based on the research into compliance, and the particular risks which audit staff should be asked to tackle. Without a strategic overview such decisions will be left to local management and the audit programme may not be nationally consistent and, ultimately, or sufficiently effective.
80. Such audit strategies are principally an internal tool, aimed at maximising the ability of any administration to effectively tackle non-compliance. However, they can also be communicated to stakeholders within government and the tax accounting industry as evidence in support of requests for resource, and as part of a "leverage" strategy designed to enhance the wider deterrent effect of the audit programme. An audit strategy must also be supported by adequate management information systems, and performance indicators, so that the outputs from the activities can be related to the outcomes desired from the compliance strategy. Performance indicators can also provide critical information for the purposes of funding, identification of emerging issues, and the development of future programmes.

## Operational management

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81. If the resources dedicated to audit work, in accordance with the strategy, are to be used to best effect then a clear and efficient operational management structure is also required. The following paragraphs illustrate elements of good practice specific to the management of audit teams.
82. **Delegation** – the statutory powers (some of which are outlined above) available to a revenue body must be delegated appropriately so that front line audit teams and their managers can make effective use of them. The principle benefits of this are flexibility and efficiency.
- High work volumes mean that it would be impossible for the head of a tax authority to personally exercise all duties. Delegation provides local managers with flexibility in delivering services to taxpayers.
  - In addition, designating specific powers of delegation and levels of authority ensures that only certain officers may exercise certain powers.
83. The precise way this is achieved depends on the local, social and political organisation, but some principles are key:
- The scope for delegation should be clearly described in legislation – even if it is to be operated on a case by case basis.

- The practice of delegation needs to be documented and well managed. The use of powers always reflects closely on the integrity of the tax administration.

#### **Examples: Delegation of powers**

Australia, Canada and New Zealand all have delegation powers in their respective tax legislation. In these countries, auditors are issued with delegation of authority authorisation cards, the conditions of use for these being strictly defined.

In New Zealand, Revenue Delegations are legislative based decision-making powers devolved from the Commissioner of Inland Revenue to various Inland Revenue positions allowing day-to-day decisions to be made. Auditors have specific revenue delegations that support the auditing function and are able make decisions on behalf of the Commissioner and are responsible for the decisions they make.

84. **Auditor supervision** - refers to how the work of staff undertaking audits is organised and overseen.
85. At the highest level, the organisational structure of audit teams can vary considerably due in large part to the cultural, economic, social and political differences between the societies concerned. Generally, however, the structures adopted are driven in a matrix between two considerations:
- the geographical and political organization within the country; and
  - some segmentation of the customer base; for example on the basis of turnover, tax type or trade.
86. For operational purposes, audit activities are best organised using small teams averaging between 4-8 persons; (for example, New Zealand’s funding process for auditors working in the SME segment is based on the principle of 1 team leader for every 7 auditors).
87. **Team leaders** - should be involved in all phases of audits, including assigning cases, reviewing workloads, checking that correct procedures are followed and reviewing and signing off finished work. Their role is crucially important where they:
- ensure the consistent application of delegated authority, audit standards, policy, procedures and fair interpretation of the tax laws;
  - act as change champions and immediate leaders for organisational change and the training/development of auditors;
  - take a mediator’s role in disputes between the taxpayer and the auditor; and
  - take a key role in ensuring that audits are correctly carried out and evaluating the performance of the auditor.
88. **Scope and intensity of audits** – As noted in Part 1, a revenue body’s management should have a clear statement of policy on the scope and intensity of audits to be conducted.<sup>4</sup>
89. Too many narrowly-focused ‘single issue’ audits may provide for a high level of audit coverage but at the cost of audit quality, tax revenue, and missed opportunities to properly detect taxpayers’ non-compliance (thus potentially weakening the intended overall deterrent effect of audit activity). On the other hand, audit activities that result in an excessive number of in-depth examinations (vis-à-vis the number of more narrowly-focused examinations) will reduce the

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<sup>4</sup> Related to this is the overall number of audits that can be performed. As part of their overall management process, many revenue bodies project the expected numbers of audits to be completed (by type of audit) and monitor actual achievements versus their plans as part of their ongoing programme management approach.

numbers of audits that might otherwise have been conducted, possibly leading also to less overall deterrent effect (simply because far too few audits are being conducted) and, in all likelihood, some degree of antagonization of taxpayers who feel they are being unfairly singled out for excessive scrutiny.

90. Revenue bodies should aim to achieve a balanced program of audits—one that balances ‘coverage’, ‘audit quality’, and ‘overall deterrent’ considerations. (In practice, this is more a matter of subjective judgment than science.) To achieve this in practice, audit officials need clear guidelines on a revenue body’s routine examination philosophy and the circumstances in which an audit might be expanded to cover additional issues of interest, periods of tax liability, and even other taxes.

## **Who conducts the Audit?**

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91. An important issue in audit case working is the assignment of the case to an auditor. In revenue bodies with smaller local offices, the workload available may be the key attribute for allocation. In larger offices, more emphasis is placed upon the matching process of pairing the type or complexity of a tax return with the skill level of the auditor. In situations where a local auditor does not have sufficient technical skills, it is important to be able to call on support from those with more specialised skills – known variously as the industry specialist, the market segment specialist or the issue specialist. As the complexity of business operations increases the need for such specialists becomes more acute.
92. Such specialists receive supplementary training with a primary focus the intended areas of expertise. And the duties are generally two fold:
  - acting as a front line auditor mainly conducting audits within the particular industry/segment for which he/she received training; and
  - acting as consultant - providing assistance to other auditors with respect to any audit activities associated with their specialisation, or as reviewers inspecting the quality of all audits conducted in that area.
93. In order to avoid misuse of the audit function and possible criticism of the revenue body under no circumstances should auditors be given discretion to select their own audit cases.

## **Scope of Audit**

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94. It is necessary to have a proper structure to define what type of audit should be carried out on a case by case basis before the audits begin (full, aspect and single issue)
95. Ultimately this is a question of strategy. The scope of the audit required is defined by the risks identified within the case selection process (see below). But it is felt that there is an advantage in defining the scope of any audit prior to the audit taking place.
96. Selecting the type of audit can occur at various levels of the tax administration (e.g. national, regional or local). Some countries select the audit type during the return selection process. Special teams can be created with expertise in the unique business categories of each taxpayer. This upfront approach channels the necessary resources into the pre-contact stage by using separate technical staff to select issues, prioritise issues and set the scope of the audit.
97. Once the separate team has set the scope of the audit, the local auditor can use limited discretion to alter the scope during the audit. The general rule though is to follow the roadmap provided by the separate unit. The advantage of a separate

approach is that it removes the issue selection process from the auditor who will make decisions on how the issues develop.

98. An alternative to the centralised approach is to transfer this decision making aspect to the regional or local levels. The advantage of a decentralised approach is that it allows the various levels to add local knowledge to the scope setting process. During the audit, additional information will be developed that needs to be examined by the auditor.

## Other case management factors

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99. There are other pre-audit factors that need to be recognised in an efficient audit management structure. In particular these concern assuring the public that the burden of audits will not fall disproportionately on any segment.
100. **Inappropriate auditors** – it is useful to have regulations to preclude individual auditors from repeatedly auditing the same business, and to require an auditor to exclude themselves from taking up an audit where they are acquainted with the taxpayer selected for audit. Such rules protect both auditor and the customer from the danger of such inappropriate contacts.
101. On a similar theme, one country uses a policy titled ‘Repetitive Audit Procedures’. This procedural requirement holds that if a taxpayer is audited for non-business issues only (similar to an aspect audit) for the current year and the audit results in no additional taxes owed, the taxpayer is granted relief from audit for the next two years (except if substantial changes take place). The intent of this policy is to eliminate non-productive and/or time-consuming audits for tax authorities and to reduce the hardship associated with repetitive audits for fully compliant taxpayers.
102. ‘**Audit cycle**’ or ‘**enquiry window**’ - establishes regulations to require that all audits must be started or completed within a predetermined timeframe. This gives certainty to taxpayers that after some period of time the danger of audit will pass. It needs to be supported however by powers of discovery to overturn the enquiry window where substantial tax fraud is found. This is supported in most administrations by a statute of limitations to give the taxpayer some closure with regard to the particular tax year.

### Examples: Time period for amendment of assessments

The UK Inland Revenue has a 12-month enquiry window which begins with the filing or due date of the return and ends 12 months later (no audits would be started beyond this 12-month period unless exceptional circumstances exist).

In New Zealand the Commissioner's power to issue amended assessments is subject to a four-year time limit. The concept of an assessment in the time-bar rule includes all lawful amendments that may have been made to the original assessment. This means that the Commissioner cannot issue an amended assessment increasing the liability for tax once four years have elapsed from the end of the year in which the tax return was filed. Similarly, the Commissioner cannot issue an income statement if four years have passed since the end of the income year that follows the income year to which the income statement would apply.

The limitation periods do not apply in circumstances where, the Commissioner considers that the return is fraudulent or wilfully misleading or the return omits mention of gross income of a particular nature or from a particular source.

103. **Materiality** - is a factor considered in some countries. Although a non-compliant high-risk item may be selected for audit, the materiality of the projected tax consequence versus the auditor's labour cost of pursuing the high-risk item may override the non-compliance aspect.



### **Example: Review of cost effectiveness in the audit process**

In the US, an official form titled 'Cost Benefit Analysis' (Review of Cost Effectiveness of Investigations) is used to measure the cost benefit of continuing an audit. The form is being prepared at a predetermined stopping point in the audit (such as when 60 hours have been expended by the auditor). The form calculates cost benefit by assigning dollar values for the auditor's hourly labour costs and multiplying the cost by the hours projected to complete the audit. The auditor's total labour dollar cost is matched against the projected revenue anticipated (benefit of continuance). A negative cost benefit analysis may result in the early termination of the audit.

104. **Collectibility** is another factor for possible consideration. Some countries use collectibility as a pre-contact consideration and other countries reported that it could become a factor during the course of the audit if bankruptcy were imminent. The collectibility concept implies that a taxpayer's inability to pay a future proposed tax assessment would be sufficient basis for not conducting the audit.
105. Those administrations that do not use this concept report that collectibility is a secondary objective and should not diminish the primary objective of a correct assessment of tax liability. In addition, the limitation of collectibility considerations to the current tax period may not provide a complete financial picture for the taxpayer as it excludes consideration of future payment potential.

