

The Auditor-General
Audit Report No.37 2000–2001
Performance Audit

The Use of Audit in Compliance Management of Individual Taxpayers

Australian Taxation Office

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of Australia 2001
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Canberra ACT
23 May 2001

Dear Madam 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 this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *The Use of Audit in Compliance Management of Individual Taxpayers*.

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



P. J. Barrett
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

ANAO	Australian National Audit Office
APS	Australian Public Service
ATO	Australian Taxation Office
ATP	aggressive tax planning
ATPF	Australian Tax Practitioners Forum
BANCOM	Business Advisory Network–Compliance Management
BISEP	Business, Industry, Social, Economic and Psychological factors
CAS	Case Actioning System
CIDC	Client Identification Compliance unit
CMIF	Compliance Management Integration Forum
CMS	Compliance Management Strategy network
CRS	Case Reporting System
CSIRO	Commonwealth Scientific and Industrial Research Organisation
CTSI	Centre for Tax System Integrity
DWH	data warehouse
ELS	Electronic Lodgement System
GST	Goods and Services Tax
HATPIN	Holistic ATP Integrated Network
HOTSA	Health of the System Assessment
I&C	Interpretation and Compliance stream
ICOF	Interpretation and Compliance Operations Forum
IMS	Income Matching System
INB	Individuals Non-Business line
INBUCA	INB Unit Cost Analysis system
IT	Information Technology
KDA	Knowledge Development and Analysis unit
LB&I	Large Business and International line

LOAT	Level One and Two (complaints) management system
OCTC	Office of Chief Tax Counsel
PAYG	pay as you go tax system
PIQAR	Pre-Issue Quality Assurance Review
POQAR	Post-Issue Quality Assurance Review
PRS	Problem Resolution Service
QA	Quality Assurance
SB	Small Business line
TAB	Tax Agents Board
TAIU	Tax Agents Investigation Unit
TID	Tax instalment deduction
TSP	Total Skilling Program
TTN	Tax Technical Network
SWE	Schedule of Work Expenses
WRE	Work Related Expenses

Summary and Recommendations

Summary

Background

1. The Australian Taxation Office (ATO) is the Commonwealth's principal revenue collection agency, responsible for collecting a range of different taxes. In 1999–2000, the ATO accounted for total taxation revenue collections, including excise collections, of \$151.7 billion¹.
2. The Individuals Non Business (INB) line manages and maintains that part of the income tax system dealing with individual taxpayers who are not in business. It caters for approximately 8 million taxpayers and 24 000 tax agents. Individual taxpayer collections for 1999–2000 amounted to \$82.7 billion² or 54.5 per cent of total collections.
3. The ATO has adopted a risk management methodology which it has combined with a compliance model framework within which it manages client relations. Consistent with this framework, INB's major resource allocation is on providing information and education activities to encourage compliance. While there is a concentration of activities supporting a self-regulated approach, there is necessarily a component of audit activity. This involves an examination of taxpayer financial affairs to ensure that tax returns are correct and to verify any tax liability that taxpayers may have. Audits are conducted by a variety of means — some entirely by mail or telephone queries; others using face-to-face interviews and physical examination of taxpayer records by ATO audit staff.
4. The area of interest for the ANAO's performance audit lay with INB's audit functions. Taxpayer compliance activities within INB, including the conduct of audits, are the responsibility of staff of the Interpretation and Compliance (I&C) stream.

Audit objective and approach

5. The objective of the audit was to examine the use of audit as an element of the compliance management function within INB. In doing so, the audit reviewed both the strategic framework and operational elements in relation to INB audit activities.

¹ ATO Annual Report 1999–2000, p. 24.

² *ibid*, p. 33.

6. The audit focused on INB's audit strategy, risk assessment, audit planning, performance measurement and reporting and its operational effectiveness. In reviewing operational effectiveness, we considered a range of issues, including performance outcomes, the handling of complaints, management control practices, use of the data warehouse, quality assurance and control, correspondence with taxpayers and staff training.

Overall conclusion

7. The use of audit was found to be an effective element of INB's approach to encouraging taxpayer compliance. We also concluded that INB is working to achieve the outcome of improved taxpayer compliance by:

- developing a strong, strategic framework for addressing its compliance management responsibilities, including its use of audit;
- basing compliance activities on a sound risk management process; and
- using planning and management tools to provide a robust and effective structure for managing I&C functions, including compliance audit activities.

8. We also identified a number of areas where improvement would add to the effectiveness of INB's compliance management, as follows:

- the timeliness of developing INB's Risk Management Plan;
- the need to consider computer system reliability in determining operational risks;
- extending quality assurance processes to audit related telephone communication and computer note-taking activities; and
- the ease of understanding of correspondence to taxpayers about discrepancies found as a result of audit activity.

Key Findings

Audit strategy and planning

9. INB has developed a Compliance Management Strategy to ensure that resources are targeted at areas most at risk of non-compliance with tax law. We found the strategy provides an effective framework for the identification and priority ranking of compliance risks. It also facilitates determination of the level of audit resources required to address identified risks.

10. INB also conducts research into taxpayer behaviour and the influences on that behaviour. This research has the potential to contribute to the more effective targeting of INB's compliance strategies, including the use of audit. However, we consider that to benefit fully from this compliance research, INB should put processes in place to ensure research outcomes are integrated into its strategic and risk management planning processes.

11. In examining INB's strategic and business planning, we found that planning outputs were well structured and consistent in terms of their content and direction. Moreover, INB strategic and business planning contributes to achievement of, and reporting on, INB's operational outcomes, including audit activities.

Risk assessment

12. Risk assessments are a key element of the compliance strategy. They provide the basis for the identification of priorities and subsequent resource allocation to compliance activities, including audits.

13. INB's I&C stream undertakes risk assessment projects on taxation issues such as work related expenses, foreign source income and rental income/losses. The ANAO found that these risk assessment projects are conducted effectively, providing a sound basis to address identified compliance risks.

14. The ANAO did find, however, that INB had still not completed its 2000-01 Risk Management Plan, some five months into the operational year. As an integral element of a sound strategic framework, timely preparation and release of the Risk Management Plan each year is an important step in developing and implementing strategies to mitigate risk, particularly as these strategies are also critical to the development of the INB Operational Plan. Delays in finalising its Risk Management Plan could unduly inhibit INB's performance against the outcomes it is expected to achieve.

Types of audit

15. The ANAO found that INB uses four main kinds of audit activity to check tax returns, as follows:

- label or issue audits, where specific items of a return (known as labels) are checked;
- edits, where computer checking of returns highlight anomalies;
- audits arising from income matching with information from, for example, financial institutions; and
- tax agent based investigations.

The cost per \$100 of revenue collected from these audit activities ranges from eight cents for certain highly automated edits to about \$29 for the mainly manual activity in checking a particular label or issue based on community information.

