14 Audit

Audit is often the weakest component of VAT administration. As noted in Chapter 6, among the surveyed countries, audit performance is reported to be a particularly weak aspect of tax administration, irrespective of whether other aspects of the VAT are working well. This chapter discusses the importance of the audit function and the difficulties faced in implementing audit programs.

Background

Basic guidelines provided for the development of an audit program typically address the following key issues:

- Coverage—what percentage of taxpayers should be audited?
- Selection—how should the audit cases be identified?
- Methods—what type of audit should be performed, what should be the duration of an audit, and what approach should be taken by the auditors?
- Staffing and training—what are the staff resources needed to implement the audit program and what type of training should be provided?
- Monitoring—what are the management systems needed to monitor the audit program (including assigning targets, developing time-standards, performing quality review, and ensuring prompt collection of additional assessments)?

Detection of offenses, such as underreporting of turnover, over-reporting of VAT credits, and use of fake invoices, requires field audits by well-trained officers, rather than desk verifications. The experience of countries with successful audit programs also shows that a VAT audit plan should be primarily based on short, issue-oriented audits covering a limited tax period (no more

than one or two return periods). This plan should provide for a broad coverage of taxpayers (taking into account their classification by size and industries). Most tax administration experts agree that, by international standards, an effective VAT audit program should provide for a 25–30 percent coverage of taxpayers each year.

In addition, VAT audits need to be closely coordinated with audits of other tax liabilities (especially income tax). When significant underreporting is detected during a VAT audit, the case should be transmitted to a joint-audit division specialized in comprehensive audits. In most countries where VAT and income tax administrations are integrated (or have been able to develop close cooperation), the development of an effective VAT audit program significantly helps improve income tax compliance. Such methods have also proved to be more effective and more compatible with business requirements (for instance, in limiting the number of visits to taxpayers' premises and restricting in-depth audits to cases where significant underreporting is detected). Box 14.1 presents a typical example of an audit program recommended by FAD.

Information on audit performance was provided in only 21 of the 37 surveyed countries. Only 2 of those were seen as having sufficient audit coverage, while only 11 had implemented the recommended audit methods. As the lack of an effective audit program undermines the functioning of the entire VAT operations, beginning with the refund system (see Chapter 15), it is worrisome to find that most of the surveyed countries still need to make significant effort to develop appropriate audit programs.

More generally, in recent years, the need to strengthen VAT audit programs has been an ongoing concern of a number of countries, including industrial countries. For example, in 1993, the implementation of a new VAT taxation system for transactions between EU countries[135] necessitated the development of several programs to reduce the risks of fraud. Since then, however, despite these programs, the EU Commission and most EU countries are increasingly concerned by the development of sophisticated types of VAT fraud. Most recognize that considerable efforts have still to be made to limit these risks and continue to improve their VAT compliance—including their audit programs.

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[135]Under the new system, customs clearance is no longer needed on trade between EU countries. The purchase of goods and services from EU businesses is no longer treated as an import but as a domestic transaction and VAT on intra-European transactions must be declared and paid monthly (or quarterly), along with the domestic transactions, using the same VAT return form.

Why and How Is Audit Critical?

Why Is An Effective Audit Program Critical for VAT Operations?

Like other taxes, VAT can be evaded. The development of effective audit programs is crucial to increase the risk of being detected and punish those businesses not in compliance with their VAT obligations. Typically, the most common sources of VAT evasion are similar to those of traditional sales taxes—as discussed in Chapter 5—including non-registration of businesses, underreporting of gross receipts, abuse of multiple rates, and nonremittance to the tax authorities of the tax that has been paid to the taxpayer by its customers. However, fraud under a VAT may sometimes be more sophisticated than fraud under other indirect taxes. VAT-specific fraud includes the use of fake invoices to abuse the credit system, the misreporting of domestic sales as exports to benefit from zero-rating, and the claim of VAT credits for noncreditable purchases. Unless these types of fraud are dealt with appropriately the entire VAT system can be corrupted, particularly when the credit mechanism and the refund system are abused.

