

STRATEGIC PAPER
A STRATEGY FOR AUDITING
VOLUNTARY COMPLIANCE IN TAXATION

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PREFACE

This paper has been prepared as the part of the CCAF-FCVI Inc. (formerly the Canadian Comprehensive Auditing Foundation) International Fellowship Program. This strategy paper attempts to incorporate the audit approach, supportive factors, constraints and possible remedies for those problems in implementing the audit of voluntary compliance in income tax in Nepal. The Fellowship Program provided knowledge gained through training, attachment to an audit team and advice and suggestions from mentors and other concerned professionals of OAG Canada; this is reflected in this paper.

The Canadian tax system is based on the principle of self-assessment; however, it is a new concept to tax and audit authorities in Nepal. Since the introduction of the Self-Assessment System in Nepal, a need was felt for a sound audit approach by OAG Nepal. Therefore, this paper is focussed on those areas that contribute to conducting VFM audit of voluntary compliance in taxation.

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EXECUTIVE SUMMARY

This is a strategy paper on auditing voluntary compliance in taxation in Nepal. It has been prepared as part of the CCAF-FCVI Inc. Fellowship Program 1999-2000.

The paper aims to provide a practical VFM audit framework of voluntary compliance in income tax useful to the Office of the Auditor General of Nepal (OAG/N). It will also be the basis for conducting a pilot audit and is expected to enhance revenue audit capability of OAG/N staff.

The Auditor General of the Kingdom of Nepal conducts the audit of government expenditure and revenue considering the aspects of regularity, propriety and performance of financial transactions. This audit mandate promotes accountability in tax administration.

In 1993 a Self-assessment System was introduced in the Nepalese tax system. Under this system, taxpayers are given responsibility to assess their tax liability on the basis of their income. The objectives of introducing self-assessment were to encourage taxpayers to pay tax with dignity, promote the filing of tax return on time, collect tax in a timely manner and reduce the cost of collection.

The Training Division and Revenue Audit Division will be responsible for implementing this VFM audit project. The process of implementation will start with the approval from the Auditor General and will be in two stages – providing training to staff and conducting the pilot audit. The project will take three years, starting from 2000-2001, for its complete implementation. To build awareness about VFM audit, meetings and consultation with the tax authority will also be organized.

Parliament is interested in reporting on revenue and the government is need to improve tax administration are the main supportive factors for this approach.

Constraints include insufficient financial and technological resources and trained personnel. Also, self- assessment is new approach in our tax system; hence availability of performance information on voluntary compliance may not be adequate.

Under a self-assessment system of taxation, the role of the “tax authority should be a facilitator as well as an administrator;” therefore, audit should be focussed on analysis and assessment of an audit entity’s functional procedure in achieving the corporate goals of voluntary compliance.

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A Strategy for Auditing Voluntary Compliance in Taxation

1.0 Objectives:

This report aims to provide:

- a concise and practical VFM audit framework for auditing voluntary compliance in taxation that will be useful to the Office of the Auditor General of Nepal (OAG/N);
- a basis for conducting VFM audit of tax revenue using a pilot case; and
- an expectation to enhance revenue audit capability.

Revenue is probably the most important part of the government's budget and most of its plans and policies also depend on the amount of revenue collected. The self-assessment system of tax administration is a new exercise in Nepal. Government has also given priority to reducing the budget deficit through the mobilization of internal resources. In addition, Parliament expects high quality audit reports on revenues.

Of the countries that use a self-assessment system in taxation, it is assumed that Canada has a good rate of compliance. Therefore, the audit approach and practices applied by the Office of the Auditor General of Canada (OAG/C) may prove useful as a starting point for audit of taxation by OAG/N.

2.0 Background:

A taxation self-assessment system (Income Tax) is not new in developing countries but it is a new concept in the Nepalese tax system. Under the self-assessment system, taxpayers are given responsibility to determine their tax obligation. The number of tax returns filed under this system has increased every year since its introduction in 1993. However, the experience with the taxpayers voluntarily paying their tax liability is not satisfactory in Nepal. In last the few years, the OAG Nepal has highlighted several discrepancies regarding the legal provisions and compliance and enforcement activities through revenue audits. The Department of Taxation (DOT) will eventually need to evaluate the effectiveness of the self-assessment system.