Performance outcomes

16. We reviewed performance measures used by INB to assist in determining the effectiveness of audit activity. These relate to the number of taxpayer cases adjusted as a result of audit activity and any resultant change in taxation assessed. We found that, while a similar number of cases were audited in 1998–99 and 1999–2000, the number of adjusted cases increased slightly in 1999–2000, leading to a 50 per cent increase in taxation assessed. This suggested improved effectiveness in audit activities. However, I&C has only been recording performance information in this format for the last two years. Collection of longer-term performance information would place the ATO in a better position to assess the effectiveness of its audit program.

Complaints

17. By their nature, audit processes have the potential to lead to conflict between affected taxpayers and the ATO, resulting in complaints. The ATO has a complaints handling mechanism to deal with the concerns of those taxpayers who are not satisfied with a decision the ATO has made about their tax affairs or their treatment by the ATO.

18. We reviewed the handling of complaints relating to INB compliance functions. Overall, we found that I&C is responsive to concerns raised in the complaints received. We also found that the number of complaints related to audit activity is relatively low, given that there were fewer than 300 complaints from nearly 240 000 audit contacts with taxpayers during 1999–2000.

Management control

19. The I&C stream operates under a relatively complex matrix structure with staff performing a variety of tasks, including audit. The ANAO found that managing compliance work, including audits, using the various teams and sites across Australia could be improved. More formal arrangements such as the use of a service level agreement would enhance the transparency, accountability and management of compliance functions performed by I&C operations staff.

Data warehouse

20. The data warehouse is a repository of data collected by the ATO from sources such as tax returns and external bodies such as employers and financial institutions. INB is dependent on the data warehouse for a range of services that support its compliance functions, including audit activities. The ATO is attempting to address the increasing pressure on the data warehouse's limits of its capacity. However, given its dependency on the data warehouse, INB should also address in its risk management strategy the future capacity and functionality of the warehouse.

Quality assurance and control

21. Quality control and quality assurance are essential to sound corporate governance. As part of its quality management strategy, I&C utilises quality control checks prior to case completion. We found that quality control processes are in place for audit cases involving written records. However, audit cases that involve telephone advice, and where a computer annotation is made, are not subject to quality control processes.

22. I&C also participates in ATO-wide quality assurance checks after case completion. The ANAO concluded that there was a need to include an appropriate random sampling technique to improve the accuracy and usefulness of the post-issue quality assurance processes.

Correspondence with taxpayers

23. The ANAO reviewed the reading ease of the standard set of correspondence documents sent to a taxpayer as a result of audit processes that detected a discrepancy. We found that a taxpayer would generally have difficulty reading and understanding such correspondence. In addition to causing concern for some taxpayers, this deficiency may result in additional workloads for the ATO with taxpayers seeking further clarification.

Training

24. I&C has recognised the importance of training. Although the ANAO found that an accreditation process was in place for technical team leaders to achieve an appropriate skill level, INB need to give higher priority to staff training to ensure adequate skilling of its operational staff and continuing quality of audit work. Given the importance of training, staff training issues should also be included in performance reports to management.

Recommendations

Set out below are the ANAO's recommendations aimed at improving the effectiveness of INB's use of audit. Report paragraph references and abbreviated ATO responses are included here with more detailed responses shown in the body of the report. The ANAO considers that the ATO should give priority to Recommendations 1,4, 5 and 7.

Recommendation No.1
Paragraph 2.24 The ANAO recommends that, to ensure timely and effective management of identified risks, INB take steps to complete its risk management plan before the commencement of each operational year.

ATO Response: Agreed.

Recommendation No.2
Paragraph 2.58 The ANAO recommends that, to target compliance functions more effectively in the future, the ATO establish mechanisms to ensure the integration of compliance research outcomes with INB's strategic and risk management planning processes.

ATO Response: Agreed.

Recommendation No.3
Paragraph 3.37 The ANAO recommends that, to enhance the management of its compliance functions, INB develop a service level agreement, or similar, between its CMS and Operations streams, for management of compliance functions performed by Operations staff.

ATO Response: Agreed.

Recommendation No.4
Paragraph 3.46 The ANAO recommends that, in recognition of its significant reliance on computer systems for carrying out its functions, INB address in its risk management plan the reliability of specific operating systems and the risks to operational effectiveness associated with system failure.

ATO Response: Agreed.

Recommendation No.5 Paragraph 3.59 The ANAO recommends that, to ensure comprehensive coverage of quality review processes:

- all post-issue QA review sampling use an appropriate random selection technique; and
- INB introduce quality control mechanisms for telephone advice to taxpayers and computerised note keeping.

ATO Response: Agreed.

Recommendation No.6 Paragraph 3.69 The ANAO recommends that, to improve communication with taxpayers and reduce the risk of increased workload for the ATO, INB improve the reading ease of letters and documents sent to its clients.

ATO Response: Agreed.

Recommendation No.7 Paragraph 3.78 The ANAO recommends that, to ensure adequate skilling of its staff and continuing quality of audit work, INB:

- gives a higher priority to staff training; and
- addresses staff training and training related issues in INB management reports on performance.

ATO Response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides background information on the ATO's operating environment, including the ATO's approach to risk management and its adoption of the compliance model. The use of audit as an enforcement strategy within the compliance model is discussed. The chapter also outlines the objective and approach for the audit and the structure of this report.

Environment and context

Background

1.1 The ATO is the Commonwealth's principal revenue collection agency, responsible for collecting a range of different taxes. In 1999–2000, the ATO accounted for total taxation revenue collections, including excise collections, of \$151.7 billion³.

1.2 The ATO is structured around groups of clients, into business and service lines. Each business line has responsibility for one major market segment. The ATO business lines, set up to administer the collection of income and other taxes, are:

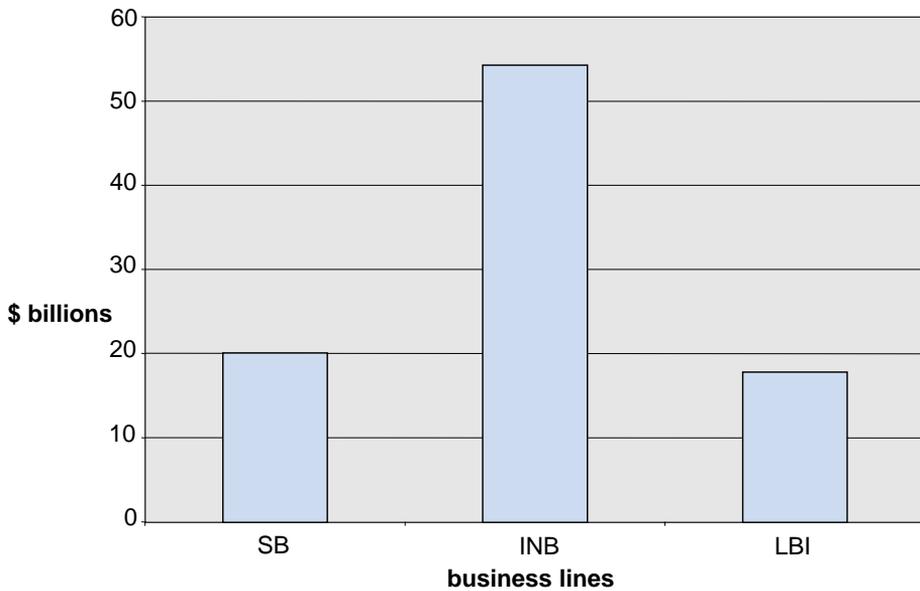
- Small Business (SB);
- Individuals Non Business (INB);
- Large Business and International (LB&I);
- Superannuation (SPR);
- Goods and Services Tax (GST); and
- Excise.

