

# Inland Revenue Department: Performance of Taxpayer Audit



Report of the  

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**Controller and Auditor-General**  
*Tumuaki o te Mana Arotake*

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Controller  
and Auditor-General**

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**Inland Revenue Department:  
Performance of  
Taxpayer Audit**

July 2003

*This is the report of a performance audit we carried out under the authority  
of section 16 of the Public Audit Act 2001.*

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## Foreword

The Inland Revenue Department (the IRD) collects most of the money that the Government requires to carry out its programmes and implement its policies. It is in the interests of New Zealanders collectively that the level of compliance with tax laws is as high as possible, i.e. that each year all taxpayers pay the correct amount of tax that is due.

The tax system relies on taxpayers making accurate self-assessments of the tax they owe, and the IRD carries out a range of activities to encourage taxpayers to comply with their tax obligations. These range from services such as providing education to taxpayers about their obligations to make it easy for them to comply, to enforcement action such as prosecuting those who do not.

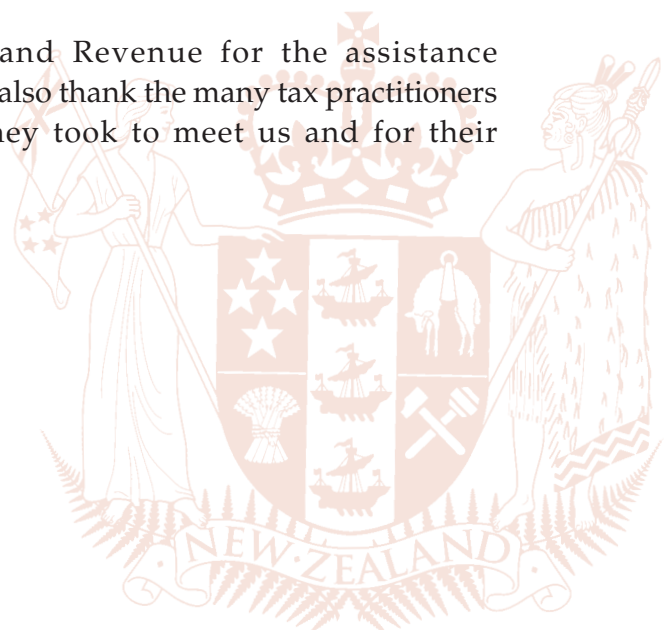
Taxpayers need to know that there are efficient systems in place to ensure that all people pay their appropriate share of tax. An important component of promoting compliance is the use of taxpayer audits. Each year the IRD audits thousands of taxpayers to detect non-compliance with tax laws, and to deter potential non-compliance in the future. Taxpayer audits are a major part of the IRD's work and involve 881 of its 4800 staff.

I am pleased to note that the IRD has used this audit as an opportunity to accelerate important initiatives and introduce a new governance arrangement for business activities including taxpayer audit. The IRD has also volunteered to keep me in touch with the changes on a regular basis. I plan a follow-up audit in two to three years' time to examine what progress has been made.

I thank the Commissioner of Inland Revenue for the assistance provided by his staff to my auditors. I also thank the many tax practitioners around the country for the time they took to meet us and for their contribution to this report.



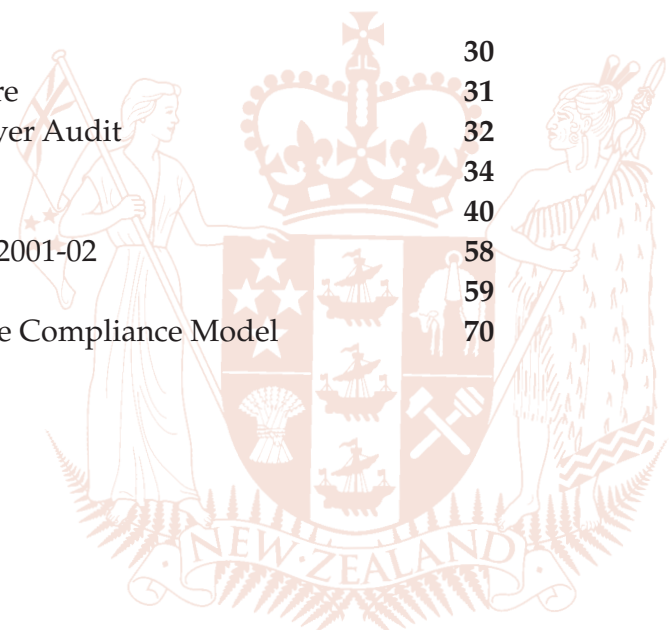
K B Brady  
Controller and Auditor-General  
28 July 2003



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## Glossary of Terms

**Aggressive Tax Issues** – the description given to schemes or arrangements entered into where the investors receive more tax losses than the amount of money they have invested. These tax savings occur regardless of the success of the scheme or arrangement. The schemes or arrangements cover a range of projects, from films to forestry and the commercialisation of “concepts”.

**Audit Portfolio Holder** – This role is currently held by a service centre manager who has responsibility for the delivery of agreed national audit outputs, promoting best practice and providing cohesion, consistency, and a co-ordinated approach to reporting on taxpayer audit performance across the service centres. Taxpayer audit staff are accountable to their service centre manager, not to the Audit Portfolio Holder.

**Branch Offices** – under the control of a service centre, these are small offices that provide similar services to the service centres. There are 12 branch offices and all have some audit staff.

**Central Agencies** – the organisations that work across the whole of central government (e.g. the Treasury and the State Services Commission).

**Compliance Risk Analysts (CRAs)** – formerly called Compliance Risk Officers, CRAs were introduced in 1999 to collect and collate information to improve the targeting of case selection for audits.

**Corporates Division** – the Corporates Division concentrates on large corporate taxpayers with an annual turnover of more than \$100 million and other specific groups such as Government agencies.

**Data Warehouse** – the IRD’s main analytical database that contains a wide range of information about taxpayers and the tax they pay. The database has been progressively developed as part of an ongoing project.

**Design and Monitoring Group** – a group based in the IRD’s National Office responsible for devising new initiatives for a range of functions, including taxpayer audit.

**Discrepancy** – the difference between the tax ascertained as a result of audit activity and the tax on income previously returned by the taxpayer.





## GLOSSARY OF TERMS

**Investigators** – the IRD’s term for staff undertaking taxpayer audits.

**Quality Measurement System (QMS)** – used to measure and report on the quality of the audits conducted by investigators.

**Service Centre** – an office in which the staff provide a range of services to taxpayers – including audit, debt collection, and customer services. The five service centres are located in Takapuna, Manukau, Hamilton, Wellington and Christchurch.

**TACTICS** – the computerised Taxpayer Audit Case Selection, Management and Reporting System.

**Taxpayer Audit** – the audit of taxpayers’ reporting of income and other amounts liable for tax. Audits are conducted to detect non-compliance with tax laws and to deter potential non-compliance.

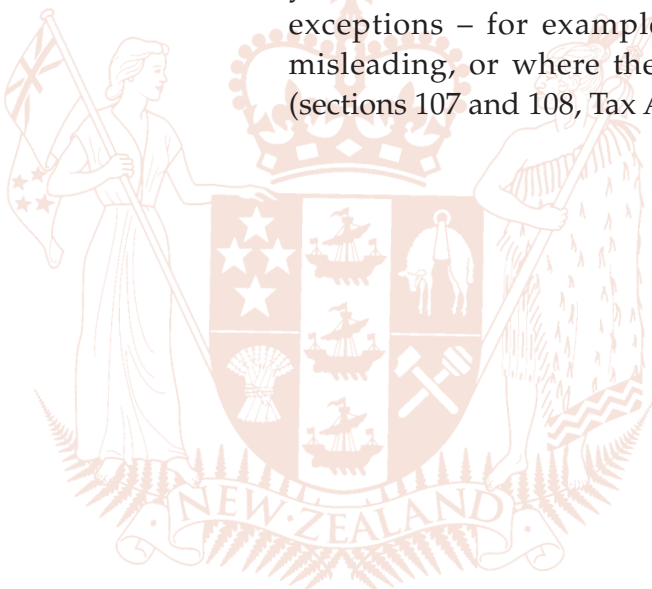
**Taxpayer Compliance Model** – provides a framework for how the IRD can interact with taxpayers to best meet their specific needs.

**Tax Practitioner** – someone involved in dealing with tax matters, such as an accountant, lawyer, or tax agent.

**Technical and Legal Support Group (TLSG)** – a group based in the service centres that provides specialist taxation advice to staff, including investigators.

**The Way Forward 2001 Onwards** – the IRD’s strategic business plan that includes the Taxpayer Compliance Model.

**Time Bar** – the end of the time within which the Commissioner of Inland Revenue can amend a taxpayer’s return. The general rule for income tax returns is that the Commissioner can only amend the return within four years after the end of the year in which the return was filed. There are exceptions – for example, when the return is fraudulent or wilfully misleading, or where the taxpayer has agreed to extend the time bar (sections 107 and 108, Tax Administration Act 1994).



# Conclusions and Recommendations

## Introduction

The Inland Revenue Department's (the IRD) strategic business plan *The Way Forward 2001 Onwards* includes a Taxpayer Compliance Model that is the cornerstone of the IRD's aim to ensure that all taxpayers pay the correct amount of tax that is due. The strategic business plan is ambitious and challenging, and the audit of taxpayers' reporting of income tax and other amounts liable for tax is a crucial component of the Taxpayer Compliance Model. It is vital that the IRD undertakes audits to detect non-compliance with tax laws and to deter potential non-compliance.

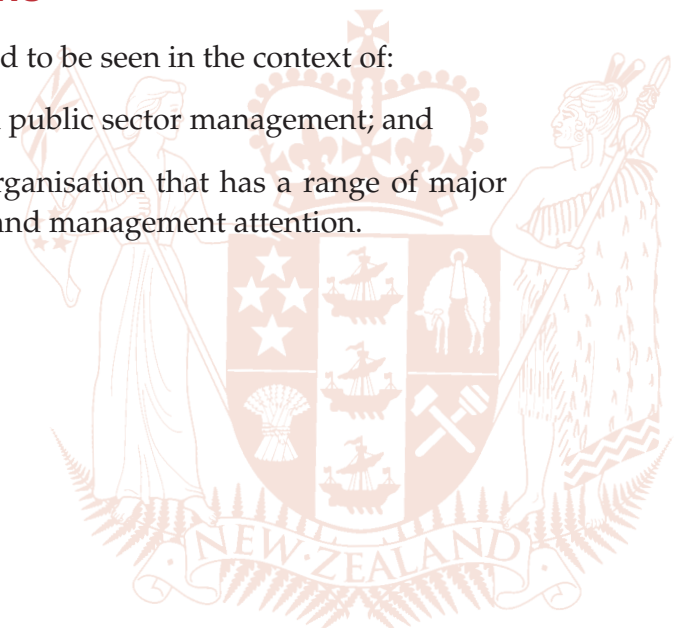
The cost of taxpayer audit is 23% of the total cost of running the IRD and is the largest single activity undertaken. For the year to 30 June 2003, the planned cost of taxpayer audit as described in this report (excluding Litigation Management) was \$91 million excluding GST – representing \$73 million for the audit work done in the IRD's service centres, and \$18 million in its Corporates Division.

In this audit, we have examined the IRD's taxpayer audit function in the context of the Compliance Model to establish whether taxpayer audit is in a position to deliver the IRD's vision to improve taxpayer compliance.

## The Context for Our Conclusions

Our conclusions on pages 11 to 20 need to be seen in the context of:

- important current developments in public sector management; and
- the IRD as a large and complex organisation that has a range of major priorities competing for resources and management attention.





## CONCLUSIONS AND RECOMMENDATIONS

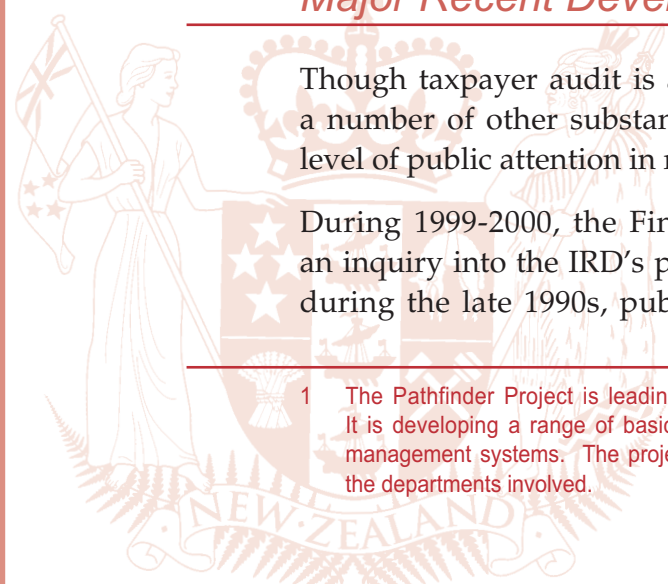
### *Current Developments in Public Sector Management*

The current public sector management system is based on an output-contracting model. Under this system, the IRD's taxpayer audit is delivering against the targets that the IRD has agreed with the Government. The IRD's annual report, the quarterly reports to the Minister, and monthly internal reports show that, over time, the performance of taxpayer audit is consistently in line with the IRD's Purchase Agreement. Central agencies have confirmed that the IRD has consistently delivered on its taxpayer audit outputs.

In recent years it has been recognised that the output-contracting model is not, on its own, an adequate model for measuring public sector performance. The IRD has been one of the departments involved from the outset in identifying the changes required to expand the model to include outcome measures. It has participated in the Pathfinder Project<sup>1</sup>, and was an early adopter of the Statement of Intent. The IRD, together with central agencies, has begun reviewing its performance measures and making changes to ensure that the measures are meaningful and include a clear focus on outcomes.

The IRD's review of performance measures has not yet focused fully on taxpayer audit. The current performance targets for taxpayer audit are still focused on output measures such as audit hours performed and the value of discrepancies identified on individual audits. The IRD recognises that these measures are not capable of demonstrating the performance of taxpayer audit in meeting the IRD's vision – to improve taxpayer compliance – that it set out in *The Way Forward 2001 Onwards*.

### *Major Recent Developments in the IRD*



Though taxpayer audit is a substantial part of what it does, the IRD has a number of other substantial activities that have been subject to a high level of public attention in recent years.

During 1999-2000, the Finance and Expenditure Committee completed an inquiry into the IRD's powers and operations. The inquiry found that, during the late 1990s, public confidence in tax administration had been

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<sup>1</sup> The Pathfinder Project is leading the way for adoption of management for enhanced outcomes. It is developing a range of basic techniques, together with practical guidance on outcome-based management systems. The project is supported by the Treasury and the SSC, but is voluntary for the departments involved.



## CONCLUSIONS AND RECOMMENDATIONS

eroded. Since then, the IRD has embarked on a major programme of change aimed at restoring public confidence and improving its efficiency and effectiveness. It has identified a two-pronged approach:

- building the internal foundations required to underpin the changes; and
- addressing immediate known priorities.

*The Way Forward 2001 Onwards* is a key document and sets out the IRD's goals over a five-year period. Major externally focused initiatives have included the development of a Taxpayer Charter, and the introduction of a complaints management service. Key initiatives to improve the internal foundations across the IRD have included revision of the IRD's Code of Conduct, focus on service delivery training, and implementation of a performance management system linking desired competencies, behaviours, and achievement of results to staff performance, remuneration, and strategic initiatives.

Operational priorities have concentrated on systems that have replaced the need for most salary and wage earners to file a tax return, and initiatives aimed at reducing compliance costs for small businesses. The IRD has also been increasing its emphasis on tax evasion and aggressive tax issues (avoidance), as well as its focus on particular sectors through, for example, its Industry Partnerships<sup>2</sup> project. The IRD has secured additional funding to address aggressive tax issues as part of the Government's 2003 budget.

### Overall Conclusions

Taxpayer audit is a difficult task. It involves highly technical issues, and audits are undertaken in often stressful, and occasionally confrontational, circumstances.

Taxpayer audit is under-developed – much of what is needed for taxpayer audit to play its full part in the Taxpayer Compliance Model and to enable the IRD to meet its strategic direction is not yet in place. The IRD agrees that the time has come for taxpayer audit to be improved and has already initiated a number of projects. The scale of change needed is substantial and requires a significant programme to manage the change.

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<sup>2</sup> This project is described in paragraphs 5.46-5.51 on pages 67-68.



## CONCLUSIONS AND RECOMMENDATIONS

Our more detailed conclusions and recommendations are set out below, under the following headings:

- Setting a Strategic Direction for Taxpayer Audit;
- What Specific Changes are Required?; and
- Managing the Changes.

### Setting a Strategic Direction for Taxpayer Audit

During our audit, we spoke to many tax practitioners who deal regularly with the IRD's investigators. These practitioners gave us a range of views about the performance of the taxpayer audit function. This enabled us to direct our audit at areas where improvements were seen to be required. Many of these practitioners supported the thrust of the IRD's vision in *The Way Forward 2001 Onwards*.

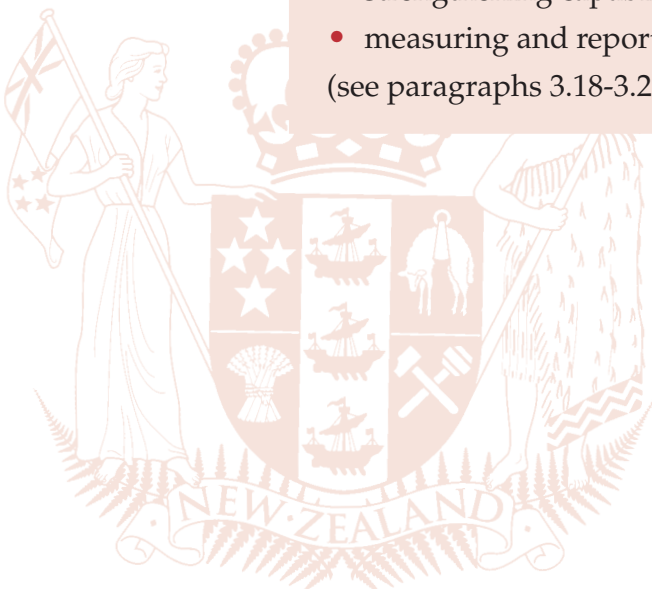
The IRD is in the process of preparing its strategy for taxpayer audit to support this vision. Many projects related to taxpayer audit are under way, and a detailed framework is needed to bring together the large amount of important work that needs to be done to ensure that taxpayer audit can play its part in achieving the IRD's aims.