The most obvious consequences of ineffective audits are the deterioration of VAT compliance and a loss of credibility of the tax administration. Even if sufficient penalties are provided for in the law, taxpayers will not be deterred from minimizing their tax liabilities if they believe that there is little chance of being audited. At some stage, honest businesses will realize that they cannot compete with those who consistently evade the VAT and may decide, in turn, to underreport their own tax liabilities.

The survey indicates that most of the countries lacking an effective audit program are also those where VAT procedures and systems are more complex. In a number of cases, tax authorities appear convinced that the lack of effective audits can be offset through increased filing requirements.

Some countries have been attracted by the theoretical possibility of cross-checking all purchases and sales invoices to promote compliance. Cases include South Korea, China, Côte d'Ivoire, Indonesia, and Bulgaria, where taxpayers are requested to attach a copy (or a list) of their purchase invoices to their monthly returns. This approach has often reflected a concern that the refund system is being abused. In several countries, requirements to audit 100 percent of the claims prior to refunding VAT excess credits complicate matters; not only does this policy delay the processing of refunds, it also implies that most audit resources are assigned to the verification of refund cases. Since not all refunds can be audited in a timely fashion, a database of all purchase and sales invoices is seen as facilitating the verification of refund claims. The South Korean experience (described in Box 14.2) indicates that

Box 14.1. Elements of an Effective Audit Program

In a function-based tax service, the audit program typically includes the following types of audits:

- *Desk verifications.* Made annually, these verifications are primarily based on (i) a review of income tax and VAT returns (including a review of basic ratios such as profit margin, cash flow, cost of personnel, and a comparison with ratios for previous periods and ratios for other taxpayers in similar industries), and (ii) the cross-checking of information included in the taxpayer files (particularly income tax, VAT, and customs information).
- *Registration checks.* These take the form of unannounced visits to a taxpayer's premises (mainly for new small and medium-sized taxpayers) during which the tax officer ensures that: (i) the taxpayer has a basic understanding of his/her obligations; (ii) appropriate records are being kept; and (iii) proper invoices are being issued.
- *VAT refund audits.* A pre-refund audit should be undertaken for a first refund claim (particularly by new enterprises); audits of further claims should be carried out selectively. Refund audits should focus only on the period covered by the claim.
- *Issue-oriented audits.* These should be directed at verifying items for which errors have been detected in the returns. Regarding the VAT, an issue-oriented audit should focus on no more than one to two returns.
- *Comprehensive audits.* All cases where serious underreporting has been detected during a desk verification, a registration check, a VAT refund audit, or an issue-oriented audit should be forwarded to a unit responsible for undertaking comprehensive audits of all tax liabilities (including VAT and income tax). These comprehensive audits may be extended to cover several years, up to the limit provided for in the law.
- *Tax fraud investigations.* In the most serious fraud cases, criminal investigations may be necessary. Such investigations may require searches (of business premises and, sometimes, domiciles), seizure of evidence, testimony from key witnesses, etc. They should be undertaken in accordance with criminal procedure laws.

massive cross-checking of invoices is costly to administer, burdensome for taxpayers, and ultimately not effective in controlling evasion. While information technology has improved spectacularly since then, the sheer volume of transactions continues to make massive cross-checking a daunting task. Moreover, it runs the risk of alienating taxpayers.

Box 14.2. Massive Cross-Checking of Invoices—Experience of South Korea

In 1977, South Korea implemented an ambitious cross-checking program in conjunction with the introduction of a VAT. Each taxpayer was required to complete four tax invoices for every sale of goods and services: one copy for the supplier; a second copy to be sent by the supplier to the district tax office; the third copy for the purchaser; and the fourth copy to be sent by the purchaser to the district tax office. The two tax offices, in turn, sent their copies to a centralized computer center for cross-checking.

This program was subsequently modified in an effort to reduce administrative costs. Sales invoices were no longer required. Instead, taxpayers were only required to submit a summary of purchase invoices above a certain amount. These summaries were processed at the computer center and aggregated by seller. This aggregate was then compared to the volume of sales reported on the VAT return. Any discrepancies identified by the computer center were forwarded to district offices for follow-up.