Revenue audit is a mechanism, that generates revenue by not only pointing out the mistakes and errors but also by showing possible areas of leakage in the future.

Eventually this impacts on future assessments and revenue collection. After the introduction of self-assessment system of taxation in Nepal in 1993, OAG/N has been developing a new audit approach, perspective and improved auditing practices for voluntary compliance in taxation.

2.1 Taxation Self-Assessment in Nepal

In the context of liberalization and globalization of the world economies, many governments have opened new investment avenues to foreign investors; in turn, government has improved tax systems and procedures. In order to meet these new challenges and to simplify tax administration, His Majesty's Government of Nepal (HMG/N) amended the tax laws with new provisions and procedures to assist the taxpayers in complying with the self-assessment process.

One of these tax improvements, occurred when HMG/N introduced Self-Assessment in Taxation through amendment to the *Income Tax Act* in 1993. This amendment is a milestone in the history of tax administration in Nepal. Under this system, taxpayers are given responsibility to assess income tax liability on the basis of their income in prescribed form and manner. This system is common in most developed countries. The objectives of introducing the self-assessment system were to:

- encourage taxpayers to pay tax with dignity;
- promote the filing of tax returns on time;
- collect tax in a timely fashions; and
- reduce the cost of tax administration.

Under the self-assessment system, the number of tax returns filed has been increasing every year. In 1996-97, the total number of returns filed were 2,123 compared with 4,178 returns in 1998-99. However, some definitions of income tax liabilities and administrative procedures need to be clarified and improved.

As a result of enhanced computer technology within DOT, departmental efficiency is expected to improve. On this front, DOT recognizes that it will be useful to update records to account for the number of taxpayers that come under the self-assessment system. The updated record may give a clearer picture of total taxpayers and facilitate smoother operations. This will permit DOT to initiate the enforcement actions against non-filers.

2.2 Statutory Base

The Constitution of the Kingdom of Nepal, 1990 and the *Audit Act* 1991 are the major mandates of the Auditor General. The Constitution mandates the Auditor General to perform the audits of the accounts of government offices in a manner prescribed by law with due consideration to regularity, economy, efficiency, effectiveness and the propriety of financial transactions.

These mandates available to the Auditor General allows the following audits of government expenditure and revenues:

- attest or financial Audit;
- regulatory and propriety audit (comprehensive audit);
- performance audit or value-for-money audit (VFM).

In addition to audit responsibility, the Auditor General performs an advisory role for matters of financial discipline by issuing directives to government entities. The Auditor General also approves the accounting formats and is consulted by the substantially owned Government Corporations for the appointment of their statutory auditor.

3.0 Strategy:

3.1 General Approach

Who will be responsible?

The Training Division and Revenue Audit Division of OAG/N will be responsible for implementing the project. Advice and assistance from the Performance Audit Division will also be needed. I too will be involved in implementing the project.

When will the project start?

Implementation of this project will start with the final approval of the Auditor General. It will be carried out in different stages, taking three years (see implementation schedule) to complete.

What are the expected outcomes from this approach?

The expected outcomes of this approach are:

- meaningful audit reports to Parliament and the Tax Department;
- promotion of accountability in tax administration;
- increased revenue generation;
- increased support from audit entity;
- effective execution of audit mandate;
- enhanced credibility of OAG/N;
- enhanced performance audit capability of OAG Nepal staff; and
- follow-up audit made easier.

How will the project be implemented?

The implementation will be carried out in different stages. However, the main activities of this approach are conducting the pilot audit and training staff in VFM auditing.

3.2 Strategy for Implementation

- ***Submission of report to Auditor General***

The Special Report framework on “Auditing Voluntary Compliance in Taxation” was approved by the Auditor General before I proceeded in September 1999 to join the Fellowship Program in Canada. Nevertheless, on my return, I will submit my Strategy Paper to the Auditor General for his review and final approval. Upon approval of the Auditor General the implementation process will be initiated.

- ***Discussion with Peers and Staff***

A brief discussion will be organized with the Central Co-ordination Unit (CCU) and with the chiefs of different audit divisions to share my knowledge and experience gained in Canada. They will also be consulted in conducting the pilot audit. The CCU, which is headed by the Deputy Auditor General (DAG) and consists of senior officers, plays a significant role as an advisory unit. The unit also looks after the different aspects of audit, including quality assurance, monitoring, providing guidance, resolving audit problems and managing the audit.