1.3 The following figures compare the net tax payable and client base respectively of the three largest revenue business lines, SB, INB and LB&I.

³ ATO Annual Report 1999–2000, p. 24.

Figure 1.1

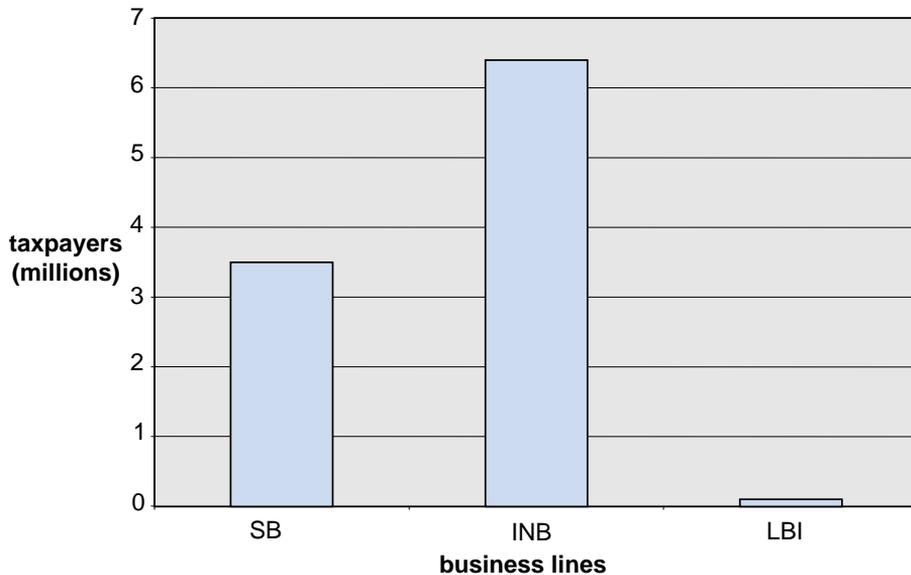
Net tax payable — ATO business line comparison



Source: Australian Taxation Office 1998–99⁴

Figure 1.2

Taxpayer client base — ATO Business line comparison



Source: Australian Taxation Office 1998–99⁵

⁴ Amount of net tax due in the 1998–99 financial year.

⁵ Figures 1.1 and 1.2 that relate to INB include all individuals, so would include individuals with small or large business income. These individuals would also be represented in the business figures for SB or LB&I.

1.4 In undertaking this audit, the ANAO focused on the tax audit activities of INB, the business line collecting the largest amount of revenue and with the greatest number of taxpayers.

1.5 INB manages and maintains that part of the income tax system dealing with individual taxpayers who are not in business. It has a client base of approximately eight million taxpayers and 24 000 tax agents.⁶ Income tax collections from individual taxpayers for 1999–2000 amounted to \$82.7 billion⁷ or 54.5 per cent of total taxation revenue.

1.6 INB comprises a number of organisational ‘streams’ that have been established to meet the various client needs of individual taxpayers and to manage functions arising from ATO contact with individual taxpayers. Major streams include the following:

- Interpretation and Compliance;
- Public Assistance;
- INB Receivables Management;
- Individuals Client Register and Alliances;
- Tax Practitioner Group;
- Business Strategy and Support Branch;
- Law Design and Development;
- Tax Technical Network; and
- Government Relations and Policy.

1.7 Taxpayer compliance activities within INB, including the conduct of audits, are the responsibility of staff of the Interpretation and Compliance (I&C) stream. I&C is managed by two officers at the Assistant Commissioner level. For 2000-01, I&C has been allocated some 650 staff and \$44 million to carry out its planned outputs.

1.8 As the name implies, I&C activities involve either or both interpretation work (such as involvement in the production of private binding rulings, handling disputes and interpretative correspondence, and telephone calls from clients and tax agents) and compliance work such as audits. I&C staff are located in each State and in the majority of ATO offices throughout Australia.

⁶ *ATO Annual Report 1999–2000*, p. 17.

⁷ *ibid*, p. 33.

1.9 I&C functional units include the following:

- I&C Operations;
- Compliance Management Strategy;
- Compliance Systems (incorporating client identification and information matching);
- Knowledge Development and Analysis;
- Corporate Assurance Team;
- Work Related Expenses;
- Tax Agents Investigations;
- Information Matching;
- Tax Reform Coordination;
- Tax Practice Management Network; and
- Aggressive Tax Planning.

Self-assessment

1.10 Prior to 1986, all taxpayers were required to lodge a tax return from which the ATO prepared an assessment of their taxable income and liability. The ATO issued the taxpayer with a notice of assessment which indicated the amount of tax payable and due date for payment.

1.11 From July 1986, the ATO moved progressively to a system of self-assessment designed to achieve a better balance in compliance strategies. It shifted the ATO's primary focus from processing returns and issuing assessments to assisting taxpayers meet their obligations and taking enforcement action against those who do not.

1.12 Under the Australian self-assessment taxation system, individual taxpayers, identified through use of a Tax File Number, complete an annual tax return for each tax year ending on 30 June, providing summarised information on income, deductions and rebates or credits. Individual tax returns have to be lodged with the ATO where tax has been paid or withheld during the year, where income has exceeded a specified threshold or where the individual carried on a business.

1.13 Some 75 per cent of individual tax returns are lodged by tax agents via the Electronic Lodgement Service (ELS),⁸ while the remainder are tax agent prepared and lodged via a paper return, or are self-prepared and lodged via a paper return, over the Internet or via Australia Post's electronic service.

⁸ ATO performance information.

1.14 Tax returns, whether electronic or on paper, are organised into a number of 'labels' to identify particular elements of information. Beside salary and wage income labels, there are labels for identification of other income sources such as rental income, interest and dividends received, that taxpayers must disclose, which may not be subject to automatic tax withholding throughout the year. There are also a number of labels that relate to deductions from income that taxpayers can claim and rebates or credits against tax that also have to be shown on the tax return.

