



USAID'S LEADERSHIP IN PUBLIC FINANCIAL MANAGEMENT

Detailed Guidelines for Improved Tax Administration in Latin America and the Caribbean

Chapter 8. Audit

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Detailed Guidelines for Improved Tax Administration in Latin America and the Caribbean

Chapter 8. Audit

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Table of Contents

List of Acronyms and Abbreviations	4
ACKNOWLEDGMENTS:	5
Chapter 8. Audit	6
8.1. Leading Practice	6
8.1.1. Legal Framework	6
8.1.2. Structure and Management	7
8.1.3. Audit Function Staffing	10
8.1.4. Overview of the Audit Process	11
8.1.5. Types of Audit	12
8.1.6. Annual Audit Plan	12
8.1.7. Risk-Based Audit Selection System	13
8.1.8. Conducting Audits	15
8.1.9. Audit Plan and Case Management	21
8.1.10. Monitoring and Reporting	21
8.1.11. Audit Review and Quality Control	22
8.2. Common Trends	24
8.2.1. Specialization	24
8.2.2. Publishing Auditing Procedures and Techniques	25
8.3. Tax Administration Maturity	25
8.4. Latin America and the Caribbean	29
8.5. Key Benchmarks and Guidelines	30
REFERENCES:	33
Appendix 8.A. Risk Scoring Criteria	34
Appendix 8.B. Information Collected during the Initial Stages of Audit	35
Appendix 8.C. Checklist of Possible Questions for the Taxpayer Interview	38
Appendix 8.D. Checklist for Inspection of Business Premises	41
Appendix 8.E. Internal Controls	43
Appendix 8.F. Audit Review and Quality Control	46
Appendix 8.G. Audit Report	53
Appendix 8.H. Audit Quality Review Report	56

List of Acronyms and Abbreviations

Acronym	Definition
CIAT	Inter-American Center of Tax Administrations
IT	Information technology
LUQS	Large, unusual, or questionable items
MOF	Ministry of Finance
TIN	Taxpayer identification number
VAT	Value added tax

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Chapter 8. Audit

The purpose of this chapter is to define "audit" and to discuss the important role that audit plays in tax administration. Audit is a core function of the tax administration and is essential to help the tax administration carry out the task of monitoring tax compliance and thus collect the total tax liabilities due to the government.

Audits examine the declarations of taxpayers to not only test the accuracy of the declaration and the accounting systems that produce the declared liability, but also evaluate the credibility of the declared or assessed tax liability. The taxpayer's anticipation of such actions has preventive and deterrent effects. The deterrent effect is the extent to which audit actions discover and stop taxpayers from continuing to under-declare or manipulate their liability. The preventive effect is the extent to which enterprises decide not to evade tax, because they are aware of audit activity and fear detection.

An effective audit program generally results in the discovery of under-declared liabilities either by omission, error, or deliberate deception. The amount of additional revenue raised obviously depends not only on the level of compliance within the taxpayer community, but also on the effectiveness of the Inspectors and the audit program planning and implementation. An efficient and effective audit division will assist the government in its pursuit of increasing taxpayer voluntary compliance and facilitate the tax administration's aim of getting "the right tax at the right time."

It is important to remember that the role and responsibility of the audit function is to control registered taxpayers. It must not be expected to also take on non-filers or the gray economy, which is usually the responsibilities of other divisions in the tax administration, such as registration and fraud investigations.

8.1. Leading Practice

The following are known leading practices on how the audit function actually works in terms of its legal framework, organization, management, staffing, process flow, and monitoring and reporting, etc.

8.1.1. Legal Framework

The legal framework that covers the tasks of the tax administration is discussed in Chapter 3. For the purposes of audit, it is important to note that a rigid legal framework has the tendency to make the audit task more difficult, as it makes it easier for taxpayers to appeal assessment and other powers claiming technical misuse of the law, which may result in long delays in the judicial appeal processes. Primary legislation regarding the carrying out of audits should be set in general terms of powers of access to all books and records of the taxpayer and powers to inspect the operating activities of the taxpayer. Detailed procedures of audit should be set out in the regulations of the tax administration to enable the administration to make changes to procedures without amendments to the law as trends in business activity or accounting practices may change.

In addition, the roles and responsibilities of the Ministry of Finance (MOF) and the tax administration should be clearly defined and separate. The MOF should restrict its role to one of setting tax policy and allow the tax administration to administer and implement that policy. Otherwise, the task of auditing can be impeded by decisions taken by the MOF that fail to recognize the effect on the audit process. The MOF will, of course, have powers to review the administration of the laws to ensure these policies are being implemented correctly.

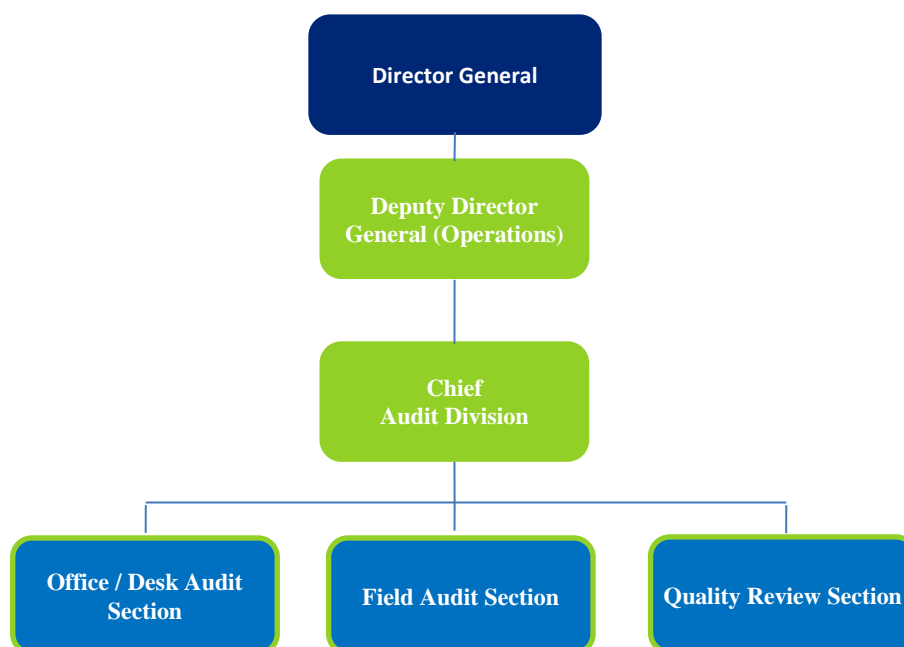
8.1.2. Structure and Management

Modern tax administrations divide responsibilities for the audit function between headquarters and district/field offices. The main responsibilities of headquarters relate to policy and management, while district/field offices are responsible for ensuring that policy decisions are implemented in a consistent way and that any problems encountered during implementation are referred to headquarters for central consideration and resolution. This division of responsibilities is also an accountability measure, since policy and operational tasks are not carried out by the same personnel. Another benefit of separating the two functions is that it helps to fight conflicts of interest and any perceptions of corruption by auditors, as it prevents the "strategic" targeting of taxpayers (i.e., based on their potential for making side payments or as a means to protect corrupt taxpayers from audits). Independent case selection will also help the tax administration respond to any allegations of political bias in audit selection, as the independence of case selection will be demonstrable. Both factors will contribute to taxpayers' perceptions about the fairness of the audit program.

The Role of Headquarters

In the tax administration, as described in Chapter 4, the functional divisions of headquarters, including the audit division, set and review policy, make forecasts, develop processes and procedures for management of the functions at district/field offices, monitor performance, and consider new concepts.

Figure 8.1. Organizational structure of the audit function at headquarters¹



In the audit function, headquarters monitors the law to ensure that the authority and powers of the auditors are transparent, fair, and equitable. It must make sure the laws do not inhibit the conduct of an audit, but must also be sure that audit powers do not exceed the rights of the taxpayer. Headquarters makes policy decisions on how the audit task will be implemented, including but not limited to the number and type of audits to be done, the resource allocations to be made, audit techniques, risk criteria to be used, staff training needed, etc. They develop processes and procedures to be used by the district/field offices to carry out the various tasks associated with audits. Headquarters also monitors performance and carries out management checks to ensure correct implementation of the law(s) and instructions. Specifically, headquarters:

- Develops and continually updates all programs, policies, guidelines, procedures, and manuals for the district/field audit functions;
- Designs and implements risk analysis scoring systems (preferably computerized), categories, and standards for risk-based selection of cases for examination;
- Develops consolidated strategic and annual audit work plans and for all district/field offices;
- Classifies, selects, and assigns cases for examination based on annual work plans;
- Allocates audit resources to district/field offices;
- Evaluates the district/field office audit programs through reviews of periodic reports and on-site field visitations, including on-site reviews of the quality of work district/field offices;

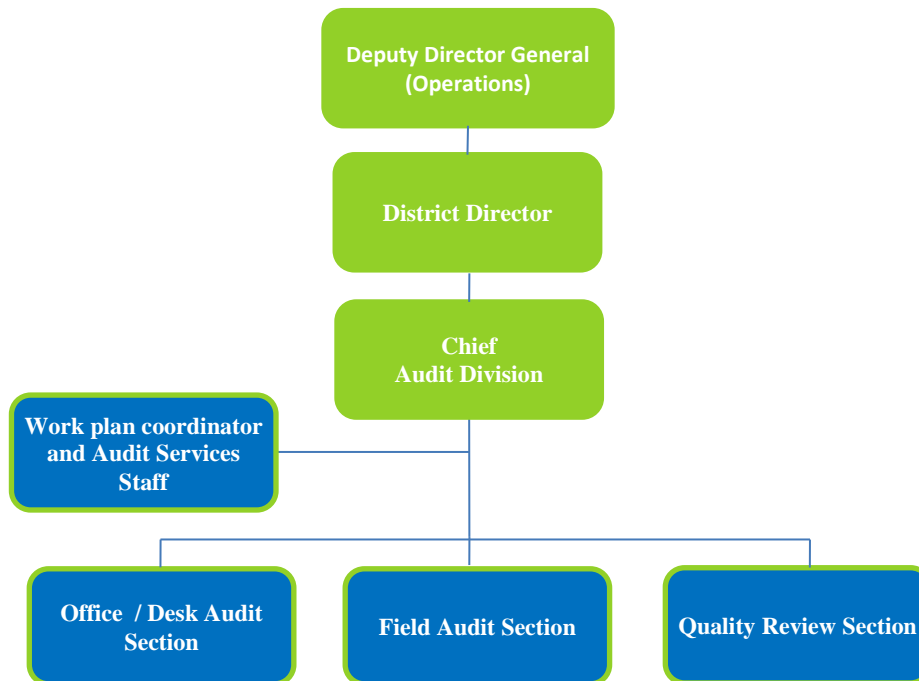
¹ The organizational structure of headquarters mirrors the organizational structure of district / field offices. The specific responsibilities of each section are described below. Of course, the role of the sections at headquarters is to plan, monitor, and evaluate, whereas the role of the district / field office sections is to implement.

- Designs controls and programs to accurately account for all assigned and closed cases;
- Determines the training needs of audit staff in all district/field offices; and
- Develops employee evaluation standards for the performance of audit staff.

The Role of the District/Field Offices

The district/field office is the primary point of contact between the tax administration and the taxpayer community. The audit manager in the district/field office undertakes the responsibilities delegated from the headquarters audit division, ensuring all planned audits are carried out in the manner laid down by procedures developed by headquarters and that the auditors have enough training to carry out their work. Of course, the audit manager and auditors have support from the administrative staff of the district/field office for clerical, information technology (IT), and other duties. The audit manager oversees the performance of audits, including the allocation of cases to auditors, the quality of work, and the achievement of the targets set by headquarters.