These programs produced mixed results. There is some evidence that taxpayer compliance initially improved following the introduction of the cross-checking programs. During the period 1977 to 1982, the number of cases where there was a sales invoice but not a purchase invoice (or vice versa) dropped slightly. However, South Korea's tax administration found the programs to be costly and difficult to administer. These costs were in the form of the increased staff and computer resources required to input and process the invoices, resources that were unavailable for other, potentially more productive, enforcement activities. The programs also imposed significant compliance costs on taxpayers. Finally, the programs were beset by inefficiencies as many of the discrepancies between the sales and purchase invoices that were detected by the computer system were found, upon closer inspection, to result from transcription errors and other innocuous mistakes.

The following examples illustrate the difficulty in implementing an effective VAT in the absence of effective audit programs. In one of the countries in the survey, the difficulty of processing exporters' refund claims within the legal time frame resulted in serious cash-flow problems for a number of exporters. In 1998, to address these problems, the government introduced VAT exemptions for exporters' imports and modified the normal VAT mechanism for their domestic purchases, by extending zero-rating of the VAT to the transactions of exporters' suppliers ("indirect exporters") up to the production stage. As discussed in the next chapter, this approach compromises the fundamental nature of the VAT and increases risks of fraud and abuse of the zero-rate system.

What Are the Main Reasons for the Lack of an Effective Audit Program?

There are several reasons for ineffective audit programs that are evident in varying degrees in several countries. First, audit typically requires higher-level skills than those needed for most other tax administration tasks, and such skills are sometimes in short supply. Second, the possibility of collusion between taxpayers and tax officials is significant during an audit.[136] Moreover, auditor errors may damage business activity. As a result, governments may, sometimes, be reluctant to support comprehensive audit programs.

However, while these general reasons cannot be ignored, the survey data point to more specific factors that also contribute to the lack of effective audit programs, including:

Inadequate preparations for VAT implementation. The consequences of a weak audit program may not be immediately perceptible. While the lack of effective collection enforcement systems, especially those needed to deal promptly with nonfilers and nonpayers, has an immediate impact on revenue, the lack of effective audits to detect underreporting of gross receipts and/or overreporting of credits may affect tax compliance only in the medium term. There have been cases in which insufficient attention has been paid to the development of an audit function when the VAT was implemented. For example, in two of the countries surveyed, although resident advisors were made available to support VAT preparations, which included the development of an audit program and the training of auditors, the audit units were not staffed until several months after the introduction of the VAT.

Weak political commitment. The absence of clear political support is another common reason for the lack of an effective audit program. In one of the surveyed countries, for instance, the most common form of evasion has been the underreporting of domestic sales, with traders, especially the largest, claiming more imports and purchases than taxable sales. This problem was not appropriately addressed at the outset; in fact, the authorities dismissed the head of the tax administration who wanted to address noncompliance issues immediately. As the implementation of an audit program was deferred for more than two years after the introduction of the VAT, there is still significant underreporting of VAT liabilities in that country. Similar problems were encountered in other countries; for example, in one case, traders were assured that there

[136]This is especially true when the disparity between salaries for the private and public sectors is substantial. A common approach to deal with the risk of collusion is to organize auditors into teams (at least two auditors for each audit); however, there is little evidence that this approach helps address the problem of corruption.

would be no exchanges of information between the VAT and income tax administrations after the VAT is introduced.

Inappropriate legal and judicial environment. In several cases, the lack of an appropriate legal and judicial environment has also militated against an effective audit function. A clear legal framework ensures that taxpayers' rights are protected and that the tax administration has sufficient and clearly defined legal powers to visit taxpayers' premises and examine their records.[137] It also ensures that appropriate action will be taken by the administration, and, as needed, by the judiciary, to collect outstanding taxes and penalties. Moreover, practice may significantly diverge from the legal and judiciary framework provided for in the law. For example, in several developing countries there are few, if any, possibilities for taxpayers to go to court to appeal the decision of the tax authorities. Conversely, in other countries the appeal process is so complex that taxpayers often take advantage of the system to delay the payment of their outstanding tax liabilities for a number of years.