The CCU will provide advice at the initial (planning) stage of the audit and help to keep the audit on track to attain meaningful results. The unit can also be useful for securing the resources required to conduct the audit.

Similarly, regular meetings with the Chiefs of Revenue Audit Division and Performance Audit Division will be organized to get their guidance in conducting the pilot audit. Regular discussion and team meetings will also be organized to enhance and update the knowledge among the team members.

- **Initiating skill development activities**

At the initial stage, a few staff will be selected from different audit divisions and a brief orientation on VFM audit and appropriate literature will be provided to give staff a better understanding of the methodology and the given audit topic.

The fruitful outcome of the audit operation depends upon the skill and commitment of audit staff. Therefore, it is necessary to enhance the audit skills of the staff. Regular in-house training, exposure to technology and a good environment conducive to growth need to be in place in order to develop a good professional team. Hence, the Training Division will assist in carrying out the skill development program.

In addition, attempts will be made at the management level to conduct joint training programs with OAG/N & DOT staff on Income Tax, particularly on voluntary compliance at the Revenue Administration Training Centre under the Ministry of Finance.

3.3 Conducting the Pilot

Formation of special team

In consultation with the Chief of Revenue Audit Division, a special team of auditors will be formed to conduct the pilot audit. VFM audit is akin to a research type of business and requires creativity and innovation. Therefore, the team of selected auditors should be capable and diligent and have adequate experience in revenue audit. After formation of the team, members will be provided with literature on VFM audit for study. With the co-ordination of Training Division, two days of orientation will be organized in VFM audit methodology and concepts for the pilot project. A few experienced auditors will participate in this orientation to discuss the VFM audit process. This will help to share knowledge and experience among team members.

Attempts will be made to apply the processes and techniques learned in Canada to our own situation. The process and techniques mentioned in this strategy paper will also be used while conducting the audit.

Building awareness with the tax authority

Tax revenue audit is a complex and sensitive task that needs protection of taxpayer rights and confidentiality. It will therefore be important to build awareness with departmental authorities regarding VFM auditing and convince and assure them about the impact and usefulness of this audit.

Audit entities are aware of VFM (referred as Performance Audit in Nepal) but the knowledge of this audit needs to be enhanced. OAG Nepal has focussed more on performance audit in the last few years and has started issuing separate audit reports. Coverage is also increasing every year. Even so, some entities' bureaucrats react to the VFM audit as if they were being investigated and feel that it is an unwarranted encroachment on their affairs. Because of this misunderstanding, they hesitate to provide required information or they conceal the real facts about the audit topic or issue. In the absence of adequate information, the objective of the audit is defeated and the audit does not contribute to improve governance.

Moreover, continuous support and facilitation from the audit entity helps to make the report meaningful, which is useful for the entity as well. Considering these factors, the concerned authorities within DOT will be consulted in a regular manner.

To this end, an introductory conference will be conducted with key staff within DOT and they will be briefed on the objectives of the pilot audit. In the process of the audit, key persons of the Tax Authority will be interviewed and consulted to achieve the objective of the pilot.

- **Focus on audit planning**

Planning is vital in VFM auditing because it is the blueprint of the audit operation. My experience in Canada has shown that audit teams decide the scope of audit, significance, relevance, criteria, risk and lines of enquiry in planning the audit. They spend at least 25 percent of time on planning. This is an area that needs to be improved within OAG/N. During the planning phase we will conduct an adequate study of the topic covering legal aspects, departmental initiatives to encourage self-assessment and other administrative processes. We will identify risk areas. This will be helpful in setting audit objectives and identifying matters of potential significance. Generally, not much time is devoted to planning in OAG Nepal. Thus, at least 20-25 percent of time will be allocated to complete the planning phase.

During the planning phase, the following will be researched: tax laws, departmental progress reports, tax strategies and other related literature. More important is that during the planning phase a structured interview practice will be introduced to gain a better understanding of the DOT business.