Figure 8.2. Organizational structure of the audit function at the district / field offices



The principal role of the Chief, Audit Division and his staff of district/field offices is to execute the annual audit work plans developed by the audit division at headquarters.

The Work Plan Coordinator and Audit Services Staff are the centralized control point of all work that flows in and out of the audit division. They assist the Chief of the Audit Division to coordinate with headquarters to ensure that only the cases most in the need of office/desk and field audit are selected, that the scope of the work plan is implemented throughout the district/field office to give full geographic coverage to compliance-enforcement efforts, and that consideration is given to audits of all

types of taxes. They also make case assignments throughout the year promptly, upon request by the audit sub-units.

The Office / Desk Audit Section has staff assigned to groups of 10-12, each with a supervisor, that handles less technically difficult or lower revenue risk in-office audit cases. They contact taxpayers by correspondence or telephone and schedule in-office desk audits of issues pre-identified as questionable and advise the taxpayer to bring to the audit conference the documentation required to substantiate income, deductions, credit, or other issues in question. In conducting the audits, the office/desk auditor follows the processes described below.

The auditors of the Field Audit Section are assigned to groups, usually of 10-12, each with a supervisor. Experienced field auditors conduct in-depth examinations of books and records and should be given broad legal and administrative authority to take any and all actions permitted by the tax code/tax laws to conduct the full scope of the audit until conclusion of the case without seeking supervisory approval. In conducting audits, the field auditor follows the processes described below.

The Quality Review Section is comprised of experienced auditors specifically selected for their technical expertise. On an ongoing basis, the staff selects samples of completed and ongoing cases to determine if auditors are conducting their audits in conformance with the tax legislation and the policies and procedures established by the headquarters staff in manuals or other documents. In addition to communicating uncovered discrepancies to specific auditors and their respective supervisors, the staff periodically issues "alerts" to all audit staff about common issues and discrepancies noted during their reviews and provides guidance for corrective actions.

8.1.3. Audit Function Staffing

The deployment and organization of the audit staff should be decided by the audit division at headquarters and international experience has found that many different organizational structures exist, due to the varying maturity of the administration and the culture of the taxpayers they seek to control. The more mature organizations will have taken into account such elements as the number of taxes involved, type of taxpayer activity, size of taxpayer, compliance of taxpayer, etc. to decide on how best to organize the resources available. These range from teams of specialist auditors for large or complicated taxpayers, e.g., auditors with high level of expertise on transfer pricing of multi-national corporations², to single generalist auditors operating in remote areas and dealing with all aspects of taxation for small or medium taxpayers.

Staffing of the audit function has always been the subject of debate. The elements for staffing are always affected by political agreements regarding the budget for the tax administration and the audit directorate's share, estimated revenue lost by lack of or underperforming auditors, savings to be made across the national budget, overall tax administration needs and expenditures, and the audit function's desire to do as many audits as possible.

² Transfer pricing issues are discussed in Chapter 3.

Planning resources in an audit function will be an ongoing task from the day the budget allocations are made until the next budget exercise. The annual audit plan will take account the number of available auditors, the average days for performing various types of audit and the corresponding number of personnel-days of support staff needed, allowances for training, annual holidays, sickness, etc. The plan will be monitored to ensure targets are being met and adjusted as necessary as events unfold.

8.1.4. Overview of the Audit Process

At a high level, the audit function should have three elements as follows: 1) taxpayers are selected for audit during audit planning; 2) audits are conducted; and 3) the quality of audits is continually monitored. These are described in detail in subsequent sections. First, however, given that it is impossible to audit all taxpayers, especially in one and the same way, a critical aspect to consider is that the first two elements of the audit function use some form of case selection.

During audit planning, risk analysis to test the credibility of the taxpayer has become a highly specialized undertaking for most tax administrations, and the actions become more and more intense as taxpayer compliance is tested. Modern risk systems will move from simple completion and correctness checks, through to checks that apply hundreds of criteria, comparisons, or standards in order to identify whether cases: (a) require no action and should be accepted as compliant; (b) leave room for some doubt and may require some review or audit action; or (c) are not credible and require action. Depending on the complexity and sophistication of the risk analysis program, the three classifications above will be subdivided many times to identify the cases that are most likely to produce additional revenue or where revenue is at high risk (e.g., VAT refunds). The tax administration will use this information or risk score to set categories for the selection of cases. The audit division at headquarters will set the score categories in order to produce a detailed annual audit plan, indicating the number of taxpayers to be targeted for each type of audit.

Whether or not only certain returns are selected for audit, it is always preferred that various types of audit are developed by the audit division. Modern tax administrations have designed procedures for comprehensive audit vs. single tax audit, desk audit vs. a field audit, monitor audit used to check the selection process, and other audits to be able to use staff more effectively.³ In any of these cases, during the conducting of the audit as described below, the tax administration has the flexibility to expand or contract the scope of audit as it deems necessary, according to findings and based on potential of the audit case to produce results.

Audits are a complex undertaking and, during the whole audit process, the audit function must aim to have a system in place that enables both headquarters and district/field office managers to be able to control and monitor each of their responsibilities. The head of the audit division needs to be able to see the status of all the plans and yearly targets on a national and local level to be able to correct, adjust, or take specific action when the process flow reports indicate either national or local problems. This same

³ Desk and field audits are defined above. A "monitor" audit is an audit that is performed not because the taxpayer necessarily should be audited, but to check whether the tax administration should, in the future, audit types of taxpayers for audit other than the ones it has selected. Audit selection is described in detail below.

system must deliver appropriate reports to each manager down the management chain in order for them to take action even before headquarters has identified problems.

8.1.5. Types of Audit

The audit division at headquarters must set the policy for classification of audit types and the expected time to be spent on each case. They will use historical data and the administration's experience to separate the relative risks of the various sizes and classifications of entities.

The audit types can vary from simple checks to in-depth inspections at taxpayers' premises. This depends on the calculated risk, based on compliance, size of turnover, previous inspections results, time since the last audit, and credibility of declarations, etc. Many tax administrations take advantage of the well used 80/20 theory (20 percent of taxpayers pay 80 percent of tax collected) and exclude the top 20 percent of the highest turnover taxpayers from any plan or risk selection program and monitor them individually. While this policy has many advantages, it should not be carried out at the cost of omitting high risk, lower turnover taxpayers.

Most tax administrations will have a classification procedure for audit types going from a simple audit of one item identified as risky by the risk-based selection system to a full, comprehensive field audit for high risk scoring taxpayers. In between these will be single tax audits, refund audits, special exercise audits, and system monitoring audits. Each tax administration will need to identify which types of audit they need and how they will be classified, plus the expected time each type of audit should take. Once the policy for audit classification is developed, work on the annual audit plan and selection procedures can progress.

8.1.6. Annual Audit Plan

This annual audit plan sets out the overall number of audit case targets for the year. It takes into account the total number of registered taxpayers, set against the total available resources, and the types of audit considered necessary by the audit division at headquarters. As the plan is developed, the targets will be purely numerical and will be used for case selection after the risk-based selection program has been run. At this stage of the exercise, headquarters will have decided on average times to be taken for the various types of audit they have chosen.⁴ If headquarters has set up special and separate measures for high turnover taxpayers, the resources for implementing these measures must be taken out of the main calculations for the annual audit plan.

The annual audit plan includes input from various sources. Headquarters provides the audit objectives for the year (e.g., number of audit files, a forecast of assessed revenue, etc.). Other sources may include:

⁴ For example, while a simple desk review may take up to a couple of days, a comprehensive field audit may span an average of several months.

- Previous experience and area specific knowledge from auditors (i.e., knowledge of large taxpayers or specific industries);
- Audit area indicating a compliance need;
- Recommended overall taxpayer classification (size, industry type, other);
- Type of business (industrial, commercial, professional, construction);
- Reasons for the recommendation (i.e., source of compliance concern, such as prior substantial audit findings, comments from taxpayers and/or representatives, feedback from speaking engagements, etc.);
- Application of risk-based selection as described below;
- Anticipated staff levels in the audit function and the net available time for direct audit work;
- Outcomes from the previous year(s) audit plan; and
- Estimates of potential revenue (per return or per hour).

The audit division at headquarters must have optimum targets for the various audit types and amount of additional tax discovered when preparing the annual audit plan, but this will be adjusted during consideration of the resources available and discussions with the district/field office managers. Matching resources to audit targets is a skilled task and requires cooperation from headquarters and a bottom-up information flow from the district/field offices regarding their estimates of the year's available resources for completion of the various types of audit. When this is done, both headquarters and the district/field offices will have their targets for the year and be ready to assign audit cases from the risk selection when it is run.

8.1.7. Risk-Based Audit Selection System

The overall objective of the audit division must be to have in place a system that will identify the most risky returns/declarations or non-compliant taxpayers for audit and then allocate these, in priority risk order, to the available resources. Since it is impossible to control and check every single taxpayer, risk management is an important element of effective and efficient audit programs. Tax administrations, where laws require universal filing, will likely audit 10 percent or less of the total taxpayer population each year. Tax administrations, where laws prescribe only 'business' filers, may audit up to 30 percent of the total taxpayer population each year. However, with proper selection, audit will cover up to 90 percent of the revenue and provide for a sufficient number of audits to effectively deter non-compliance. This said, it is unnecessary to waste scarce enforcement resources on routinely examining low-risk, compliant taxpayers. The objective of the audit program, including the file selection process, is to allocate examination resources to areas that have the most potential for generating additional revenue. Tax administrations use methods that focus on high risk taxpayers to select files for audits. This targeted approach will result in higher revenue from audit activities than an unstructured approach.

To select taxpayers for audit, tax administrations use criteria – risk criteria – that measure at least those elements of a taxpayer's compliance that can be measured within tax returns and within the historical performance of their responsibilities. A number of risk criteria will be used on each taxpayer and

combined into a "risk scoring algorithm" – an algorithm to quantify and compute risk for each taxpayer.⁵ Sophisticated risk scoring algorithms may also include criteria to do comparisons with industry averages and norms, such as margins, mark-ups and profitability ratios, matching of third-party data, etc. The main goal of the risk scoring algorithm is to identify the taxpayers with the highest risk to revenues and the highest probable additional liability that will be discovered by audit.

The risk-based audit selection system is not possible without automation, if risk is to be calculated for all taxpayers. This said, many developing tax administrations do not have the available information – both electronic information from tax returns and historical information on successful audits – to do more than a very simple risk analysis. A simple automated risk analysis, however, is still better than an attempt to audit all returns received or to manually identify the most risky taxpayer. The number of criteria and the quantifying mechanism used can be augmented and developed over time.

The efficiency of an automated risk-based selection system depends largely on the quality and the number of the risk criteria used. The more accurate they are, the better the taxpayer's credibility will be assessed by each criterion and the more effective the system will function as a whole. Hence, the selection of the criteria and their continuous adjustment over the years are vitally important. Thus, as described below, it is also necessary that headquarters has, as a precondition to an automated risk selection system, audit monitoring and assessment activities. The individual prioritizing and scoring of criteria can have major effects on the final risk score, and only constant monitoring and testing will produce lasting good results. Over or underweighting scores on individual risk scoring criteria can result, in the following effects, among others:

- Compliant taxpayers may appear in the high risk taxpayers' group if they had mechanical errors in their tax returns;
- Not all taxpayers who underreport their tax liabilities will immediately appear in the high risk score bracket; and
- The lack of filed returns could cause non-compliant taxpayers to receive lower scores in the system.

The selection program should be run (and the audit plan updated) on a regular basis during the tax year, not just once, as this ensures late filers are included in the overall risk assessment and scored accordingly. This also gives the district/field offices a current list of high risk taxpayers, ensuring a better allocation of audits during the year. Many tax administrations in emerging countries run the program just once a year shortly after the filing due date, but this is not good policy. Not only does it miss the late filers, but it probably means that the district/field office will carry out a complete distribution to individual auditors for the whole year. This not only stops the flow as far as management information is concerned, but is inefficient, encourages 'cherry picking' of cases, and distorts the production of accurate achievement reports against the annual audit plan.