1.15 While there is usually no requirement for most individuals to provide documentation with a tax return other than the pay as you go payment summaries,⁹ taxpayers are required to retain all appropriate documentation, such as receipts for items claimed as deductions from income, for a period of five years.

1.16 Tax return information is used by the ATO to automatically generate a Notice of Assessment with either a debt to pay or a refund (83 per cent of individual taxpayers received a refund for the 1998–99 income year¹⁰).

Risk management

1.17 The ATO introduced a risk management process in 1994–95, known as the Health of the System Assessment (HOTSA). The HOTSA process was designed to form the basis of a continuing assessment of the risks involved in the collection of tax, and was implemented within all ATO business lines. Risk assessments provide the basis for identification of priorities and subsequent resource allocations. This process requires each of the ATO business lines to identify and assess their major areas of risk, to establish plans to manage those risks within available resources and to justify how conclusions on risk areas, management plans and resourcing are reached.

1.18 Risk assessments derived from the HOTSA process or equivalent¹¹ are part of the compliance strategy implemented throughout the ATO.

⁹ A statement of the amount of income paid to an individual by an employer and the amount of tax withheld by the employer.

¹⁰ ATO performance information.

¹¹ Some business lines no longer use the HOTSA title, for example, the Superannuation business line prepares an 'Integrated Compliance Strategy' comprising risk assessments and recommended strategies.

ATO Compliance Model

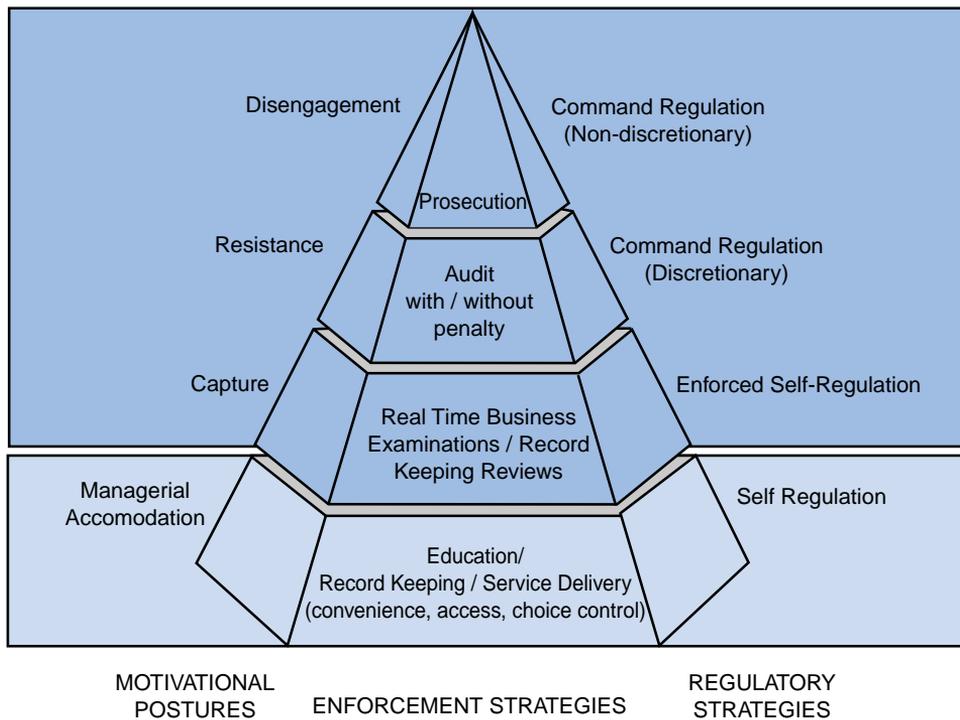
1.19 As part of its risk management approach, and in response to a recommendation from the Cash Economy Task Force, which reported in 1998, the ATO has adopted a structured approach to improving taxpayer compliance. This is known as the ATO Compliance Model.

1.20 The Compliance Model acknowledges that the majority of taxpayers comply voluntarily with no need for ATO intervention. Others will not comply in the first instance but will if prompted further. A small proportion will not comply voluntarily and may need enforcement action. The ATO is committed in its corporate and business planning processes to managing taxpayer client relations across all business lines in accordance with the parameters established by the Compliance Model.

1.21 An interpretation of the elements of the Compliance Model is depicted by the following figure:

Figure 1.3

ATO Compliance Model



Source: Cash Economy Task Force Report 1998, p. 25

1.22 As can be seen in Figure 1.3, the Compliance Model involves levels of taxpayer behaviour that rise from self-regulation through enforced self-regulation to active measured enforcement. This active measured enforcement includes various audit products. The Model identifies

several audit approaches, ranging from the top of the second level (enforced self-regulation) with Pre-lodgement audits,¹² to the top level range of full, roll over and specific issue audits.¹³

1.23 Within each business line, an analysis model, broadly comprising Business, Industry, Social, Economic and Psychological (BISEP) factors, is in use as an integral component of the Compliance Model. The ATO regards BISEP as reflecting the ‘world of the taxpayer’. The ATO’s compliance management strategies acknowledge that BISEP factors are relevant to the behaviour of taxpayers, and therefore to the decisions that taxpayers make as to their level of compliance with the tax system. ATO officers aim to increase their knowledge of taxpayers in these areas and to use this knowledge to increase compliance and produce greater ‘leverage’ from ATO dealings.

1.24 Each business line uses BISEP model analysis to design an approach to the Compliance Model which sets out a graduated series of responses to the general issues associated with ensuring that all taxpayers pay all, and only, the tax properly payable. That is, the ATO aims to encourage voluntary compliance of taxpayers through education and the provision of convenient and efficient service delivery. Where voluntary compliance is not obtained, there is an escalation of action.

1.25 Consistent with the broad base of the Compliance Model, INB’s major resource allocation is on providing information and education activities rather than audit functions. The latter are, of course, more applicable to the higher, narrow end of the Compliance Model. While there is a concentration of information and education activities on the lower, self-regulation related levels of the Compliance Model, there is nevertheless, necessarily a component of audit activity. This may involve an examination of taxpayer financial affairs to ensure that tax returns are correct and to verify any tax liability that taxpayers may have. The area of interest for the ANAO’s performance audit lay with INB’s audit functions. Audits are conducted by a variety of means — some entirely by mail and telephone; others employ face-to-face interviews and physical examination of taxpayer records by ATO audit staff from the relevant business line.

¹² An examination of a taxpayer’s affairs for the period in respect of which the next return is to be lodged.

¹³ Full Audit: a comprehensive examination, limited to highest risk taxpayers;
 Roll-over audit: a comprehensive audit, previously recommended through an earlier audit; and
 Specific issue audit: examines a number of specific issues for one taxpayer, a group of taxpayers or as part of a project.

