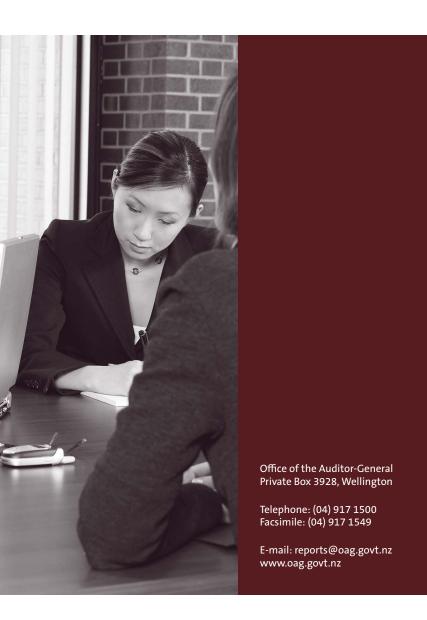CONTROLLER AND AUDITOR-GENERAL
Tumuaki o te Mana Arotake

Performance audit report

Inland Revenue Department: Performance of taxpayer audit — follow-up audit

Inland Revenue Department: Performance of taxpayer audit – follow-up audit

Foreword

In July 2003, I reported on the performance of the Inland Revenue Department's taxpayer audit function. I made 11 recommendations.

In 2006, I considered it timely to go back to the Department to see what progress it had made in implementing my recommendations.

It is encouraging to see that the Department has made significant progress in implementing my recommendations, which has resulted in considerable changes in the operation of taxpayer audit. I expect the Department to continue to maintain and improve its performance.

I thank staff of the Inland Revenue Department for their assistance and co-operation during my follow-up audit.

K B Brady
Controller and Auditor-General

3 October 2006

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Summary

Background

In 2003, we examined how the Inland Revenue Department (IRD) carried out its taxpayer audits to ensure that taxpayers complied with appropriate taxation law and regulations. In our report *Inland Revenue Department: Performance of Taxpayer Audit*,[1] we concluded that taxpayer audit was under-developed. Much of what was needed for taxpayer audit to play its full part in the Taxpayer Compliance Model was not in place. We concluded that the scale of change needed was substantial, and that the IRD required a significant programme to manage the change.

The scope of our follow-up audit

Our audit has been confined to examining the extent to which the IRD has implemented the recommendations we made in 2003.[2] We have not carried out an audit of the new methodology that the IRD is developing.

In particular, the IRD has devised a method of operation that will funnel all potential audit candidates through a risk assessment process to prioritise the work before it is allocated to Investigators. Our follow-up audit did not include a detailed examination of this new methodology. However, we agree this appears to be a logical approach to targeting taxpayer audit resources effectively.

Our 2003 report recommended that the IRD identify its requirements for case management of taxpayer audit, and purchase or create the relevant tools. The IRD is currently working on an organisation-wide case management solution. During our 2006 follow-up audit, we carried out a limited review of the processes used to identify the requirements for case management and to purchase the relevant tools.

Our findings

The IRD has undertaken a programme of projects to implement its strategy for taxpayer audit and has implemented significant change in the three years since we published our 2003 report.

The IRD has allocated considerable resources to this change process. This has involved 20 full-time equivalent staff during the first year and 27 in the second; there are plans to allocate 15 in the third year. The budget for the three-year programme is $7.8 million. In July 2006, actual expenditure was in line with budget expectations at $6 million.

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1   ISBN 0-478-18106-X, available from our website — www.oag.govt.nz.

2   Our 2003 recommendations are set out in full in the Appendix to this report.

The changes the IRD has made include:

- developing a clear strategy for taxpayer audit;

- improving the sharing of information across the organisation;

- identifying the requirements for case management of taxpayer audit, implementing an interim solution, and purchasing an organisation-wide tool for case management;

- implementing a comprehensive induction process and training framework tailored to the needs of taxpayer audit staff;

- improving the technology and audit tools available to help taxpayer audit staff in their work;

- defining intelligence needs and developing a strategy to meet those needs;

- increasing Compliance Risk Analyst staff resources and improving the technology available to provide risk analysis both across industries and tailored to specific individuals and entities;

- issuing guidelines for classifying and reporting additional tax assessed;

- enhancing the internal process to measure and maintain quality standards;

- creating performance measures specific to taxpayer audit; and

- establishing mechanisms to manage change across taxpayer audit.

