

The Auditor-General
Audit Report No.35 2005–06
Performance Audit

**The Australian Taxation Office's
Administration of Activity Statement
High Risk Refunds**

Australian National Audit Office

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of Australia 2006

ISSN 1036-7632

ISBN 0 642 80895 3

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Canberra ACT
28 March 2006

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *The Australian Taxation Office's Administration of Activity Statement High Risk Refunds*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely



Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations/ Glossary

ANTS	<i>A New Tax System</i>
AQS	Action Queue Service
ATO	Australian Taxation Office
AWA	Automated Workflow Allocation system / Automated Workflow Application
BAS	Business Activity Statement
EFT	Electronic Funds Transfer
CVC	Compliance Verification Centre
DRI	Delayed Refund Interest
COF	Correspondence Out Facility
GCS	Government and Community Sector
GST	Goods and Services Tax
HRR	High-Risk Refund
IAS	Instalment Activity Statement
ILEC	Interpretation and Large Enterprise Compliance
IPS	Instalment Processing System
IT	Information Technology
QA	Quality Assurance
QM	Quality Management
RBMG	Refund Business Management Group

RISC	Refund Integrity Steering Committee
RRE	Risk Rating Engine
SRM team	Strategic Risk Management team

Summary and Recommendations

Summary

Introduction

1. Activity statements were introduced on 1 July 2000 as part of A New Tax System (ANTS).¹ They are the ATO approved forms used by taxpayers to report and remit certain tax obligations.²
2. Under Australia's self-assessment taxation system, taxpayers are only required to provide a limited amount of information on activity statement forms regarding their relevant tax obligations. However, taxpayers are required to retain detailed records to substantiate the information provided in their activity statements.
3. The ATO uses a risk-based approach to identify activity statements (including activity statement refunds) that are at risk of being incorrect because:
 - the large number of activity statements processed by the ATO limits the ATO's ability to conduct in-depth investigations of all the information it receives on activity statements; and
 - taxpayers are only required to remit limited information on activity statements. The ATO may need to request additional information from taxpayers to determine whether the information on activity statements is valid.³
4. An activity statement refund arises where the credit entitlements claimed on an activity statement are greater than the debts recorded on that statement. A taxpayer is entitled to receive a full activity statement refund amount where the taxpayer:

¹ There are two types of activity statements: Business Activity Statements (BAS) - which are used by taxpayers who are registered for Goods and Services Tax (GST)) and Instalment Activity Statements (IAS) – which are used by taxpayers who are not registered for GST.

² These specific tax obligations include: the GST; Pay As You Go (PAYG); Fringe Benefits Tax (FBT); Wine Equalisation Tax (WET); Luxury Car Tax (LCT); and deferred company instalment (COIN) obligations.

³ The amount and type of information contained in an activity statement does not allow the ATO to fully assess whether a refund claimed in that activity statement is correct. For the purposes of this audit, a valid activity statement refund is a refund that has been assessed using risk-based processes to determine whether the limited information provided in that statement is likely to be correct.

- does not have any other current primary tax debts (for example, unpaid Income Tax, Fringe Benefits Tax, or GST);
- has submitted all outstanding activity statements; and
- does not have a debt with another Commonwealth agency which is permitted to garnishee tax refunds.

5. In 2004–05, 68 per cent of the total value of activity statement refunds was claimed by large business, and the government and community sector.⁴ These claims account for two per cent of the total number of activity statements processed in 2004–05. Conversely, 97 per cent of all activity statement refunds claimed was made by micro, small and medium business.⁵ However these refunds only accounted for 26 per cent of the total value of refunds claimed in 2004–05.

6. A High-Risk Refund (HRR)⁶ is a potentially incorrect refund⁷ claimed through an activity statement, which could result in a significant risk to revenue, or which could undermine the community's confidence in the ATO's administration of the tax system. The following are broad reasons why the ATO may classify an activity statement as a HRR: fraud; non-compliance with the tax law; misapplication of the tax law; and administrative error.

7. The following statistics illustrate the importance of having robust activity statement refund systems identify and resolve HRRs:

- HRRs account for 4 per cent (approximately 82 000 activity statements) of the total number of activity statement refunds processed in 2004–05;
- HRRs account for 45 per cent of the total value of activity statement refunds (\$12.6 billion) processed in 2004–05; and
- through compliance activity applicable to HRRs, the ATO recovered approximately \$450 million in 2004–05.

⁴ The Large Business includes all business entities that have an annual turnover of greater than \$100 million. The government and community sector includes federal, state and territory government bodies and not for profit organisations.

⁵ Micro businesses are defined as entities with an annual turnover of less than \$2 million as distinguished from small to medium business enterprises that have a turnover of between \$2 million and \$100 million annually.

⁶ Although the term High-Risk Refund (HRR) can also be used to describe certain income tax refunds, for the purposes of this audit, HRRs refer only to a high-risk activity statement refunds.

⁷ An incorrect refund occurs where the ATO has paid to a taxpayer an amount to which they are not entitled.

Objective and scope

8. The objective of the audit was to assess the ATO's administration of activity statement HRRs. Specifically the audit sought to:

- examine aspects of ATO governance relevant to its administration of activity statement HRRs. This includes: ATO planning, the integration between Lines to administer HRRs; corporate risk management processes; and performance management;
- assess the ATO's methodology and practice to identify and, if necessary, correct activity statement HRRs; and
- identify and assess the Information Technology (IT) and manual systems, processes and controls used by the ATO to process HRRs resulting from the lodgement of activity statements.

Key Findings

Background and context (Chapter 1)

9. With the introduction of ANTS in 2000–01, the ATO adopted a new approach to provide assurance that taxpayers were complying with their activity statement tax obligations. The cornerstone of this approach was assessing the risk of activity statements being incorrect before refunds are issued to taxpayers. Since that time the ATO has made significant and ongoing changes to the systems, processes and controls it uses to process activity statement refunds and identify HRRs.

10. After issuing a large, incorrect refund in 2001, the ATO adopted a conservative approach to identifying HRRs. This approach involved stopping large numbers of high-value activity statement refunds for manual examination by ATO staff prior to being issued. This manual examination process to ensure the validity of refunds lengthened the time the ATO took to issue activity statement refunds.

11. A result of this conservative approach to refund processing was that the ATO received complaints from the community regarding the length of time taken to process activity statement refunds. In 2004–05, the ATO amended its conservative approach to decrease the time it takes to process HRRs.

12. Although timely refund processing is an important aspect of effective activity statement administration, the validity of the revenue refunded by the

ATO is equally important. A failure of activity statement refund systems to effectively detect incorrect refunds has the potential to:

- impact Commonwealth revenue detrimentally; and
- undermine community confidence in the ATO's ability to manage the tax system.

13. A key challenge for the ATO is to achieve the right balance between issuing activity statement refunds in a timely manner, and establishing the validity of the refund.

High-risk refunds governance issues (Chapter 2)

14. The administration of activity statement HRRs is the responsibility of a number of different functional areas within the ATO. To provide assurance that HRR systems, processes and controls are coordinated well and managed effectively, it is important that the ATO has a robust governance framework that delivers a seamless approach to manage refunds.

15. The ANAO found that the ATO has a well-established governance framework in place to manage activity statement refund processing (including HRRs). However, the ANAO considers that this framework could be strengthened by:

- improving planning processes for the ATO functional areas⁸ responsible for activity statement refund processing;
- developing a robust approach to measuring the overall performance of activity statement refund processing which includes measures of both the timeliness and validity of activity statement refunds issued by the ATO;
- clearly specifying the roles and functions of the ATO committees and management groups responsible for monitoring activity statement refund processing and approving changes to activity statement processing; and
- establishing a fully effective Certificate of Compliance process. When operating effectively, this process will provide additional assurance

⁸ At the time of the audit, eight teams are responsible for managing aspects of activity statement processing, ranging from IT support to activity statement refund compliance activity. These teams are situated throughout Australia, and are located within three ATO Lines: GST Line, Operations Line and the Information and Communications Technology Line.

that payments of public monies (including those related to activity statement refunds) are valid.

16. The ATO advised that it was making, or had made, progress to further enhance its governance arrangements around HRRs during the audit.

A risk-based approach to the identification and resolution of high-risk refunds (Chapter 3)

17. The effective identification and timely resolution of HRRs using a robust risk-based approach is essential, given the large volume of work associated with activity statement processing, and the finite resources the ATO has to examine the validity of activity statement refunds.

18. The ANAO found evidence that the ATO had considered, and was addressing strategic and operational compliance risks relevant to the identification and resolution of HRRs. However, these risks were not clearly documented, or consistently reported. During the audit, the ATO commenced initiatives to reform its approach to risk management of HRRs. These initiatives had not been completed at the time of the audit.

19. The ATO uses a range of HRR compliance products⁹ to mitigate compliance risks relevant to identifying and resolving HRRs. If these products are not underpinned by a sound risk-based approach to compliance, there is the potential that: HRRs will not be identified, and the ATO will issue incorrect refunds; or valid refunds will be incorrectly identified as HRRs, and will be delayed from issuing.

20. The ANAO found that, based on data maintained by the ATO, it is difficult to determine the overall effectiveness of these compliance products. While analysis is undertaken for some products, the ANAO considers that it is now timely that the ATO analyses, and regularly reports on the performance of, all of its compliance products relating to HRRs. This will allow the ATO to determine whether it is using the 'optimal balance' of compliance products to identify and resolve HRRs.

21. In mid 2004, the ATO extensively modified its conservative approach to identifying and resolving HRRs. These modifications included changing the

⁹ The ATO uses approximately 20 different compliance products to mitigate HRR compliance risks. These products can range from the invasive (for example, large tax audits) to the less invasive (for example, telephone calls from ATO staff to taxpayers to confirm activity statement refund information).

automated tests applied by the Risk Rating Engine (RRE) IT system¹⁰ to identify HRRs. The ATO also introduced an 'override policy', which excludes selected taxpayers' refunds from being fully assessed by the RRE. The ATO intended that the modifications would reduce the number and value of refunds delayed for manual examination, while improving the detection of incorrect or fraudulent refunds.

22. The ANAO found that ATO data shows some indications that the changes to the RRE tests, and the override policy, are successfully decreasing the overall time taken to process activity statements while increasing the total revenue adjustments made by ATO staff reviewing HRRs. Although these indicators are showing a positive trend, further analysis of this data needs to occur, and other measures of performance need to be explored, to fully understand these results. The ANAO considers that the ATO needs to develop, document and apply a methodology to assess the effectiveness of the override policy and the changes to the RRE tests.

High-risk refund systems, processes and controls (Chapter 4)

23. The ATO is heavily reliant on a number of complex IT systems, to process the large volume of activity statement refunds it issues to taxpayers. The failure of any one of these IT systems to support business processes and activities could result in incorrect refunds being issued, or in refunds being delayed unnecessarily.

24. The ANAO sought assurance that the ATO has effective controls in place for the two main IT systems used to identify and process HRRs. These IT systems are:

- RRE IT system. This is the principal IT system used by the ATO to identify HRRs before they are issued to taxpayers;
- Refunder IT system. This system is responsible for a number of functions applicable to refund processing, including offsetting refunds against garnishee commitments with applicable Commonwealth agencies, generating accounting transactions in individual taxpayer accounts, allocating Delayed Refund Interest (DRI) to taxpayers, and posting financial information to the ATO's financial management system.

¹⁰ The RRE is the main information technology system used by the ATO to identify HRRs.

25. The ANAO examined a range of controls that are essential to the effective operation of these two IT systems. Specifically, the ANAO assessed whether the Refunder and the RRE: had complete and accurate systems documentation; and whether robust system testing was undertaken for changes made to these IT systems.

Systems documentation

26. The ANAO found that the systems documentation for the RRE provides strong assurances that it is operating as specified, and in accordance with tax legislation and ATO policy.

27. In contrast the ANAO found that Refunder systems documentation lacks technical detail for certain functions, has inconsistent content, and changes to the system have not been incorporated appropriately in all cases. Without improvements to system documentation, it is difficult for the ATO Executive to be assured that this IT system is operating as specified.

System testing

28. The ANAO sought to examine a sample of relevant regression testing¹¹ for the two main activity statement refund processing systems (RRE and Refunder). The results of our analysis were that regression testing for the RRE is comprehensive and complete.

29. The ANAO found that the ATO did not conduct sufficient regression testing for a significant system change relevant to the Refunder system.¹² Without comprehensive system testing it is difficult for the ATO to assess the effect of changes on the overall operation of the Refunder system and other related systems.

Manual controls

30. Manual processes and controls such as procedures documentation, staff skilling, and quality assurance are used to provide assurance that the work undertaken by compliance staff responsible for identifying and reviewing HRRs is timely and is consistent with relevant ATO policy and tax legislation. Overall, although some quality assurance results are below benchmark

¹¹ Regression testing, is the process of testing which is used to assess whether system changes have an adverse or unexpected effect on existing system functionality. An example is whether particular RRE or Refunder system changes have an unexpected impact on other systems within the end-to-end refund process.

¹² The ATO made a significant change to the Refunder system in May 2003. This significant change included the automatic calculation of DRI.

standards, the ANAO found that the manual processes and controls relevant to identifying and reviewing HRRs are sound.

Overall conclusion

31. The identification and resolution of HRRs has been a key management issue for the ATO since the introduction of the *New Tax System* in 2000–01. In 2004–05, the ATO processed approximately 2.1 million activity statement refunds. Of these, approximately 82 000 were identified as high-risk refunds worth \$12.6 billion. The large number and high value of these refunds, combined with the limited information taxpayers are required to provide in activity statements, means it is important that the ATO has a sound risk-based approach to identify and resolve HRRs.

32. The cornerstone of the ATO's approach to identify and resolve HRRs is to assess the risk of an activity statement refund being incorrect before it is issued (this is also known as a pre-issue compliance approach). A key management challenge raised by this compliance approach is for the ATO to strike the right balance between obtaining assurance that the activity statement refunds it issues are valid, and the length of time it takes to process activity statement refunds.

33. The ATO has a well established governance framework in place to manage HRRs. This comprises a committee and management groups, the use of specific IT systems, and compliance staff from a number of functional areas to undertake specialist audit work on activity statement refunds. Although this framework does provide assurance that HRRs are being managed systematically, the ATO can improve its governance of HRR refunds. This would involve better coordinating its planning processes, developing a robust approach to assess and report on all aspects of activity statement refund processing, and clearly specifying the roles and functions of the relevant committee and management groups.

34. The ATO has undertaken work to identify and address risks applicable to the identification and resolution of HRRs. However, these risks were not clearly documented, or consistently reported. During the audit, the ATO commenced initiatives to improve its risk management processes.

35. The ATO uses a broad range of compliance products to identify and resolve high-risk refunds from simple telephone inquiries from ATO staff to taxpayers made before refunds are issued (pre-issue audits), to complex tax

audits undertaken after a refund has been issued (post-issue audits). Based on the data maintained by the ATO, it is difficult to determine the overall effectiveness of these compliance products to resolve HRRs. The ATO needs to develop and apply a robust methodology to determine the optimal combination, and overall cost effectiveness, of these compliance products.

36. The ATO uses the RRE IT system and the Refunder IT system to identify and process HRRs. The ANAO found that the ATO's ability to provide assurance around the correct operation of these two systems was mixed.

37. Although the ATO was able to provide robust assurance that the RRE IT system was operating correctly, it was not able to provide the same assurance for the Refunder IT system. The ATO needs to improve Refunder systems documentation and system testing to provide adequate assurance to the ATO Executive that this IT system is operating correctly.

38. The ANAO made seven recommendations aimed at strengthening the ATO's documentation, risk management and planning practices. The ANAO considers that the implementation of these recommendations will assist the ATO to determine whether it has an optimal balance of compliance products to resolve HRRs effectively, while also issuing timely activity statement refunds to taxpayers. The ATO agreed with all recommendations.

Summary of the ATO's response

39. Managing risk is an important imperative for the Tax Office. We welcome the ANAO's recognition of the Tax Office's well established governance framework to manage Activity Statement Refund processing and the suggestions to strengthen the framework.

40. The Tax Office supports the recommendations contained in your report and has provided a response to each.

41. The ATO's full response is reproduced in Appendix 1 of this report.

Recommendations

Set out below are the ANAO's recommendations aimed at improving the administrative practices of the ATO relating to its administration of activity statement high-risk refunds. Report paragraph references and abbreviated ATO responses are also included. More detailed responses are shown in the body of the report. The ANAO considers the ATO should give priority to Recommendations 4, 5, 6 and 7.

Recommendation No.1

Para 2.11

To provide assurance that activity statement high-risk refunds are being managed effectively, and that relevant risks are being mitigated and priorities implemented as intended, the ANAO recommends that the ATO develop and implement:

- an integrated approach to planning within the GST Line and the Operations Line in accordance with relevant ATO practice statements; and
- procedures to provide assurance that ATO planning documentation applicable to the effective administration of high-risk refunds is appropriately linked.

ATO response: Agreed.

Recommendation No.2

Para 2.31

To provide robust assurance that the activity statement refund process is efficient and effective, the ANAO recommends that the ATO:

- develop a framework to assess the performance of activity statement refund processing, which includes measures of both timeliness and the validity of activity statements issued by the ATO; and
- report regularly on the performance of activity statement refund processing to the relevant ATO area responsible for overseeing ATO refund processing.

ATO response: Agreed.

Recommendation No.3

Para 2.43

To improve the efficiency and effectiveness of relevant activity statement refund committees and groups, the ANAO recommends that the ATO complete the process to:

- clearly establish and document the roles, responsibilities and accountabilities of committees and management groups;
- clearly define and document the interrelationships between committees and the management groups; and
- document all major decisions made by the relevant committees and groups, and the reasons for those decisions in accordance with Australian records management standards.

ATO response: Agreed.

**Recommendation
No.4**

Para 3.17

To support the correct identification of activity statement high-risk refunds, and to effectively target compliance resources to mitigate high-risk refund risks, the ANAO recommends that the ATO:

- identify and assess strategic and operational compliance risks relevant to high-risk refunds in accordance with relevant ATO corporate risk practice statements; and
- develop and implement regular risk reporting processes at the strategic and operational levels to report on relevant high-risk refund risks.

ATO response: Agreed.

**Recommendation
No.5**

Para 3.34

To assess the effectiveness of the ATO's strategy to identify and resolve activity statement high-risk refunds over time, the ANAO recommends that the ATO:

- develop, document and implement a methodology to assess the overall effectiveness of its high-risk refund compliance strategy to identify and resolve activity statement high-risk refunds;
- regularly analyse the performance of, including the costs of, individual compliance products used to mitigate high risk refunds; and
- develop and implement a systematic approach to report on the effectiveness of its high-risk refund compliance strategy.

ATO response: Agreed.

**Recommendation
No.6****Para 3.61**

To assess the effectiveness of the changes made to the identification of high-risk refunds in 2004, including the effectiveness of the ATO's policy to override key tests in the Risk Rating Engine, and changes made to Risk Rating Engine tests, the ANAO recommends that the ATO:

- document the objectives of the override policy and the expected results of the policy;
- develop, document and apply a methodology to assess the performance of the override policy combined with the changes made to the Risk Rating Engine tests;
- develop, document, implement, and report on, a well coordinated quality assurance process for activity statement refunds subject to the override policy; and
- report to the relevant executive body on the performance of the override policy and the changes to the Risk Rating Engine tests.

ATO response: Agreed.

**Recommendation
No.7**

Para 4.24

To provide adequate assurance that information technology systems, which support activity statement refund processing are operating as specified, the ANAO recommends that the ATO:

- compile and maintain comprehensive systems specifications documentation for the Refunder system;
- revise document management processes and procedures to maintain effective version control and ensure accessibility by appropriate staff for the Refunder system; and
- as part of its testing program, undertake regression testing relating to Refunder system changes to assess the overall effectiveness of relevant activity statement refund processing systems.

ATO response: Agreed.

Audit Findings and Conclusions

1. Background and context

This chapter establishes the background to the audit, provides contextual information relevant to the Australian Taxation Office's administration of activity statement refunds, and outlines the audit's objective and methodology.

Background

Australian Taxation Office revenue collection and refunds

1.1 The Australian Taxation Office (ATO) is responsible for effectively managing and shaping systems that support and fund services for Australians, and give effect to social and economic policy through the tax system. It is Australia's principal revenue collection agency, collecting over \$265.5 billion (gross)¹³ in tax and excise revenue in 2004–05.

1.2 In the same year, the ATO was responsible for processing over 11.9 million refunds, worth approximately \$50.7 billion.¹⁴ Of these refunds, 2.1 million were claimed through activity statements, with a total value of \$28.1 billion.¹⁵

1.3 As at 30 June 2005, 20 797 full-time equivalent staff were employed by the ATO.¹⁶ The ATO advised that 439 full-time equivalent staff undertook activity statement refund processing and compliance activities at a cost of \$28.5 million.

¹³ Gross revenue collections refer to total tax revenue collections excluding refunds that have been sent to taxpayers. See Commissioner of Taxation, *Taxation Annual Report 2004–05*, p.39 and p.42.

¹⁴ Commissioner of Taxation, *ibid.*, pp.42–54.

