



VITARA

Virtual Training
to Advance Revenue
Administration



REFERENCE GUIDE

THE AUDIT PROGRAM

Inter-American Center of Tax Administrations

International Monetary Fund

Intra-European Organisation of Tax Administrations

Organisation for Economic Co-operation and Development

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Preamble

A series of Virtual Training to Advance Revenue Administration (VITARA) reference guides have been developed based on the content of the VITARA online modules. Readers are encouraged to enroll in the online modules.

This reference guide focuses on how an audit program fits into the overall set of activities a tax administration undertakes to promote and enforce compliance with its tax laws. The key elements of an effective audit program are identified. An effective audit program is crucial to the success of the tax administration in carrying out its mandate to maximize compliance with the country's tax laws.

This guide is divided into nine chapters highlighting key concepts, processes, and good practices relating to the operation and management of a tax administration audit program.



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CHAPTER 1.

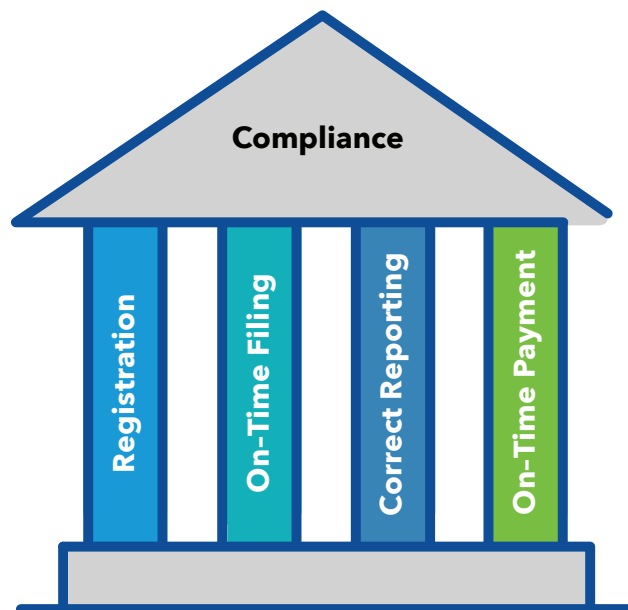
Compliance and the Role of Audit

The primary mandate of every tax administration is to collect the tax and duties for which it is responsible in accordance with the law. To do this, tax administrations aim to maximize taxpayer compliance. An audit program is one of the many but critical tools that a tax administration can use to increase compliance. This chapter will define the various terms used throughout this reference guide and describe the various tools available to a tax administration to enhance compliance.¹

Definition of Terms

Compliance is the degree to which taxpayers meet their tax obligations by registering when required, filing on time, correctly reporting their tax obligations, and paying on time. These are called the “pillars” of compliance or core compliance obligations, as shown in Figure 1.1.

Figure 1.1. The Four Core Compliance Obligations



To be fully compliant, a taxpayer needs to comply with all four core compliance obligations on a timely basis. Compliance is impacted by various factors, such as taxpayer behaviors toward compliance, the degree to which taxpayers understand their tax obligations, as well as taxpayers' perception of the fairness of the tax system.

Noncompliance is where a taxpayer has not fully met the four obligations—registration, on-time filing, correctly reporting their tax obligations, and on-time payment. Noncompliance can be unintentional or intentional. If taxpayers don't understand their tax obligations, their noncompliance may be unintentional. Noncompliance is intentional when the taxpayer knows the law and chooses not to comply with or is indifferent to understanding the law.

¹ For more information on compliance risk management (CRM), see VITARA: Compliance Risk Management.

A tax administration's main goal is to maximize compliance with the four pillars through a balance of voluntary and enforced compliance. The compliance continuum is shown in Figure 1.2.

Figure 1.2. The Compliance Continuum



Voluntary compliance is the degree to which taxpayers meet their four tax obligations with little or no intervention by the tax administration. The modern tax administration uses a multifaceted approach to maximize voluntary compliance. While voluntary compliance is the ultimate goal, the reality is that tax administrations will never achieve full voluntary compliance.

Identifying where noncompliance may be occurring in the tax system and the impact of the noncompliance on the tax base is the function of **compliance risk management (CRM)**. Having identified the compliance risks, treatment options can be identified.

Treatment options are the possible actions that the tax administration can take to address the risk that taxpayers are not correctly complying with their tax obligations. Treatment options are a response to an identified risk, its nature and materiality. The term **materiality**, in this context, refers to the magnitude of the risk in terms of the monetary impact on the country's tax base (if the risk proves to be valid). The tax administration's goal is to bring the risk to an acceptable level, not to eradicate the risk altogether—no tax administration in the world has sufficient funds to bring compliance risks to zero.

The types of treatment options include **preventative**, **facilitative**, and **enforced compliance**. Examples of each type of treatment option are outlined in Table 1.1.

Table 1.1. Types of Treatment Options

| Treatment Option Categories | Examples of Treatment Options |
|-----------------------------|--|
| Preventative | Education, reminders for on-time filing and payment, legislative changes to address loopholes, rulings that outline the administration's position on a certain issue |
| Facilitative | Prefilled tax returns; letters to point out common errors, with the opportunity to self-correct returns; voluntary disclosure programs |
| Enforced compliance | Verifications and audits, investigations, penalties |

Using a differentiated approach is cost efficient for the tax administration and minimizes the compliance burden on those who are trying to comply by matching the response to the risk, rather than treating all types of noncompliance in the same manner. Audit, as the most expensive treatment option, should be focused on the highest-risk taxpayers who do not intend to comply—for example, materially underreport their tax obligations—and, therefore, present the largest risk to the tax base.

Audit and verification are enforcement tools that address the most serious instances of potential noncompliance.

Verification is typically used where the tax administration has third-party information available to it for comparison with the taxpayer's return to confirm compliance. Verifications can also be used to validate deductions or check for inconsistencies made by the taxpayer on their return. The characteristics of verifications and audits are described in Table 1.2. In this reference guide, the terminology "verification" will be included as part of "audit" activities.

Audits are conducted to determine whether the taxpayer reported their tax liability correctly. This is a civil process, as compared to a criminal investigation.

Table 1.2. Characteristics of Verifications and Audits

| Verification | Audit |
|--|---|
| Is less comprehensive | Is more comprehensive |
| Typically focuses on one item on the tax return | Reviews the compliance of the taxpayer for all their tax obligations and may also examine the compliance of any related parties, such as partners or subsidiary companies |
| Can be completed in a matter of minutes or hours | Can range from several hours to hundreds of hours |

Audits can be conducted using a **desk** or **field** approach. Desk audits are conducted from the auditor's office, whereas a field audit is conducted at the taxpayer's premises.

In the case of both an audit and a verification, the individual conducting the activity is referred to as an **auditor** in this reference guide.

A **reassessment** is a supplementary assessment indicating that the tax liability of the taxpayer has changed compared to what was initially assessed when the taxpayer filed their return. The reassessment can be initiated by the taxpayer or the tax administration. In the case of an audit or verification, where errors or omissions are identified, the taxpayer is issued a reassessment outlining the updated tax payable. The reassessment is legally binding and represents the new tax liability owed by the taxpayer. A reassessment could also occur if a taxpayer identified an error and requested that the tax administration correct it, or if the taxpayer was requested to evaluate their compliance and submit an amended return if errors were found.

Criminal investigations are conducted when a tax administration has strong evidence that serious tax evasion or fraud has occurred, which generally requires use of the most invasive powers and which may lead to criminal prosecution. Countries vary regarding who undertakes a criminal investigation. In some countries, the law provides that this function is carried out by a separate government agency, such as the police. In other countries, criminal investigations are carried out by a specialized group within the tax administration.

Case selection is an extension of CRM. CRM identifies potential compliance risks, and case selection is about identifying individual taxpayers who exhibit that risk. Typically, cases selected by the CRM process are further reviewed by CRM staff to determine whether an audit is warranted.

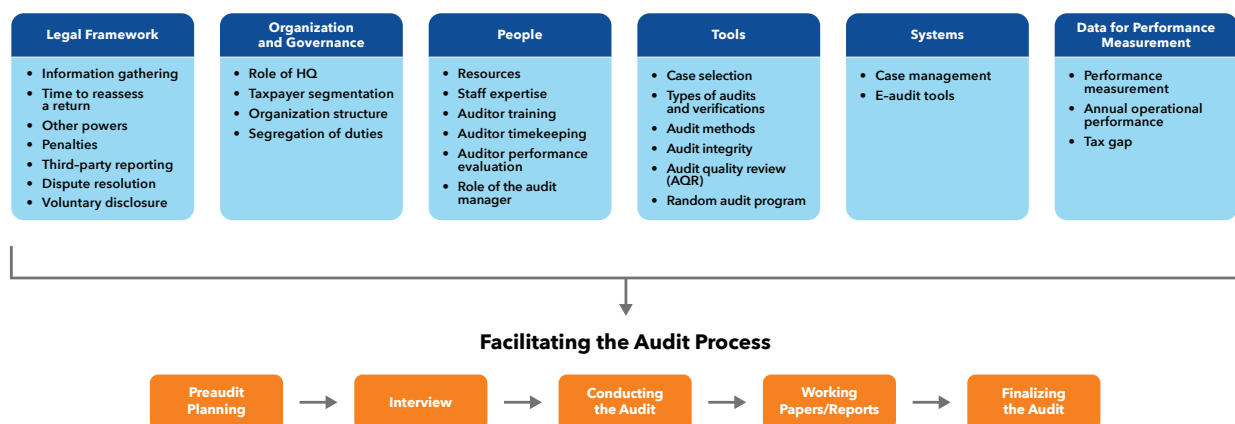
Components of an Effective Audit Program

Having an effective audit program requires strong processes across several key areas, all of which are interdependent. Leading tax administrations develop their capacity in the following key areas:

- Legal framework
- Organization structure and governance
- People
- Tools
- Systems
- Performance measurement

Figure 1.3 illustrates the key elements of an effective audit program and summarizes the audit process. Tax administration leaders must continually assess their progress toward good practice in each of these six key areas as they strive to improve the administration's effectiveness and optimize tax collection.

Figure 1.3. Key Categories of an Effective Audit Program



Note: AQR = audit quality review; HQ = headquarters.

Chapters 2-7 of this reference guide will address each of these six categories as they pertain to the audit program within a tax administration. Chapter 8 will discuss the audit process.

CHAPTER 2.

The Legal Framework

This chapter focuses on the legislative provisions that tax administrations need to support the audit program.

Information Gathering and Other Tax Administration Powers

The legislative powers described in this chapter represent a full range of authorities. There may be wide variations in the legal provisions available in a particular country, and this will impact the operations of the audit program. An evaluation of a country's specific legislative authorities against the provisions identified in this chapter will allow senior management to identify gaps. If the administration considers the missing legislative provisions important to effectively carry out its duties, the administration will need to develop a business case for submission to the Ministry of Finance to justify why the provision is needed and the impact it would have if the provision were available to the administration.

Figure 2.1. Common Legislative Provisions for an Effective Audit Program



As shown in Figure 2.1, some of the important legal provisions are as follows:

- Requirement to file a tax return (i.e., under a self-assessment system, taxpayers are required to file if there is a tax liability owing, or they can choose to file a return if a refund is owed);
- Requirement to maintain financial books and records (i.e., laws stipulate how and in what form the financial books and records should be maintained (prescribed in regulations), how long the records should be kept, where they are to be kept, and in what language and currency);
- Right to inspect (i.e., the right to access taxpayer information and their premises to determine whether the correct tax payable has been declared);
- Prescribed information (i.e., provisions on what information must be provided by the taxpayer with their return, along with the format that the information should be presented in);

- Power to obtain information from third parties through court orders (i.e., provided information from banks and other financial institutions, suppliers, and clients needed to verify the reported income of a taxpayer is not shared by the taxpayer or available automatically from third parties); and
- Power to obtain search warrants (i.e., provisions that allow the tax administration conducting a criminal investigation to search the taxpayer's business and personal properties to gain access to business and financial records to gather evidence of possible criminal offenses).

Time Period to Reassess a Return

The legislation generally documents the time frame the administration has to correct any errors or omissions in a taxpayer's return (called a **statute-barred date**). This is partially to protect the taxpayer by limiting the tax administration from adjusting the taxpayer's tax liability beyond a specific time frame. Beyond this date, no adjustments can be made, unless there is also the provision in the law that the statute-barred date does not apply in certain situations, such as fraud. The statute-barred date for most countries is between three and ten years.

Some countries provide an extended statute-barred date in situations where the taxpayer is involved in offshore transactions. This is to recognize that delays can occur in receiving information (e.g., from foreign tax administrations) when dealing with these offshore entities. The extension can be in the range of three to five years. A country with a three-year statute-barred period and a possible three-year extension, where offshore transactions are being reviewed, would have a total of six years to evaluate the taxpayer's compliance with the country's tax laws.

Penalties

In addition to the legislative powers that are generally in a country's tax laws to support the audit function, there should also be sanctions to address situations where taxpayers do not abide by these legislative powers. Table 2.1. describes some of those penalties, specifically those that relate to the audit function.

Penalties can be:

- Either fixed or a percentage of the underdeclared tax or a combination of the two based on the country's penalty policy; and
- Levied on the taxpayer, on his/her agent, or on both.