⁵ An example list of criteria and a simple risk scoring algorithm are provided in Appendix 8.A.

With the use of a risk-based audit selection system, taxpayers should be satisfied that they are being audited due to a procedure that was completely automated and governed by a fair and automatic process that selects cases based on predetermined criteria that are tested against all taxpayers.

Box 8.1. Case Selection Management System in El Salvador

The case selection management system introduced in El Salvador during 2009-2010 by USAID's Tax Policy and Administration Reform project selects cases for audit automatically based on the quantified risk to revenue of each taxpayer and distributes audit cases automatically rather than leaving these to the discretion of tax officials. It also allows for the monitoring of progress along audit cases and effectively standardizes audit procedures and workflow. The introduction of the system yielded an increase of audit assessments to an estimated 6 percent of national revenue in 2010 from 1.8 percent in 2009.⁶

8.1.8. Conducting Audits

The audit is a powerful tool to be used by the tax administration to control the tax register, and it must be well planned, with well-trained and professional auditors. As stated earlier, the type of audit will be stipulated by the policy laid down by the audit division at headquarters, and the procedures to be carried out during the audit should be available for all staff involved in the audit task.

Modern tax administrations have intensive training programs and detailed audit manuals for their auditors, giving them not only knowledge and skills for effective 'revenue' audits, but insight into the activities of the taxpayer. There may well be special manuals developed for businesses or activities that have particular difficulties or problems and need specific audit methods outside the general principles described below.⁷ In all cases, it is understood that the "revenue audit" is not the same as the "financial audit" carried out by the accounting profession, and great care is taken to ensure that the auditors look behind the accounting books, records, and operating processes to establish the credibility of returns and declarations. They are looking for under-declarations of tax caused by deliberate omissions or incorrect application of the law, not simply accounting errors of posting or arithmetic.

In developing tax administrations, this is not always the case. Recruitment of Inspectors is generally geared to graduates with accounting or economic degrees, and little training is given. More emphasis is placed on checking arithmetic accuracy or looking for technical bookkeeping errors that produce fines or penalties. This produces a less than effective deterrent, as the taxpayer views the Inspector as nothing more than a clerk who understands little of the businesses processes of the activity.

The use of the risk-based selection system must be used by the audit division at headquarters to introduce a modern case management process that will place responsibility at the correct level and do away with bureaucratic multilevel approvals prior to audits being commenced and completed. The system can give managers at each level the taxpayers to be audited and specify which type of audit

⁶ Murdoch et al. (2012), p. 9.

⁷ In much of this section we focus on the audit of "businesses." The steps to be taken in auditing personal income tax returns are similar. Furthermore, in many countries, a business, such as a sole proprietorship or a partnership is not taxed on income, but its owners are instead taxed on their income through the personal income tax.

should be used. In this way, the managers overseeing the audit function can concentrate on performance against the plan at each stage and the quality of the results. With established reporting lines and clearly defined management roles and responsibilities, along with managers that accept accountability, there should be no reason for multilevel approvals of decisions.

The conduct of each type of audit must be carried out using a set of guidelines, usually in the form of a manual, developed by the audit division at headquarters. The various types of audits considered necessary by the tax administration will range from the in-depth comprehensive audit and single tax audit, through to the less detailed desk audit (cameral), specific audit, and system monitor audit, but all will have specific areas identified to be checked, backed up by the selection system's previous risk assessment information.

The methods used during an audit are detailed and must be developed by the audit division at headquarters. The tax administration should have procedures, manuals, and guidelines in place setting out the best practices to be followed. These documents can run to hundreds of pages, but for the purposes of this chapter the main stages required for a comprehensive audit are illustrated below. These stages represent accepted international leading practice, and all tax administrations should aim to have all their auditors trained in and using these techniques.

Although the mechanics of audit are set by procedures, manuals, and guidelines, the task of conducting the audit should not be mechanical or routine. The procedures below provide guidance on how best to approach the analysis and assessment of the taxpayer under audit. This said, the auditor's judgment is paramount – not all of the information sources will be reliable or accurate. By its very nature, audit involves continuous development of the picture as inquiries are pursued and observations made and an ongoing review of information to focus the auditor on areas of potential problems. Developing an understanding of the taxpayer and its industry will assist the auditor to identify where tax risk areas are most likely to exist. The better appreciation the auditor has for the taxpayer and its industry, and for the external and internal factors that affect the taxpayer, the easier it will be for the auditor to assess whether there is significant distortion in the taxpayer's tax reporting.

Stage 1. Pre-visit Planning

Once a case has been allocated, the auditor must collate as much information as is available to have reliable background about the taxpayer. The details from the risk selection system will have given the results of the criteria scores and the taxpayer file will give standard profile information. Any third-party details available within the department should also be obtained. The auditor will analyze these data to decide which areas will need specific attention, how the audit will be conducted, and how the auditor will make sure the audit is completed within the time allowed. Unless there are indications that warning of a visit would prejudice the availability of books and records, the auditor or a support team should contact the taxpayer, make an appointment for the visit and list the books and records that the Inspector will need to examine.

The auditor also uses this stage to develop an audit work plan. It is unlikely that a comprehensive audit work plan could be developed based only on pre-contact analysis, as there are many things that may not become clear to an auditor until after he or she has had the opportunity to observe the taxpayer's operations directly. The auditor must continually exercise judgment throughout the audit process to expand or contract the scope as needed with appropriate approval (even changing the type of audit from office to field). A critical consideration here is that the auditor is not bound by the scope of audit that is determined at this (or any other) stage of the audit. This said, the principles of risk-based audit require the auditor to have a clear idea of how the audit should evolve from the pre-contact analysis, based on potential risks that have been identified. If subsequent inquiries suggest that the initial risk assessment was incorrect or incomplete, the auditor is expected to review the scope of the audit to take any relevant new information into consideration.

Stage 2. Interview with Taxpayer or Representative and Inspection of Premises

This initial contact with the taxpayer is very important and it is critical that the auditor uses the interview to establish how the business is organized and how the books and records are prepared. The auditor may well feel all the facts are already in the taxpayer file, but it is essential to confirm them again and get the taxpayer to agree the facts are current. By getting the taxpayer to set out all relevant processes, the normal procedures will be reviewed to enable the auditor to identify any irregularities. The pricing policies and profit margins should also be confirmed at this time for use during the conclusion of the audit. Likewise, an inspection of the premises will enable the auditor to confirm that the activity revealed by the books and records is consistent with the physical activity observed in the operational part of the premises. The taxpayer's compliance and any lapses in meeting deadlines will be discussed.

Stage 3. Basic Checks of Books and Records

The basic checks will test the system and methodology the taxpayer has described to calculate their liability. The type of tax will of course have various measures within the accounting procedures to produce the liabilities, but initially the check should be to examine one return for each tax and trace some items of the accounting events through to the final declared amount. Once the system has been proved or otherwise, the Inspector can decide how to proceed. Provided there is an audit trail found from the primary documents through to the final declaration, the decision as to how many returns and which element of the process should be examined can be made. Using the information gained from this stage, plus the risk assessment system and other data from the administration, it will become clearer as to whether the fundamental accounting procedure is generally sound.

Stage 4. Further Checks

The stage is used to follow up on any details that give concern during the previous stages. If any inconsistency is revealed by the information held, the basic checks, or large variations in what should be a regular activity, these will need to be investigated. The subsidiary records must be examined to test the main accounting records and these can include purchase invoices, sales invoices, production

records, cutting records, credits received and given, delivery notes and goods received notes. This list is not all inclusive and the auditor must make decisions depending on the facts and circumstances of the current audit. The examinations must be sufficient so that there is satisfaction that the routines do produce consistent accuracy for the overall results to be credible.

It is typically at this stage where it will be decided whether with the steps taken so far, the audit can be considered to have demonstrated that, on the balance of probabilities, the accounting records of the taxpayer produce credible liability declarations. This is important, because if the Inspector is satisfied with the bookkeeping records and the operational records relating to them, the audit can be concluded and the taxpayer status considered up to date. Only if new information comes to light can the taxpayer be re-audited. This is a crucial decision as it will not only affect the taxpayer status within the risk selection system but it will contribute to the cost effectiveness of the audit plan. By not continuing to the final stage, the allotted time will be shortened and returned to the resource pool.

Stage 5. In-depth and Credibility Checks

When this stage is reached, it is because the Inspector is not satisfied that the accounting system described by the taxpayer at the interview, and that applied checks indicate that the liability declared is not correct. This being the case, further actions must be taken to prove all the tax due has been declared.

At its simplest, in-depth checks can be established by using the basic records that are outside the recognized accounting system and mentioned earlier, e.g., delivery notes, cutting records, production records, etc., and checking that the all transactions are captured by the prime records.

In depth checks are not achieved by comparing invoices to 'daybooks' or 'sales books,' as this only tests the credibility of the clerk transcribing the information. The Inspector must look for other ways of checking all transactions are accounted for and concentrate on full checking of particular aspects. For example, if the profit margin appears low or purchase to sales ratio appears low the auditor must investigate whether all sales are being recorded, whether there are there cash sales or factory door sales where the details are not recorded. It is also necessary to understand the taxpayer accounts, so that accountants' adjustments and other accountancy protocols are investigated.

Another method of establishing the accuracy of declarations, when the basic checking has not been sufficient, is the credibility or indirect method. This is a technique that uses any of the various known facts or figures discovered during the audit and test or extrapolate the facts against the declared results producing the tax liability. The types of credibility check will depend on the activity, the accounting records, and laws in force. The types of credibility checks include gross profit ratio, parts/labor ratio, food drink/drink ratio, cash reconciliation, invigilation, component check and mark up exercise. Life style and net worth are exercises that must also be considered.

It is essential that the indirect methods of calculating an assessed tax liability has the force of law and is clearly written in the statute. When the books and records of the taxpayer do not appear credible or are

not produced, the auditor must be able to demonstrate that on the balance of probabilities with the information provided by the Taxpayer the real liability should have been different to that declared.

There is no exhaustive list of in-depth checks and it is up to the skill and expertise of the auditor to identify the possibilities that could exist for the unsatisfactory prior checks. The type of activity and the findings at the time of the audit will dictate the in-depth checks to make.

Audit Report

Once the auditor is satisfied with the compliance of the taxpayer or that the errors discovered do reflect the true liability, the audit must be concluded with the report written up and the assessments issued where necessary. The auditor compiles the audit report without undue delay and while the auditor is still familiar with the case.

The audit report is a summary of the audit findings and is an important part of the audit process as it explains the legal and procedural basis for any conclusions that the auditor may reach on the taxpayer's liability. If a taxpayer appeals an assessment, the audit report represents the key evidence on which the appeal body will base its conclusion. The audit report is also important to help evaluate the effectiveness of the auditing approach and risk-based selection criteria. The results of audits will be reviewed as part of a continuous cycle, so that the audit program becomes increasingly more effective over time. The auditor prepares an audit report on every audit, whether or not measures regarding taxation are proposed.

In order to create an effective audit report, the auditor employs a process of continuous documentation. The auditor writes up the procedures and finding as soon as they occur throughout the audit, including the pre-contact stage and the actual audit. The auditor also prepares any notes or working papers in a manner such that another auditor with no background to this specific audit can review these notes or working papers and understand what procedures have been performed and what the data in various working papers represent.

An audit report contains a written draft of the audit that the auditor carried out, all relevant information on the basis (legal and procedural) for any conclusions the auditor reaches on the taxpayer's liability, and the proposed measures to be taken because of these conclusions.⁸ An audit report contains suitable details on the following:

- Information on the taxpayer company and general information on its business, including the business sector or industry, and business scope;
- Information on the audit, including the date and time, places of business audited, interviews with the taxpayer, whether notification was given to the taxpayer, and whether there was cooperation with other authorities;
- A description of the taxpayer's accounting and other related systems;

⁸ An example template for the audit report is shown in Appendix 8.G.