Our conclusions

The IRD developed a clear set of long-term goals for taxpayer audit and has made considerable progress. These goals encompassed all the recommendations from our 2003 report. The IRD has so far achieved a substantial change in taxpayer audit operations through a range of short-term and medium-term actions. The change process is not complete yet. It is too early to assess the impact of the long-term actions, such as the organisation-wide solution for case management, and the new methodology for managing taxpayer audit priorities identified by a risk-based approach. However, we agree this appears to be a logical approach to targeting taxpayer audit resources effectively.

Part 1
Introduction

Background

1.1   The Inland Revenue Department (IRD) provides a range of services that enable taxpayers to comply with tax law, and undertakes enforcement action to encourage taxpayers to comply. One of these activities is to audit taxpayers. This function is carried out by a group of staff known as taxpayer audit. In 2006-07, the IRD expects to assess $828 million of additional tax as a result of audits conducted across all taxpayer groups. The IRD has a budget of $124 million to spend on taxpayer audit in 2006-07. This is 23% of the IRD's total appropriation for the year.

The scope of our follow-up audit

1.2   In 2006 we assessed the progress made since our 2003 audit, by examining whether the IRD had implemented the recommendations made in our report.

1.3   During our audit, we briefly reviewed the project documents for the new taxpayer audit methodology that the IRD has devised. However, our follow-up audit did not include a complete examination of these new arrangements.

1.4   We previously recommended that the IRD identify its requirements for case management of taxpayer audit, purchase or create tools to improve the timeliness of taxpayer audits, and actively monitor the progress made on each audit. The IRD is currently working on an organisation-wide solution to manage taxpayer cases across all internal departments. Our audit of case management was limited to a review of the processes used to identify the initial requirements and to purchase the relevant tools.

How we conducted our follow-up audit

1.5   In conducting our 2006 follow-up audit, we reviewed a number of documents relating to the changes made by the IRD, including a small number of taxpayer audit files.

1.6   We spoke to IRD Investigators and Compliance Risk Analysts at offices in Manukau, Takapuna, and Christchurch. We spoke to a number of managers in those offices and in Wellington, including team leaders, area managers, and managers with portfolio responsibility for particular topics, such as tax evasion.

Part 2
Setting a strategic direction for taxpayer audit

2.1 In this Part, we:
- briefly describe our 2003 findings about taxpayer audit strategy; and
- set out our findings in 2006.

Setting a strategic direction in 2003

2.2 In our 2003 report, we concluded that the IRD needed a detailed framework to bring together the large amount of work required to ensure that taxpayer audit can play its part in achieving the IRD's aims.

2.3 We recommended that the IRD enhance its current strategy to improve the focus and conduct of audits, strengthen capability, and measure and report performance.

Our findings in 2006

2.4 Since our 2003 report, the IRD has developed its taxpayer audit strategy to include information and proposals to address the issues we highlighted. It has devised an extensive programme of projects to focus on developing resources, enhancing capability and measuring results.

2.5 At the time of our audit in 2003, the existing taxpayer audit strategy included a number of ongoing initiatives. The IRD brought these initiatives together into a formal programme, which was approved by senior management in August 2004. This programme refers to the recommendations of our 2003 report, and includes matrices to align the broad objectives of the programme closely with our recommendations.

2.6 The programme has nine objectives. Initially seven projects were identified to achieve these objectives and, over time, the delivery of these objectives was realigned into five projects. Three of the projects relate directly to our recommendations:
- developing processes and resources– this project covers the focus and conduct of taxpayer audit, and strengthening capability;
- scoping information needs, intelligence needs and technology needs – this project also covers capability; and
- measuring results – this project includes reporting and measuring performance.