¹⁵ *ibid.*

¹⁶ *ibid.* p.17

Administering activity statements within a self-assessment environment

1.4 Activity statements were introduced on 1 July 2000 as part of *A New Tax System* (ANTS).¹⁷ They are the ATO approved forms used by taxpayers to report and remit certain tax obligations.¹⁸

1.5 Under Australia's self-assessment taxation system taxpayers are only required to provide a limited amount of information on activity statement forms regarding their relevant tax obligations. However, taxpayers are required to retain detailed records to substantiate the information provided in their activity statements.

1.6 The claims made by taxpayers in activity statements are generally accepted by the ATO, usually without adjustment. However, all activity statements may be subject to further review by the ATO up to four years after the tax becomes due and payable. Where anti-avoidance provisions apply, the period is extended to six years. Where anti-avoidance is due to fraud or evasion, there is no time limit on amending the activity statement.

1.7 To obtain assurance that taxpayers are completing their activity statement forms correctly, the ATO uses a risk-based approach to identify activity statements (including activity statement refunds) that are at risk of being incorrect. A sound, risk-based approach to identifying incorrect activity statements is important because of the:

- large number of activity statements processed by the ATO. This prevents it from examining each activity statement in detail¹⁹; and
- limited information contained on activity statements. That is, the amount of information contained on an activity statement does not provide enough information to fully determine whether taxpayers have complied with their relevant activity statement tax obligations. The

¹⁷ There are two types of activity statements: Business Activity Statements (BAS) - which are used by taxpayers who are registered for Goods and Services Tax (GST)) and Instalment Activity Statements (IAS) - which are used by taxpayers who are not registered for GST. Although taxpayers need only complete one activity statement each reporting period, the ATO currently produces nine separate BAS forms and five separate IAS forms (used by those taxpayers not required to register for GST). For more information on the characteristics of each see Audit Report No. 33, 2003–04, *The Australian Taxation Office's Collection and Management of Activity Statement Information*, March 2004.

¹⁸ These specific tax obligations include: the GST; Pay As You Go (PAYG); Fringe Benefits Tax (FBT); Wine Equalisation Tax (WET); Luxury Car Tax (LCT); and deferred company instalment (COIN) obligations.

¹⁹ In 2004–05 the ATO processed 16.8 million activity statements.

ATO may need to request and review additional information from taxpayers (which taxpayers are required to keep), to determine whether activity statements are valid.

What is an Activity Statement Refund?

1.8 An activity statement refund arises where the credit entitlements claimed on an activity statement are greater than the debts recorded on that statement.²⁰ A taxpayer is entitled to receive a full activity statement refund amount where the taxpayer:

- does not have any other current primary tax debts (for example, unpaid Income Tax, Fringe Benefits Tax, or GST);
- has submitted all outstanding activity statements; and
- does not have a debt with another Commonwealth agency which is permitted to garnishee tax refunds.²¹

1.9 All activity statement refunds must be paid into a financial institution account (for example, a bank account) nominated by the taxpayer. If the taxpayer does not provide financial institution account details to the ATO, their activity statement refund may be withheld until that information is provided.

1.10 Where the ATO does not process an activity statement refund within 14 days of receiving that statement, the taxpayer is entitled to receive interest on that refund amount. This is known as Delayed Refund Interest (DRI).²²

1.11 Where a taxpayer does not pay the correct amount of tax on time (for example, by failing to lodge an activity statement on time) the taxpayer may be liable to pay interest on their tax liability. This is known as the General Interest Charge (GIC).

Who claims Activity Statement Refunds?

1.12 Activity statement refunds are claimed by a wide range of taxpayers, from large companies through to individual members of the public. Figure 1.1

²⁰ Label 9 on all activity statement forms is used by the taxpayer to record whether they have a tax liability owing, or a refund. The ANAO considers that an activity statement refund occurs when a credit balance occurs in Label 9.

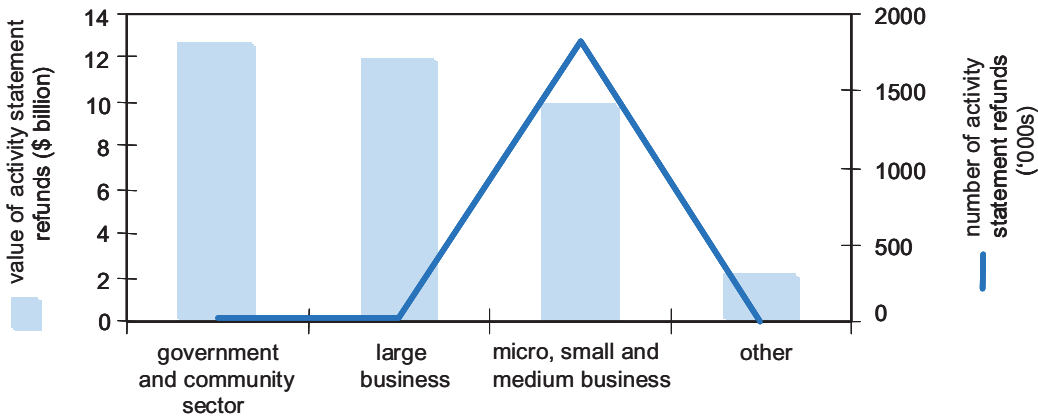
²¹ Examples of Commonwealth agencies that garnishee activity statement refunds include the Child Support Agency and Centrelink.

²² DRI is discussed further in paragraphs 2.56 to 2.60.

below provides an overview of the types of taxpayers claiming activity statement refunds, and the value of those refunds.

Figure 1.1

The value and number of activity statement refunds by taxpayer category for 2004–05



Source: ANAO analysis of ATO data²³

1.13 Figure 1.1 shows that although micro, small and medium business²⁴ lodge approximately 97 per cent of the total number of activity statement refunds processed by the ATO, the value of these refunds is comparatively small (26 per cent of the total value of activity statement refunds claimed in 2004–05).

1.14 Conversely, large business and the government and community sector²⁵ lodge a small number of activity statement refunds (combined, this is approximately two per cent of the total number of activity statements lodged in 2004–05). However the refunds applicable to these taxpayer groups are approximately 68 per cent of the total value of activity statement refunds claimed in 2004–05.

²³ The 'Other' category in Figure 1.1 includes some not for profit organisations, and instances where the ATO has not been able to categorise a taxpayer into a taxpayer category.

²⁴ Micro businesses are defined as entities experiencing an annual turnover of less than \$2 million as distinguished from small to medium business enterprises that have a turnover of between \$2 million and \$100 million annually.

²⁵ The Large business sector encompasses all business entities that have an annual turnover of greater than \$100 million. The government and community sector comprises federal, state and territory government bodies and not for profit organisations including charitable, religious and community service organisations.

1.15 As shown above, the number and value of activity statement refunds claimed by each taxpayer category varies markedly. The ATO uses strategies tailored to each taxpayer category to identify activity statements that may not be correct (that is, high risk refunds). The distinct areas of the ATO responsible for managing the activity statement refunds relevant to each taxpayer category are discussed in Chapters 2 and 4.

What is a High-Risk Refund?

1.16 Although the term High-Risk Refund (HRR) can also be used to describe certain income tax refunds, for the purposes of this audit, HRRs refer only to high-risk activity statement refunds.

1.17 A HRR is a potentially incorrect refund²⁶ claimed through an activity statement, which could result in a significant risk to revenue, or which could undermine the community's confidence in the ATO's administration of the tax system. The ATO advised that the following are broad categorisations of the reasons for such incorrect refunds:²⁷

- fraud. This is where the taxpayer deliberately attempts to defraud the Commonwealth, usually by disguising their activities as a business in order to obtain a refund.
- non-compliance with the tax law. This occurs where a taxpayer is unable to demonstrate that they have fully complied with their obligations under GST and other taxation laws to claim a refund. The principal reasons for non-compliance involve an absence of relevant tax invoices and income recognition timing issues.
- misapplication of the tax law. This results from a taxpayer's lack of understanding of, or poor interpretation of, the tax law. It can also result from taxpayer's attempting to push the boundaries of the tax law.
- administrative error. These errors can arise from taxpayers having poor administrative systems, which result in activity statements being

²⁶ An incorrect refund occurs where the ATO has paid to a taxpayer an amount to which they are not entitled. Examples of funds being incorrectly paid to a taxpayer can include, but are not limited to, the overpayment of interest; or processing of an income tax return or activity statement incorrectly. An incorrect refund may be the result of: a system error; taxpayer and/or staff error; or a deliberate intention to defraud the Commonwealth.

²⁷ Incorrect activity statement refunds may also arise from ATO administrative errors. This occurred notably in a large refund being issued incorrectly in 2001 (see Appendix 2).

completed incorrectly. The most common errors involve the taxpayer transposing numbers on their activity statement and including dollars and cents instead of whole dollars. These later may sometimes be compounded by the ATO scanning of activity statements.

1.18 The ATO uses a number of compliance products²⁸ to identify and resolve HRRs, which are applied pre-issue (before the refund is issued to the taxpayer) or post-issue (after the refund has been issued). The ATO's compliance products, and the application of these products in either a pre-issue or post-issue environment, are discussed in Chapter 3.

Significance of activity statement refunds and HRRs

1.19 As discussed in Audit Report No.33, 2003–04, *The Australian Taxation Office's Collection and Management of Activity Statement Information* (the Activity Statement audit), processing activity statements effectively was 'key to the New Tax System' and was a 'mission critical activity for the ATO'.²⁹ The following statistics illustrate the importance of having robust activity statement refund systems to protect revenue, and the challenges faced by the ATO in processing large numbers of activity statement refunds:

- approximately 10.5 per cent of gross tax revenue collected by the ATO in 2004–05 was refunded to taxpayers through activity statements;
- the number of activity statements processed increased from 10.9 million in 2000–01 to 16.8 million in 2004–05 (a 53 per cent increase);
- the number of activity statements refunds increased from 1.5 million in 2000–01 to 2.1 million in 2004–05 (a 41 per cent increase);
- HRRs account for 4 per cent (approximately 82 000 activity statements) of the total number of activity statement refunds processed in 2004–05;
- HRRs account for 45 per cent of the total value of those refunds (\$12.6 billion); and

²⁸ A compliance product refers to the mechanism the ATO uses to enforce taxpayer compliance with the tax law. Compliance products include tax audits, as well as reviews of taxpayers. The range of compliance products used by the ATO is described in paragraphs 3.25 to 3.26.

²⁹ Audit report No. 33, 2003–04, *ibid.* p.27.

- through compliance activity applicable to HRRs, the ATO recovered approximately \$450 million in 2004–05.³⁰

1.20 The ATO estimates that if it did not have processes in place to identify HRRs and amend incorrect activity statements, between \$500 million and \$1 billion in taxation revenue would be at risk annually.

1.21 These statistics show that identifying and resolving HRRs represents a considerable challenge to the ATO, both in terms of the large volume of refunds that need to be processed, and the large amount of revenue potentially at risk if HRRs are not detected.³¹

Context

1.22 With the introduction of ANTS in 2000–01, the ATO adopted a new approach to provide assurance that taxpayers were complying with their activity statement tax obligations. The cornerstone of this approach was assessing the risk of activity statements being incorrect before refunds are issued to taxpayers (this is also known as a pre-issue compliance approach).³²

1.23 Since that time, the ATO has made significant and ongoing changes to the systems, processes and controls it uses to process activity statement refunds and identify HRRs. Although these changes can be attributed to the ATO's improved understanding of taxpayer compliance (which has developed over time), change also resulted from a large activity statement refund being issued incorrectly in 2001. This case is referred to as the '2001 case', and is described in more detail in Appendix 2.

1.24 The '2001 case' led to a review of all aspects of activity statement processing, and resulted in the introduction of stringent controls to provide the ATO with assurance that only correct activity statement refunds were being issued. These controls included new criteria to determine which activity statements were to be considered 'high-risk'.

³⁰ ANAO analysis of 2000–01 to 2004–05 ATO data. The ATO advised that there are some discrepancies which cannot be reconciled between the data used to compile these statistics, and the data used in the Commissioner of Taxation's Annual Report 2004–05. The statistics presented are only indicative of the volumes and revenues applicable to the ATO administration of activity statements, activity statement refunds and HRRs.

³¹ A more detailed analysis of refund data is contained in Appendix 3.

³² The evolution of the ATO's compliance approach is discussed further in paragraphs 3.20 to 3.24.

1.25 A consequence of this more conservative approach to refund processing was that large numbers of high value activity statement refunds were stopped and manually examined by ATO staff prior to being issued. This manual examination process lengthened the time it took the ATO to issue activity statement refunds.

The management challenge – refund timeliness versus refund validity

1.26 The ATO recognises that, under a pre-issue compliance approach, it needs to strike the right balance between obtaining assurance that the length of time it takes to process refunds is acceptable, and that the activity statement refunds it issues are valid.³³ The ATO's 2004–05 Operations Sub-plan states that:

...The community expects that the right amount of refunds are paid on time to the right person. The government needs to have confidence that we have the right checks and controls in place to allow this to occur. These measures must provide the right balance between protecting the revenue and not causing others to experience cash flow problems by our inactions.³⁴

1.27 Following the changes made to activity statement refund processes resulting from the '2001 case', the ATO received complaints from the community regarding the length of time it took to issue activity statement refunds. The Inspector-General of Taxation, after receiving submissions from Australian businesses, noted that a slow refund process could have a detrimental effect on a business' operations.³⁵

1.28 Although timely refund processing is an important aspect of effective activity statement administration, providing assurance that the revenue refunded by the ATO is valid is equally important. With the introduction of activity statements in 2000–01 the ATO determined that a failure of activity statement refund systems to effectively detect incorrect refunds before they are issued to taxpayers has the potential to:

³³ The amount and type of information contained in an activity statement does not allow the ATO to fully assess whether a refund claimed in that activity statement is correct. For the purposes of this audit, a valid activity statement refund is a refund that has been assessed using risk-based processes to determine whether the limited information provided in that statement is likely to be correct.

³⁴ ATO Operations Sub-plan Part B 2004–05 p.11.

³⁵ Inspector-General of Taxation, January 2005, *Review of Tax Office administration of GST refunds resulting from the lodgment of credit BASs*, p.3. This report is discussed further in paragraph 1.34 to 1.36.

- impact Commonwealth revenue detrimentally; and
- undermine community confidence in the ATO's ability to manage the tax system.

1.29 A key theme examined throughout this report is whether the ATO has achieved the right balance between issuing timely activity statement refunds, and valid ones.

The end-to-end activity statement process

1.30 As discussed in the Activity Statement Audit, there are a number of distinct functions that comprise the 'end-to-end' activity statement process, which includes the activity statement refund process. These functions include:

- client (taxpayer) registration³⁶;
- activity statement generation³⁷;
- activity statement data capture³⁸;
- activity statement processing³⁹;
- activity statement refund finalisation⁴⁰; and
- debt recovery and activity statement non-lodgement.

1.31 As part of the audit, the ANAO examined two functions of the end-to-end process that are particularly relevant to activity statement refund processing. These are activity statement processing and refund finalisation. These functions were selected as they:

³⁶ Includes the registration of taxpayers for an Australian Business Number (ABN) and for the GST. This function was examined as part of Audit report No. 59, 2002–03, *Administration of Australian Business Number Registrations*.

³⁷ Includes the systems, processes and controls used to identify the type of activity statement required by registered taxpayers, and the mechanisms to deliver activity statements to them.

³⁸ The process of capturing activity statement information electronically, or capturing and translating paper-based activity statement information to an electronic form. This function was examined as part of Audit Report No. 33, 2003–04, *ibid*.

³⁹ The process of identifying and correcting incorrect information contained on activity statements, prior to finalisation. This also includes the identification and correction of incorrect refunds. Aspects of this function were examined as part of Audit report No. 33, 2003–04, *ibid*.

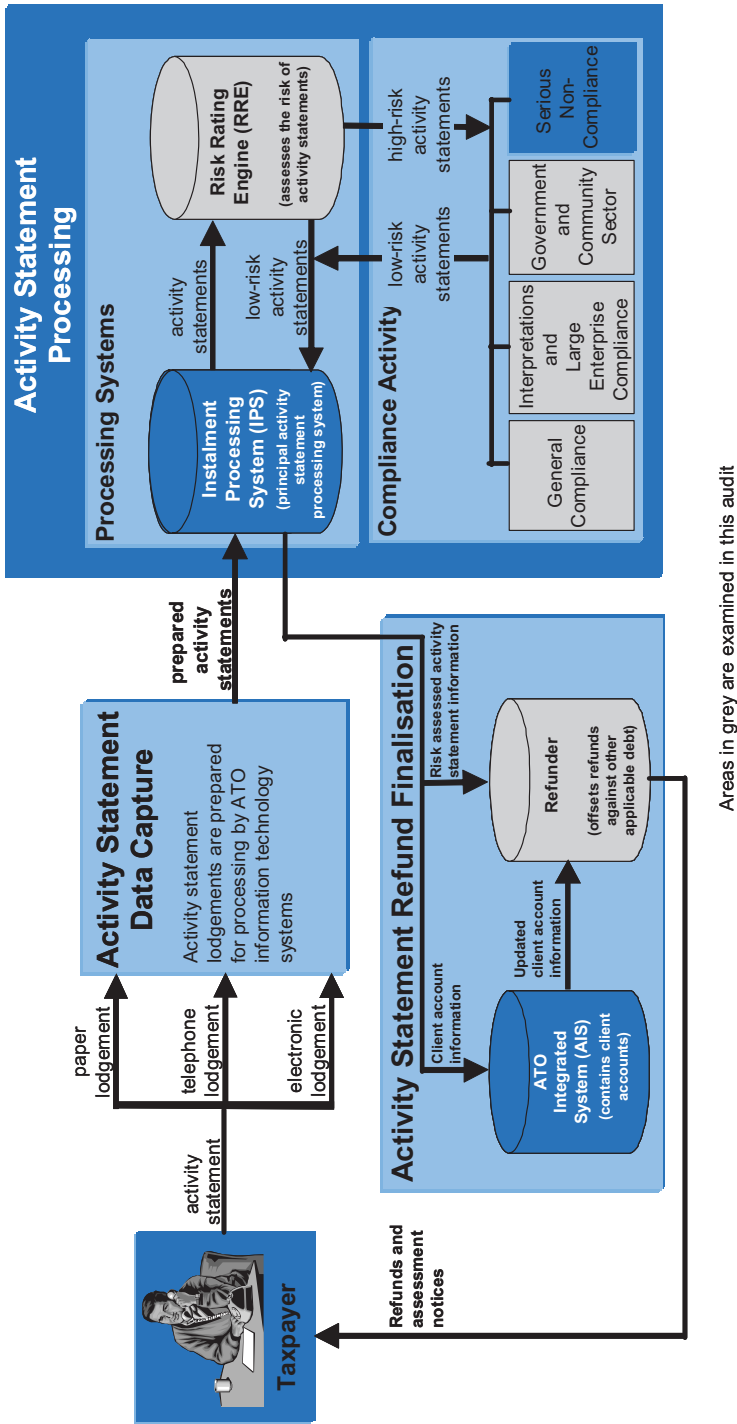
⁴⁰ Includes the systems, processes and controls to determine and confirm a taxpayer's overall tax position. This includes offsetting activity statement refunds against other tax liabilities, and other specified Commonwealth debt.

- cover the main ATO systems, processes and controls that are used to administer activity statement refunds, and identify and correct HRRs; and
- complement a series of performance audits already undertaken by the ANAO on aspects of ANTS. This audit will complete the ANAO's examination of the '*end-to-end*' activity statement process (see paragraph 1.40).

1.32 Activity statement processing and refund finalisation are complex functions of the end-to-end activity statement process, and comprise a number of IT systems and manual processes. Figure 1.2 provides a high-level overview of the end-to-end activity statement process, and the areas examined in the audit.

Figure 1.2

High-level overview of the end-to-end activity statement process



Source: ANAO analysis of ATO systems information.

1.33 The operation of the principal IT systems (the RRE and Refunder) used to identify and process HRRs, are explained in Chapter 4. Compliance activity applicable to identifying and resolving activity statement high-risk refunds is discussed in Chapter 3.

The review of GST refunds by the Inspector-General of Taxation

1.34 On the 19 January 2005 the Inspector-General completed a *Review of Tax Office administration of GST refunds resulting from the lodgment of credit BASs*. The focus of the review was on:

...evaluating the balance between competing priorities of protecting the revenue from mistaken or fraudulent refund claims and the necessity of maintaining cash flows for business and other entities by expeditiously issuing refunds.⁴¹

1.35 The Inspector-General made 12 recommendations in his report aimed at improving the ATO's administration of GST refunds. Two key recommendations in his report focus on the ATO:

- improving its systems to better match the risk issues associated with paying GST refunds; and
- establishing 'whole of office' systems which measure the total elapsed time for the payment of GST refunds.

1.36 At the time of the audit, the ATO had invested significant resources in, and was making progress towards, implementing the Inspector-General's recommendations.

Audit Objective and Methodology

Audit Objective

1.37 The objective of the audit was to assess the ATO's administration of activity statement HRRs. Specifically the audit sought to:

- examine aspects of ATO governance relevant to its administration of activity statement HRRs. This includes: ATO planning, the integration between Lines to administer HRRs; corporate risk management processes; and performance management;

⁴¹ Inspector-General of Taxation, January 2005, *ibid.* p.59.