Table 2.1. Types of Penalties and When They Are Used

| Type of Penalty | Where It Is Used |
|--|--|
| Penalty for failing to provide documents and information | This relates to the right to inspect provision. If information is requested by the auditor relating to the determination of correct tax payable and the taxpayer refuses to provide this information, s/he can be subject to a penalty for failing to provide the information. |
| Gross negligence penalty | Where the taxpayer was found to be grossly negligent (knew or ought to have known that the tax return was not correct or the definition in the tax administration's legislation), then this penalty is applied to the additional tax assessed based on the audit results. Countries can vary in their definition of what constitutes gross negligence. |
| Late or non-filer penalty | Where a taxpayer is required to file a return on time but does it late or does not file at all, a penalty is generally imposed for the offense, which acts as a deterrent to future noncompliance. |
| Penalty for obstruction of tax officials | If an individual, whether a taxpayer or other person, seeks to circumvent the work of the tax official, then an obstruction penalty could be levied. |
| Penalty for assisting in making an incorrect tax return (agents) | This penalty relates to the role of tax agents in filing improper returns. If it can be proven that an agent knew or ought to have known that a return was incorrect, the agent can be penalized in addition to the taxpayer. The taxpayer has the ultimate responsibility for the accuracy of a return, however, so the tax agent cannot be solely accountable. |
| Penalty for failing to withhold and remit tax | This penalty is related to legal obligations placed on third parties (e.g., employers and financial institutions) to withhold taxes at source and remit the withheld amounts to the government. This would apply in a situation where a taxpayer employed staff and did not deduct and remit the payroll deductions required by law. Similarly, this could also apply to the collection of value-added tax (VAT), as both these examples represent trust funds (government revenues), which do not belong to the taxpayer. |
| Penalty for destruction of records | This penalty would apply if the administration can establish that the taxpayer destroyed their business records in an attempt to avoid the determination of correct tax payable. |

Note: VAT = value-added tax.

As part of a country's penalty regime, there are often graduated penalties for repeat offenders. This means that if a taxpayer is noncompliant a second time, a higher penalty would be levied. The number of levels of penalties is determined as part of the country's penalty policy, which is set by the Ministry of Finance or a similar government agency. From a compliance perspective, graduated penalties are an important tool in enforcing compliance for those who are determined not to comply.

Third-Party Reporting Obligations

Tax administrations often collect data from third parties (e.g., financial institutions, customs, land registry, vehicle registry, regulatory body, and subnational governments) to manage compliance. The authority for collecting these data should be in the legislation or in a memorandum of understanding (MOU), which also specifies the frequency and methodology of data transfer. These data are often referred to as **bulk data**, as these include all transactions undertaken with the data provider.

Where there is no legal requirement or MOU in place for bulk data, tax administrations can still compel third parties to provide information on a specific taxpayer basis. This requirement would be stated in the law and is most often used to obtain bank information regarding a specific taxpayer under audit.

The purpose of obtaining third-party data is to strengthen a tax administration's CRM processes and to provide information for the audit. The CRM processes are only as good as the data being analyzed. More and better data allows tax administrations to conduct richer analyses and identify systemic compliance risks.

To make full use of third-party data, tax administrations should have the following:

- Protocols around the format of the data being received to ensure it can be read by the information technology (IT) system;
- Sufficient storage to hold the data, including backups;
- A repository where the data can be manipulated without changing the original data;
- Data analysis software; and
- Staff capacity in data analysis.

Dispute Resolution

Another common legal provision relates to a dispute resolution process. While this function is separate from the audit function, it is important, given its downstream impact from audits.

Since tax law is open to interpretation and there could be a misunderstanding of the facts, it is important for taxpayers to have the right to an independent review of their case post audit. Having dispute resolution processes makes the tax system fairer and improves voluntary compliance, as taxpayers can trust that a second official will review the audit outcome and consider their concerns.

Voluntary Disclosure Program

While not mandatory, some tax administrations use a **voluntary disclosure program (VDP)** to enable taxpayers to correct their returns to avoid possible compliance actions by the tax administration in the future.

A **VDP** allows a taxpayer who has made an incorrect return in the past to come forward and report and pay the correct amount of tax. The main benefit of making a voluntary disclosure is to avoid penalties and possible criminal prosecution if the incorrect tax amount is subsequently detected by the administration. The number of years that a taxpayer can apply for voluntary disclosure varies but can be up to ten years.

The taxpayer must apply to the VDP, and the jurisdiction can accept or reject the voluntary disclosure. Country practice varies as to whether penalties and interest are waived with a complete voluntary disclosure, in the event the disclosure is accepted.

Some common criteria for an acceptable disclosure are as follows:

- The information given under the disclosure must be complete and accurate;
- The tax administration has not begun any compliance efforts related to the years in question;
- The taxpayer must comply with the administration's efforts to validate the information provided; and
- The taxpayer must pay the outstanding tax liability in full at the time of the disclosure or submit a proposal to pay that is acceptable to the tax administration.

The basis for the VDP can be administrative or legislative. In the case of an **administrative VDP**, the authority stems from ministerial discretion to waive penalties and interest, which is codified in the law. The circumstances around when the penalty and interest can be waived to implement the VDP are then contained in an administrative policy. Other countries have specific **legislation** that provides the authority for the VDP.

Having a VDP provides an opportunity for noncompliant taxpayers to correct their filings and set the path for continued correct reporting in the future. Having such a program available may identify taxpayers who would otherwise never have been discovered as noncompliant.

While what is described here is the primary VDP used in many countries, some jurisdictions also offer a **"prompted" voluntary disclosure**, where taxpayers can still apply for voluntary disclosure after initial contact by the administration to begin compliance actions.

In summary, a VDP allows taxpayers to rectify past incorrect tax returns, potentially avoiding penalties and criminal prosecution, making it a valuable tool for promoting compliance.

CHAPTER 3.

Organization and Governance

This chapter focuses on governance and organizational issues related to the audit program that help ensure the program is delivered with transparency and integrity.

Role of Headquarters

Headquarters (HQ) is considered the brain of the administration. It shapes the administration by setting the strategic direction, developing strategies on how to achieve the administration's priorities, and monitoring its progress in achieving results. Table 3.1 outlines the typical roles that would be the responsibility of HQ, along with a description of each role.²

Table 3.1. Role of Headquarters

| Role | Description |
|--|---|
| Planning | Set the compliance strategy, prepare national work plans, and allocate resources to the regions and districts for the audit programs. |
| Manage compliance risks | Identify, assess, and prioritize compliance risks, and develop compliance improvement plans (CIPs) for the key risks. |
| Manage performance | Evaluate audit results, and compare against the plan established at the beginning of the year. Make in-year adjustments if required. |
| Develop national programs, policies, and procedures | Create audit-specific policies and procedures to ensure consistency across the country. |
| Ensure good governance | Ensure segregation of duties is in place, along with appropriate management approval processes for applying penalties. HQ should also manage the audit quality review (AQR) program, which evaluates audit quality based on comparing a sample of completed audits to identified audit standards. |
| Manage reforms | Reforms could be audit specific, or an audit may be impacted by the reforms of other functions within the tax administration. Managing this at the HQ level is necessary to ensure the reforms will continue to meet the program's objectives. |
| Central control over field operations | Provide direction to audit teams across the country on expectations related to the type and number of audit activities expected during the year, as well as on audit policies and procedures. |
| Provide support services | Provide technical support to auditors on the interpretation of the law. |

² For further details on organizational aspects, and HQ responsibilities, see VITARA: Organization.

| Role | Description |
|---|---|
| Analyze tax revenues | Evaluate revenue collection trends year over year. Analyze additional reassessments as a result of audit activities by tax type and taxpayer segment. Trace incremental revenue through the dispute resolution process to evaluate ultimate outcomes. |
| Manage relationships with stakeholders | Meet with industry associations and tax return preparers to discuss audit-related issues and to inform of administration policies. Address their concerns regarding audit processes or procedures. |

Note: AQR = audit quality review; CIP = compliance improvement plan; HQ = headquarters.

The activities of HQ should be organizationally separate and distinct from the operational activities related to an audit.



HQ staff should not be engaged in audit operations.

This separation is important to ensure the necessary attention can be paid to forward the strategy and monitoring results. When staff are expected to do forward planning as well as operational activities, the operational demands always take precedence to the detriment of the forward planning activities. The HQ activities are very important to the success of the audit function and, therefore, should have dedicated resources undertaking the activities.

Taxpayer Segmentation

Taxpayer segmentation divides the taxpayer population into groups with similar characteristics. Administrations segment their taxpayer population to help assess compliance risks as part of the CRM process. Analyzing the data related to businesses with similar characteristics or within the same industry promotes comparisons that can identify potential areas of noncompliance.

Segmentation is also important when a certain population is very important to the tax collection efforts of the administration. For example, large taxpayers, who together are generally few in number, but often contribute more than 60 percent of the total tax collected by an administration, comprise a group that warrants close attention. Defining and segmenting the large taxpayer population allow the administration to develop a closer relationship with these taxpayers and to monitor any changes in their compliance behavior. The large taxpayer segment is so critical to the administration that a separate organizational unit(s) is normally dedicated to its management, and the most experienced auditors are typically assigned to work with these taxpayers. In terms of resources, recent studies³ have shown that administrations are investing about 4 percent of their total full-time equivalents (FTEs) to staffing the large taxpayer office (LTO).

³ OECD, *Tax Administration 2022: Comparative Information on OECD and Other Advanced and Emerging Economies* (Paris: OECD Publishing, 2022), <https://doi.org/10.1787/1e797131-en>. See also CIAT, IMF, IOTA, OECD, *International Survey on Revenue Administration*, "Table A.34 Large Taxpayer Office/Program: Existence and Revenue Collected" (2022), <https://data.rafit.org/regular.aspx?key=74180907>.



Large taxpayers often contribute more than 60 percent of the tax administration's total tax collection.

Average LTO staff devoted to managing the compliance of large taxpayers is about 4 percent.

In addition to large businesses, common taxpayer segments include the following:

- High-net wealth individuals;
- Small and medium enterprises (SMEs);
- Micro businesses; and
- Nonbusiness individuals.

Another reason for segmenting the taxpayer population relates to the opportunity for staff specialization by industry or taxpayer segment, such as large taxpayers, high-wealth individuals, the construction industry, and banking. Having audit staff specialize in a certain industry or segment can improve results, because with experience, auditors typically can identify risk and complete audits more effectively and quickly.

Segregation of Duties

Segregation of duties is an internal control designed to minimize the risk of error or fraud. Transparency and fairness are achieved through segregation of duties, where designated officials perform specific roles independent of one another.



In the audit program, good segregation of duties requires a separate person being responsible for each of the following:

- **Selecting the audit**
- **Conducting the audit**
- **Approving the audit outcome**
- **Conducting the dispute resolution phase**
- **Conducting the criminal investigation, if applicable.**

Even in a small tax administration, efforts should be made to ensure each of these activities is conducted by a different person. If possible, these functions should also be physically separate to reinforce independence.

Audit cases require varying levels of approval. The immediate supervisor should approve the proposed adjustments for every completed case. Depending on the materiality of the additional tax assessment, a second level of review could be required at the managerial level (i.e., the supervisor's supervisor). This would be determined by local policy. Other situations may also require management approval, such as, application of a gross negligence penalty, obtaining taxpayer-specific data from third parties, and referral of the case for criminal investigations.

The extent of supervisory reviews is generally an administrative policy. Tax laws stipulate what decisions can be made by the tax administration (e.g., decisions to impose penalties). Typically, the law delegates this authority to the head of the administration, who then subdelegates certain decisions to lower-level positions in the organization.

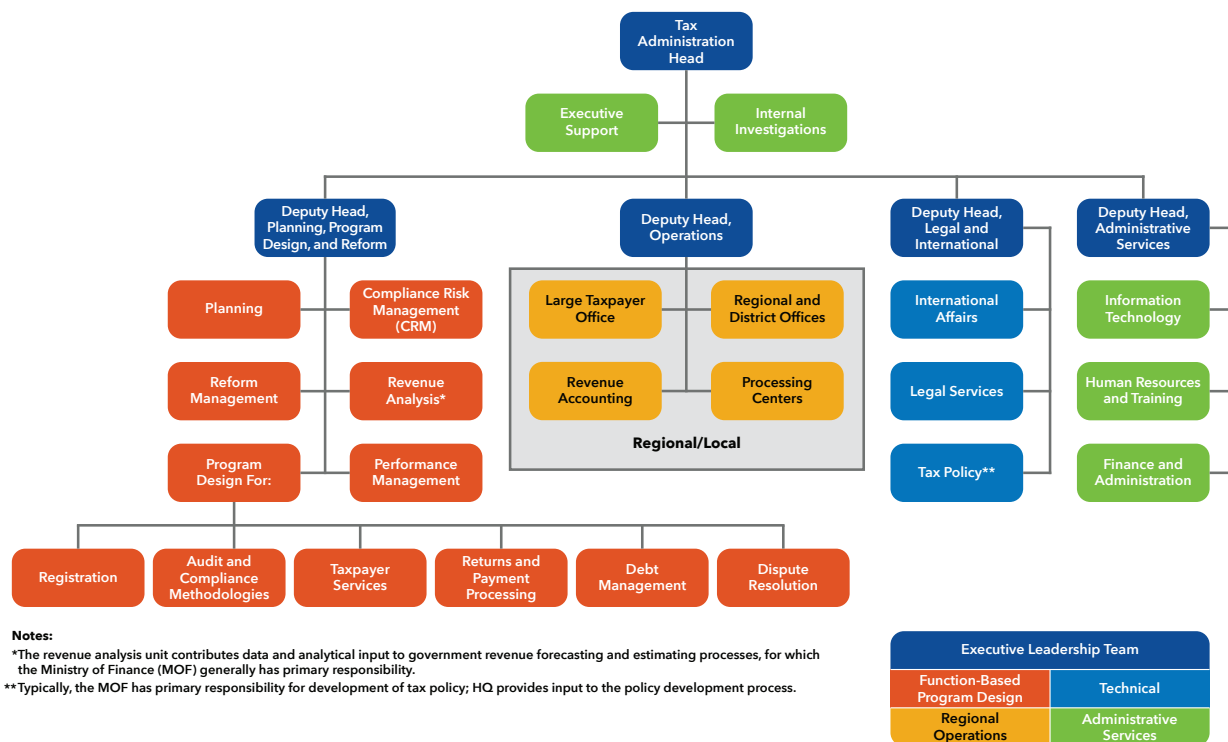


Delegations of authority are to a position, not a person.

The delegation of authority does not follow the person if they change jobs. Delegations of authority should be carefully considered and documented internally. They should be issued to the positions selected through a formal letter outlining the nature of the delegated powers and when they are to be used. One such power that is often delegated to a senior manager is the application of gross negligence penalties. This means that the auditor is not permitted to decide on their own that a penalty should apply, but rather, it must be approved by the delegated official, which brings the necessary rigor to the process. Given that penalties are punitive, this additional layer of approval is warranted.