2.7   The other two projects cover managing resources and managing change.

Our conclusion

2.8   The IRD has taken action to implement our recommendation on enhancing its strategy. In 2004, the IRD strategy to meet the needs of taxpayer audit was developed further. The IRD started work on a programme of complementary projects to improve the focus and conduct of audits, enhance the taxpayer audit capability, and measure the impact of taxpayer audit work. This has provided a clear framework to support the changes implemented since 2003 and ongoing improvements. In our view, the IRD has implemented our recommendation in full.

Part 3
Improving case selection and conduct of audits

3.1   In this Part, we:

- briefly describe our 2003 findings about case selection and conduct of audits; and

- set out our findings in 2006.

Improving case selection and conduct of audits in 2003

3.2   In our 2003 report, we concluded that the management of taxpayer audit was highly devolved. Taxpayer audit staff had substantial discretion over selecting individual audits and the techniques they use. There was no standard practice to bind Investigators to proven methods of case selection, and practices varied widely. Audit manuals were out of date and not used consistently.

3.3   We recommended that the IRD:

- implement best practice by routinely sharing all good ideas, and improve the availability of information across the organisation; and

- identify the case management requirements of taxpayer audit, and purchase and/or create the tools to meet those requirements.

Our findings in 2006

3.4   Since our 2003 report, the IRD has:

- implemented best practice across taxpayer audit, including introducing risk analysis to target audit resources;

- implemented a number of improvements to the availability and sharing of information; and

- taken steps to identify and address its case management requirements, and has implemented an interim solution for taxpayer audit.

Implementation of best practice

3.5   The IRD has implemented a number of improvements to the taxpayer audit procedures since our 2003 audit. Our 2006 follow-up audit examined a number of the examples of best practice specifically identified in our 2003 report.

3.6   All taxpayer audits now include a formal analysis of risk. Compliance Risk Analysts analyse risk at a national level across industry and tax type. They further refine this analysis to identify individual taxpayers and organisations before passing their analysis to Investigators for their input. This sharing of information results in a completed Risk Analysis Template, which is included on taxpayer audit files.

3.7   Taxpayer audit files are clearly indexed, and many working papers are now electronic. Since our audit in 2003, the IRD has made significant progress in improving the structure and content of the taxpayer audit files and the quality of record-keeping. We reviewed a small sample of files that included files where activity spanned a number of years. These showed improvements in the content and layout of the taxpayer audit files.

3.8   In addition, there is a standard process for signing off technical matters that involves a group of tax technicians set up by the Technical Legal Support Group (TLSG). This process is familiar to all taxpayer audit staff, and is detailed in the TLSG pages on the intranet.

3.9   The IRD aims to use the taxpayer audit resource efficiently by allocating 65% of its taxpayer audit resources to national risks and 35% to local emerging risks. Each year, a working party of experts, drawn from across the taxpayer audit sites, identifies a range of national audit risks. The IRD conducted a specific audit risk identification exercise in 2003-04, and has continued to refine this process. The national risks are supplemented by local risks, which are identified by the IRD's local offices.

3.10   The IRD monitors taxpayer audit activity on a monthly basis, and produces six-monthly risk analysis reports that have limited commentary to interpret the data. Our analysis of the data for the period July 2004 to December 2005 indicated that the IRD spends about 75% of taxpayer audit time on national risks and 15% on local risks. Taxpayer audit staff spend the remaining 10% on "other" risks, which should be classified as national or local risks.

Information sharing

3.11   As part of the programme of projects to develop taxpayer audit, the IRD has reviewed the availability of and requirements for information, and devised a new taxpayer audit methodology, that was formally approved by senior management in February 2006. This methodology defines how information will be gathered, analysed, and shared with taxpayer audit staff to target their resources to address priority risk areas.

3.12   There will be a gradual transition to the new methodology during 2006-07. This will involve the IRD restructuring taxpayer audit functions to bring together those Investigators who currently deal with large corporate taxpayers and those who deal with small and medium-sized enterprises and individuals. The importance of sharing information is included in taxpayer audit staff's new draft job descriptions.

