Selecting Cases for Audit

Margaret Cotton
Pacific Islands Tax Administrators
Association Conference
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Cook Islands
What we are going to cover today

- My background
- Case selection
- Customising the model to PI environments
- Realistically what can be done now
- Workshop
- Further assistance and contacts
My background

- Qualifications in Law & Accountancy,
- New Zealand Inland Revenue
- National Manager Technical Standards
- Change Manager for Audit Strategy project
Case selection: why it is important

- Role of Revenue Authorities is to maintain and improve compliance.
- Revenue Authorities manage risk with scarce resources through assistance, education and enforcement.
- Case selection is about effective use of the audit or enforcement resource.
- Theory: Good case selection leads to more effective audits which means more compliance and ultimately more revenue is collected.
Case selection: why it is important

Audit Strategic Principles

1. Audit has a key role in the wider process of compliance management

2. The outcome of Audit activity is maintaining and improving compliance

3. Audit activity should be strongly focused on the identification of compliance risk, based on credible intelligence

4. Audit activity should concentrate on high risk and be visible throughout the community

5. Audit activity should involve a range of interventions which maintain and improve compliance

6. Audit activity should support measures to reduce compliance costs
Case selection: a model

- New Zealand Inland Revenue audit strategy programme
- Approved February 2006
- Ongoing implementation
Case selection: the New Zealand model

Compliance Strategy

Factors that influence taxpayer decisions and behaviour

Attitude to compliance

Compliance strategy

Create pressure down

Level of compliance costs

Make it easy

Assist to comply

Deter by detection

Use full force of the law

Have decided not to comply

Don’t want to comply

Try to, but don’t always succeed

Willing to do the right thing

Economic

Sociological

Business

Industry

Psychological

Taxpayer
Case selection: the New Zealand model

• Issues New Zealand faced
  ○ Minimal national co-ordination
  ○ Some risk areas over resourced and some risk areas under resourced
  ○ Audits were carried out when there may have been a more effective response to the risk.
  ○ Needed co-ordinated approach
  ○ Needed to look beyond 1 year
  ○ Need to use alternative responses where they would be more effective
  ○ Needed to develop audit staff to respond to future known risks
Case selection: the New Zealand model

6 phase Audit approach

1. Intelligence Co-ordination
2. Risk Profiling
3. Risk Analysis
4. Determine Response
5. Risk Response
6. Outcomes
Case selection: the New Zealand model

Identifying and targeting compliance risks

Level 1

Compliance Profiling
Behavioural Analysis
Environmental Scanning

Level 2

Identify & score risk
National

Level 3

Identify & score Local

Identifying and targeting compliance risks
Level 1: Macro Profile

Risks & Issues

Filter 1
New owners, high risk

Filter 2
30 agents – 25% of risk
3 risk hot spots identified

Data

Macro Profiling

Hypothesis
Level 2: Scoring national risk

Identify & score risk
National

Prioritised Risk Profiles

Findings
Profile scores high Impact and likelihood of occurrence
Level 3: Micro Analysis

- Prioritised Risk Profiles
- Identify & score Local
- Micro/Local Analysis Additional analysis of construction loss activity
- Selected risks or issues
- Selected cases
- Rejected cases
- Job Bank
- Leaders and Investigators
Case selection: the New Zealand model

- **National Intelligence function:**
  - Identification of national risks
  - National coordination of
    - intelligence & risk analysis activities
    - data gathering, storage & quality
    - knowledge capture, sharing & use
    - tools, technology & support
  - Macro analysis & environmental scans

- **Local Intelligence function:**
  - Input to the national risk assessment process
  - Identification of local, regional and/or segment risks
  - Local responsibility for:
    - intelligence & risk analysis activities, case selection & support
    - data gathering, storage & quality
    - knowledge capture, sharing & use
    - tools, technology & support
  - Support ongoing cases
Customising the model: to recap filtering & prioritising risk

Level 1
5 risk areas
300 taxpayers

Level 2
Only top three risks get done
70 taxpayers

Level 3
Decisions made locally
On which cases to audit

Collate data and identify risk
Score and prioritise risk
Select & Allocate
Customising the model to a PI environment

- Phase 1, determines the risks at national level,
  - What are the risks across all FSM

- Phase 2 ranks the risks nationally

- Phase 3 ranks and allocates resources to the risk at local level
  - Yap, Chuuk, Kosrae, Pohnpei

- Case selection and allocation within those priorities is made on the basis of:
  - risk
  - availability of skills and people
  - other enforcement options.
1. Level 1, FSM determines the risks at national level,
   - A brainstorming session determines likely areas of high risk:
     - E.g. non-resident contractors, tourism, construction, new VAT registration, foreign owned companies, remilitarization of Guam
   - For some or all of these areas consider what is the actual risk:
     - all non-resident contractors or only those employed by XX company
     - All foreign owned companies or only those engaged in fishing
     - If fishing companies, is it all fishing companies or only those from YY country, or only those who fish for ZZ fish stock
     - All new VAT registrations or only those with zero rated or exempt supplies
Customising the model to a PIC - FSM