Organization Structure

To meet the segregation of duties rule, the audit function should be organizationally separate from the CRM, audit case selection, dispute resolution, and criminal investigation functions. To ensure independence, ideally, these functions should not operate within the same reporting structure. In very small tax administrations, it may not be possible that each function has its own reporting structure, but the activities should be conducted in separate teams, as a minimum. To illustrate good segregation of duties through organization structure, see Figure 3.1, which illustrates a mature, function-based organization structure, with large taxpayer segmentation. While the goal would be an organization structure such as that shown, variations may be warranted for small tax administrations, as well as to allow a graduated progression to the desired end state.

Figure 3.1. Indicative Function-Based Organization Structure

Note: CRM = compliance risk management; HQ = headquarters; MOF = Ministry of Finance.

The HQ program design and CRM activities (which include audit case selection) are primarily conducted within the program design and reform directorate (with some flexibility for local or regional case selection for a portion of the cases). The LTO and other segments (included in regional and district offices) report to the deputy head, operations. For administrations that have a criminal investigations division, this division would fall within the legal and international directorate. In some countries the dispute resolution function reports directly to the tax administration head rather than through the HQ function as shown in Figure 3.1.

As Figure 3.1 shows, the responsibility for HQ program design is separate from the operational delivery of the audits and verifications, which is in the operations directorate. HQ sets the strategic direction and selects cases through the CRM function. The regional offices deliver the program by conducting the audits identified by CRM and according to the strategy developed by the HQ program design group.

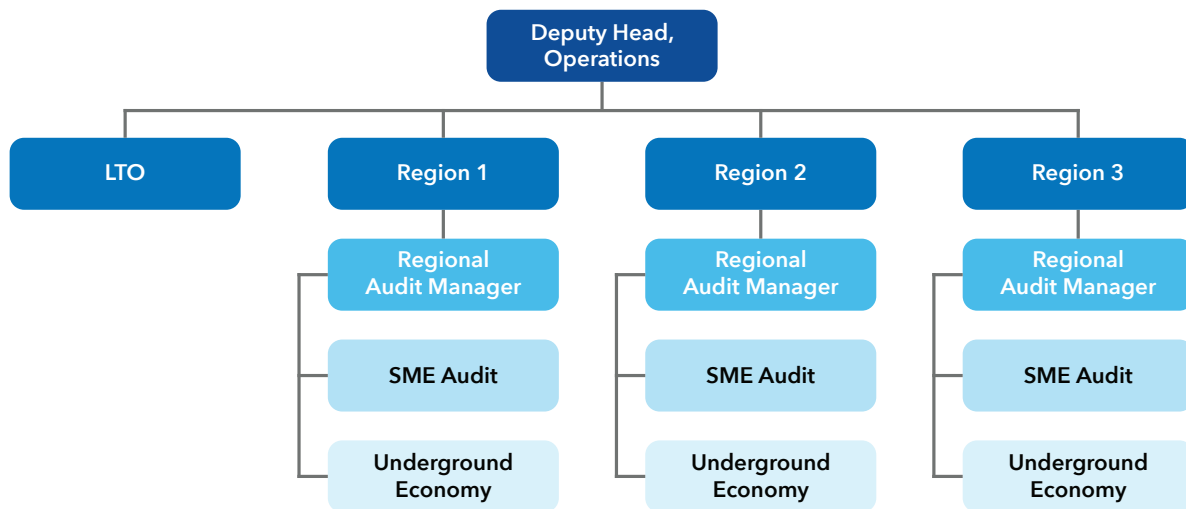
The LTO reports directly to the deputy head, operations, who is an HQ executive, as shown from the color coding in Figure 3.1. There may be one or several regions who would be responsible for all audit operations, except for those taxpayers who are part of the LTO.

Where the volume of taxpayers and audits allows, administrations can further segregate their workloads using centers of expertise. This is where an organizational unit specializes in a certain industry or issue. Examples include high-net-worth individuals (HNWIs), the underground economy, or aggressive tax planning. In Figure 3.1, these centers of expertise would be within the regional and district offices.

While Figure 3.1 represents a typical model for administrations to use as a starting point in their organizational design, adjustments should be made to recognize specific country circumstances.

In the example in Figure 3.2, and focusing only on the LTO and regions, note that within each region, there are two centers of expertise—one for small and medium enterprise SME audits and the other for the underground economy. These can be adapted to focus on the major risks in a particular country. There may only need to be a center of expertise for SME audits, which would cover everything beyond that is included in the LTO. Alternatively, there could be centers of expertise for high wealth, aggressive tax planning, and international tax. The number of centers of expertise needed will depend on the size of the taxpayer base, the number of auditors, and the types of compliance risks identified. A center of expertise would be justified where material risks have been identified, affecting the filing of a significant number of taxpayers.

Figure 3.2. Operations Indicative of Organization Chart for Audit Functions



Note: LTO = large taxpayer office; SME = small and medium enterprises.

As noted, the tax administration will need to adapt the model to the individual circumstances of the country, recognizing the size of the administration.

CHAPTER 4.

People

This section outlines the key human resource requirements for an effective audit program.

Resources

How a tax administration organizes its audit teams can be reviewed using the following two key criteria:

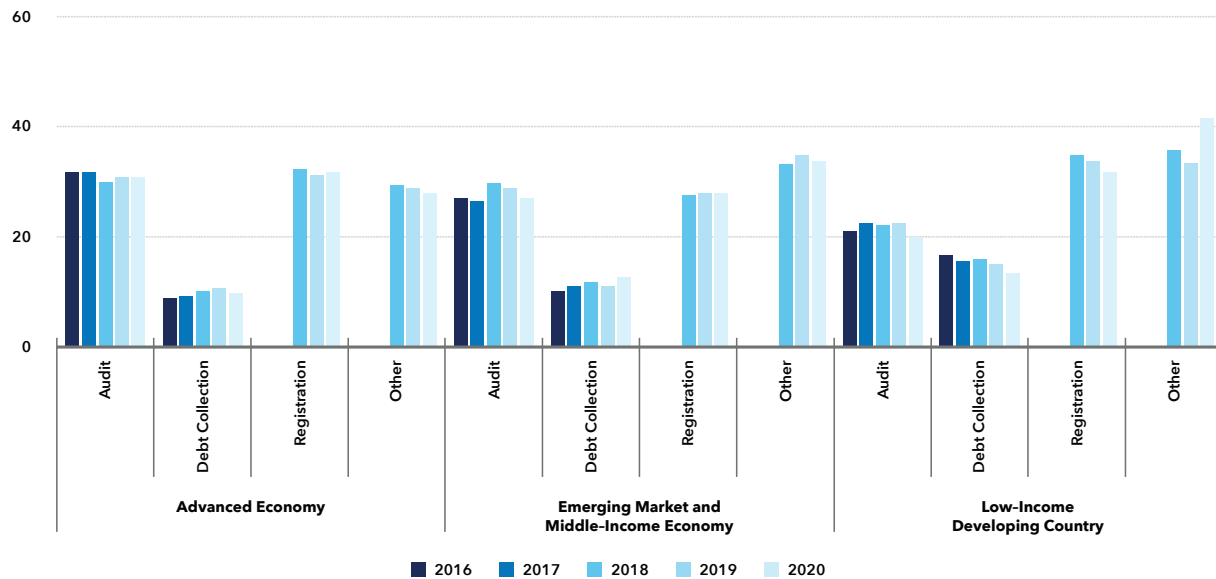
Number of Auditors

The factors governing the number of auditors required for an effective audit program will vary from country to country, but the following should be considered:

- Taxpayer attitudes toward compliance;
- Experience gained from previous enforcement efforts, which should provide a sense of the extent of noncompliance; and
- The degree of risk identified through the CRM process.

Most advanced tax administrations allocate approximately 30 percent of their overall staff resources to their audit programs, with the balance being allocated to registration, collection of tax, providing customer service to facilitate voluntary compliance, and administrative duties. Investing in CRM reduces the burden on audit teams to participate in audit case selection and is in line with the need for segregation of duties.

Figure 4.1 shows the size of the audit function as a percentage of total staff across tax administrations.

Figure 4.1. Percentage of Full-Time Equivalents (FTEs) by Function⁴

Note: FTE = full-time equivalents.

Span of Control

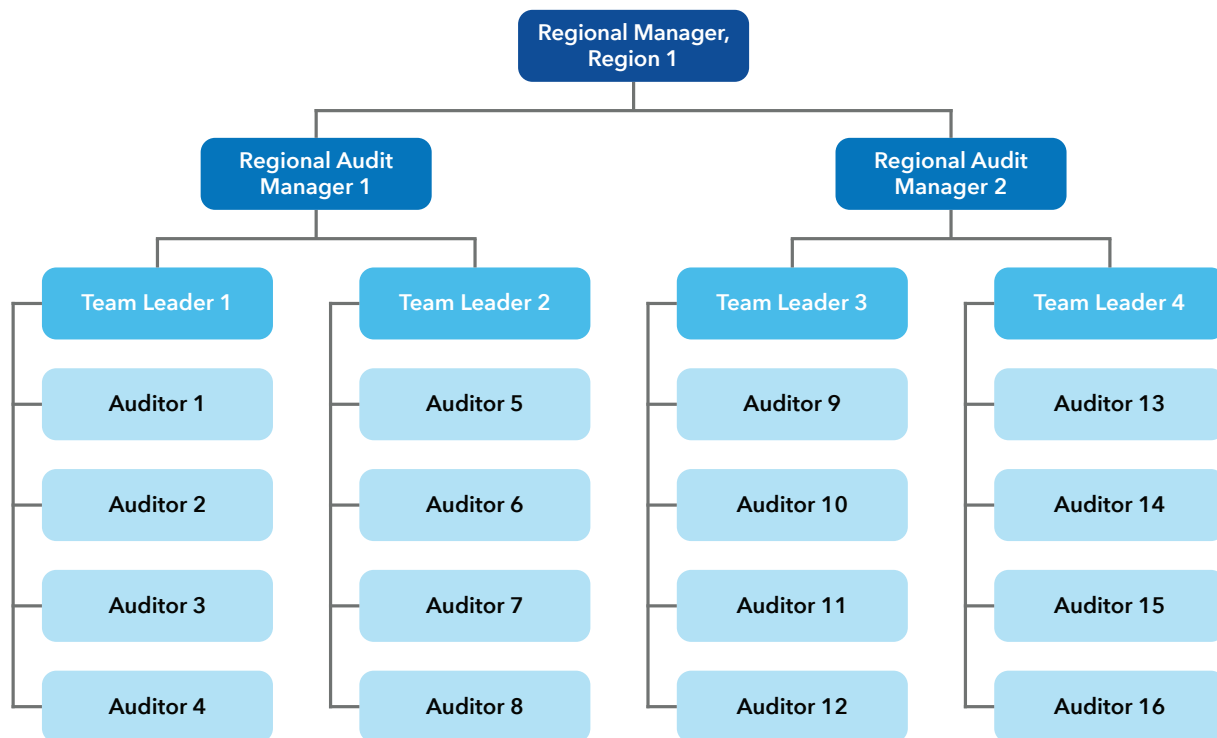
“Span of control” is a term used to describe the number of staff each supervisor would have reporting to them. Criteria that can impact span of control decisions include the complexity of the work and the experience level of the staff. This is because:

- The more complex the work, the lower the span of control that is recommended.
- Conversely, the more experienced the auditors are, the higher the span of control the tax administration can have.

Where auditors are inexperienced, a lower span of control will allow the supervisor to provide more hands-on support to the auditors, which will decrease the duration of their learning curve, allowing them to work independently more quickly.

A span of control in the range of four to eight auditors per team leader is advisable. Figure 4.2 is a typical regional audit team organization chart.

⁴ IMF staff calculations based on CIAT, IMF, IOTA, OECD, International Survey on Revenue Administration: 2020 and 2021, (2022), <https://data.rafit.org/?sk=8b008788-ebde-4d61-bc90-7438d6aa12dc&slid=1637191076670>.

Figure 4.2. Indicative Regional Audit Organization Structure

It is advisable to have separate teams for those staff conducting desk and field audits and those conducting less complicated verifications. This contributes to the efficient use of resources as illustrated below.

Staff Expertise

It is important to resource the different types of audits with the appropriate staff expertise. Verifications can be staffed by less experienced staff, while the more complex audits require more experienced staff.

Verification

In many tax administrations, staff assigned to verification work are often sourced from the tax administration's registration or customer service teams. Conducting verifications requires the following skills:

- A good knowledge of the taxation issues to be verified;
- Attention to detail and good communication skills; and
- The ability to recognize when a case needs to be escalated to an audit or, in some cases, a criminal investigation.

Some verification work can involve significant amounts of tax (e.g., VAT refund claims), so the work of inexperienced staff needs to be supervised by an experienced manager.

Audit

Tax administrations have for many years recognized the benefits of strong investment in developing their audit team's expertise and skill sets. Increasingly complex taxation issues, combined with an ever-changing business landscape, mean that auditors:

- Must be equipped with a wide range of expertise and skills;
- Can expect to work in a challenging environment where they must balance their duty to respect taxpayers' rights with the task of testing the veracity of tax returns, sometimes using invasive powers; and
- Be able to handle conflict and remain calm when under pressure.

These skill sets are in addition to formal qualifications in accountancy and, preferably, tax laws. A summary of the professional and operational competencies required of auditors is in Appendix 1.

Large Taxpayer Audit (including HNWIs)

Depending on resources and the level of risk, having auditors specializing in large industry sectors will result in efficiency gains from audits being completed more quickly and better revenue yields from an in-depth knowledge of the industry and its inherent risks.

The LTO and HNWIs teams should be staffed with the most experienced auditors and audit managers. They will be meeting the taxpayers' most qualified and experienced advisers and should, therefore, have the following skills:

- The expertise to challenge the advisers when necessary;
- Deeper and more specialized knowledge about specific regulations for their assigned segment (financial sector, government, natural resources, energy sector, etc.);
- Specialist knowledge to enable them to recognize and tackle compliance issues regarding profit-shifting, transfer pricing, capital accumulation, anti-avoidance, and so on; and
- The ability to understand the links between large taxpayers and the shareholders (often HNWIs) who may control them.