- A listing of audited accounting records, tax records, and other materials audited, and an indication of the period of time that the audit is concerned with;
- The assessment measures proposed by the auditor on the basis of the audit and a separate justification for each measure, including justification for not proposing any measures;
- The contents of the legislation, regulations, instructions, legal cases, and taxation practice relevant to the audit and the content of any expert conclusion that the audit relied upon when justifying assessment measures;
- Calculation of the penalty and interest payable, if any;
- Any other facts, evidence, and justifications that were of material importance when determining the tax liability of the taxpayer;
- Any issues that may be relevant to future audits;
- Names and signatures of the auditors that carried out the audit; and
- Copies of any necessary details that provide clarification on the issues at hand should be enclosed in the audit report as appendices and numbered so that their connection with the issues presented in the audit report can be found without difficulty.

The audit report and any assessment calculations must be checked by an auditor or manager with the appropriate level of authority before issuance and final closure. This should be the only authorization required, but line management roles and responsibilities around performance and quality monitoring will serve as further control.

Audit Closing

After checks by an auditor or manager, the auditor enters the results of the proposed assessment (if any) in the tax administration IT system⁹, sends a notice to the taxpayer that there is a proposed assessment, and returns the file to archives.

The taxpayer or representative is usually given some time (e.g., 30 days) to send a letter that he or she does not agree with the notice of proposed assessment, stating their reasons in a clear and concise manner.¹⁰ If the taxpayer responds with such a rebuttal, the file is reviewed by a manager and any collection action that may have been initiated is suspended. The manager prepares and sends a response (e.g., within 15 days) to the objection. Where the taxpayer does not agree with this response or where the tax administration did not respond within the period, the taxpayer should be allowed to file an appeal.

⁹ This should trigger a collection action.

¹⁰ Typically, if the taxpayer is correct, no assessment is ever made and hence the assessment above is only "proposed." A related leading practice is that the actual assessments are then made by a centralized group of select auditors in a "central assessment unit" that would also review the audit and ensure that multiple erroneous assessments are not continually being entered into the system.

8.1.9. Audit Plan and Case Management

As audits are carried out and completed, cases should be tracked and monitored at the individual level, but also with attention to how each case contributes to the overall national targets. In this regard, both headquarters and district/field offices have roles and responsibilities. Headquarters must ensure that the audit case selection system is producing the best results, and district/field offices must implement the annual audit plan, with auditors carrying out their work in a timely and effective manner.

It is essential that the audit division has in place a clear set of roles and responsibilities for every aspect of the workflow process. Together with this, there must be acceptance of managerial and personal accountability at every level. In international leading practice, all staff involved in administering and implementing the audit function have a clear understanding of their roles and responsibilities and how they fit into the operation of the division. Depending on their level, each staff member will know how they must monitor their own performance, how their performance will be monitored by others, and their level of responsibility for monitoring other staff members' performance.

The audit division of headquarters must regularly analyze all factors that contribute to the national audit function. The section responsible for the annual audit plan must regularly monitor the results of each target and take action when and where targets are missed. Headquarters will also review the criteria and scoring that govern the selection of cases for audit to ensure that they are producing the optimal results. The section responsible for audit processes and procedures must monitor whether those are still appropriate and being applied correctly. All sections will undergo review and inspection to confirm that they are performing all of their tasks and responsibilities at a high standard.

Likewise, the district/field offices must conduct regular analysis of their performance with regard to the audit function, both in terms of individual contributions and from the point of view of overall performance against set targets. In turn, the chain of authority as described below will analyze and review the results to gauge performance at the office, team, and individual levels and confirm that performance at each level conforms to high standards.

8.1.10. Monitoring and Reporting

Ideally, the whole audit process from planning to case closure should be closely monitored with regular reports produced. Unless each stage of the audit process is managed effectively and the progress and results reported regularly, the targets and objectives of the audit division cannot be reviewed and adjusted or updated as necessary.

The tax administration must have a robust management information system in place that will give regular (weekly, monthly, etc., as necessary) reports that will inform managers of the performance and progress within their responsibilities. In the audit function the reports must include the number of audits completed, the amount of additional tax discovered, the time taken, the number of appeals against assessments, etc., so that both headquarters and district/field office managers can quickly take action when indications or trends show signs of lack of progress or deviation from the plan.

To determine whether the basic audit objectives are being met, certain measurement criteria are applied to the audit results. Those measurement criteria can be categorized as follows:

- **Quantity** – The quantity of the audits produced is important primarily because a minimum amount of "audit coverage" is necessary to obtain effective enforcement of the tax laws. Audit coverage is the percentage of the total taxpayer population subject to audit in a given year. By tracking the number of audits completed each year, with its available resources, the tax administration can determine whether it is meeting its audit coverage goals. However, quantity of audits must never override high-quality audits as the primary objective of the tax administration.
- **Revenue** – The amount of revenue assessed is important because it helps to target the taxpayers who have underpaid or misallocated the largest amount of taxes. Since audit coverage is limited, it is crucial the taxpayers selected for audit are those responsible for the largest amounts of underreporting. By measuring the revenue generated by audits over a period of time, the tax administration can determine whether it is meeting its audit revenue goals.
- **Quality** – Generally, quality can be determined from the number and type of review comments generated by supervisors and internal review processes, the number and type of protests received, and the percentage of collection recovery on audit assessments. By promoting high quality standards, the tax administration can assure that resources are used productively, provide taxpayer education, and maintain a high collectability rate.

Such reports highlight the results and will also explain variances to the plan. Audit results are also used to measure the effectiveness of the current audit file selection process and to inform the future year's audit selection process.

One of the key elements of the accomplishment of the annual audit plan is the time spent by auditors in completing the audits included in the annual audit plan. A time reporting system must provide the details of all direct audit time spent by auditors, as well as time spent on indirect activities. The monitoring of such time enables audit management to ensure that resources are used as planned and in accordance with the overall goals and objectives. The monitoring of time also provides the ability to recognize and make necessary changes to redirect audit activity to meet plan objectives.

8.1.11. Audit Review and Quality Control

In general, completed audits should go through a two-stage quality review, as follows: (1) all should be subject to a supervisor review, and (2) a sample should be selected for a strategic review. The purpose of both reviews is to appraise whether auditors are following all audit manual guidelines, technical and policy memorandums, rulings, regulations, statutes, and procedures. However, the strategic review will also review the audit for viability. This means the review is performed similarly to a taxpayer filing a protest and will look for lapses in documentation, discrepancies, contradictions, errors, or any other problems that might jeopardize the tax administration's position. It will also review whether the result of the audit justified the time spent by the auditor conducting the audit. Finally, the strategic review is

also used to determine if the tax administration is being equitable in its administration. Sometimes, audits identify the need for additional regulations, changes in policy, or additional training.

Supervisor Review

During the course of the audit, supervisors must discuss with the auditor procedures and methods for conducting and documenting the audit and monitor each auditor's progress. Auditors are required to keep supervisors informed about their audits, but both auditors and supervisors are responsible for audits being done correctly and efficiently.

The supervisor reviews and discusses all phases of the audit with the auditor to the extent the supervisor considers necessary to ensure that the auditor followed all audit manual guidelines, technical and policy memorandums, rulings, regulations, statutes, and procedures.

The supervisor should treat all employees equitably in the monitoring process so every auditor is given the opportunity to learn from feedback. At the same time, supervisors should expect better audits from auditors who are more experienced or are in a higher classification. Supervisors should determine the appropriate balance of monitoring based on individual auditor needs. The supervisor should also recognize the training potential of the review process and discuss with the auditor what could have been done differently, based on their experience.

Notwithstanding this basic management responsibility of the supervisor, it is not possible, given the volume of audit throughput, to check and discuss in detail every audit with every auditor. This is where the strategic review comes in.

Strategic Review

A sample of files (perhaps up to 10 percent) is selected for quality review from the taxpayer files that have been audited during the previous month or quarter. Although this selection should be as random as possible, it is preferable that the list includes files from across all segments of taxpayers, including large, medium, and small, and perhaps from various industries and taxpayer types. The strategic review is conducted to determine the substantially correct tax at the least cost and in a manner that promotes public confidence in the tax administration. Through the use of quality standards, such conduct is identified and defined as an expectation for all tax administration audit staff. The strategic review:

- Reviews each selected file, focusing on the file documents to support the auditor's technical conclusions;
- Ensures accurate tax and penalty computations;
- Ensures proper completion of all procedural requirements;
- Ensures proper managerial involvement; and
- Ensures that taxpayer rights have been protected.

The recommended process to be followed in the performance of an audit review, including the standards and attributes of a 'quality' review, as well as a reviewer's checklist and report are in

Appendix 8.F. The corresponding form is provided in Appendix 8.H. On completion of the review, the reviewer documents his/her findings in the report which in turn provides feedback to the auditors.

8.2. Common Trends

Throughout this chapter, comparisons between modern and developing tax administrations have been made during the description of various elements of the audit function, and they have been collated here together with other areas where there is generally still no commonly accepted approach.

8.2.1. Specialization

Over the last 10-15 years, modern tax administrations have extended the training of their auditors so that they can use new techniques and software to increase the professionalism and effectiveness of the audit function. As the task of controlling the tax register has become more complex and difficult, tax administrations have had to ensure their Inspectors understand international accounting standards, the work and role of the accounting profession, and the latest trends in tax avoidance and evasion. They have used both internal and external training opportunities. Internal national training institutions have been set up with highly qualified tutors engaged, and staff has been sent to universities and other bodies for specialized training.

There has been no standard approach to the use of specialist auditors mainly because of the expense, availability of suitable candidates, size of the taxpayer register, and the culture of the tax administration. Approaches have ranged from recruiting specialist fraud recognition accountants direct from the profession to comprehensive, in-house training courses being developed.

In between has come a gradual evolution of the pool of expertise within the audit division and individual Inspectors becoming the recognized 'expert' within a particular field. The team concept has also developed due to the big increase in customized computer accounting systems. Depending on the size of the taxpayer, the team could consist of activity expert auditors, tax specific auditors, global accounting experts, and computer program/forensics experts to complete a comprehensive audit. Each of these specialist Inspectors should be used in the specialist role as much as possible, but they can also take part in basic audits as well. The computer program expert will be able to check that the accounting program does, in fact, produce accurate results leading to correct declaration of tax liability and nothing is diverted to external accounts. He/she will also be able to use auditing software to test and validate checks requested by the Inspectors. The global accounting expert will be able to assist the Inspectors in interpreting the accounts and transfer pricing when multinational business is recorded. The computer expert and the global accounting expert will be used other departmental tasks when not needed on audits.

The use of the specialist for audits is so diverse that the developing audit division will need to train and develop specialist auditors as and when the budget allows. The cost of training and purchase of auditing software is high and each administration must decide on priorities, but, suffice to say, the use of more and more sophisticated accounting programs puts the computer program auditing task high on the list.

The use of contract experts is also a controversial topic. Many modern tax administrations use consultants to assist in improving many aspects of various divisions, but, when it comes to audits, opinions are divided. Many civil servants argue that using consultants to do revenue audits creates a conflict of interest for the consultant, who may be required to carry out special audit techniques designed by the tax administration, giving them information that could be of use to their private clients when having contracts with them. Others argue that all departmental techniques should be published and, therefore, no conflict exists.