Audit objective and approach

1.26 The objective of the audit was to examine the use of audit as an element of the compliance management function within INB. In doing so, the audit reviewed both the strategic framework and operational elements in relation to INB audit activities.

1.27 The audit focused on INB's audit strategy, risk assessment, audit planning, performance measurement and reporting and its operational effectiveness. In reviewing operational effectiveness, we considered a range of issues, including performance outcomes, the handling of complaints, management control practices, use of the data warehouse, quality assurance and control, correspondence with taxpayers and staff training.

1.28 In undertaking this audit, we:

- conducted audit field work at 14 ATO regional site offices throughout Australia as well as in its National Office in Canberra;
- held discussions with officers at various levels within INB and, as necessary, with ATO officers in other business lines;
- held general discussions regarding INB's audit activities with a number of external stakeholders;
- collected and examined relevant documents; and
- reviewed ATO planning and performance data.

1.29 The total cost of the audit was approximately \$306 000. The audit was conducted in accordance with ANAO auditing standards.

Related reports

1.30 There has been no recent specific examination by the ANAO of the ATO's administration of audit functions at the individual taxpayer level. However, as stated in paragraph 1.27, the ANAO conducted this audit having regard to the risk management practices adopted within the INB business line as part of the ATO's overall compliance strategy. The ANAO has reported on risk management practices within the ATO in three previous reports.

1.31 In particular, Audit Report No.27 1999–2000, *Risk Management of Individual Taxpayer Refunds* was concerned with aspects of information matching and edit checking that were also relevant to the present audit's focus on individual taxpayer compliance activities within INB.

1.32 More generally, Audit Report No.37 1996–97, *Risk Management—Australian Taxation Office* focused on the broad strategic

issues relevant to risk management for the ATO as a whole while Audit Report No.19 1997–98, *Risk Management in ATO Small Business Income* focused on the risk management processes of the ATO's then Small Business Income business line.

1.33 Further, the ANAO has conducted a number of performance audits in recent years that have relevance to other matters covered during the present audit. We took account of a range of relevant findings from the following reports:

- Audit Report No.22 1996–97, Client Service—Australian Taxation Office;
- Audit Report No.36 1998–99, Pay-As-You-Earn Taxation—Administration of Employer Responsibilities;
- Audit Report No.37 1998–99, Management of Tax File Numbers—Australian Taxation Office; and
- Audit Report No.31 1999–2000, Administration of Tax Penalties—Australian Taxation Office.

1.34 On 17 November 1993, the then Joint Committee of Public Accounts¹⁴ (JCPA) tabled its Report 326, *An Assessment of Tax*,¹⁵ detailing the findings of its Inquiry into the operations of the ATO. In its coverage of the ATO's audit functions, the Committee's emphasis was on audits of businesses rather than individual taxpayers. The ATO has substantially changed its organisational structure and approach to audits since the Committee's report. Nevertheless, we considered relevant issues raised by the Committee in undertaking this audit.

Structure of the report

1.35 This first chapter describes background issues and relevant aspects of the ATO environment regarding the use of audit as an element of the compliance management function within INB.

1.36 Chapter 2 of the report deals with major strategic issues in relation to audit activities in INB, particularly the areas of strategic risk and compliance management. The chapter addresses also audit business planning and management, performance reporting and the contribution of compliance research to the audit function.

¹⁴ The Joint Committee on Public Accounts became the Joint Committee on Public Accounts and Audit in 1998 when it assumed the functions of the Audit Committee of the Parliament and thereby took on a formal role in the activities of the Auditor-General and the ANAO.

¹⁵ *An Assessment of Tax*. (Report 326, November 1993). Joint Committee of Public Accounts, p. 3.

1.37 Chapter 3 of the report deals with the operational aspects of audit activities carried out by INB. It describes the different kinds of audit and how they are selected. In particular, it discusses the outcomes of the audit activity and a range of issues relating to its management effectiveness, including the organisation of audit work, quality assurance and quality control practices, and the support training and tools provided to audit staff. Taxpayer perceptions of INB's audit activity are also discussed.

Acknowledgments

1.38 The ANAO wishes to express its appreciation for the time, effort and expertise contributed by ATO officers at all levels within INB during the audit and the preparation of this report.

2. Strategic Framework

This chapter discusses the major strategic issues in relation to audit activities in INB, particularly the areas of strategic risk and compliance management. The chapter addresses also audit business planning and management, performance reporting and the contribution of compliance research to the audit function.

The INB compliance management environment

2.1 For the majority of individual taxpayers who are clients of INB, employers withhold tax at prescribed rates from employee salaries each payday, and forward tax instalment deductions (TIDs) to the ATO under the Pay as you go (PAYG) system.¹⁶

2.2 Self-assessment places the onus of understanding and applying tax law on taxpayers and relies on high levels of voluntary compliance. Non-compliance may result if taxpayers are unaware that they have a liability, if they are unsure of their obligations, or believe that the ATO is unlikely to detect their non-compliance.

2.3 Essentially, self-assessment is a very large-scale compliance risk management venture. Compliance risks arise when taxpayers fail to comply with the tax law, inadvertently, or deliberately; for example, by understating their income, overstating their credits, deductions and rebates, or failing to lodge tax returns.

2.4 We did not examine INB's processes for checking that returns were lodged. We note that, as stated in paragraph 2.1, for most INB taxpayers, contributions to annual income tax obligations are made as regular deductions at source as TIDs. That is, most non-lodgers would already have met their tax obligations, and, in fact, may be entitled to a refund. In such cases, there is relatively limited risk to revenue through non-lodgement of a return.

¹⁶ PAYG was introduced from 1 July 2000 as part of the Government's tax reform package. The new PAYG system replaced 11 existing payment and recording systems, including provisional tax, company and superannuation fund instalments, pay-as-you-earn, and the prescribed payments and reportable payments systems.

2.5 The self-assessment policy that has been in operation since the mid-1980s means that the ATO does not examine each return on an individual basis. INB relies therefore on a series of compliance management strategies with the aim of maintaining or enhancing taxpayer compliance with the taxation law—that is, securing the correct quantum of taxation revenue. Compliance management strategies in place within INB at the time of the ANAO audit included:

- use of research, risk assessment and real-time intelligence (including targeted surveys) in planning processes;
- a corporate risk management framework;
- information reporting by third parties in relation to various income streams (PAYG, welfare, dividends, interest and other investment-related products);
- integration of compliance and help products; for example, the redesign of tax returns to remove uncertainties between labels may assist taxpayers in their completion of tax returns and, at the same time, provide more targeted information for INB compliance checking;
- looking for compliance leverage points and areas of mutual interest, and building relationships and alliances;¹⁷
- undertaking law improvement and legislative change, as necessary;
- understanding the underlying reasons for particular taxpayer behaviours; and
- an increased focus on aggressive tax planning.