The LTO will need to have e-auditing skills among its complement of auditors. E-auditing will be covered further in Chapter 5.

Criminal Investigations

Given that the criminal investigations function deals with criminal tax evasion, there should be a clear separation from the audit function. The skill set required of criminal investigators is also distinct from that of an auditor. The function requires criminal investigators to:

- Have specialist training in criminal investigation techniques and be highly trained and skilled investigators who can conduct in-depth investigations;
- Typically, be experienced auditors but also skilled in gathering all necessary evidence to prove criminal tax offenses beyond a reasonable doubt; and
- Have witness training because they are likely to participate as expert witnesses in judicial proceedings for cases that the legal staff of the tax administration submit for prosecution.

Auditor Training and Mentoring

A formal training program, supported by mentoring, is essential for building and maintaining an effective audit team. Even with recruitment criteria like degrees in accountancy or a similar profession, auditors need to be trained in specific tax audit techniques. Auditors also need to be skilled in IT, software applications, and the use of computer-assisted audit tools and techniques (CAATs). Relying on on-the-job experience or auditors' self-funded professional development is not adequate. Therefore, tax administrations should provide for thorough training for auditors to ensure they have the right skill sets to address the identified compliance risks.

The tax administration should adopt a proactive role in designing formal audit training. How the training is provided, however, differs from country to country. Training should be supported by clear instructions, in the form of audit manuals, guidance on new legislative developments, updates on emerging identified risks and policy changes, and other knowledge management (KM) products. Such instructions should be written in plain language with references to the relevant legislation where appropriate.

Auditor Timekeeping

The cost of training auditors and the time dedicated to conducting audits mean that auditors are an expensive resource for the tax administration, making it very important that this resource be used wisely. Two concepts that are relevant in evaluating how auditors use their time are described as follows.



Applied time is the cumulative number of hours spent by the auditor to undertake all the phases of the audit of a particular taxpayer.

Elapsed time is the number of days from when the file was assigned to the auditor to the date of completion.

Auditors should record the amount of time spent on each audit or verification (applied time) so that a cost-benefit analysis can be conducted. This cost-benefit analysis compares the input costs (salary of auditors) to the outputs of the audits (additional tax assessments) on a program-by-program basis. This allows management to evaluate the relative contribution of each program to the administration's goal of maximizing revenue collection under the law. Calculating applied time is more easily done where the tax administration uses an electronic case management system (CMS) for recording the activities of the audit program. However, even in a paper-based system, it is important that auditors record how they spend their time.

Auditor timekeeping is important:

- For evaluating trends in applied and elapsed time on audits of various levels of complexity;
- To help identify effective auditors for the purpose of performance evaluation; and
- To help management evaluate program deliverables and to assess return on investment (ROI).

Spending audit time on low-risk issues is not valuable. The tax administration should work to dispel the feeling among some auditors that they need to spend the allotted time and carry out every check, even when no significant risk exists.



Auditors should “audit to the risk,” which means they focus their time only on identified areas of risk, not on transactions that represent little or no risk of incorrect reporting. Finding the areas of material risk quickly is the key to efficiency in conducting audits.

Given the importance of timekeeping, some key actions that both auditors and the tax administration can undertake are described in Box 4.1.

BOX 4.1. Key Considerations in Auditor Timekeeping

To ensure efficiency in audits, **auditors** should:

- Be constantly undertaking a cost-benefit analysis, comparing the potential remaining compliance risks against the time needed to address those risks.
- Conclude the audit if they identify that the cost to address the risk (based on its probability of being a material compliance risk) is equal to or higher than the potential additional tax.
- Be conscious of the cost incurred by the taxpayers who are the subject of an audit.
- Recognize when an audit needs to be extended or perhaps escalated to a more comprehensive audit; this should only be done with the team leader's or audit manager's approval.

To develop a system for measuring how auditors spend their time on audit work, **tax administrations** should:

- Oblige auditors to record the time spent on audit work (including planning, conducting, finalizing, and report writing) preferably using a CMS.
- Encourage auditors to close nonproductive audits as soon as their audit tests of the risks identified indicate that there is no significant risk.
- Instruct auditors to switch to other audit work when time gaps appear in current audits; auditors should be able to manage multiple audits simultaneously.
- Ensure that audit managers and team leaders oversee their auditors' timekeeping on audit work to ensure that most of their time is spent actively doing audit work.

Note: CMS = case management system.

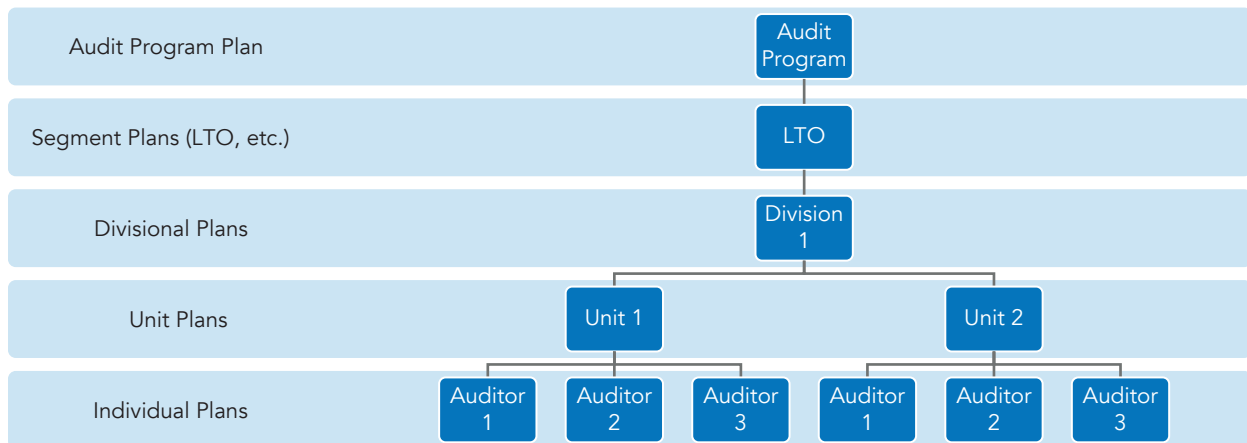
A key skill for auditors is the ability to manage multiple audits simultaneously, where they use their time wisely and can skip from one audit to another (while waiting for information), to keep audit cases progressing. Auditors with good time-management and risk-analysis skills are usually among the top performers in terms of numbers of audits completed and additional tax identified.

Auditor Performance Evaluation

Operational managers and team leaders should work together with the human resources (HR) team in defining the optimal competencies and performance indicators for audit staff, and HR should support operational managers in managing auditor performance.

The assessment of individual auditor performance should align with organizational performance—that is, individual performance measures must be logically linked with the overall audit program performance, ensuring alignment with strategic objectives. Accordingly, individual objectives should then roll up to unit plans, which are aligned with divisional plans, program plans, and ultimately, the “whole of audit” plan. This alignment between the various levels of performance measures is illustrated in Figure 4.3.

Figure 4.3. Alignment of Operational Performance Measures



Note: LTO = large taxpayer office.

This approach helps achieve **“line of sight”** between the tax administration’s outcomes and individual performance measures, and it supports the measurement of the individual auditor’s contribution to the audit program outputs. Thus, tax administrations should choose key performance indicators (KPIs) for auditors that reflect and contribute to the overall audit program performance goals and measures.

Here are some key considerations regarding setting KPIs for auditors.

Measuring KPIs: A wide range of expertise and skills are necessary to be an effective auditor. It is important to first consider what are the important KPIs to measure good auditor performance. Next, consider how to measure whether a particular KPI is met. **If it cannot be measured, then it should not be included as a KPI. Similarly, “what gets measured, gets done.”** This means that auditors’ behavior will change based on how their performance is measured. If the administration only measures the amount of additional tax assessed, auditors will orient their behavior accordingly. While generating additional revenue for the government is important, auditors also need to be concerned with quality of the audit and fairness to taxpayers.

KPIs and career outcomes: An important reason to “get it right” when it comes to setting individual KPIs is that performance measures used in individual performance agreements often contribute directly to remuneration or career advancement outcomes for the auditor. The credibility of the overall performance management system and pay and career advancement outcomes will therefore be linked directly to the perceived appropriateness and fairness of the performance measures.

KPIs and promoted behavior: Individual auditor performance should not be solely based on additional revenue collected. In particular, the additional revenue collected from completed audits should not result in an increase in remuneration for the auditor. Such systems can promote undesired behavior. Errors made by inexperienced auditors should be treated as learning experiences; inexperienced auditors should not be penalized for genuine errors.

KPIs and performance measurement: The individual performance measurement should encapsulate a range of measures, including the team leader's narrative assessment of the auditor's overall performance. The individual targets (KPIs) should be agreed with each auditor at the beginning of each year. At a minimum, the targets should describe the number of each type of audit (full scope, limited scope, single issue, team audit, verification) to be completed for the year. The number of audits that an auditor should complete annually is best determined by the audit manager. He or she is best placed to determine the correct numerical targets based on the following:

1. The complexity of the cases to be audited.
2. The skills and experience of the particular auditor.

The progress should be measured at year-end but should include at least one interim progress review during the year. The interim review can be useful for resetting targets if unforeseen circumstances dictate a change in the original targets.

Some suggested KPIs for individual auditor performance include the following:

- **Number of completed audits:** This describes the number of each different audit type.
- **Expected strike rate:** This is the percentage of completed audits that identify additional liability. However, tax administrations should be careful with this KPI (e.g., the reason for a nil-yielding audit could be due to poor audit case selection). If an auditor consistently returns a low strike rate, it can indicate several possible reasons, including poor performance, need for additional training, or even corruption issues.
- **Timely completion of audits:** This is measured by the age of the oldest open audit and number of audits open for more than three months, six months, and so on. Caution should be exercised with this KPI. Delays are often the fault of the taxpayer; however, auditors should routinely be capable of managing delays caused by the taxpayer (by using legislative powers as appropriate).
- **The number of completed audits that result in a request for an internal administrative review:** This KPI, or an appeal to an external reviewer or to the courts, should be used judiciously, bearing in mind that there could be many reasons for a large number of such appeals—for example, auditors dealing with LTO or HNWI cases.
- **The number of mentoring meetings held:** This applies for auditors who also have a role as a mentor.

The key is to avoid using one measure for auditor performance, but rather, selecting a range of indicators that together will provide an accurate picture of performance and promote desired behaviors by auditors.

CHAPTER 5.

Tools

This chapter focuses on the fourth key component of an audit program and covers tools such as audit case selection, audit types, and audit methods and the importance of integrity and quality assurance.

The Role of the Audit Program within CRM

Compliance risk management, or CRM, means taking a high-level view of all risks that might threaten a tax administration's primary mandate of collecting the tax and duties for which it is responsible in accordance with the law and then deciding on treatment strategies that best address those risks.

The findings from the CRM process are then translated into a compliance improvement plan (CIP), which should identify the practical actions (treatment strategies) to address the identified risks. One means of addressing identified risks is through the tax administration's audit program. While audit (including verification) is just one of the possible treatment strategies, it is a significant strategy, primarily aimed at those who choose not to comply.

It is very important that the CRM team, the audit case selection teams, and the functional audit managers work together closely when developing the CIP. Analysis conducted by CRM must be matched with direct experience from frontline staff who have local knowledge of the risks encountered throughout the region. A good way to do this is to host an annual compliance conference three months before the commencement of the fiscal year to harness the knowledge and experience of HQ and frontline staff. This allows adequate time for the next year's CIP and regional audit plans to be drafted and approved in good time.

Case Selection

Audit case selection should target the riskiest cases. Some tax administrations fall into the trap of allowing external pressures to divert the case selection process by prioritizing requests from external sources, which usurp their own case selection process. Audits of bankruptcies, liquidations, cases identified by external bodies, and complaints from citizens are all useful sources of information that can be fed into the existing risk-analysis process. These sources of information should not be allowed to take precedence over audits selected using risk analysis.

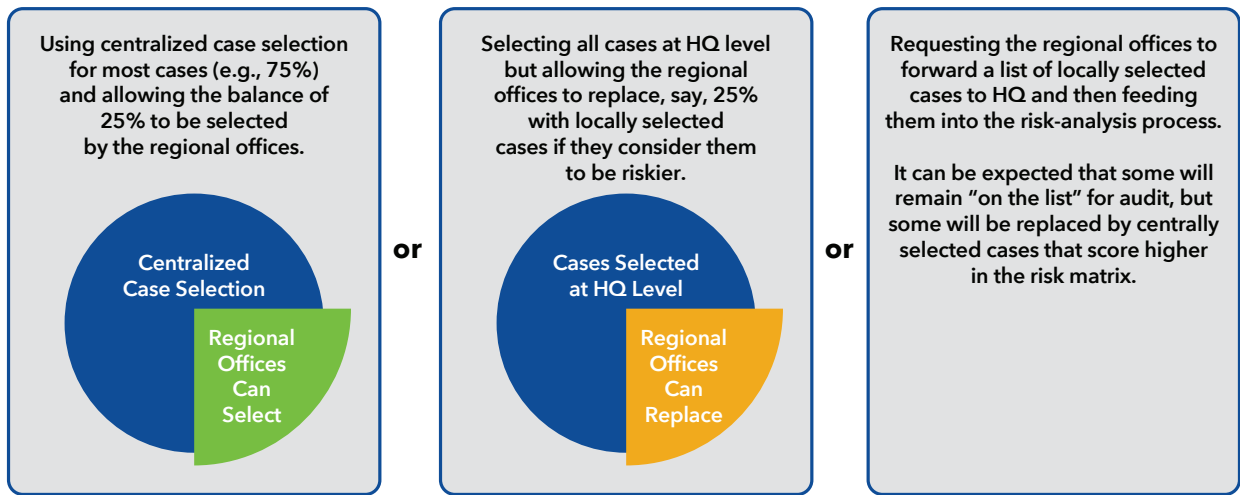


Don't allow factors other than risk to drive case selection.