3.13   The IRD holds a significant amount of information on its intranet. Investigators, Compliance Risk Analysts, and the TLSG have their own sections, which include pages for taxpayer audit manuals, best practice material, meeting minutes, details of current issues (such as recent rulings and new developments), and standard practice statements. Taxpayer audit staff regularly use the intranet resources in their work.

3.14   The IRD has improved its communication systems, and has an effective communication structure to ensure that all staff are informed about the changes taking place. This structure includes specific interest forums, formal presentations and workshops for all taxpayer audit staff, a comprehensive intranet, regular staff meetings at a local and national level, and regular newsletters. This has helped taxpayer audit staff across the country to understand and implement the operational changes to taxpayer audit activity.

3.15   As part of the new methodology for taxpayer audit, the team managing the programme of projects has recently released about 100 guidance documents on the intranet. These replace or supplement existing taxpayer audit manuals and support the new taxpayer audit methodology due to be implemented in 2006-07. This will give taxpayer audit staff time to become familiar with the content of the guidance documents and give some feedback before the IRD fully implements the new methodology.

3.16   Taxpayer audit staff participate in a number of forums that focus on high priority risk areas, including the National Compliance Risk Analyst Forum, Tax Evasion Forum, and Aggressive Tax Issues Forum. The IRD staff can access the summary notes from the forum meetings on the intranet. This provides a useful mechanism for sharing ideas and promoting a consistent approach to taxpayer audits across the IRD offices.

Case management

3.17   The Team Leaders currently monitor the progress of audits during regular meetings with Investigators. The Team Leaders access milestone reports that identify all current audits and the number of hours spent on each audit, and discuss any matters of concern that might cause delays, so they can be resolved.

3.18   In July 2004, the IRD implemented an interim case management system for taxpayer audit. This encouraged a more structured approach to investigative work, and promoted a change in working practices to encourage Investigators to focus on prioritised areas of risk.

3.19   In April 2004, the IRD began work on a case management solution to meet the needs of the whole organisation as well as those of taxpayer audit. The project began with focus groups meeting across the organisation to define the case management needs before a formal tendering process was undertaken. The IRD completed contract negotiations to purchase off-the-shelf software in September 2005. Work is currently under way to configure the package for taxpayer audit and build the technical interfaces to allow the case management system to access the other information sources held by the IRD. The IRD expects to pilot the system later in 2006 at three taxpayer audit sites, and implement it in the remaining sites early in 2007. In 2007, work will begin on configuring the case management system for use by Child Support staff and Return and Debt Collection staff.

3.20   There have been some delays during this case management project, which is now about nine months behind schedule. We understand, through discussions with the IRD, that these delays were caused by unexpectedly lengthy contract negotiations, and the need for additional resources to configure the interfaces between the new case management software and the existing IRD systems.

Our conclusions

3.21   The IRD uses a range of effective and complementary communication mechanisms, and has provided funding and time for staff to contribute ideas and to network with staff in other IRD offices. This has promoted the sharing and implementation of best practice, and in our view has implemented our recommendation in full.

3.22   The IRD has implemented a number of positive changes to improve the availability and sharing of information. In particular, the intranet site is a comprehensive source of reference material, and is widely used. In our view, the IRD has improved the availability of information and implemented our recommendation in full.

3.23   The IRD has taken steps to identify and address its organisation-wide case management requirements. This has included purchasing a case management tool. This tool is yet to be fully implemented, but the IRD has implemented an interim solution for taxpayer audit, which introduced the Risk Analysis Template and focused taxpayer audit activity on areas where the risk of non-compliance with tax law is high. In our view, the IRD has implemented our recommendation, but there is still work to do to complete this project.

Part 4
Strengthening capability

4.1   In this Part, we:

- briefly describe our 2003 findings about strengthening capability; and
- set out our findings in 2006.

Strengthening capability in 2003

4.2   In our 2003 report, we concluded that the IRD was identifying the changes in capability that taxpayer audit staff would need, which would in turn require Investigators to acquire capabilities they did not then have. The IRD needed to prepare detailed plans to bridge the gap covering Investigator training, availability and use of technology, and collecting and using intelligence about taxpayer compliance behaviour.