- assess the ATO's methodology and practice to identify and, if necessary, correct activity statement HRRs; and
- identify and assess the IT and manual systems, processes and controls used by the ATO to process HRRs resulting from the lodgement of activity statements.

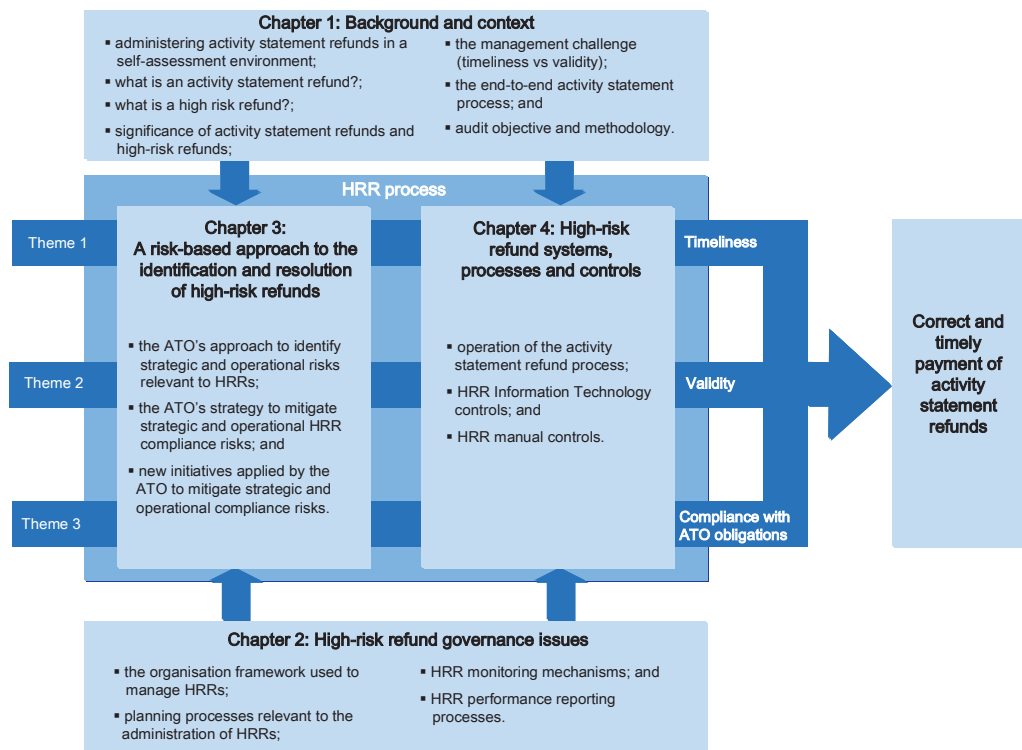
1.38 The audit also examines the following themes in relation to activity HRRs:

- the time it takes to process HRRs;
- whether the refunds the ATO issues are valid; and
- whether the ATO complies with its obligations under tax legislation and the Taxpayer's Charter.

1.39 Figure 1.3 depicts the structure of the report.

Figure 1.3

Audit Report Structure



Source: ANAO.

Audit Methodology

1.40 This is one of a series of audits into aspects of ANTS, and completes the ANAO's examination of the end-to-end activity statement process. The other audits completed in this series are:

- Audit Report No. 19, 2002–03, *The Australian Taxation Office's Management of its Relationship with Tax Practitioners*. December 2002;
- Audit Report No. 55, 2002–03, *Goods and Services Tax Fraud Prevention and Control*. June 2003;
- Audit Report No. 59, 2002–03, *Administration of Australian Business Number Registrations*. June 2003;
- Audit Report No. 33, 2003–04, *Australian Taxation Office's Collection and Management of Activity Statement Information*. March 2004; and
- Audit Report No. 13, 2005–06, *Administration of Goods and Services Tax Compliance in the Large Business Market Segment*. October 2005.

1.41 Audit fieldwork was conducted between May and October 2005. In addition to the review of documentation, the ANAO undertook quantitative and qualitative analysis of ATO information from a number of ATO Lines. Interviews with relevant ATO staff from these Lines were also undertaken.

1.42 Interviews were conducted with stakeholders with an interest in the activity statement refund process. These included representatives from the: Commonwealth Ombudsman's Office; office of the Inspector-General of Taxation; the Institute of Chartered Accountants Australia (ICAA); Australian Society of Certified Practising Accountants (ASCPA); National Institute of Accountants (NIA); and the National Tax and Accountants' Association (NTAA).

1.43 The ANAO also examined a number of ATO activity statement refund IT systems. This examination analysed information from the following systems: Risk Rating Engine (RRE); Refunder; Automated Workflow Allocation (AWA) system; and Action Queue Service (AQS).

1.44 The audit was conducted in accordance with ANAO auditing standards at a cost of \$480 000.

Acknowledgements

1.45 The ANAO recognises, and appreciates, the contribution of ATO officers, representatives of industry, accounting and tax professional organisations, and Commonwealth organisations, who assisted in the conduct of this audit.

2. High-risk refunds governance issues

This chapter examines aspects of governance relevant to the ATO's administration of HRRs. In particular the ANAO examines how the ATO coordinates its approach to plan, monitor and report on activity statement refunds, and whether this approach provides assurance that HRRs are being managed well.

Introduction

2.1 The administration of HRRs is the responsibility of a number of different functional areas within the ATO. To provide assurance that HRR systems, processes and controls are coordinated and managed effectively, it is important that the ATO has a robust governance framework.

2.2 Although the ANAO comments on aspects of governance throughout the report, this chapter focuses on the higher-level strategies, controls and reporting arrangements the ATO uses to manage HRRs. In particular the ANAO examines:

- the organisational framework;
- relevant planning processes;
- HRR monitoring mechanisms; and
- HRR reporting processes.

2.3 While the ATO's application of risk management to identify and mitigate HRRs is discussed in Chapter 3, the ANAO examines risk management principles relevant to HRR planning, monitoring and reporting in this chapter.

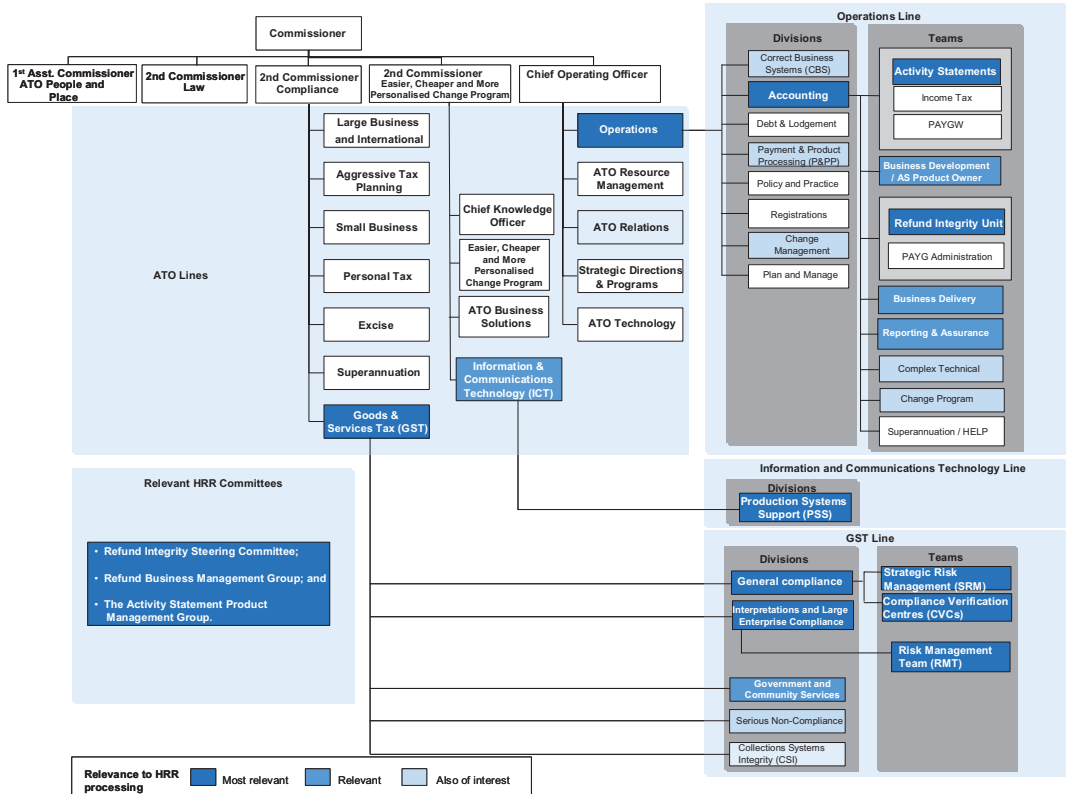
The organisational framework used to manage high risk refunds

2.4 As discussed in Chapter 1, activity statements are used to collect a large amount of summary information relating to a number of business taxes including GST, PAYG and FBT. These taxes are collected from a wide range of taxpayers, from large companies through to individuals. To manage this complex administrative environment, the ATO has an organisational framework structured around Lines, which are supported by a range of

committees and management groups. An abridged organisational framework for managing HRRs is shown below.

Figure 2.1

ATO organisational framework and areas relevant to the administration of high-risk refunds



Source: ANAO analysis of ATO information.

2.5 The figure above shows that many areas (shown in dark blue) are responsible for managing individual aspects of activity statement refund processing. For a description of the functions of these areas see Appendix 4.

2.6 As the ATO's approach to managing HRRs is complex, it is essential that the roles, responsibilities and accountabilities of relevant Lines, divisions and teams are clearly defined and are understood by all staff involved in HRR processing. A disjointed approach to managing HRRs could result in the duplication of processing functions (which may, in turn, result in inefficient

and untimely refund processing), or could result in incorrect refunds being issued.⁴²

Planning processes relevant to the administration of HRRs

2.7 Effective planning processes are particularly important for managing HRRs, as a number of ATO Lines, divisions and teams are responsible for distinct aspects of HRR processing (see Figure 2.1). A detailed description of the ATO's approach to planning processes relevant to managing high-risk refunds is discussed in Appendix 5. This Appendix also describes why it is important that the ATO plans relevant to administering HRRs are linked.

ANAO comment on the ATO's high-risk refund planning framework

2.8 To determine whether the ATO had an integrated and cohesive approach to managing HRRs, the ANAO examined the relevant ATO plans related to the Lines, divisions and teams responsible for activity statement refund processing.⁴³ The ANAO noted that high-level strategic planning documentation was clearly linked to the ATO's output and outcomes framework.

2.9 Although the content of, and links between, higher-level strategic planning documentation (see tiers 1 and 2 in Appendix 5) was adequate to provide assurance that relevant aspects of HRR were addressed, elements of planning at the operational level (tiers 3 and 4 in Appendix 5) need to be improved. In particular:

- some relevant divisions and teams do not have work plans. For example, the Accounting Activity Statement Stream (within the Operations Line) did not have plans for the 2004–05 year;
- for the majority of plans at the operational level (tiers 3 and 4), it is not clear how they are linked to other higher-level plans. It is also unclear

⁴² One cause of the 2001 case (see Appendix 2) was that ATO activity statement processing staff did not have an understanding of ATO systems, or of the manual processes undertaken by ATO staff throughout the end-to-end activity statement process. This emphasises the requirement for a coordinated approach to manage HRRs.

⁴³ The documents examined relate to those areas shown in dark blue in Appendix 5.

whether many of the plans at the operational levels address the relevant strategic priorities and risks identified in the ATO sub-plans⁴⁴;

- it is unclear how the risks identified in many operational level plans (tiers 3 and 4) were determined (that is, whether a robust risk analysis underpinned planning documentation). Some plans do not identify any risks;⁴⁵ and
- the majority of the planning documentation at the operational level (tiers 3 and 4) does not comply with the ATO's Corporate Planning Practice Statement.⁴⁶

2.10 Based on the examination of ATO planning documentation relevant to HRR, the ANAO concluded that the ATO needs to improve relevant planning processes to provide robust assurance that HRRs are being administered in a coordinated and consistent way at the operational level.

Recommendation No.1

2.11 To provide assurance that activity statement high-risk refunds are being managed effectively, and that relevant risks are being mitigated and priorities implemented as intended, the ANAO recommends that the ATO develop and implement:

- an integrated approach to planning within the GST Line and the Operations Line in accordance with relevant ATO practice statements; and
- procedures to provide assurance that ATO planning documentation applicable to the effective administration of high-risk refunds is appropriately linked.

ATO response: Agreed.

⁴⁴ For example, it is unclear how the information contained in the Accounting Delivery Plan (see Appendix 5) is linked to the objectives and risks detailed in the ATO sub-plans.

⁴⁵ ATO Practice Statement CM 2003/02 states that 'The ATO Executive's role is to ensure that all risk reviews are built into the annual planning cycle and are a precursor to the detail of the Sub-Plans'.

⁴⁶ For example, ATO Practice Statement CM 2004/06 states that: '...Lines have delivery or tactical plans that include, at a minimum, those key activities, products, projects and processes for which they have been allocated sub-plan resources. These plans also include performance measures and, where relevant, will reflect the measures in our output outcome framework.' For 2004-05, the ATO did not have a delivery or tactical plan for the Operations Line.

2.12 The Tax Office recognises the need to have an integrated approach to planning. We note the ANAO's acknowledgement of the clear link from the ATO's output and outcomes framework in its high-level strategic planning documentation.

2.13 Through compliance with ATO Practice Statement CM 2004/06 Corporate Planning, the Tax Office will ensure that lower tier plans are prepared, documented and overtly linked to the relevant higher level plans of the organisation.

High-risk refund monitoring mechanisms

2.14 An important aspect of managing HRRs as part of an end-to-end activity statement process is that effective mechanisms exist to monitor refund processes, and identify and rectify systemic problems.⁴⁷ This provides assurance that any potentially systemic refund processing problems (that may go undetected by discrete refund processing areas) are identified in a timely way, before incorrect refunds are issued, or before there are significant delays in refund processing.

2.15 Also, without a robust approach to planning (discussed above), additional pressure is placed on refund monitoring mechanisms to provide assurance that refunds are being processed efficiently and effectively.

Background to HRR monitoring

2.16 The ATO's approach to administering activity statement refunds changed significantly following the completion of the Refund Integrity Project in 2002. The focus of the project was to identify the principal causes of the '2001 case'. Nineteen recommendations were made as part of the Refund Integrity Project, which were aimed at strengthening activity statement refund controls, and at improving the coordination of the various areas responsible for refund processing. These recommendations were fully implemented in July 2003.⁴⁸

2.17 As part of the implementation of the Refund Integrity Project's recommendations, the ATO created several new review bodies to provide

⁴⁷ The end-to-end activity statement process is discussed at paragraph 1.30.

⁴⁸ The implementation of the 19 recommendations of the Refund Integrity Project was examined as part of ANAO Audit Report No. 33, 2003–04 *The Australian Taxation Office's Collection and Management of Activity Statement Information*, March 2004.

ongoing assurance that all refunds⁴⁹ were being managed effectively. These review bodies are:

- the Refund Integrity Team; and
- ATO refund related committees and management groups.

2.18 In addition, the ATO had an existing assurance process, known as the Certificate of Compliance process, in place prior to the commencement of the Refund Integrity Project.

2.19 To assess the effectiveness of the ATO's HRR assurance processes, the ANAO examined the work of the review bodies in paragraph 2.17 and the Certificate of Compliance process.

Refund Integrity Team

2.20 The Refund Integrity Team is a team within the Operations Line that was initially responsible for the implementation of the nineteen recommendations of the Refund Integrity Project. At the completion of the project, it was recommended that the Refund Integrity Team (which is lead by the Refund Integrity Custodian) be maintained. The aim being, to provide a measure of assurance to the Operations Line Executive that all refunds issued by the ATO are correct and timely. The Refund Integrity Team is now tasked with monitoring the end-to-end refund process. The Refund Integrity Team specified these roles and functions as part of its 2005–06 plan.

Has activity statement refund processing improved since the introduction of the Refund Integrity Team?

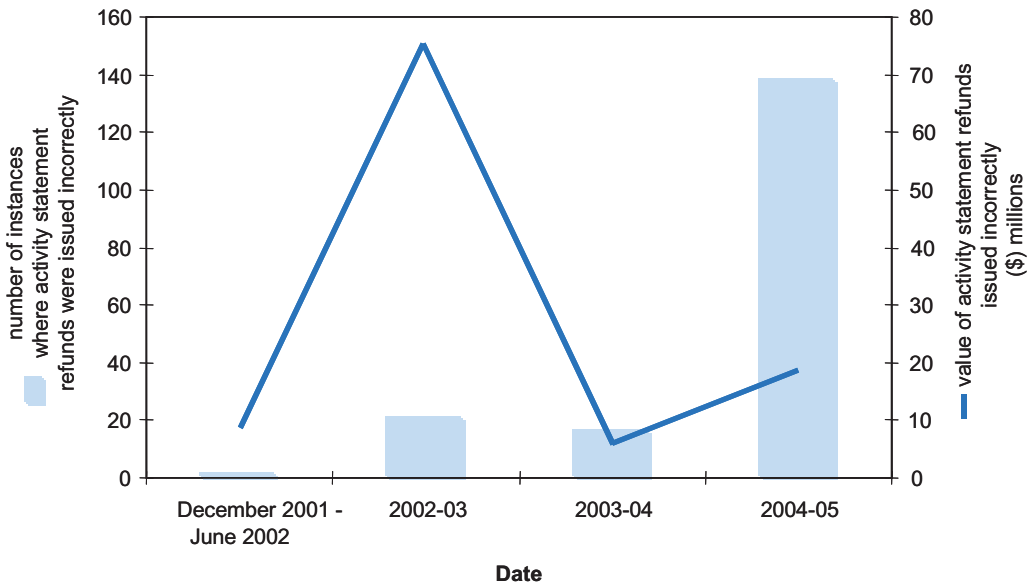
2.21 Since the introduction of the Refund Integrity Team, the ATO has not issued an incorrect refund with characteristics similar to the '2001 case'. This is one indication that the recommendations of the Refund Integrity Project, and the work of the Refund Integrity Team, has helped identify HRRs that would have ordinarily been issued incorrectly.

2.22 However, since 2001 there have been a number of high value refunds that have been issued incorrectly, and subsequently detected by the ATO. Each of these incorrect refunds had different characteristics to the '2001 case'. The incorrect activity statement refunds issued, and subsequently detected, by the ATO is shown in Figure 2.2.

⁴⁹ Including income tax refunds.

Figure 2.2

Number and value of incorrect refunds detected by the ATO after they have been issued from 1 December 2001 – 30 June 2005



Source: ANAO analysis of ATO incorrect refund data.

2.23 The information contained in Figure 2.2 is indicative only of the total number of refunds issued by the ATO incorrectly.⁵⁰ It shows that the number of instances where incorrect activity statement refunds were issued⁵¹, and subsequently detected by the ATO, increased significantly since December 2001.

2.24 The ATO considers that the increases in the number of incorrect refunds recorded, and the low average value of refunds relevant to the cases recorded in the register, may be indicative of improvements in the ATO’s ability to identify and report on incorrect refunds, rather than an increase in the occurrence of incorrect refunds. The ATO notes further, that improvements made in the identification and recording of incorrect refund information between 2003–04 and 2004–05 may account, in part, for the large variances shown in Figure 2.2 for these years.

⁵⁰ The information contained in Figure 2.2 from 2001–02 to 2003–04 is not complete as the ATO’s procedures for identifying and recording incorrect refund information were still being developed at that time.

⁵¹ The total number of incorrect activity statement refunds issued and detected by the ATO since December 2001 is 180.

2.25 That said, the ATO had not undertaken a comprehensive analysis of incorrect refund statistical information, to identify the principal reasons for the large variances in the number of incorrect refunds detected between December 2001 and June 2005.

2.26 In mid-2005 the Refund Integrity Team commenced analysing the statistical information shown in Figure 2.2, to identify the common major causes of incorrect refunds being issued. The ATO stated that the Refund Integrity Team uses this statistical information to monitor and report on the implementation of changes aimed at addressing causes of incorrect refunds. The ANAO considers that, once the statistical information contained in Figure 2.2 is analysed fully, it may assist the ATO to assess its performance in managing HRRs.

The ATO's approach to assessing its management of high-risk refunds

2.27 To assess whether the ATO has improved its management of HRRs over time, it is important that the ATO, has a sound framework to measure its performance regarding the identification and resolution of HRRs.

2.28 At the time of the audit, the Refund Integrity Team had not fully analysed the effectiveness of the ATO's strategies to manage HRRs. Analysis performed by the Refund Integrity Team to date has focussed on identifying common causes and monitoring progress of actions taken to prevent their re-occurrence. This analysis should be extended to include an assessment of whether the initiatives introduced since the '2001 case' have improved the identification and resolution of HRRs. Without this type of performance assessment, the ATO cannot:

- fully assess its overall performance regarding the successful identification and resolution of HRRs, and adequately identify which aspects of the end-to-end activity statement process need to be strengthened to improve refund processing; and
- provide the ATO Executive with strong assurance that activity statement refund systems, processes and controls are reducing the number and value of incorrect refunds issued by the ATO.⁵²

2.29 The ANAO considers that for performance assessment to be thorough, the ATO must include measures of both the timely processing of activity

⁵² The ATO's refund control monitoring is discussed further in paragraph 2.46 when the ANAO examines the Certificate of Compliance process.

statement refunds⁵³, and whether the activity statements it issues are valid. These measures should be monitored by the Refund Integrity Team, and regularly reported to the area responsible for overseeing the ATO's management of refunds.⁵⁴ Performance reporting is discussed further in paragraphs 2.50 to 2.52.