Case selection can be done at the national or regional level, but it is important to remember the principle of segregation of duties and accountability of decision-making.⁵ Many administrations are moving to centralized national case selection, following the CIP development at the HQ level, to ensure the cases selected represent the highest risk throughout the country. If audit case selection is conducted at a regional (local) level, there is a likelihood of inconsistency in case selection nationally because of varying perceptions of what is considered “risky.”

While local knowledge is a very important factor in identifying the riskiest cases for audit, a means of capturing the benefits of both centralized case selection and using local knowledge is to consider hybrid solutions, as described in Figure 5.1.

Figure 5.1. Case Selection Models



Note: HQ = headquarters.

A table showing the strengths and weaknesses of possible audit case selection models is provided in Appendix 2.

It is critically important that no matter which model is adopted, there is a strong feedback loop from the regional offices to HQ on the value of the risk indicators and overall case selection. This is best achieved by designing a formal feedback system for auditors, which obliges them to comment on the risk indicators. The feedback should then be used to enhance the risk-analysis system. The audit case selection model can be further enhanced by establishing a random audit program, discussed in more detail in Appendix 3.

Table 5.1 is a summary of the key elements of CRM and case selection.

⁵ For more information on segregation of duties and delegation of authorities, see VITARA: Institutional Governance.

Table 5.1. Key Elements of CRM and Case Selection

| Compliance Risk Management | Case Selection |
|--|---|
| <ul style="list-style-type: none"> • Identification of current and emerging compliance risks • Informs strategic planning process, including resource allocation by prioritizing compliance risks by: <ul style="list-style-type: none"> ◦ Tax type ◦ Core tax obligations ◦ Key segment and major sectors ◦ Topical and emerging issues • Specific treatments captured in a CIP | <ul style="list-style-type: none"> • Strong corporate commitment to risk-based case selection • Central systems-driven process • Access to data sources to strengthen selection • Good analytics capability and tools • Fixed and flexible risk criteria to guide selection • Information on the effectiveness of existing audit interventions • Independent from audit delivery but with strong feedback from auditors • Provides for escalation and referral • Random audit generation to enhance selection and criteria |

Note: CIM = compliance improvement plan; CRM = compliance risk management.

Types and Scope of Audits

Because of the increasing complexity and variety of risks, most modern tax administrations have developed an assortment of audit methods. Figure 5.2 outlines three types of interventions used to manage compliance risks. They range in degree of intensity from a verification check on minor items to audits to criminal investigations, which is the most intensive intervention available to a tax administration.

Figure 5.2. Range of Interventions by Degree of Intensity

International good practices concerning the selection of the type of audit and verification include the following:

- The type of audit or verification should match the nature of the identified risk.
- The legislation empowers the tax administration to conduct inquiries using a variety of methods.
- Detailed guidelines on how compliance staff should choose the most appropriate audit type should be included in manuals and other training resources.
- Resources are allocated in a balanced way.
- The ratio of the various audit types is monitored to ensure efficient coverage of identified risks.

- Large numbers of minor verification checks that may contribute little to overall compliance management are minimized.
- CRM and audit case selection teams decide on the nature of the audit type and inform the auditor accordingly.

Appendix 3 provides additional information on the different types of audits. The purpose and benefits of a random audit program are also discussed.

Audit Methods

Audit managers should strive to ensure that auditors focus on the risks and are familiar with the various audit methods available to address those risks. Auditors should already have been provided with a summary of the potential risks (by the CRM or the case selection teams), but once they commence the audit, the interviews with the taxpayer and observation of the business should alert them to any possible additional risks. The CRM team or auditors' preparation work should provide them with some idea regarding the types of audit methods that would be most useful for the audit. However, it is often the case that such decisions can only be made once the audit commences.

The two types of audit methods are direct and indirect. The choice of method will depend on the nature of the business, the extent and quality of the business records, and the amount of third-party information available to the auditor. It is often the case that a combination of methods may be required.

Direct methods are suitable for cases in which the books and records can be relied on to reflect the reality of the business operations. The audit consists of comparing the tax return with the business books and records to identify differences in facts or legislative interpretation. This is the traditional method of auditing.

Indirect methods could be more appropriate where it has been determined that the books and records cannot be relied upon. For example, there could be weak internal controls, or there are many cash transactions, which could point to the unreliability of the books and records. This means that the records could be manipulated or inaccurate, and the correct amount of tax may not be reported. Sometimes it is what is **not** in the books and records that's important (i.e., unreported income), which requires a different approach than a direct audit.



If the taxpayer's books and records cannot be relied upon, the auditor should use an indirect method of audit for verifying reported income.

It is generally recognized that indirect audit methods fall into six different categories: benchmarking, cross-checking, bank deposit and cash expenditure, source and application of funds, percentage markup, and unit and volume. Depending on the nature of the business and the risks identified, it may be appropriate to use a combination of different indirect audit methods.

Some indications that the auditor should adopt indirect methods include the following:

- The taxpayer fails to maintain records.
- Unexplained wealth or declared income that does not reflect the taxpayer's standard of living.
- The income recorded in the books and records does not appear consistent with the observed business activity, either in terms of the scale of the operation or the types of products or services being sold.
- The taxpayer consistently declares losses or insubstantial income for an extended period.
- Most business operations are in cash.
- Documents are incomplete, recordkeeping is poor, and internal controls are weak.

Auditors need to be skilled in both direct and indirect auditing methods and able to recognize which method is most appropriate for different circumstances. For more details on the categories of indirect methods, see Appendix 4.

Audit Integrity

There are three important areas of focus that should assist management in maintaining audit integrity. Training material and line management guidelines should include oversight and monitoring processes to mitigate possible integrity risks in these areas.

Case Selection

Cases for audit or other verification processes should be selected exclusively based on the risks identified. While case selectors should use all available sources of information, including tip-offs and local information when assessing risk, it is important that the reasons for audit case selection are risk based and clearly evidenced and documented.

To ensure audit integrity in case selection, tax administrations should:

- Be cautious when dealing with information provided by citizens; while some may act in good faith to report noncompliance, be aware that false information might be supplied to harm a business competitor.
- Test any information received using the tax administration's risk-analysis procedures.
- Never target a taxpayer for audit or verification for any reason other than as part of an independent risk-based process.

Finalizing the Audit Where the Taxpayer Does Not Agree

This is an area that can be problematic. Audit reassessments should always be fact based and supported by working papers and technical research. The auditor should always use professional judgment in arriving at audit conclusions in cases where there is a difference of opinion on the facts.

The following two approaches could be used to resolve cases where the taxpayer does not agree with the auditor's conclusion:

1. **Approach 1:** The auditor could take the approach to assess based on the facts as understood by the auditor, without accepting the taxpayer's view. This will likely result in the taxpayer using the dispute resolution process, which is costly, and the assessment may be overturned.
2. **Approach 2:** Some administrations allow auditors to make a compromise to bring the audit to a reasonable conclusion that fairly represents the actual tax payable. The risk in using this approach is that it may result in the auditor being susceptible to corruption if the taxpayer offers money to reduce the assessment. If an administration allows judgment calls to bring the audit to an agreed conclusion, it must be done with full transparency, proper management oversight, and based on documented internal guidelines or manuals.

Each administration must weigh the benefits and risks of both approaches to determine how best to guide auditors in bringing their audits to a conclusion that are fact based and efficient for the administration.

This situation is distinguished from the case where an auditor and taxpayer agree on a tax payable amount without having conducted a thorough audit. Under no circumstances should such a practice be condoned. Such a practice could lend itself to payments being made to the auditor to avoid an audit that could potentially unveil significant unreported income. Any auditor who is offered a bribe should immediately report it to their supervisor.

Delegation of Authority

Where a country's tax laws permit delegation of authority, it is important to carefully consider what will be delegated and how to decide to what position the authority is delegated to prevent corruption opportunities. Considerations include whether the decision will impact multiple taxpayers and whether segregation of duties can still be maintained. Any delegation of authority guidelines or procedures should be clearly documented and, in particular, should not allow individual managers or auditors to transfer audit cases without sound, transparent reasoning and approval at the senior management level.

Some processes and systems to mitigate against corruption are as follows:

- **Secure websites:** Some tax administrations offer a secure website where the taxpayer can check the veracity of the audit and the name of the assigned auditor(s). This is to avoid the risk of auditors initiating "fake" audits for bribery purposes.

- **Random review of cases:** Many tax administrations, in addition to the normal approval of audit case selection and finalized audit approvals by immediate managers, also have a random selection of cases referred to the most senior management level. This provides additional protection against possible corruption, and it also serves to keep senior management updated on real-time audit activity.

Audit Quality Review

A key goal of an effective audit program is that the audit governance and standard of conduct for the audit will be the same, regardless of where the audit takes place across the country or which auditor or audit team handles the audit.

Audit quality review (AQR) is an independent assurance process that is conducted after the conclusion of the audit, which evaluates the audit through various standards to ensure consistency, correct application of the law, and fair treatment to the taxpayer. There are numerous reasons why an AQR program should be implemented. These are detailed in Box 5.1.

BOX 5.1. Reasons to Implement an Audit Quality Review Program

1. Assure stakeholders, including the public, staff, management, and government that the tax administration is conducting a robust audit program, targeted at the riskiest taxpayers, while making optimum use of resources.
2. Assure all stakeholders of the consistency of treatment in carrying out audits across all areas of the tax administration.
3. Assist in the continuous improvement of the audit program by identifying and disseminating best practices and by identifying and eliminating weaknesses, all of which should ultimately lead to increased voluntary tax compliance.
4. Assist in staff development by identifying and addressing training needs.

Note: AQR = audit quality review.

Responsibility for AQR

Everyone involved in the audit programs and processes is responsible for quality. Quality assurance in relation to all compliance programs is a matter for local and regional managers. Each region should ensure that an AQR standard policy is in place in all relevant operational areas and is being operated fully and consistently. The control and operation of AQR, however, should be centralized at HQ level.

There are seven AQR standards in use in many modern tax administrations. These can be adapted to suit individual country requirements. Details on these standards are shown in Table 5.2.

Table 5.2. AQR Standards

| Seven AQR Standards | |
|--|--|
| Selection Standard | Measures whether all relevant steps were taken to identify the most appropriate case or risk for an audit during the screening and selection process. |
| Planning Standard | Measures whether the audit was planned within the appropriate scope, having regard to the issues/risks being examined. |
| Probing Standard | Measures whether appropriate probes were applied and completed to establish that substantially all taxable/dutiable items were reported and all refund claims were valid. |
| Recording Standard | Measures the quality of documentation for the audit, techniques used, procedures applied, and overall case activity. |
| Legislation and Policy Standard | Measures whether the conclusions reached were based on a correct application of the tax and duty legislation, regulations, and policy. |
| Timeliness Standard | Measures time usage and timeliness of actions throughout the audit process. |
| Customer Service Standard | Measures whether the taxpayer's needs were promptly addressed, professional communications were used, and the audit was conducted under the terms of the tax administration's customer service policy. |

Note: AQR = audit quality review.

Structure of an AQR Program

An effective AQR program can operate by establishing a small centralized, independent unit based in the HQ audit division or directorate and staffed by experienced auditors. A statistically robust random sample of completed audits should be selected annually and checked against the seven standards. Management should ensure that the results of the AQR analysis are shared with the audit teams and that they are used to:

- Address any common issues identified;
- Inform CRM and audit case selection; and
- Identify additional training requirements.

Typically, results are shared at the global level, outlining common errors, rather than at an individual auditor level.

It is very important that the AQR program is **not** used to penalize individual auditors for making genuine errors; it should instead be used as a vehicle for identifying common issues requiring a corporate remedy.

CHAPTER 6.

Systems

This chapter looks at the usefulness of electronic systems in aiding audit programs.

Case Management Systems

Many tax administrations use electronic case management systems, or CMSs, to provide improved workflow management for auditors and managers. A fully functional CMS can greatly improve the efficiency of the audit program.

Building a CMS for audit should not be considered in isolation. A holistic assessment of the tax administration's IT systems' existing status and future requirements should be conducted, and the building of any new systems should be prioritized for integration and scheduled step by step by following an agreed road map. Ideally, a CMS will cater for the following:

- Registration
- Processing
- Collection
- Work automation
- Workflow regulation
- Audit case management
- Risk analysis and treatment

The CMS should also be able to provide staff with a comprehensive view of all taxes for each taxpayer and be capable of providing management reports.⁶

Building any IT system takes time and money; it is unlikely that a CMS will be built and commissioned for use in less than three years. The costs, even for a small country, are likely to be large. It will also take time to train staff to use it. It is important that a change management strategy is designed early in the process to ensure a smooth transition from the old to the new.⁷ A sample checklist for good IT support (CMS and other components) is provided in Appendix 5.

⁶ See VITARA: Information Technology and Data Management.

⁷ For additional details on change management, see VITARA: Reform Management Specific Topics: Managing a Reform Program.

Electronic Audit Tools

Modern tax administrations use CAATs to conduct audits more efficiently (often referred to as “e-audits”). Various tools exist to help auditors improve efficiency when analyzing large amounts of data in the taxpayer’s books and records. For the audit of small- and medium enterprises, the benefit of using this software may not be significant. For large taxpayers, this software can be very helpful, as the data can be sorted and various analytical procedures can be done electronically, leaving more time for the auditor to analyze the results rather than manipulating the data.

Several hybrid forms of e-audit and continuous controls are currently employed by tax administrations worldwide. Data collection is becoming increasingly real time, with data now being gathered closer to the transaction’s actual time. In advance of the audit, tax administrations can triangulate taxpayers’ data with that of their trading partners and other entities such as banks and logistics providers.

Before implementing CAATs, it is important that:

- Tax administrations evaluate the need for such software and weigh it against the cost of procuring and maintaining these software programs (regular updates and maintenance fees will likely apply).
- Each auditor has their own powerful laptop and, at a minimum, is adept at using all the standard functionality provided for in the laptop and software programs.