4.3   We recommended that the IRD:

- draw up a standard induction programme for new Investigators;
- review its technology strategy;
- urgently define the intelligence needs of taxpayer audit in the context of the Taxpayer Compliance Model, and initiate projects to meet these needs; and
- clearly communicate the role of Compliance Risk Analysts (CRAs) to staff.

Our findings in 2006

4.4   Since our 2003 report, the IRD has:

- introduced a standard induction process for new Investigators, and implemented a comprehensive national training framework for Investigators and CRAs;
- reviewed and refined its technology strategy and its audit strategy, and made improvements in the technology and tools available to Investigators;
- identified its intelligence needs and devised the final strategy, which it will implement in 2006-07; and
- communicated the role of CRAs, and the support they can provide to other staff.

Staff induction and training

4.5   The IRD has introduced a comprehensive induction programme for new Investigators.

4.6   The IRD has established an Investigator Training Framework for new and existing staff. This is made up of discrete modules. Staff work on the modules relevant to

their needs and expertise, and use a formal Training Needs Analysis created by the IRD to identify which modules they need to work on.

4.7   The IRD also undertakes an annual performance review with all staff. Training needs are identified as part of this process. They are monitored every six months, and revised every year.

4.8   The IRD is implementing a new structure for taxpayer audit, and this will link in with the Investigator Training Framework to give more opportunities for career progression.

Use of technology

4.9   At the time of the 2003 audit, the IRD's technology strategy covered the period 2002 to 2005. The IRD reviewed this strategy in 2006 and produced an IT strategy for 2006 to 2011, which was approved by senior management in June 2006.

4.10   The taxpayer audit strategy in place in 2003 covered a range of projects including:
   • formulating a number of key audit principles that senior management approved in June 2003;
   • implementing an interim solution for case management within taxpayer audit; and
   • implementing a specific taxpayer audit technology project.

4.11   The IRD brought all the projects together into a formal programme of projects in August 2004.

4.12   The IRD completed the first taxpayer audit technology project ahead of schedule in December 2003, and started a further taxpayer audit technology project. The IRD formally terminated this second project in May 2004 when the drafting of the programme of projects began. Its objectives were included in the new programme. One of the core projects under this programme relates to defining intelligence needs and technology requirements. The project team managing this programme of projects has also produced the new methodology for taxpayer audit mentioned in paragraph 3.11.

4.13   The technology available to the taxpayer audit staff has improved since 2003. In 2004, the IRD introduced the interim solution for case management and started work on an organisation-wide solution. There is a comprehensive intranet and a range of computer-based tools that assist in the analysis of data gathered from taxpayers. The IRD has also made improvements to the efficiency of the main analytical database, allowing better interrogation of internal data.

Intelligence needs

4.14   The IRD initially defined the intelligence needs of taxpayer audit in a formal strategy document in May 2005. These needs were further refined during the development of the new taxpayer audit operating methodology drafted in December 2005, which will be gradually introduced during 2006-07. This methodology was approved by senior management in February 2006.

4.15   The IRD has made various improvements to the analytical database since our 2003 audit. All the relevant data has been loaded into the database, and a new server has been introduced to improve stability and speed. The IRD has upgraded the query reporting tool, and CRA staff are able to share common folders to access query tools more efficiently.

4.16   Technical changes have been made to the main analytical database. These allow taxpayer audit staff to access information more effectively and efficiently. This helps the IRD to meet the legislated timescales for processing GST refunds.

Compliance Risk Analyst role

4.17   The CRA role is now a key part of taxpayer audit. The CRA staff have formal job descriptions, and the IRD has created a training framework tailored to their needs. At the time of our audit in 2003, there were two CRA staff at each of the five Service Centre locations. There are now 28 CRA staff across the organisation.

4.18   There is a CRA section on the intranet, which is accessible to all taxpayer audit staff. This holds details of the CRA role and a variety of reference material. There is a CRA National Forum, which meets quarterly and is attended by CRA representatives from each of the five Service Centre locations. The summary notes from these meetings are also available on the intranet.

4.19   CRA representatives also participate in other national forums, and have liaison responsibilities with other taxpayer audit teams at each of the five Service Centre locations. These include attending team meetings and being a point of contact for queries.