- **Consultation with external tax experts**

Taxation is a specialized and complex subject. Its administration and audit also needs specialized skill and knowledge. The OAG/N has a large number of graduate and post-graduate staff, including some with degrees in law. However, hiring the appropriate tax consultants can enhance knowledge of the staff. The experts may be chartered accountants, tax experts, legal advisors, etc. and will help us to understand the audit in a legal and professional fashion. Regular consultations and audit planning will be useful in developing professional skills of the staff.

- **Focus on DOT's voluntary compliance promotion initiatives**

Basically, the objective of voluntary compliance is the determination of tax liability by the taxpayers themselves in a free and fair manner. Instead of interference, tax authorities need to assist and facilitate the taxpayers in complying with the tax laws through providing information, forms, guidelines and other support services to the taxpayers. The audit exercise must be focussed on the commitment of DOT and initiatives need to be taken in promoting voluntary compliance. Details on tax facilitation in Canada and Australia are given in Appendix I.

The DOT Progress Report of 1998-1999 revealed that although the tax system has been improved every year through provisions in the *Finance Act*, the practice of voluntary compliance has not been developed among the taxpayers.

The existing legal, administrative and educational procedures of DOT for promoting voluntary compliance need to be evaluated and examined during the audit. (Appendix II).

3.4 Implementation Schedule

The main activities to be initiated are listed in the following chart:

ACTIVITIES	2000-2001	2001-2002	2002-2003
• Submission of Report to Auditor General and Approval	*****		
• Consultation with Peers and CCU	*****	*****	*****
• Skill Development Activities	*****	*****	*****
• Building Awareness with Tax Authority		*****	
• Conducting Pilot Audit			*****

4.0 Supportive Factors of the Strategy:

- **Interest of Parliament in audit report on revenue**

In recent years, Parliament has shown interest in receiving audit reports on revenue in order to know the problems in revenue collection and to understand accountability in this field. Also, the increase in the fiscal deficit and inefficiency in revenue collection has become a significant concern for parliamentarians. Last year, a parliamentary committee was formed to look into the revenue collection process. The committee recommended many initiatives to be taken by the government to improve the revenue collection process. Four years before, the government had formed a special task force to review the government revenue system. Therefore, a meaningful report on taxation from the Auditor General will be useful for Parliament to gauge the actual position of government initiatives.

- **Government need for improved tax administration**

Income tax is one of the major sources of government revenue. Considering the status of the resources, HMG/Nepal is focussing on improving the tax system. One of the major thrusts of reform in the tax system is to encourage voluntary compliance while achieving other objectives, such as encouraging revenue for national affairs, balanced development of economic activities, promotion of needed business and growth and development.

Recently, the government has announced the following: a comprehensive economic and organizational policy for bringing foreign investment; the mobilization of internal means and resources by strengthening institutional infrastructures; improved tax administration and collection; and the proper use of capital. All these initiatives are important for the fiscal stability and economic growth of the country.

- **OAG/N's emphasis on revenue audit**

The OAG/N has also shifted the focus of its audit efforts toward conducting performance audit of revenues. Such performance audits evaluate the reform efforts of the government and suggest improvements in the existing revenue collection process. The OAG/ Nepal is especially taking into account the following: the interest of Parliament, the importance of revenue collection, limited budgetary resources within government, changed fiscal realities and the priorities of the government.

- **Improved VFM Manual is available in OAG/N**

A manual and other audit tools are essential for VFM auditing. At present, the OAG/N has its own improved VFM audit manual available for audits. The manual was updated last year by an OAG/N consultant, KPMG Malaysia under a World Bank assisted project called “Enhancing the Performance Auditing Capability Project”. The improved VFM Manual provides better guidelines and audit tools; thus it will be used while conducting the pilot audit and providing training to staff.

- **Support from Central Co-ordination Unit (CCU)**

Within the OAG/N organizational structure, the Central Co-ordination Unit (CCU) supervises and provides advice in managing audit operations in a smooth and efficient manner. Instructions and directives are provided to all audit divisions, which helps to educate audit staff. In this context, advice from CCU will be useful to carry out the pilot audit in a meaningful way.

5.0 Impediments to Implementation:

- **Financial and technological resources**

The process of VFM auditing requires external experts and technological support for better results. The Office of the Auditor General is mandated to hire experts for audit work. However, it will need additional money to pay remuneration, buying computers and audio visual teaching aids to carry out staff training. Hiring of tax consultants should also contribute to enhancing staff skills and the quality of audit reporting as well.