Increasingly, many tax administrations are introducing the use of standard audit file for tax (SAF-T) for larger businesses. This obliges businesses to maintain their records in a standard format. SAF-T facilitates auditors’ access to data in a readable format for substantive testing of system controls and data, resulting in increased effectiveness and productivity in computer-assisted audits.

Even where the SAF-T is not present, the use of CAATs can contribute to more effective and speedier audits. CAATs are particularly useful when auditing businesses that have large numbers of transactions (e.g., retail, manufacturing, hospitality).

Appendix 6 summarizes (1) the types of CAAT tools and common functions of those tools and (2) useful features that can be identified using CAATs to spot noncompliance.

CHAPTER 7.

Performance Measurement

This chapter outlines various performance measures for the audit program, a possible operational performance evaluation framework, and the tax gap methodology.

Performance Measurement

Performance measurement is the process of collecting and analyzing data and reporting on the performance of individuals, groups, or organizations.

The three levels of performance management are strategic, operational, and individual staff member level, representing the hierarchy of the various levels being evaluated (Table 7.1). Setting goals will be done from the top down (strategic, operational, and then individual), while measuring results will be from the bottom up (individual to operational to strategic).⁸

Table 7.1. Levels of Performance Management

| Type | Description |
|--------------------|--|
| Strategic | Has the administration been effective in reaching its desired strategic goals and outcomes (such as improving voluntary compliance)? |
| Operational | Has the administration been efficient in using its resources (inputs) in conducting its activities (such as audits) to deliver outputs? |
| Individual | Have individual staff members contributed to the achievement of the administration's goals through the quantity and quality of their work? |

Figure 7.1 shows a bottom-up approach to performance measurement, with a starting point of inputs (e.g., resources such as auditors' time), leading to impact (e.g., protection of taxpayer base). This allows programs within the tax administration to be compared to each other to determine their relative impact on achieving the tax administration's goals.

⁸ For additional details on performance management, see VITARA: Performance Management.

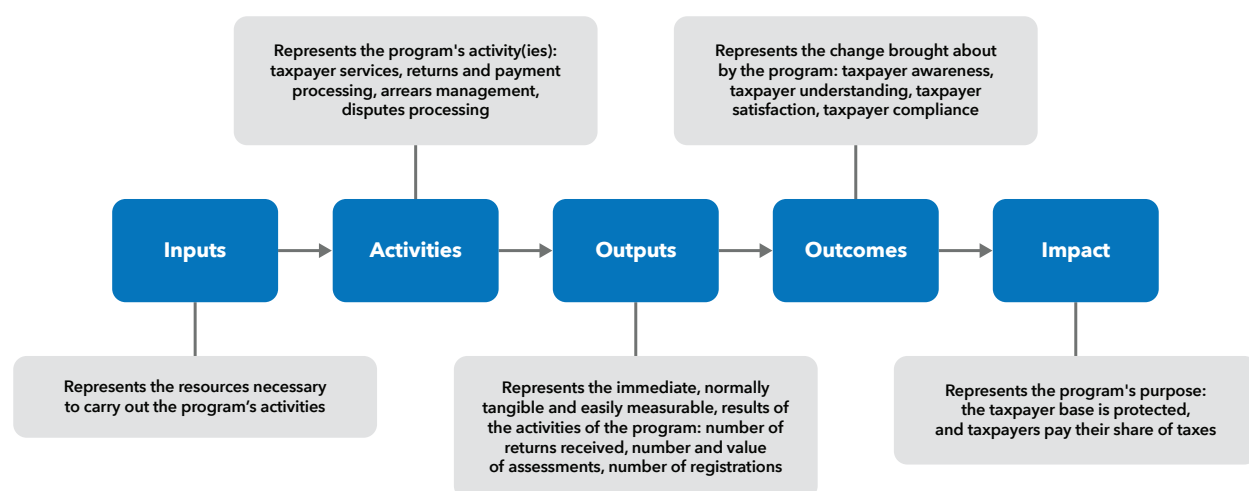
Figure 7.1. Elements of Performance Management

Table 7.2. illustrates a desired outcome pursued by a tax administration (often coming from the tax administration's strategic plan⁹), the activities to achieve the outcome (including audits), and the outputs resulting from the activities (e.g., additional tax assessed) for the audit program. For each level (outcome, activity, output), there are corresponding measures and KPIs. Outcome measures are used to evaluate whether the desired outcome was achieved, while output measures are used to assess whether the planned outputs have been produced. In addition, for each activity there is a corresponding output, which is measured using a KPI.

Terms often heard to describe performance are effectiveness (doing the right things) and efficiency (doing things right). For best results, efficiency and effectiveness have to work together. A tax administration can be very efficient in undertaking activities, but if the activities are not the right ones to achieve its goals, then the administration won't achieve the success it is looking for.

Table 7.2. Example of Output and Outcome Measures for an Audit Program

| Desired Outcome | To promote voluntary compliance through taxpayer service and differentiated approaches to noncompliance to ensure a level playing field for all taxpayers | |
|-------------------------------|---|----------------------------------|
| Activities to Achieve Outcome | 1. Provide education on common errors for small businesses | Effectiveness (Outcome Measures) |
| | 2. Letters to taxpayers in a particular industry, pointing out common errors and inviting taxpayers to self-correct | |
| | 3. Conduct audits of highest-risk taxpayers | |
| Outputs from the Activities | 1. Number of website clicks, number of requests for adjustments related to the particular issue that education was provided on | Efficiency (Output Measures) |
| | 2. Number of letters issued, number of taxpayers who self-corrected, number of taxpayers where follow-up was required and additional tax was assessed | |
| | 3. Number of audits completed, strike rate, amount of additional tax assessed, return on investment | |

⁹ See VITARA: Strategic Management.

In selecting both output and outcome measures, qualitative and quantitative measures can be used, as illustrated in Table 7.3.

Table 7.3. Examples of Quantitative and Qualitative Measures

| Quantitative Measures | Qualitative Measures |
|--|---|
| These measures are numerical and can include data from within the tax administration, as well as results from a tax gap analysis. | These measures are more subjective in nature. |
| <p>Examples:</p> <ul style="list-style-type: none"> • Percentage of audits completed against annual target. • Percentage of audits completed with a material change. • Percentage of additional tax assessed against the annual target. • Reduction in compliance gap over a certain time frame. | <p>Examples:</p> <ul style="list-style-type: none"> • The perception of tax advisers representing taxpayers during audits related to the quality of the audit and professionalism of audit staff. • Taxpayer surveys about attitudes toward compliance. |

A **material change** is characterized as an amount that is significant according to the metrics of the taxpayer. For example, a reassessment of additional revenue of \$1,000,000 in a company with a turnover of \$10,000,000 would be considered significant, and therefore, material. Conversely, a reassessment of \$20,000 in a company with a turnover of \$10,000,000 would not be considered material. Every administration should decide what is material in their context. Another consideration related to materiality is the cost of processing the reassessment. If the cost is more than the additional tax being proposed, it would not be considered material.

Annual Operational Performance

Operational performance evaluation should be at the **program level** (all of audit), at the **segment level** (e.g., large taxpayers), and at the **individual auditor level**.

At the program level (all of audit), it is helpful to calculate not only the **total additional tax assessed** but also the **ROI**, which compares the time taken to generate the additional revenue. For ease of calculation, most administrations just use auditor time (hours dedicated to the case multiplied by average auditor salary) to calculate ROI. If the calculations for all audit programs are done with the same methodology, the results will be comparable.

ROI allows a comparison among tax administration programs so that senior leaders can evaluate how best to allocate resources among programs. It can also be conducted at the segment level (large, medium, small) if auditors record their time for individual cases.

Where countries do not have auditor timekeeping, the ROI can be calculated as total reassessments for the fiscal year divided by the total cost of audit staff.

It is also beneficial to know the ultimate **result of the audit reassessments after all dispute resolution processes** have been exhausted. If the administration's reassessments do not hold up in court, then the amounts are not due to the government, and these amounts should not be counted in incremental revenue collection. A KPI to track this would be done at a global audit level, rather than at an individual auditor level, since there could be a significant time lag from the date of assessment to the date of the ultimate resolution. If a significant portion of audit assessments are reversed at the dispute resolution stage, it could point to an issue with auditors making assessments without sufficient facts and legislation to support the adjustment, which should be addressed by management. Audit teams should be educated on what types of assessments are being overturned, so they do not create assessments that will not be supported at the dispute resolution stage.

Ideally, the tax administration would establish **outcome measures** that track the voluntary compliance trend over time. For example, the percentage of taxpayers who have their return adjusted is decreasing over time for a certain issue that the tax administration has been providing education on. This would be an outcome measure, as voluntary compliance has increased. A positive trend in the tax gap analysis is also an outcome measure, which will be discussed in the next part of this chapter.

Audit Indicative Performance Measurement Framework

Taking the example of an operational performance framework, Table 7.4. illustrates a possible audit program dashboard to measure the performance of the audit program.

On the left side of Table 7.4., note the trend analysis in the tax collected based on tax type. This will give senior management a quick snapshot view of the various taxes and how they are performing based on the returns filed by taxpayers.

On the right side of the dashboard, the framework tracks the various KPIs listed on the dashboard on a quarterly basis. The statistics are divided based on the taxpayer segments, which, for illustration purposes, show large taxpayers and small and medium enterprises (SMEs).

The KPIs being tracked include the following:

- Number of audits completed;
- Total amount of reassessments;
- Return on investment (annual, not quarterly);
- Percentage of audits with a material change; and
- Additional reassessments from the matching program (for the verification program); this would be where the administration has access to data that they can compare to reported income or claimed expenses to validate whether what was reported was correct.

Table 7.4. Performance Measurement Dashboard for an Audit Program

| Population and Revenue Collection (Annual) | | | | | | |
|--|--------------------------|--------------------|------|----------|------|----------|
| Type of Tax | Number of Taxpayers 2022 | Revenue Collection | | | | |
| | | 2020 | 2021 | % Change | 2022 | % Change |
| CIT | | | | | | |
| VAT | | | | | | |
| PIT | | | | | | |
| Other Main Taxes | | | | | | |

| Trend Analysis in Audit Results (Annual) | | | | | | | |
|--|-------------------|------|----------|------|----------|---------------------------|-----------------------------------|
| Type of Tax | Amount Reassessed | | | | | | |
| | 2020 | 2021 | % Change | 2022 | % Change | Quality Rating (from AQR) | % Upheld after Dispute Resolution |
| Large | | | | | | | |
| SME | | | | | | | |
| Verification | | | | | | | |

| Overall Audit Program—2022 (Quarterly) | | | | | |
|--|--------|--------|-------------------------------|--------|--------|
| Indicator | Target | Actual | Indicator | Target | Actual |
| Audit recoveries | \$ | \$ | Number of audits completed | | |
| % audits with material change | % | % | Revenue from matching program | \$ | \$ |

| Large Taxpayer Audit—2022 (Quarterly) | | | | | |
|---------------------------------------|--------|--------|---|--------|--------|
| Indicator | Target | Actual | Indicator | Target | Actual |
| Audit recoveries | \$ | \$ | Number of audits completed | | |
| % audits with material change | % | % | Return on investment (Total Reassessments/ Salary cost of audits) | | X:1 |
| % on-time filing | % | % | Percentage on-time payment | % | % |

| SME Taxpayer Audit—2022 (Quarterly) | | | | | |
|-------------------------------------|--------|--------|----------------------------|--------|--------|
| Indicator | Target | Actual | Indicator | Target | Actual |
| Audit recoveries | \$ | \$ | Number of audits completed | | |
| % audits with material change | % | % | Return on investment | | X:1 |

| Verification—2022 (Quarterly) | | | | | |
|-------------------------------|--------|--------|-----------------------------------|--------|--------|
| Indicator | Target | Actual | Indicator | Target | Actual |
| Audit recoveries | \$ | \$ | Number of completed verifications | | |
| Return on investment | | X:1 | Revenue from matching program | \$ | \$ |

Note: AQR = audit quality review; CIT = corporate income tax; PIT = personal income tax; SME = small and medium enterprises; VAT = value-added tax.

Other criteria that could be added to the dashboard include the following:

1. An indicator to track whether reassessments were upheld on appeal; the KPI could be reassessment confirmation rate, calculated as the total reassessments confirmed divided by the total reassessments.
2. Average reassessment per taxpayer.
3. Total reassessments divided by revenue collected.

Another component on the dashboard that is useful to track over time is the audit program results. Evaluating three years' worth of data can provide a sense of how well the program is performing. With the same resources, tax administrations expect to see increased reassessments year over year. This trend analysis can point to potential issues with a program that management might not otherwise notice. If results decrease, it would be worth investigating further to see whether there is a logical explanation.

Note that the results of the AQR program can be tracked in the trend analysis section. Management should be concerned not only with additional revenue but also quality audits. Where quality is weak or declining, it can point to a training need for staff, which can be addressed more proactively because statistics are available to monitor trends over time. Quality audits contribute to the sense of fairness that citizens have about the tax administration.

Availability of Data

The availability of data to populate the dashboard may be an issue. If the administration's IT system cannot produce the full range of data outlined in the dashboard, an administration can start with the available data and make plans to strengthen the reporting processes in the IT system as soon as possible. Performance data is critical to management decision-making. A manual calculation may be possible if completed audit data can be downloaded into a spreadsheet.

Tax Gap Analysis

Tax gap studies estimate the gap between the total tax paid and the total tax expected to be paid, which reports on the extent of inaccurate reporting.

The gap is further segregated into a tax policy gap and a compliance gap.

- The **policy gap** relates to tax not collected due to policy decisions or gaps in the law. An administration has no control over those.
- The **compliance gap** calculates the amount of tax not collected due to noncompliance;¹⁰ an administration has more control over this type of gap.

A tax gap analysis can point out which industry sectors are contributing the most to the tax gap, which is important information for risk assessment. Over time, administrations should seek to reduce the compliance gap through more efficient audits, better trained staff, and better risk targeting, which will result in additional tax assessed. This additional tax, along with the indirect impact of an audit on other taxpayers' behaviors toward compliance, should increase overall levels of compliance. A possible outcome measure would be to "reduce the compliance gap by x percent by 20xx." This is a longer-term measure—typically, over a period exceeding five years.