4.20   There is a National Portfolio Holder for CRA staff, whose responsibilities include promoting the CRA role and ensuring that their skills are employed effectively. The CRA staff are involved in a number of projects across the country (including PAYE Evasion, Manipulation of Personal Income, and Industry Monitoring), which has helped to raise their profile with Investigators and increase understanding of the resources they offer.

4.21 The IRD has introduced a system whereby CRAs run reports from taxpayer data and identify instances where the data suggests that a taxpayer is not complying with tax law. In some instances, the IRD sends letters to taxpayers to invite them to comply and submit the relevant documentation. The IRD monitors the responses, and considers those taxpayers who fail to respond for further audit activity. This is a means to focus activity on specific areas of concern, and to encourage compliance without undertaking formal taxpayer audits, which is a more efficient use of resources.

4.22 When the IRD introduces the new methodology for taxpayer audit in 2006-07, the risk and intelligence staff (including CRAs) will have a major role in completing initial risk analysis to identify higher risk of non-compliance with tax law. These staff will give their assessments to Investigation Team Leaders for further assessment before final selection and distribution to Investigators.

4.23 We reviewed the six-monthly risk analysis reports, which analyse how Investigators spend their time. These show the changes in how Investigators use their resources and the amount of additional tax assessed due to audits resulting from CRA risk analysis activity. (CRA risk analysis focuses taxpayer audit resources on areas where there is high risk of taxpayer non-compliance.)

4.24 Our analysis of the figures in these reports indicated there were differences between the IRD offices in the level of additional tax due, which has been highlighted as a result of the CRA risk analysis. Our work indicated that some IRD offices generated better returns than others. There was no commentary in the risk analysis reports that we reviewed to explain these variations, so it was difficult for us to assess the effectiveness of the CRA analysis.

4.25 The IRD needs a better mechanism to measure the effectiveness of CRAs when it monitors and reports the levels of additional tax assessed from taxpayer audit hours spent across all IRD offices. It should be in a position to give attention to this once the new methodology is integrated into regular practice. This would make it easier to assess the effectiveness of the new methodology.

Our conclusions

4.26 The IRD has implemented our recommendation and a tailored induction process is now in place for new Investigators, and the IRD has implemented a national training framework for new and existing Investigators and CRAs.

4.27 The IRD has reviewed and refined all the project and strategy documents mentioned in the recommendation in the period since 2003. In our view, the IRD has taken steps to implement our recommendation, and there have been

improvements in the technology and tools available to Investigators. However, the longer-term effect of these changes and developments is unlikely to be measurable until the new methodology for taxpayer audit is integrated into business operations in 2006-07.

4.28   In the three years since we published our report, the IRD has identified its intelligence needs and has devised the final strategy for implementation in 2006-07. The main analytical database is now an integrated part of the taxpayer audit process. It is an important tool for more than 150 users, including the CRAs who use it to interrogate data to identify potential areas of non-compliance with tax law. In our view, the IRD has made significant progress towards implementing our recommendation, but there is still work to do to implement the final strategy.

4.29   In our view, the IRD has implemented our recommendation, and has communicated the CRA role and the support CRAs can provide to other staff. As a result, the volume of risk analysis undertaken by the CRA staff has increased. This is expected to increase further as the new methodology for taxpayer audit becomes integrated into business operations, when CRA staff will provide risk analysis for all audits to more than 800 Investigators.

Part 5
Measuring and reporting on performance

5.1 In this Part, we:

- briefly describe our 2003 findings about measuring and reporting on taxpayer audit performance; and
- set out our findings in 2006.

Measuring and reporting on performance in 2003

5.2 In our 2003 report, we concluded that the performance measures being reported could be having unintended effects, as Investigators could select cases that would easily achieve the targets rather than improve taxpayer compliance.

5.3 We recommended that the IRD:

- distinguish between the different types of discrepancies identified by taxpayer audit, to provide a more transparent view of the value of additional tax assessed when reporting to Parliament;
- complete the review of its quality management system; and
- explore ways of assessing the impact of audits on taxpayer compliance.