## **Publicity as leverage for Audit**

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106. Increasingly, revenue bodies see the establishment of a clear communications strategy at the programme level (though not specifically for audit alone), as crucial to the effective management of compliance and to enhancing the deterrent effect of audit and other compliance activity.
107. There are generally legal limitations on the level of detail that can be put into the public domain. But working within those limits the key elements in such a communications strategy include:
  - Materials aimed at promoting voluntary compliance (e.g. the results of specific audit projects in key risk areas);
  - Many national revenue bodies publish fairly comprehensive details of the results of audit activities in their annual performance and/or statistical reports. For example, the US Internal Revenue Service (IRS) publishes in its annual statistical publication—the IRS Data Book—the aggregated results (i.e. numbers of taxpayers examined, tax assessed, and tax refunded) of all tax audit activities by detailed taxpayer size classification criteria and type of audit.
  - Publicising convictions for tax evasion (acts as a deterrent to the potentially non-compliant);
108. In using publicity to leverage results of audit activity, potential risks identified were:
  - The inability of the tax authority to provide comment to media on some claims by taxpayers in court cases (because of privacy provisions/legislation)
  - Increased publicity about tax non-compliance could lessen public confidence in the efficacy of the tax system
109. On the other hand, identified benefits include:

- Improving the public’s general knowledge about tax issues;
  - Increased support from compliant taxpayers; and
  - Increased compliance among taxpayers who may have trouble complying with their tax obligations.
110. Many countries also publish in their annual performance and/or statistical reports fairly comprehensive details of the results of audit activities. For example, the US Internal Revenue Service (IRS) publishes in its annual statistical publication—the IRS Data Book—the aggregated results (i.e. numbers of taxpayers examined, tax assessed, and tax refunded) of all tax audit activities by detailed taxpayer size classification criteria and type of audit

## Performance objectives and measurement

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111. Audit operations constitute a critical program of the work of national revenue bodies in all OECD countries, given their direct relationship to the achievement of improved taxpayers’ compliance, budget revenue targets and the significant level of staff resources involved. It thus follows that these operations should be underpinned by sound management practices including the development and implementation of a comprehensive set of performance measures/indicators (both output and outcomes-focused) and with close monitoring of the results and quality of operations achieved in practice. In a number of countries, there are formal agreements that tie a revenue body’s performance, including for audit activities, to the achievement of specific outcomes and/or outputs.

### **Example: Formal performance agreements**

In the UK, HMRC is party to a Public Service Agreement (PSA) that commits it to achieve certain outcomes (expressed in terms of targets) for stated objectives. For example:

*Objective 1:* Improve the extent to which individuals and businesses pay the correct amount of tax due and receive credits and payments to which they are entitled.

*Targets:*

1. By 2007-08, reduce the scale of VAT losses to no more than 1% of the theoretical liability.
2. By 2007-08, reduce the illicit market share for cigarettes to no more than 13%; reduce the illicit market share for spirits by at least a half; and hold the illicit market share for oils in GB at no more than 2%.
3. By 2007-08, reduce the underpayment of direct tax and national insurance contributions due by at least £3.5 billion a year.
4. By 2007-08, increase the % of self-assessment returns filed on time to at least 93%.

112. Measuring effectiveness is best done by using a number of indicators, of both outputs and outcomes, as no single reliable measure can capture every aspect of audit effectiveness. These indicators often relate to the structures within which audit work and other compliance are undertaken. In all systems uncovering the causal chains that link a specific activity to a final effect is difficult. It is particularly hard to determine whether compliance has improved due to audit activity or some other causal influences.
113. Nevertheless, it is essential that indicators are devised and used to judge and to improve the levels of effectiveness in audit programmes. Most OECD administrations use several indicators to compensate for the inadequacy of any single measure. In many administrations these indicators form the basis of contracts between the revenue authority and the government on which continued funding levels are predicated.
114. In many ways the measures chosen by revenue bodies will reflect their audit and more general compliance strategies. They will also be influenced by the

practicality (or lack of practicality) of actually measuring the outcomes desired within the strategy.

115. Increasingly, revenue bodies do want to use outcome measures, which show the levels of behavioural change that follow compliance activities, to direct their compliance programmes. In reality, most administrations use output measures for guidance. To the extent that output measures can be fashioned into measures of behavioural impact, they will facilitate better compliance decisions.
116. Output measures, which are described more fully in the following section, provide general benchmarks and standards to evaluate the effectiveness of all aspects of compliance programmes including:
  - case selection & allocation;
  - case planning;
  - productive versus non productive cases;
  - ensuring impacts on case selection, taxpayer and auditor behaviour including complaints mechanisms; and
  - quality assurance.

### 1) Output measures

117. Revenue bodies in OECD member countries use a variety of output-related measures to evaluate audit program performance. Outputs must be measured because they give the most direct evidence of the levels of achievement and, more importantly, trends (both positive and negative) in day to day audit activities. The individual measures most widely used, either in aggregate and/or for specific classes/types of audit activity, are described under the following categories: 1) yield/productivity measures; 2) volume measures; and 3) quality measures. Specific examples of measures applicable to 1) and 2) that are used by many member countries are elaborated in Table 1.
118. **Yield and productivity measures** – The fundamental aim of a compliance audit is to address instances of non-compliance. Monetary measures are an essential output measure of the effectiveness of audit techniques. Particular difficulties with the use of pure yield and productivity measures include:
  - It is necessary to specify the point at which assessed tax and penalty resulting from audit is measured and ensure that that point is reached only after any appeal process is concluded and taken into account;
  - Yield and productivity are usually measured by reference to additional amounts assessed to the taxpayer as a result of the audit. However, in cases where no additional tax is actually collected (e.g. as a result of a successful objection/ appeal) the effect on overall revenue collections is nil and the deterrent effect of the audit intervention is likely to be minimal. Thus, amounts ultimately collected on assessments resulting from audit activity should be measured as part of the overall performance management process to properly evaluate audit activities and guide future decision-making; and
  - There is no guarantee that an audit has detected all understatements of tax liability.
119. It is also necessary to guard against any preoccupation with short term monetary results to the detriment of long term improvements in compliance levels.
120. One response to this is to include within the yield an estimate of the future revenue benefit achieved by an audit. This will push the output yield measures nearer to being a pure outcome measure. This would make it easier to do cost-benefit analyses, and make it possible for managers to allocate resources to audit areas where the real yield is highest.

### Example: Measuring audit yield

In the UK, yield is measured to show whether the revenue body is fulfilling its commitments under the Public Service Agreement with the UK Treasury. Both the 'direct' yield achieved from audit activity, and the 'indirect' yield (the continuing effect of the compliance activity) are taken into account.

121. **Time measures** – These measures essentially fall into two categories:
- those measuring the direct case time taken for each individual audit, enabling an overall average case time to be computed for specific types of audit;
  - those measuring the average direct and indirect case time of audits, noting that some of the time spent by audit staff cannot be related directly to individual cases; and
  - those measuring the time elapsed for each audit (i.e. the time between audit commencement and audit completion).
122. Time measures such as these serve a number of purposes. They can be used to estimate the expected number of audits that may be completed over a planning horizon for audit programming purposes, or alternately they might be used as part of a business case for additional audit resources, leading to projections of additional tax revenue that might flow from an expansion of audit activity.
123. They might also be can be used to gauge positive or negative trends in auditor performance. For example, reductions in average case times for a class of audits may indicate, on the one hand, increased efficiency resulting from the use of streamlined audit techniques or, on the other hand, they may reflect a failure by an increasing number of auditors to properly pursue and settle all of the issues relevant to an audit. A deterioration of average cases times may be due to any one of a variety of factors (e.g. less experienced audit officials, cases of increased complexity, and/or unco-operative taxpayers). Accordingly, these benchmarks do not of themselves accurately indicate good or poor performance and, in the main, point to the need for further inquiry to understand the underlying reasons for the trends being observed.
124. When setting targets with time limits there is a danger of adversely affecting the behaviour of auditors - an auditor may compromise the quality of their work in order, or neglect larger or more difficult cases, to meet a time target. On the other hand, an absence of time limits may encourage the auditor to spend excessive time pursuing insubstantial extra amounts of yield. These considerations point to the need for close management of work-in-progress by audit supervisory staff.
125. **Volume and coverage measures** – It is very important to measure the volume of audits undertaken, while some revenue bodies also measure the extent of audit coverage across particular classes of taxpayers either in pure numbers or as a percentage of the target population. Presence in the population is the basis for the deterrent effect of audit activity.
126. It is also of the utmost importance that audits are carried out to a high standard. Large numbers of poor quality audit activity is likely to have a detrimental effect on compliance. Thus volume and coverage measures in themselves may not give a reliable indication of the real effectiveness of the audit programme. In the absence of any practical ways to take complexity into account within the measure some count of audits started or completed each year is a feature of all administrations measurement schemes.
127. **Quality measures** – It is important to include within any basket of output indicators some measures that can be used to gauge the quality of the audit

process. Generally, this will involve allocating experienced audit staff within the revenue authority to carry out a predetermined set of audit quality checks on a sample of completed cases. This can cover both the audit process and audit results using a system of quality scores. This may be done by a team leader, some independent quality verification body, through feedback from the appeals systems, or a combination of these approaches.

128. Some measures will allow an assessment as to whether the casework meets the required standards, and will enable managers to intervene where a case has reached a certain milestone, for example a complex technical decision. Such quality assurance procedures may also ask team leaders to report on cases where the case has exceeded a set of timeliness standards. Such a process provides for an early warning that the auditor needs additional support, or that there is a need to review the audit plan.
129. A good quality audit is one that is: 1) focused on the targeted risks; 2) technically correct; 3) procedurally correct; and 4) referenced correctly.

**Table 1. Measures of audit yield, productivity, and volume**

<b>Measure</b>	<b>Definition</b>	<b>Comments</b>
Total assessed tax and penalties	The aggregate value of assessments resulting from all audit activities or by class/type of audit activity.	This measure provides an initial indication of the additional revenue that may be expected from audit activities; in practice, settled disputes in favour of the taxpayer and any non-payment reduce the amount of revenue ultimately collected.
Total revenue collected in respect of assessed tax and penalties	The aggregate value of revenue collected within the fiscal year from that year's audit activities.	This measure reflects actual revenue collections and its quantum may be influenced by the 'quality' of assessments raised and the time taken to resolve disputes.
Average tax and penalty per case (i.e. taxpayer)	The total value of assessed tax and penalties divided by the number of completed audits (including non-productive audits), noting that an audit may cover multiple years and taxes.	This measure may reflect, in broad terms, the extent of non-compliance detected from audits undertaken.
Number of completed audits, both productive and non-productive	The aggregate number of completed audits from all audit activities over a defined period. This number might be broken down into sub-categories (e.g. by class /type of audit, tax type)	This measure may give a sense of overall coverage of the taxpayer population, as well as indications of the relative mix of different audit class/ types where these data are available
Average tax and penalty per unit cost	The total value of assessed tax and penalties divided by agreed unit cost measure (e.g., the cost of employing one audit official for a full year).	This measure reflects an indication of the net return on investment.
Relative size of understatements detected	The total value of adjustment made as a result of audit as a proportion of total assessed liability	This measure reflects an indication of the relative level of detected non-compliance from the audited population of taxpayers.
No change/ adjustment rate	The proportion of audits where no assessment results from the examination undertaken.	Trends in this ratio may reflect the quality of underlying case selection processes and/or audit examination techniques.