¹⁰ It is important to note that while more effective audits may contribute to the reduction of the compliance gap, so can better taxpayer services and education as well. Changes in the compliance gap can be caused by multiple factors that need to be carefully analyzed and corroborated by the tax administration before any definitive conclusion is made.

CHAPTER 8.

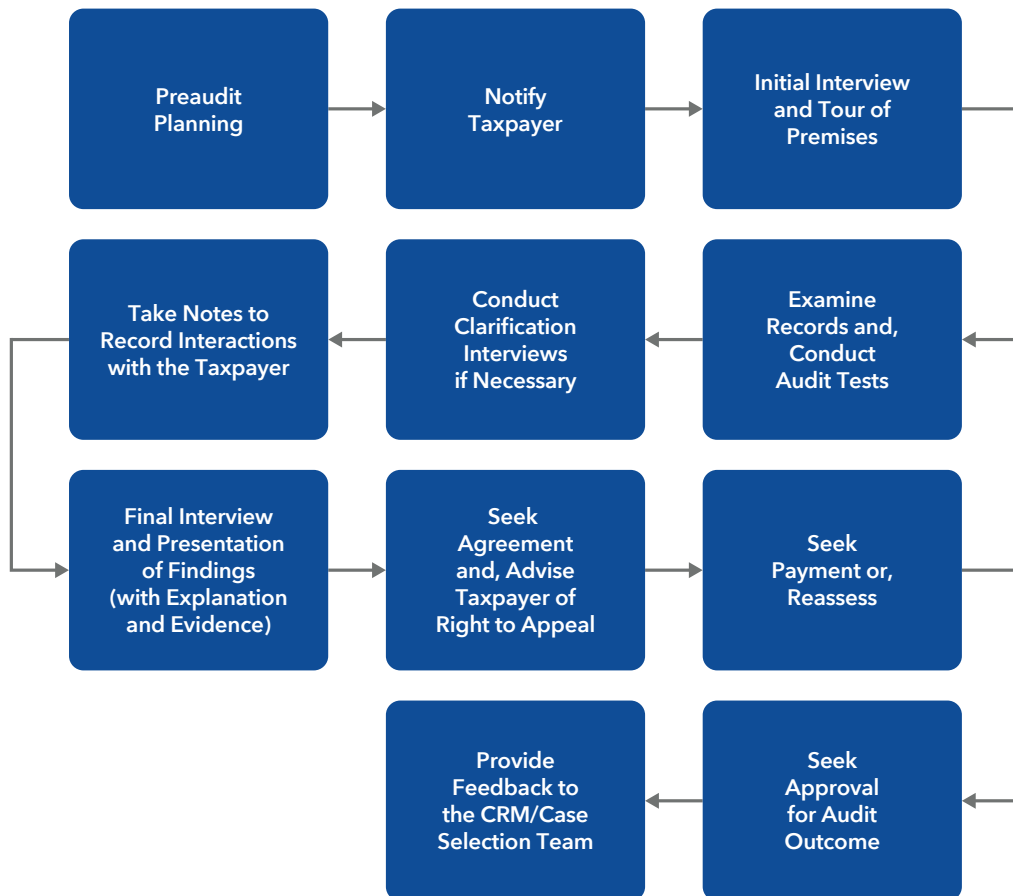
The Audit Process

This chapter will focus on the essential components of the audit process. All steps in the audit process are important, and none should be eliminated, or the risk of not identifying compliance risks will increase.

Overview of the Audit Process

It is important to have a good understanding of the overall audit process from beginning to end. Figure 8.1. summarizes the steps involved in the audit process.

Figure 8.1. The Audit Process



Note: CRM = compliance risk management.

- **Preaudit planning:** In addition to analysis and risk identification provided by the CRM and audit case selection teams, the auditor should conduct their own more in-depth analysis of available information.
- **Notify taxpayer:** The taxpayer should be notified in writing two to three weeks in advance and be provided with all necessary information about the audit.

- **Initial interview and tour of premises:** This is an opportunity for the auditor to explain the audit process and to gather additional information.
- **Examine records, and conduct audit tests:** This is the main work involved in checking the accuracy of the tax returns. It will form the basis for any challenges to figures reported on the tax returns.
- **Conduct clarification interviews if necessary:** These may be needed if the records are unclear and further information is necessary from the taxpayer.
- **Take notes to record interactions with the taxpayer:** It is crucial that all interactions with the taxpayer are recorded clearly. Such notes may need to be relied on if a dispute arises later.
- **Final interview and presentation of findings:** This is a critical stage of the process. The auditor should be well prepared and present the audit findings supported by documentary evidence.
- **Seek agreement, and advise taxpayer of the right to appeal:** The aim is to obtain the taxpayer's agreement to the audit findings, but the taxpayer must also be advised of their right to appeal if they do not agree.
- **Seek payment or reassess:** If agreement is reached, the auditor should reassess the tax liability and make payment arrangements between the taxpayer and the tax administration (if the administration's policy is for auditors to collect outstanding assessments).
- **Seek approval for audit outcome:** All audits should be approved by management before being finalized.
- **Provide feedback to the CRM/case selection team:** The auditor should provide feedback on the audit results; this can be used to improve the tax administration's risk identification processes.

Preaudit Planning and Taxpayer Notification

The first step in the audit process—preaudit planning—is critical. Typically, CRM staff will have identified potential risk areas and should have provided the auditor with a file containing consolidated taxpayer information, history, reason for selection, and suggested risks for testing. It is nevertheless important that audit managers ensure that the auditor assigned to the file undertakes their own more in-depth analysis of available information. This should include the following:

- Reviewing the tax return for large, unusual, and questionable items beyond those selected during the risk assessment process;
- Reviewing data held by the tax administration (prior audit results, history of compliance, etc.);
- An analysis of international transactions;
- Reviewing transactions between related taxpayers;
- Checking for tax avoidance issues; and
- Identifying specific risks inherent in the sector that the taxpayer operates in.

Businesses primarily exist to generate wealth for their owners or shareholders. Where appropriate, audit managers should direct auditors to include in the audit plan an analysis of the tax affairs of the proprietary directors or owners of a business. The audit manager or team leader should also consider if any preaudit visits are required—for example, to conduct surveillance of the business or to make anonymous purchases for later comparison with the business records. Audit managers should consider the following:

- Will the auditor need to access specialist expertise?
- If CAATs will be used, is there a need to download electronic records in advance?

After the preaudit planning step is complete, the next step is to notify the taxpayer of the audit. Providing the taxpayer with adequate notice and explaining what is required of them will aid the efficiency of the audit and will reduce the likelihood of a request for postponement.

Managing Audit Delays

Taxpayers are typically nervous when notified by the tax administration that they are to be the subject of an audit. They don't know what to expect and need time to prepare. It's important that a written notification provides them with all the necessary information about their obligations and rights in relation to the audit. Some tax administrations enclose a summary of these in a leaflet format with the audit notification. To minimize the risk of requests for postponement of audits, it's essential that the taxpayer and his or her agent are notified in writing two to three weeks in advance of the commencement of the audit.

The following information should be communicated as part of the notification process:

- The legal basis for the audit;
- The period(s) being audited;
- Scope and type of audit;
- Tax type under audit;
- Names of auditors; and
- What records are expected to be available to the auditor on the first day of audit. It's important to specify that in addition to all the usual business records, the auditor will require access to both business and personal banking information, and the agent's working papers (sometimes referred to as linking papers).

In addition, it's important to communicate where the audit will take place and that the business owner should be present. The audit should usually be at the business premises, except in very exceptional circumstances.

If the tax administration has a system of reduced penalties for taxpayers who make an early voluntary disclosure of noncompliance, the notification letter should explain that process.

A well-worded written notification can help to relieve some taxpayers' fears around the audit process and also increases the likelihood that the necessary records will be available to the auditor at the commencement of the audit.

Conducting Audits

Interviewing

Information gathering is an essential component of the auditor's job, and using the correct mix of interview questions is crucial to gathering information and establishing a rapport with the taxpayer and/or his or her agent. A successful interview is dependent on the auditor's focus, preparation, technique, and skill. While the auditor's preaudit planning will have used preaudit information to evaluate potential risks, the interview is the first opportunity to:

- Hear directly from the taxpayer about important aspects of his or her business and transactions;
- Explore in detail how the taxpayer generates his or her income and how the records are maintained;
- Explain the audit process to the taxpayer, summarize his or her rights and obligations, and explain the basis for the audit; and
- Ensure that all necessary records are available for examination; it is important that this is established early, as they may not be available later.

Managing the Audit

The time needed to conduct an audit can vary widely, depending on the type of audit, the complexity of the case, and the number of identified risks. Management should encourage auditors to utilize the time necessary to address material risks, but there should be an ongoing cost-benefit analysis by the auditor to determine whether more time should be spent ("If I spend another x hours, what will be the likely additional tax generated?"). Over time, averages can be calculated to provide a guideline for auditors to use, but it should not be a hard target. Auditors should discuss their progress on audits with their team leader, and if there is significant risk, the needed additional time should be utilized.

Audit managers should guide auditors to develop expertise for selecting the best audit method to address identified risks. They must also ensure auditors keep taxpayers informed about the audit's progress, including potential adjustments, through regular communication. Interim interviews may be conducted to clarify matters discovered during the audit.

Working Papers and Report Writing

Managers must stress the importance of maintaining comprehensive working papers and writing accurate audit reports. The written record should be in a style that can be clearly understood by a non-tax expert. When writing, the auditor should bear in mind that the report may be read by senior managers, internal and external reviewers, and court judges.

It is crucial that the report:

- Clearly sets out the reasoning for any proposed additional liabilities and supports them with documentary evidence and working papers;
- Fairly describes the taxpayer's and the taxpayer's agent's views and counterarguments, if any;
- Documents the risks identified and the techniques and tests employed to assess them; and
- References the audit findings to the relevant legislative provisions being relied on to make the reassessment.

The report and working papers should be retained by the tax administration until the audit, any appeal or review procedure, and all collection matters are finalized or until the country's statute-barred period for retention of records has passed, whichever is the later.

The auditor should separately provide feedback in relation to the value or appropriateness of the risks identified by the CRM and case selection teams and highlight any additional areas of risk that were not identified at the case selection stage. Such feedback should assist with the ongoing development of CRM and audit case selection.

If the taxpayer has outstanding debts, the auditor should include information in the audit report that can assist the collection team, such as the existence of assets and location of bank accounts.

The Approval Process

The tax administration should have a system for the supervisory review of all audits at finalization stage to ensure that compliance risks were addressed and that the conclusions reached were consistent with the law. The review process should be tiered with levels of approval required based on identified criteria such as the following:

- The materiality of the adjustment;
- If penalties are being applied;
- Sensitive taxpayer audits (e.g., a high-profile taxpayer, controversial issues that may be challenged in the courts or be subject to media scrutiny); and
- If the issue affects multiple taxpayers.

Some tax administrations build in an element of random selection of any audit case for approval at the highest management level. This helps guard against the possibility that some auditors or team leaders might keep additional assessments below a certain level to avoid management scrutiny.

Written policies should be in place to document these criteria and the associated level of management approval needed for each stage. Once approval is obtained, a reassessment is made to adjust tax payable to reflect the audit results.

CHAPTER 9.

Summary

Compliance is the ultimate goal of tax administrations and is achieved through a combination of voluntary and enforced compliance. An audit program is a critical part of a tax administration's tool kit to manage compliance.

There are three categories of treatment options to address noncompliance: preventative, facilitative, and enforced compliance. Audit programs (and, for the most serious cases of tax evasion, investigation programs) fall into the enforced compliance category. The right balance of activities to manage compliance is critical. Tax administrations can't simply audit their way to compliance; preventative and facilitative measures are also required.

As discussed in this reference guide, the six categories of an effective audit program include the following:

Legal Framework

- Audit programs must be supported by legislation that empowers the tax administration. The legislation should ensure the tax administration has the right to make inquiries, obtain information, make reassessments, and impose or waive penalties.

Organization and Governance

- Taxpayer segmentation is an important part of managing compliance. Dividing the population into segments with similar characteristics allows the administration to identify and address potential areas of noncompliance more easily. In the case of large taxpayers, a dedicated focus on monitoring the compliance of this group is warranted, given their significant contribution to total tax collections.
- Segregation of duties between auditors and those who select cases for audit and those who undertake the dispute resolution function is critical. Certain situations require a higher level of supervisory approval to ensure that the law is applied consistently and in accordance with tax administration policy. These measures help assure citizens that they will be treated fairly by the tax administration, and it reduces the opportunity for corruption.
- Audit teams should be organized on a regional basis but ultimately reporting to HQ. Teams of auditors should report to team leaders, who report to audit managers, who in turn report to HQ. The factors governing the optimum number of auditors will vary from country to country.

People

- Auditors must have a broad range of expertise and skills supported by effective training and mentoring. When tax administrations invest resources in developing their audit personnel, it pays dividends in higher outcomes from their audit programs (additional tax assessments).
- The CRM team, audit case selection team, and functional audit managers must work together. The optimum benefit for the audit program will be obtained when these three elements operate as a fluid but cohesive group.

Tools

- Modern tax administrations employ a variety of audit types, depending on the nature of the risks identified. Depending on the reliability of the books and records and the extent of internal controls, an auditor may choose direct or indirect methods of verifying tax payable. Serious tax evasion should be tackled by specially trained investigators who are skilled in investigation and evidence-gathering techniques.
- Programs to assess audit quality and allow for an independent review of audit findings are important to build trust in the tax system. An AQR program provides senior management with a health check on the quality of the audits being completed. A dispute resolution system allows for an independent review of the adjustments made to ensure they are legislatively sound.

Systems

- Utilizing electronic systems and tools can significantly contribute to the effectiveness of audit programs. Although initial setup costs for electronic CMSs and for CAATs can be high, the benefits to be reaped over time can be significant.