2.30 During the audit, the ATO advised that its Refund Business Management Group (see Appendix 6 for a description of the group) commenced work to identify key performance indicators relevant to the end-to-end activity statement process.⁵⁵ This is a positive step in developing an effective framework for the ATO to monitor and report on its administration of activity statement refunds (including HRRs).

Recommendation No.2

2.31 To provide robust assurance that the activity statement refund process is efficient and effective, the ANAO recommends that the ATO:

- develop a framework to assess the performance of activity statement refund processing, which includes measures of both timeliness and the validity of activity statements issued by the ATO; and
- report regularly on the performance of activity statement refund processing to the relevant ATO area responsible for overseeing ATO refund processing.

ATO response: Agreed.

⁵³ In 2004–05, the ATO introduced revised procedures to assess the length of time it takes to process activity statement refunds. The ANAO notes that these revised performance measures have improved the ATO's measure of 'timeliness'. This performance measure is discussed further in paragraphs 2.53 to 2.60.

⁵⁴ The ANAO considers that the Refund Integrity Steering Committee or the management groups responsible for overseeing end-to-end activity statement processing should receive and analyse performance information of this kind. The committee and management groups are discussed in paragraphs 2.37 to 2.42.

⁵⁵ The ATO advised that the Refund Business Management Group was developing relevant key performance indicators in response to recommendations made by the Inspector-General of Taxation (see paragraph 1.34). The ANAO notes that the Inspector-General made recommendations relevant to the timely processing of GST refunds only, and considers that the ATO should also develop performance measures to examine the validity of activity statement refunds issued to taxpayers. One source of information to examine the validity of activity statement refunds, is the Incorrect Refund Register.

2.32 The Tax Office accepts this recommendation.

2.33 We note the acknowledgement in the report of our initial positive steps in the identification of key performance indicators for end-to-end activity statement processing. We will build on this work to finalise an effective framework to assess the overall performance of activity statement refund processing. We will continue with the risk-based processes that determine whether the limited information provided in that statement is likely to be correct before refunds are released.

Impact of issuing incorrect refunds on tax revenue

2.34 Figure 2.2 shows that that, since December 2001, the ATO identified approximately \$110 million in activity statement refunds it issued incorrectly, with the largest incorrect refund worth approximately \$11 million.⁵⁶ Notably, this amount is significantly higher than the incorrect refund issued in the '2001 case'. However the risks to the ATO's reputation associated with the \$11 million refund were significantly lower than the '2001 case' and the revenue relating to this refund was recovered easily.

2.35 Since May 2004, the ATO has used an Incorrect Refund Register to record and monitor incorrect refunds on a case-by-case basis. This allows the ATO to actively monitor how much revenue it recovers from each incorrect refund issued.

2.36 As at 17 July 2005, the ATO had been able to recover \$18.9 million of the \$19 million in refunds identified as incorrectly paid in 2004–05.⁵⁷ This statistic indicates that where the ATO detects incorrect refunds, there is a high likelihood that it will be able to recover the revenue applicable to that refund. However, as illustrated by the '2001 case', the community's perceptions of the ATO's ability to administer refunds effectively is a key reputational risk to the ATO, which is not always related to its ability to recover refunds issued in error.

⁵⁶ The ANAO was unable to determine what proportion of the \$110 million incorrect refunds has been recovered, as refund information relating to 2001–02, 2002–03 and 2003–04 is incomplete.

⁵⁷ Prior to 2004–05 the ATO did not record the amount it recovered from incorrect activity statement refunds. Between December 2001 and June 2004 the ATO issued \$163 million in incorrect refunds. The ATO has not determined what proportion of these refunds has been recovered.

ATO refund related committees and management groups

2.37 Committees and management groups play an important part in coordinating projects affecting the end-to-end activity statement process⁵⁸, including monitoring refund processing performance, and approving changes to the end-to-end refund process. Importantly, the committees and management groups comprise staff from a wide variety of relevant Lines, divisions and teams. This promotes a coordinated approach to formulate ATO refund policy, and resolve refund processing issues.

2.38 The ANAO examined the committee and management groups responsible for overseeing refund processing. These are the:

- Refund Integrity Steering Committee;
- Refund Business Management Group; and
- Activity Statement Product Management Group.

2.39 The framework of the ATO committee and management groups related to refunds, are reviewed Appendix 6.

ANAO comment on the ATO's committee and management group framework

2.40 For the refund committee and management group framework to be efficient and effective, the ATO must clearly define the roles and responsibilities of each committee and management group. The ATO undertook measures to define the roles and responsibilities of the committee and management groups (see Appendix 6). However these measures (which include the development of comprehensive charters) were not finalised at the time of the audit.

2.41 If the roles and functions of the committee and management groups are not clearly defined, there is a risk that work may be duplicated, or not carried out at all.

2.42 The ANAO also considers that clearly defining the roles and responsibilities of the committee and management groups will provide greater accountability for important decisions involving HRRs, such as the application of the override policy (see paragraphs 3.40 to 3.53). To further improve accountability, significant decisions made by committees and management groups (and the justification for those decisions) should be adequately

⁵⁸ Consistent with Figure 2.1, most projects involve a number of Lines, divisions and teams. The committees and management groups are used to coordinate this activity.

documented in accordance with Australian standards on record management.⁵⁹

Recommendation No.3

2.43 To improve the efficiency and effectiveness of relevant activity statement refund committees and groups, the ANAO recommends that the ATO complete the process to:

- clearly establish and document the roles, responsibilities and accountabilities of committees and management groups;
- clearly define and document the interrelationships between committees and the management groups; and
- document all major decisions made by the relevant committees and groups, and the reasons for those decisions in accordance with Australian records management standards.

ATO response: Agreed.

2.44 The Tax Office accepts this recommendation. Since the completion of the audit the Tax Office has implemented changes that substantively address the recommendation. Specifically, the Credit-Refund Integrity Steering Committee:

- has agreed and documented its role, functions, composition and relationship with the Refund Business Management Group(s); and
- will record and maintain minutes of its meetings, decisions and action items.

2.45 We are in the process of engaging an external organisation to deliver a base-line risk framework against which we can further assess the completeness of our existing strategic and operational governance and controls.

The Certificate of Compliance process

2.46 The *Certificate of Compliance for the Payment of Public Money (through Client Account Management)* process assures the ATO's Chief Finance Officer that all payments of public monies by the ATO are correct, following

⁵⁹ See AS ISO 15489.1-2002 *Australian Standard, Records Management Part 1: General*, 9.1. Better practice in records management is also discussed in Audit Report No. 7, 2003–04, *Recordkeeping in Large Commonwealth Organisations*, September 2003.

processing by ATO IT systems. Assurance is provided through the identification of key controls using a risk assessment process. Once identified, controls are continually assessed by ATO operational staff, and the effectiveness of these controls is reported on a monthly basis to ATO national managers. A large number of the controls monitored as part of the Certificate of Compliance process are found in HRR related systems.

2.47 The ANAO examined the Certificate of Compliance process as part of its financial statements audit program, and in performance audits conducted in 2003–04 and 2004–05.⁶⁰ In these audits, the ANAO found that the Certificate of Compliance process was not fully effective in providing assurance that public monies were being paid correctly.

2.48 Since that time, the ATO has improved the Certificate of Compliance process. In particular, it has undertaken a new risk assessment to identify controls that are key to providing assurance that public monies are being paid correctly.⁶¹ The ANAO notes that the reports used by operational staff to report on the effectiveness of these controls are more meaningful⁶², and provide a higher level of assurance that the end-to-end activity statement process is effective.

2.49 However, the ANAO considers that the Certificate of Compliance process requires further improvement to be fully effective. To identify improvements required to the process, the ATO commissioned an independent review⁶³ of its financial management framework (including the Certificate of Compliance process).

High-risk refund performance reporting processes

2.50 Performance reporting is an important aspect of HRR management. Without the timely collection and analysis of performance information, informed decisions about the management of HRRs cannot be made.

⁶⁰ Auditor-General Report No. 33, 2003–04, *ibid.* Auditor-General Report No. 39, 2004–05, *The Australian Taxation Office's Administration of the Superannuation Contributions Surcharge*, April 2005.

⁶¹ The ATO undertook a risk review of all Certificate of Compliance related controls in March 2004. This review was undertaken in accordance with ATO risk assessment methodology.

⁶² These reports are known as Certificates of Evidence. The ANAO has viewed examples where these reports have been effective in identifying potential weaknesses within the end-to-end refund process. For example, the miscalculation of DRI.

⁶³ The independent review by Ernst and Young commenced in 2004 and was not finalised at the time of the audit.

Timeliness, consistency and coordination are crucial aspects of reporting HRR performance as:

- there are a number of areas within the ATO responsible for processing activity statements (see Figure 2.1);
- staff from these divisions are distributed nationally; and
- each Line, division and team does not report solely on their HRR performance, and there is not a standard approach to reporting across these areas (from an HRR perspective).

2.51 As discussed in paragraphs 2.8 to 2.10, the ATO does not have a coordinated approach to planning for all relevant areas with HRR processing responsibilities. Similarly, in paragraphs 2.27 to 2.30, the ANAO found that at the time of the audit, the ATO did not have a robust approach to report on all aspects of performance of activity statement refund processing (including HRRs and incorrect refunds). The ANAO makes specific comment about HRR compliance performance reporting practices in Chapter 3.

2.52 During the audit the ATO made progress to improve the quality and type of HRR performance information it collects, analyses and reports. In particular, the information the ATO reports publicly is now more accurate and meaningful. The ATO's public reporting arrangements are discussed below.

ATO public reporting responsibilities relevant to high-risk refunds

2.53 When the ANTS legislation was introduced in 2000, a key commitment from the Government was that activity statement processing would be timely. This commitment is measured and reported against commitments made in the ATO Taxpayers' Charter service standards.

Taxpayers' Charter service standards

2.54 The Taxpayers' Charter outlines taxpayers' rights and obligations under the law as well as the service and other standards they can expect from the ATO.⁶⁴ The ATO has 18 service standards to measure how it performs in a range of areas covering most aspects of its administrative responsibilities. One relates specifically to the processing of HRRs. This standard specifies that the ATO will process activity statement refunds within 14 days.⁶⁵ The performance

⁶⁴ Audit Report No. 19, 2004–05, *Taxpayers' Charter* provides a detailed explanation of the Taxpayers' Charter and ATO obligations under the Charter.

⁶⁵ The ATO notes that it may take longer to process an activity statement that is incomplete, incorrect or one that needs checking.

benchmark set by the ATO to determine whether it is successfully meeting this standard is that 92 per cent of activity statement refunds are processed within 14 days.

2.55 Since 2001–02 the ATO has reported that it has met this performance benchmark. However, ATO reporting on this performance benchmark between 2001–02 and 2003–04 was flawed.

Assessing and reporting against the 14 day standard

2.56 An aspect of the Government's commitment that activity statement processing would be timely, involved compensating the taxpayer for delays in processing activity statement refunds, including where ATO activity statement refund processing procedures delay the refund from issuing within 14 days.

2.57 This compensation is known as Delayed Refund Interest (DRI)⁶⁶, and is calculated from the 14th day after the later of the following days:

- the date of lodgement of the activity statement; or
- the received date for all information necessary to process the refund from the taxpayer.⁶⁷

2.58 In simple terms, where the taxpayer is at fault for delaying the processing of refunds, the ATO does not pay DRI. Where the ATO is at fault for delaying the refund, the Government pays DRI.

2.59 Between 2000–01 and 2003–04, the ATO determined whether it had met the 14 day standard by determining how many refunds attracted DRI, and comparing this to the number of refunds processed. This method of assessing the 14 day standard was flawed because:

- one DRI payment can relate to a number of activity statement refunds; and
- multiple DRI payments can result from a single refund.

⁶⁶ For the quarter September 2005 the rate of DRI was 5.68 per cent.

⁶⁷ Specifically, section 35-5 of A New Tax System (Goods and Services Tax) Act 1999 provides for interest payable (DRI) if the ATO is 'late' in processing an activity statement refund. This provision is outlined in s12 AA of the Taxation (Interest on overpayments and early payments) Act [T(IOEPA) A] 1983.

2.60 During the audit, the ATO advised that it had identified this issue, and that it revised the methodology used to measure the 14 day standard from 2004–05. Further, the ATO noted that it now individually measures the time it takes to process each activity statement refund. The ANAO considers that with the introduction of these measures, the ATO is able to accurately measure its performance against the 14 day activity statement processing standard.

3. A risk-based approach to the identification and resolution of high-risk refunds

This chapter examines the ATO's risk framework, methodology and practice to identify and resolve activity statement high-risk refunds. This chapter also assesses the compliance strategies and products the ATO uses to mitigate and report on these risks.

Introduction

3.1 The identification of HRRs using a robust risk-based approach is essential given the large volume of work associated with activity statement refund processing, and the finite resources the ATO has to identify incorrect refunds. As noted in Chapter 1, the ATO uses a range of compliance products⁶⁸ to resolve HRRs. If these products are not underpinned by a sound risk-based approach to compliance, there is the potential that:

- HRRs will not be identified, and the ATO will issue incorrect refunds. This increases the risk to Commonwealth revenue, and to the ATO's reputation within the community; and
- valid refunds will be incorrectly identified as HRRs. This increases the risk that the ATO will unnecessarily delay processing these refunds. It also increases the risk that ATO compliance staff⁶⁹ will undertake unnecessary work.

3.2 This chapter examines whether the ATO uses a transparent and robust risk-based approach to identify and report on the strategic and operational compliance risks⁷⁰ relevant to the correct identification of HRRs, and whether this approach is effective. In particular, the ANAO examines:

- the ATO's approach to identify, monitor and report on strategic and operational compliance risks relevant to HRRs;

⁶⁸ The ATO's range of compliance products are discussed in paragraphs 3.25 to 3.26.

⁶⁹ The compliance teams responsible for resolving HRR identified by the RRE are located in the ATO's Compliance Verification Centres (CVCs), Interpretation and Large Enterprise Compliance (ILEC) and Government and Community Sector (GCS). These teams are described in Chapters 2, 3 and 4.

⁷⁰ See Appendix 5 for the strategic and operational planning and reporting framework relevant to HRR risks processes.

- the ATO's strategy to mitigate strategic and operational HRR compliance risks; and
- new initiatives introduced by the ATO to improve the identification of HRRs.

3.3 The specific criteria and thresholds of a number of compliance products are classified as 'highly protected' and therefore are not disclosed in this audit report. However, the ANAO does broadly discuss the methodology and compliance products used by the ATO to manage HRR related risks.

The ATO's approach to identify strategic and operational risks relevant to high-risk refunds

3.4 The identification of strategic compliance risks⁷¹ and operational compliance risks⁷² is the first stage in establishing a framework to correctly identify and address HRRs. Without the clear articulation of these risks, the ATO cannot define precisely what a HRR is, and consequently, what risks its HRR compliance strategy⁷³ is seeking to mitigate. These risks should be constantly monitored and reassessed, when taxpayer compliance behaviour patterns change.

The ATO's approach to risk management

3.5 In 2003, the ATO released a corporate practice statement⁷⁴ on the application of risk management principles within the ATO. This practice statement provides a standard methodology for identifying, monitoring, and reporting on risk within the ATO. This methodology is shown in Figure 3.1.

⁷¹ Strategic risks refer to high-level ATO and GST Line risks relevant to the administration of HRRs (see tiers 2 and 3 of Appendix 5).

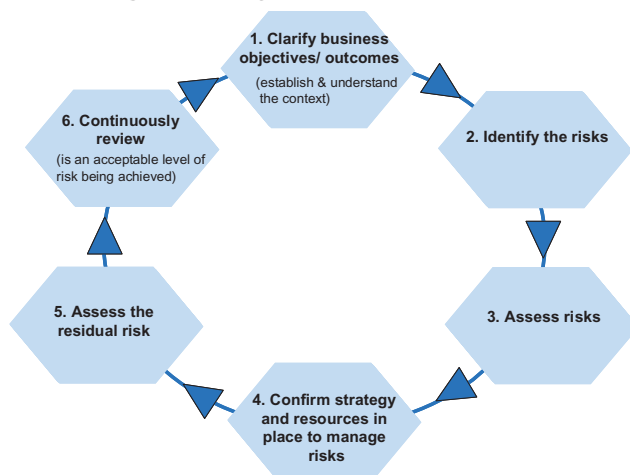
⁷² Operational compliance risks refer to low-level GST line and individual team risks relevant to HRR processing (see tiers 3 and 4 of Appendix 5).

⁷³ The ANAO defines the ATO's 'HRR compliance strategy' as the strategy the ATO has in place to identify and resolve high-risk activity statement refunds.

⁷⁴ ATO Practice Statement PS CM 2003/02.

Figure 3.1

The ATO Risk Management Cycle



Source: ATO.⁷⁵

3.6 To assess the ATO’s risk assessment framework relevant to HRRs, the ANAO examined the GST Line’s application of this model to identify and assess risks relevant to HRRs.⁷⁶

The GST Line’s approach to identify strategic risks relevant to high-risk refunds

3.7 The ATO first undertook an assessment of the strategic risks associated with the introduction of the GST in June 1998. As part of this assessment, the ATO determined that issuing incorrect refunds was the highest risk applicable to good taxpayer compliance within a GST environment. Since this time, the ATO advised that issuing incorrect refunds has remained the GST Line’s highest ranked compliance risk to 2004–05.

3.8 While the GST Line has devoted considerable resources and effort to the management of HRRs, since October 1999, it could not provide documentary evidence that it regularly assessed, monitored or reported on the ‘issuing incorrect refunds’ strategic risk. Although the ATO regularly reported on the results of its efforts in relation to HRR for the different divisions within the GST Line, the ANAO considers that by not clearly identifying, monitoring

⁷⁵ ATO Practice Statement, *ibid.* p.6.

⁷⁶ The ANAO focused only on the GST line, as it is primarily responsible for identifying the majority of the compliance risks related to HRRs, and for developing the compliance products used to mitigate those risks.

and reporting on the strategic risks relevant to HRR at a whole of GST Line level, the GST Line cannot make fully informed decisions about:

- the level of resourcing required to adequately mitigate strategic HRR risks in comparison to other GST Line risks; and
- the type and combination of compliance products it should use to mitigate HRR risks.

3.9 The ATO advised that there has been, and continues to be, a considerable senior ATO management focus on HRR related strategic risks, specifically by the Refund Integrity Steering Committee, which includes the Deputy Commissioners of the GST, Small Business and Operations Lines.

The GST Line's approach to identify operational risks relevant to high-risk refunds

3.10 HRR operational risks should underpin and provide insights into the management of relevant strategic risks, and are generally assessed, and reported, by relevant compliance divisions and teams.⁷⁷ Importantly, specific compliance products should be developed to mitigate operational risks, with the performance of these products being evaluated when reassessing the operational risks at a later time (the performance of compliance products is discussed further in paragraphs 3.29 to 3.33).

3.11 Since the introduction of activity statements in 2000, the ATO has not completed a formal risk assessment process to identify, assess and report on the operational risks relevant to HRRs. Although operational risks have not been properly documented, the ATO advised that it has always developed and implemented its HRR compliance strategies and products to mitigate the following four broad operational level compliance risks:

- fraud;
- non-compliance with the tax law;
- misapplication of the tax law; and
- administrative errors.

3.12 The ATO provided evidence to support that the GST Line's Strategic Risk Management team (SRM team) considered these risks when assessing

⁷⁷ See paragraph 3.27 for the ATO divisions and teams responsible for assessing, and reporting on, HRR operational compliance risks.

existing and developing new, HRR compliance strategies and products.⁷⁸ The work of the SRM team is discussed further in paragraph 3.29.

3.13 That said, it was unclear whether the ATO systematically monitored and clearly reported on the four operational HRR compliance risks. It was also unclear how effective the ATO's HRR compliance strategy had been in mitigating these risks.

3.14 The ATO advised that, during the audit, it had undertaken significant steps to improve its risk management documentation practices (see paragraphs 3.15 and 3.16 below).⁷⁹ Further, the ATO considers that now it has documented these risks, it will look to develop both specific mitigation strategies for each of the four risk categories, and a process to report on how effective these strategies have been.

Recent developments in risk management in the GST Line

3.15 In September 2004, the ATO announced an internal review of its GST large corporate compliance program.⁸⁰ Although this review was focused specifically on the large market segment, the GST Line has used the recommendations of the review, which was released in September 2005, to reform its approach to risk management. Among other initiatives, the GST Line has:

- formed a risk management committee to assess and review compliance risks with a role of prioritising risks from a whole of revenue product view; and
- formed a new intelligence and risk assessment unit. This unit amalgamates the SRM team (within the General Compliance division) and the Risk Management Team (within the Interpretations and Large Enterprise Compliance division).⁸¹

⁷⁸ Between 2001–02 and 2004–05 the SRM team produced a range of reports on the results of HRR activity which mainly focused on the performance of the RRE tests. Although HRR related risks were not specifically identified (and commented on) in these reports, the content of these reports indicate that the four operational compliance risks were being considered by the ATO.