#### Recommendation 1

The IRD's strategy for taxpayer audit needs to be further developed to provide information and proposals to address the issues we have highlighted – in particular:

- improving the focus and conduct of audits;
- strengthening capability; and
- measuring and reporting performance.

(see paragraphs 3.18-3.23 on pages 43-44)



### What Specific Changes Are Required?

#### Improving Case Selection and the Conduct of Audits

The management of taxpayer audit is currently highly devolved, with most of the decisions about how the work should be done being taken in the five service centres and the Corporates Division where the audit staff are based. Within general categories of identified compliance risks, audit staff have substantial discretion over the individual audits selected and the techniques they use, leading to the following circumstances and results:

- There is no standard practice or policy that binds investigators to proven methods of case selection.
- The practices of investigators vary widely – for example, case plans are not always prepared.
- Audit manuals are out of date and not being consistently used – investigators refer mainly to their team leader for advice, but he or she may have differences in approach and practices from colleagues.
- Best-practice case management techniques have not been identified and shared among service centres in a systematic manner.

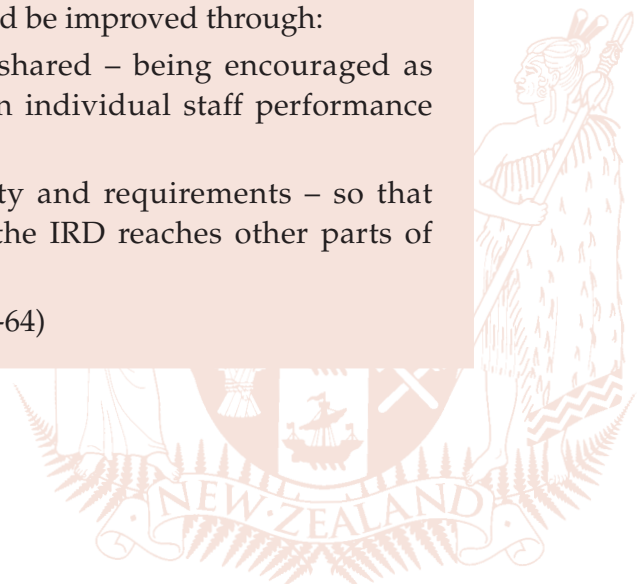
The IRD has recognised the need for greater consistency in the application of taxpayer audit methodologies, and is setting up a number of projects to achieve this.

#### **Recommendation 2**

Implementation of best practice should be improved through:

- having all good ideas routinely shared – being encouraged as a “good thing”, and recognised in individual staff performance agreements; and
- reviewing information availability and requirements – so that information held in one part of the IRD reaches other parts of the organisation that need it.

(see paragraphs 5.21-5.30 on pages 63-64)





## CONCLUSIONS AND RECOMMENDATIONS

### Recommendation 3

The IRD should identify the case management requirements of taxpayer audit, and purchase and/or create tools to meet these requirements.

(see paragraphs 4.33-4.35 on page 53)

### Strengthening Capability

As part of the strategy being prepared for taxpayer audit, the IRD is identifying the changes in capability that audit staff will need to match the requirements of *The Way Forward 2001 Onwards*. These changes will require its investigators to acquire some capabilities they do not currently have. We endorse the identification of the changes required to fill the capability gap.

The IRD will need to prepare detailed plans to bridge the gap – covering, for example, aspects of investigator training, availability and use of technology, and the collection and use of intelligence about taxpayer compliance behaviour. This work will be a major challenge for the IRD.

### Investigator Training

Investigators' take-up of IRD's formal auditing training is low. The IRD does not have a standard audit induction programme for new investigators. In addition, the performance management system is not being systematically used to identify the training and development needs of audit staff, tailor courses and opportunities to meet these identified needs, and follow up to check that the training is done.



### Recommendation 4

The IRD should draw up a standard audit induction programme for new investigators. The performance management system should be systematically used to assess training needs, and to design an ongoing training programme for investigators containing modules that can be linked to individual investigators' requirements, performance management, and career progression.

(see paragraphs 5.15-5.20 on pages 62-63)

### Availability and Use of Information Technology

Appropriate availability and use of information technology is central to the effectiveness of taxpayer audit. It is also an important feature of a good working environment that helps to attract and retain quality audit staff. As our benchmark for assessing the status of information technology in taxpayer audit, we used the availability and use of information technology in the audit division of large accountancy firms.

Measured against this benchmark, some aspects of information technology for taxpayer audit are substantially under-developed. Individual investigators have not historically had access to the computer audit tools they need to do their job – such as laptop computers and electronic working papers.

In October 2002, the IRD began an audit technology project that envisages substantial change to the technologies that auditors will use and the skills required to facilitate the increased use of technology in the audit process. This project aims to ensure that all investigators that need to use audit technology tools are able to do so effectively by June 2004.

The audit technology project forms part of the IRD's wider technology strategy that was launched in December 2002. The inter-relationships between the technology and audit strategies and the audit technology project need to be clearly identified.

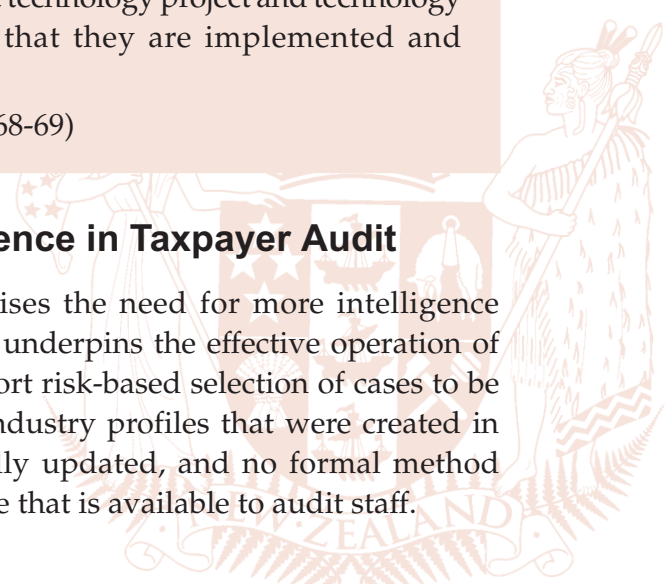
#### Recommendation 5

The IRD should review its technology strategy – including the range of tools required – so that the principles identified in the audit strategy are implemented as a priority. The review should clarify the inter-relationships between the audit technology project and technology and audit strategies, and ensure that they are implemented and monitored in a co-ordinated way.

(see paragraphs 5.52-5.58 on pages 68-69)

### Collection and Use of Intelligence in Taxpayer Audit

The IRD's strategic direction recognises the need for more intelligence about the tax base. Such intelligence underpins the effective operation of taxpayer audit – for example, to support risk-based selection of cases to be audited. However, for some years, industry profiles that were created in the 1980s have not been systematically updated, and no formal method exists to collect and use the intelligence that is available to audit staff.







## CONCLUSIONS AND RECOMMENDATIONS

While a number of commendable intelligence-related projects – such as the ongoing development of the Data Warehouse – are well advanced, the IRD does not yet have a comprehensive plan for all the intelligence it needs to collect – and some projects are likely to take years to complete. For example, Industry Partnerships is a long-term programme with plans for work on 15 industry sectors to be under way by December 2003.

Five Compliance Risk Analysts (CRAs) based in service centres have the primary responsibility for collecting and collating information to improve targeting of case selection for audits. Individual investigators can choose whether or not to use the results of the CRAs' analysis. More effective and consistent use should be made of their work.

### **Recommendation 6**

The IRD should urgently define the intelligence needs of taxpayer audit in the context of the Taxpayer Compliance Model and initiate projects to meet these needs. Elements of the Data Warehouse project that are essential to the improvement of taxpayer audit should be given a priority that enables them to be effectively co-ordinated with the taxpayer audit strategy.

(see paragraphs 5.28-5.51 on pages 64-68)

### **Recommendation 7**

The Compliance Risk Analyst role should be clearly communicated to staff. The Analysts' managers should be made responsible for ensuring that their skills are effectively employed.

(see paragraphs 4.6-4.9 on page 48)



### *Measuring and Reporting the Performance of Taxpayer Audit*

We identified instances where performance measures currently being reported could be having unintended effects. Some investigators tended to select cases that would easily achieve targets. For example, because the targets do not measure tax actually collected as a result of audits, an investigator may prefer a case with a likelihood of a large assessable but uncollectable discrepancy over a case where a smaller discrepancy, if identified, is ultimately likely to be collected.



## CONCLUSIONS AND RECOMMENDATIONS

As explained on page 75, the IRD has started to establish outcome measures – in order to bring its performance reporting into line with its strategic focus on improving taxpayer compliance, and to measure the extent to which it is meeting its statutory responsibility of protecting the tax base.

The IRD is aware that this work will not be straightforward, because effective measurement will not be achievable solely through the kinds of output measures that are currently being used. The performance reporting model will have to cope with difficult apparent contradictions for taxpayer auditors. For example, in the future, audits that detect discrepancies will continue to be seen as positive outcomes, as will those that do not detect discrepancies where they demonstrate that the compliance model is working.

As part of its move towards reporting outcomes, the IRD intends to focus more on qualitative measures. A Quality Measurement System (QMS) designed to measure audit quality and to lift the overall standard of taxpayer audit through monitoring and learning was piloted from October 2001 and formally introduced from July 2002. We identified problems with the QMS that relate to:

- the level of its acceptance by taxpayer audit staff;
- delays in feedback to investigators; and
- insufficient training for those who perform the reviews.

A review of the QMS to address these problems is in progress and a number of initiatives to improve its effectiveness are being considered.

### **Recommendation 8**

In its current reports to Parliament, the IRD should distinguish between the different types of discrepancies identified by taxpayer audit to provide a more transparent view of the value of additional tax assessed.

(see paragraphs 6.6-6.9 on page 76)

### **Recommendation 9**

The review of the IRD's quality measurement system should be completed as soon as possible, and (when completed) plans and timelines set for implementing the review's recommendations.

(see paragraphs 6.21-6.30 on pages 79-81)





## CONCLUSIONS AND RECOMMENDATIONS

The IRD is currently considering options for measures of taxpayer compliance post-audit, the quality of the audit from the taxpayer's perspective, and public perceptions of the likelihood of the IRD identifying under-declarations of tax liability.

### Recommendation 10

The IRD should continue to explore ways of assessing the impact of audits on taxpayer compliance. It should adopt performance measures that provide investigators with the necessary incentives to align their audits with the aims of the compliance model.

(see paragraphs 6.14-6.20 on pages 78-79)

## Managing the Changes

Adoption of the Taxpayer Compliance Model emphasises the need to manage not only on a geographical basis but also on a functional, customer, and tax-type basis. Securing the changes needed for taxpayer audit to support *The Way Forward 2001 Onwards* will require management of change through clear allocation of roles and responsibilities, and agreed accountabilities.

Currently, there is insufficient accountability for ensuring that good practices and new initiatives are taken up – initiatives are not always mandatory, and this reduces the scope for calling a particular service centre to account for not adopting them.

Responsibilities for the taxpayer audit function are therefore diffuse:

- Service centre managers are responsible for those investigators in their own service centre – as well as for a range of other staff and functions. Service centre managers' exposure to and knowledge of taxpayer audit varies according to their own career history.
- The senior manager responsible for taxpayer audit field delivery activities also covers all other service centre staff, comprising 2359 people (or just under half of the IRD's workforce).
- The taxpayer audit "portfolio holder" is a third-tier manager and also the manager of a service centre.
- The IRD's Design and Monitoring Group – which is responsible for devising new initiatives for a range of functions, including taxpayer audit – has a separate reporting line from taxpayer audit delivery, and the two only come together managerially at Commissioner level. The Group's

initiatives are not always mandatory – its staff sometimes have to persuade Field Delivery Staff to take up the initiatives, resulting in variable levels of implementation, because much of the value of an initiative usually comes from the wholehearted commitment of the very people being persuaded.

### *Principles for Managing the Changes*

In presenting our findings to the IRD, our primary concern was that the IRD needed to establish sound arrangements to promote and allocate accountabilities for the changes required for taxpayer audit. In order to ensure that the changes required to fulfil the IRD's strategy for achieving its aims for taxpayer audit are comprehensively achieved, any change programme must include:

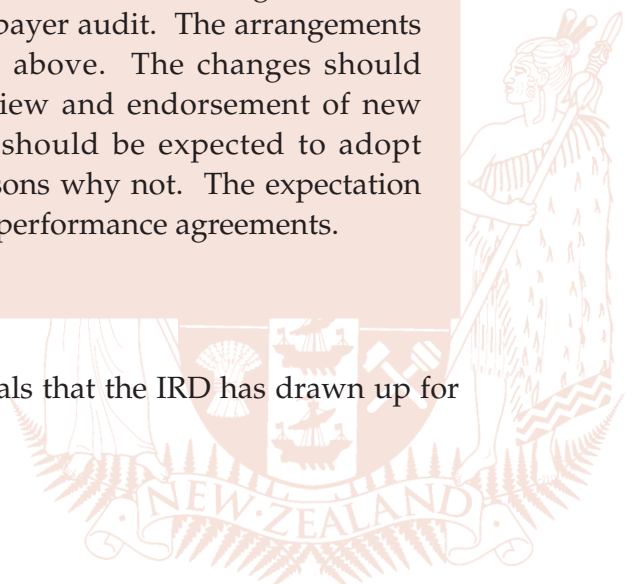
- agreement and commitment to the project timeline, and resources for the changes;
- commitment of investigators to the changes – through a combination of leadership, firm and fair management, application of best practice, and well-targeted training, so that investigators understand the changes and see how they fit into the IRD's overall strategic direction;
- oversight of and accountability for implementation of the changes; and
- on completion of the change programme, an assessment of whether the changes can be sustained into the future.

### **Recommendation 11**

The IRD should establish and implement sound arrangements for managing the changes required to taxpayer audit. The arrangements should meet the principles outlined above. The changes should also include senior management review and endorsement of new initiatives – after which audit staff should be expected to adopt them unless there are exceptional reasons why not. The expectation should be included in individual staff performance agreements.

(see paragraphs 3.22-3.23 on page 44)

We describe on the next page the proposals that the IRD has drawn up for managing the changes.





## CONCLUSIONS AND RECOMMENDATIONS

### *The IRD's Proposals for Managing the Changes*

The IRD has already set up a Business Initiatives Governance Board to oversee further development of the audit strategy and the implementation of strategic initiatives. The Governance Board:

- is modelled on the IRD's Information Technology Governance Board, which is well established and has been providing leadership and a focus for its technology strategy and oversight of all technology projects and operations;
- is a subcommittee of the IRD's Senior Management Team;
- is chaired by the General Manager – Service Delivery;
- includes as members the Commissioner, the General Manager – Business Development and Systems, and the General Manager – Strategic Design; and
- meets monthly.

The responsibilities of the Business Initiatives Governance Board include:

- ensuring that the IRD's business strategies are aligned with its strategic business plan;
- ensuring that business initiatives deliver against the strategy;
- ensuring that business initiatives deliver value to the IRD;
- managing the risks associated with business initiatives; and
- monitoring the performance of the business initiatives governance process.

Specifically in relation to the taxpayer audit strategy, the Board's role will include scrutiny of all key projects – including their prioritisation, approval to initiate, allocation of resources, monitoring progress, and resource and financial reporting.

The IRD has invited us to monitor progress against the audit strategy on a regular basis. We intend to do so, and propose to test the IRD's management of the changes against the principles set out on page 19. We will report publicly on the IRD's progress towards the end of 2005.

## Part One

# Introduction





## Purpose of Our Audit

- 1.1 The assessment and collection of tax revenue is an important function that the Government requires to fund its many programmes and policies – for 2002-03 the IRD expected to collect \$41,569 million in gross tax revenue<sup>3</sup>. Detecting and deterring non-compliance through taxpayer audit is one important means of fulfilling the responsibility for maintaining the integrity of the tax system.
- 1.2 The purpose of our audit was to examine and provide information to Parliament and the public on how the IRD carries out its taxpayer audits to ensure that taxpayers have complied with the various Taxation Acts.
- 1.3 The authority for our audit is section 16(1)(a) of the Public Audit Act 2001, which enables the Auditor-General to examine the extent to which a public entity is carrying out its activities effectively and efficiently.

## What We Did

- 1.4 We interviewed:
  - senior IRD managers and other staff – such as planning, finance, personnel, and information technology staff – in the National Office;
  - staff – senior managers, area managers, team leaders, and investigators – in the five service centres and in the Corporates Division; and
  - IRD lawyers, systems design staff, and those involved in quality assurance projects.
- 1.5 In order to hear a range of views from audit staff we held a series of focus group sessions. A number of these sessions were with senior investigators, while others were with more junior staff.

3 Estimated actual, before refunds. *Estimates of Appropriations, 2003-04*, parliamentary paper B.5 Vol. II, page 1130.





## INTRODUCTION

- 1.6 We also reviewed a large number of IRD documents, such as:
- annual reports, departmental forecast reports, and the new Statement of Intent;
  - business plans;
  - planning documents;
  - internal monthly and other performance reports;
  - documents related to taxpayer audit strategies and projects;
  - specific audit files; and
  - reports from the Quality Measurement System.
- 1.7 During our visits to the IRD's service centres we arranged meetings with local tax practitioners to hear their views on the performance of the taxpayer audit function.
- 1.8 We met with people from law and chartered accountancy firms and from local tax liaison committees. We also held discussions with the Institute of Chartered Accountants of New Zealand, the New Zealand Institute of Economic Research, and a Professor of Law who specialises in tax law.
- 1.9 At the initial meeting with the IRD in which we indicated our intention to conduct this audit, the Commissioner nominated a service centre manager to act as a liaison person between the IRD and our auditors. This manager led a team of two National Office staff who were dedicated to helping us with our audit, and provided documents and information to help us understand the IRD.
- 1.10 During the planning stage we had several discussions with the liaison team about its role. We emphasised, and the IRD agreed with, the need for our audit to be independent. Members of the liaison team attended interviews only when we invited them to do so.
- 1.11 The liaison team provided valuable assistance to us. Its members collated information, organised meetings, proposed who in the IRD we needed to speak to on certain matters, and ensured that we had access to the people that we indicated we wanted to interview.