## Outcome Measures

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130. Audit programmes are designed to deliver a number of benefits to the administration of a community's taxation system. These include enforcing compliance, educating taxpayers, minimising disruption to compliant taxpayers and targeting non-compliant taxpayers to ensure a return on the resources allocated to audit activities. Other positive effects are also sought, such as influencing compliance in the broader community, providing a level of assurance that the system is working as intended, promoting public confidence by providing a high profile compliance programme and displaying the fairness of the compliance processes. These benefits all contribute towards the desired outcome of audit work, which is to increase taxpayer compliance.
131. It is fully recognised within the compliance community that such outcomes are the most appropriate way ultimately to judge the effectiveness of activities to treat non-compliance. But it is also recognised that the evidence to support such indicators is difficult to establish, and improvements are difficult to measure (even within well-established parts of the compliance strategy such as the audit programme). And a pragmatic approach will usually move administrations towards the use of feasible and practical measures – and therefore output based measures. A broad consensus is nevertheless developing around the use of a few key outcome indicators:
- Objective measures of the amount of non-compliance within the economy – so called tax gap measures. These can also be run on a sector specific basis;
  - Measures of changes in customer behaviour over time – particularly around filing and payments risks;
  - Measures of customer awareness and attitude to audit and non-compliance; and
  - Measures of the quality of audit processes – testing adherence to published policies and procedures and the technical accuracy of decisions.

### **Examples: Evaluating audit impacts**

One approach for verifying the impact of audits on future compliance behaviour is to establish and evaluate the behaviour of a test group of audited taxpayers and compare these results to a control group of non-audited taxpayers. This will provide a valid comparison of the effect that the audit activity has had on the test group. The data from this approach can eventually be used to estimate the parameters of econometric models in order to quantify the effect of audits on compliance.

In the UK, HMRC uses an outcome measure as their key strategic target - a specific reduction in the VAT Gap by 2006. This has involved taking a new strategic approach to compliance to 1) understand the size and nature of the problem; 2) set clear objectives and outcome-based targets; 3) identify resources and tactics needed to tackle the problem in an integrated way; and 4) monitor effectiveness and redirect resources as necessary. The intervention then planned to deliver the target have included legislative changes, publicity, tighter controls and better regulatory tools for dealing with missing trader fraud, incentives to encourage registration, increased resources, and better targeted compliance activities.

132. Quality outcomes have generally been measured in terms of adherence to correct audit procedures, and appropriate application of tax law. It is also possible to measure quality outcomes from audit activity in terms of the taxpayer reaction to the audit process. It is difficult for a taxpayer to be neutral when it comes to assessing an unfavourable audit outcome. With this reservation, customer satisfaction surveys can provide useful information on how the audit activity is considered among the public.

### Example: Sampling taxpayers to gauge impacts

In the UK, a sample of taxpayers and/or their agents are surveyed at the completion of direct taxes audits to gauge their understanding of the process and their perception of the tax authority's taxpayer relationship management. To help improve audit processes and encourage compliance, this can be seen as a positive initiative.

## Evaluation of audit activities

133. As discussed earlier in this part, audits are a major program activity in any revenue body and their efficiency and effectiveness should therefore be kept under constant review. With this objective in mind, revenue bodies need to adopt a comprehensive and holistic approach to the evaluation of audit activities, ensuring that they employ a robust set of measures to gauge the direct and indirect results. One revenue body's approach, with an emphasis on measuring the outcomes achieved, is described in the following example:

### Example. An outcomes-based performance standard for audit activities

In order to assist its ongoing evaluation of tax audit activities, New Zealand IRD has devised a comprehensive performance standard designed to encompass the impacts and outcomes from tax audit activity. The key elements are as follows:

**Compliance review task:** The objective is to measure taxpayers' compliance behaviour following an audit via a post-assessment audit review. The key measures to be used are:

- The % of taxpayers reviewed found to be compliant and the trend compared to the previous year's result.
- The % of taxpayers who changed their behaviour compared to those who needed to change their behaviour, and the trend compared to the previous year's result.
- Analysis of the types of change in behaviour.

**Compliance tracking analysis:** The objective is to evaluate the compliance patterns of a group of audited taxpayers compared to a control group of non audited taxpayers. This measure will be run and tracked during 2005/06 but will not form part of the measurement standard this year. The key measures to be used are where audited taxpayers':

- Assessed income tax and GST increases to a greater extent than that of the control group;
- The ratio of late payment penalties to payments due and returns filed shows greater improvement compared to the control group.

**Taxpayer education provided:** The objective is to measure the education provided to influence taxpayers to comply with their tax obligations. The key measures to be used are:

- Derived from QMP:
  - The % of taxpayers who received education about compliance risks that did not result in a discrepancy;
  - The % of times education was provided in relation to discrepancies
- Derived from CRT:
  - The % of taxpayers who were provided with education in the previous audit;
  - The % of taxpayers who received education in the previous audit, compared to the % of compliant taxpayers who were not given education in the previous audit.

Results will be calculated for each year and compared to the previous year(s) to establish a trend.

**Survey of audited taxpayers:** The objective is to measure businesses' understanding, expectation and perception of audits; their suggestions for improvement; and the likely effect of audit on future compliance behaviour. The key measures to be used are:

- Taxpayers' expectations of frequency of audit.
- Perceptions of IRD's professionalism.
- Level of influence audits are perceived to have on future compliance.
- Whether the audit was helpful in meeting future tax obligations.

**Media profile:** The objective is to measure audit's profile in the media as this is linked to compliance. The key measures to be used are:

- Initially, the number of audit-driven or audit-related media items will be tracked.
- In 2005/06 a deliberate and structured media strategy for Audit will be developed and we will measure actions taken against it to enhance Audit's profile, or actions taken against a wider organisational media strategy encompassing Audit.

**Voluntary disclosures:** The objective is to measure voluntary disclosures, as they show improved voluntary compliance as the taxpayer self-corrects their incorrect tax position. The key measures to be used are:

- The % change in the number of cases opened and closed, the value of discrepancies and the volume of business hours spent on voluntary disclosures (made when an audit is not underway) compared to previous benchmarks.
- The % of voluntary disclosure cases (made when an audit is not underway) that result in spin-off audit cases.
- Number of voluntary disclosures and the % of value of voluntary disclosures (made when an audit is underway) compared to discrepancies found during all risk audits will be assessed to form a benchmark to compare to future results.



## 4 AUDIT TECHNIQUES

### KEY POINTS

- There should be a comprehensive documented set of audit policies and procedures that is readily accessible to all audit staff.
- Audit policies and procedures should be based on principles of accuracy, efficiency, fairness, objectivity, transparency, completeness, consistency, and defensibility.
- Revenue bodies require a systematic approach to the planning of individual tax audits.
- The efficiency and effectiveness of audit activities can be greatly facilitated by a broad range of support tools (e.g. industry benchmark data, business specific guidance materials, IT facilities, and the use of indirect income measurement techniques, an EDP audit capability).
- Good quality working papers are an integral element of a finalized audit.

134. This chapter examines some common principles of good practice around the conduct of individual tax audits, and attempts to give a broad overview of the elements required within an effective and improving audit regime.

### Key principles

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135. The success of any audit programme has a direct relationship with the quality of the individual audits that comprise that programme.
136. There are a number of key principles that apply to quality audits which are visible in the audit programmes already in place in OECD administrations, regardless of jurisdiction or revenue type. Following these principles is not intended to take away or limit the authorities granted through legal or procedural guidelines. Rather they are descriptive of the manner in which an audit should be conducted;
- **Accurate** - They identify non-compliance, entail a correct interpretation of the law, and lead to a correct assessment of liability.
  - **Efficient** - They minimise the compliance burden on the taxpayer and minimise the use of the revenue body's resources in terms of the outcome delivered.
  - **Objective** - All decisions made are based on facts.
  - **Transparent** - As issues are developed and fully documented in the work papers, these developments are generally discussed with the taxpayer during the course of the audit.
  - **Fair** - Technically accurate and procedurally correct in accordance with domestic laws and policies.
  - **Complete** - The audit has a defined start and end point and the taxpayer knows when the audit process is complete.
  - **Defensible** - The decisions made in the audit and the actual audit process can stand up to external scrutiny.
  - **Consistent** - The same taxpayer circumstances should produce the same result regardless of which auditor undertakes the audit.
137. The likelihood of an audit displaying these principles is dependent upon the quality of audit procedures and the subsequent audit planning and management.

## Audit support tools

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138. In order to deliver quality outcomes, auditors need access to approved procedures, policies and tools. Obviously, such products vary considerably with the variety and complexity of the regimes administered by individual tax administrations. Nevertheless it is possible to identify certain pre-requisites that must be in place if auditors are to be able to carry out their work efficiently.
139. The first essential tool is a comprehensive audit manual. Such a tool can help to achieve consistency when dealing with taxpayers, the proper interpretation of legislation, and the correct use of operational procedures. It can also assist in the interpretation of information and in responding to requests for information by external bodies (e.g. Government, ombudsman, complaints etc.)
140. The manual(s) will generally be published in an electronic format, to ensure ease of updating and made available to staff via the revenue body's Intranet. In addition, versions are made available to the general public (sometimes in edited form) by some revenue bodies to provide transparency around the administration's procedures and standard interpretations. They should contain guidance on:
- The legislation and its interpretation;
  - National policy and compliance strategy;
  - Operational management and QA/QC procedures;
  - Case management techniques.
141. Many administrations build on their formal guidance by producing process maps to explain and simplify sometimes complex operations. They are easily modified so that steps are quicker and more straightforwardly shown i.e. how various areas/relationships fit together. It is able to show, at a glance, what each party should do, and when, within a process.
142. The conduct of audits will also be facilitated if audit officials can prepare their plan of audit with some awareness of how particular industries and businesses are conducted and the likely level of profitability and expenses that might be expected of a business of a particular size and in located in a particular region. To this end, a number of revenue bodies have developed systems of industry/business profiles and/or provide industry benchmark data obtained from various sources— see examples below. More detailed information on the use of industry benchmarks and business guidance can be found in the accompanying note *'Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Techniques'*.

### **Examples: The use of industry benchmarks and business guidance**

In the United States, the IRS has established an extensive series of 'Audit Techniques Guides' (ATGs) that focus on developing highly trained examiners for a particular market (industry) segment. The guides, which are made public, contain examination techniques, common and unique industry issues, business practices, industry terminology and other information to assist examiners in performing examinations and, in particular, highlight unique issues and approaches that may be relevant for an industry/ business type using one or more of the various indirect income measurement techniques.