8.2.2. Publishing Auditing Procedures and Techniques

Both modern and emerging audit divisions argue about revealing the procedures used during an audit. Whereas some administrations publish their entire auditing policy and methods, others insist on complete secrecy arguing that this gives far too much information to the taxpayers, enabling them to avoid some liabilities. Again, the tax culture of the country has to be taken into consideration, but, today, with generally more openness in government, the trend is to less secrecy. Countries have had to deal with freedom of information laws and calls for transparency for years, which have led to much of what used to be internal instructions and procedures being available to the general public via the government's websites.

8.3. Tax Administration Maturity

Four levels of maturity of the audit program of tax administrations are presented below to help interested officials make determinations about the level of maturity of the program and as rules of thumb to make self-assessments about strengths and weaknesses.

Audit: Maturity Level 1

Key word: "Unfocused"

- There is no audit policy regarding where, when, and how audits are conducted, or how to control the tax register, other than to audit all return/declarations received.
- Direction from tax administration headquarters to district/field offices is confused, contradictory, and short-term.
- The lack of a management information system minimizes performance monitoring at any level.
- There is no audit strategy or annual audit plan.
- No audit manuals are ever prepared and auditors are always in a state of confusion and subject to whatever interpretations are made by their local managers.
- Lack of standardized processes and procedures and the absence of an audit manual cause poor quality audits and chaotic case management.
- The audit target is still set at 100 percent of all returns/declarations filed, causing massive backlogs.

- No risk analysis selection system is in place. Rather, selections are more influenced by tax collection performance, set against the budget estimates, usually ignoring actual declared tax and estimated liabilities.
- Auditors are aggressive and concentrate on identifying misdemeanors for the imposition of fines and penalties, instead of the credibility of returns and declarations.
- No use is made of indirect methods during audits or to reach assessed liability.
- The inconsistencies in interpreting the law contribute to many appeals or delays in finalizing cases.
- Auditor recruitment, training, and retention policy ignores real needs and concentrates on economy and law graduates with little specialized in-house training.

Audit: Maturity Level 2

Key word: "Looking to improve"

- The functional managerial responsibility and accountability start to be considered with a review of the current status compared to leading international practice.
- There is recognition that the policy of 100 percent audit of returns/declarations must be changed if self-assessment and voluntary compliance are to be encouraged. Various actions for different types of audit are being proposed, and even a risk analysis selection program is being considered.
- An audit strategy and plans are prepared, but without top management ownership, and commitment to implementation is lacking.
- Managers prepare their own records to try to have some level of control, but little central information is available.
- A review of written regulations, instructions, processes, and procedures produces recommendations for all to be updated and improved. In view of the results, an audit manual is still not considered necessary.
- Auditors are encouraged to be more helpful to taxpayers, but at the same time start checking the credibility of declared liabilities, looking for under-declared tax rather than just misdemeanors.
- Depending on the law, the audit function takes steps either to urge clarification of the powers of indirect methods of assessment, or, if they are clear, then to train and instruct auditors on the use of these techniques.

Audit: Maturity Level 3

Key word: "Focused"

- With roles and responsibilities understood, a management structure is set up with delegation of powers and authority levels established to facilitate a more effective and efficient implementation of the modernization being undertaken.

- A clear audit policy is written that identifies various types of audit and provides guidance on how to carry out each type. The policy also indicates that audit selection must be targeted to cases where there is a high potential risk of lost revenue.
- Recognition that the methods of communication within the audit function are not sufficient to meet the needs of the staff leads to a complete review and significant improvements.
- Moves are made to create a computerized, risk-based audit selection system based on the new policies. The system accounts for the types of audit indicated in the policy, as well as the steps required to undertake different types of audit and the resources available.
- An audit strategy is now being written using the new policy, and top management is taking ownership. Commitment to the strategy is displayed by management monitoring and adjusting resources and actions when necessary.
- An annual audit plan is produced that takes the strategy and audit policy into account and gives weight and information to a (computerized) selection system.
- More management information reports are available, but they tend to be on a 'one off' or 'on request' basis, and many managers are unaware of what reports can be generated or are available. Little consideration is given to a true Management Information System as the IT department does not understand its purpose is to serve, not dictate operations.
- The recommendations made for rewriting regulations, instructions, processes, and procedures are implemented and the new documents issued. Lack of training for the staff and little management support makes the impact less than desired.
- An audit manual is commissioned and gradually being introduced.
- Auditors are producing better quality audits using their new techniques, producing more under-declared tax, and contributing to the self-assessment and voluntary compliance effort.
- Large taxpayers are being identified for special controls, but no national plan is in place.
- The improvements and changes noted above have created a substantial increase in staff training needs. The audit function is ensuring that short-term needs are met, while also reviewing the long-term needs of a modern department.
- The recruitment policy for auditors is reviewed and more appropriate criteria are proposed.

Audit: Maturity Level 4

Key word: "Strategic"

- The tax administration's drive for taxpayer voluntary compliance and self-assessment is at the center of all the audit function's plans and actions.
- The audit function recognizes its role and responsibilities and accepts accountability for the implementation of the law, as well as instructions, policies, processes, and procedures set out by the tax administration, including the audit division at headquarters.
- The management structure within the audit function is clear and well defined. Top management has taken ownership of the delegation and authority levels ensuring checks and balances are in place at each stage of the process.

- The roles and responsibilities of the management structure within the function are clearly defined. All managers understand their delegated powers and level of authority and implement their tasks correctly.
- The communication and information flows of the audit function give clear and concise directions and advice to all levels of staff.
- The audit strategy, annual audit plan, and audit policy are all operating well. The targets set are achievable and relevant to available resources, estimated liability due, complexity and perceived risk of taxpayers, and a management that is dedicated to encouraging effective processes and procedures in all tasks. Monitoring, reviews, and development are all part of the ongoing tasks undertaken by dedicated sections.
- A five-year audit strategy is developed, and senior managers accept ownership, ensuring regular monitoring, updating, and communication to staff.
- Preparation of the annual audit plan is now a routine process and the division uses expertise and experience to target the highest risk taxpayers and continually improve the criteria used in the targeting process. Control of the largest taxpayers has become specialized.
- An audit manual has been developed setting the best practice for each type of audit and explaining special techniques where the auditor experiences difficulties in verification of accounts or declarations.
- The well-written regulations, instructions, processes, and procedures of the audit function are implemented in an effective manner and are constantly monitored and developed by a dedicated section.
- Audit managers and auditors focus on establishing actual liabilities of taxpayers and getting the right tax at the right time.
- Audit techniques detailed in the audit manual, including indirect methods, are being used more, and the quality of audits is becoming much more professional.
- A fully automated, risk-based audit selection system is in place, incorporating a case tracking procedure that informs the annual audit plan and management information reports.
- The management of large traders is routinely monitored and the appropriate regimes put in place to ensure best practice control is maintained.
- A full Management Information System is in place, giving regular, routine reports of all areas of audit function's activities, from national down to individual performance. Using the reports, a system of monitoring and inspection is developed to enable managers at each level to ensure fulfillment of their tasks. The reports are used intelligently to adjust focus or methods to improve results.
- The managers, auditors, and audit support staff of the audit function are given the necessary training that enables them to implement the processes and procedures of their tasks and use audit manual techniques. Further dedicated training is also obtained for specialist areas, such as computer auditing, international accounting standards, and transfer pricing, etc.
- The recruitment and retention policy incorporates a specification underlining the need for individuals with good interpersonal skills who are able to deal with confrontational situations, not just individuals with a degree in law or economics.

8.4. Latin America and the Caribbean

In 2003, the Inter-American Center of Tax Administrations (CIAT) developed an Examination Handbook¹¹ to assist in the formulation of audit procedures across Latin American and Caribbean (LAC) tax administrations. In its foreword, the book states that examination in many countries is poorly developed in comparison with other functions and its introductory "justification" states that there are large cultural, organizational, and statutory differences between administrations.¹² Other sources cite audit as weak, outdated, and underfunded.¹³ In general:

- Audits are few in number, amounting to 0.2 percent of active taxpayers subject to field audits and 8.5 percent for basic checks.¹⁴
- A heavy presence of informal activity leaves less room for sophisticated taxes and requires more reporting by taxpayers and more complex auditing by tax administrators.¹⁵
- Although manuals are present, they are not updated often.
- Although the administrations rely on risk scoring, there is a need for better automation to develop audit plans that focus on different types of audits (e.g., to include quicker and less intensive audits)¹⁶ or on specialization within economic sectors. Auditors have too much influence on the selection of cases.

These sources also highlight that there is lack of legislation regarding exchange of information between government departments, which inhibits the data available for risk selection systems, that many tax administrations fail to automate the basic checks on receipts, and that protective assessments are not automatically issued for stop-filers, indicating that LAC administrations fail to demonstrate to the taxpayer that the tax administrations are proactive in seeking to identify errors or liabilities that are not credible.

On a positive note, most tax administrations have a formal approach to audit planning, subject audit plans to continual review and update, and have standardized audit procedures. A number of countries provide auditors with compliance data warehouses and/or software to perform verifications.¹⁷ These characteristics would place LAC countries in the third level of the maturity model above. It is likely that with additional focus on specialization and data exchange, along with proper funding, the audit function of the tax administrations in LAC countries could progress quickly to international leading practice.

¹¹ Inter-American Center of Tax Administrations (CIAT) (2003).

¹² Ibid., p. viii-ix,

¹³ Alm et al. (2007), p. 10.

¹⁴ Inter-American Center of Tax Administrations (CIAT) et al. (2012), p. 48.

¹⁵ Alm et al. (2007), p. 36.

¹⁶ Ibid., p. 55.

¹⁷ Inter-American Center of Tax Administrations (CIAT) et al. (2012), p. 44.

8.5. Key Benchmarks and Guidelines

Four key questions to maximize the effectiveness of audit are presented in the European Commission's Fiscal Blueprint¹⁸.

Figure 8.3. The European Commission's key audit indicators

Strategic objectives	Key indicators
<p>1. A sound legislative basis for tax audit, including access to data in taxpayers' computer-based systems</p>	<p>Is there a clear and consistent legal basis for tax audits?</p> <p>Does the legislation require the taxpayer to provide access to data in computer-based systems?</p> <p>Does the legislation achieve a sound and appropriate balance between the rights and responsibilities of taxpayers and the tax administration?</p>
<p>2. A risk-based tax audit strategy that determines and prioritizes audits according to agreed risk factors, such as the (size) and complexity of taxpayers and their compliance record</p>	<p>Does the administration have a risk-based tax audit strategy?</p> <p>Has the taxpayer population been appropriately categorized according to relative revenue risk?</p> <p>Does the risk-based system used for selecting taxpayers for audits draw on a wide range of information sources (e.g., register of incorporated companies, banks or financial institutions) and provide an overall evaluation based on all relevant tax types?</p>
<p>3. Use of the most appropriate and modern tax audit tools and techniques to control taxpayers' accounting systems, including the computerized ones</p>	<p>Have tax auditors been provided with sufficient training, information, and logistical support to undertake effective audits?</p> <p>Are the auditors routinely provided with specialist technical information and support for the latest auditing software approved for use in their jurisdiction?</p>
<p>4. Regular monitoring and evaluation of the performance and outputs of tax audits</p>	<p>Does the tax administration have clear rules and procedures that require the prompt and accurate recording of all tax audits undertaken?</p> <p>Is the tax audit information regularly and routinely analyzed (e.g., number of audits undertaken, additional tax liability identified, ratio of additional revenue to audit resources deployed)?</p> <p>Are the results or outcomes from tax audits used to inform and update the strategic risk model?</p>

¹⁸ European Commission (2007), p. 35.

Strategic objectives	Key indicators
	<p>Are the results or outcomes from tax audits used to keep the tax administration aware of anti-fraud or tax avoidance strategies?</p> <p>In terms of results, has the tax administration achieved the correct balance between audits at taxpayers' premises and desk audits at offices of the tax administration?</p>

In addition, the following are specific quantitative benchmarks based on OECD and other country experience.