2.6 In support of these compliance management strategies, and in accordance with the ATO Compliance Model, INB applies a graduated scale of compliance approaches to treat individual compliance risks. The principal ones are:

- publications, including through electronic sources, directed towards individual clients, professions and occupations, tax agents and the community generally;¹⁸

¹⁷ Two examples of leverage and alliance activities involving INB that were cited to the audit team were:

- external software providers (providing individual tax return preparation software to agents) are building increasing levels of sophistication into their products that contributes towards the correct preparation of individual tax returns; and
- the Australian Tax Practitioners Forum (ATPF), a forum comprising ATO and tax practitioners, influences policy development and ongoing compliance activities.

¹⁸ Examples of information sources include:

- TaxPack — an annual publication provided to all taxpayers that lodge their own tax returns; designed to help such taxpayers to correctly complete their tax returns;
- the ATO website — provides a range of information supporting individual taxpayer needs; and
- the Tax Agent Newsletter — sent regularly to tax agents.

- return form changes to elicit better and more useful information and/or to enhance the 'correctness' and 'completeness' of returns;
- provision of information through public contact services. These include responding to telephone calls and correspondence and undertaking visits, particularly to tax agents;
- focussed marketing activities prior to lodgement to raise client awareness, particularly covering areas of returns that INB has under notice for compliance action;¹⁹
- use of compliance products to influence taxpayer behaviour prior to submission of returns. For example, certain taxpayers might be asked to complete client information schedules on such matters as rental income and deductions and work related expenses (WRE);²⁰
- automated computer matching of third party information (for example, from banks, investment managers or Centrelink) to returns. This helps to identify, for example, omitted income, overclaimed tax credits and rebates, PAYG income, interest, dividends, government welfare benefits or subsidies;
- automated computer checking of returns to identify inconsistencies or incorrect entries for follow-up (edit checks); and
- targeted enforcement activities, such as label or specific issue audits.

2.7 Automated systems in use throughout the ATO provide high volume information matching and compliance actioning processes. For example, the Income Matching System (IMS) matches external and internally sourced data with tax returns to identify 'discrepancies'.²¹ Once discrepant cases are selected for action, the process is largely automated with the issue of correspondence and the amended notice of assessment issuing to the taxpayer with no intervention unless contact is generated by the taxpayer.

¹⁹ An example of this that was noted by the ANAO was INB's June 2000 advice to tax agents providing feedback on progress with the work related expenses and rental income and expenses programs conducted on returns for the 1999 tax year, and outlining INB plans for these programs in respect of returns for the 2000 tax year including areas of concern and the compliance approach that INB would be taking in such areas.

²⁰ As well as supporting automated tax return form capture from tax agents, Australia Post and directly from taxpayers via Internet returns, the ELS also supports capture of supplementary information on return form schedules, eg. for WRE and rental income and deductions, that assists in preparation of compliance assessments by INB staff and in monitoring taxpayer behaviour.

²¹ For example, omitted income from interest and dividends received by a taxpayer during the relevant year. IMS is described further from paragraph 3.8.

2.8 In addition to automated computer systems, INB, and other ATO business lines, make use of the ATO data warehouse (DWH) that provides access to a range of data received by the ATO, for example, through tax returns, together with some data made available to the ATO by external bodies. The DWH allows selected INB compliance staff to apply a range of query tools in analysing this taxpayer data for compliance research and analysis purposes and also supports reporting activities. Further comments on the operations of the DWH are provided in paragraph 3.39 of this report.

2.9 In general, improved technology and better access to data analysis tools means that information matching and analysis can be automated further over time. This is important for INB compliance functions, as resources such as staffing need to be used efficiently and effectively to maintain taxpayer compliance in a population of some eight million taxpayers, within an environment of growing complexity in the tax affairs of individuals (as described below). Although automated data matching processes will be critical in maintaining appropriate compliance coverage over the entire population of individual taxpayers, one-on-one audits will remain an important component of taxpayer compliance for those higher risk individuals whose activities require targeted enforcement action.

2.10 During the course of the audit, the ANAO also noted that INB management had identified a number of trends relevant to the characteristics of the INB client segment of the population that are influencing compliance management methods and outcomes. Among the more marked of these are:

- the move from traditional interest bearing investments to other investment types such as shares and rental properties, with the consequence of increasing complication in individual taxpayer returns such as, for example, the need to take account of capital gains tax issues;
- the increase in e-commerce and electronic payments that may cause difficulty in tracing the flow of funds through an inability to identify transactions and the country in which they take place; and
- continuing integration by government of welfare, tax and other government assistance, for example, the recent private health insurance incentive initiative.

2.11 INB is attempting to meet the challenges to compliance arising from such influences, and from the general growth in the size and complexity of the individual taxpayer client segment, through a number of 'customised' responses such as:

- seeking to identify homogeneous groups of taxpayers. Segmentation of individual taxpayers may comprise particular income types, occupational groupings and/or lifestyle segments (I&C titles this 'Client Relationship Management'). This should provide opportunities for reducing taxpayer compliance cost through leveraged arrangements to address common client behaviour;
- researching characteristics of and placing a greater emphasis on understanding individual taxpayer behaviour;²² and
- carrying out an ongoing project to implement within INB best practice business intelligence processes in the compliance management area.²³

Strategic planning and risk management

Strategic planning

2.12 This audit focused on taxpayer audit activities undertaken within the I&C organisational stream of the INB business line. The ANAO recognises that strategic planning and risk management within the ATO are conducted in an integrated and on-going fashion. This results in a series of plans that are formulated and implemented at ATO's various organisational levels. It is necessary, then, to understand certain aspects of the strategic planning and risk management environment at the ATO corporate, business line and segment levels.

2.13 At the highest level, the ATO Strategic Statement²⁴ sets the strategic direction for the ATO as a whole. The ANAO found appropriate planning links between the ATO Strategic Statement and INB compliance management strategies, including the use of audit.

²² For example, at the time of the audit INB was undertaking a high profile research project designed to deliver a best practice Compliance Management System for individual taxpayers for 2002 and the foreseeable future. The focus of the project will include:

- compliance risk management strategy development/implementation;
- new approaches for evaluating/monitoring/addressing risk;
- alternative methods/products for client compliance interactions;
- techniques for understanding client behaviour and segmenting client markets; and
- information flows supporting risk decisions.

²³ This work flows from the ATO's ongoing Business Intelligence Capability project that is responsible for the development and implementation of a business intelligence architecture and process within the ATO. INB's Compliance Management Strategy (CMS) and Knowledge Development and Analysis (KDA) units have been identified as key data intelligence areas within INB and have been selected as one of five key focus areas.

²⁴ The current statement was approved by the Commissioner of Taxation in May 2000.