In the United Kingdom, HMRC holds detailed reports on specific industries. These reports explain how an industry operates and provide information about industry performance and trends. The industries that HMRC hold reports on tend to be ones that have, from experience, been non-compliant. The reports are called 'Tactical Information Packages' (TIPs). These reports are used to provide background on an industry before an investigator begins an enquiry. They are also used to help the investigators create "business economics models (BEMs)".

In Australia, the ATO derives industry benchmarks from data disclosed principally in monthly (for larger taxpayers) and quarterly (for SMEs) Business Activity Statements (BAS) required from all businesses. (A BAS is an integrated return form required from businesses, generally monthly or quarterly, to report all of their regular tax liabilities and payments.) Some benchmark data are also derived from return labels of annual tax returns for self-employed taxpayers, partnerships, trusts and corporations. These benchmarks are used to identify 'outliers' that fall outside the norms and the accepted tolerances and to assist audit officials gauge the potential understatement of reported sales/ net profit etc.. For the purposes of outlier detection, taxpayers are segmented into fine industry levels and turnover ranges. Seven ratios are used to measure the performance of a business and to highlight potential anomalies.

In Germany, benchmarking of industries has been used for over 15 years by tax authorities to identify taxpayers who fall outside industry norms, to test the declared income of businesses, and to make estimations of income in the case of taxpayers with incomplete books and records. The underlying principle is that businesses of comparable size working in the same industry should perform similarly. Benchmarks exist for 147 industries and are updated annually. Until 2005, auditors conducted test audits to develop the country-wide benchmark data. From 2005, benchmarks have been prepared drawing on data from all completed audits. On a full year basis these number around 180,000. The procedure of obtaining the industry benchmarks was changed to reduce costs for the revenue body administration and to facilitate the provision of data that reflect regional characteristics.

For the purpose of developing industry benchmarks, relevant taxpayer information reported in tax returns, adjusted for the results of audit activity, along with the taxpayer's unique industry code (based on the Government wide system of industry classification) are captured by local tax offices and compiled on regional databases that are made widely accessible to audit officials.

143. It is becoming increasingly important, insofar as local technology allows, to supply IT based tools to support the audit teams in their work. These tools are (as with the guidance) as multifarious as the regimes they are being used to review. But in general they fall into three categories:

- Support for audit planning and processes including access to on line guidance.
- Access to data and tools with which to test the records and returns entries within audit.
- Laptop based tools to meet the operational requirements of auditors in the field.

#### **Examples: Audit IT support tools**

Support for audit planning and processes including access to on line guidance:

New Zealand Inland Revenue has recently introduced a Compliance Based Auditing framework designed to streamline its previous auditing task structure and to assist auditors to complete a more complete risk analysis before opening a potential case. The framework provides an electronic template that is an easy-to-use "one stop" tool for investigators to record identified risks, prepare case plans, produce standardised work papers, and schedule queries and discrepancies. Administrative tasks involved with audit cases are reduced considerably by using the template which automatically transfers data to the appropriate plans and schedules. The standardisation of the package facilitates information sharing among investigators and transfer of cases to another investigator when necessary.

Access to data and tools with which to test the records and returns entries within audit:

In New Zealand, various IT tools are used to bring together data to identify risk areas and cases selection options. A data warehouse tool is used to mine data from the central database and this data is then imported into a tax audit selection system [TASS] tool.

Laptop based tools to meet the operational requirements of auditors in the field:

- Private Affairs Analyzer, a database tool for analyzing whether there is sufficient funds to support the living style of the taxpayer.
- Various calculators

- Use of I2 Analyst Notebook (a charting and analysis tool for looking at relationships between complex information – good for looking at complex schemes etc)
- Summation (a document management tool)
- Wireless connectivity so that auditors can have access to all internal support references while working off-site.

A custom designed system is also used in the USA to automate the examination process from case-building and assignment to assessment and archiving. The system, for example: computes tax, penalties and interest; proposes adjustments; provides for automated case building; provides the taxpayer an accurate, legible, and easily understood audit report where the tax law and interest computations have been uniformly applied; and provides immediate access to appropriate account data for the taxpayer, therefore allowing for timely responses.

In Canada, an integrated audit tool called Windows Audit Laptop System is used. It contains a collection of audit working papers, forms, reports and letters. It provides strong automated capability for effective audit operations at the field level.

In Australia, laptop computers provide the necessary tools for audit staff to perform their duties:

- audit procedures across all compliance areas and market segments are developed in a consistent format and style, and are located on one central intranet site. Process maps are used to summarise and navigate the audit procedure
- electronic data software applications are provided on the laptops for auditors to perform data analysis and other computer audit techniques
- a portable reference tool that is downloaded to the laptop is used by auditors to access procedural, policy and technical information offline when working remotely. Regular updates are made using a purpose built synchronisation programme
- audit staff may connect remotely to ATO mainframe systems and network applications using dial-in technology. This enables them to view taxpayer and other records while in the field, and
- electronic worksheets, case management systems, and other automated tools used in audits are available on the laptop.

## Audit Planning

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144. A comprehensive and responsive audit planning process is the key to the proper use of audit techniques, and the completion of an audit in line with the principles outlined above.
145. This process starts with the preparation, prior to the beginning of the audit, of a written plan containing a list of prioritised risks and issues identified at that time, the data needed to test those areas of risk, and a list of interview questions for inquiries with the taxpayer, their representative and/or other parties.
146. This plan provides a path to follow to ensure that the audit is performed effectively and efficiently. However, it should not be treated as set in stone once created. Case planning must be a flexible tool and the original audit plan should be reviewed and updated regularly during the course of the audit. Characteristics of effective audit plans are:
  - flexibility to allow for unusual audit issues, adequacy of internal controls and the adequacy of books and records;
  - alignment with any quality assurance framework; and
  - a clear focus, with potential areas of concern noted during the preliminary review and audit procedures selected that will address the concerns identified.

147. The plan should also include some degree of issue prioritisation. Once a return has been selected for audit, the audit plan is analysed again for possible non-compliance impact and/or materiality. An issue sequence is established according to the relative weight of each issue. As the audit progresses, at the discretion of the auditor, if the highest impact issues are resolved without tax consequence, the lesser impact issues may be abandoned on the grounds of diminished risk.
148. The following example illustrates the sorts of tasks that need to be completed in devising a useful audit plan.

**Example: Taxpayer profiling in the Australian Taxation Office**

Taxpayer profiling is the development of a thorough understanding of the taxpayer's compliance behaviour and their business. The following tasks should be completed:

**Review basic tax information:** The auditor should determine:

- Whether the return was filed by due date;
- Whether required schedules are were completed;
- Whether taxes are were overdue; and
- Whether financial statements have been filed with other statutory authorities.

**Review the taxable income and tax amount calculated:** The auditor should determine:

- Whether carry over loss, exempted income and deducted income were properly applied;
- Whether accumulated income tax is properly calculated; and
- That the tax amount and tax credit are properly calculated.

**Review financial statements:**

- Perform trend analysis on major accounts.

**Review changes in paid-in capital and major shareholders**

- Review stock exchanges between affiliated companies
- Review stock exchange tax return filed at district tax office

**Review on transfer pricing issues of international issues**

- Review transfer pricing
- Review the flow of funds to or through tax havens
- Examine arms length dealings;
- Research any Advance Pricing Arrangements.

**Review the taxpayer:** The auditor should examine:

- Organisation chart
- Major products
- Functions of each part of enterprise
- Review the documentation relating to tax planning strategies
- Consider taxpayer's use of e-commerce
- Third party information

If an area, which has been targeted by the case plan, is not yielding any signs of discrepancies, the auditor should move on to look at other issues. This method achieves maximum coverage, combined with efficient use of time.

## **Pre-contact Analysis & Case Selection methods**

149. The first key to successful audit is in the case selection methodology. Case selection through the use of risk management techniques is necessary to ensure that the audit programme is fully in line with the administrations compliance strategy, and to set up the necessary audit trails to show why cases have, and have not, been made the subject of an audit. This subject is dealt with in some detail in

companion papers to this document,<sup>5</sup> the second of which also gives detailed case studies of some case selection frameworks in place.

150. Pre-contact analysis is considered an essential part of the audit process. Time invested here can pay dividends in terms of a reduced burden on taxpayers and reduced compliance resources expended during the audit. As the name suggests, this activity takes place before the audit begins, and where a thoroughgoing risk management process is in place, is an essential part of the risk analysis and prioritisation process<sup>6</sup>. In other circumstances the activity will be carried out by the auditor in preparing the audit plan.
151. One element of many case selection procedures that usually sits within audits teams is the manual review or screening of tax returns. There are a number of key facets in this process.
- Screening needs to be supported by appropriate training and guidance regimes, and to be fully integrated with the risk management process. The screening role can be carried out in local audit teams or in specialised (and centralised) units.
  - The process is monitored to assure accuracy and the proper application of guidance. There are two general techniques:
  - **Managerial Review** is a centralised screening procedure in which, a supervisory official reviews the work of the employees in the centralised unit. If the screening takes place at the local office, the auditor's manager conducts the quality review.
  - **Secondary Review** is a centralised review function, which is responsible for all case processing activities. Once a no-audit decision is made, a sample of no audit cases is forwarded to the central review function for quality assessment. This activity may also be conducted as a post closed case review.
  - An essential part of any such screening review is a review of prior audit history of the taxpayer, looking for evidence of previous issues with tax compliance, or conversely confirmation of a previously blameless compliance history.
  - Where IT-based initial selection procedures are in use, the physical screening is usually a second order check, to validate the decision to audit or to give evidence supporting a decision not to audit.
  - Written documentation of a no-audit decision is usually required.
152. The level of other pre-contact work will largely depend on the complexity of the affairs of the customer concerned, and the tax risks identified during risk assessment. Nevertheless they can be categorised into four general headings:
- Reviews of unreported income
  - Intelligence gathering
  - Reviews of prior compliance history.
  - Returns preparer performance
153. **Unreported income** is a critical element of the audit process and can be prevalent in many small businesses. The pre contact work must review evidence for potential under reporting. In particular:

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<sup>5</sup> OECD Guidance note *'Managing & Improving Tax Compliance'* (October 2004) & OECD Information Note *'Audit Case Selection Systems'* (October 2004).

<sup>6</sup> OECD Guidance Note *'Managing & Improving Tax Compliance'* Chapters 2 & 3 (October 2004).

- the auditor/risk assessor might carry out additional analysis of the tax return to ensure that all income is properly reported using such techniques as gross profit reviews (comparing this business to commercial standards in similar businesses), and cash flow analysis (looking at the flow of cash receipts and payments on a daily basis if possible, to identify any idiosyncrasies);
- in addition, minimum income verifications- may be identified during the selection process to address unreported income. These minimum verifications may vary depending upon the type of return examined (business versus non-business), the cash nature of the business or other attributes.