### Expert Advice and Guidance

- 1.12 We contracted external expertise. Kevin Fox, a recently retired audit partner from a large accountancy firm, assisted us in preparing the audit proposal, conducting the field work, and drafting the final report. Kevin has extensive experience as an auditor over the last 23 years.
- 1.13 We also obtained helpful guidance from John Waugh. John is a Chartered Accountant who, prior to his recent retirement from public practice, was a specialist tax practitioner. A past chairman of the Institute of Chartered Accountants National Tax Committee, he was also chairman of the government-appointed Consultative Committee on Tax Simplification, and a member of its Committee of Experts on Tax Compliance. In the private sector, John undertook a wide range of client assignments, including representing taxpayers in their dealings with (and investigations and audits by) the IRD.

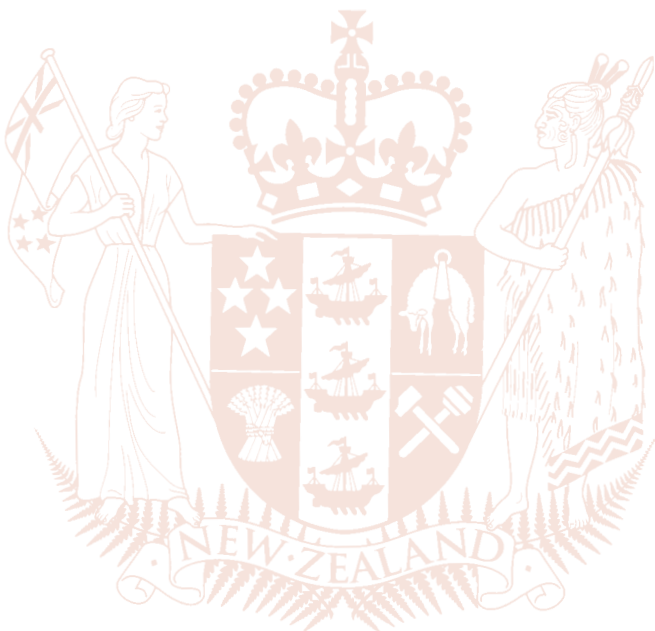
### What Our Audit Did Not Cover

- 1.14 Taxpayer audit interacts closely with many other parts of the IRD. We have referred to these other parts where they directly affect taxpayer audit, but we have not examined their role in any detail. These include the:
- Technical Standards Group;
  - Technical Development Unit;
  - Technical and Legal Support Group;
  - Litigation Management Group;
  - Internal Audit Group;
  - Policy Advice Division; and
  - National Research Unit.
- 1.15 Owing to time and resource constraints, and the fact that the IRD was itself reviewing them at the time of our audit, we did not review the disputes process and compliance penalties regime, notwithstanding that they are a feature of taxpayer audit.
- 1.16 Nor did we analyse in detail all of the many systems and processes (such as the staff appraisal system) that the IRD uses to manage its taxpayer audit function.



## INTRODUCTION

- 1.17 Time and resource constraints also prevented us from benchmarking IRD's taxpayer audit activity with other tax jurisdictions around the world. While this would have been an interesting and potentially useful exercise, the complexity of tax departments and the different legislation they operate under would have made meaningful benchmarking time-consuming and expensive.
- 1.18 We did not examine the compliance costs incurred by taxpayers audited by the IRD.



## Part Two

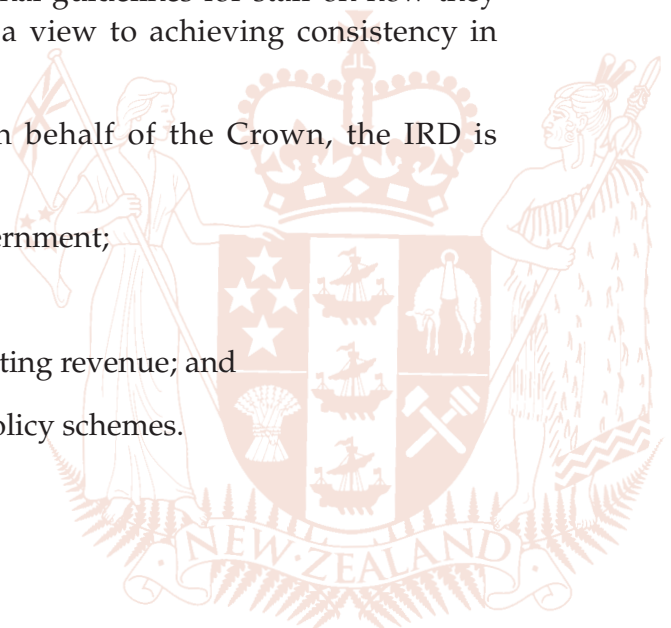
# Background





## Duties and General Responsibilities of the IRD

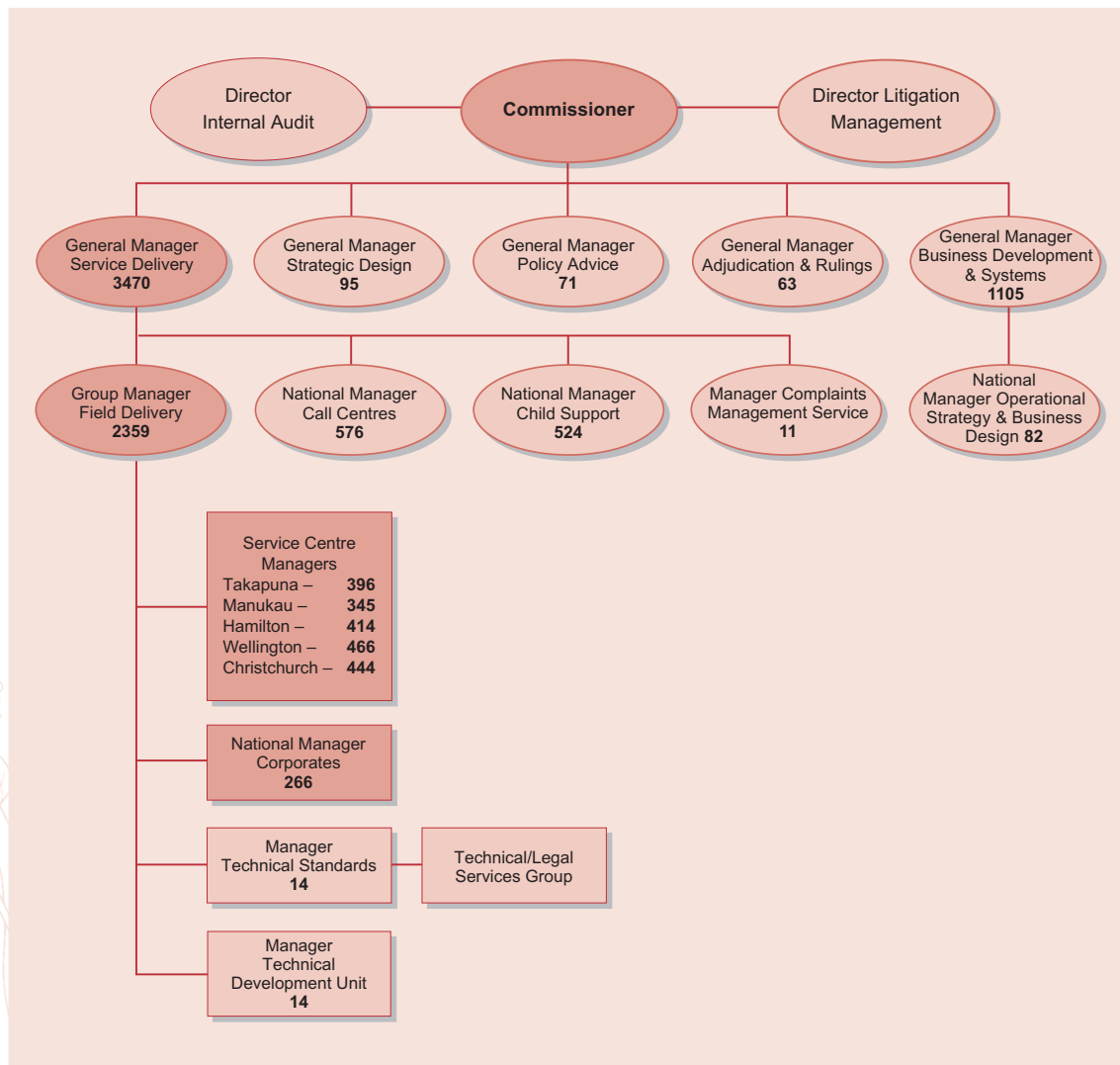
- 2.1 Section 6 of the Tax Administration Act 1994 imposes a responsibility on the Commissioner and all IRD staff “at all times to use their best endeavours to protect the integrity of the tax system”.
- 2.2 Section 6A of the Tax Administration Act sets out the Commissioner’s principal duties under revenue legislation:
- “care and management of the taxes covered by the Inland Revenue Acts”; and
  - the duty to “collect over time the highest net revenue that is practicable within the law, having regard to the resources available to the commissioner, the importance of promoting compliance by all taxpayers, and the compliance costs incurred by taxpayers”.
- 2.3 In short, the Commissioner is not expected to assess and collect every dollar of tax due, come what may.
- 2.4 In 1999, the IRD began to prepare a standard practice statement that would clarify for IRD staff, taxpayers and tax practitioners some uncertainties in the wording of section 6A(3) relating to the IRD’s ability to reach agreements with taxpayers on a case-by-case or global basis. That year, the IRD issued a draft standard practice statement, but the draft was subsequently withdrawn, and some four years later there is a concern that the issue has still to be resolved.
- 2.5 Reaching agreement on a revised statement is a complex matter. The IRD has therefore decided to prepare internal guidelines for staff on how they should interpret section 6A(3), with a view to achieving consistency in how the section is applied.
- 2.6 In addition to collecting revenue on behalf of the Crown, the IRD is responsible for:
- providing policy advice to the Government;
  - interpreting tax legislation;
  - providing services to assist in collecting revenue; and
  - the administration of some social policy schemes.



## Structure, Roles, and Responsibilities

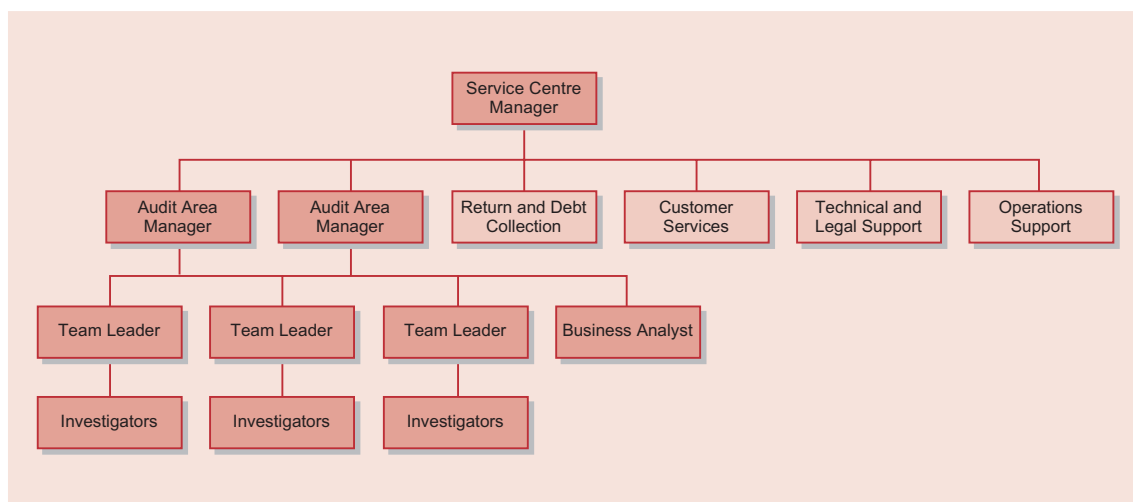
2.7 The IRD's taxpayer audit forms a large part of the IRD's business with some 853 staff involved in delivering audits (and approximately 28 staff in management, compliance risk analyst, and design roles related to audit) out of a total workforce of 4800 at February 2003. The delivery of taxpayer audit is one of a range of responsibilities of the General Manager – Service Delivery, who is the lead manager for most of the IRD's staff. The management structure is shown in Figure 1 below.

Figure 1  
IRD Senior Management Structure



- 2.8 A different general manager, the General Manager – Business Development and Systems, has among his responsibilities the Design and Monitoring Group (see Figure 1 on the previous page). This group establishes the overall design of activities undertaken in service centres, including taxpayer audit. The design includes output contracts, quality standards, measures, and systems. For example, the group designed the audit manuals and the Quality Measurement System, which we refer to in other parts of this report.
- 2.9 Service Delivery is made up of four functions, one of which is Field Delivery. It is through this management line that taxpayer audit staff (based either in the Corporates Division or one of the five service centres) report to the Group Manager – Field Delivery. This manager is also responsible for the customer service and return and debt collection work undertaken in the service centres and Corporates Division.
- 2.10 Figure 2 below illustrates the management structure of a typical service centre (the Corporates Division structure is shown in the Appendix on pages 83-84), showing the detail of the taxpayer audit element. The service centre managers are responsible for a range of key customer-facing activities, of which taxpayer audit is one. They and the audit staff have wide discretion for determining the way audits are done. To date, the Design and Monitoring Group has generally only used persuasion to get them to adopt new initiatives that the group designs.

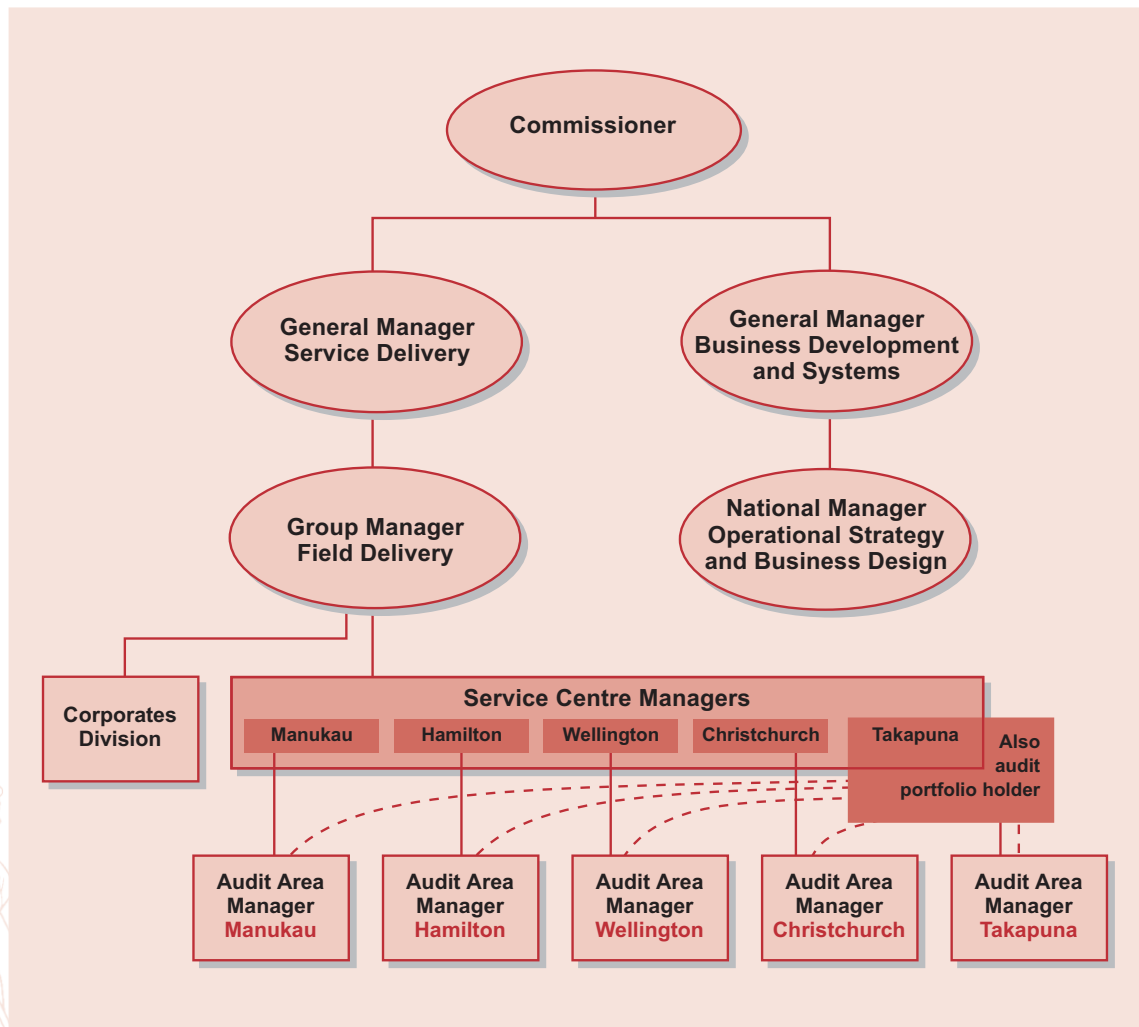
*Figure 2  
Service Centre Management Structure*





- 2.11 As outlined on page 20, the IRD has recently set up a Business Initiatives Governance Board. The Board has, as one of its objectives, to ensure that new initiatives are formally adopted and implemented.
- 2.12 Figure 3 below provides a simplified overview of the structure for taxpayer audit, including the position of the “Audit Portfolio Holder” role that we describe in paragraphs 2.14-2.15.

*Figure 3  
Overview of the Structure for Taxpayer Audit*



- 2.13 As illustrated in Figures 1 to 3 and in the Appendix, the structure of taxpayer audit is complex, reflecting its size and importance to the IRD.
- 2.14 The Audit Portfolio Holder (see Figure 3) has a remit across the five service centres but has no direct responsibility for audit staff, except those in his own service centre. He is responsible for ensuring delivery of national targets and promoting best practice in taxpayer audit across the five service centres. This involves providing cohesion, consistency, and a co-ordinated approach to reporting on taxpayer audit performance, but the discretionary nature of many initiatives limits the effectiveness of the role.
- 2.15 In January 2003, the role of the Audit Portfolio Holder was strengthened in an attempt to clarify its relationship with service centre managers, audit area managers, and team leaders. The change was intended to help increase consistency and reduce the autonomy of the service centres in relation to taxpayer audit. However, it is too soon to tell how much effect this has had on the respective responsibilities of the service centre managers and the Audit Portfolio Holder.