2. Level 2: FSM ranks the risks nationally

- Determine which factors will be used to rank the risk eg
  - Likelihood of risk
  - Occurrence/impact – regularity, number of taxpayers involved
  - Amount of revenue involved
  - Likely leverage from audit activity
  - Timing
  - Public interest
  - Other government activity
  - Skills of staff available

- Rank the risks and determine national priorities.
Customising the model to a PIC - FSM

- Level 3: FSM ranks and allocates resources to the risk at local level
  - Cases allocated to local offices - Yap, Chuuk, Kosrae, Pohnpei
  - Local office determines order of cases based on skill of local staff and prioritising of the risks locally,
  - What if Chuuk has more high risk cases than Kosrae but same number of staff?
  - If one risk is across all offices can all the cases be co-ordinated? How do we ensure coverage and high risk cases are done
Customising the model to a PIC - Palau

- Level 1, Palau determines the risks at national level,

  - What are the risks with GRT, VAT:
    - Under reporting of revenue
    - Entities outside the tax system
    - Complexity of compliance requirements

  - For some or all of these areas consider what is the actual risk
    - Which businesses are likely to under report?
    - In what circumstances are they likely to under report?
Customising the model to a PIC - Palau

2.

- Level 2: Palau ranks the risks nationally
  - Determine which factors will be used to rank the risk
    - Likelihood of risk,
    - Occurrence/impact – regularity, number of taxpayers involved
    - Amount of revenue involved
    - Likely leverage from audit activity
    - Public interest
    - Timing
    - Other government activity
    - Skills of staff available
  - Rank the risks and determine national priorities.
Customising the model to a PIC - Palau

- **Level 3**: Rank and allocate resources to the risks using local knowledge.
  - Cases allocated based on skill of staff and priority
    - What about activity on the outer islands of Peleliu and Anguar? Or at Melekeok where the new capitol building is situated
  - Can all under reporting cases be co-ordinated even though they involve different industries?
  - How many cases need auditing to influence others to voluntarily comply?
Customising the model to a PIC: year end review

1. Intelligence Co-ordination
   Did we have the right data? Y/N

2. Risk Profiling
   Did we profile the risks properly? Y/N

3. Risk Analysis
   Was our analysis correct? Y/N
   If no, what can we do better?

4. Determine Response

5. Risk Response
   Was the risk response the right one? Y/N

6. Outcomes
   Did we achieve the outcomes we expected? Performance measures? Y/N

If no, what can we do better?
Realistically, what can be done now – identify categories of risk

<table>
<thead>
<tr>
<th>Revenue Type</th>
<th>Industry</th>
<th>Technical Area</th>
<th>Other</th>
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<td>Gross Revenue Tax</td>
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<td>Value Added Tax</td>
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<tr>
<td>Presumptive Tax</td>
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<tr>
<td>Duties</td>
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<td>Sales Tax</td>
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<td>Land Tax</td>
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<td>Income Tax</td>
<td>Tourism</td>
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<tr>
<td>Gross Revenue Tax</td>
<td>Non-resident contractors</td>
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<tr>
<td>Value Added Tax</td>
<td>Petroleum</td>
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<td>Presumptive Tax</td>
<td>Agriculture</td>
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<td>Duties</td>
<td>Airlines</td>
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<tr>
<td>Sales Tax</td>
<td>Land Development</td>
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<td>Land Tax</td>
<td>Fishing</td>
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<td>International service Providers</td>
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<tr>
<td>Income Tax</td>
<td>Tourism</td>
<td>Wages &amp; Salary</td>
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</tr>
<tr>
<td>Gross Revenue Tax</td>
<td>Non-resident contractors</td>
<td>Depreciation</td>
<td></td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>Petroleum</td>
<td>Capital/Revenue</td>
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<tr>
<td>Presumptive Tax</td>
<td>Primary Producers</td>
<td>Cash suppression</td>
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<tr>
<td>Duties</td>
<td>Airlines</td>
<td>Transfer pricing</td>
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<tr>
<td>Sales Tax</td>
<td>Land Development</td>
<td>Repairs &amp; maintenance</td>
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<tr>
<td>Land Tax</td>
<td>Fishing</td>
<td>Illegal Income</td>
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<td>International service Providers</td>
<td>Charitable/exempt income</td>
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<td>Tourism</td>
<td>Wages &amp; Salary</td>
<td>Political unrest</td>
</tr>
<tr>
<td>Gross Revenue Tax</td>
<td>Non-resident contractors</td>
<td>Depreciation</td>
<td>Cost of Living Allowance payouts (eg Fiji)</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>Petroleum</td>
<td>Capital/Revenue</td>
<td>Natural disaster</td>
</tr>
<tr>
<td>Presumptive Tax</td>
<td>Primary Producers</td>
<td>Cash suppression</td>
<td>Remilitarization of Guam</td>
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<tr>
<td>Duties</td>
<td>Airlines</td>
<td>Transfer pricing</td>
<td>Government policy changes</td>
</tr>
<tr>
<td>Sales Tax</td>
<td>Land Development</td>
<td>Repairs &amp; maintenance</td>
<td>Natural resources diminished</td>
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<tr>
<td>Land Tax</td>
<td>Fishing</td>
<td>Illegal Income</td>
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<tr>
<td></td>
<td>International service Providers</td>
<td>Charitable/exempt income</td>
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</tbody>
</table>
Realistically, what can be done now – Phase 3 micro data collection