154. **Intelligence gathering** – this is an essential part of the risk assessment process, but where data is not available prior to case selection, auditors need to ensure that all relevant intelligence from internal and external sources is gathered together to inform the audit plan.

- Internal sources of information include bank interest and other financial details, prior/subsequent tax returns on file and third party information for interest, dividends, or other income payments to taxpayers.
- External resources include anything available in the public domain or by use of formal information requests from public bodies such as local authorities, and with the advent of Internet the list is unending. Thus it is very important to keep control of the resource costs in compiling additional data compared to the potential benefits in more effective audit.
- In some administrations auditors are allowed to observe business activities discreetly. Most countries prohibit this practice for privacy reasons.

155. **Reviewing prior compliance history** - A common technique is to get the tax returns from multiple tax years for comparison of income, expense or balance sheet issues. Some countries formalise the review process with ratios to gain a better perspective on the overall picture of the taxpayer's track record for tax compliance.

**Examples: Analysing returns to detect potential indicators of noncompliance**

The Australian Taxation Office (ATO) uses a variety of ratios to analyse taxpayer behaviour. The comparison of relevant figures provides a means by which trends can be identified and comparisons made to a business's historical and related industry results.

The ATO will base its analysis on a number of *Essential Ratios* derived from three different categories:

- *Profitability Ratios*; these ratios indicate the profitability and financial strengths of the business by comparing profits or earnings with sales, expenses or assets.
- *Capital Structure Ratios*; these ratios indicate whether the business is able to meet its debt in the short term, for example by comparing debt with equity or earnings with interest.
- *Income Tax Risk Ratios*; these ratios compare a business's tax payments with its income, taxable income or profits to indicate the likelihood of those payments being inadequate.

The ATO will then use *Supplementary Ratios* from each category to further test and refine any conclusions drawn from the *Essential Ratios*.

The ATO will also use *Liquidity Ratios*, comparing a company's debt repayment liabilities with its assets, liquid assets or cash. This could help to determine a company's ability to pay any outstanding tax liabilities that an audit might uncover.

In New Zealand, various IT tools are used to bring together data to identify risk areas and cases selection options. A data warehouse tool is used to mine data from the central database and this data is then imported into a tax audit selection system [TASS] tool.

The TASS tool brings together a range of internal information including:

- Number of Outstanding Returns - Data Warehouse.
- Total Debt Outstanding – Data Warehouse.
- Shortfall Penalty Imposed - Data Warehouse.
- Number of Open Audit Cases.
- Number of Closed Audit Cases.
- Anonymous Information - Anonymous Information register.

For each potential audit candidate, financial data is also extracted from the following sources for the current year and the preceding four financial years:

- Trading Account.
- Profit and Loss Account.
- Balance Sheet.
- Income Tax Returns.
- GST Returns.
- Payroll Returns.
- Fringe Benefit Tax Returns.
- Accident Compensation Corp Returns.

The TASS tool provides value in that:

- All of the risks are identified.
- Each candidate has an overall score and candidates with the highest risk can be targeted.
- There is a flag to indicate that Anonymous Information is held.
- It is time saving resulting from not having auditors collating the data for each candidate.

156. **Returns preparer performance** – it is a common practice to consider the firm or individual who prepared the return as a factor in selecting returns for audit. The use of this standard varies from country to country.
157. One policy holds that if the preparer is perceived as a risk to the health of the tax system, additional scrutiny may be exercised. Another policy suggests that the promotion of tax avoidance schemes by a preparer is justification for audit selection. Other standards for returns preparer audits include poor performance, defrauding taxpayers, filing false tax credit claims, negligence and fraudulent performance. Advance managerial approval is generally required to expand the scope of a return preparer investigation to include all tax returns prepared by the individual or firm.

## Examination Techniques

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158. An auditor will apply various techniques to examine the books and records behind a return. These will vary with the customer and the tax regime concerned. Broadly they will adhere to a few key principles:
159. **Analytical review** - An analytical review of financial statements and returns as filed is often completed during the preliminary stages of the audit.
160. Ratios, such as gross profit and inventory turnover ratios, are used to test the accuracy of a taxpayer/registrant's reported sales, cost of sales, or ending inventory; unusual variances are noted and addressed during the interview with the taxpayer/registrant and additional audit procedures developed where necessary.
161. **Investigative approach** - Auditors are encouraged to use an investigative approach in their audits. Such an approach uses information obtained through observation, discussion, documents or records obtained from either the taxpayer/registrant or from other sources; it requires judgement, imagination and using information outside the accounting records to perform the audit.



162. Field examinations are also utilised as opportunities for gathering information on significant events such as (i) backdoor trade, (ii) disguised transaction, (iii) shift of investments, and (iv) other data concerning transactions regarded by the auditor in charge as having potential linkage with discovery of irregularities. They also include on-sight survey of the current conditions of the taxpayer's business through on-the-spot physical checks of original transaction records and vouchers; assets and liabilities such as cash, accounts receivable, inventory assets, and accounts payable; and other contents of business.
163. **Records Examination** - the main approaches to detect false accounting include the examination of books and documents conducted at the taxpayer's business office or branches, counterpart examinations and examination of savings and deposit accounts. Examples include:
- Cross-checking purchase and sales invoice to look for the possibility of off-record sales;
  - Cross-checking declared sales with money deposited into bank accounts to identify indications of diverted income;
  - Cross-checking appointment or order books with sales invoices to look for the possibility of off-record sales; and
  - Checking purchases and sales invoices for any information that might indicate forms of ancillary income.
164. If the business supplies computerised records, products such as 'IDEA' or 'ACL' can be used to interrogate the records and pick up anomalies or points to investigate further.

#### **Examples: EDP audit activities**

In Canada and the USA, accounting systems are analysed and documented by electronic commerce auditors, who are specialized in the audit of electronic records. They perform data extraction and conversion for subsequent use by the audit team. They also perform Record Retention Evaluations and participate in the preparation of Record Retention Agreements with large business to ensure that the relevant data is accumulated in anticipation of a comprehensive tax audit.

In the Netherlands, EDP-audit is fully integrated into the audit process. EDP-auditors are to be (at least) consulted in every audit. The EDP auditors support all stages of the audit process. A number of other countries including Denmark, New Zealand, Australia, Sweden and Austria use computer audit techniques.

165. **Third party information/Counterpart examinations** - Where warranted, information can be obtained during the course of an audit from third parties to verify the taxpayer's income, for example:
- financial institutions and public companies information on interest and dividends matched with what taxpayers report in their tax return;
  - information from Government regarding social benefit payments, and employer information concerning salary and wages paid and tax deducted , both for income and non-monetary benefits;
  - matching foreign source income; and
  - other parties, for example notices may be issued to real estate agents demanding that they release information on an individual's rental income.

### Examples: Using third party information reports

In Mexico, relevant third party information is cross checked against annual tax return information to identify non-reported income and calculate the correct VAT liability of a taxpayer e.g. information from government suppliers, customers and suppliers reports, and credit card transactions is used. Calculations are carried out on an annual basis at central office, and more frequently at local offices.

In Japan, large volumes (over 158 million per annum) of third party data covering over 40 different payment categories for the personal tax are electronically matched with taxpayers' examination files and used to identify potential areas of risk and to assist determine the breadth of inquiries to be undertaken by audit officials.

## Use of indirect methods to verify income

166. In the SME sector, in particular, there is a great risk that the auditor will see no clear audit trail or adequate records to support a proper calculation of the tax liability. Indirect methods of verification and re-calculations of profits are therefore essential tools to bring audits to an effective conclusion. There are a variety of methods and the extent of their use varies across revenue bodies. Some common examples, drawing on descriptive material in the US Internal Revenue Service's Examination Manual are provided hereunder, while more detailed information and a number of case studies can be found in the accompanying note '*Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Techniques*'.

### 1) Source and Application of Funds Method (also known as the T-account method)

<b>Description of method</b>	The Source and Application of Funds Method of reconstructing income to determine the actual tax liability is an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is unreported taxable income.
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### 2) Bank Deposits and Cash Expenditures Method

<b>Description of method</b>	<p>The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds. It is based on the theory that if a taxpayer receives money, only two things can happen: it can either be deposited or it can be spent. This method is based on the assumptions that:</p> <p>244. Proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts.</p> <p>244. Outlays, as disclosed on the return, were actually made. These outlays could only have been paid for by credit card, check, or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for. It is the burden of the taxpayer to demonstrate a nontaxable source for this cash.</p> <p>The Bank Deposits and Cash Expenditures Method can be used in the examination of both business and nonbusiness returns. It may supply leads to additional unreported income, not only from the amounts and frequency of deposits, but also by identifying the sources of such deposits. Determining how deposited funds are dispersed or accumulated (to whom and for what purpose) might also provide leads to other sources of income.</p> <p>If the Bank Deposits &amp; Cash Expenditures Method indicates an understatement of income, it may be due to either unreporting of gross receipts or overstating expenses, or a combination of both.</p>
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### 3) Markup Method

<b>Description of method</b>	<p>The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's Gross Receipts. By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of relevant declared items in tax returns, official data of Government statistical bodies or industry publications. However, it is preferable to use the taxpayer's actual markups if possible.</p> <p>The Markup Method is a formal indirect method that can overcome the weaknesses of the Bank Deposits &amp; Cash Expenditures Method, Source &amp; Application of Funds Method, &amp; Net Worth Method, which do not effectively reconstruct income when cash is not deposited and the total cash outlays cannot be determined unless volunteered by the taxpayer. If personal enrichment occurs that cannot be identified, the effectiveness of these methods is diminished. For example, the possibility exists that significant personal acquisitions or expenditures are paid with cash &amp; are not evident.</p> <p>The Markup Method can also be used when conducting audits of indirect taxes (e.g, retail sales taxes). The cost of goods sold is verified and the resulting Gross Receipts are determined based on actual markup. This method is most effective when applied to businesses whose inventory is regulated or purchases can be readily broken down in groups with the same percentage of markup. An effective initial interview with the taxpayer is the key to determining the pertinent facts specific to the business being examined.</p>
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### 4) Unit and Volume Method

<b>Description of method</b>	<p>In many instances Gross Receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer. The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books as the records under examination may be adequate as to cost of goods sold or expenses. In other cases, the determination of units or volume handled may come from third party sources.</p> <p>This method for determining the actual tax liability has been effectively applied in carryout pizza businesses, coin-operated laundry mats, and mortuaries.</p>
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### 5) Net worth method

<b>Description of method</b>	<p>The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history, since the Government must account for all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period.</p> <p>The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities.</p> <p>The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible</p>
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	<p>items, and subtracting that portion of the income which is partially or wholly nontaxable.</p> <p>The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income.</p>
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## Working papers

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167. Working papers are themselves a vital tool within any audit, because:
- they assist the team leaders and other officers who may be dealing with the case at a later stage i.e. at tribunal/court proceedings;
  - they are the connecting link between the examination of a taxpayer's affairs and the audit report; and
  - they can be evaluated as part of the Quality Assurance process.
168. Working papers should be set up so that there is a readily identifiable trail that other officers are able to follow without the need to ask for further details. They should be clear, legible and easy to understand and should include all documents, systems profiling checks, records of interview, bank analyses, relevant notes, minutes of telephone and verbal conversations, and other papers which do not form part of the audit report.
169. Good working papers should have:
- methodical continuity;
  - clarity of purpose;
  - simple yet complete cross-referencing;
  - each page numbered;
  - where necessary, pages should have a heading identifying the taxpayer;
  - a description of the content or purpose of the sheet and period covered;
  - each page/ letter/document should be placed in chronological order;
  - papers should be filed in the correct compartment; and
  - working papers should evidence all significant verification activities detailing what was actually done (i.e. reconciliation of income from source documents).