## What Does an Investigator Do?

- 2.16 IRD investigators have a challenging job. They have to deal with complex legislation and highly technical issues, and audits are undertaken in often stressful, and occasionally confrontational, circumstances.
- 2.17 Investigators are involved in selecting particular taxpayers to be audited and carry out the audits to identify any potential discrepancies. They are not involved in collecting the tax they have assessed as due – return and debt collection staff carry out this function.
- 2.18 As the length and complexity of taxpayer audits increase, the need also increases for investigators to have more skills, experience, and an in-depth understanding of tax laws and technical accounting issues.
- 2.19 Figure 4 on the next page outlines the three categories of taxpayer audits. Audits vary greatly in length, and not all audits involve visits to taxpayers. Investigators complete many of the short-term audits using information that the IRD holds about taxpayers.

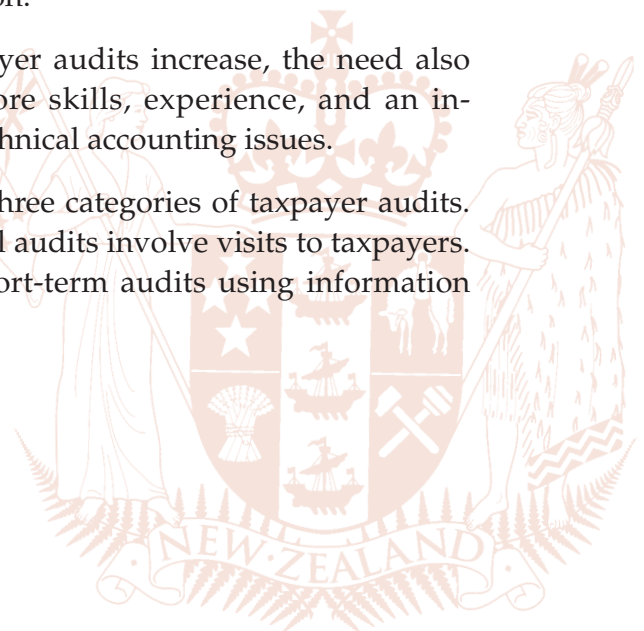


Figure 4  
Types of Taxpayer Audits

Type of Audit	Tasks Undertaken
<p><b>Short-term Audits</b> – generally deal with one return period only and one tax type. They are of short duration, taking less than 20 hours.</p>	<p>Registration checks Non-filer checks Goods and Services Tax (GST) refund checks Income tax audits GST audits Payroll audits Voluntary disclosure checks</p>
<p><b>Medium-term (Extended) Audits</b> – generally deal with more than one return period for one or more tax types. They are of medium duration, taking 20-50 hours.</p>	<p>Extended income tax audits Extended GST audits Multi-revenue audits Extended dual revenue audits</p>
<p><b>Long-term Audits (Investigations)</b> – generally deal with more than one return period and all tax types. They are of relatively long duration and ordinarily take 50-500 hours. In the Corporates Division these audits can take well over 1000 hours.</p>	<p>GST investigations Full investigations Aggressive tax issues (tax avoidance) investigations Evasion investigations Criminal Fraud investigations</p>

### The Cost and Scale of Taxpayer Audit

2.20 Taxpayer audit consumes 23% of the total cost of running the IRD and is the largest single activity undertaken.

2.21 ★ For the year to June 2003, the planned cost of taxpayer audit (excluding Litigation Management) was \$91 million excluding GST – representing \$73 million for the audit work done in the service centres, and \$18 million in the Corporates Division.<sup>4</sup>

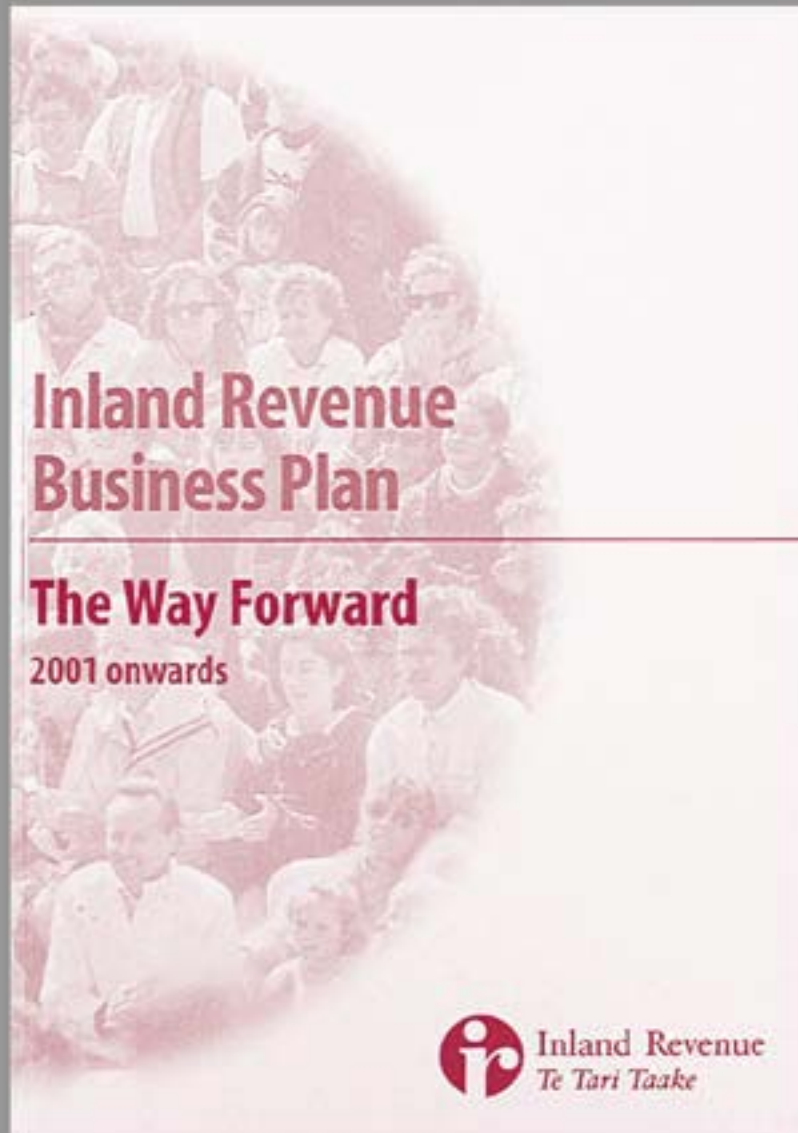
<sup>4</sup> IRD Statement of Intent, 2002-03, parliamentary paper B.23 SOI (2002).

- 2.22 With this funding the IRD intended to dedicate between 823,000 and 843,000 hours to conducting audits in the service centres, and to assess tax payable of at least \$550 for every audit hour completed. In the Corporates Division, the IRD planned to dedicate between 191,000 and 201,000 hours to audits.<sup>5</sup>
- 2.23 When the IRD seeks additional funding for increased taxpayer audit activity, it demonstrates that additional tax revenue will be assessed as a result. Given that the IRD can demonstrate this fact, it is up to Parliament to decide how much additional funding it wants to give the IRD for taxpayer audit activity to secure additional revenue. The balance between the amount of funding given to the IRD and other government departments is necessarily a political decision.
- 2.24 Most taxpayer audit staff are based in the IRD's five service centres. At February 2003, there were 615 investigators and 84 team leaders across all the service centre areas. All service centres except Manukau have at least one branch office – Christchurch with five has the most.
- 2.25 At February 2003 there were 154 investigators and senior investigators in the Corporates Division.
- 2.26 In addition, 28 staff are in management, design, and analyst roles related to taxpayer audit.

5 The length of audits conducted by the Corporates Division and the very large sums assessed mean that a measure of additional revenue gained per audit hour is of little value and no such target is set.

Part Three

# A Strategy for Taxpayer Audit





## The IRD's Strategic Direction

- 3.1 In July 2001, the IRD set out its vision in its new strategic business plan *The Way Forward 2001 Onwards*. This document identifies the IRD's strategic direction, presents a framework for enhancing the tax administration business, and outlines the areas on which the IRD will focus over the coming years.
- 3.2 *The Way Forward 2001 Onwards* includes the following major themes, the first three of which have a direct impact on taxpayer audit:
- to streamline and simplify tax processes;
  - to create an environment which promotes compliance;
  - to enhance people capability; and
  - to enhance the administration of non-tax business.

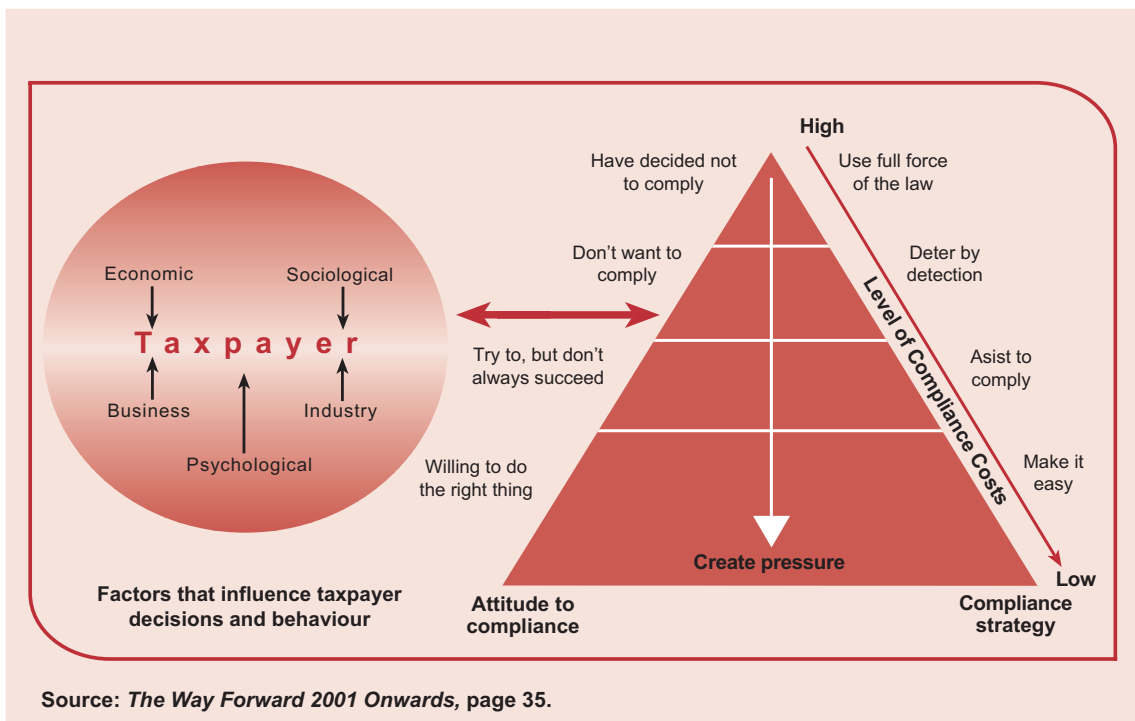
## The Taxpayer Compliance Model

- 3.3 *The Way Forward 2001 Onwards* uses the IRD's Taxpayer Compliance Model as the cornerstone of its aim to ensure that all taxpayers pay the correct amount of tax that is due (see Figure 5 on the next page). The model, originally created for the Australian Taxation Office:
- is based on academic research undertaken across a number of regulatory agencies;
  - provides a framework for thinking about how the IRD can most appropriately interact with taxpayers; and
  - incorporates a range of activities designed to increase taxpayer compliance – including taxpayer audit, which the IRD identifies as fundamental to ensuring voluntary compliance by taxpayers with tax law.
- 3.4 The underlying principle of the model is that the IRD will tailor its actions to match the attitude of taxpayers to compliance. In Figure 5 on the next page, the circle shows the world of the taxpayer, and the factors that affect taxpayers' decisions and behaviour. Taxation compliance behaviour is influenced by five factors – business, industry, sociological, economic and psychological – all of which interact and influence whether a person meets their tax obligations.

## A STRATEGY FOR TAXPAYER AUDIT

- 3.5 Each segment of the triangle in the model shows the range of taxpayer attitudes towards compliance. At the base of the triangle, taxpayers have the desired attitude of 'willing to do the right thing'. At its top are the taxpayers who have decided not to comply – they choose to evade or opt out of the tax system. Individual taxpayers may, over time, change position in the model, as factors affecting their attitude change.

*Figure 5*  
*The Taxpayer Compliance Model*



- 3.6 The right-hand side of the triangle shows the IRD's hierarchy of possible compliance responses. By understanding the factors that influence taxpayer decisions and behaviours, and the range of attitudes towards compliance, the IRD is able to select the most appropriate response. The model is constructed on the basis that:

- For the majority of taxpayers who choose to pay the correct amount of tax on time, ongoing assistance will be the most helpful response to encourage continuing compliance. To keep taxpayers 'willing to do the right thing' the IRD uses strategies such as advisory visits, record-keeping tools and information.



- At the level of ‘assist to comply’ the IRD might use reminder letters and helpful phone calls.
- For taxpayers who have continued to be non-compliant after having been given reasonable opportunity to comply, actions increase in severity and frequency. Examples might include audits, final notices, and legal action.
- At the top of the triangle, the severest responses – such as prosecution – are used only for the most non-compliant taxpayers.

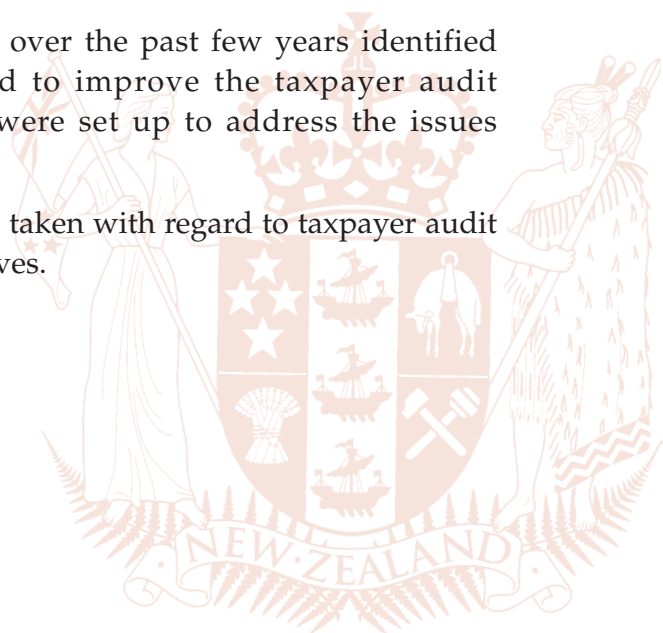
3.7 Thus, the model implies that the IRD has the ability to influence taxpayers’ behaviour through the way in which it responds to them. And, rather than responding in the same way to all taxpayers, the IRD can distinguish between different sub-groups and tailor its response accordingly. For example, taxpayers who ‘get it wrong’ will not necessarily always be non-compliant.

3.8 The IRD might want to distinguish between taxpayers who have filed late on one occasion, and those who file late consistently. By responding to non-compliance in a positive rather than punitive way, the IRD intends to encourage future compliance, effectively moving taxpayers towards the base of the triangle.

3.9 In this audit we have examined the IRD’s taxpayer audit function in the context of the compliance model, to establish whether taxpayer audit is in a position to deliver the IRD’s strategic direction. We did not seek to measure the IRD’s success in increasing compliance.

### Key Issues that Have Influenced Taxpayer Audit

- 3.10 A number of reviews and initiatives over the past few years identified issues that needed to be addressed to improve the taxpayer audit function. In many cases, projects were set up to address the issues identified.
- 3.11 We looked at what action the IRD had taken with regard to taxpayer audit as a result of these reviews and initiatives.





## A STRATEGY FOR TAXPAYER AUDIT

- 3.12** The 1992 Audit Strategy identified work required to improve taxpayer audit.<sup>6</sup> Many of the aspects requiring improvement – risk analysis, case selection, audit methodologies, best practice case management techniques, and industry profiles – were also identified in the Audit 2000 project. However, the IRD’s senior management postponed many of these improvements to allow efforts and resources to be concentrated on improvements that they judged to be a higher priority – for example, enabling many salary and wage earners to cease filing a tax return, and reducing compliance costs for small businesses.
- 3.13** This reprioritisation meant that much of the work required to improve taxpayer audit was not completed. The improvements remain key priorities for the audit strategy currently being prepared by the IRD and it is crucial that this work is now completed.
- 3.14** In the last few years, other events have had an impact on the attention given to taxpayer audit. For example:
- Changes in priorities by successive new Commissioners. Several individuals have held that post over a relatively short period.
  - The IRD has been subject to a number of major external reviews that have required time and attention, particularly at a senior level. The IRD’s response to these reviews has involved implementing substantial changes to its organisation.
- 3.15** We interviewed Sir Ivor Richardson, Chairperson of the 1994 Organisational Review, who confirmed that the IRD had made the major changes in specialisation that the review recommended. These changes included the establishment of the Policy Advice Division, Adjudication and Rulings Groups, and Technical and Legal Support Group.
- 3.16** Sir Ivor indicated that the Review Team had hoped that after a period of time there would be plenty of evidence of knowledge transfer from these specialist centres of excellence to lift the general skills levels and enhance the culture for the staff in audit. We saw examples of transfer of knowledge, but it was not happening consistently. The IRD is looking at putting further resources into building more technical capability in the Corporates Division, Technical and Legal Support Group, Technical Standards Group, and Litigation Management Unit, so that the relationships between these groups and investigators can be further enhanced.

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<sup>6</sup> A number of significant changes followed – such as the establishment of the Corporates Segment and the Risk and Research Unit, the development of the current audit methodologies, and the computerised Taxpayer Audit Case Selection, Management and Reporting System (TACTICS).