⁷⁹ The ATO advised that it commenced work in May 2005 to reform its GST Line risk management practices following an internal review of the Interpretations and Large Enterprise Compliance area of the GST Line.

⁸⁰ The high-level findings of this review are discussed in Audit Report No.13, 2005–06, *Administration of Goods and Services Tax Compliance in the Large Business Market Segment*.

⁸¹ See Appendix 4 for a description of the functions of the Strategic Risk Management team and the Risk Management team.

3.16 As part of the work undertaken by the risk management committee in September 2005, the GST line commenced a wide-ranging process to identify all risks for the line. Although this risk process has identified some strategic and operational risks relevant to HRRs, it was not finalised at the time of the audit.

Recommendation No.4

3.17 To support the correct identification of activity statement high-risk refunds, and to effectively target compliance resources to mitigate high-risk refund risks, the ANAO recommends that the ATO:

- identify and assess strategic and operational compliance risks relevant to high-risk refunds in accordance with relevant ATO corporate risk practice statements; and
- develop and implement regular risk reporting processes at the strategic and operational levels to report on relevant high-risk refund risks.

ATO response: Agreed.

3.18 The Tax Office agrees with this recommendation. We recognise the need for improvement to clarity and completeness of documentation. The Tax Office has a number of measures in place to identify, assess and report high-risk refunds. For example, a GST Risk Committee has already been established with responsibility for systematically identifying, rating and maintaining the high level documentation of all major GST risks (including refund risk).

The ATO's strategy to mitigate strategic and operational HRR compliance risks

3.19 To review the effectiveness of the ATO's approach to mitigating strategic and operational HRR compliance risks, it is useful to examine the evolution of the compliance strategies and products the ATO currently uses to identify and resolve HRRs.

Evolution of the ATO's approach to compliance

3.20 With the introduction of activity statements in 2000–01, the ATO sought to develop a new approach to assess taxpayer compliance with their activity statement obligations. This compliance approach departed from traditional ATO income tax compliance activity, which is largely based on reviewing (or

auditing) income tax returns after refunds have been issued (known as post-issue reviews or post-issue audits).

3.21 The cornerstone of the new methodology was to assess the risk of activity statement refunds being incorrect before they are issued to the taxpayer (pre-issue review or pre-issue audits). A compliance approach based around pre-issue reviews or audits offers advantages, including that the ATO does not need to recover incorrect refunds from taxpayers. However, a disadvantage is that pre-issue reviews or audits lengthen the time it takes the ATO to issue refunds to taxpayers.

3.22 To implement a pre-issue compliance approach effectively, presented a significant challenge to the ATO given the: large number of activity statements it processes (see paragraph 1.19); and the legislated time restrictions it has to process activity statement refunds (see paragraphs 2.56 to 2.57).

3.23 Given these challenges, the ATO developed the Risk Rating Engine (RRE) IT system. The RRE applies a series of automated tests to activity statements to identify potential HRRs. An activity statement refund that does not pass the automated tests, is considered to be a HRR and is forwarded to ATO compliance staff for resolution. For 2004–05, 83 per cent of all HRR compliance work undertaken by the ATO was generated by the RRE. The majority of this work was undertaken in a pre-issue environment.

3.24 As part of a broader approach to HRR compliance, the ATO underpins the compliance work generated by the RRE with ‘other case selection approaches’ that are used to identify HRRs. The majority of these other approaches identify and resolve HRRs in a post-issue environment. In 2004–05, ‘other case selection approaches’ identified 17 per cent of all HRR compliance work.⁸²

ATO high-risk refund compliance products

3.25 The type of activity statements identified as HRRs by the RRE and ‘other case selection approaches’ can vary markedly. In particular, HRRs can:

- relate to a variety of taxpayers ranging from small business to large corporations;
- be identified for different reasons ranging from complex cases of fraud, to simple calculation errors; or

⁸² The ATO notes that while not specifically related to HRRs, many of the ATO’s field and office audits (around 140 000 annually) will, in many cases examine activity statement refunds.

- involve small or very large refunds.

3.26 To resolve HRRs with this broad range of characteristics, the ATO uses approximately 20 different compliance products. These products can range from the invasive (for example, large, post-issue audits) to the less invasive (for example, a pre-issue telephone call from ATO staff to a taxpayer). The full range of pre-issue and post-issue compliance products are shown in Appendix 7.

ATO high-risk refund compliance staff

3.27 The ATO uses a wide range of compliance staff with different skills to resolve the range of HRRs. As shown in Figure 1.2, the ANAO examined three main ATO compliance divisions responsible for resolving HRRs. These are:

- **General Compliance.** This area includes a number of Compliance Verification Centre (CVC) teams that are responsible for resolving HRRs for individuals, as well as micro, small and medium businesses. CVCs were responsible for resolving 90 per cent of all HRRs in 2004–05, with other HRRs resolved by Interpretations and Large Enterprise Compliance (ILEC) area or the Government and Community Sector (GCS) area. The value of HRRs resolved by CVCs is generally lower than for the other compliance areas.
- **Interpretations and Large Enterprise Compliance.** Staff in ILEC are responsible for examining HRRs relevant to large businesses with a turnover of greater than \$100 million.
- **Government and Community Sector** is comprised of a comparatively small number of government and community sector taxpayers claiming high value refunds. There are a low number of HRRs in this area as GCS taxpayers are considered by the ATO to be a low-risk.

3.28 The compliance staff within each of these divisions uses different compliance products to resolve HRRs.

The effectiveness of the ATO's high-risk refund compliance strategy

3.29 Since the introduction of activity statements in 2000, the SRM team has been analysing the effectiveness of the RRE, and the performance of a number of compliance products relevant to the General Compliance division. In particular, the SRM conducted detailed reviews of the operation of the RRE

and other compliance products in 2002 and 2003 to enhance the ongoing development of HRR-related compliance products.

3.30 The ATO considers that its work to date supports the range of pre-issue and post-issue compliance products it has in place to mitigate risks involved with HRRs. The ATO view is that the mitigation strategies it has in place are effectively mitigating the HRR risks.

3.31 To assess the effectiveness of the ATO's HRR compliance strategy the ANAO analysed data relevant to the RRE and 'other case selection approaches' (see Appendix 8). The ANAO considers that this data does not provide a clear indication of whether the ATO's current high-risk refund compliance strategy is effective, or whether the ATO's performance in identifying and resolving HRRs has improved over time. The ANAO was also not able to determine, based on the data provided, whether the ATO uses an 'optimal balance' of pre-issue and post-issue compliance products.

3.32 Although the ATO has undertaken detailed work to assist the evolution of its HRR compliance strategy, the ANAO considers that the ATO has not fully developed and documented a methodology by which it continuously assesses the effectiveness of its HRR compliance strategy. The ANAO considers that the ATO needs to further develop, document and apply a methodology to:

- assess the overall performance of the RRE and 'other case selection approaches';
- compare the performance of, and costs of, individual compliance products; and
- report regularly on the performance of the RRE and 'other case selection approaches', to effectively identify and resolve HRRs.

3.33 Without this kind of analysis and reporting, the ANAO considers that the ATO cannot fully assess the effectiveness of its HRR compliance strategy, and determine whether it has the optimal combination of compliance products to provide assurance that it is using its resources efficiently.

Recommendation No.5

3.34 To assess the effectiveness of the ATO's strategy to identify and resolve activity statement high-risk refunds over time, the ANAO recommends that the ATO:

- develop, document and implement a methodology to assess the overall effectiveness of its high-risk refund compliance strategy to identify and resolve activity statement high-risk refunds;
- regularly analyse the performance of, including the costs of, individual compliance products used to mitigate high risk refunds; and
- develop and implement a systematic approach to report on the effectiveness of its high-risk refund compliance strategy.

ATO response: Agreed.

3.35 The Tax Office accepts this recommendation and the need to better assess the effectiveness of various compliance tools in mitigating risks. The Tax Office will consider measures including:

- pre-issue checks
- strike rates;
- incident of incorrect refunds; and
- cost effectiveness.

New initiatives applied by the ATO to improve the identification of HRRs

3.36 Following the issue of a large incorrect refund in 2001 (the '2001 case') the ATO adopted a conservative approach to issuing large refunds (see Chapter 1). This approach was manifested in the RRE, with new RRE tests introduced in July 2003 to identify and allocate all large refunds to ATO compliance staff for manual examination.

3.37 The consequence of this conservative approach was that significant numbers of large refunds were being checked (and therefore delayed) by ATO compliance staff prior to being issued. As shown in Appendix 3, from 2000–01 to 2003–04, between 55 to 70 per cent of the dollar value of all activity

statement refunds were identified as HRRs and were held for review by compliance staff.⁸³

The ATO's new approach to identify high-risk refunds through the Risk Rating Engine

3.38 In mid-2004, the ATO extensively modified its conservative approach to identify and resolve HRRs. This new approach to identify HRRs involved significant changes to the way the RRE operates⁸⁴, and to the type and number of RRE tests applied to activity statement refunds. These changes have been combined with an override policy. This policy is aimed specifically at reducing the number and value of refunds delayed for manual examination, while improving the detection of incorrect or fraudulent refunds.

3.39 The override policy, and the changes made to RRE tests, are initiatives used by the ATO to address some of the key recommendations of the Inspector-Generals' report (see paragraphs 1.34 and 1.35). The ANAO considers that, if effective, these initiatives should substantially address these recommendations.

ATO override policy

3.40 The override policy utilises functionality within the RRE that 'overrides' key RRE tests (but not all), so that they are not applied to the refunds of approved taxpayers.⁸⁵ As the RRE is the primary tool the ATO uses to identify HRRs, the ANAO sought to determine whether the ATO's override policy, combined with the changes made to RRE tests, maintains an appropriate balance between the time taken to process HRRs, and that the refunds issued by the ATO are valid. To do this, the ANAO examined the:

- development of the override policy; and

⁸³ For 2004–05, approximately 92 per cent of all activity statement refunds were issued within the ATO's 14 day service standard. The ATO's calculation of the 14 day standard is discussed in Chapter 2.

⁸⁴ The ATO's approach to identifying HRRs has changed significantly since the ANAO last reviewed the RRE in ANAO Audit Report No.55 *ibid*. The ATO now uses intelligence collected about taxpayers and their activity statements, including historical trends and behavior, to identify HRRs. Changes were made to the RRE in July 2004 to accommodate this shift in approach. The RRE tests were redeveloped and changes to functionality of the RRE reduced the emphasis of risk profiling a taxpayer to determine risk and allowed for risk profiling of individual activity statements on a test-by-test basis.

⁸⁵ The ATO identifies these taxpayers as: large publicly listed companies; and any large taxpayer that has a minimum of a five-year history with the ATO (that is, has been registered for any tax for a minimum of five years) that indicates a satisfactory compliance record.

- the effectiveness of the override policy and the changes made to the RRE tests.

Development of the override policy

3.41 Although the functionality to ‘override’ RRE tests has always been available to the ATO, it was not until mid-2003 that it was formally considered by the Refund Integrity Steering Committee. The committee decided that it would not implement an override policy until further analysis of the potential impacts of the policy was undertaken, and that the override policy was underpinned by sound quality assurance processes to provide assurance that genuine HRRs were not being overridden.

3.42 Following work undertaken by the SRM team, the ATO approved⁸⁶ an override policy in April 2004. This policy was progressively introduced from July 2004.⁸⁷ The ANAO analysed the override policy and found that:

- the ATO did not document an assessment of the impact (the risks, costs and benefits) of the proposed override policy, that would assist the Refund Integrity Steering Committee in making decisions relating to the development and implementation of the policy;
- the policy document did not clearly articulate the objective of the policy⁸⁸;
- the policy document was incomplete, and did not provide adequate guidance for implementation;
- the instructions and guidelines within the policy document were inconsistent and unclear; and
- the ATO did not specify performance measures against which to assess the effectiveness of the policy, in particular to enable the ATO to assess whether the policy achieves its objective.

⁸⁶ The Refund Integrity Steering Committee was responsible for approving the override policy. The roles and responsibilities of the committee are discussed in Chapter 2.

⁸⁷ The ANAO notes that although the policy document is called ‘Risk Rating Engine (RRE) GST Compliance Override Policy and Procedures’, the document states that the scope of the document ‘does not include the detailed procedures required to implement this policy.’

⁸⁸ The ATO advised that it could be inferred from the policy document that the purpose of the policy was to reduce the need to review taxpayers’ refunds where they had previously been subject to a review in order to minimise taxpayer and ATO costs.

3.43 The ANAO considers that the documents used to define and support the management of the override policy, were inadequate to support its implementation. In particular, the documents do not adequately define the objective of the override policy, and do not specify how the overall effectiveness of the policy is to be determined.

3.44 The ATO advised that analysis of the potential impact of the override policy was undertaken by the SRM team. The ATO advised also that analysis of the potential impact of the override policy, including lists of taxpayers to be overridden, was examined and approved by the Refund Integrity Steering Committee.

Assessing the effectiveness of the override policy and changes made to the RRE tests

3.45 Although the ATO undertook assessments of the impact of the override policy for specific compliance areas⁸⁹, it has not clearly assessed and documented the effectiveness of the override policy and the other changes made to the RRE, for all compliance areas. The ANAO sought to assess the effectiveness of the override policy, and changes made to the RRE tests, based on: general HRR performance data collected by the ATO; and post-issue review processes relevant to the override policy. These areas are discussed below.

The performance of the override policy and other RRE changes based on HRR performance data

3.46 The methodology used to examine the performance of the override policy and other RRE changes was undertaken as part of the ANAO's wider analysis of the effectiveness of the ATO's approach to HRR compliance. This analysis is contained in Appendix 8.

3.47 ATO data⁹⁰ indicates that the override policy has been successful in reducing the number of activity statement refunds delayed by compliance activity. Specifically the ATO's data shows that:

- from 2003–04 to 2004–05, the number of HRRs identified by the RRE decreased by 18 per cent from 47 000 to 40 000. This indicates that the

⁸⁹ See paragraph 3.27 for the compliance areas examined during the audit. We note that overrides relevant to the General Compliance Division of the GST Line were examined in detail by the SRM team.

⁹⁰ See Appendix 8.

ATO is delaying significantly less activity statement refunds in 2004–05 compared to 2003–04;

- 45 per cent of the dollar value of activity statement refunds were identified as HRRs in 2004–05. In 2003–04, 65 per cent of all activity statement refunds were HRRs (a decrease of 20 percentage points)⁹¹; and
- the revenue generated from adjusting refund amounts on HRRs (identified by the RRE) increased by 18 per cent (approximately \$45 million) from 2003–04 to 2004–05.

3.48 Also, in May 2005, the Commissioner of Taxation gave a commitment that approximately 8 000 taxpayers would have activity statement refunds bypassing RRE compliance verification processes. The ATO advised that at the end of the 2004–05 year, it had overrides in place for approximately 8 000 taxpayers. The value of the ‘overridden’ refunds was approximately \$7 billion, and is expected to rise to \$11 billion in 2005–06.

3.49 Based on the statistics in paragraphs 3.47 and 3.48, it appears that the override policy has been successful at reducing the number of activity statements delayed for compliance verification.

3.50 However, the effectiveness of the RRE, (which is principally measured by the ‘strike rate’⁹²) rose by only one per cent between 2003–04 and 2004–05. Given the introduction of the override policy, and the change made to RRE tests to improve the identification and resolution of HRRs⁹³, it would be expected that the ‘strike rate’ should have been higher.

3.51 Without further detailed analysis of the strike rate result, and the results described in paragraphs 3.47 and 3.48, the ATO is unable to provide definitive assurance that the override policy, in conjunction with the changes to the RRE, has significantly improved the time taken to process HRRs, while at the same time improved its ability to identify and resolve incorrect refunds before they are issued.

⁹¹ This statistic could indicate that the ATO is identifying HRRs more effectively.

⁹² The ‘strike rate’ is calculated by dividing: the total number of HRRs identified by the RRE and subsequently adjusted (i.e. incorrect refund claims); by the total number of HRRs identified by the RRE. Using this measure, a higher strike rate indicates that the RRE is more effective at identifying incorrect refunds, because it is identifying a higher proportion of incorrect refunds compared to the total number of HRR it selects. Figure (b) of Appendix 8 shows that HRR strike rate results for 2003–04 and 2004–05.

⁹³ The other measures to improve the identification and resolution of HRRs are discussed in paragraph 3.38.

Post-issue review processes relevant to the override policy

3.52 A key aspect of assessing the overall effectiveness of the override policy is that there are robust post-issue review⁹⁴ processes to provide assurance that the activity statement refunds issued by the ATO are correct. As noted in paragraph 3.41, the Refund Integrity Steering Committee recognised the importance of having a robust quality assurance process (or post-issue review process) in mid-2003, when the override policy was first considered.

3.53 The ANAO sought to assess the post-issue review process relevant to the override policy for each of the compliance areas responsible for resolving HRRs (that is, CVCs, ILEC and GCS). The results of the ANAO's examination are presented in Table 3.1.

⁹⁴ The post-issue reviews examine whether the treatment of an activity statement refund was correct, once the refund has been issued.

Table 3.1

Results of post-issue reviews conducted in 2004–05 for activity statement refunds paid as a result of an override being in place (as at 27 June 2005)

	Overridden activity statements			Overridden activity statements subjected to post-issue review			Incorrect overridden activity statement refunds		
	Number	Value (\$millions)	Proportion of total \$ value (per cent)	Number	Proportion of number by total number reviewed (per cent)	Value (\$millions)	No Adjusted	Value (\$millions)	Value the subject of current audits
ATO Compliance Teams									
CVC	3405	631	9	471	13.8	75.5	9	0.09	Unknown ¹
ILEC	772	2771	39	188	24.4	685	2	13	25
GCS	742	3739	52	98	13.2	733	0	0	0
Total	4919	7141	100	757	15.3	1493.5	11	13.09	Unknown ¹

Source: ATO

Note 1: Value not available to the ANAO at the time of the audit.

3.54 The information contained in Table 3.1 shows the following:

- ILEC accounted for 39 per cent of the total value of overridden activity statement refunds, while GCS taxpayers accounted for 52 per cent;
- activity statements relating to small and medium businesses accounted for nine per cent of all activity statements overridden⁹⁵;
- ILEC (which is responsible for large taxpayers) undertook post-issue reviews of 24 per cent of all activity statements that were overridden; and
- of the 188 post-issue reviews undertaken by ILEC, three are currently being examined further (worth approximately \$25 million), and two refunds were issued incorrectly. One of these incorrect refunds was worth \$11 million.

ILEC override post-issue review processes relating to large taxpayers

3.55 From the information presented in Table 3.1, it is apparent that although a comparatively small number of refunds relating to large taxpayers and the GCS have been overridden, the value of these refunds is large. The high value of these refunds means that it is important that the ATO has a sound process to review overrides relating to large business.

3.56 Given the size of the refunds overridden for large taxpayers, ILEC considered that it should undertake post-issue reviews on 100 per cent of all overridden activity statements, until the effectiveness of the override policy could be determined. However, ILEC did not undertake any post-issue reviews from 1 July 2004 to 22 April 2005.

3.57 The ATO acknowledges that for large and government sector taxpayers, it has not yet fully implemented the post-issue sampling of overridden cases as envisaged in its override policy. However, the ATO notes that it has in place a general client management approach for managing large taxpayers, which involves the regular review of all relevant taxpayers' activity statements by the ATO officer responsible for the taxpayer.⁹⁶ The ATO believes

⁹⁵ The ATO advised that, of the activity statements overridden for small and medium businesses, post-issue sampling showed that only 1.9 per cent of those refunds required adjustment. The ANAO considers that this is one indicator which suggests that the override policy for small and medium businesses is effective.

⁹⁶ The general client management approach used by ILEC is discussed in Audit Report No. 13, 2005–06, *Administration of Goods and Services Tax Compliance in the Large Business Market Segment*. p 67.

that this approach has minimised any risk involved in the delayed implementation of the post-issue sampling requirements for large taxpayers.

ANAO comment on the effectiveness of the ATO's post-issue review processes relevant to the override policy

3.58 A robust post-issue review process developed prior to the implementation of the override policy, and reviewed shortly after its introduction, would have provided the ATO with a way to assess the overall effectiveness of the override policy. Ideally, a documented risk-based approach should have been used to identify the number and type of refunds to be reviewed post-issue.

3.59 The ANAO considers that the ATO did not have a well developed, coordinated⁹⁷, and risk-based post-issue review process at the time of the implementation of the override policy.

3.60 The ANAO considers that the ATO should use a well coordinated⁹⁸ and risk-based post-issue review process. This would provide meaningful information on the effectiveness of the override policy in identifying valid refunds. Information of this kind would also be useful to further refine other aspects of the ATO's high-risk refund compliance strategy (see paragraphs 3.29 to 3.33).