## Finalising the Audit

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170. It is important that audits are finalised according to a proper and consistent process. This helps directly to assure a defensible outcome, and a level of customer satisfaction. And indirectly it assures consistency across the population, and that learning points are picked up and processes adjusted over time. Similar processes are followed whether the audit is closed with no adjustment to the returns, or whether it is closed with significant additional liabilities and penalties brought into charge.
171. A final discussion with the taxpayer should take place to outline findings and the decisions that will be made. During this discussion the auditor will discuss the following:
- the nature and details of expected adjustments to income and /or expenditure;
  - any penalty considerations;

- the tax authorities view on any technical interpretations and supporting references such as tax rulings, legislation etc;
- arrangements for payment of any tax debt incurred through the audit; and
- discussions of the taxpayer's appeal rights.

172. The audit papers should then be completed with a report covering the following areas:

- identifying the results of the fieldwork activity;
- comparing actual to planned outcomes;
- identifying any learning;
- capturing fieldwork intelligence; and
- sign-off by the team leader.

## 5 AUDIT WORKFORCE MANAGEMENT ISSUES

### KEY POINTS

- Without competent staff, tax audit activities will not achieve their objectives.
- Performance management is an important tool for shaping auditor behaviour.
- Competency models and competency improvement activities help develop and manage the audit workforce
- Both initial and ongoing training is essential for all audit staff.

173. The focus of this chapter is the recruitment, training, development, management, retention and motivation of audit staff, and the different administrative structures in which they can operate. Much of the information in this part is based on a surveyed of countries conducted in 2005/2006.<sup>7</sup>

### Competency / capability models

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174. All revenue bodies must manage and develop their audit workforce to deliver their planned outcomes. To assist with this task, administrators are increasingly designing and implementing capability / competency models.
175. The terms ‘capability or competency models’ refers to a formal specification of the skills, knowledge and attributes that are required of staff to perform a specific job in a competent (i.e. efficient and effective) manner.
176. Competency models generally contain job descriptions, functional descriptions and/or competency profiles using task-related competencies, and are typically supported by training, exams, and educational requirements to ensure and/or build capability.

#### Example

In New Zealand, a competency framework exists across the audit function. It contains:

- Series of job expectations – these clearly define the requirements of respective jobs of investigators (auditors), Team Leaders and Investigations Managers in terms of deliverables, core competencies and tax technical/commercial knowledge.
- Each position (except for managers) have a set of specific tax technical competencies together with supporting training products to provide a training platform based on which these competencies can be developed and enhanced.
- For investigators, there is also a training framework that aligns the learning requirement from entry over a 3 year horizon and links training to the type of work that would be expected of an investigator with 3 months, 6 months, 12 months, 18 months experience etc.

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<sup>7</sup> More in-depth information and guidance on this topic can be found in the accompanying note ‘*Strengthening Tax Audit Capabilities: Auditor Workforce Management Survey Findings and Observations*’, also published in October 2006.

177. Competency models are typically used as a basis for managing performance, training, staff development and recruitment across the audit function.
178. Administrations are increasingly extending the use of such competency models, to ensure that all relevant human resource management processes across the organisation, such as hiring, training, evaluation, certification, performance assessment, staff and career development, learning and professional development, workforce planning and design etc are based on competencies.

**Examples**

In Mexico, a competency model has been developed to provide a solid basis for successful career development. The model includes three types of competencies:

1. Basic: Generic (IQ, personality, achievement orientation, honesty) and Managerial (strategic thinking, communication, problem analysis and decision-making, leadership and organization).
2. Organizational: Generic (teamwork, communication, service attitude, result orientation, institutional principles (respect, responsibility, professionalism)) and Managerial (systemic approach, change management, negotiation, personal impact).
3. Technical: Generic (legal, office software, legal framework for the public service) and Specialty (tax, foreign trade, information technology and resources management).

Under the new scheme of resources management, every process dealing with human resources management such as hiring, training, evaluation, certification, performance assessment, staff and career development etc must be based on competencies.

Australia has identified nine core capabilities required of audit staff. It has commenced using its' capability model (including a capability dictionary and capability profiles) to provide a standard and consistent frame of reference for a number of activities across its people system, as outlined in the wheel below.

**CORE JOB PROFILE FOR AUDIT STAFF**

Core capabilities:

- Apply ATO view of the law
- Determine compliance
- Tax accounting & financial analysis
- Apply work practices
- Communicate effectively
- Conduct research & analysis
- Make effective decisions
- Manage client relationships
- Self management

## Identifying the required competencies

179. Identifying the required competencies of auditors, audit managers and audit directors is critical.
180. The required competencies of auditors can be identified by analysing the activities required to perform particular audit tasks, and through practice and experience. Many revenue bodies base the requirements on the notion that

auditors are initially 'generalists'<sup>8</sup>, who may subsequently develop into 'specialists'<sup>9</sup> to meet organisational needs.

181. The required competencies of audit managers and directors are typically identified and based on the notion that they are to be both people leaders and tax technical leaders. Coaching, communication, and leadership skills are seen by many revenue bodies as important capabilities.
182. Experienced personnel (who have proven and demonstrated abilities to perform audit work) can be used to identify the required competencies to perform audit work. Specialist qualifications and skills are not important factors in determining who is to identify the required capabilities. Most revenue bodies cite senior management, team leaders and experienced audit staff as the people who identified the required capabilities for their competency model. This is often done jointly or in consultation with human resource stakeholders, training departments and head office.
183. The required competencies may be ranked and/or weighted in importance. The design of the competency model / system will influence this. Current experience from a number of countries indicates that the required competencies are not ranked or weighted in importance. Generally the required competencies are recognised as the critical competencies expected of any staff member to be competent at a baseline level in that role (i.e. all competencies must be observable to a minimum standard).
184. The required competencies for auditors are, as shown in a recent survey of several administrations, similar to the high level competencies listed below:
  - conduct investigations
  - determine compliance
  - tax accounting and financial analysis
  - conduct research and analysis
  - apply the law (technical expertise)
  - make effective decisions
  - communicate effectively
  - apply work processes and procedures
  - manage own work
  - achieve results, and
  - manage relationships.
185. The required competencies for audit managers and directors often, as shown in a recent survey of several revenue bodies, focus on the following themes:
  - leadership and management skills
  - technical expertise
  - advanced audit skills

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<sup>8</sup> A 'generalist' can be defined as an official who has a balanced and well-rounded knowledge of all topics sufficient to enable them to individually perform all audit tasks.

<sup>9</sup> A 'specialist' can be defined as an official who has specialised knowledge in one or a few areas e.g. tax technical knowledge, accounting, computer-assisted auditing, and negotiation, etc. where they may work in a team.



- achievement orientation
  - ability to develop and coach others
  - high level communication skills, and
  - ability to make strategic decisions.
186. Different competencies may be identified for work in different market /taxpayer segments (e.g. large businesses), or work performed on clients exhibiting different behaviours towards tax compliance (e.g. non-compliant aggressive clients, serious fraud cases). The structure and allocation of work across the revenue body, and the design of the relevant competency model influence whether such different competencies are identified and/or recognised.

**Example**

In Australia, the Tax Office's set of core capability profiles outlines the generalist skills required of all auditors. It is expected that differing complexities of work in various roles would require additional and a greater depth of competencies to be applied to particular roles. The model allows for business areas to identify and apply additional capabilities where necessary.

Adopting a generalist approach allows the Tax Office to have a flexible audit workforce, enabling the movement of staff across the organisation to the greatest risk and/or priority work.

187. Competency models (and the required competencies for particular audit roles) are typically documented, communicated and made available to audit staff on a revenue body's intranet site. Job and function descriptions are also used to communicate this material internally.

## **Assessing competencies**

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188. It is important for administrations to assess and evaluate the competencies of their staff. Annual and bi-annual performance appraisals are generally used to evaluate a staff member's competencies, and are often performed by the direct manager. Access to human resources specialists is provided if required.
189. Other assessment methods used include: knowledge-based assessments administered on-line, formal testing and exams to attain a recognised qualification, peer reviews, a tutor to support and assess newly hired staff, and assessment centres (including psychometric and technical evaluations).
190. A revenue body's employment conditions and/or country employment laws do not generally prevent the use of competency assessments. Many of the laws relate to the entitlements and/or rights of staff members, and therefore indirectly influence how capability assessments are performed (e.g. equal opportunity considerations in staff recruitment).
191. Competency assessments are commonly performed during recruitment and promotional processes and on an annual or bi-annual basis for those staff maintaining current positions. Other events triggering capability assessments include: prior to performing a new type of work, prior to starting a new role, and on-going informal assessments and learning and development activities.
192. Some administrations record the skills (including qualifications) and areas of expertise of individual staff. Using and sharing this information across the organisation may allow administrations to better allocate work and identify specialist resources / skills when required.

### Examples

In Italy, the Revenue Agency records the skills and areas of expertise of its individual staff using specific software. These details are recorded and made available for use by others across the Agency, e.g. to boost tax investigations.

In Korea, the personnel management team records each auditors' career paths including prior experiences such as large taxpayer audit, individual audit, property related tax audit. It also records education and training history and certificate holdings of each individual.

193. Few revenue bodies currently measure and track the competency level of their whole audit workforce. Such a process provides management with tangible information of the resource and capability mix / trends across the whole audit workforce, providing valuable data for workforce and succession planning.
194. Many revenue bodies indirectly attain a measure of the competency level of their audit workforce by considering: key performance indicators and results, quality assurance results, client / professionalism survey results, quantity of audits performed, training course and other assessment results, etc.