- 3.17 The recommendations agreed to by the Government arising from the 1999 inquiry by the Finance and Expenditure Committee<sup>7</sup> have been adopted, although some matters (e.g. time bars) are being addressed as part of other reviews.

### A New Strategy for Taxpayer Audit

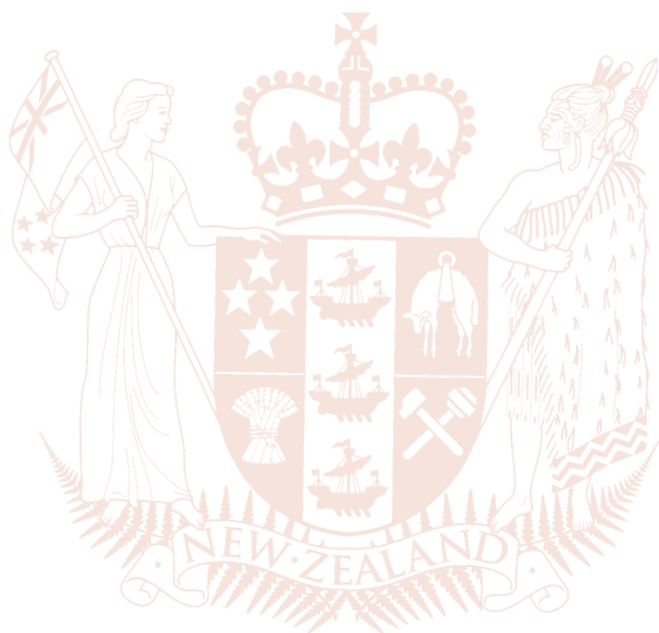
- 3.18 When we started our audit in April 2002, the IRD did not have a current strategy for taxpayer audit. In September 2002, it set up a small team in its Design and Monitoring Group to start preparing a strategy, comprising a sector manager seconded from the Corporates Division and a national adviser in the Design and Monitoring Group. At that time, preparation of a strategy for taxpayer audit was less formal than the arrangements for preparing and maintaining the IRD's technology strategy, which were well established and headed by a governance board.
- 3.19 Taxpayer audit consumes nearly one quarter of the IRD's annual operating expenditure. In our view, preparation and communication of the audit strategy needs to be given the same high profile as other major strategies. The IRD is now increasing its focus on the audit strategy through the changes outlined on page 20.
- 3.20 There appeared to be slippage with progress on the strategy at the time of our audit. As at February 2003, the IRD had not completed its assessment of the current status of the audit function, which had been due for completion by 30 December 2002. A draft audit strategy has since been completed and was presented to the Business Initiatives Governance Board (see paragraph 2.11 on page 32) in May 2003. A revised version was approved at the Board's June meeting.
- 3.21 As at 30 June 2003, the IRD had identified the range of initiatives required to successfully implement the audit strategy. By September 2003 it expects to have finalised implementation plans – including prioritisation, detailed scope, and resourcing requirements. The IRD will regularly review and revise the plans as necessary.

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<sup>7</sup> *Inquiry into the powers and operations of the Inland Revenue Department*, parliamentary paper I.3i.

### Implementing the New Audit Strategy

- 3.22** The successful implementation of the new audit strategy will entail fundamental changes in working practices and substantial new initiatives. It will require changes in the approach of audit staff, as well as technical changes, if the strategy is to be successfully implemented.
- 3.23** The IRD has acknowledged the significance of the changes required and the need for them to be effectively managed in its decision to establish the Business Initiatives Governance Board. The Board's role will be to ensure that senior management signs off new initiatives and agreed strategies, and that an appropriate level of resources and full commitment are applied to implementing them.



## Part Four

# Case Selection and the Conduct of Audits





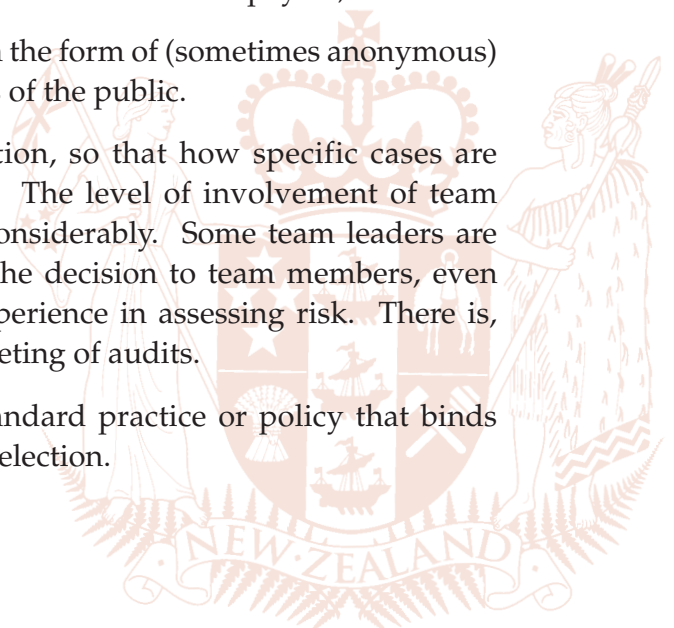


## Introduction

- 4.1 There are a number of key steps in the audit process – including case selection, conducting field activities, gathering evidence, and satisfactory resolution of any discrepancies with the taxpayer.
- 4.2 In this part of the report we examine the key steps in the taxpayer audit process that we feel need to be improved. Our decision to focus on these steps arises from our field work results and from the findings of the IRD's previous reviews of taxpayer audit. These steps are:
- selection of cases to be audited;
  - preparation of case plans;
  - organisation of working papers;
  - choice of audit methodologies; and
  - case management to improve timeliness.

## Case Selection

- 4.3 Investigators use a number of techniques to select cases, but they do not use the techniques on a co-ordinated or consistent basis across the IRD. The techniques include:
- computer analysis of data in tax returns;
  - analysis of compliance and/or payment records of taxpayers; and
  - responses to information received in the form of (sometimes anonymous) phone calls or letters from members of the public.
- 4.4 Individual investigators have discretion, so that how specific cases are selected varies between audit teams. The level of involvement of team leaders in case selection also varies considerably. Some team leaders are closely involved, while others leave the decision to team members, even though some may not have much experience in assessing risk. There is, therefore, little by way of directed targeting of audits.
- 4.5 We are concerned that there is no standard practice or policy that binds audit staff to proven methods of case selection.



### *Compliance Risk Analysts*

- 4.6 In 1999, Compliance Risk Officers (CROs) were introduced into the service centres on a trial basis to assess whether the role should be established. Their primary purpose was to collect and collate information to improve targeting of cases selected for audit – for example, they were responsible for improving the queries run in Taxpayer Audit Selection System (see paragraphs 4.12-4.14 on the opposite page).
- 4.7 There are currently five CROs. In practice, audit area managers decide the nature of the CRO role, and the enthusiasm with which service centres endorsed the role has varied. Individual investigators can choose whether or not to use the CROs' results, and where an audit area manager or team leader is not supportive, it is less likely that they will do so.
- 4.8 When we started our audit, the CROs' role had still not been formalised. CROs told us that they had no job description, and they felt that the low profile of the role hindered their effectiveness.
- 4.9 In May 2003, the IRD announced the position of Compliance Risk Analyst (CRA)<sup>8</sup>. At the time of writing this report, IRD was interviewing applicants and plans to have made 10 appointments to these positions by late-July 2003.

### *Use of Risk Analysis in Case Selection*

- 4.10 In April 1998, a paper to the IRD's Senior Management Team identified two major problems with the risk identification process:
- The process was a closed system that made little use of external research to determine risk areas and the geographical location in which they occur. The result was self-perpetuating cycle – for example, a focus on GST because it is an area of high discrepancies results in a focus on gathering information about GST that reinforces the view of GST as a high-risk area.
  - There was little analysis of the optimal mix of service and enforcement delivery, and no cost/benefit analysis to assist in determining the value of one type of audit as opposed to another, or as opposed to education.
- 4.11 Addressing these issues will be crucial to the successful implementation of the new Audit Strategy.

<sup>8</sup> The job title was changed from "officer" to "analyst" to better reflect the type of work involved in the role.

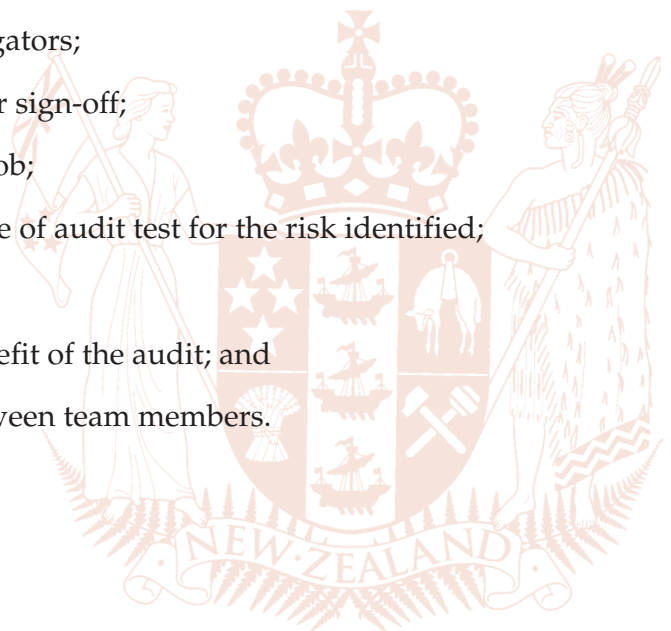


## *Taxpayer Audit Selection System*

- 4.12 The Taxpayer Audit Selection System (TASS) is currently run twice a year in December and June on all return types to generate a selection of potential taxpayers for audit. It involves interrogating the Data Warehouse database (see paragraphs 5.31-5.33) using selected queries (currently 26, though not all are relevant to every type of tax return). The results are exported onto a computerised database so that individual investigators can screen cases. The investigators then complete a risk analysis for each taxpayer and conclude with a risk rating that is used to help make the final audit selection.
- 4.13 Other than using TASS to select some cases, selection methodologies have been unchanged for a long time. Case selection plays an important part in achieving the audit outcome of maintaining and improving compliance. The Audit 2000 project sought to review case selection methods. As part of the review a predictive case selection model was created but the review was then deferred because other work was judged to be a higher priority.
- 4.14 The IRD recognises that improving case selection will require improved intelligence systems and resources, which we discuss in Part Five on pages 64-69.

## Case Plans

- 4.15 The IRD requires case plans to be prepared for all audits other than short-term audits (see Figure 4 on page 34). The plans are required for a number of important purposes – to:
- provide continuity between investigators;
  - facilitate file review and team leader sign-off;
  - provide training for juniors on the job;
  - document the most appropriate type of audit test for the risk identified;
  - ensure that all risks are addressed;
  - allow determination of the cost-benefit of the audit; and
  - document the division of work between team members.





## CASE SELECTION AND THE CONDUCT OF AUDITS

- 4.16 The IRD has a process that investigators should follow in preparing case plans, but often it was not followed. For the service centre cases we reviewed, plans were rarely done. And, where there were plans, they generally did not meet the required standards.
- 4.17 Many of the investigators we interviewed stated that they saw little or no value in preparing a plan, and that they preferred to rely on their experience. Preparing case plans was seen by some as an unnecessary overhead that did not merit the additional time required to prepare them, particularly so when audit discrepancies can be identified without using a case plan. Some of the case plans we saw were poor and offered no indication of what risks had been identified and what audit tests were to be carried out.
- 4.18 By contrast, the Corporates Division has devised and operates a planning process that starts with industry risk analysis, followed by analysis of company risk, with the results being used to help formulate an audit plan. One of the Corporates Division case plans we reviewed was particularly comprehensive.
- 4.19 A case plan is required to be updated after the initial interview with the taxpayer. This requirement is supported by the Quality Measurement System that indicates that risks should be finalised after the initial client interview. The requirement is important because the interview often uncovers what the issues and accounting practices are.
- 4.20 Often, therefore, it is only after this interview that the investigator is in a position to identify what audit tests need to be performed and what evidence needs to be gathered. However, we saw nothing to show that the requirement to update case plans after the initial interview was being met. Thus, the plans we reviewed often did not reflect the work that was actually carried out.
- 4.21 The exception we observed is that comprehensive case management planning is applied to effectively manage the audit activity undertaken in Auckland and Wellington directed at mass-marketed schemes involving aggressive tax issues.

### *Use of Risk Analysis in Planning Audits*

- 4.22 We did see evidence of some good risk analysis in the Corporates Division. For example, the Tax Risk Analysis Report for one industry sector was a comprehensive and excellent analysis of current issues and emerging trends in that industry.
- 4.23 However, in one very large Corporates Division audit we examined, the risk analysis process was inefficient. Many generic risks were initially identified but then ignored, and other risks were identified but not documented in a revised case plan. Additionally, the Tax Risk Analysis Report prepared on the company did not identify any of the important issues.
- 4.24 Based on the case files we reviewed in service centres, risk analysis at the taxpayer level is being done to varying extents and standards. In some cases, it was not possible to tell from the file what risks had been identified and how (and, indeed, whether) they had been addressed. Where risks were identified, the work was often superficial, and we saw numerous examples of work performed not following the case plan.

### Organisation of Working Papers

- 4.25 Investigators take widely varying approaches to organising their working papers. Some of the files we reviewed were helpfully ordered and referenced, and were therefore easy to follow. However, the majority were difficult to follow and did not use any standard format. The documentation management practices supporting the audits that we examined in Auckland and Wellington of schemes involving aggressive tax issues were of a significantly higher standard.
- 4.26 As noted above, this made it difficult to see what risks had been identified or whether the risks had been addressed. Nor was it clear (without asking the investigator) how audit findings were supported by the working papers.
- 4.27 The IRD does not currently operate a system of computer-based working papers but – in line with long-established practice in major audit firms – may wish to do so in future. It will be important to substantially improve investigators' approaches to keeping orderly working papers in any event – but particularly in the event that a computer-based system is introduced.

### Audit Methodologies

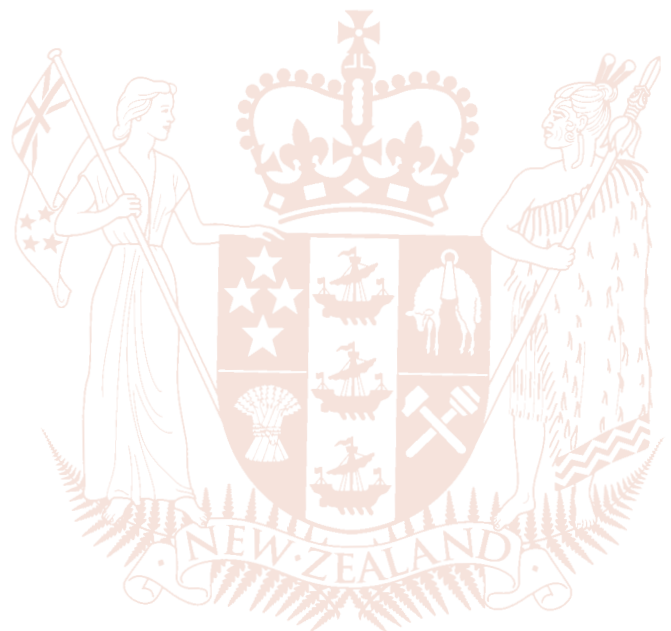
- 4.28 Audit methodologies are detailed in audit manuals. There are two key manuals – the Business Investigations Manual and the Audit Techniques and Policies Manual, which were written in 1994 to support modernisation following the 1992 audit strategy. Separate chapters for each type of audit task are designed to provide in one place all the material that audit staff need.
- 4.29 Until a rewrite of the manuals was started in September 2002, neither had been updated since 1994. The rewrite has now been completed and the new manuals are available on the IRD’s intranet. The IRD is also undertaking a project to ensure that the new manuals support a risk-focused approach, rather than the task-based approach currently documented. The manuals are to be amended to provide more information on matters such as common risk factors and available audit tests.
- 4.30 Audit staff we interviewed indicated that they currently do not use the manuals. The only use of manuals that we noted was the inclusion in some case files that we examined of copies of standard working papers drawn from a manual. Junior staff indicated that team leaders were their main source of advice and guidance about auditing.
- 4.31 The low level of use of manuals may partly account for us finding that audit staff rarely used some of the techniques we would expect to be used (e.g. ratio analysis, asset accretion techniques<sup>9</sup>, and reasonableness tests) – including techniques in training manuals (although those staff applying TASS selection criteria would automatically be applying some of these techniques). Team leaders told us that investigators previously made more use of the techniques, but moved away from them when the performance focus changed to emphasise quantitative measures such as audit hours and tasks, and the size of assessed discrepancies (see paragraphs 6.6-6.13 on pages 76-77).
- 4.32 Some investigators also told us they felt they had lost the ability to undertake income-related tests. We noted a generally low level of testing of income, which was borne out by some specific examples. In one service centre, audits of farming operations did not include tests of cost of sales or of livestock valuations. For a manufacturer being audited in another service centre, the investigators did not understand the manufacturing system, and they undertook no testing of cost of sales or product margins.

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<sup>9</sup> Asset accretion is a common method of determining the level of income based on statements of financial position.

### Case Management to Improve Timeliness

- 4.33 Timeliness of audits is an inherent problem for the IRD (as it is for many tax authorities), and is sometimes hampered by slow responses of taxpayers (or their agents) to information requests. Case management is an important technique to help improve timeliness of audits.
- 4.34 Several recent initiatives illustrate the high priority that the IRD has set for managing timeliness through better case management:
- In Corporates Division, time bar dates are identified in audit plans. The National Manager – Corporates receives monthly feedback on the status of open cases, and the sector managers are responsible for expediting the progress of older cases.
  - At their monthly meeting, area audit managers based in the service centres also monitor their timeliness statistics. However, the approach of different service centres to expediting older cases varies, as does the extent of management oversight at this more detailed level. The Quality Measurement System has identified “non-consideration of time bars” as an area of concern.
- 4.35 TACTICs is a tool that is available to managers to enable them to view case information and to see, for example, how a case is progressing. The tool requires delegated sign-off matters to be recorded. However, the IRD does not have organisation-wide software to support workflow issues for groups heavily focused on cases of evasion and aggressive tax issues. It needs to look at sourcing such a product externally or to create one in-house.