- Audit coverage will depend on the resources of the tax administration and the size of the filing population, among other factors. OECD countries audit from less than 1 percent of taxpayers (e.g., Austria) to 5-10 percent of taxpayers (e.g., Australia, Netherlands). Countries in which filing is not universal (i.e., not all businesses and persons file) audit a larger portion of returns.
- 100 percent of large taxpayers should be audited;¹⁹
- Approximately 30-50 percent of the staff time of the whole tax administration should be devoted to audit and fraud investigations;²⁰
- Approximately 2-8 percent of net revenues should come from assessments; and
- There should be at least about 70 percent success (positive assessments) in risk-based audits (i.e., positive assessment).

Other important performance measures for the audit function are listed below, but the actual percentage or measure set must depend on local circumstances and the stage of development of the particular tax administration.

- Operating costs of the audit division set against the revenue collected;
- Total number of registrants to total number of auditors;
- Number of auditors compared to total staff;
- Completion of an annual audit plan;
- Average time spent per field/desk audit carried out set against additional liability discovered; and
- Effective field/desk auditing: Comparison between total number of audits carried out and total number of audit adjustments made.

The list is not exhaustive but gives the basis for information that can be used to set benchmarks and then monitor and analyze the performance of audits.

The number of tax administration staff employed per taxpayer can vary from 1 staff member to 1,000+ taxpayers to 1 staff member to as little as 20 taxpayers. The different staffing levels across country

¹⁹ See, for example, OECD (March 2011), p. 52, 111.

²⁰ See OECD (March 2011), p. 163.

imply differences in government employment policies, as well as audit policies. Due to a drive for efficiency and cost-cutting, modern tax administrations are likelier to have the high 1 to over 1,000 ratios. In developing tax administrations, where the government may well be the largest employer, the drive for improved efficiency will not mean less staff but redeployment and rearrangement of processes, so the ratios are likely to be much lower. The ratio of tax administration staff per taxpayer will have a major effect on the audit policy in terms of how many audits of each type to undertake and how long they will take to complete.

All tax administrations must aim to reduce the burden of intervention and administration for the taxpayer. In order to do so, they must develop an audit policy that makes the best use of the resources available by concentrating on the riskiest taxpayers, but not without limits on the time expended on individual cases or to the exclusion of other important risks. Chapter 3 discusses the rights of taxpayers selected for audit that should be clearly listed as part of the legal framework.

When reviewing the benchmarks set, it is important that the tax culture is understood before the quality of the benchmarks are assessed. The audit function must be able to justify the percentages of taxpayer audits set, the average time set for each audit, the time spent on large taxpayers, and the percentage of desk and special audits set. They must also be able to demonstrate that their monitoring systems are sufficient to give them assurance that the targets are SMART (specific, measurable, achievable, realistic, and time-targeted).

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Appendix 8.A. Risk Scoring Criteria

The following are example criteria that may be considered when selecting returns for audit. The audit division at headquarters may consider all or some of the below criteria, depending on available data and resources, and may use additional criteria not listed below.

- The taxpayer was / was not previously audited;
- The taxpayer is / is not newly registered;
- Length of time since last audit;
- The taxpayer had / did not have substantial assessment during previous audits;
- The size of the taxpayer's turnover / net profit;
- The size of the taxpayer's loss, if any;
- The size of the taxpayer's refund, if any;
- The size of change in the taxpayer's turnover/net profit from the previous year;
- The size of the impact detected mistakes had on the taxpayer's turnover / net profit;
- The ratio expenses/turnover;
- The ratio turnover/total assets;
- The ratio loans/total assets;
- The size of income from high risk activities (e.g., real estate income);
- The size of exemptions, if any;
- The percent of the net profit in comparison to the activity average;
- The percent of the total profit compared to the activity average;
- The taxpayer requested waivers, is departing, or is bankrupt;
- The taxpayer's files inconsistently / files consistently;
- The taxpayer is / is not currently involved in legal disputes;
- The taxpayer's return was / was not previously investigated for evasion;
- The taxpayer received notifications from other governmental entities;
- The quality of the taxpayer's books and records (manual / automated; well-kept / not well-kept);
- The taxpayer's returns is / is not prepared by questionable accountants;
- The specific sector, in which the taxpayer operates (e.g., typical high-risk activities include restaurants and hotels, apartment rentals, professionals, car rental, spare parts for vehicles, chemicals, telecommunications, retail);
- The form of the legal entity (e.g., corporation / partnership);
- The multitude of the taxpayer's legal relationships with other entities;
- The taxpayer has / does not have multiple branches;
- The taxpayer has / does not have multiple activities;
- Audit differences (past audit assessments).

Appendix 8.B. Information Collected during the Initial Stages of Audit

The list is not intended to be comprehensive and, indeed, some of this information may not even be available to the auditor. Information that might be collected during the pre-contact stage includes:

- The tax return.
- Information on the taxpayer's activity, the taxpayer's industry, and commercial issues affecting the taxpayer's industry (e.g., commercial statistics). Virtually all businesses operate in a sector that has certain characteristics. These characteristics usually form the basis for commercial or governmental analysis of key ratios and trends. Examination of the key sector trends and comparison to the business under review may reveal unexpected variances that will call for further inquiry and explanation;
- Information on the legal structure and capital of the taxpayer, including any debt financing;
- Financial performance of the taxpayer, including profitability (e.g., annual accounts);
- Location(s) where the taxpayer operates business;
- Number of employees and names of responsible accounting staff;
- Summary of tax compliance record, including copies of tax returns;
- Details of prior audits. Other audits may generate routine verification requests based on the premise that one person's sale is another person's purchase. The auditor should note large or unusual transactions and forward details for inclusion in the supplier/customer's tax file for examination on the next planned audit. In addition, a definite case of tax evasion discovered at a business can often generate suspicion about the customers or suppliers of that business, which should generate a specific reference for immediate query;
- Third party information held on file. It is not unusual for informers, such as disgruntled employees, to tip off the tax administration about undeclared business activities. Informers' letters vary from the extremely specific to the vague. While an interesting source of information, informers' letters need to be treated with some caution as they can simply be used as a method to damage a business competitor or personal enemy of the writer. As a general rule, specific attributable information should be treated as reliable and action should be taken to verify the information given, if serious, through the implementation of a control audit; if minor, through a desk audit inquiry. Non-attributable or vague information should be treated as unreliable and the reference left on the taxpayer's file to be dealt with during the next routine audit. Audit management will decide which action should be taken;
- Customs data;
- Business registry data;
- Supplier and customer businesses. Sales are made to customers and purchases made from suppliers. Direct inquiry of suppliers and customers may reveal differences in declared and actual transactions;

- Newspaper and magazine articles. Many firms in the public sector are the subject of media attention. Sales, acquisitions, and other important milestones are reported in areas such as the financial press and trade magazines. These can be a valuable source of information when building up the background of the company.

The auditor looks for any large, unusual, or questionable items (LUQs) on the return. Some factors to be considered when identifying LUQs are:

- Comparative size of the item — an expense item of \$6,000 with total expenses of \$30,000 would be a large item; however, if total expenses are \$300,000, the item would not be generally considered a large item.
- Absolute size of the item — despite the comparability factor, size by itself may be significant. For example, a \$50,000 item may be significant even though it represents a small percentage of taxable income.
- Inherent character of the item — although the amount of an item may be insignificant, the nature of the item may be significant; e.g., airplane expenses claimed by a tradesman.
- Evidence of intent to mislead — this may include missing schedules, incomplete schedules, misclassified entries, or obviously incorrect items on the return.
- Beneficial effect of the manner in which an item is reported — expenses claimed on a business schedule rather than claimed as an itemized deduction.
- Relationship to other items — incomplete transactions identified on the tax return. For example, the taxpayer reported purchases of stock but no dividend income.
- Missing items — consideration should be given to items which are not shown on the return but would normally appear on the returns of similar taxpayers. This applies not only to the examination of income, but also to expenses, deductions, etc., that would result in tax changes favorable to the taxpayer.

The auditor may use financial ratios for the taxpayer's business to highlight potential issues for further review. Such analysis can focus on both:

- External ratios: Do the taxpayer's financial ratios vary significantly from industry norms? The auditor may use external ratios for understanding how participants in the taxpayer's industry generally perform and compare the taxpayer's performance to the industry standards looking for significant variations;
- Internal ratios: Does the relationship between various internal financial data (e.g., sales and cost of goods sold) or between financial and non-financial information (e.g., salary expenses and headcount) make sense, given the nature of the taxpayer's business? The auditor may use internal ratios to review whether the taxpayer's reporting is consistent from period to period and to determine whether the taxpayer's performance is consistent with what one might expect based on the actual business operated by the taxpayer. Although variations do not mean that there is necessarily a problem, the auditor may use variations to form a line of inquiry that might be pursued in the audit.

Poor financial ratios do not necessarily mean that a taxpayer has underreported tax. As such, the auditor may pursue inquiries to determine whether a reasonable or logical explanation for the variance exists.

Appendix 8.C. Checklist of Possible Questions for the Taxpayer Interview

The auditor should structure the interview to obtain the following information:

- A summary of the business;
- An understanding of who does what in the business;
- Details of the targets of the business, especially for profitability, and how the business intends to meet those targets;
- Details of the private financial affairs of the directors/partners involved;
- Clarifying any points of information already established which do not seem to correlate with the information being given;
- Probing for any perceived weaknesses in the control system or business records that may subsequently throw doubt on the tax accounts submitted; and
- Establishing what further information is required and a timetable for its provision.

Figure 8-C.4. Checklist of possible questions for the first interview

FIRST INTERVIEW : Checklist of possible questions	
The pre-prepared questionnaire should include standard questions that are posed in all interviews as well as non-standard questions concerning specific issues identified in the audit work plan.	
Business Background and Future	<p>When registered? Business purpose? Has method of producing income changed? History of the business, i.e., how started, by whom, why? How long at present location? How long at previous locations? Where? Have there been any unusual or extraordinary events during the past three years? (Reorganizations, major acquisitions, dispositions, decline in income due to casualty, loss of prime customers/clients or other economic/business conditions.)</p> <p>Has there been any expansion or re-modeling of the facilities in recent years? Any asset dispositions? What was disposed? Method of disposition? Any asset acquisitions? What assets were acquired? Amount paid and source of capital to purchase? Any asset acquisitions or dispositions to related parties? If yes: When? Any future plans to re-model or expand? If yes: When? Source of capital for expansion?</p> <p>Dividend history (why or why not)? Has the stock of the corporation or interest of ownership been sold or exchanged since incorporation? If yes: When? Parties involved? How recorded?</p>
Business Current Activities	<p>Any branches or related companies (domestic and foreign)? If yes: Where? Any business activities with these entities--purchasing, sales, loans, and borrowing? Principal customers/clients? Principal suppliers/vendors?</p> <p>What stockholders (owners) are actively involved in the business? What are their duties? Who are the managers of the corporation? President, Vice President,</p>