- **Shortage of trained and skilled staff**

Trained and skillful staff are a prerequisite to conduct VFM audits and are greatly needed within OAG/N for efficient discharge of its constitutional mandate. Training is essential because of the complexities of the *Income Tax Act*, the dynamic nature of the tax environment and the introduction of computer technology by the audit entity.

For example, DOT has established a computer network to link all tax offices. Recently, a Web site has been established to provide general information on taxation for taxpayers. Although we have qualified and committed staff in different disciplines, we require trained personnel to conduct VFM audit. Similarly, use of improved technology and automation within the tax authority makes it necessary to meet these challenges by

updating knowledge and skills through training programs for staff. Only then we can expect a high quality product.

- **Availability of performance information**

Performance information is vital in VFM auditing. The Department of Taxation issues an Annual Progress report that provides information concerning different types of educational and information services to taxpayers. Similarly, DOT also issues different publications such as the Income Tax Directory (a collection of circulars) and statistical abstracts. However, the information needed to assess voluntary compliance, such as quantitative details of inquiries (written or otherwise), processing of returns, and refund of taxes, may not be available in adequate detail. This could limit our ability to carry out the pilot audit.

6.0 Conclusion:

Replication of any other country's system cannot be taken as an ideal solution to local problems and conditions. However, we can learn and adapt useful techniques from others and improve existing audit work performance.

The strategy proposed in this paper is not a panacea for the audit of voluntary compliance. Moreover, all factors, processes and approaches mentioned in the paper for the audit of voluntary compliance in income tax may not be applicable in Nepal. However, they could be guiding factors for VFM audit of revenues.

The success of the strategy will depend on the commitment from OAG/N and an eagerness to strive for excellence among auditors through co-operation from the concerned department. The benefit from success will accrue to all stakeholders.

In conclusion, we must note that under a self-assessment system of taxation the role of the "tax authority should be a facilitator as well as an administrator"; audit, therefore, should be focussed on analysis and assessment of the audit entity's new role of facilitator applied against its corporate goals.

THE FACILITATION PROCESS IN CANADA AND AUSTRALIA

APPENDIX I

Canada:

- In Canada the Canadian Customs and Revenue Agency (formerly known as Revenue Canada) provides a separate program to assist taxpayers in voluntary compliance.
- This program includes activities such as education on rights and obligations, the provision of forms and information for filing accurately and on time.
- The program includes regimes to ensure that responses to inquiries are made in a timely fashion, notifying tax payers of assessments, providing updates on recent tax changes, and providing “advance rulings” on the potential implications of possible transactions or tax situations.

Australia:

- The Compliance Model acknowledges that the majority of taxpayers comply voluntarily with no need for intervention by the Australian Tax Office. Those who don't comply are prompted further before enforcement action occurs. Only a small proportion ultimately do not comply voluntarily and necessitate enforcement actions.
- ATO encourages voluntary compliance of taxpayers through education and efficient service delivery.
- The ATO imposes penalties to encourage and promote future voluntary compliance.

FACILITATION PROCESS IN VOLUNTARY COMPLIANCE

APPENDIX II

<i>MEASURES</i>	INITIATIVES
1-Policy and Legislation	<ul style="list-style-type: none">• Policy and legislation• Research and development• Issuing advance rulings
2-Administrative	<ul style="list-style-type: none">• Tax roll registration• Correspondence with taxpayers• Assisting taxpayers with changes in legislation and tax administration• Refund of tax in time
3-Educational	<ul style="list-style-type: none">• Publication of users' guides, news letters, forms, notifications• How to fill out tax returns or forms• Consequence of non-compliance and enforcement action• Safeguarding the rights of taxpayers• Tax entitlements and obligations• Conducting consultation and interaction programs• Organizing seminars and workshops
4-Encouragement	<ul style="list-style-type: none">• Responding to inquiries (general and complaints)• Benefit of timely payment of tax obligations• Assisting through support programs for low income groups• Hearing of appeals• Timely processing of applications for tax registration• Timely processing of returns and issuing assessment notices• Timely processing of returns and issuing assessment notices