## Part Five

# Resources





## Introduction

- 5.1 In this part we examine the human resources available for taxpayer audit under the following headings:
- staff numbers, recruitment, and retention;
  - qualifications and competence; and
  - staff training.
- 5.2 We also discuss information and intelligence, and use of technology in taxpayer audits. Finally, we consider the implications of the IRD's strategic direction and compliance model for enhancing the future capability of taxpayer audit.

## Staff Numbers, Recruitment, and Retention

### Staff Numbers

- 5.3 In recent years, the IRD has been increasing the numbers of staff allocated to taxpayer audit. At February 2003, there were 853 field delivery staff in total, comprising 699 in the service centres (615 investigators and 84 team leaders) and 154 in the Corporates Division. This represented an 8% increase on the annual average level of staff (788) in 1999-2000.

### Recruitment and Retention

- 5.4 Figure 6 on page 58 shows that, in 2001-02, 106 staff were recruited to taxpayer audit and 46 people left. This level of turnover (approximately 5%) is very low compared with turnover experienced by the large private accounting firms. The low turnover is likely to be caused by a wide range of factors – one important factor we noted was the IRD's relatively flexible employment conditions, which staff view positively and are likely to act as a competitive advantage.

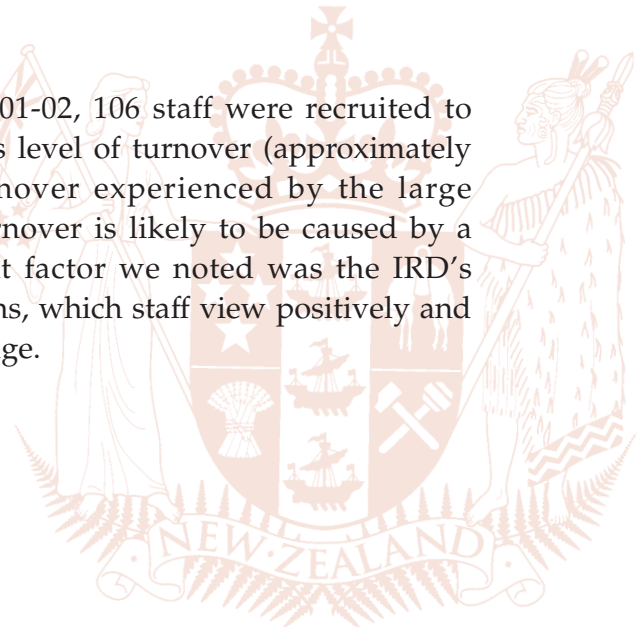
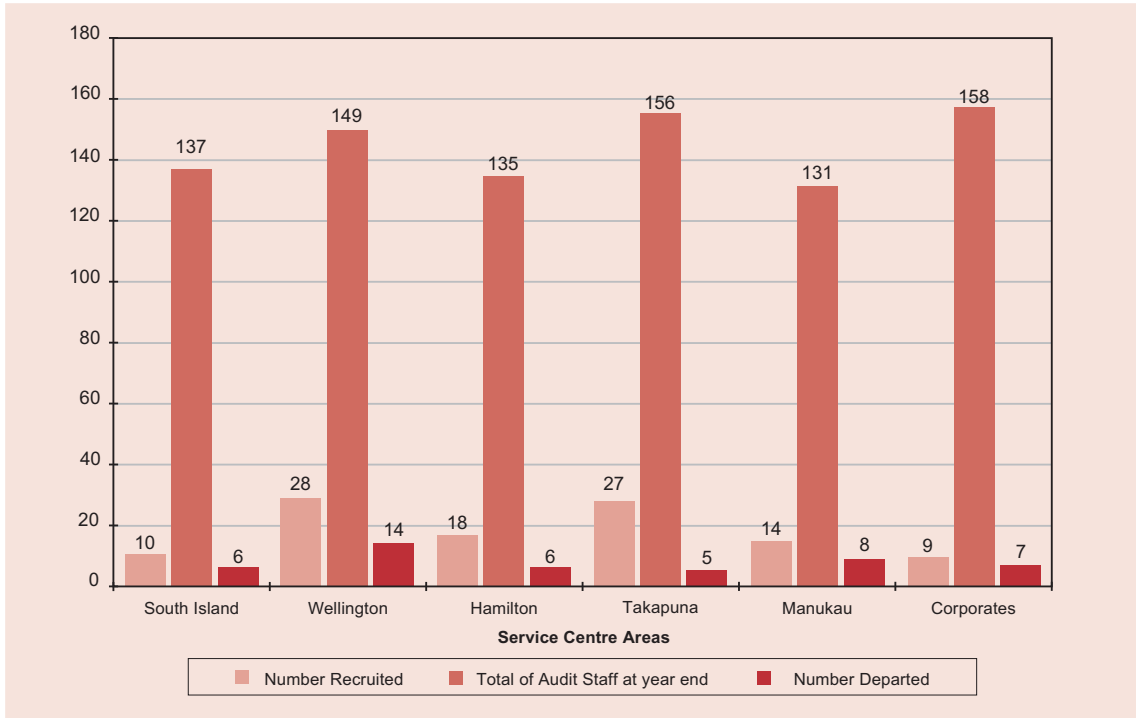


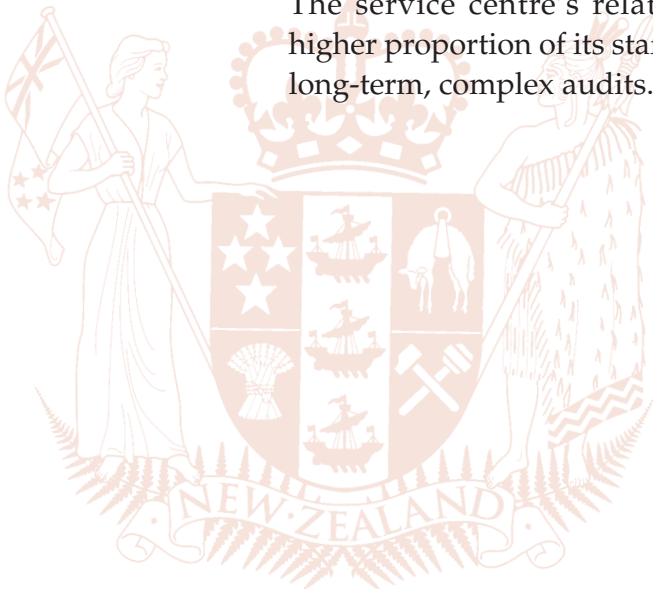


Figure 6  
Audit Staff Recruited and Departed 2001-02



5.5 However, much of the turnover represents the IRD losing some of its most capable audit staff, who are highly desirable to private sector employers.

5.6 The problem is particularly acute in Wellington, where external competition for good staff is compounded by Wellington’s service centre also losing them to the IRD’s National Office and the Corporates Division. The service centre’s relatively higher turnover inevitably results in a higher proportion of its staff having low levels of experience in undertaking long-term, complex audits.



## Qualifications and Competence

### *Numbers of Qualified Audit Staff and Staff Undertaking Study*

- 5.7 In terms of qualifications, the profiles of staff working in the Corporates Division and those in the service centres are different. At 30 June 2002, 75% of audit staff in the Corporates Division were tertiary qualified – this included more than 60% of audit staff having or also studying for professional accountancy qualifications. In contrast, in the service centres only 39% of the audit staff were qualified. However, over a third of the unqualified audit staff are studying for an accountancy or other tertiary qualification.
- 5.8 Figure 7 below shows that the number of audit staff studying for a tertiary qualification has been steadily increasing over recent years, both absolutely and as a percentage of all audit staff. These numbers represent an important investment in capability. Audit staff told us that the availability of opportunities to undertake training and study is an important factor in enabling the IRD to recruit and retain staff.

*Figure 7  
Staff Undertaking Tertiary Study<sup>10</sup>*

	1999-2000	2000-01	2001-02
Total Audit Staff	788	798	866
Number Studying	109	137	155
Percentage Studying	13.8%	17.2%	17.9%

<sup>10</sup> Includes professional accountancy and other qualifications such as PCE/PAS (the Professional Competence Examination and Professional Accounting School qualifications) required before becoming a member of the Institute of Chartered Accountants of New Zealand.

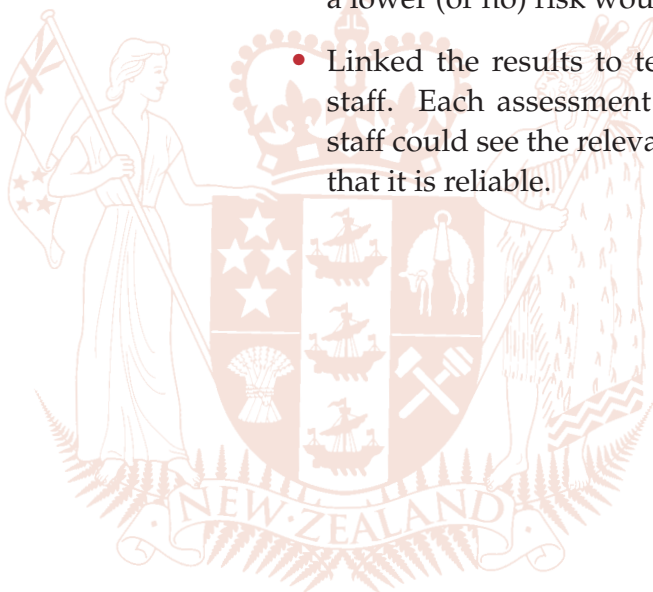
## *Measures of Core and Technical Competence*

5.9 Investigators, through the IRD's performance measurement system, have their core and technical (audit and tax) competence checked regularly. We wanted to include in this report aggregated data about the levels of competence, but were unable to do so because of the following shortcomings in the data:

- The database from which the tax technical figures are drawn is not linked to the overall performance rating of individual staff. Some parts of the IRD have therefore not paid sufficient attention to the technical competence database or kept their records up to date.
- The assessment of technical competence is against a common standard, rather than one that takes account of the level of experience and qualification of a member of staff and the work they actually do. So, a relatively new and inexperienced member of staff in training will be assessed as not being technically competent, even though their actual performance (i.e. work done on an audit) may be technically competent where they are allocated work appropriate to their level of experience and appropriately supervised.

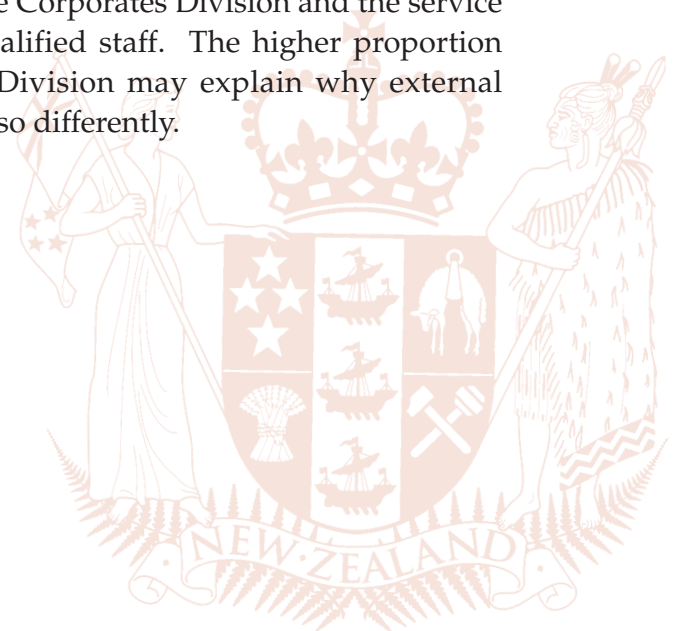
5.10 In any organisation, staff who are allocated work beyond their technical competence represent a business risk. We consider that the IRD would obtain a better understanding of its risk in this area than it currently does if it:

- Measured competence relative to the work that staff actually undertake. Thus, if staff are being allocated work beyond their competence, the measure would indicate business risk, but if relatively inexperienced staff are being given appropriate work and properly supervised, a lower (or no) risk would be indicated.
- Linked the results to technical competence assessments of individual staff. Each assessment could then be used to validate the other, and staff could see the relevance of the measure and be encouraged to ensure that it is reliable.



## *External Perspectives on Competence*

- 5.11 The IRD identified enhancing the capability of its staff as a major theme in *The Way Forward 2001 Onwards*. From our interviews and file reviews, we also identified the need for the IRD to improve the capability of taxpayer audit staff. Some external people we consulted, including some who had worked in the IRD in the recent past, confirmed this view.
- 5.12 Tax practitioners' views are relevant to taxpayer audit performance, especially since they are likely to be able to comment on changes in performance over time. Taxpayer auditors tend to get a mixed review. While there is always a risk that practitioners will generalise from a few examples, the following consistent points of criticism came from the tax practitioners we spoke with:
- Investigators tend to focus on the areas in which they have competence and experience. Therefore, some significant risks are missed.
  - Inexperienced staff are expected to do audits beyond their capability.
  - New staff are not adequately supervised.
- 5.13 Despite these comments, many of the practitioners (including large accounting firms) we spoke to, particularly those in Auckland, considered that the IRD's taxpayer audit function was moving in the right direction and that standards, competence, and approach were all improving. Practitioners also held the view that managers were aware of many of the current weaknesses and were working hard to address them.
- 5.14 Tax practitioners also consistently expressed an opinion that Corporates Division staff are better qualified and more able than staff in the service centres. As noted in paragraph 5.7, the Corporates Division and the service centres have a different profile of qualified staff. The higher proportion of qualified staff in the Corporates Division may explain why external stakeholders perceive the two groups so differently.



## Staff Training

- 5.15 Basic formal training of investigators is part of the IRD's ASPIRE<sup>11</sup> training modules, which also provide training in mainstream tax areas such as tax law, disputes procedures, rights and powers, and what constitutes income and deductions. ASPIRE also provides training on some specialist topics (such as evasion and aggressive tax issues) and on non-tax skills (such as business writing).
- 5.16 Two ASPIRE modules specifically address auditing. In the three years to 30 June 2002, 71 and 18 staff respectively completed the applied and advanced audit modules. Over the same period, the IRD appointed 280 new audit staff. While not all of these staff would necessarily need to complete these modules, we consider that take-up has been surprisingly low given the modules' content.
- 5.17 The focus group and interview evidence we collected suggested that, in practice, most investigators receive most of their training from their team leader. There is no standard audit induction programme for new investigators. In addition, the performance management system is not being systematically used to:
- identify the training and development needs of audit staff;
  - tailor courses and opportunities to meet the identified needs; and
  - follow up to check that the training is done.
- 5.18 The IRD has a project under way to increase the capability of team leaders. One objective of the project is to clarify the team leader's role in training and mentoring staff.
- 5.19 In our view, the current relatively unsystematic approach to training reinforces the variations in investigators' practices that we describe in other parts of this report. As part of tackling the inconsistency of approach, a planned programme of training needs to be prepared and applied to new staff, together with systematic training of all auditors in the application of important new developments – such as the revision of the manual that we outline in paragraphs 4.28-4.29 on page 52.

11 ASPIRE is the 'Acquisition of Skills Programme for Inland Revenue Employees'. It includes a range of training products and modules, and an assessment framework which is designed to meet the knowledge and skill requirements of technical competence.

- 5.20 At all levels within taxpayer audit we came across talented people committed to the IRD's objectives, notwithstanding the opportunities available elsewhere. We feel that the IRD could make more and better use of some of the investigators we met (and, no doubt, many we did not meet) by making them mentors for less experienced staff. The aim would be to promote good practice and help new recruits to gain experience and improve their competence.

## Sharing Best Practice

- 5.21 We saw examples of good ideas being disseminated among different teams within the same service centre. However, there is little evidence of good practice sharing between service centres. Audit area managers meet periodically, but their meeting minutes indicated that best practice initiatives are not usually discussed.
- 5.22 Historically, there has been a high level of competition between service centres. While this has provided an incentive to meet targets, it is likely also to have impeded good transfer of new practices and ideas. In our view, changing existing practices is likely to be a considerable challenge.
- 5.23 Tax practitioners commented to us on the importance of the information contained in the Adjudication and Rulings database, but this database has not been readily accessible to investigators. We understand that the IRD is reviewing access, and that the Technical Standards Group is sending a monthly summary of the latest Adjudication reports to the Technical Legal Support Group managers, who are based in the service centres, and to the Corporates Division.
- 5.24 The Technical Standards Group also has access to all Public Rulings and can get copies of specific Private Rulings as required. The challenge for the IRD is how to make this large volume of technical information available to investigators when they need it and in a form that is easy to access and use.
- 5.25 The changes required in communicating best practice reinforce our view that some form of management for change is necessary. A number of useful forums have been and are being established – including regular meetings of audit area managers, IRD's National Compliance and Penalties Consistency Committee, and the National Quality Review Committee. We would expect these forums to be monitored to ensure that they are successfully communicating, reinforcing, and monitoring best practice.

- 5.26 An area where effective communication of best practice is assisting the investigators in their work is the good access they have to support on difficult technical issues. A range of support is provided by other team members, team leaders, Litigation Management, the Technical Legal Support Group based in the service centres, and the central Technical Standards area.
- 5.27 Currently, a less effective area is mandatory reporting – which is the mandatory referral of certain technical matters to a more senior level, as a means of ensuring the integrity of decision-making. This new initiative is being well used by some audit staff but is poorly understood by others, who are not clear on what matters need to be reported on a mandatory basis. Better communication of best practice about the initiative would help make the process routine and reduce the risk of important decisions being taken by insufficiently experienced and/or qualified staff.

## Information and Intelligence

- 5.28 In order to do their work effectively under the compliance model, investigators need to have access to and make full use of good information and intelligence on the circumstances of taxpayers to enable investigators to:
- respond to taxpayers in a way that is appropriate to their circumstances; and
  - use the information to make risk analysis and case selection as effective as possible.
- 5.29 Intelligence is central to all the IRD's activities involving managing and improving compliance, including taxpayer audit. Improving intelligence and information is a key IRD priority, with fundamental work required to:
- identify and clarify requirements;
  - establish ways to gather intelligence and information that is not currently being gathered; and
  - set up systems to make better use of the intelligence.
- 5.30 Taxpayer audit's most advanced tool for case selection is the Taxpayer Audit Selection System (see paragraphs 4.12-4.14 on page 49). Other information resources that investigators can draw upon are examined below.