⁹⁷ That is, there should be coordination between CVCs, ILEC and GCS regarding an agreed approach to post-issue review.

⁹⁸ The ANAO acknowledges that the methodology for identifying non-compliance for ILEC taxpayers as opposed to other taxpayers is distinctly different, given the nature of large industry. However, the ATO can use a coordinated approach to post-issue review that takes these factors into consideration.

Recommendation No.6

3.61 To assess the effectiveness of the changes made to the identification of high-risk refunds in 2004, including the effectiveness of the ATO's policy to override key tests in the Risk Rating Engine, and changes made to Risk Rating Engine tests, the ANAO recommends that the ATO:

- document the objectives of the override policy and the expected results of the policy;
- develop, document and apply a methodology to assess the performance of the override policy combined with the changes made to the Risk Rating Engine tests;
- develop, document, implement, and report on, a well coordinated quality assurance process for activity statement refunds subject to the override policy; and
- report to the relevant executive body on the performance of the override policy and the changes to the Risk Rating Engine tests.

ATO response: Agreed.

3.62 In December 2004, in response to a review by the Inspector-General of Taxation, the Tax Commissioner stated the objective of the override policy in terms of a reduction in refund revenue held, and the number of taxpayers with withheld refunds. Clearly, we need to update and restate the override policy, documenting and clearly articulating this policy.

3.63 In relation to quality assurance and reporting, the existing reporting arrangement to the Credit –Refund Integrity Steering Committee will be enhanced by establishing appropriate exception reporting to the ATO Executive through the relevant Tax Office sub-plan executive.

4. High-risk refund systems, processes and controls

This chapter examines the information technology (IT) and manual systems, processes and controls used by the ATO to process activity statement high-risk refunds.

Introduction

4.1 The ATO is heavily reliant on a number of complex information technology (IT) systems to process the large volume of activity statement refunds it issues to taxpayers. The failure of any one of these IT systems to support business processes and activities could result in incorrect refunds being issued, or in refunds being delayed unnecessarily.

4.2 Although the ATO uses IT systems to identify HRRs, it is reliant on manual processing to examine and resolve these refunds on a case-by-case basis. Inefficient or ineffective manual processing can also result in incorrect or delayed refunds being issued by the ATO.

4.3 In this chapter, the ANAO examines whether the ATO has a range of automated and manual controls in place to provide assurance that HRRs are processed efficiently and effectively. To obtain this assurance the ANAO examined:

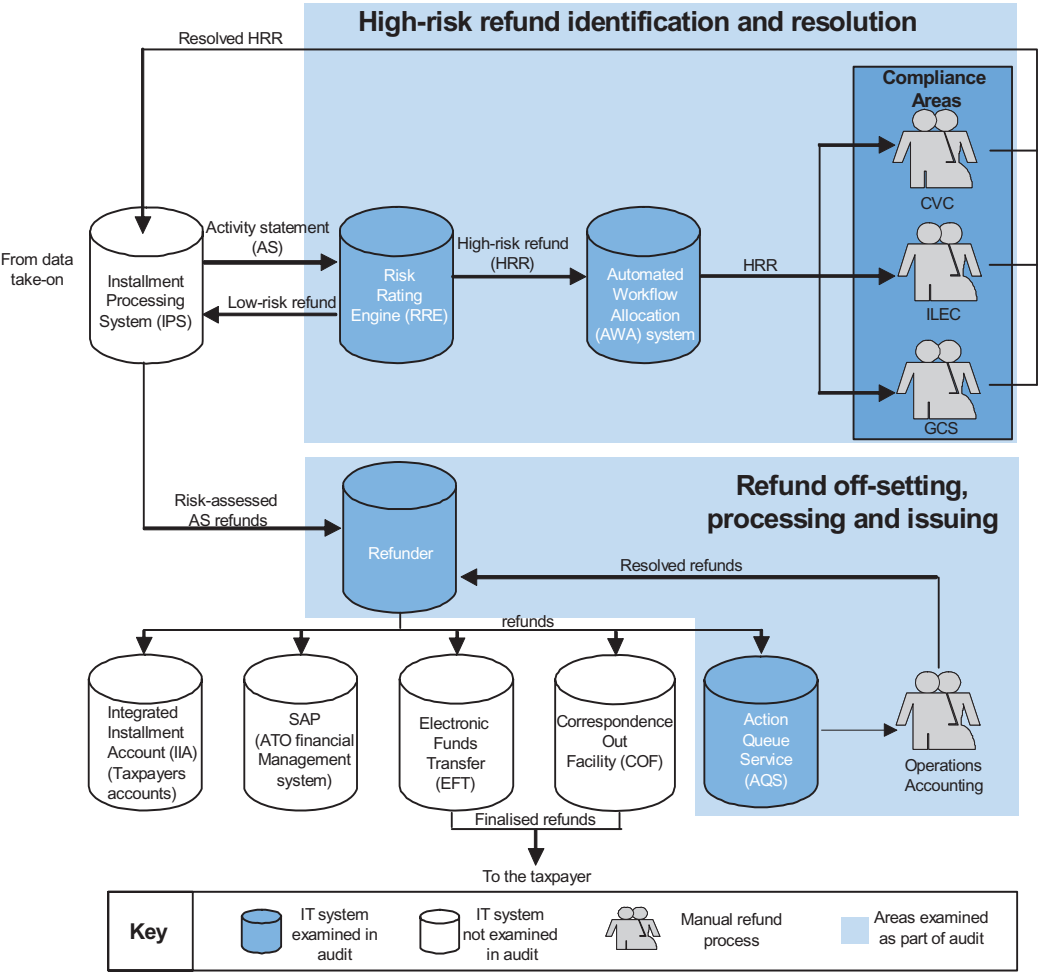
- **the operation of the ATO's activity statement refund process;**
- **high-risk refund IT controls**, which should be used to provide adequate assurance that all relevant IT systems and processes are operating as the ATO intended, and in accordance with tax legislation and ATO policy; and
- relevant **high-risk refund manual controls**, which should be used to provide assurance that ATO staff are following clear processes and procedures, that are correct and are efficient (that is, timely).

4.4 Each of the areas in bold text is examined below.

The operation of the activity statement refund process

4.5 The ATO uses a number of IT systems and complex manual processes to identify and manage HRRs. At an aggregated level, these systems and processes are shown in Figure 4.1.

Figure 4.1
The activity statement refund process



Source: ANAO representation of ATO information.

4.6 To consider the ATO’s systems, processes and controls relevant to activity statement refund processing, the ANAO divided the activity statement refund process into two areas: high-risk refund identification and resolution; and refund off-setting, processing and issuing. These two areas are described below.

High-risk refund identification and resolution

4.7 Following the capture of activity statement information and initial processing by the Instalment Processing System (IPS)⁹⁹, all activity statement information is forwarded to the RRE. The RRE applies a series of fraud and compliance tests, to identify refunds that indicate that the taxpayer may not be complying with their taxation obligations. The ATO considers that activity statement refunds that fail RRE tests are HRRs.

4.8 All HRRs are distributed by the Automated Workflow Allocation (AWA) system to compliance staff¹⁰⁰ for manual review on a case-by-case basis. Once all HRRs have been reviewed and resolved to the satisfaction of compliance staff, these refunds are forwarded to the Refunder IT system for further processing.

Refund off-setting, processing and issuing

4.9 The Refunder IT system performs a number of functions, including:

- offsetting the refund against other ATO debt and applicable Child Support Agency (CSA) and Centrelink garnishee commitments;
- generating accounting transactions in individual taxpayer accounts¹⁰¹;
- allocating DRI to taxpayers¹⁰²; and
- posting relevant financial information to the ATO's financial management accounting system.

4.10 Once Refunder has completed the final stages of processing, activity statement refunds are issued through an ATO Electronic Funds Transfer (EFT) system. Occasionally refunds may be issued by cheque via the Correspondence Out Facility (COF).

⁹⁹ IPS was previously examined by the ANAO in ANAO Audit Report No.33, 2003–2004, *The Australian Taxation Office's Collection and Management of Activity Statement Information*. Activity statement processing systems were not re-examined as part of this current performance audit. Note that, although all activity statements are examined by the RRE, this performance audit considers the process as it relates to activity statement refunds only.

¹⁰⁰ As noted earlier, compliance staff are located in three areas of the ATO. These are: CVCs; ILEC and GCS. The roles and functions of each of these areas is discussed further in Chapter 3 and in Appendix 4.

¹⁰¹ The Integrated Instalment Account (IIA) maintains ATO taxpayer account details, and is part of the ATO Integrated System (AIS).

¹⁰² See paragraphs 2.56 to 2.60.

4.11 There can be instances where Refunder detects an error, or discrepancy, that prevents a refund from undergoing final processing. In these circumstances, Refunder raises an item in the Action Queue Service (AQS) system for resolution by ATO Operations Accounting staff.

High-risk refund information technology controls

4.12 HRR IT controls are the checks and balances that provide the ATO with assurance that IT systems are operating: as specified (that is, in accordance with the ATO's business requirements); and in accordance with ATO policy and legislation.

4.13 The ANAO examined a range of controls that are considered essential to the effective operation of HRR IT systems. Specifically, the ANAO sought to determine if the ATO has:

- complete and accurate systems documentation; and
- robust system testing.

4.14 These controls are discussed below. The ANAO notes that the Certificate of Compliance process¹⁰³, if operating correctly, would provide a high-level of assurance that relevant IT systems controls are effective. However, as noted in Chapter 2, the ATO is continuing to undertake steps to make the Certificate of Compliance process fully effective.

Complete and accurate systems documentation

4.15 An important element of managing IT systems effectively is the creation and maintenance of systems documentation. This documentation should describe all aspects of the system including business requirements¹⁰⁴, hardware, software, data, and dependencies with other systems. Without adequate systems documentation, the ATO cannot provide a high level of assurance that its IT systems are operating in accordance with ATO policy and taxation legislation. Also, poor documentation may adversely affect any future changes to, and the ongoing maintenance of, ATO IT systems.

4.16 The ANAO examined two key types of IT system documentation relevant to the IT systems used to process HRRs (see Figure 4.1). These are

¹⁰³ The Certificate of Compliance process is examined in paragraphs 2.46 to 2.49.

¹⁰⁴ Business requirements should specify the intended purpose, role and function of the IT system.

system specifications¹⁰⁵, and samples of documentation used in changing relevant IT systems.¹⁰⁶

4.17 To assess this IT system documentation the ANAO examined whether system specifications:

- had adequate document control¹⁰⁷;
- were complete; and
- were current.

4.18 Also, the ANAO assessed whether documentation used in changing relevant IT systems:

- existed; and
- received appropriate sign-offs/approvals.

4.19 The results of the ANAO's analysis are summarised in Table 4.1, where a '✓' indicates that the ATO satisfied the criteria assessed, and a '✗' indicates that the ATO was unable to adequately satisfy the criteria.

¹⁰⁵ System specifications include functional and technical specifications which are documents used to describe, in detail, the role, function and operation of an IT system. These documents may also contain descriptions of user tasks (manual processes) and inter-dependencies with other systems and IT processes. These specifications should be updated whenever any change is made to the system to reflect current system functionality and operation.

¹⁰⁶ These documents included amongst others, IT system change requests and IT change specifications.

¹⁰⁷ Document control refers to the controls established to provide assurance that functional and technical specifications are complete and accurate. These controls include the physical protection of documentation, and applying and maintaining strict version control procedures.

Table 4.1

ANAO analysis of system documentation for activity statement high-risk refund related IT systems

	RRE	AWA	Refunder	AQS
System specifications (functional and technical specifications)				
Document control ¹	✓	✓	✗	✓
Currency ²	✓	✓	✓	✓
Completeness	✓	✗	✗	✓
Development / change documentation				
Existence	✓	Not reviewed ³	✓	Not reviewed
Signoff	✓	Not reviewed	✗	Not reviewed

Source: ANAO analysis of ATO documentation.

Note 1: Ownership of document is assigned, document is centrally maintained, and version control is applied.

Note 2: Document is up-to-date reflecting current system functionality.

Note 3: Use of standard development methodologies for AWA and AQS were not reviewed as part of this audit as these systems / programs are less significant in activity statement refund processing.

4.20 Based on this analysis, the ANAO found that RRE system specifications and change documentation is detailed, complete, secure and easy to understand.

4.21 In contrast there are a number of areas where the ATO could improve its IT systems documentation practices. In particular, the ANAO found that:

- Refunder systems documentation lacks technical detail for certain functions¹⁰⁸, has inconsistent content, and changes have not been incorporated appropriately in all cases;
- all components of Refunder systems documentation (which is necessary to obtain a complete understanding of how it operates) is not centrally located and maintained; and
- there is not an overarching system specification for the AWA system. The ANAO considers that a high-level systems documentation of how the various components of AWA interrelate is important to obtain an understanding of how it operates.

¹⁰⁸ A key function of Refunder examined by the ANAO was the calculation of DRI. The ANAO found that Refunder systems documentation for this function lacked technical detail. Issues concerning DRI are discussed in detail in Chapter 2.

Robust system testing

4.22 System testing is a form of internal control used for all IT projects. It is used to provide assurance that a system change operates as specified, and does not have any unexpected impacts on the overall operation of the system and other related systems.

4.23 The ANAO sought to examine a sample of relevant regression testing¹⁰⁹ for the two main activity statement refund processing systems (RRE and Refunder). The results of our analysis were that regression testing for the RRE is comprehensive and complete. However, the ATO did not conduct sufficient regression testing for a significant system change relevant to the Refunder system.

Recommendation No.7

4.24 To provide adequate assurance that information technology systems, which support activity statement refund processing are operating as specified, the ANAO recommends that the ATO:

- compile and maintain comprehensive systems specifications documentation for the Refunder system;
- revise document management processes and procedures to maintain effective version control and ensure accessibility by appropriate staff for the Refunder system; and
- as part of its testing program, undertake regression testing relating to Refunder system changes to assess the overall effectiveness of relevant activity statement refund processing systems.

ATO response: Agreed.

4.25 The Tax Office accepts this recommendation. Effective document management is an important part of systems management and centralisation of systems documentation has commenced under the Production Change Management System Document Configuration and Rollout project. Migration of the documentation is due to occur in 2006 and will provide:

- a single repository;

¹⁰⁹ Regression testing is the process of testing which is used to assess whether system changes have an adverse or unexpected effect on existing system functionality. For example, whether particular RRE or Refunder system changes have an unexpected impact on other systems within the end-to-end refund process.

- consistency in initiating change; and
- ability to record and track changes.

4.26 This will provide the assurances suggested by this recommendation.

4.27 Regression testing relating to the systems changes took place, providing a high degree of assurances, however the documentation was inadequate. The Tax Office recognises the need for documenting an explicit overarching testing strategy and will ensure this occurs through the improved document control and management processes mentioned above.

High-risk refund manual controls

4.28 The ATO uses a number of manual controls to provide assurance that staff follow procedures correctly, and make correct decisions when reviewing the validity of claims for activity statement refunds. There are three main areas responsible for managing these controls. These are:

- CVCs;
- ILEC¹¹⁰; and
- Activity Statement Stream (within Operations Accounting). This area is responsible for administering taxpayer accounts, including correcting errors or anomalies identified by the AQS IT system.

4.29 To determine whether the ATO has appropriate and effective manual controls in place to administer HRRs, the ANAO examined relevant:

- procedures documentation;
- staff skilling (including training documentation); and
- quality assurance (QA) processes.

Procedures documentation

4.30 Manual procedures documentation is an important control to provide assurance that activities undertaken by ATO staff are correct, and comply with ATO policy and tax legislation. If ATO staff do not apply, or are not guided by, robust procedures, HRRs may not be resolved satisfactorily, or may not be issued in a timely way.

¹¹⁰ The ANAO did not review procedures documentation, staff skilling, and quality assurance processes for ILEC. These issues were considered as part of Audit Report No. 13, 2004–05, *Administration of Goods and Services Tax Compliance in the Large Business Market Segment*.

4.31 The ANAO considers that the ATO maintains a range of procedures documentation to support work practices, and to assist staff in all aspects of HRR processing. Overall, this provides a level of assurance that HRRs are being reviewed and resolved by ATO processing staff efficiently and effectively.

4.32 That said, quality assurance (QA) results¹¹¹ for CVCs are well below established benchmarks (QA results are discussed in paragraphs 4.37 to 4.39). This may indicate that procedures documentation is unclear, or not being adhered to by staff.

Staff skilling

4.33 Staff skilling is undertaken by the ATO to provide assurance that staff are appropriately and adequately equipped to undertake their work. The ANAO reviewed staff skilling processes for CVCs and the Activity Statement Stream.

4.34 The ANAO found that both areas maintain an extensive program for staff skilling, which combines formal and informal training. Current ATO skilling processes provide a robust measure of assurance that ATO staff are provided with appropriate training to process HRRs correctly.

Quality assurance

4.35 Robust QA processes provide assurance that staff are adhering to work procedures, and that the information they are providing to taxpayers is correct. Importantly, an effective QA process enables the ATO to monitor the quality of staff work, and identify training requirements.

4.36 The ATO has a number of QA processes, tailored to specific needs of ATO Lines. The ANAO focused on those QA processes relating to CVCs and the Activity Statement Stream.¹¹²

Quality assurance for Compliance Verification Centres

4.37 The GST Line has a comprehensive policy to achieve a nationally consistent approach to quality assurance, which includes CVCs. The Quality Management (QM) policy specifies benchmarks against which the quality of

¹¹¹ QA provides a measure of assurance that staff adhere to established procedures.

¹¹² The ANAO did not review QA for ILEC. Quality assurance for ILEC is discussed in Audit Report No.13, *ibid*.

work undertaken by CVC staff is assessed. The benchmarks for the 2004–05 financial year were that 90 per cent of CVC work reviewed would ‘pass’ the QA process, and 83 per cent would achieve an ‘A’ rating.¹¹³ The results of the CVC’s performance against these benchmarks are shown in Table 4.2 below.

Table 4.2 Comparison of CVC national quality results (2004–2005)

	Benchmark %	Sept 2004 %	Dec 2004 %	March 2005 %	June 2005 %
Pass	90	86	84	83	86
‘A’ Rating	83	64	69	66	48

Source: ATO (statistics are collected on a quarterly basis and have been rounded to nearest full percentage).

4.38 As Table 4.2 shows, for the 2004–05 year, CVCs have not met the required benchmarks to provide assurance that their work is of a sufficiently high standard. The quality of the work undertaken by CVC staff continued to decline throughout 2004–05. Based on these results, the ATO cannot provide comprehensive assurance that HRRs are being resolved by CVCs at an acceptable level.

4.39 To address the issues that have led to these results, the results need to be fully analysed. Comprehensive analysis of the QM results enables the ATO to identify potential areas for improvement (for example additional training or improved procedures), and recommend measures to resolve issues identified. Although the ATO did provide some limited analysis of these QM results, this analysis could be improved to identify the key reasons for its performance, or to provide a sound basis to resolve performance problems.¹¹⁴

Operations Accounting Activity Statement Stream and quality management

4.40 The Activity Statement Stream has implemented an extensive QM process to measure its performance against validity, consistency, clarity and timeliness in dealing with taxpayers. This QM process:

- monitors the consistency of procedures and decisions made by staff;

¹¹³ The ATO developed the *ATO Judgement Model* as a basis for assessing the quality of decisions made by ATO staff. The model looks at the question, the decision, the explanation, and the delivery. The model also specifies an A to E rating scale to assess the quality of ATO staff work.

¹¹⁴ The ANAO was provided with the following documentation regarding CVC quality management: feedback notices to CVC staff; reports to CVC regional managers; and the national CVC monthly report to the GST Line Executive. These documents did not analyse QM results, or provide recommendations to improve systemic poor performance.

- identifies training and development needs, and possible areas for improvement; and
- assesses the ATO's performance for: timeliness; case management; documentation; policy and procedure; and decision-making, against a benchmark of 95 per cent.

4.41 The ANAO reviewed the results of the Activity Statement Stream quality review QM process for 2004 and 2005. These results are presented in Table 4.3.

Table 4.3 Comparison of quarterly quality review results (2004 and 2005)

	Benchmark %	Timeliness %	Case Management %	Documentation %	Policy & Procedure %	Decision-making %
Apr 2004	95	83	82	79	78	87
Aug 2004	95	95	92	90	92	94
Dec 2004	95	88	95	88	93	96
Apr 2005	95	94	94	88	95	93

Source: ATO (statistics have been rounded to nearest full percentage).

4.42 In examining the results of these reviews, the ANAO found that, although the ATO falls below its benchmark standard, overall results have improved significantly in each of the five categories between April 2004 and April 2005. The Activity Statement Stream conducts comprehensive analysis of the results of quality reviews, which enables the ATO to identify potential areas for improvement, and recommend measures to resolve issues identified.

4.43 The ANAO considers that the Activity Statement Stream's QM process (and the analysis of its performance) demonstrates a robust quality assurance process to support the timely and accurate processing of activity statement refunds.



Ian McPhee
Auditor-General

Canberra ACT
28 March 2006

Appendices

Appendix 1: Agency response

Mr Ian McPhee
Auditor-General
Australian National Audit Office
19 National Circuit
Barton ACT 2600

Dear Mr McPhee

Thank you for your letter to the Commissioner of Taxation, dated 23 January 2006, from Executive Director Peter White in relation to the performance audit on the ATO's Administration of Activity Statement High Risk Refunds.