FIRST INTERVIEW : Checklist of possible questions

	<p>Secretary, Treasurer? How many employees of the company?</p> <p>Are any immediate family members/relatives employed by the company? If yes: Whom? Relationship? Duties, Compensation, Time devoted? Are separate life insurance policies maintained on the managers or stockholders (owners)? Policy amounts, Who are the beneficiaries? Any personal use of assets? Which assets? Percentage used? Fair market value of the assets?</p> <p>Rent expense/income (if any)? What is rented? By/to whom? Rental agreements? If related, how was fair market determined?</p> <p>Other sources of income: non-taxable, factory rebates, interest dividends, transactions with foreign parties, any other sources? Amounts? How recorded? Who opens the mail?</p>
Sales	<p>Who makes the sales? How is pricing determined? Percentage mark-up? Main customers?</p> <p>How is revenue received? Who receives the revenue? How is revenue recorded? Who records the revenue? Who disposes of revenue? Use of revenue?</p> <p>What activities occur once a sale is made, i.e., what documents are generated, who receives them, etc. What are the activities involved in the receipt of cash and payments?</p> <p>What is your policy on returns and allowances? How recorded? Scrap sales? How handled?</p>
Purchases	<p>How frequently are purchases made? Is a purchase journal maintained? Main suppliers?</p> <p>How are discounts handled? Are large purchases made at year-end?</p> <p>Is there a specific mark-up of merchandise? Are expenses paid by cash or check?</p> <p>How are cash purchases handled? Who maintains the petty cash fund? Any personal expenses paid? Which expenses? Amount paid? How recorded?</p>
Inventories	<p>What method is used and how often changed?</p> <p>How is the inventory priced? (mark-up) determined?</p> <p>How often is a physical inventory taken? By whom? When?</p> <p>Does the taxpayer or anyone else use any of the inventories for personal use? How is it accounted for? Amounts?</p>
Financial and Accounting General Information	<p>If applicable, what types of services are provided by the company's accounting firm: Certified financial statements? Preparation of tax return? Preparation of general ledger? Financial statements? Summaries? Management and/or consulting services? Who is responsible for recording: General bookkeeping, Accounts receivable, Accounts payable?</p> <p>Who records the payments/receipts? How frequently?</p> <p>Step by step check the recording of sales and purchase transactions from the beginning to end.</p> <p>Is the business involved in any litigation? Please explain nature? Attorney?</p>

FIRST INTERVIEW : Checklist of possible questions

	<p>How much cash is kept on hand? Petty cash amount? Who has access to it? What is it used for? Other cash—stashed cash? Where kept: safe, register?</p> <p>How are gross receipts determined? What do they comprise of? Were there any barter transactions? If yes, what kind, and how were they recorded? Were there any goods/services exchanged in payment of loans? If yes: What amounts? How were they determined? How were they recorded?</p> <p>What types of bank accounts does the company maintain? Name of banks and location? Type of account(s)? Are any of the banks located outside of the country? If so, what countries? How often are deposits made and by whom? Who reconciles the bank statements? How often? Who has authority to conduct bank operations?</p> <p>What types of investment accounts are maintained and where? What is the policy regarding transfers between the accounts? Who is authorized to transfer funds? Who is authorized to withdraw funds? Who is authorized to take cash out of the daily register (if a cash business)? Is the withdrawal recorded on the books and how? What is the percentage of cash receipts as opposed to those obtained through the bank? Which credit cards are accepted? Which ones? How are these sales recorded? How frequently are deposits made? Who prepares the deposit slips? Who makes the deposits? Were there any receipts from third parties such as insurance proceeds?</p> <p>Did the company receive any loans? For what purposes? From whom? Did the company make any loans? For what purpose? To whom? Loan agreement? Amounts and repayment plan? What are the terms of repayment? Interest received? Were any repayments received? How recorded?</p>
Tax Compliance	<p>Who completes the tax return? Who signs it? Are all your sales taxable? Any income not taxable? Withholding? Who decides what deductions are allowable? How do you differentiate between allowable and non-allowable deductions?</p>

Appendix 8.D. Checklist for Inspection of Business Premises

Figure 8-D.5. Checklist for the inspection of business premises

RESULT OF PREMISES INSPECTION		OBSERVATIONS
General description of facilities	<p>Number of departments?</p> <p>Number of employees?</p> <p>Is the number of employees compatible with reported sales?</p>	
Observation of raw material inventories	<p>Are stocks of materials and parts consistent with reported sales?</p> <p>Note names of a few suppliers for cross checking with purchase records</p> <p>Any indications of manufacturing or products for personal use?</p> <p>What inventory records are maintained? (documentation in and out)</p>	
Observation of production facilities	<p>Note number of employees.</p> <p>How old is production equipment?</p> <p>Any new major capital additions? New assets?</p>	
Observation of finished goods inventories	<p>Are products consistent with reported business activity?</p> <p>Is inventory compatible with reported sales?</p> <p>What products are purchased from other manufacturers?</p> <p>What inventory records are maintained (documentation in and out)?</p>	
Observations of shipping area	<p>What modes of transportation are used (own vehicles, commercial trucks, etc.)? Number of vehicles and deliveries by day/week?</p> <p>Evidence of export goods - packing crates?</p> <p>Any indications of scrap material sales?</p> <p>Is the volume of activity in the shipping area consistent with reported sales?</p>	
Observation of sales operations	<p>Number of employees?</p> <p>How are prices established? Are prices indicated on products?</p> <p>Are products and observed volume of sales consistent with reported sales?</p>	

RESULT OF PREMISES INSPECTION		OBSERVATIONS
	<p>How and when sales are recorded (documentation)?</p> <p>Are cash registers used?</p> <p>Any indication of other business activities?</p>	
Accounting department	<p>How many employees?</p> <p>What use is made of computers?</p> <p>How are monies handled and deposited?</p>	
General observations	<p>Is the scale of operations consistent with reported revenues?</p> <p>Is there any evidence of business activities beyond those reported?</p> <p>Are the entire premises being used by the taxpayer's business? Any sub-let?</p> <p>Is the investment in new capital goods consistent with reported revenues?</p>	

Appendix 8.E. Internal Controls

Figure 8-E.6. Areas of management control of concern

Area	Concern	Established by	Notes
Management understanding	Is senior management aware of the risk of fraud in the business? Are prevention or detection controls in place?	Questioning management; obtain details of control	If controls are not present this indicates lack of awareness and therefore the response is unsatisfactory.
Attitude of management	Does management have an anti-fraud attitude?	Questioning management	The auditor should use his judgment in summing up the attitude – management may connive at fraud if this benefits management directly or indirectly.
Personnel policies	Does the company's personnel policy limit the risk of recruiting fraudulent employees?	Questioning management; examining the personnel policy	The policies examined should show the business takes up references. The high risk areas of employment should be noted in the personnel department with additional checks being carried out where the honesty of the employee is paramount.
Management Controls	Does senior management monitor the accounting systems? Does management obtain adequate information on matters that require further examination?	Questioning management; reviewing the controls in place and evidence of checks carried out; reviewing the provision of management information	Management should evidence all reviews carried out, and the management information available should be sufficient to point up unexplained variances for further investigation.
Security of assets	Are assets of the business at risk of loss through theft?	Questioning management; review of authorization, physical controls, division and rotation of duties, detection controls, and attitude of staff to fear of detection	The requirement for authorization and the existence of physical controls must be real. Authorization should be evidenced.
Asset disposal	Are asset disposed of at less than fair value?	Questioning management;	Great care must be taken for liquid assets and the controls should not only detect the fraud but also

Area	Concern	Established by	Notes
		examining authorization procedures for pricing and one-off transactions	prevent the fraud from taking place. This will involve physical measures as well as division of duties and regular examinations to promote the fear of detection.
Company income	Is there risk of diversion of income due to the company?	Questioning management; review of control system to prevent the fraud	The possibility of bribery and corruption should be borne in mind. Controls must prevent the fraud taking place that will involve effective authorization, division of duties, and regular examinations of payments made.
Purchase procedures	Does the payment reflect the value of goods and services or were goods and services not received?	Questioning management; review of control system to prevent the fraud	The possibility of bribery and corruption should be borne in mind. Controls must prevent the fraud taking place that will involve effective authorization, division of duties, and regular examinations of payments made.
Accounting records	The records may be falsified to conceal the evidence of theft that may not be apparent or detected too late to prevent loss	Questioning management; review the access to the records, division of duties, authorization, and investigation of exceptions.	The possibility of bribery and corruption should be borne in mind. Controls must prevent the fraud taking place that will involve effective authorization, division of duties, and regular examinations of payments made.
Computer security	The computer (if used) may be programmed to create fraudulent data to remove evidence of fraud.	Questioning management; reviewing the computer security system.	

Figure 8-E.7. Internal control structure

Function	Area	Concern
Control Environment	Organizational structure	Is the structure effective? Role of management and directors.
	Internal audit	Is internal audit honest, reliable, and independent?
	Management Information	Is the management information accurate and relevant?
	Business control	Are there adequate policies and procedures in place?

Function	Area	Concern
	Management fraud	Is it possible for management to override internal controls and intentionally manipulate the financial statements?
	Computer operations	Is there effective management control?
	Other operations	Is there effective management control?
Accounting Systems	Transaction control	Does the accounting system allow the transaction to be reflected in the financial statement?
	Compilation of financial Statements	Is the transaction description sufficient and accurate to ensure correct recording in the financial statements.
	Fraud	Is the accounting system adequate to limit irregularities?
Internal Accounting Controls	File controls	Do files remain correct and current?
		Are asset movements properly approved and recorded?
		Are records adequately protected from unauthorized amendment?
		Are records adequately protected from incorrect amendment?

Appendix 8.F. Audit Review and Quality Control

Quality Standards for Audits

The quality standards are concise statements of the tax administration's expectations for quality audits and are guidelines to assist auditors in fulfilling their professional responsibilities. These standards provide objective criteria against which audit quality can be evaluated. Each standard is defined by elements representing components that should be present in a quality audit. The standards consist of twenty-three quality attributes which are grouped as follows:

- Planning;
- Income determination;
- Audit techniques;
- Timeliness;
- Customer (taxpayer) relations/professionalism;
- Documentation/reports.

These groups are further sub-divided as follows:

1. Planning

- i. Pre-planning: Required actions are taken prior to the commencement of audit.
- ii. Requests for Information: Requests for documents from the taxpayer are made, as appropriate.
- iii. Verification of Full Compliance: Required filing and payment checks are performed.
- iv. Risk Analysis: The depth and scope of audit is appropriate.
- v. Audit Work Plan: An appropriate audit work plan is included in the file.

2. Income Determination

- i. Sources of Income: Appropriate techniques are used to determine the taxpayer's income.
- ii. Analysis of Income: Thorough analysis of income and application of law; a correct determination is made of income that is subject to tax

3. Audit Techniques

- i. Audit/Compliance Interviews: Planned interviews with clear questions are conducted throughout the audit with the taxpayer and appropriate third parties.
- ii. Internal Control: The review of internal control is appropriate for the specific audit.
- iii. Review of Records: The type of records requested and methodology for review is appropriate.
- iv. Tax Law Application: Tax law is applied and interpreted correctly, and audit issues are developed correctly.
- v. Anti-Evasion Determination: Anti-evasion is pursued and developed appropriately.

- vi. Tax/Penalty Determination: Tax and penalty determination and computation are correct.

4. Timeliness

- i. Time Commensurate with Complexity: Time spent on issues and the audit overall is commensurate with complexity.
- ii. Actions Taken in a Timely Manner: Timeframes on audit actions are efficient and in accordance with standards.

5. Customer Relations/Professionalism

- i. Clear/Professional Written Communication: All correspondence is businesslike and professional in tone, appearance and content.
- ii. Taxpayer/Representative Kept Appraised: The taxpayer and/or representative are kept well informed throughout the audit.
- iii. Taxpayer Rights: The taxpayer and/or representative is advised of all rights.
- iv. Taxpayer Confidentiality: The confidentiality of the taxpayer's return and information are appropriately protected.
- v. Managerial Involvement: The level of managerial involvement is appropriate for the audit.

6. Documentation/Reports

- i. Auditor File History Documentation: Auditor activity record is used to document audit activity and time charges.
- ii. Work papers: Work papers support the conclusions of the audit including the scope, depth, and techniques used during the audit.
- iii. Report Writing: The appropriate audit report writing procedures are followed, and the quality/necessity of the information therein is appropriate.