2.14 In order to implement its component of ATO-level strategies, INB has developed a Strategic Plan and a Strategic Statement. Together, these documents take account of ATO priorities as outlined in the Commissioners' HOTSAs,²⁵ the deliberations of the Compliance Management Integration Forum (CMIF)²⁶ and INB's own environmental scanning, risk assessment and strategic and business planning processes. They cover such issues as INB's:

- purpose and niche (the value that INB adds);
- role, vision and strategic framework;
- current and future environment;
- key outcomes, strategies and performance measures to be used as indicators of success such as collection of budgeted revenue;
- resources and investments available to deliver the outcomes;
- operational planning aspects such as required outputs, resource allocations and summarised risk assessments; and
- monitoring and review processes.

2.15 To provide focus for its business planning, the INB Strategic Statement sets out Taxpayers' Charter standards, INB's targets against those standards and the level of performance recorded in the previous year. The Taxpayers' Charter is discussed later in this report (paragraphs 3.19 to 3.21).

2.16 The required outcomes set out in INB's Strategic Plan and Strategic Statement, and the associated INB Operational Plan, are reflected in strategic and operational planning at the stream level within INB. For example, the I&C Business Focus Statement establishes planned outputs, including for individual taxpayer compliance management activities such as audits, to be achieved in 2000–01.

²⁵ The ATO's HOTSAs process is referred to from paragraph 1.17.

²⁶ CMIF operates under the direction of a Second Commissioner of Taxation, and comprises Senior Executive Service (SES) level compliance management representatives from all ATO business lines, the heads of Strategic Intelligence Analysis (LB&I) and Revenue Analysis Branch, and representatives of various business tax reform projects. CMIF has been operating since March 1999 with a focus on identification of gaps and overlaps between business line market segments in their compliance approaches and consideration of opportunities to operate more corporately in designing and treating compliance risks. This role includes developing a corporate risk identification and assessment process which would enable a consistent examination and escalation of identified risks.

2.17 In its examination of the INB and I&C strategic and business planning hierarchy relevant to this audit, the ANAO found that planning outputs were well structured and consistent in terms of their content and direction. They established a required level of performance on the part of those INB elements that were responsible for the achievement of various aspects of INB's role within the ATO. The ANAO recognised that these documents had taken account also of INB's assessment of its environment and the risks arising from dealing with the individual taxpayer segment of the Australian community.

Risk management planning

2.18 INB has developed an Integrated Planning System (or planning framework). Using this framework, I&C refers intelligence information on risks through the strategic and business planning processes at the stream and business line levels to senior management. The purpose is to develop risk treatment processes and provide assurance through reporting on the outcomes of risk treatment strategies.

2.19 At the highest level ATO Commissioners, and the ATO as a whole, need to be aware of specific risks that are identified through intelligence from all levels of the ATO. The ATO's on-line Risk Register, available to all ATO staff, provides for the identification and comprehensive description of intelligence on risks of which staff members may become aware.

2.20 When risks are identified at the ATO level, the strategic approach to the treatment of risks can then be authorised by ATO management. The different business lines then take responsibility for addressing risk in their particular market segments. Depending on the particular risk to be addressed, action undertaken by business lines, including INB, may involve targeted audits as a compliance measure.

2.21 As in other ATO business lines, the INB risk management process is a key part of the annual planning and budgeting cycle.²⁷ Top-down and bottom-up input provides a comprehensive strategic risk management plan. Throughout the year INB is provided with advice from the Commissioner of Taxation on priorities, resourcing, required outputs and risks relevant to INB functions. At the same time, the INB Executive gains input from INB streams on work that will need to be undertaken to address areas of risk and the impact if resourcing is not applied to those risks.

²⁷ Risk management within the ATO is based on the *Australia-New Zealand Risk Management Standard* (AS/NZS 4360-1999) and *Guidelines for Managing Risk in the Australian and New Zealand Public Sector* (HB143-1999).

2.22 During the course of the audit, the ANAO reviewed the INB Risk Management Plan 1999–2000, finalised in June 1999. This plan had been developed using the ATO’s standard risk management methodology, in that it outlines the nature of the risks identified, assesses the degree of risk arising for the ATO/INB and outlines the approaches to be taken to mitigate the risk to an acceptable level of tolerance. Documentation of the Plan aligns with risk management requirements included in MAB/MIAC’s *Guidelines for Managing Risk in the Public Service*.²⁸

2.23 The ANAO found that, at the time of the audit, INB had still not completed the 2000–2001 Risk Management Plan, some five months into the operational year. As an integral element of a sound strategic framework, timely preparation and release of the Risk Management Plan each year is an important step in developing and implementing strategies to mitigate risk, particularly as such strategies are necessarily required for incorporation in the INB Operational Plan. Otherwise, the benefits deriving from the use of such a strategic framework are compromised. There is a risk that such a delay in formulating and implementing the Risk Management and Operational Plans could weaken INB’s performance against the outcomes it is required to achieve.

Recommendation No. 1

2.24 The ANAO recommends that, to ensure timely and effective management of identified risks, INB take steps to complete its risk management plan before the commencement of each operational year.

ATO Response

2.25 The ATO agrees with the recommendation. While a draft of the consolidated INB 2000-01 Risk Management Plan was completed during the course of the ANAO audit, that consolidated plan was not available at the start of the financial year when strategy and resourcing decisions were first made. Instead compliance management strategy and resourcing decisions were based on risk assessments completed within the Interpretation and Compliance stream. Plans are in place to ensure timely completion of the consolidated INB 2001-02 Risk Management Plan.

²⁸ Management Advisory Board/Management Improvement Advisory Committee, *Guidelines for Managing Risk in the Australian Public Service*, Report No. 22, October 1996.

Risk assessment projects

2.26 Within INB, risk assessment and management processes that relate to taxpayer compliance functions are based on the conduct of Risk Assessment Projects. These are managed by the I&C Compliance Management Strategy network (CMS), with advice and assistance to CMS being provided by the I&C Knowledge Development and Analysis Unit (KDA).²⁹

2.27 CMS is an INB initiative that was introduced at the start of the 1997–98 operational year. It was developed to ensure that resources are targeted at the areas most at risk of non-compliance with tax law. CMS involves four key processes:

- formal risk assessment for a return label or issue;
- appropriate action to improve taxpayer compliance;
- evaluation of the compliance improvement action undertaken; and
- maintenance of the improved taxpayer compliance level.

2.28 The risk assessment cycle within I&C is designed to identify and investigate emerging issues in a timely way. The cycle begins with the monitoring of trend and tax return label information by CMS ‘label holders’. Label holders are senior I&C staff members who monitor compliance and develop research in relation to one or more tax return labels. Emerging trends and/or environmental changes identified in this way may indicate or lead to a compliance problem in relation to INB clients. Provision of business intelligence, through such processes as the system of INB BANCOM meetings,³⁰ is an important element in ensuring that label holders are aware of issues relating to their areas of responsibility.