- Build a profile of your risk groups, taxpayers and industries?
  - Who is in the risk group/industry?
  - What is their turnover, is it what you would expect it to be?
  - Is their turnover similar to others in the industry?
  - Are they a new or old taxpayer?
  - What is their compliance history?
  - Are they financially solvent?
  - Do they have international connections?
  - What transactions are they making internationally?
  - How much cash goes through the business?
  - Are their accounts up to date?
  - What other ‘gossip’ do you know about the taxpayer?
  - Is it a locally based company or a foreign company?

- Build the profile over time.
Realistically, what can be done now

- Store your profiles so they can be accessed and updated easily

- Think about:
  - How to store the data;
    - Computer - Excel, Access, customised program
    - Paper based files
  - Issues with data storage
    - Security
    - Accessibility
    - Updating
    - Ability to compare with others in comparable positions (industry, size, turnover, international connection)
    - Third party information – access and storage
Workshop

• Break into 6 Groups

• Brainstorm possible risk areas (10 minutes)

• Complete the Phase 1 & 2 templates for 2 of those risks (20 minutes)

• Pair up with your other group and rank the top 4 risks (Template 3)

• Back together as a large group discussion on top risks
### Phase 1: Macro Level Risk Assessment

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Questions</th>
<th>Comments</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>What is the specific risk?</td>
<td></td>
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<tr>
<td></td>
<td>When does it occur?</td>
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<tr>
<td></td>
<td>Who takes advantage of this risk?</td>
<td>(Industries, named taxpayers, etc)</td>
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<tr>
<td></td>
<td>When do they take advantage of the risk?</td>
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<td></td>
<td>How do they take advantage of the risk?</td>
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<tr>
<td></td>
<td>Why do they take advantage of the risk?</td>
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<td>What other information could you get?</td>
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<tr>
<td></td>
<td>Where could you get it from?</td>
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</tbody>
</table>
## Phase 2: National Ranking & Scoring

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Ranking</th>
<th>Weight</th>
<th>Score</th>
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<tbody>
<tr>
<td>Likelihood of risk</td>
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<tr>
<td>Occurrence – regularity</td>
<td>L M H</td>
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<tr>
<td>(Always = H, Often = M, Sometimes = L)</td>
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<tr>
<td>Occurrence – # of taxpayers</td>
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<tr>
<td>(&lt;50 = L, 50 - 100 = M, &gt;100 = H)</td>
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<tr>
<td>Amount of Revenue</td>
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<td>(per taxpayer or in total)</td>
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<tr>
<td>&lt;$5,000 = L, $5,000 - $50,000 = M, &gt;$50,000 = H)</td>
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<tr>
<td>Likely leverage</td>
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<tr>
<td>Timing</td>
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<tr>
<td>(Urgent = H, Important = M, Ideal = L)</td>
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<tr>
<td>Other government activity</td>
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<td>(or importance to Government)</td>
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<tr>
<td>Skills of staff</td>
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<td>Other</td>
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Workshop: Phase 3 – rank and allocate using local knowledge

- Phase 3 requires decisions to be made around:
  - Which national risks will be audited this year?
  - How can responses to national risks be co-ordinated nationally?
  - What percentage of capacity (staff, technology, budget,) will focus on national risk?
  - What percentage of capacity (staff, technology, budget,) will focus on local risk?
  - How will the national risks be responded to?
  - Will all taxpayers in the risk group receive the same response?
  - What happens to newly identified risks?
### Phase 3: Allocation of Risk

<table>
<thead>
<tr>
<th>Risk in order of priority</th>
<th>No of Taxpayers and Location</th>
<th>Audit/Other</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Total taxpayers =</td>
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<tr>
<td></td>
<td>Site1 Site2 Site3 Site4</td>
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<td># of Tax Pyrs</td>
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<td>2.</td>
<td>Site1 Site2 Site3 Site4</td>
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<td>3.</td>
<td>Site1 Site2 Site3 Site4</td>
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Case selection: reflections

• Purpose of audit activity is to promote voluntary compliance

• Not possible or appropriate to audit everything

• Need to get value for money from audit dollar and from audit staff

• Three step case selection model:
  1. identify the risks,
  2. rank the risks
  3. select and allocate the cases,
Case selection: reflections

- This model is about building the blocks to ensure:
  - Audit activity is strongly focused on the identification of compliance risk, based on credible intelligence
  - Audit activity concentrates on high risk and is visible throughout the community
  - the right audits are undertaken at the right time with the right staff and voluntary compliance is maximised.
Further assistance and contacts

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Please note the views in this presentation are mine and may not represent the views of the organisations referred to.
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