Performance Measurement

- Measuring individual auditor performance is more than simply measuring the numbers and results of audits completed. The best auditors operate with an awareness of the overall tax administration's goals regarding compliance, and a balanced set of KPIs should be designed to capture a holistic view of performance.
- "What gets measured gets done" is a truism recognized by all tax administrations. Staff will focus on what they are being measured on, so the administration must ensure that the selected criteria drive the desired behavior in staff. Ideally, a mix of both output and outcome measures are used to evaluate the efficiency and effectiveness of audit programs. This can be achieved by measuring performance against preset targets and using tax gap analysis to estimate the compliance gap.

APPENDICES

Appendix 1. Competencies

| Professional and Operational Competencies | |
|---|---|
| Competency | Description of Importance |
| Knowledge <ul style="list-style-type: none"> Expert knowledge of national tax code and other relevant legislation and the role of the tax administration within the national and international economic and tax environment. Ability to recognize when to use direct and indirect auditing techniques. Ability to understand and analyze business financial accounts and process information logically. IT skills. | <p>Auditors must have an expert knowledge of all taxes and be able to understand the principles of accounting and taxation. Their work involves testing whether the books and records of a business truly reflect the business activity and whether the tax return represents the correct tax position. They must be able to understand and operate IT systems and tools.</p> |
| Interpersonal Skills <ul style="list-style-type: none"> Skilled at oral and written communication, interviewing, negotiation, teamwork, and handling conflict and stress. | <p>Auditors must develop a broad range of communication skills to enable them to interact with taxpayers and their professional advisers and their tax administration colleagues.</p> |
| Drive for Results <ul style="list-style-type: none"> Skilled in project management and planning audits. Managing multiple tasks simultaneously and managing time effectively, focusing on results. | <p>Auditors must assume personal responsibility for and deliver on agreed objectives/goals.</p> |
| Analysis and Decision-Making <ul style="list-style-type: none"> Ability to quickly get up to speed in a complex situation, rapidly absorbing all relevant information/data (written and oral). Ability to use numerical data skillfully to understand and evaluate business issues. | <p>Auditors often operate under time pressure, and they need to be capable of identifying key themes and patterns across different sources of information and arrive at logical conclusions.</p> |
| Integrity <ul style="list-style-type: none"> Upholds the highest standards of honesty and integrity at all times. | <p>Auditors represent the public face of the tax administration, and they must uphold its values of fairness and honesty and respect the taxpayer's rights at all stages of the audit process.</p> |

Appendix 2. Strengths and Weaknesses of Possible Case Selection Models

| Model | Strengths | Weaknesses |
|---|---|--|
| All cases selected by HQ. | <ul style="list-style-type: none"> 100% of cases selected using CRM risk analysis. | <ul style="list-style-type: none"> Potential loss of the benefits of local knowledge. Regional offices may feel excluded from the risk-analysis process. |
| All cases selected by regional offices. | <ul style="list-style-type: none"> Audit case selection tailored to risks identified locally. Regional offices fully involved in audit case selection. | <ul style="list-style-type: none"> Inconsistencies in audit case selection across the tax administration. No “bird’s-eye view” of case selection at HQ level, making it difficult to coordinate, set targets, and manage quality and performance. The riskiest cases nationally could be missed. Possible region shopping by unscrupulous noncompliant taxpayers (setting up business in regions where tax administration is perceived as weak). Possible unfair selection of compliant cases for audit if the principle of segregation of duties is not strongly enforced. Regional offices might avoid complex audits in favor of simpler audits. Possible deliberate omission of cases for audit (corruption). Possible omission of risks associated with businesses that are multiregional or multinational. |
| Most cases selected by HQ (e.g., 75%), with the balance (e.g., 25%) selected by regional offices. | <ul style="list-style-type: none"> Most cases selected using scientific risk analysis. Consistency across country for the HQ-selected cases. Regional offices included in the risk-analysis process. | <ul style="list-style-type: none"> Regional offices may prioritize their “own” 25% over HQ-selected cases. |
| All cases selected by HQ, but regional offices allowed to replace a set percentage (25%) with locally selected cases. | <ul style="list-style-type: none"> Most cases selected using scientific risk analysis. Consistency across country for the HQ-selected cases. Regional offices included in the risk-analysis process. | <ul style="list-style-type: none"> Regional offices may prioritize their “own” 25% over HQ-selected cases. Regional offices might replace risky HQ cases with less risky cases selected locally. |
| Regional offices forward a list of locally selected cases to HQ, which is fed into the risk-analysis process by HQ. | <ul style="list-style-type: none"> 100% of cases selected using CRM risk analysis. Regional offices involved in the risk-analysis process. | <ul style="list-style-type: none"> Regional offices may feel aggrieved if all of their locally selected cases are not accepted by HQ. |

Appendix 3. Type of Audit or Verification

Factors that should be considered when deciding on the type of audit or verification to be used include the following:

- How much tax is at risk?
- What taxes are involved?
- What period(s) are involved?
- Can the identified risks be checked from my office, without the need for examining records on the taxpayer's business premises?
- Can the identified risks be checked without interviewing the taxpayer?
- Do the identified risks apply to a group of taxpayers or a particular business sector?
- Do the identified risks indicate possible serious tax evasion or fraud?
- Legislative provisions or constraints

Various types of audit checks used by modern tax administrations include the following:

1. Verification Checks

These are simple assurance checks conducted to verify or clarify an item or items on a tax return or a refund claim. They are usually conducted by phone call, email, or letter. Sometimes it may simply be a matter of requesting supporting documentation. It should be possible to determine the validity of the tax return or refund claim quite quickly. If not, then the case may be escalated for a more detailed inquiry—that is, desk or field audit.

Verification checks are often used to check VAT refund claims. Many modern tax administrations categorize VAT refund claims according to risk using a traffic-light system:

- Green: Repay immediately.
- Orange: Conduct verification check. If a case fails the verification check, it may be escalated to an audit.
- Red: Conduct desk or field audit.

Alternatively, tax administrations could use low risk, medium risk, and high risk as traffic lights, in place of green, orange, and red, respectively.

2. Desk Audits

These are audits conducted at the tax office when the auditor is confident that all necessary information can be ascertained through in-office examination. The taxpayer may be asked to reply to queries and supply additional documentation. They are only suitable if there is no need to inspect business premises, check stock levels, or view prime business records in situ. Sometimes they involve requesting the taxpayer to attend the tax office for interview.

3. Single (or Specific) Issue Audits

These focus on a single tax type, single issue, or single tax period. They usually take less time than a full or comprehensive audit.

4. VAT Refund Audits

These are used to verify the taxpayer's entitlement to a refund prior to processing the refund. They are usually undertaken for the taxpayer's first refund claim and in cases where the refund claim varies significantly from established patterns and trends. The audit should focus on the specific reason for the refund; it should not be used as a platform to widen the inquiry to cover additional periods and taxes unless serious additional risks are identified. These audits have a time pressure, driven by the need to process the VAT refund promptly, and therefore, the audit needs to be dealt with promptly.

5. Comprehensive (or Full) Audits

These cover all tax obligations, and the period covered is usually the most recent financial year. The period audited may be broadened if serious wrongdoing is identified. As they are usually time consuming, they should only be applied to taxpayers if there is an indication of underreporting or other risks that will impact on a number of taxes.

6. Audit Projects

Audits can be organized as a separate project for specific groups of taxpayers: an industry (e.g., construction), or a line of business (e.g., retail), or certain items from the declaration or profit and loss account (e.g., depreciation) to address a particular risk or to establish the degree of noncompliance in a particular sector.

7. Reaudits

Reaudit programs consist of conducting a second audit of a taxpayer when the first audit uncovered significant noncompliance. The second audit usually takes place two to three years after the first one is completed and focuses on the most recent year or period. They can be useful for measuring the impact of the audit program on compliance outcomes. If taxpayers are aware that they might be reaudited, it may deter the temptation for unscrupulous taxpayers to "recoup" their losses from a yielding audit by continuing noncompliance after the first audit is completed.

8. Random Audits

Many tax administrations devote a part of their audit resources to conducting a random audit program. A statistically robust sample of taxpayers is selected at random, and those taxpayers are included in the comprehensive audit program. The benefits of a random audit program include the following:

- They can be useful in identifying gaps in the risk-management process (if random audits result in significant additional yield, that might raise questions as to why the case did not trigger risk rules).
- They can be useful as a tool to measure the tax gap using a bottom-up approach.
- They can act as a deterrent for anyone considering noncompliance (anyone could be selected for audit under a random audit program).
- They can be useful for gaining an understanding of compliance behavior (identifying trends in business activity).

- They can be used to assist with measuring overall compliance, including measurement of the audit gap.

However, some downsides to a random audit program include the following:

- Fully compliant taxpayers are subjected to the expense of dealing with an audit.
- There is an opportunity cost; the auditors could be conducting risk-driven audits instead.

9. Criminal Investigations

When there is evidence of serious tax evasion, it may be necessary to carry out a criminal investigation. These are conducted by specially trained criminal investigators, and the criminal investigation process should be separate from the audit process. Criminal investigations are very time consuming, often taking years to complete. Auditors should be made aware of what to do if they encounter cases of serious evasion. They should immediately contact the tax administration's criminal investigation team (or the statutory body with responsibility for such investigations—for example, police) for advice on how to proceed. If they continue with an audit after they have reason to believe serious evasion has occurred, it may damage any possibility of a criminal prosecution for that case.

Appendix 4. Summary of the Six Indirect Audit Methods

1. Benchmarking (comparing with other similar businesses to determine whether there are any outliers).
2. Cross-checking (difference between taxpayer's assets at the beginning and end of a period, compared to his/her income). Also known as net worth or asset betterment method.
3. Bank deposit and cash expenditure (if deposits plus expenditure exceeds declared income, an explanation is necessary).
4. Source and application of funds (like no. 3 but focused on identifying expenditure that cannot be explained by looking at the tax return).
5. Percentage markup (applying standard markups to purchases to identify undeclared sales or exaggerated purchases). Closely related to no. 6.
6. Unit and volume (applying price and profit figures to the known business volume). Closely related to no. 5.

Depending on the business, a combination of methods may be required.

Appendix 5. CMS Checklist of Requirements

A CMS that meets good practice can do the following:

- Conduct financial analysis of declaration/return forms and other data to automatically select cases for audit (sometimes case selection is part of a separate CRM system) and manage all types of workflow for an individual case—for example, a taxpayer audit, a taxpayer debt, a disputed assessment, an outstanding return, and responding to taxpayer correspondence.
- Prioritize cases to be created and allocated using predetermined risk assessment criteria.
- Electronically assign cases by a supervisor to case officers on the basis of relative priority and maintain an inventory of cases by team and division.
- Record case details at the time of case selection.
- Record reassessment details and update taxpayer account.
- Display other cases involving the same taxpayer.
- Record actions taken and date of actions.
- Record time lapsed from commencement to completion and maintain status of case: pending, closed, and so on.
- Generate standard letters and notices.
- Provide easy access to technical notes and manuals.
- Notify supervisors if cases are not being resolved in a timely manner.
- Retain and retrieve case history, indexed by the taxpayer identification number.
- Generate determined management information for cases created, cases closed, cases still outstanding, elapsed time for actions, results of audits, the success rate of audit cases selected, changes to selection criteria.
- Provide information for the preparation of the annual audit work plan.

Other desirable features:

- Provide tools to assist with audit activities—for example, software that can analyze taxpayer accounting records, links to third-party information and reference material, and the ability to work remotely from a taxpayer site.
- Maintain an audit trail of access to various compartments of the system/groups of taxpayers. These should be determined and controlled by role-based security permissions, if possible, linked to the HR system.
- Update risk data according to outcomes of audit.

An analytical capability that can do the following:

- Receive and assemble data from multiple sources (including customs data).
- Cater to multiple views of data with multi-indexing capability.
- Provide analysis tools for risk assessment, trend analysis, “what-if” scenario analysis, and so on.
- Generate predefined reports.
- Respond to requests for ad hoc reports and analysis.

Appendix 6. CAAT Tool Features

CAAT tools include Audit Command Language (ACL), International Data Encryption Algorithm (IDEA), Excel, Access, and Structured Query Language Server (SQL).

Common functions of these tools include the following:

- Data queries
- Data stratification
- Sample extractions
- Missing sequence identification
- Statistical analysis
- Calculations
- Duplicate transaction identification
- Pivot table creation
- Cross tabulation

CAATs can identify features that indicate possible noncompliance, including:

| | |
|---|--|
| Payroll | <ul style="list-style-type: none"> • Identification of ghost employees (i.e., not genuine) • Employees who are registered as suppliers • Employees with multiple pay slips in a month • Recalculate pay slip totals • Agree pay slips to general ledger • Employees paid after their leave date • Duplicate employees |
| Expenses | <ul style="list-style-type: none"> • Excessive claims • Unauthorized merchants • Application of Benford's law • Spend above approved limits |
| General ledger and journals | <ul style="list-style-type: none"> • Unusually large postings just prior or after year-end • Journals posted during the night or on weekends • Profile of journals by type, user, time of day, day of week, and so on • Application of Benford's law • Accounts used once or infrequently |
| Fraud | <ul style="list-style-type: none"> • Searching for fictitious suppliers • Searching for unusual payments (e.g., round-sum amounts) |
| Sales and accounts receivable (AR) | <ul style="list-style-type: none"> • Creation of aged debtors report • After date cash testing • Exceeding credit limit • Unusual AR transactions |
| Purchasing and accounts payable (AP) | <ul style="list-style-type: none"> • Identification of duplicate payments to suppliers • Identification of suppliers sharing the same bank account details • Unusual AP transactions |
| Stock | <ul style="list-style-type: none"> • Testing calculation of net realizable value (NRV) • Negative stock quantities |
| Fixed assets | <ul style="list-style-type: none"> • Testing calculation of depreciation to ensure it is in line with policy • Cash value of register to confirm completeness and accuracy |
| Data quality | <ul style="list-style-type: none"> • Identification of blank data fields • Identification of nonuniform entries (i.e., noncompliance with required format) |

Note: AP = accounts payable; AR = accounts receivable; NRV = net realizable value.



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