Our findings in 2006

5.4 Since our 2003 report, the IRD has:

- introduced clear guidance to classify and report errors identified through taxpayer audit activity, which is reflected in the detail of the annual report;
- completed the review of the quality measurement system, and implemented all of that review's recommendations; and
- introduced a number of measures to assess the impact of taxpayer audits on taxpayer compliance.

Reporting

5.5 The IRD introduced a best practice statement in July 2005 to detail how it should report additional amounts of tax assessed. Management promoted the statement during visits to IRD offices, and made it available on the intranet. Investigators regularly refer to the statement during audits. The IRD measures compliance with the statement's requirements through its internal quality measurement process.

5.6 The IRD's Annual Report for 2005 highlights the amounts of additional tax assessed in graphical format showing:

- comparisons between actual and budget figures;
- amounts due following self-corrections by taxpayers;

- amounts refunded;
- reports of the IRD's progress in challenging tax avoidance schemes; and
- underpayments of tax due to tax evasion and fraud.

Review of the quality measurement process

5.7   The IRD operates an internal quality measurement process whereby nominated IRD staff review a sample of completed taxpayer audit files and mark them against a checklist to ensure that the files comply with internal quality standards.

5.8   The IRD completed the review of the quality measurement process in August 2003. Senior management approved recommendations from the review at a meeting in September 2003.

5.9   The quality measurement process is now an integrated part of the IRD's internal review system. The list of areas checked by the review is available on the intranet, and staff are given prompt feedback after a review of their completed taxpayer audits. Training is provided to those staff who undertake the reviews, and there is an extensive moderating system to ensure that there is a consistent approach across the country.

5.10   In June 2005, the implementation of the review's recommendations was audited by the IRD's Internal Audit team. This noted that many issues from the review had been adequately addressed, but some actions were overdue. The Internal Audit team has recently followed up the outstanding actions, and all have now been cleared.

Assessing the impact of taxpayer audit

5.11   The IRD has devised a range of measures to assess the performance of taxpayer audit. In July 2005, the IRD published details of these performance measures internally in a booklet. The booklet defines a range of indicators to monitor the effectiveness of taxpayer audit activities in maintaining and improving compliance. These measures include surveying taxpayers, reviewing previous non-compliance, and assessing the level of self-correction made by taxpayers following a prompt from the IRD.

5.12   The IRD introduced a taxpayer survey in 2003-04. An external organisation carries out the survey annually, by contacting a sample of taxpayers who had been recently subject to an audit to request feedback. The external organisation collates this feedback to share with the IRD staff to improve how the IRD conducts taxpayer audits.

5.13   The IRD monitors previous non-compliance by selecting a sample of taxpayers who made underpayments of tax in the preceding 1-2 years. These taxpayers are then subject to a further audit to indicate whether their behaviour has changed and they are now compliant. This annual process was introduced in 2004-05. Once sufficient data is available, the IRD will be able to measure the impact of its taxpayer audit function by monitoring indicators of changes in taxpayer compliance.

5.14   The IRD also analyses taxpayer data to identify areas where there may be underpayments of tax. In some instances, the IRD contacts the taxpayer by letter and invites them to make the relevant corrections. The IRD monitors the responses received from taxpayers and carries out further audit activity where necessary. By monitoring taxpayer response, the IRD can measure changes in compliance behaviour.

5.15   When the IRD implements the organisation-wide case management system and adopts the new methodology for taxpayer audit, candidates for audits will be initially subject to risk assessment by risk and intelligence staff before being passed to Investigation Team Leaders for further assessment and potential audit action. This will ensure that taxpayer audit staff align their audits to key risk areas and to the IRD's aims to target particular industries or types of taxpayer.

Our conclusions

5.16   The IRD has introduced clear guidance to classify and report errors identified through taxpayer audit activity, and this is reflected in the detail of the annual report. In our view, the IRD has implemented our recommendation in full.

5.17   The IRD completed the review of the quality measurement process soon after we published our 2003 report. A recent review by the IRD Internal Audit team found that the IRD has now implemented all the recommendations. In our view, the IRD has implemented our recommendation in full.