### Example

In New Zealand, the Inland Revenue Department (IRD) tracks from an individual through to an organisational level the following details, therefore providing a measure of capabilities across the whole audit workforce:

- Corporate core competencies of: customer focus, achievement focus, analysis and decision making, communication, self management, strategic responsibility and management via a rating system that reflects the following rating levels; (1) not yet met; (2) partially met; (3) met, (4) exceeded and (5) consistently exceeded.
- For tax technical competencies, the IRD also tracks from an individual through to an organisational level the tax technical knowledge of staff at 3 levels: Fundamental, Applied and Advanced. It is able to set targets, monitor and report on using a percentage basis the level at which staff are at by location, function and ultimately at an organisational level. (That is, the IRD can report on how many people are a 100% competent, 80% competent, and 60% competent etc.)

A critical component to the assessment of competence for each individual is the provision of evidence. This is so the IRD defines competence as an ability to do things. It is one thing to know something, but something else to actually do it. It is the ability to put knowledge into practice which really counts. So the most important type of evidence is work samples because they show how individuals apply their knowledge by doing something, not just knowing something.

In addition to above, the IRD is able to monitor and report on the progress being made from an individual through to an organisational level on the delivery of the Training Framework. The training framework is a 3 year structured learning and development program.

## Improving competencies and addressing capability gaps

195. Responsibility and accountability for improving auditors, audit managers and audit directors commonly lies with the staff member in question and their direct manager and/or local management team. Human resource departments (where applicable) often have joint responsibility and/or are significant contributors to this process, together with tax auditing / training departments.
196. It is critical to ensure competency improvement is integrated into normal business activities, and not seen by staff as an extra task. Common methods used by revenue bodies to integrate these activities includes:
  - building expectations regarding capability improvement, and learning and development into the performance management system (often including

annual and/or biannual reviews) and an individual's performance agreement / job description

- making staff and managers mutually accountable to ensure development needs are met
  - including time for training and other capability improvement activities in budgets and plans
  - allowing work time to be allocated to these activities
  - funding training and development courses, and
  - offering a range of capability improvement activities to ensure they are easily integrated into the normal course of duties (eg self paced packages, on-line learning, mentoring and coaching, on-the-job training, case and issue debriefs, and formal skilling and induction courses).
197. It is important that capability gaps are identified and acted upon. Feedback and observations regarding capability gaps are typically gathered from the following sources, considered at a corporate level, and used to improve training and development activities and competency improvement programs: quality management system results, performance system interviews and appraisals, client professionalism, satisfaction and other similar surveys, and training program evaluations.
198. Revenue bodies may develop staff and address capability gaps through recruitment processes and the use of: training and development programs, mentoring and coaching programs, accreditation models, job rotation and/or placement programs, career paths, knowledge sharing initiatives, knowledge tests and other activities.

## Recruitment

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199. Recruitment of staff from internal sources and/or the external labour market is one avenue that administrations can explore to boost the capability level of their audit workforce.
200. All revenue bodies must recruit audit staff specifically to carry out audits. Effective recruitment policies are essential to attract the right staff in increasingly competitive and skilled labour markets. Staff are generally recruited either fully trained, so they can be effective in post very quickly, or selected because they have strong potential to become auditors through in-house training and education.
201. A minimum standard of specific academic qualifications, such as a diploma or degree or being a chartered accountant, is often required for some grades of audit staff.

### Examples

In Japan, all applicants must be high school or college graduates.

In Norway and Switzerland, applicants must already be chartered or public accountants.

In Canada, an on campus recruitment initiative 'Auditor Apprenticeship Program' is used to recruit candidates from both universities and colleges. Auditors with some audit experience are also hired separately to thereby create a mix of new employees with a range of skills and expertise.

202. Revenue bodies also assess applicants against competencies relevant to their audit work. These are generally in the areas of problem solving, analytical skills, interpersonal skills, self-management, decision making and oral and written communications.

### Examples

The Canada Revenue Agency (CRA) has competency profiles for each position / level. Each competency profile has three categories of competencies:

- Organizational competencies - based on the key values and principles of the organization and will be found in all job profiles eg client service, commitment to learning, conflict management, supporting CRA values etc
- Behavioural competencies - how a person acts as compared to what that person knows e.g., adaptability, analytical thinking, decisiveness, initiative, self-confidence, dealing with difficult situations etc, and
- Technical competencies - the technical knowledge or skills that are relevant to specific jobs e.g., auditing, information seeking techniques, legislation, policies and procedures, writing skills, managing for results etc.

Each selection process identifies the competencies that will be tested from the relevant profile. Competencies are tested by written tests and/or interviews.

203. As a foundation, all auditors require computer skills with other more specialised skills, such as legal experience or specific types of tax knowledge being needed for more technical posts. All revenue bodies conduct interviews as part of the recruitment process to test the suitability of applicants. Some also use other forms of assessment: these commonly include exercises, role-play or other methods to test the potential auditors' competencies and aptitudes. Some countries use work sampling, structured interviews, psychometric testing and referee checks.
204. Some revenue bodies recruit all auditors internally. The majority recruit external applicants through traineeships or graduate recruitment of more experienced applicants for senior or specialist positions. Internal candidates are usually expected to go through the same recruitment processes as external candidates, though they may be run as separate competitions. This includes the need for relevant qualifications and competencies. In one country, a competence-based series of hurdles is used, and this is not unusual. Other bodies allow staff to apply for any suitable post provided that they can demonstrate the necessary competencies, while others set a minimum grade or level of experience before an application can be made.
205. Fairness considerations often dictate that recruitment opportunities must be offered to existing staff as well as to external candidates. Where this is the case, it is necessary to demonstrate that the recruitment exercise has given all applicants an equal chance. There is an emerging shift towards a requirement for internal candidates to hold the same qualifications as external ones so as to demonstrate recruitment processes are fair and open.
206. Personal integrity is an essential requirement for auditors. As a result, it is not unusual for background checks to be made to ensure potential recruits are suitable for employment. Staff are commonly required to conduct themselves in a way that will not bring their employer into disrepute and in many cases this requirement is a part of the contract of employment. More in depth checks can be made, and some administrations examine the personal tax background of potential recruits to check that they comply with tax legislation, while others expect employees to keep their tax affairs in order, facing dismissal and possibly prosecution if they fail to do so.

### Examples

Canada, New Zealand and the USA all carry out background checks on potential audit employees. As part of this process, USA and New Zealand also examine the taxes background and performance of the individual, to check they have met tax obligations.

207. As a general rule, revenue bodies expect new recruits to also sign a confidentiality agreement or verbally swear an oath, facing penalties of dismissal and/or prosecution if this is breached. Many countries have a specific statutory provision in their legislation requiring confidentiality to be observed.

## **Training and development**

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208. In order to maintain standards of auditing it is essential that auditors are given both initial training (classroom and on-the-job instruction) to bring auditors up to the required level, and continued training so that their skills are kept up to date and relevant. The extent and nature of this training and the balance between the two varies according to need, and relates to the recruitment and development policies adopted.

## **Initial training**

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209. This varies depending on the level of qualifications and experience expected of new recruits. For example, those revenue bodies that recruit staff who are already professionally qualified provide much shorter initial training and new auditors are effective in their job very quickly. This can lead to new staff carrying out audit work within as little as three months of joining the organisation.
210. However, revenue bodies that recruit staff without professional qualifications need to provide much more extensive initial training in tax law and auditing.

### **Examples**

In Japan, new recruits attend a residential tax school for 13 months.

In France, employees spend a year in a dedicated Tax School, followed by six months working in a local tax district.

211. Any competency assessments and testing methods are also affected by the recruitment policy adopted. Those bodies that employ people with recognised accounting qualifications and experience generally do not use an in-house exam system. Their training is more focused on orientation and procedures for public sector work, rather than tax and auditing theory. Where there are no exams, trainees may have to collect a portfolio of evidence showing that they have used the techniques and methods, which they will need as auditors.
212. Revenue bodies that recruit staff without professional auditing qualifications (and so provide tax and audit training) generally use in-house testing to confirm that trainees reach the required standard. This is not usually geared towards external professional qualifications, but some bodies have a process by which auditors can study for them or count internal training as credit, even up to degree standard.

## **Ongoing training and development**

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213. Continuing professional development is important to all revenue bodies as a means to ensure that auditor's skills are kept up to date. All bodies offer training or development activity to address specific business needs such as the introduction of new software, legislation or practices, and to address the general training needs of individual auditors to make them more effective in their posts.
214. A multitude of methods are used to deliver ongoing training and development, including training courses, computer based training packages, memos, guidance notes, self-study packs, facilitated workshops and discussion forums, on-the-job training, coaching and mentoring and virtual university and learning tools. As a

rule, continuing professional training is not normally examinable and the amount of training undertaken varies between countries and over time.

### Examples

In the Netherlands, countrywide summer courses (one and two days) are organised yearly for auditors to upgrade their knowledge on different areas. Practical courses are also organised regionally. These often address new subjects or provide an update on important subjects.

Members of the Dutch Institute of Chartered Accountants, also have the obligation from the institute to perform at least 30 hours of education a year.

In Canada, auditors are responsible for their own learning plan. A learning path, including the training required at each level of auditor in the organization assists audit staff to define their skilling needs, create their learning plan, and ensure their continuing professional development.

The learning framework available to staff consists of:

- Introductory training - provides the new auditor with sufficient knowledge of the organization, auditing and legislation to assist a senior auditor in a field audit where they will undergo on-the-job training
- On-the-job training - the new auditor would assist or be assisted by a senior auditor / coach during the course of an audit. The coach is provided with a guide to ensure all relevant information is covered. Additional training often follows, allowing the auditor to perform, independently at the novice auditor level
- Intermediate / advanced level workload specific training for experienced audit staff. This is linked to workload / operational requirements and personal development, and
- Soft-skills training is provided for all positions.

In Denmark, exchanges occur between the private sector and other government departments. The exchange is not considered as a loss, but as part of the training and development of the staff member concerned.

## Mentoring and coaching programs

215. Mentoring, buddying and/or coaching programs are used across all revenue bodies to guide and develop staff. Typically new or less experienced auditors receive such mentoring. In a number of countries coaching and mentoring support is made available to existing staff where required.
216. Experienced and/or senior staff may be used to mentor others (and impart their experience). Panels of internal and external specialists are also be used to provide guidance and leadership to audit staff. Specialist executive coaching and mentoring services are made available to new and existing audit managers and directors, if desired, in a number of countries.

### Examples

In Australia, successful participants of the intermediate audit and accounting training program are required to coach and mentor less experienced audit staff. This enables the agency to develop audit skills at lower levels and achieve exponential improvement in audit capability. The coaching process also acts as a mechanism to ensure program participants reinforce and transfer their skills in the workplace.

In Sweden, a program for developing new tax auditors includes allocating a buddy/tutor. The buddy is an experienced auditor specially chosen for this kind of assignment. There is a short education program to become a buddy, after which they are responsible for training the auditor during the first 2-3 years. The topics dealt with by the buddy are in line with planned education program.