Managing risk is an important imperative for the Tax Office. We welcome the ANAO's recognition of the Tax Office's well established governance framework to manage Activity Statement Refund processing and the suggestions to strengthen the framework.

The Tax Office supports the recommendations contained in your report and has provided a response to each.

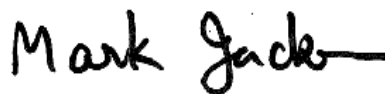
Thank you for the constructive and thorough approach taken by your office. We would like to acknowledge the collaborative efforts of Peter White, Jon Hansen, Katherine Buchanan, Elisa Serje and Brenda Canning during the course of the audit.

Yours sincerely



Geoff Robinson
Deputy Commissioner of Taxation

24 February 2006



Mark Jackson
Deputy Commissioner of Taxation

24 February 2006

**Tax Office response to proposed report
under s.19 of the *Auditor-General Act 1997*
The Australian Taxation Office Administration of Activity
Statement High-Risk Refunds**

Recommendation No. 1

To provide assurance that activity statement high-risk refunds are being managed effectively, and that relevant risks are being mitigated and priorities implemented as intended, the ANAO recommends that the ATO develop and implement:

- an integrated approach to planning within the GST Line and the Operations Line in accordance with relevant ATO practice statements; and
- procedures to provide assurance that ATO planning documentation applicable to the effective administration of high-risk refunds is appropriately linked.

Tax Office Response:

Agreed

The Tax Office recognises the need to have an integrated approach to planning. We note the ANAO's acknowledgement of the clear link from the ATO's output and outcomes framework in its high-level strategic planning documentation.

Through compliance with ATO Practice Statement CM 2004/06 Corporate Planning, the Tax Office will ensure that lower tier plans are prepared, documented and overtly linked to the relevant higher level plans of the organisation.

Recommendation No.2

To provide robust assurance that the activity statement refund process is efficient and effective, the ANAO recommends that the ATO:

- develop a framework to assess the performance of activity statement refund processing, which includes measures of both timeliness and the validity of activity statements issued by the ATO; and
- report regularly on the performance of activity statement refund processing to the relevant ATO area responsible for overseeing ATO refund processing.

Tax Office Response:

Agreed

The Tax Office accepts this recommendation.

We note the acknowledgement in the report of our initial positive steps in the identification of key performance indicators for end-to-end activity statement processing. We will build on this work to finalise an effective framework to assess the overall performance of activity statement refund processing. We will continue with the risk-based processes that determine whether the limited information provided in that statement is likely to be correct before refunds are released.

Recommendation No.3

To improve the efficiency and effectiveness of relevant activity statement refund committees and groups, the ANAO recommends that the ATO complete the process to:

- clearly establish and document the roles, responsibilities and accountabilities of committees and management groups;
- clearly define and document the interrelationships between committees and the management groups; and
- document all major decisions made by the relevant committees and groups, and the reasons for those decisions in accordance with Australian records management standards.

Tax Office Response:

Agreed

The Tax Office accepts this recommendation. Since the completion of the audit the Tax Office has implemented changes that substantively address the recommendation. Specifically, the Credit-Refund Integrity Steering Committee:

- has agreed and documented its role, functions, composition and relationship with the Refund Business Management Group(s); and
- will record and maintain minutes of its meetings, decisions and action items.

We are in the process of engaging an external organisation to deliver a base-line risk framework against which we can further assess the completeness of our existing strategic and operational governance and controls.

Recommendation No.4

To support the correct identification of activity statement high-risk refunds, and to effectively target compliance resources to mitigate high-risk refund risks, the ANAO recommends that the ATO:

- identify and assess strategic and operational compliance risks relevant to high-risk refunds in accordance with relevant ATO corporate risk practice statements; and
- develop and implement regular risk reporting processes at the strategic and operational levels to report on relevant high-risk refund risks.

Tax Office Response:

Agreed

The Tax Office agrees with this recommendation. We recognise the need for improvement to clarity and completeness of documentation. The Tax Office has a number of measures in place to identify, assess and report high-risk refunds. For example, a GST Risk Committee has already been established with responsibility for systematically identifying, rating and maintaining the high level documentation of all major GST risks (including refund risk).

Recommendation No.5

To assess the effectiveness of the ATO's strategy to identify and resolve activity statement high-risk refunds over time, the ANAO recommends that the ATO:

- develop, document and implement a methodology to assess the overall effectiveness of its high-risk refund compliance strategy to identify and resolve activity statement high-risk refunds;
- regularly analyse the performance of, including the costs of, individual compliance products used to mitigate high risk refunds; and
- develop and implement a systematic approach to report on the effectiveness of its high-risk refund compliance strategy.

Tax Office Response:

Agreed

The Tax Office accepts this recommendation and the need to better assess the effectiveness of various compliance tools in mitigating risks. The Tax Office will consider measures including:

- pre-issue checks
- strike rates;
- incident of incorrect refunds; and
- cost effectiveness.

Recommendation No.6

To assess the effectiveness of the changes made to the identification of high-risk refunds in 2004, including the effectiveness of the ATO's policy to override key tests in the Risk Rating Engine (RRE), and changes made to Risk Rating Engine tests, the ANAO recommends that the ATO:

- document the objectives of the override policy and the expected results of the policy;
- develop, document and apply a methodology to assess the performance of the override policy combined with the changes made to the RRE tests;

- develop, document, implement, and report on, a well coordinated quality assurance process for activity statement refunds subject to the override policy; and
- report to the relevant executive body on the performance of the override policy and the changes to the RRE tests.

Tax Office Response:

Agreed

In December 2004, in response to a review by the Inspector-General of Taxation, the Tax Commissioner stated the objective of the override policy in terms of a reduction in refund revenue held, and the number of taxpayers with withheld refunds. Clearly, we need to update and restate the override policy, documenting and clearly articulating this policy.

In relation to quality assurance and reporting, the existing reporting arrangement to the Credit –Refund Integrity Steering Committee will be enhanced by establishing appropriate exception reporting to the ATO Executive through the relevant Tax Office sub-plan executive.

Recommendation No.7

To provide adequate assurance that information technology systems, which support activity statement refund processing are operating as specified, the ANAO recommends that the ATO:

- compile and maintain comprehensive systems specifications documentation for the Refunder IT system;
- revise document management processes and procedures to maintain effective version control and ensure accessibility by appropriate staff for the Refunder IT system; and
- as part of its testing program, undertake regression testing relating to Refunder system changes to assess the overall effectiveness of relevant activity statement refund processing systems.

Tax Office Response:

Agreed

The Tax Office accepts this recommendation. Effective document management is an important part of systems management and centralisation of systems

documentation has commenced under the Production Change Management System Document Configuration and Rollout project. Migration of the documentation is due to occur in 2006 and will provide:

- a single repository;
- consistency in initiating change; and
- ability to record and track changes.

This will provide the assurances suggested by this recommendation.

Regression testing relating to the systems changes took place, providing a high degree of assurances, however the documentation was inadequate. The Tax Office recognises the need for documenting an explicit overarching testing strategy and will ensure this occurs through the improved document control and management processes mentioned above.

Appendix 2: Refund issued in error—2001 case

Case Study

Mistaken issue of \$8.4 million refund to a taxpayer – ‘the 2001 case’.

Case Overview

Under the tax law, taxpayers are entitled to claim a refund for wholesale sales tax paid on stock on hand at the start of 1 July 2000. Taxpayers can make these claims using Activity Statements.¹¹⁵

In December 2001 the ATO issued a significant refund to a large taxpayer as a result of a claim for wholesale sales tax. Almost 87 per cent (\$7 million) of this refund was issued in error. The ATO recognised that a series of errors, and poor internal communication led to the refund being issued in error.

Result of the incorrect refund being issued

The ATO was criticised widely in the media following its request to the taxpayer to repay the incorrect refund. The Commissioner for Taxation stated that while it was not acceptable for the ATO to issue the refund to the taxpayer incorrectly, it had to recover the incorrect refund from the taxpayer, as it was not appropriate for the taxpayer to keep a refund it was not entitled to.

The taxpayer considered that it was disadvantaged by the ATO’s decision to require the return of the refund, as it had already distributed the refund to its shareholders.

The ANAO notes that this case highlighted the potential risk to the ATO’s reputation within the community regarding issuing incorrect refunds.

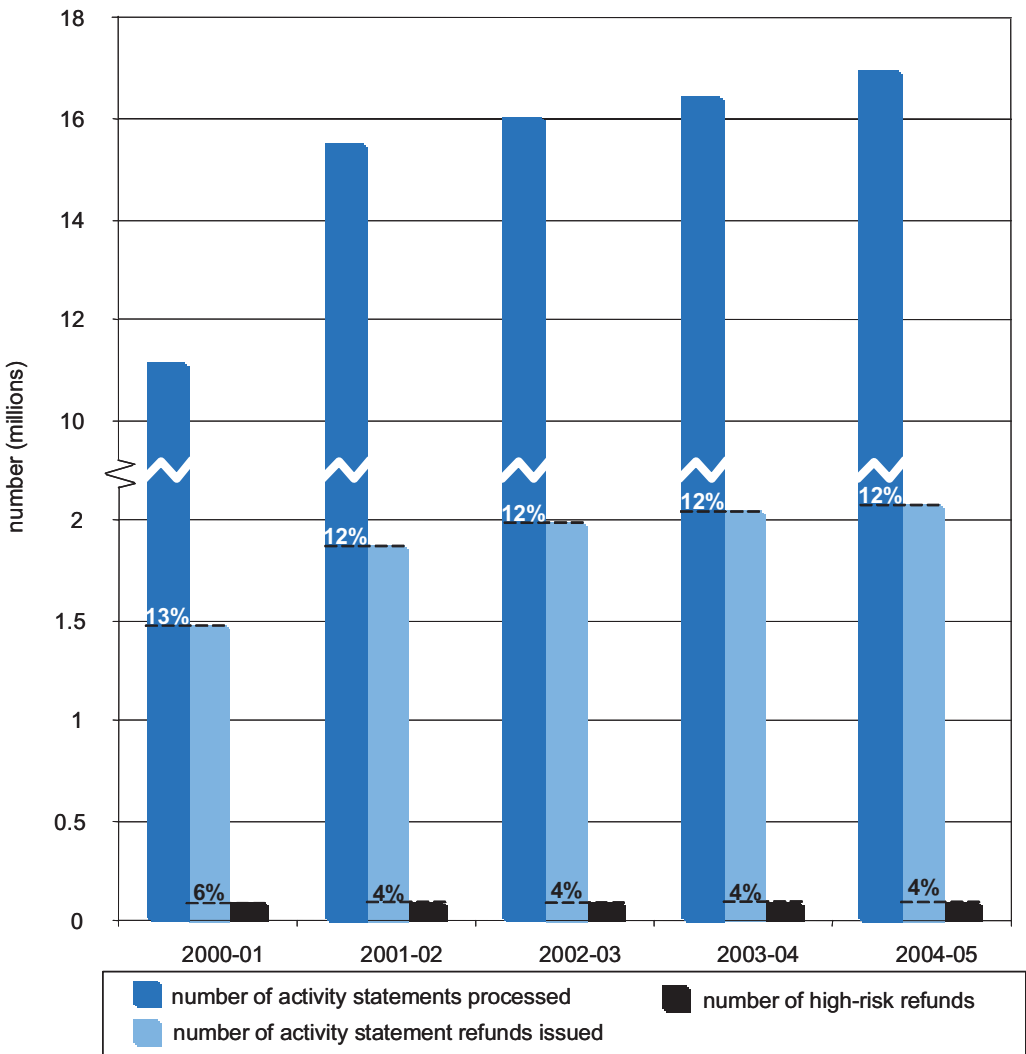
General limitations identified with activity statement processing systems in this case

- **Escalation procedures.** Existing escalation procedures were adhered to by ATO staff, however, these were not sufficient to ensure that an ATO staff member with enough expertise reviewed the ‘legal’ reasoning the taxpayer gave for claiming the large refund.
- **Systems.** The ATO’s Risk Rating Engine (RRE) did not identify that this refund was potentially risky and should be separately reviewed. The ATO later recognised that other systems, such as the Electronic Commerce Interface (ECI) and the Instalment Processing System (IPS), could also have been used to identify potentially risky refunds if appropriate validation and exception rules were in place.

¹¹⁵ Label 1G on a relevant BAS is used to claim wholesale sales tax credits of this type.

Appendix 3: Analysis of high-risk refund statistics

Activity statements processed and refunds issued for 2000–01 to 2004–05



Source: ANAO analysis of HRR data¹¹⁶

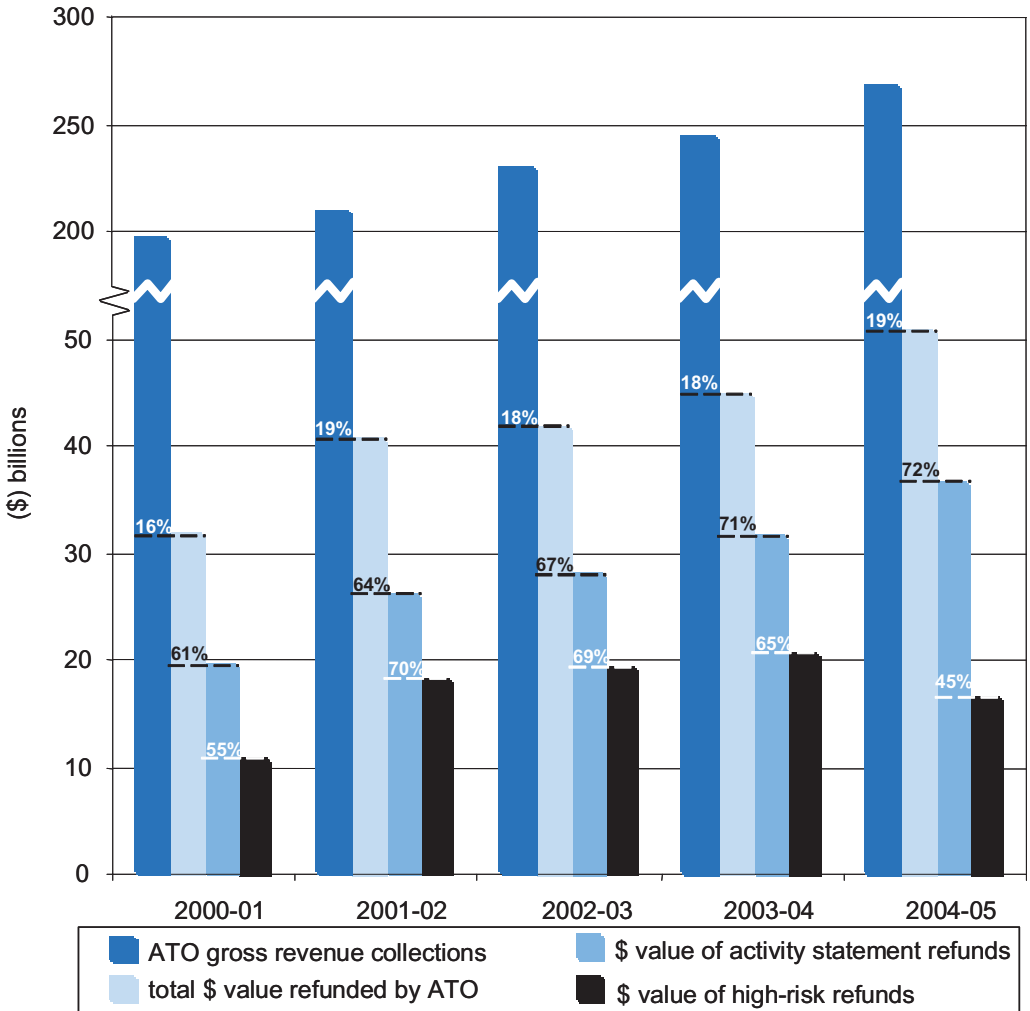
Note: The scale on Y axis changes from 0.5 million increments to 2 million increments after the scale break.

¹¹⁶ The ATO advised that there are some discrepancies which cannot be reconciled between the data used to compile these statistics, and the data used in the Commissioner of Taxation's Annual report (see paragraphs 1.1-1.3). The statistics presented, however should be indicative of the volumes and revenues applicable to the ATO administration of activity statements and activity statement refunds.

Analysis of the figure above shows that:

- between 12 per cent and 13 per cent of all activity statements processed resulted in an activity statement refund;
- of the activity statements that resulted in refunds, between 4 per cent and 6 per cent were considered to be HRRs, and were manually examined by ATO staff; and
- The number of activity statement refunds compared to the number of HRRs has remained relatively consistent between 2001–02 and 2004–05.

Comparison of gross ATO revenue collections to revenue collected through Activity Statements and HRR for 2000–01 to 2004–05



Source: ANAO analysis of HRR data¹¹⁷

Note: The scale on Y axis changes from 10 billion to 50 billion increments after the scale break.

Analysis of the figure above shows that:

- the proportion of the \$ value of activity statements has ranged between 16 per cent and 19 per cent of total gross revenue collections;

¹¹⁷ The ATO advised that there are some discrepancies which cannot be reconciled between the data used to compile these statistics, and the data used in the Commissioner of Taxation's Annual report (see paragraphs 1.1-1.3). The statistics presented, however should be indicative of the volumes and revenues applicable to the ATO administration of activity statements and activity statement refunds.

- between 61 per cent and 72 per cent of all refunds issued by the ATO between 2000–01 and 2004–05 were related to activity statement refunds; and
- of the dollar value of activity statement refunds issued by the ATO from 2000–01 and 2004–05, between 55 per cent and 70 per cent were considered to be high-risk. In 2004–05, 45 per cent of the total dollar value of activity statements were high-risk. This decrease may relate to the changes in ATO HRR policy described in Chapter 3.

Examination of both diagrams shows that although HRRs only account for a small proportion of the total number of activity statement refunds issued (approximately 4 per cent for 2004–05), HRRs represent a large proportion of the total dollar value of activity statement refunds issued (45 per cent for 2004–05).

Appendix 4: Description of the ATO areas responsible for the administration of high-risk refunds

The two Lines primarily responsible for the administration of HRRs are the Operations Line and the GST Line. Within these Lines, there are a number of divisions and teams with specific responsibilities regarding aspects of HRR management. These are:

- GST General Compliance division. This division includes:
 - the Strategic Risk Management team, which is responsible for, among other activities, the creation and maintenance of automated risk tests¹¹⁸ applied by ATO systems (the Risk Rating Engine) to identify HRRs; and
 - Compliance Verification Centre teams, which are responsible for, among other activities, investigating and resolving HRRs.
- Interpretations and Large Enterprise Compliance (ILEC).¹¹⁹ This division includes the Risk Management Team, which is responsible for, assisting in maintaining automated GST risk tests to identify HRRs for businesses with a turnover of greater than \$100 million.
- Operations Accounting. This division includes:
 - the Activity Statement Stream, which is responsible for, among other activities, administering taxpayer accounts, including the administration of activity statement refunds and the calculation of delayed refund interest¹²⁰; and
 - Refund Integrity Team, which is responsible for, among other activities, providing the ATO executive with assurance that activity statement refunds are issued promptly and that refunds issued by the ATO are correct. The roles and functions of the Refund Integrity Team are:

¹¹⁸ See Chapter 1 for an overview of the automated tests used to identify HRRs.

¹¹⁹ Interpretations and Large Enterprise Compliance was examined in Audit Report No. 13, 2005–06, *Administration of Goods and Services Tax Compliance in the Large Business Market Segment*.

¹²⁰ Delayed Refund Interest is discussed from paragraphs 2.53 to 2.60.