5.18   The IRD has introduced a number of mechanisms to assess the impact of taxpayer audits on taxpayer compliance. In our view, the IRD has taken steps to implement our recommendation. However, it is too early to assess the effectiveness of these new measures, as some have not yet been implemented fully, and others have been operational for only a year.

Part 6
Managing change

6.1   In this Part, we:
- briefly describe our 2003 findings about managing change; and
- set out our findings in 2006.

Managing change in 2003

6.2   In our 2003 report, we concluded that the IRD needed to establish sound arrangements to promote and allocate accountabilities for the changes required for taxpayer audit.

6.3   We recommended that the IRD establish and implement sound arrangements for managing the changes required to taxpayer audit. Our 2003 report included details of the IRD's proposals for managing the changes, which the IRD had started implementing at the time of our audit.

Our findings in 2006

6.4   Since our 2003 report, the IRD has established formal arrangements for managing the changes, which have included senior management review, allocation of staff resources, extensive communication structures, and a project management approach.

6.5   The programme of projects to develop taxpayer audit has been the main mechanism for the development of initiatives. This programme has had 47 staff seconded to it from relevant business areas since it was introduced in August 2004. The IRD recruited a programme manager specifically to run this project.

6.6   The programme has a good governance structure, which includes clear reporting arrangements to senior management through the programme's steering committee. In addition, the programme manager regularly attends senior management meetings.

6.7   The IRD has allocated responsibility for change management to specific members of staff. There is a specific project for integrating the new arrangements for taxpayer audit. In addition, the IRD has introduced a senior role with the responsibility to manage and implement key project initiatives across taxpayer audit. The role provides an overview of the proposed changes, monitors communication, and encourages liaison with key stakeholder groups to ensure that the initiatives are integrated into normal business operations.

6.8   There are also a number of national groups (for example, the CRA National Forum and the National Quality Panel) that oversee the changes made, and provide input about how the changes are implemented into day-to-day operations.

6.9   An independent organisation also reviews the programme of change regularly, as part of the IRD's governance protocols. This organisation submits formal reports to the programme's steering committee.

6.10   The IRD has introduced changes on an ongoing basis since our last audit in 2003. A number of these were in progress at the time we published our 2003 report. These included creating the interim solution for managing audits, making improvements to the main analytical database, and introducing the taxpayer audit survey. Changes have been communicated to staff through the intranet, presentations, and workshops. In addition, staff have been involved in focus groups to give input to the proposed changes. This has encouraged the commitment of taxpayer audit staff to the changes.

6.11   The programme manager is currently drafting plans for the handover of the five core projects to the teams who will manage the new arrangements once they are operational. The projects will also be subject to a formal post-project review in line with the IRD's established systems.

Our conclusion

6.12   In our view, the IRD has implemented our recommendation, and has established formal arrangements for managing the changes that were set out in a documented strategy endorsed by senior management. The arrangements included project management, senior management review, allocation of staff resources, and extensive communication structures that have kept staff at all levels well informed about the new audit methodology.

Appendix
Our 2003 recommendations

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.

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.

Recommendation 3

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

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.

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.

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.

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.

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.

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.

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.

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.

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Principles to underpin management by public entities of funding to non-government organisations
- Ministry of Education: Management of the school property portfolio
- Local authority codes of conduct
- Local government: Results of the 2004-05 audits – B.29[06b]
- Inquiry into certain allegations made about Housing New Zealand Corporation
- Department of Conservation: Planning for and managing publicly owned land
- Ministry of Agriculture and Forestry: Managing biosecurity risks associated with high-risk sea containers
- Annual Plan 2006-07 – B.28AP(06)
- Foundation for Research, Science and Technology: Administration of grant programmes
- Management of the West Coast Economic Development Funding Package
- Management of heritage collections in local museums and art galleries
- Central government: Results of the 2004-05 audits – B.29[06a]
- Progress with priorities for health information management and information technology
- The Treasury: Capability to recognise and respond to issues for Māori
- New Zealand Police: Dealing with dwelling burglary – follow-up report
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