## Accreditation models

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217. The majority of revenue bodies use accreditation models and processes as a framework to develop their staff and provide assurance that the required competencies are held by auditors to effectively and efficiently perform their role.
218. Accreditation models often include formal components (theoretical study and learning) and/or practical components (e.g. demonstration of skills and know how in the workplace). Successful completion of such processes typically results in that staff member being ‘accredited’ to perform a particular role or type of work. Some processes may accredit a staff member based on evidence of their past experiences and work history (recognised prior learning) and/or require staff to complete an assessment or practical test.

### Examples

In Mexico, a ‘Technical Competency Certification Program’ is used. Performance, product and knowledge evidence (e.g. practical cases, knowledge exams, critical incident interviews etc) is gathered, assessed and if satisfactory, ‘certification’ awarded to the staff member. Candidates not certified receive further training and development.

In Australia, it is mandatory and an employment condition to obtain a Diploma in Government in Fraud & Investigation for senior investigators performing work in the serious non-compliance area.

## Job rotation and/or placement programs

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219. Job rotation and/or placement programs provide auditors and other staff with new opportunities, experiences and challenges. Such processes help to: achieve workforce shifts, provide development opportunities, prevent inappropriate relationships with clients developing, develop the breadth and depth across the audit workforce, share knowledge and ideas across the organisation, raise staff morale, and encourage staff to improve their abilities.
220. Job rotation and/or placement programs can be formal structured processes or operate on an ad-hoc or needs basis.

### Examples

In Japan, a regular personnel reshuffle is carried out every year in July. Personnel are transferred to a new post on average every 3 years to prevent them from developing inappropriate relationships with taxpayers, to raise staff morale, and to optimise the NTA’s human resources. Promotions and transfers to other posts are performed after considering the staff members abilities and aptitudes.

In the Netherlands, the Dutch Tax Administration has a general policy that staff must change positions on a horizontal level every 5 years unless appointments are made for a shorter period.

In Australia, the base level auditor development program includes 3 work rotations, exposing staff to audit, law and client contact work.

## Career paths, grading and promotion systems

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221. The variety and range of audit work necessary in any large revenue body will inevitably lead to an established grade structure and movement between these grades, or promotion to them. Revenue bodies should consider creating career paths for their auditors to reflect increases in work complexity and leadership roles.
222. Career paths typically outline the opportunities and advancement options (i.e. communicate a path) an auditor may take over time to progress up and through the organization.

223. The proportion of staff involved in audit work varies enormously across revenue bodies in member countries (ranging from 5% to 58%) of all staff. Most revenue bodies have described a grade structure that runs from clerical staff through to senior management with grades related to level of responsibility as well as complexity of work. The number of grades used varies between 4 and 15, and audit support, audit, and audit team management are three distinct groups common across many organisations.
224. Applications for promotion are based on merit and competence. Length of service is not generally an issue, though some administrations found a minimum length of service was likely to be needed to acquire the necessary experience. Some administrations stipulate minimum experience levels for some posts. Promotion may be decided solely by management, but this does include consideration of an individual's personal circumstances.
225. Recent observations indicate that most revenue bodies do not have formal career paths developed and/or implemented. Several countries did, however, cite that career paths informally existed and are typically taken by staff. Themes common to these were progression from: simple to complex work, dealing with small to large businesses, regional / local to national team based work (where relevant), and generalist roles to specialist and/or leadership roles.

#### **Examples**

Australia is in the early stages of articulating and identifying career paths for audit staff. A concept model has been developed which sees staff entering the audit workforce at the APS 3 (base level), then gaining breadth of knowledge and experience in the APS 4-6 levels, then developing depth of technical knowledge at the APS 6 and EL1 levels (senior auditor levels).

In Spain, the common career path for an 'A' auditor from beginning to retirement is as follows:

- Unit Deputy Leader (1.5 years).
- Unit Leader (directing 2 'B' deputy auditors and 1 Tax agent). Normally devoted to audit taxpayers with an annual turnover of less than €6 million and professionals. In this level it is possible to belong to a National Team.
- Regional Unit Leader (directing 2 'B' deputy auditors and 1 Tax agent). Normally devoted to audit taxpayers with an annual turnover of less than €60 million. It is also possible to work inside a National Team.
- Regional Team Leader (directing 3 'B' deputy auditors and 1 Tax agent). Normally devoted to audit complex and large taxpayers international taxation, consolidated taxation and economic groups.
- National Team Deputy Leader. Second Chief of a National Team (directing 2 'A' auditors \*(1), two 'B' deputy auditors, and 2 Tax agent). Normally devoted to audit taxpayers with an annual turnover of more than €60 million.

Every step of this career involves higher wages.

## **Knowledge-sharing initiatives**

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226. Knowledge-sharing and knowledge management is critical to all organisations. It is particularly relevant to the audit function, where it is important for staff to understand and have access to information on: business trends, industry practices, audit techniques, tax revenue and system integrity risks, and common errors.
227. All administrations use knowledge-sharing initiatives to help increase the capability of staff through the sharing of best practice, techniques, learnings and experiences.



228. The knowledge-sharing methods and tools used are wide and varied. Examples include: workshops, case debriefs, technical discussion forums, communities of interest, action learning sets (facilitated discussion on a particular topic), knowledge databases, internet based knowledge sharing tools (eg online chat rooms, virtual conferences) and conferences.

## **Knowledge tests**

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229. Knowledge tests and assessments are often used across training and development programs, certification processes and/or competency models. In several countries, training and an associated knowledge test on particular topics (e.g. corporate policy programs on topics such as fraud prevention) is compulsory across the audit workforce. Such assessments and processes provide assurance that critical knowledge areas are learnt and understood.

## **Measuring cost benefits of competency improvement programs**

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230. Costs of competency improvement programs and activities may include: cost of time taken to develop training products (if internal training), travel, trainer salary costs, costs to hire presenters and/or acquire course materials (if external), cost of time taken to attend training, and other input costs including information technology / online publishing costs.
231. Benefits from competency improvement programs should be measured where possible. Potential indicators include: quality results, training evaluations, knowledge tests pre and post-capability improvement activity, capability assessment results and trends over time, audit function performance etc. Recent observations indicate the ability to measure benefits from competency improvement activities is correlated to the level of capability / competency assessments performed.

## **Incentives to participate in competency improvement programs**

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232. Incentives and rewards are often used to encourage staff to self-develop and participate in the competency improvement programs. It is recognised that participation in such activities increases performance. Monetary bonuses and rewards are directly linked to performance across most administrations.
233. Other incentives include: ability to attain certification and/or work towards recognised qualifications (e.g. diploma or certificate); opportunity to change roles, including performance of new, more complex work; option to seek out training and other development opportunities; enhanced promotional prospects; and recognition by managers and local management teams.
234. Disagreements on competency assessment process and results may be managed by:
- early discussions with the staff member and manager (where the majority of cases are resolved). This is commonly used when disagreements on the staff member's performance and appraisal interviews occur. Human resource department and/or union representatives may be invited to participate.
  - escalation to a panel or board of staff members. This is typically useful where disagreements relate to the certification, exam results and/or other tests where formal qualifications may be awarded, and
  - use of internal advocates and/or mediation.

235. Revenue bodies need to have performance management processes to manage staff that fail to meet required competency levels, performance outcomes and/or are disengaged.

## **Performance management and motivation**

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236. Most revenue bodies have a formal process for setting out and monitoring performance, either at individual auditor level, or at the team level where team managers are responsible for ensuring that expectations of team performance are met. Expectations are expressed as personal performance agreements, critical job elements and performance standards. Where formal performance agreements do not appear to be used, administrations use meetings and discussion to ensure individual performance is satisfactory.
237. Measurement criteria for auditor performance include numbers of cases worked and casework quality. Yield is not universally used as a performance indicator. Some administrations are deliberately moving away from yield-based targets to focus more on targets based on quality.
238. Interventions used to manage staff that fail to meet the required competency levels, performance outcomes and/or are disengaged typically include: identifying why the person fails to meet the capability standard or other benchmark, and applying learning interventions and additional training (including mentoring if appropriate). Pay freezes, re-deployment to a more suitable role and/or dismissal of the officer may occur where the above is ineffective.
239. There are several different approaches to monitoring the time usage of individual auditors with a variety of computer-based systems being widely used. Some administrations allocate cases on an annual basis with the auditor being responsible for their own time management such as computer programmes based on individual input by staff. Others have closer supervision, with managers inspecting timesheets/reports on a daily or weekly basis as it has been recognised that self-inputted data can lead to inaccuracies, which can be picked up through close monitoring of systems.
240. Surveys are used to monitor the motivation of auditors, although their use is not universal. They are often used in conjunction with one-to-one or team meetings that allow audit staff to discuss their needs and concerns.
241. The provision and discussion of personal development opportunities, through formal plans or an informal process, is seen as an important part of maintaining staff motivation levels.

## **Remuneration**

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242. Retention of competent staff is crucial. There needs to be a consistent flow of hiring to deal with the loss of skilled staff to other employers. Pay will always be a strong factor in influencing the recruitment and retention of staff, but its significance will vary depending on other factors such as the availability of jobs, the cost of living or individual preferences. Working conditions will also have an important influence on auditor performance.
243. There is a wide range between maximum and minimum salary rates in most countries, but this is to be expected given the equally wide range of grades. If salaries are compared to national per capita GDP figures then average pay ranges from between 136% and 342% of GDP, dependent on grade seniority.
244. Links between individual performance and pay are common to most revenue bodies. Other forms of non-monetary recognition such as organisation certificates

of achievement can also be important contributors to employee motivation and morale. There can be a direct link, with performance being assessed on a scale and with an appropriate related pay award, such as the use of a system for managerial staff with bonuses of up to 15% available for high achievers. Other bodies have no link between individual performance and pay.

#### **Examples**

Canada has a 5% bonus available for managerial high achievers.

France and Finland do not have a direct link between individual performance and pay.

## **Conclusions**

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245. The audit programme of a revenue body performs a number of important roles that, effectively carried out, can make a significant contribution to improved administration of the tax system.
246. The efficiency and effectiveness of a revenue body's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.
247. Revenue bodies should aim to achieve a balanced program of audits—one that balances 'coverage', 'audit quality', and 'overall deterrent' considerations. Audit policies and procedures should be based on principles of accuracy, efficiency, fairness, objectivity, transparency, completeness, consistency, and defensibility.
248. The efficiency and effectiveness of audit activities can be greatly facilitated by a broad range of support tools.
249. Without competent staff tax audit activities will not achieve their objectives. Competency models and competency improvement activities help develop and manage the audit workforce. Performance management is an important tool for shaping audit behaviour and contributes too the attainment of audit program objectives. Pay also will always be a strong factor in influencing the recruitment and retention of competent staff, although not the only factor.