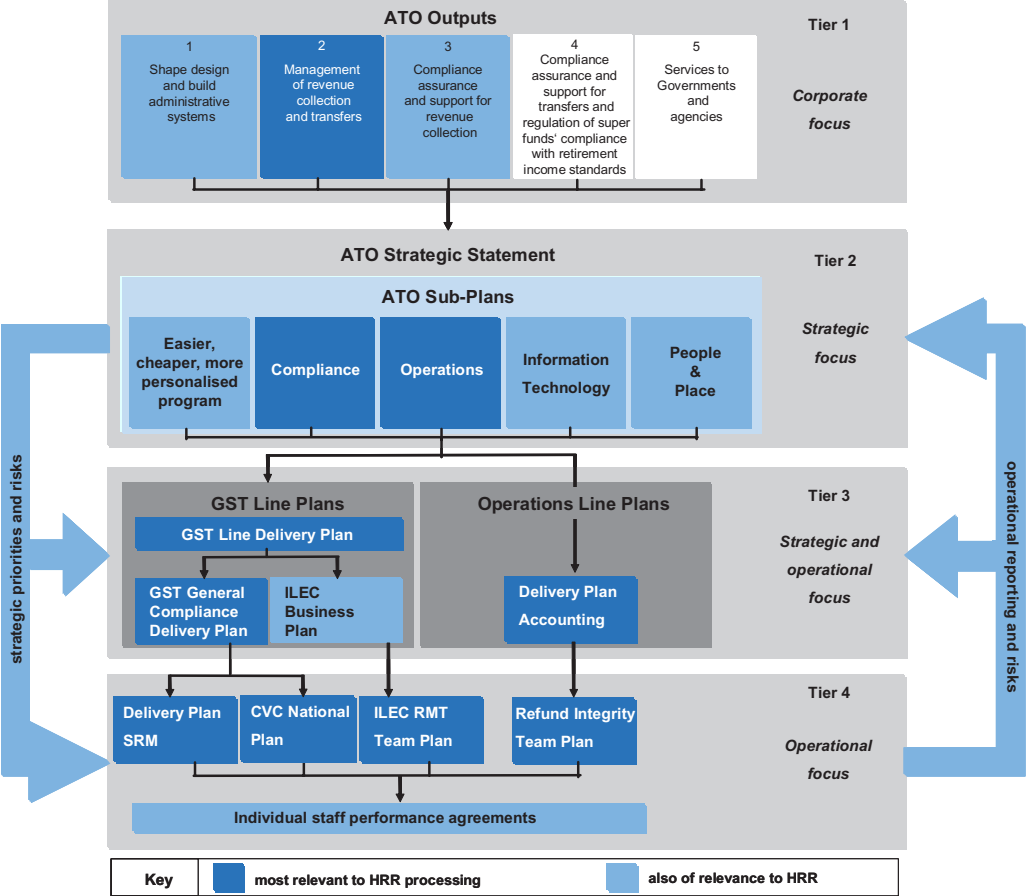
- analysing intelligence relevant to refund processing, and providing recommendations for improvement¹²¹;
- supporting the Certificate of Compliance process (see paragraphs 2.46 to 2.49);
- liaising with organisations external to the ATO regarding refund processing;
- liaising between the various areas of the ATO responsible for refund processing;
- providing support for the development of business requirements for systems and processes relevant to refund processing, and undertaking specific projects to improve refund processing;
- providing a secretariat function for the various committees and management groups responsible for monitoring refund processing (from paragraph 2.37); and
- reporting to the various committees and management groups regarding the efficiency and effectiveness of refund processing systems and controls.

In addition to the Lines, divisions and teams, the ATO has three committees/management groups that are used to oversee the end-to-end activity statement process, including the management of HRRs. These committees are discussed further from paragraph 2.37.

An essential element of a complex governance framework is that roles, responsibilities and accountabilities of work areas are clearly defined, and that a cohesive approach to managing HRRs is used.

¹²¹ The ANAO considers that this would include the investigation of significant incorrect refunds issued by the ATO.

Appendix 5: Aspects of the ATO’s planning and reporting framework relevant to the administration of high-risk refunds



Source: ANAO analysis of ATO information.

For the HRR planning framework to be effective, it is important that there are clear links between the planning documentation between each tier and within each tier. This includes integrating objectives, ensuring a consistent and cohesive approach to assessing risk, and monitoring and reporting performance. Each tier, and its relevance to the administration of HRRs, is discussed below.

ATO outputs (Tier 1)

The ATO’s outputs establish its corporate direction, and specify the products and services it undertakes to deliver to the community. It is also a mechanism

used to report the ATO's performance publicly.¹²² Activities associated with the administration of HRRs mainly relate to Output 2 — management of revenue collections and transfers. Key quantitative measures for this output include the number of refunds issued and performance against Taxpayers' Charter standards.¹²³

ATO sub-plans (Tier 2)

The ATO sub-plans articulate the strategies, priorities, risks and performance measures the ATO uses to manage its performance, and report against its outcome¹²⁴ and outputs. Aspects of each sub-plan provide the strategic direction for the administration of HRRs. The ANAO focused on the Compliance sub-plan (which identifies compliance priorities and risks for the ATO by market segment¹²⁵) and the Operations sub-plan (which specifies many of the performance targets and strategies specific to refund processing and HRRs).

GST Line plans and Operations Line plans (Tier 3)

Planning at this tier should be used to translate strategic priorities and other directives outlined in the sub-plans, into tangible and measurable priorities for ATO Lines. It should also be used by Lines to identify strategic priorities and risks; which should be used by relevant teams to develop their planning documentation. The ANAO's focus was on the relevant plans from the Operations Line and the GST Line.

Team plans (Tier 4)

Plans at this tier should provide a greater level of detail regarding the practical implementation of the priorities documented in line plans. The ANAO notes that, at this tier, planning documentation may differ significantly from team to team depending on the role and function of individual teams.

¹²² The ATO reports its performance through the ATO's Portfolio Budget Statements, Portfolio Additional Estimates Statements, and in its annual report.

¹²³ The Taxpayers' Charter states that the ATO aims to issue 90 per cent of activity statement refunds within 14 days. This issue is discussed further in paragraphs 2.54.

¹²⁴ The ATO's outcome is: *effectively managed and shaped systems that support and fund services for Australians and give effect to social and economic policy through the tax, superannuation, excise and other related systems.*

¹²⁵ Market segments comprise: individuals; micro-businesses (turnover of less than \$2 million); small to medium enterprises (turnover of between \$2 million to \$100 million); and large business (turnover greater than \$100 million).

Appendix 6: Committee and management group framework relevant to refund processing

Refund Integrity Steering Committee

The Refund Integrity Steering Committee (or RISC) is the principal forum used to, amongst other functions, develop the strategic direction of the ATO's management of all refunds. The permanent membership of the Refund Integrity Steering Committee includes the ATO Deputy Commissioners in charge of the Operations Line, GST Line and Small Business Line.¹²⁶

During the audit, the ATO Executive asked the Refund Integrity Steering Committee to review its charter and role. This resulted in the committee deciding that:

- the Refund Integrity Steering Committee be chaired by DC Operations and that the RISC and its support from the Refund Business Management Group take on a broader role that covers pre-issue fraud tests and refund integrity (focussing on activities that incorrectly take money out of the system by fraud, identify theft or error);
- be formally responsible for determining the balance between the risk treatments for all revenue products and the operational effectiveness of the associated processes; and
- include members of the product committees.¹²⁷

Although the Refund Integrity Steering Committee provides a means to monitor and direct end-to-end activity statement refund processing activities, the ANAO notes that:

- the Committee does not have a comprehensive charter specifying its role¹²⁸, responsibilities, accountabilities, membership and interaction with other relevant management groups;
- it is unclear what responsibilities the Committee has with regard to changing refund systems, processes and controls; and

¹²⁶ The Deputy Commissioner for the Serious Non-Compliance Line also attends the Refund Integrity Steering Committee regularly, as well as a number of Assistant Commissioners attached to other ATO Lines.

¹²⁷ ATO written comments provided to the ANAO on 6 October 2005.

¹²⁸ Refer to paragraph 2.40.

- key decisions made by the Committee, and the reasons for those decisions, are not documented well in meeting minutes, or other relevant documentation (in particular decisions regarding the override policy).

Refund Business Management Group

The Refund Business Management Group was originally formed in mid-2004, and is responsible for identifying and managing integrity, process and administration issues in the end-to-end process. In February 2005, the group further clarified its role and function in a charter which states that the:

Refund Business Management Group was formed to ensure that correct refunds are issued within the service standards outlined in the Taxpayer's Charter and to serve as a conduit to the Refund Integrity Steering Committee.¹²⁹

The membership of the Group includes a range of business managers, each of which is responsible for an aspect of the end-to-end refund process (see Figure 2.1).

Although the Group has taken steps in 2005 to define its role and function more clearly, the ANAO notes that, based on the Group's charter, it is difficult to determine whether the roles and functions of the group duplicate, or unnecessarily overlap, those of the Activity Statement Product Management Group and the Refund Integrity Steering Committee.

Activity Statement Product Management Group

The Activity Statement Product Management Group was established in 2005 to

Provide direction and governance on all activities relating to activity statements. In particular the group will focus on improving the product and addressing associated risks and issues, and thus improving the overall client experience.¹³⁰

Specifically the ATO sees the Group as an advisory forum to:

- provide 'connectiveness' across all activity statement projects, from end-to-end;
- make recommendations for changes to activity statements;

¹²⁹ Australian Taxation Office *Refund Business Management Group Charter*, February 2005.

¹³⁰ Australian Taxation Office *Activity Statements Product Management Group Charter*, June 2005.

- receive activity statement related issues from staff and escalate them to the right ATO stakeholders; and
- provide sign-off on changes to ATO activity statement systems.

The Group has a large membership representing approximately 22 individual areas within the ATO. These areas cover the end-to-end activity statement process. Also, many of the members of the group are also members of the Refund Business Management Group.

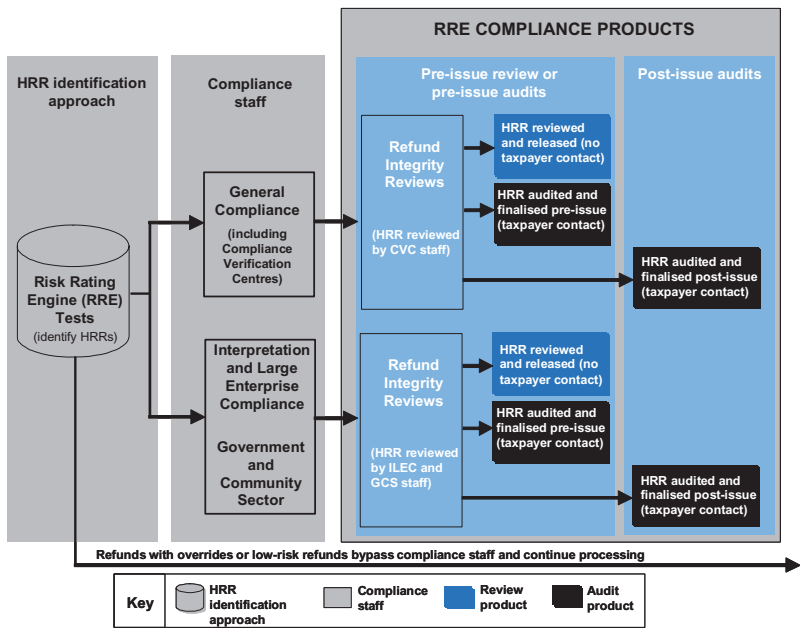
The role and function of the newly formed Group has been refined between February and July 2005. However, the ANAO notes that it is not clear whether:

- the role and functions of the Refund Business Management Group is being duplicated; and
- some of the functions of the Refund Integrity Steering Committee (for example, signing-off changes to systems) are being duplicated.

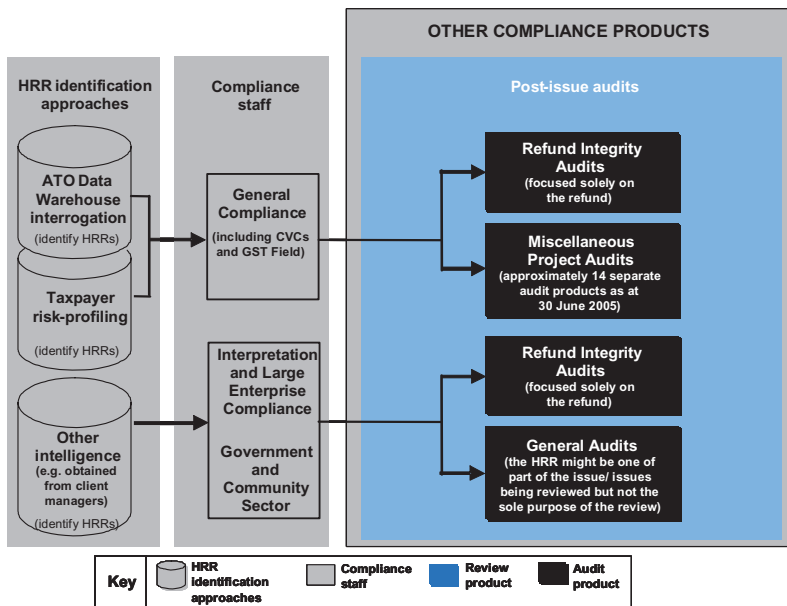
The ATO advised that the Refund Business Management Group has prepared 'an outline of how the various management groups would inter-relate', which is to be provided to the Refund Integrity Steering Committee for comment.

Appendix 7: Risk Rating Engine and other compliance products

RRE CASE SELECTION APPROACH



'OTHER CASE SELECTION APPROACHES



Appendix 8: ANAO assessment of the effectiveness of the ATO's approach to high-risk refund compliance

To examine the effectiveness of the ATO's HRR compliance strategy, the ANAO sought to assess whether the ATO uses the optimal combination of compliance products and compliance staff to successfully identify and resolve HRRs. The optimal combination of compliance products and staff, would seek to identify and resolve the largest number of HRRs, at the lowest cost to the ATO, across a range of taxpayers.

How does the ATO assess the effectiveness of its high-risk refund compliance strategy?

Prior to 2003–04, the ATO did not regularly assess the performance of its HRR compliance strategy. From 2003–04 the ATO collected information on three performance measures which can be used to assess aspects of the effectiveness of its compliance strategy. These performance measures are:

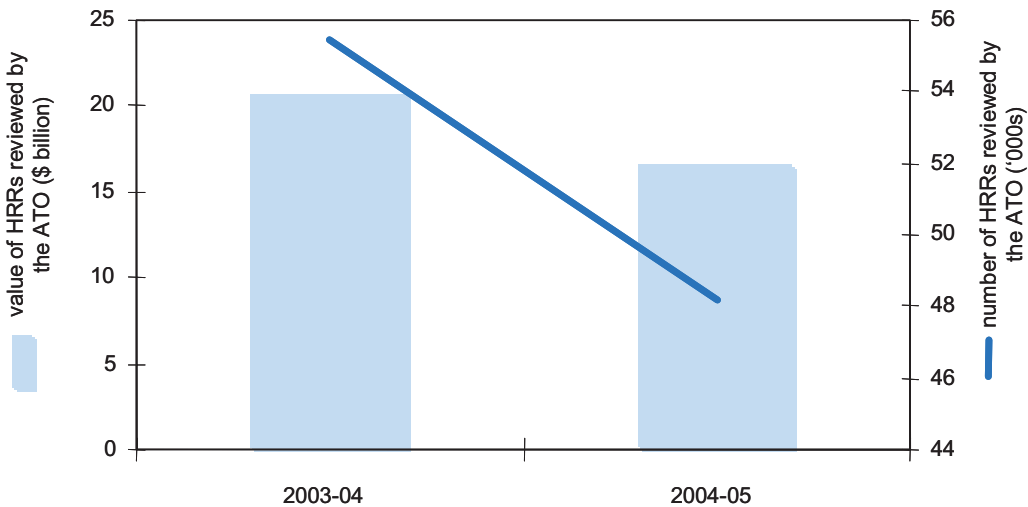
- value and number of HRRs reviewed by the ATO;
- value of revenue raised from adjusting activity statements identified as HRRs; and
- strike rate. This is used to measure the effectiveness of the RRE or 'other case selection approaches' in identifying HRRs that result in an adjustment to the activity statement. The strike rate is calculated using the following formula:

$$= \frac{\text{total number of HRRs adjusted}}{\text{total number of HRRs identified where client contact is made}}$$

The performance of the ATO's HRR compliance strategy using these performance measures is shown in the figures below.¹³¹

¹³¹ The information contained in Figures (a) and (b) are indicative only, of the overall performance of the HRR compliance strategy. The data used in the graphs is not complete, as data for all compliance products has not been included because it was not available.

Figure (a): Value and number of HRRs reviewed by the ATO for 2003–04 and 2004–05



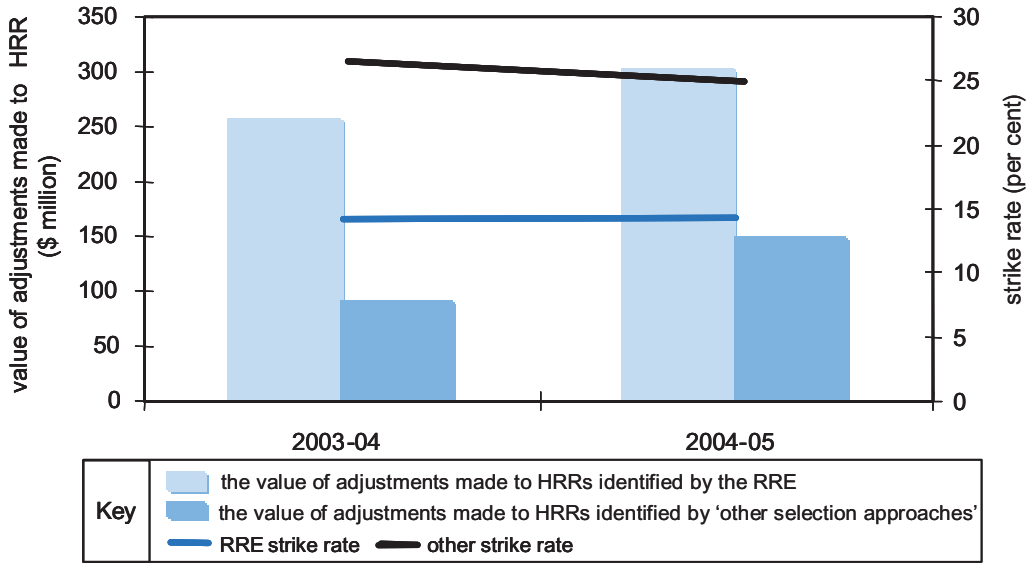
Source: ANAO analysis of ATO data

Analysis of figure (a) shows that between 2003–04 and 2004–05:

- the total number of HRRs reviewed by ATO compliance staff decreased by 15 per cent; and
- value of refunds reviewed decreased by approximately 25 per cent (\$4.2 billion).

The ANAO considers that the significant decreases in the number and value of HRRs reviewed by ATO compliance staff is likely to be largely attributed to the introduction of the ‘override policy’ and new RRE tests. The override policy is discussed in paragraphs 3.46 to 3.53.

Figure (b): Value of revenue raised from adjusting HRRs and strike rate for 2003–04 and 2004–05



Source: ANAO analysis of ATO data

Figure (b) shows that between 2003–04 and 2004–05:

- the value of refunds adjusted as a result of RRE compliance related activity increased by 18 per cent (\$45.9 million);
- the value of refunds adjusted as a result of 'other case selection approaches' increased by 65 per cent (\$58.1 million);
- the effectiveness of the RRE at identifying genuine HRRs (that is, activity statement refunds that require adjustment) increased marginally, by approximately 1 per cent;
- the effectiveness of 'other case selection approaches' at identifying genuine HRRs decreased by approximately 4.5 per cent; and
- 'Other selection approaches' are significantly better at identifying genuine HRRs (25.24 per cent strike rate) compared to the RRE (14.33 per cent)

The ANAO also notes that in 2004–05 the average RRE-generated audits resulted in an adjustment \$7 637 to HRRs. In comparison, the average adjustment from 'other case selection approaches' was \$17 254.

From the statistics above, the RRE appears to be less effective in identifying HRRs than 'other case selection approaches'. However to effectively draw a comparison between the RRE and 'other case selection approaches', other information, such as the cost of each HRR selection approach needs to be assessed.

Also, the RRE recovers approximately 50 per cent more revenue (from identifying adjustments to HRRs) than 'other case selection approaches'. However the RRE identified approximately 63 000 HRR (which had to be reviewed by compliance staff) in comparison to 'other case selection approaches' which identified approximately 13 000.

The ATO notes that, to fully assess the effectiveness of the RRE and 'other case selection approaches', the type of compliance risk being managed needs to be considered. Also, qualitative performance measures such as the deterrent benefits of pre-issue and post-issue compliance approaches need to be assessed.¹³² Without consideration of these, it is difficult to achieve an optimal balance of compliance products based on the figures above.

ANAO comment on HRR compliance strategy performance analysis

Based on the available information it is difficult to make a meaningful assessment of whether the ATO's HRR compliance strategy has improved between 2003–04 and 2004–05. It is also difficult to assess whether the ATO has achieved an optimal balance of compliance products based on the figures above.

The ANAO notes analysis of this type of performance information is essential to determine whether the compliance strategy is achieving its objectives, and performance is improving. That said, the ANAO notes the following about the analysis above:

- It is incomplete. The data for some compliance products (see Appendix 8) relevant to ILEC and GCS has not been collected consistently by the ATO for 2003–04 and 2004–05. A methodology to obtain consistent and comparable data over time is being refined by the ATO.
- The methodology to collect information relevant to particular compliance products is inconsistent. In some cases (particularly for

¹³² The ATO notes that it is difficult to obtain a meaningful measure of the deterrent effect the various HRR compliance strategies have on taxpayer compliance with their refund related obligations.

ILEC) the methodology for gathering the performance information relating to particular compliance products has not been established. This prevents direct comparisons being made between compliance products.

- Performance targets have not been established for each product. For example, 'strike rate' targets, for individual compliance products.
- Costing information for each product is not collected. This prevents the ATO from comparing the cost (in terms of value and staff resources) of each product.

Also, although the ATO has collected the data shown in the figures above, there is no documentary evidence to show that it has analysed it, or reports on it regularly. As discussed in Chapter 2, the ANAO considers that analysing and reporting this type of performance information (once complete and accurate) could provide an effective measure of the 'validity' of activity statements (see paragraphs 2.50 to 2.52).

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