## The Data Warehouse

- 5.31 The IRD's Data Warehouse stores a wide range of taxpayer information. It is being enhanced as part of a long-term project that is being implemented in a number of phases.
- 5.32 One development of the Data Warehouse that is crucial to improving the efficiency and effectiveness of taxpayer audit is the bringing together in one place of a wide range of information and intelligence that investigators currently receive from many sources. Examples include information referred from:
- (i) other parts of the IRD,
  - (ii) other investigators,
  - (iii) analysis of previous audit activity,
  - (iv) industry,
  - (v) the media, and
  - (vi) the general public.
- 5.33 If successful, this development of the Data Warehouse will enable the IRD to understand the tax base better, and audit staff will be able to use this knowledge to improve the targeting of audit effort.
- 5.34 In the meantime, the IRD needs to make best use of the information generated in the conduct of audits. The IRD's 1999 Health Report<sup>12</sup> stated that –
- ... there is still significant potential to make further improvements to the risk assessment process. In particular, the Department needs to make greater use of information on completed audits collected by its audit systems, which can be broken down by up to 420 industry types ...*
- 5.35 An analysis of completed audit cases by industry sector for the 1997-98 and 1998-99 years was then under way. The analysis was completed in early 2000, and the results were used to inform work on industry profiles (see paragraphs 5.40-5.45) and at the start of the Industry Partnership initiative in 2001 (see paragraphs 5.46-5.50).

12 The Organisational Review of the IRD in 1994 recommended that the IRD should prepare a 'health report' for the Minister of Revenue, identifying major issues confronting the Department. Between 1994 and 1999 the IRD prepared four such reports, but none have been completed since 1999. They have been replaced by reports against the IRD's Customer Charter, the first of which was completed in June 2002.



- 5.36 Part of the Data Warehouse project involves enabling the IRD to gain access to sources of third-party information that will assist in targeting audits. Examples include the Births, Deaths, and Marriages Register; the Building Consent Application Lists held by District Councils; and, from the Registrar of Companies, particulars of newly formed companies. However, the issues around access are complex.
- 5.37 The IRD is conscious of privacy issues with respect to accessing certain third-party information, but believes that this type of information can be appropriately obtained within the existing legislation. It is investigating the legal, policy, and public relations consequences before it proceeds further with this important work that is necessary for taxpayer audit to be improved in line with the Taxpayer Compliance Model.
- 5.38 The Data Warehouse development has plans approved through to July 2003. Plans for a further phase are being prepared, and the work under way includes ensuring that the plans will take full account of the outcomes of the current phase and progress on other elements of the IRD's technology strategy.
- 5.39 The elements of the Data Warehouse project that are essential to the development of taxpayer audit should be given a priority that enables them to be effectively co-ordinated with the taxpayer audit strategy.

### Industry Profiles

- 5.40 Companies that fall within the responsibility of Corporates Division pay 50% of all revenue collected by the IRD each year. It is therefore important that the Division has good information on these companies.
- 5.41 Corporates Division has account managers responsible for the largest companies in each of its six sectors, enabling them to concentrate their efforts on gaining a good level of understanding of the companies and the sectors they operate in. They routinely produce industry specific tax risk analysis reports that are used to help select the audits to be conducted and to decide the focus of the audits.
- 5.42 The investigators based in the service centres have a much more numerous and diffuse client base. Historically, their understanding of this client base was assisted by information contained in an Industry Profile manual. We understand that most of the material in the manual was written in the early 1980s. It described in detail how different industries operated – e.g. Milk Vendors, Public Houses, Farmers, Chemists, Corner Dairies – and contained useful sections on common business ratios and tax legislation relating to each particular industry.

- 5.43 We understand that the manual has only once been subject to a major update – in 1986 when the profiles were amended to reflect the new GST regime. The IRD told us that the nature of business had not changed substantially and, therefore, that in many cases these original profiles were still relevant.
- 5.44 During 1998, the IRD decided to create a new series of industry profiles containing information such as a description of the industry, industry associations, business and accounting practices, specific legislation, case law, and the number, type and outcome of audits conducted.
- 5.45 Work on these new profiles has so far been limited. In June 2000, work was done in relation to 11 industries – not to produce profiles along the lines envisaged, but to provide statistics on the number of businesses within an industry, and details of the audit work conducted, i.e. number of completed cases, coverage, average hours per case, average discrepancy per case. Further work was planned for early 2002, but has been deferred in favour of other work assessed to be a higher priority.

### *Industry Partnerships*

- 5.46 In the past, some industry specific projects have been undertaken in particular locations. The IRD has also previously undertaken a number of industry-wide initiatives – e.g. in the taxi and real estate industries.
- 5.47 The IRD has established a new project – Industry Partnerships – that involves a concerted and co-ordinated IRD focus on particular industries. The project is being undertaken by a multi-disciplinary team attached to Service Delivery – comprising audit, debt collection, and service staff.
- 5.48 In the short term, this project cannot replace the industry profiles, because what is envisaged is much more involved and will be carried out over an extended period. The goals of the project are to make it easier for businesses to meet their obligations and for the IRD to target non-compliance, particularly around cash transactions. A key difference is that the products of Industry Partnerships are intended to assist the relevant industries to comply, as well as to provide information that is useful to IRD staff.

- 5.49 Industry Partnerships is creating a process to evaluate taxpayer behaviour with reference to the compliance model (see Figure 5 on page 40). So far, four criteria have been identified and will be used to group taxpayers who behave in a similar way and place them on the compliance model in one of the four categories – for example, “have decided not to comply”. This intelligence will then be used to better target audit work.
- 5.50 The first industries selected in 2002 for the Industry Partnerships project were painters and decorators and electricians. The IRD has established working relationships with groups representing these industries, and detailed industry profiles for internal use have been prepared and will be updated as necessary. Since March 2003, the IRD has expanded the project to include hairdressers, collision repairers, entrepreneurs (home businesses), and fruit growers. Over time, the IRD aims to create profiles for a large number of other industries.
- 5.51 The IRD still has some way to go to extend its risk profiling more generally. However, from July 2003, service centres are selecting more audits based on compliance risk factors. The IRD also has areas of expertise in which risks are especially well understood, and audits are effectively targeted. For example, the IRD knows a great deal about the practice of transfer pricing, and about some particular types of tax avoidance and evasion.

## Use of Technology

- 5.52 In December 2002, the IRD launched its technology strategy that aimed to identify:
- the current status of the IRD’s technology environment;
  - the future technology requirements to support its strategic direction; and
  - the activities required to reach the desired future state, as set out in the strategic direction.

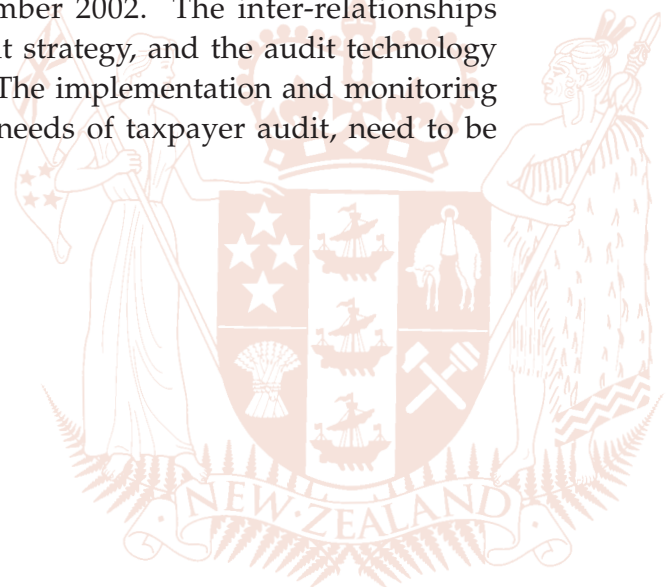
### Computer Tax Audit Group

- 5.53 The Computer Tax Audit Group assists investigators by downloading and analysing general ledgers, reviewing computer systems, and providing computer forensic expertise. The group has concentrated primarily on the Corporates Division’s audits, but is increasingly involved in assisting with audits in the service centres.

- 5.54 Computer tax audit is a complex and continually developing activity. The head of the Computer Tax Audit Group is leading a project to establish a strategic plan for the group, and resourcing will be an important topic for this project to consider.

### Use of Technology by Investigators

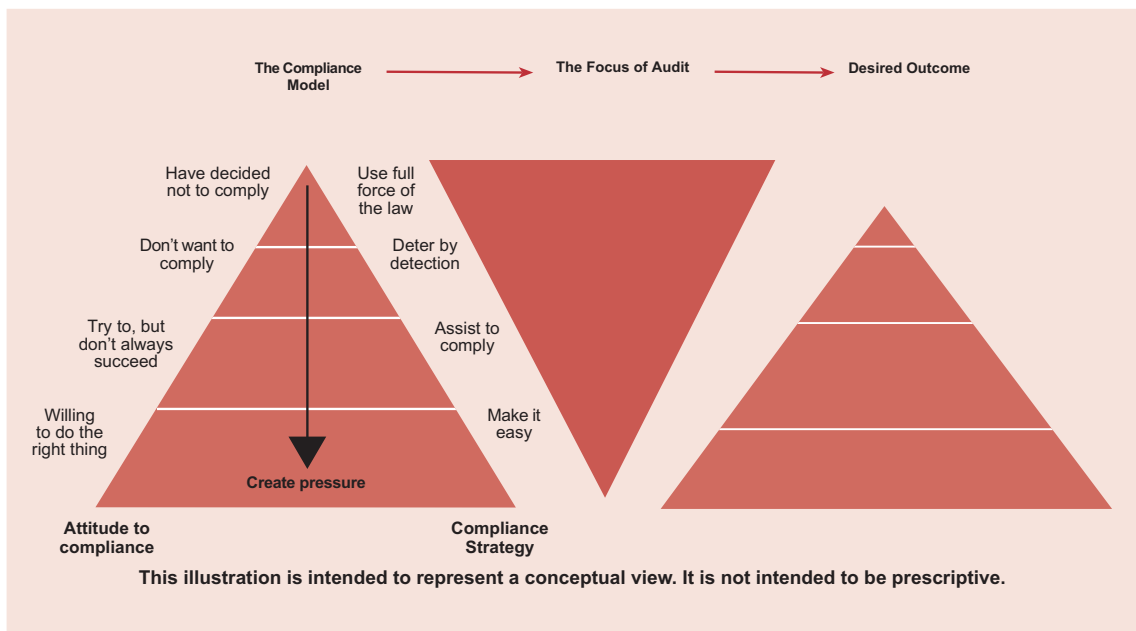
- 5.55 While the IRD has provided support to investigators through the Computer Tax Audit Group and through tools such as TACTICS (see paragraph 4.35 on page 53), in our view it has historically under-invested in technology directly for individual use by investigators. For example, it has only recently reached the position of all investigators having a desktop computer. In the meantime, equipping audit staff with laptop computers has lagged behind what we would expect to see even in a medium-sized accountancy firm.
- 5.56 In our view, there is no doubt that this resource constraint will have affected past effectiveness and efficiency of taxpayer audit. It will inevitably have inhibited the establishment of a range of computer-based practices – such as the documentation of material and on-line access to manuals, announcements of policy changes, and other guidance.
- 5.57 In October 2002, the IRD launched an audit technology project to facilitate the increased use of technology in assisting the audit process. The project envisages the need for substantial changes to the type of technology used by investigators and the skills required to use technology in the audit process, and aims to ensure that all investigators that need to use audit technology tools are able to do so effectively by June 2004.
- 5.58 The audit technology project forms part of the IRD's wider technology strategy that was launched in December 2002. The inter-relationships between the technology strategy, audit strategy, and the audit technology project need to be clearly identified. The implementation and monitoring of these strategies, in relation to the needs of taxpayer audit, need to be done in a co-ordinated way.



## Implications of the IRD’s Strategic Direction and Compliance Model for Future Capability

5.59 Figure 8 below depicts the relationship between the Taxpayer Compliance Model, the focus of audit, and the desired outcome. The first triangle shows the current situation in terms of taxpayer compliance. The desired outcome is the flattened triangle on the right-hand side, whereby even more taxpayers have been moved into the lower sections to join the majority of taxpayers who are fairly or very compliant.

**Figure 8**  
*Intended Effect of Audit Focus on the Compliance Model*



5.60 The middle (inverted) triangle represents the required focus of audit to achieve the desired outcome. Taxpayers at all levels of the model need to be subject to some audit attention to ensure that taxpayer compliance is not eroded. However, there is a heavy emphasis on identifying and auditing the taxpayers at the top of the triangle who have “decided not to comply”.

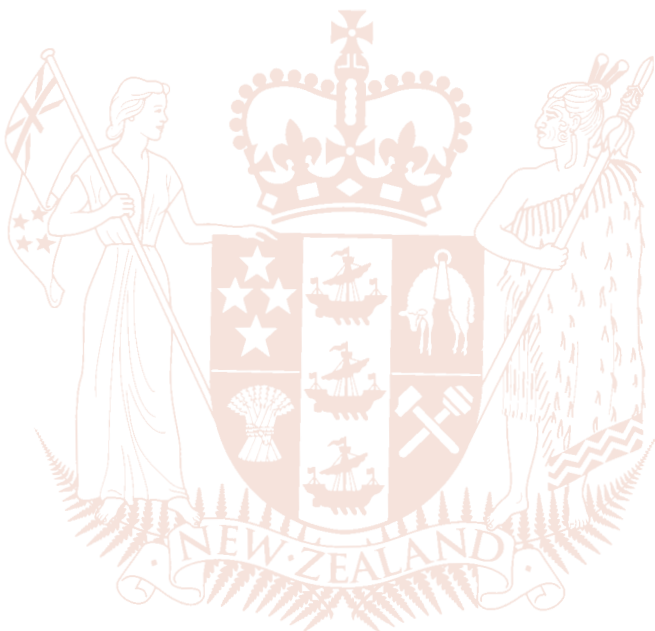
5.61 As the IRD learns more about the behaviour of those at the top of the compliance model, it will be able to re-evaluate the audit coverage for different types of taxpayers and of tax types. By linking coverage with the changing levels of tax compliance, the IRD can achieve more targeted audits.

- 5.62 The skills necessary to audit taxpayers at the top of the compliance model are very different from those required to perform the routine GST checks or to audit large companies. In the 2002-03 year, the IRD budgeted to spend a little more than 20% of audit staff hours on aggressive tax issues and evasion-related work. Of this:
- 11% of hours were targeted at aggressive tax issue work, which is largely concerned with mass-marketed tax schemes; and
  - 10.5% of hours were targeted at tax evasion.
- 5.63 The IRD has been gradually increasing the allocation of audit hours to these activities in recent years.
- 5.64 *The Way Forward 2001 Onwards* envisages a human resource strategy that will set out specific initiatives to increase capabilities to enable its staff to more effectively achieve its strategic direction. Work undertaken in 2002 towards preparing this strategy led to observations that mirror, directly or indirectly, the findings and conclusions of our audit:
- There needs to be a much better understanding of future capability requirements, the gap between them and current capabilities, and the speed with which changes in capability need to take place. This will be a major challenge for the IRD.
  - The compliance model requires strong knowledge-based decision-making skills. A key transition will be from transactional to knowledge-based work, and from clerical and process skills to more analytical and relationship management skills. E(electronic)-business calls for a further set of skill requirements that will continuously increase.
  - Competition for people with specialist tax audit training is likely to increase. This makes it particularly important that the work of such specialist staff is well targeted – for example, by risk-based selection of audits using good intelligence.
  - Management skills need to be improved, and to become more consistent with greater transparency and accountability for management decisions. The important team leader role needs to be continuously reviewed – particularly in relation to its contribution to managing staff.
  - There needs to be more focus on achievement and results – and on finishing tasks – and on high-quality analysis that contributes to achieving results without hindering the process.



## RESOURCES

- 5.65** From our perspective, these observations provide a comprehensive diagnosis of future skill requirements. Further work is required to define in detail the gap between these requirements and current capability, and to specify what needs to be done to bring capability up to the required level.



## Part Six

# Measuring and Reporting Performance







### Introduction

- 6.1 In this part we examine:
- the IRD's performance against its Purchase Agreement;
  - measuring discrepancies attributed to taxpayer audit;
  - the effect of performance targets on case selection;
  - the extent of taxpayer compliance; and
  - internal reporting, including the Quality Measurement System.

### Performance Against the Purchase Agreement

- 6.2 We examined performance in terms of numbers of audits and audit hours, and rates of return for taxpayer audits, for the three years to June 2002. Under-performance in some years and activities was matched by over-performance in other years and activities. For example, in the year to June 2002, audit hours undertaken by the Corporates Division matched planned activity. In the previous three years there had been some under-delivery (the lowest in 2000, by 11.1%), matched by over-delivered hours for compliance risk analysis.
- 6.3 Rates of return per hour have been running at a much higher level in 2002-03 compared with those achieved in the previous year. Some of the difference is likely to reflect the difficulty of predicting the year in which returns will fall for audits of aggressive tax issues and for audits by the Corporates Division.
- 6.4 Overall, the IRD's taxpayer audit has delivered what was agreed with the Government, and its reporting against output measures was in line with the Purchase Agreement. However, these measures provide only a weak indicator of whether the IRD is meeting its legislative obligation to collect 'the highest net revenue over time'.
- 6.5 The IRD is currently identifying the changes required to move towards a focus on the delivery of outcomes, and this work will include an examination of the performance targets for taxpayer audit and how these might be improved.