Other technical issues. There are several additional technical issues that contribute to the lack of an effective audit strategy in the surveyed countries, including the following:

- *Misallocation of resources.* Ill-designed procedures and complex forms result in the allocation of the majority of staff resources to paperwork.
- *Lack of audit selection and monitoring systems.* Several tax administrations have yet to develop basic audit systems. Weaknesses include: (i) the lack of a system for the selection of audit cases;[138] (ii) absence of audit targets

[137]There are often concerns in the business communities of developing countries and transition economies that the tax system is not always applied in a transparent manner and that objections and appeals are costly and complicated. In these countries, taxpayers are sometimes presented with large tax bills, which are intended to provide a basis for negotiation of a settlement of increased liabilities resulting from audits. In a number of cases, little explanation is provided to justify the reasons for these additional liabilities and auditors are not always interested to discuss technical issues.

[138]Most modern tax administrations have developed case selection systems (usually computer based) to select VAT returns for audits. The more effective systems utilize taxpayer profiles and criteria to identify the highest risks for the revenue. These systems are frequently based on the cross-checking of internal information—for example: comparing return information with basic ratios (markup ratio), comparing information from different taxes (VAT and income tax), and using information from previous audits. Most systems also use information from other sources, for example: comparing customs information on tax paid on imports with input tax credit claims in the VAT returns; comparing customs information on exports and amount of zero-rated sales in the VAT return; and cross-checking of information on sales and purchases (information collected from large enterprises and government suppliers).

and lax time completion standards for audits; (iii) rudimentary techniques (such as, in certain countries, checking 100 percent of invoices); and (iv) flawed management reporting systems. In some countries, there is no appropriate audit organization, with tax auditing responsibilities being split between different administrations (including tax police forces in several transition countries).

- *The absence of an effective training program.* This is an area in which the assistance provided by bilateral donors could be improved.

Conclusions

Although various technical and political reasons may contribute to poor audit performance in most of the surveyed countries, the difficulty faced in convincing countries' tax authorities to adopt effective audit suggests several areas where reorientation of advice would be appropriate. For example:

Impact of the legal and judicial environment. It is important that the tax administration apply tax laws and regulations consistently—including through the publication of information regarding interpretation of the laws and regulations—and that objections and appeals are resolved through administrative channels as much as possible. To ensure that taxpayers are treated fairly, recent FAD advice has also recommended establishing the position of an ombudsman responsible for handling taxpayers' complaints regarding the quality of services provided by the tax administration.

However, the overall weakness of the legal and judicial environment, which impedes the development of effective appeals procedures in many developing countries and transition economies, is an issue that requires significant effort, including technical assistance.

Elimination of massive cross-checking programs. Those cases where countries attempt to cross-check on a large scale are often particularly challenging when it comes to giving advice concerning effective refund processing and audit programs. In several cases mentioned above, FAD has not been successful in convincing tax authorities that 100 percent pre-refund audits or/and massive invoice cross-checking is unworkable. Additional efforts are needed to promote more modern audit strategies developed in successful tax administrations,[139] which would need require extending technical assistance in tax administration beyond short-term implementation issues.

[139]For example, replacing the checking of 100 percent of invoices by selective programs (ranging from the cross-checking of sample quantities of purchase and sales invoices in the course of VAT audits to intensive cross-checking of invoices within specific industries or among major taxpayers).

Attention paid to the need for effective audit programs. Since revenue issues are often a major source of concern at the outset, priority is often given to measures aimed at bolstering VAT revenue immediately, such as establishing a large taxpayer unit, developing new filing and payment procedures, and implementing collection enforcement systems.

As governments and tax administrations often begin to be interested in audit and refund issues only several months or, sometimes, several years after the introduction of the VAT, it is mainly at that time that assistance to implement refund and audit programs will be most effective. This may explain why a number of countries with established VATs have subsequently requested further assistance from the IMF in these specific areas. Experience with these countries shows that, as soon as refund and audit issues are recognized as major problems, advice may be more successful (even if they cannot have a revenue impact immediately).

An important lesson from these experiences is that a period of more than the 18–24 months of the standard VAT implementation schedule is eventually required to implement a VAT successfully. Indeed, the effective implementation of a VAT may take several years.