Application of Quality Standards during Audit Reviews

For each of the standards, the answers to certain key questions should be considered by the reviewers as they go through the audited files. Reviews of audited files are made for the purpose of determining compliance with the standards. The review includes, but is not limited, to these key questions:

1. Planning

- Pre-Planning
 - Were there any reasons why the auditor should not perform this audit?
 - Was risk analysis properly used in determining scope of the audit?
 - Was information available within the tax administration properly utilized?
 - Did the auditor make inquiry as to tax administration's internal data?
 - Was the data appropriately utilized?

- Requests for Information
 - Was the initial request to the taxpayer appropriate?
 - Were additional information requests discussed with the taxpayer and clarified where needed?

- Risk Analysis
 - In office audit, were all classified issues properly developed?
 - Were issues selected that have the most audit potential and probability of error?
 - Was materiality of the issue appropriately considered?
 - Was the analysis of the return properly utilized to determine whether or not to expand the audit?

- Audit Work Plan
 - Was the audit work plan prepared in a timely manner (consider date on the audit work plan)?
 - Does the content of the audit work plan address all required aspects of the audit, such as required filing checks, specialist referrals, tour of the business, etc.
 - Was the audit work plan approved in a timely manner?
 - Were there types of tax issues that should most appropriately be audited by specialists, and, if so, were the specialists requested?
 - Was the request for specialists made early enough in the audit to ensure timely completion of the audit?
 - Was there oversight on the audit to ensure that the specialists' issues were resolved in a timely manner?

- Verification of Full Compliance
 - Were prior and subsequent years' returns reviewed for audit potential?
 - Were related tax returns reviewed for audit potential?
 - Were referrals made as appropriate for specialists needed on the audit to ascertain return filing requirements?

2. Income Determination

- Sources of Income and Analysis of Income
 - Was the taxpayer asked about sources of income other than those on the return?
 - Was the taxpayer questioned about the source of accumulated funds?
 - Was the taxpayer questioned concerning the company's financial history?
 - Was the taxpayer questioned regarding currency kept on hand?
 - Was an analysis done to determine whether income reported is sufficient to support the taxpayer's activities?

- Was analysis of cash flow performed as appropriate?
- Were appropriate business analyses performed?
- Was income reported on the return reconciled to the books and records?
- Was a tour of the business performed as appropriate?
- Were financial status techniques appropriate and used to determine whether income was properly reported?

3. Audit Techniques

- Audit Compliance Interviews
 - Did the auditor interview appropriate persons?
 - Were questions asked in the interview clear and appropriate?
 - Were third party interviews conducted where appropriate?
 - Were the results of the interviews appropriately documented?

- Tax Law Application/Issue Development
 - Did the auditor secure data relative to prior audit activity?
 - Was the prior audit information appropriately utilized in the current audit?

- Review of Unpaid Debt
 - Did the auditor review the taxpayer's servicing of any debt?
 - Did the auditor review the changes in the taxpayer's debt where appropriate?
 - Was the pay down of debts by the taxpayer consistent with the income sources available?

- Review of Records
 - Did the auditor determine methods of handling cash?
 - Did the auditor make appropriate tests of sales or gross receipts?
 - Did the auditor trace entries in original books and records to documentation?
 - Were appropriate business ratios computed to determine if sales reported appear valid?
 - Was the volume of sales compared to prior years and appropriate action taken regarding unusual variances?
 - Was third party data regarding sales used appropriately?

- Review of Internal Control:

The reviewer will consider whether or not the auditor reviewed the taxpayer's system of internal control.

 - Were discussions held with the taxpayer about the taxpayer's procedures for business operations?
 - Were discussions held with the taxpayer relative to the accounting systems in place?

- Were tests made of the business operations system and the accounting system?
 - Were significant changes in assets identified in analyses and the impact on taxable income appropriately considered?
- **Review of Anti-Evasion:**

The reviewer will consider whether or not the auditor considered the indicators of evasion.

 - Did the auditor ask appropriate questions in documented interviews with the taxpayer to identify areas of suspected tax evasion?
 - Were suspicious areas properly pursued to appropriate conclusions?
 - Where evasion was present, did the auditor follow existing procedures for referral and development?
- **Review of Tax and Penalties:**

The reviewer will consider whether or not the auditor considered the applicability of penalties in the specific audit.

 - Did the auditor ask appropriate questions of the taxpayer and/or third parties to determine the applicability of penalties?
 - Did the auditor correctly apply the law with respect to penalty considerations?
 - Did the auditor appropriately secure the taxpayer's explanation in matters potentially requiring the application of penalties?
 - Did the auditor correctly compute the tax and penalties, when applied?

4. Timeliness

The reviewer will consider whether or not the auditor's actions were timely.

- Was the elapsed time from file assignment to first appointment appropriate?
- Were large gaps of time between audit actions explained?
- Was the auditor's report prepared in a timely manner?
- Were closing actions on the audit timely?

The reviewer will consider whether or not the time spent on the audit by the auditor is commensurate with its complexity.

- Do the tasks performed on the audit by the auditor support the time charges to the audit?
- Were the auditor's work practices appropriate for efficient completion of the audit?

5. Customer Relations/Professionalism

- **Communications with the Taxpayer and Taxpayer's Representative**

The reviewer will consider whether or not the auditor's communication with the taxpayer was professional.

- Was correspondence to the taxpayer of appropriate tone, appearance, and content?
- Was the auditor responsive to written correspondence from the taxpayer?

The reviewer will consider whether or not the auditor provided customer focus to the taxpayer and the taxpayer's representative.

- Were the taxpayer and the representative kept apprised about the audit status and issues throughout the audit?
- Did the auditor ensure that questions from the taxpayer, even if not part of the audit, were appropriately coordinated with other areas of the tax administration?

The reviewer will consider whether or not the auditor kept the taxpayer and the representative informed of their rights.

- At the initial phase of the audit, were the taxpayer's rights explained by the auditor?
- Throughout the audit, was the taxpayer informed of the tax administration's procedures and taxpayer's rights, as appropriate?
- Throughout the audit, were taxpayer's rights honored by the auditor?

The reviewer will consider whether or not the auditor safeguarded the taxpayer's privacy and confidentiality.

- Did the auditor ensure that tax returns and return information was safeguarded?
- Did the auditor refrain from disclosing information about the audit in accordance with the law and the Audit Procedures Guide?

- Supervisor's involvement with the audit

The reviewer will consider whether or not the supervisor was appropriately involved in decisions in the audit.

- Was the audit work plan approved in a timely manner?
- Were expansions of the audit or limitations on scope approved by the manager?
- Was the manager present for taxpayer meetings, as appropriate?

6. Documentation and Reports

The reviewer will consider whether or not the auditor documented actions in the audit.

- Did the auditor prepare an audit report?

The reviewer will consider whether or not the work papers support the conclusions reached in the audit.

- Were the work papers legible and prepared in accordance with the audit procedures?
- Do the audit issues in the audit report agree with the issues in the work papers?
- Do the work papers contain sufficient information to reach the conclusions presented in the audit?

The reviewer will consider whether or not the auditor's report was correct.

- Did the auditor use the appropriate report writing procedures as per the audit procedures guide?
- Is the explanation of the issue in the auditor's report clear and concise and in accordance with the law?
- Is the tax computation correct in the report?

Appendix 8.G. Audit Report

Figure 8-G.8. Audit report

Audit Report	
Taxpayer Name: <i>Business name</i>	TIN: <i>Taxpayer identification number</i>
Taxpayer Address: <i>Address where the business is registered with the tax administration</i>	
Taxpayer Contact Details: <i>this should include the name and telephone contact of the taxpayer</i>	
E-Mail: <i>e-mail address of the key person to contact at the business</i>	
Taxpayer's Accountant / Representative: <i>insert the name, address and contact of the taxpayer's accountant or representative</i>	
Principal Business Activity: <i>Main business activity of the taxpayer (by turnover if more than one activity)</i>	
Subsidiary Business Activity (if any): <i>Secondary business activity of the taxpayer (by turnover)</i>	
Associated Businesses: <i>Note the names and TINs of any businesses that are associated with this taxpayer and the type of association.</i>	
Branches: <i>Note the details of any branches operated by the taxpayer or any other premises used in the operation of the taxpayer's business</i>	
Description of the Business: <i>Insert here a summary description of the business, its scope, age, sector, main customers, staff numbers, etc.</i>	
Description of the Accounting System: <i>List here the key books and records maintained by the taxpayer as part of its accounting system. If an automated system is used, the name of the software package should be noted.</i>	

Audit Report

Key Internal Controls: *List here the key internal control functions, noting any particular strengths and weaknesses.*

Audit Start Date: *Date when pre-visit checks commenced*

Type of Audit: *Office, field, or other control activity*

Tax Year(s) Under Audit:

Place of Conduct of Audit: *location where the auditor conducted the audit*

Persons Interviewed: *note who was interviewed by the auditor and when*

Business Premises Inspected: *Yes/no and any noteworthy comments resulting from the inspection*

Description of Audit Activity: *Note all key actions taken during the audit, including records examined, creditability checks performed, and the summary results. Pre-contact analysis and any calculations should be attached to the report as separate sheets.*

Audit Report

Rulings: *note details of any rulings given to the taxpayer (verbally or in writing) e.g., liability ruling, interpretation of legislation, etc. If none, state 'none.'*

Assessment Issued: *Provide details on the proposed assessment measures and justify each measure separately; also provide justification if no measures were proposed.*

Penalties Imposed: *calculate the penalty and interest payable, if any.*

Future Audits: *list any issues that may be relevant to future audits.*

Final Result of Audit: *note total tax and total penalties/interest assessed.*

Date Audit Closed: *this should be the date when the assessment was issued to the taxpayer*

Name of Auditor:

Signature:

Name of Auditor:

Signature:

Name of Auditor:

Signature:

Name of Auditor:

Signature:

Name of Supervisor:

Signature:

Name of Audit Section Head:

Signature:

Appendix 8.H. Audit Quality Review Report

Figure 8-H.9. Audit quality review report

Taxpayer _____ Registration No. /File _____
 File Type _____ Auditor _____
 Date of Audit Period: _____ to _____
 Audit Type: Field _____ Office _____

ITEM REVIEWED	YES	NO	N/A	COMMENTS
A. PLANNING				
A1 Were pre-audit activities appropriate?				
A2 Was the audit work plan appropriate?				
A3 Were appropriate requests made for documents and/or information from the taxpayer?				
A4 Were required filing and payment checks performed?				
A5 Was risk analysis performed to set the scope of the audit?				
B. INCOME DETERMINATION				
B1 Was the taxpayer interviewed concerning sources of income other than those reported?				
B2 Was an analysis performed of the file regarding income?				
C. AUDIT TECHNIQUES				
C1 Were interviews with clear questions conducted throughout the audit with the taxpayer and appropriate third parties?				
C2 Were the taxpayer's internal control procedures reviewed and				

ITEM REVIEWED	YES	NO	N/A	COMMENTS
described?				
C3 Were the type of records requested and the methodology for review appropriate?				
C4 Was the law interpreted and applied correctly in all aspects of the audit?				
C5 Were indicators of anti-evasion pursued and developed?				
C6 Were penalties and tax properly identified and computed?				
D. TIMELINESS				
D1 Was the time spent on the audit commensurate with its complexity?				
D2 Were all actions taken in a timely manner?				
E. TAXPAYER RELATIONS				
E1 Was correspondence businesslike and timely?				
E2 Was the taxpayer/rep kept informed throughout the audit?				
E3 Was the taxpayer advised of all rights?				
E4 Was the confidentiality of the taxpayer's return and information protected?				
E5 Was the level of managerial involvement appropriate?				
F. DOCUMENTATION AND REPORTS				
F1 Do the work papers document the activities and time charges throughout the audit?				
F2 Do the work papers support the conclusions reached in the audit?				

ITEM REVIEWED	YES	NO	N/A	COMMENTS
F3 Were the appropriate report writing procedures followed?				

KEY RECOMMENDATIONS (if any):

Reviewer Name _____

Signature _____

Date _____