### Measuring Discrepancies Attributed to Taxpayer Audit

- 6.6 We identified a number of examples in which the discrepancies attributed to taxpayer audit included amounts where there was little, if any, likelihood of the additional tax revenue actually being collected or of a claimed refund being paid out. All related to results that have been counted in the IRD's reports of performance.
- 6.7 The examples included:
- Reassessment of carried-forward losses where the taxpayer was unlikely in any event to have a sufficient future surplus to make use of the losses.
  - Imputation credit account adjustments where the likelihood of the taxpayer being able to declare a dividend was minimal.
  - Recording discrepancies that were valid under previous legislation but are no longer valid.
  - Counting the full adjustment when the discrepancy is only a matter of timing – where the taxpayer is in default because they have claimed tax deductions in the wrong (earlier) period. (Unless differing tax rates apply in the two periods, the real value of the discrepancy is only the time value of the monetary advantage that the taxpayer would otherwise have enjoyed.)
- 6.8 In addition, the IRD has a policy of recognising the gross amount of voluntary disclosures as discrepancies. For example, if a taxpayer makes a voluntary disclosure of \$100 but, after an audit to verify the accuracy of the disclosure, the correct amount of tax owing is \$120, the IRD claims \$120 as the audit discrepancy. In our view, only the adjustment to the amount of the voluntary disclosure arising from audit activity (in this case, \$20) should be counted as contributing towards audit targets.
- 6.9 The IRD acknowledges that the definition of a discrepancy needs to be tightened, and is preparing guidelines to assist audit staff with more meaningful reporting of the value of discrepancies identified in the course of their work. In our view, the IRD's reports to Parliament should distinguish between the different types of discrepancies identified by taxpayer audit to provide a more transparent view of the value of additional tax assessed.

## Effect of Performance Targets on Case Selection

- 6.10 The IRD sets each service centre a target for the number and type of audits to be undertaken. Each team leader is also set a revenue target for the value of discrepancies identified. Standard times are assigned for each type of audit task.
- 6.11 It is entirely appropriate that these targets should drive the selection of audits to some extent, and in practice they do. However, we identified some examples where the targets were having unintended effects:
- At the beginning of each year, investigators are given a set of tasks they must complete. Their focus tends to be on completing the tasks in the required numbers rather than on ensuring that the particular tasks they select take account of relative risk to the tax base.
  - Some investigators tend to select cases that will easily achieve the targets, without sufficient consideration of other important factors. For example, because the targets do not measure tax actually collected as a result of audits, an investigator may prefer a case with a likelihood of a large assessable but uncollectable discrepancy over a case where a smaller discrepancy, if identified, is ultimately likely to be collected.
- 6.12 We noted a tendency among some investigators to focus on the easier cases. A number of team leaders we interviewed felt that there was a risk that complex cases that could, nevertheless, present a greater long-term risk to the tax base, would not be investigated. There is also a consequential risk that investigators will not maintain or increase their capability to undertake the kind of work demanded by more complex cases.
- 6.13 A current project to improve audit risk identification and analysis involves the redesign of audit tasks undertaken by investigators. The project is building risk analysis and case planning tools to help investigators to focus on compliance risks rather than on specific audit tasks. The need for this project was identified at a workshop run by the Design and Monitoring Group in August 2000 and is being delivered in phases:
- various Best Practice Standards were issued on 7 July 2003;
  - risk analysis and case planning tools will be finalised in December 2003; and
  - revamped Investigations Manuals will be available in June 2004.

### Extent of Taxpayer Compliance

- 6.14 An ideal outcome is that every taxpayer pays the correct amount of tax that is due. However, complete compliance is unlikely to be achieved. Nor would it be possible to demonstrate that complete compliance had been achieved, because there is no internationally agreed methodology for measuring the size of a country's cash economy (sometimes referred to as "the black economy").
- 6.15 Measuring the extent of overall compliance is similarly difficult. The IRD is looking to its Industry Partnerships initiative and the further development of the Data Warehouse (see Part Five on pages 65-66) to support monitoring and reporting on the level of compliance achieved. These long-term developments are equally as important for assessing and reporting on the performance of other parts of the IRD as for taxpayer audit.
- 6.16 The IRD is investigating whether it is possible to create an econometric model to estimate improved compliance attributable to Industry Partnerships. This work is at an early stage and there are challenges ahead – including understanding whether or not current data is sufficient and reliable enough to apply the model successfully.

### Internal Reporting

- 6.17 Each month the IRD produces a Taxpayer Audit Output Class Report, showing performance against both external output targets and internal targets set at the start of each year and published in its Performance Management and Monitoring Document.
- 6.18 All reporting is of actual performance against targets. Performance reporting is analysed monthly at national, service centre, and (within service centres) team leader level, and in the Corporates Division. The executive summary of the Taxpayer Audit Output Class Report contains analysis of reasons for variances and indicates areas of focus that are necessary to meet targets.
- 6.19 The IRD has started work on establishing outcome measures, in order to bring its performance reporting into line with its strategic focus on improving taxpayer compliance, and to measure the extent to which it is meeting its key long-term priority of protecting the tax base.

- 6.20 The work will not be straightforward, because effective measurement will not be achievable solely through the kinds of output measures that are currently being used. The performance reporting model will have to cope with difficult apparent contradictions for taxpayer auditors. For instance, audits that detect discrepancies in future will continue to be seen as positive outcomes, as will those that do not detect discrepancies where they demonstrate that the compliance model is working.

### *Quality Measurement System*

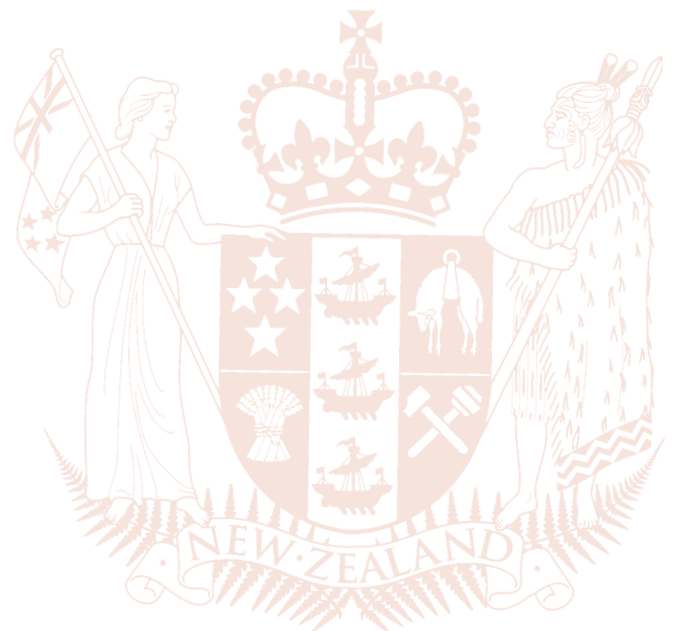
- 6.21 To provide a consistent and accurate measure of audit quality and to lift the overall standard through monitoring and learning, the IRD introduced the Quality Measurement System (QMS) (which was piloted from 1 October 2001 to 30 June 2002). Since 1 July 2002, the QMS has been used to measure and report on the quality of audits. Currently, about 150 completed cases are selected each month for a quality review.
- 6.22 The objective of the QMS was to enable review and promotion of improvements in a range of areas of audit work, including:
- adequate case planning;
  - appropriate documentation of planning and the audit;
  - clear feedback from team leaders during the audit and at case closure; and
  - consistent application of practices relating to obtaining agreement to a discrepancy.
- 6.23 In October 2001, the Design and Monitoring Group informed Field Delivery of the following areas of concern:
- Size and composition of the quality review panels – that panels should comprise no less than five members and be a mix of team leaders, experienced investigators, and Technical and Legal Support Group staff, with team leaders predominating.
  - A lack of universal acceptance of the process (and the option of reviews being undertaken between, rather than just within, service centres was suggested).
  - Inconsistent staff awareness of the new process – staff in one service centre did not have information that should have been made available through local management.



## MEASURING AND REPORTING PERFORMANCE

- The level of quality achieved – in order to achieve quantitative targets, audit staff had over the years taken shortcuts that reduced the quality of their work. Work practices also needed to be reviewed.
- 6.24 In the results reported in February 2003 (covering the period January to October 2002), the IRD indicated some improvement in the areas of case planning, risk assessment, and cost-benefit analysis. However, when we examined reviews of QMS cases in service centres in September 2002, we found little evidence of best practice – there were many more failures than passes.
- 6.25 We also noted that many of the reviews were completed under the time allowed, and that in some service centres there were only isolated examples of comprehensive reviews. We formed the view that the time taken on some reviews made it unlikely that the potential learning from the reviews was being maximised.
- 6.26 We found a better standard of practice in respect of the cases and reviews undertaken in the Corporates Division.
- 6.27 We identified two further problems with the implementation of the QMS:
- Delays in providing feedback to investigators on reviews of their work – routinely three months after the work was performed – reduce opportunities for effective learning. We received a generally negative message from service centre staff about the value of the reviews.
  - Though membership of the review panels has changed since the 2001 workshops, no further training on how to perform reviews has been provided for new panel members.
- 6.28 A National Quality Committee – made up of team leaders, senior investigators (from Corporates Division), audit design representatives, and an audit area manager – first met in January 2003. Its role is to demonstrate management's commitment to the QMS by ensuring a high level of national consistency in its application and by requiring area managers to take greater responsibility for addressing areas of concern raised through the QMS.
- 6.29 At this first meeting, the common issues included unsuitability of the review questions for mass-marketed aggressive tax issue cases, the non-random method of selecting cases for review, and the lack of timeliness in selection of cases for review. Case planning and case plan quality were also discussed. A review of the QMS is in progress looking at initiatives for improvement.

- 6.30 The IRD's Statement of Intent for 2002-03 includes quality measures related to the time taken to complete audits and the percentage of audits that meet internal quality assurance standards, which will rely on measurement through the QMS. It will be important to have evidence of substantial improvements in the application of the QMS – including adoption of the initiatives outlined above – in order to have confidence in the data used to report on these quality measures in future Annual Reports.





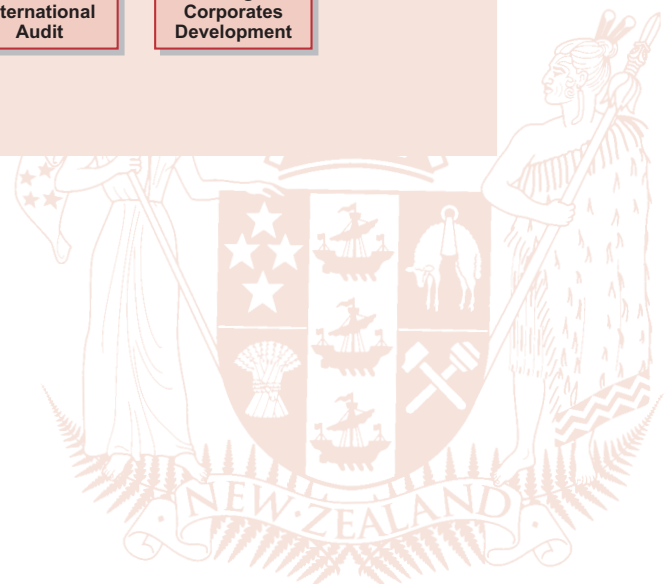
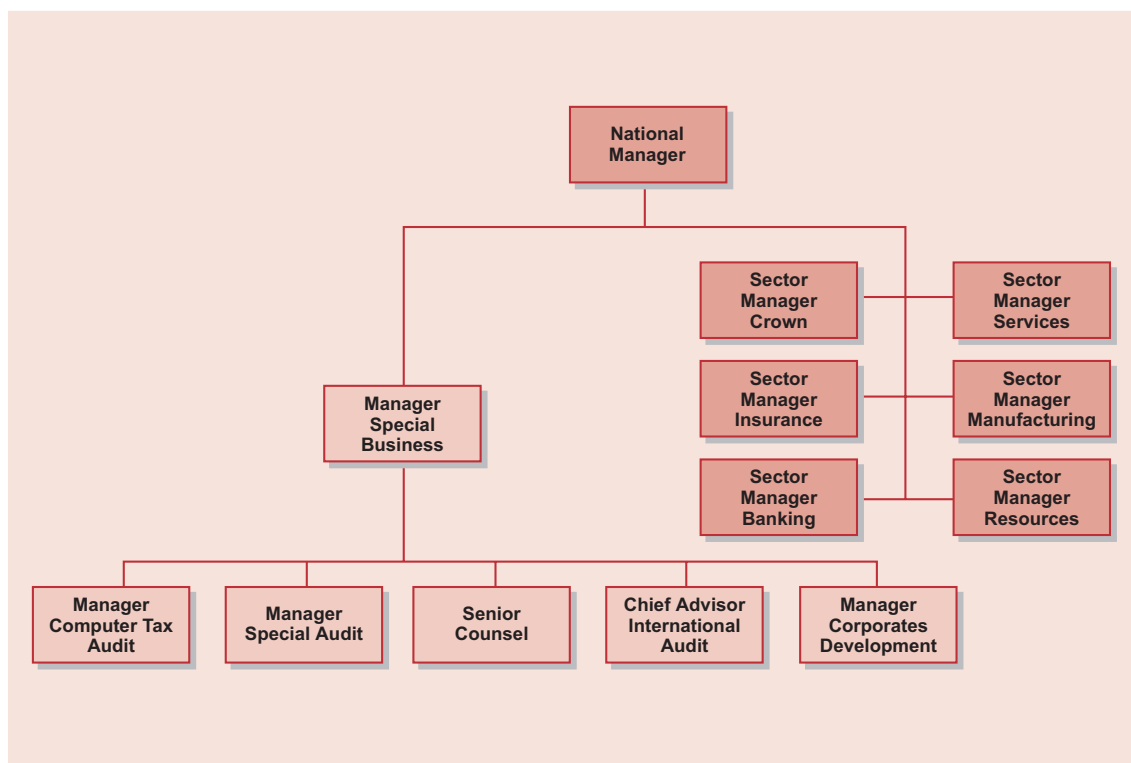
**Appendix**

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# **Management Structure of the Corporates Division**

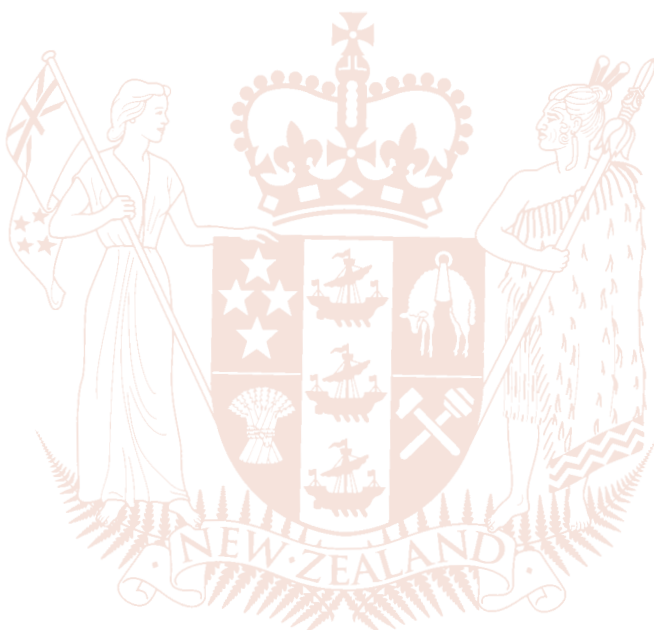
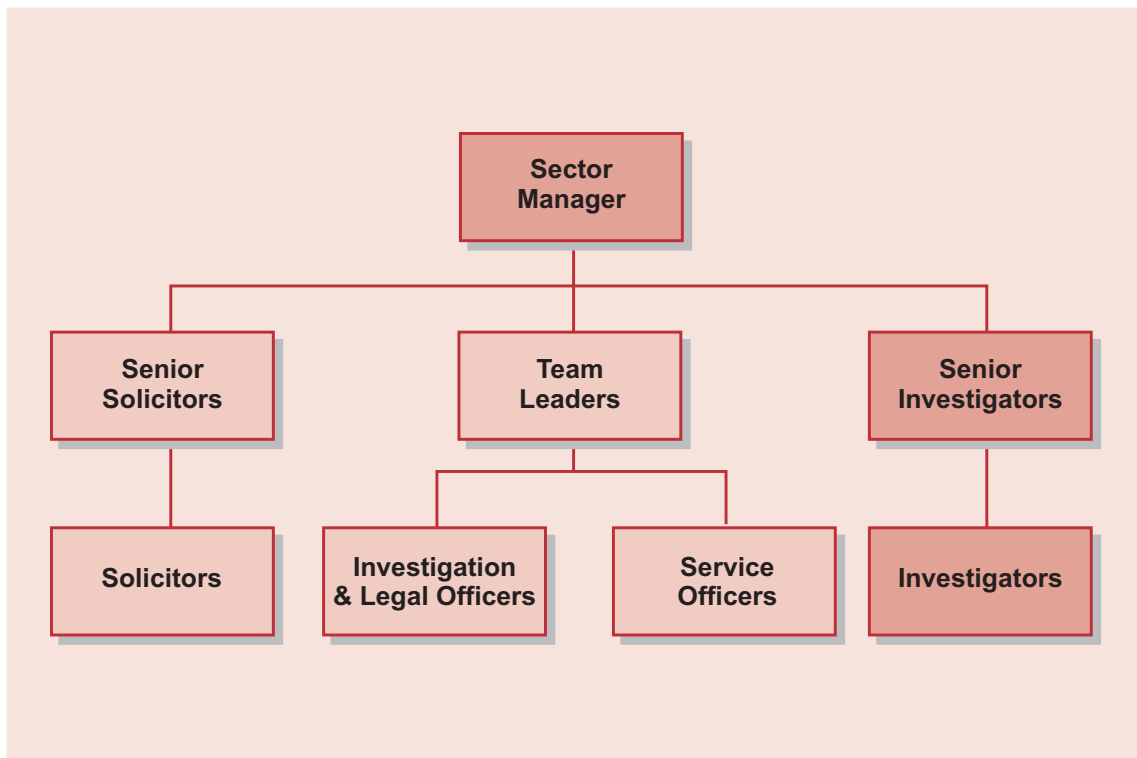
## Management Structure of the Corporates Division

The Corporates Division was established in March 1994 following the 1992 Taxpayer Audit Review, with the purpose of focusing on large corporate taxpayers with an annual turnover greater than \$100 million. The Division initially provided only audit services but, following the Organisational Review, other services relating to the same group of taxpayers (such as debt collection) were moved from the service centres to the Division. The Division is structured on industry lines in the sectors illustrated below.



## APPENDIX

Each sector is responsible for a relatively small number of taxpayers, making case selection and audit coverage more straightforward than for service centres. In respect of the “top ten” taxpayers (in terms of turnover), in each sector there is a close relationship with an IRD account manager. In some of the largest companies, the IRD has a permanent presence. A typical sector structure is illustrated below.



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