²⁹ KDA's role is to:

- provide the support needed by both strategic and business decision makers in the risk management arena;
- develop systems which allow information to be shaped into the knowledge which drives I&C risk management and decision making processes; and
- create a framework which allows for the identification, prioritisation and treatment of compliance risks.

³⁰ A role of BANCOMs (Business Advisory Network—Compliance Management) is to collect intelligence from INB staff in locations throughout Australia and to refer it to the CMS network for appropriate action, or to share it with other ATO business lines. Operational staff within INB may be the first to recognise potential compliance problems through answering taxpayers' queries, processing returns and requests for taxation rulings or even through scrutiny of the media. BANCOMs can play a vital role in the early detection of emerging issues and assist in the ATO being able to develop strategies, ranging from education through to enforcement activities, to address compliance risks as they occur. BANCOM issues are recorded electronically, and can be examined on-line by I&C staff.

2.29 Once a potential problem has been identified, a formal risk assessment project is then initiated to:

- investigate the extent of the risk; and
- provide advice on the type of compliance activity required to reduce the risk to acceptable levels.

2.30 The decision as to which risk assessment projects will be carried out in any given year rests with the CMS Steering Committee, comprising INB Senior Executive officers. This Committee's decisions are based primarily on a combination of the level of the perceived risk and the resources available to assess that risk.

2.31 The ANAO has examined the practical application of the Risk Assessment Project Guidelines in place throughout I&C. We traced action taken, such as sample selection, adoption of specific research instruments and conclusions and recommendations reached, on a range of projects carried out in recent years on a number of return labels or on particular issues. The ANAO has concluded that I&C risk assessment projects are conducted effectively. As intended, they provide analytical evidence of the need to address, in a strategic fashion, particular compliance risks. We see this strategic framework process as providing a sound basis to address identified compliance risks.

Business planning and management

2.32 I&C has developed a number of planning and management tools to assist in the day to day site, regional and national management of its staff and of its required outputs, including the conduct of targeted audit and other compliance management activities such as IMS checks relevant to individual taxpayers.

2.33 In particular, the INB Unit Cost Analysis (INBUCA) system captures and reports on salary and unit costs for the various work types performed in INB. All staff and management within I&C must use the INBUCA system. Appropriate use of INBUCA forms part of the performance agreement for all staff. Monitoring and enforcement of INBUCA usage is included as part of all Team Managers' performance agreements. Use of INBUCA by I&C staff is overseen by I&C's Corporate Assurance Team staff, and is subject to periodic audits and spot checks.

2.34 Based on recorded daily data on time spent by staff on each work type, annual salaries for the various levels of staff working on different I&C products, and the volumes of work handled, unit (staff) costings have been developed from INBUCA. With approval from the I&C

Operations Forum (ICOF),³¹ I&C has set standard work times and direct and total costs for all of its activities, including those relating to taxpayer compliance such as audits and edits. For example, the standard time for handling a particular edit check is one hour, while for handling a multi-issue rental audit it is 12 hours. Further with regard to audits, actual costs for each type of audit work are calculated from the recorded daily data and compared with the revenue gained. Costs per \$100 of revenue collected from audit activities range from about eight cents for certain edits to about \$29 for actioning community information. This reflects the different approaches to audit from highly automated processes to those with high levels of staff involvement. Such a diverse range of approaches is necessary given the varied nature of the information available for checking.

2.35 Standard times and unit costs are at the core of I&C planning and management tools. In particular, unit costs are used in the resourcing and budgeting process to calculate staff numbers and costs required to meet planned work loads, for measuring achievement against benchmark unit costs and for analysis of monthly, trimesterly or year to date trends that may identify work force planning issues. For example, using INBUCA, staff report on monthly, trimesterly and year to date bases, for each site and region, and nationally.

2.36 During the course of the audit, the ANAO examined the parameters of the business planning and management tools in use within I&C, and had access to a range of reports produced using such facilities. In the context of the audit, the ANAO noted that I&C management at all levels made extensive use of such tools and reports in planning and resourcing compliance functions. Moreover, these systems provided a range of outputs that were then included in management reporting (see discussion below). Based on our examination of documents and discussions with relevant I&C staff, the ANAO considers that, taken together, these systems and the output that they provide represent a robust and effective structure for planning and managing I&C functions, including compliance audit activities.

³¹ ICOF is an example of an I&C forum where directors and managers work together on operational plans and priorities with a focus on achieving immediate business objectives.

Performance management and reporting

2.37 As with the other ATO business lines, INB is required to meet the requirements of the ATO Commissioners for line performance and governance reporting. Reporting components include:

- the relevant monthly business line performance report to provide an ongoing aggregate picture of line performance; and
- bi-annual governance reports to provide assurance on the line's operations.

2.38 The ANAO has examined INB's and I&C's most recent reporting against annual and monthly accountability requirements, particularly in connection with taxpayer compliance functions. Input from I&C staff at the team, office and regional levels contributes to the content of such reports, utilising the range of reporting tools noted earlier.

2.39 The 1999–2000 end-year Accountability Report for I&C provides performance data and comments against the output measures set down for I&C, including audit functions. The report also comments on I&C's performance against Taxpayers' Charter requirements, on technical quality performance, and on I&C's dealing with complaints.

2.40 ANAO examination of the report established that sufficient information is provided in an acceptable format for INB management to be able to assess the achievements of the I&C stream, including on taxpayer compliance activities, during the 1999–2000 year.

2.41 The ANAO considers that the I&C monthly corporate governance report also provides appropriate information to INB management on the achievements of the I&C stream, including on compliance management functions. Reporting of performance has regard to strategies set out in the I&C Business Focus Statement document (mentioned at paragraph 2.16) and includes performance data on, for example, achievements against Taxpayers' Charter standards and on problem resolution (complaints).

2.42 Input from INB streams such as I&C contributes to development of performance reporting at the INB business line level. The ANAO noted that the INB Accountability Report for the year ended June 2000, reported on major achievements for INB in 1999–2000, and covered performance levels reached against such outputs as revenue gained. The ANAO noted that such reports included information on the major compliance and audit projects conducted by the I&C stream such as on WRE and rental income and deductions.

2.43 In relation to the conduct of individual taxpayer compliance functions, including audits, the ANAO considers that annual and monthly INB Accountability Reports effectively meet required accountability standards.

Compliance research

2.44 In establishing the objective of this audit, the ANAO considered that an important aspect for review was the extent to which INB was gaining a good understanding of taxpayer behaviour through its various compliance research projects. This is important, for example, in establishing the types of compliance risk emerging from the changing nature of the economy and society in Australia. Together with the results of business intelligence, and risk management projects discussed above, compliance research outcomes should contribute to the more effective targeting of compliance functions in the future, including audits of particular components of the overall individual taxpayer population.

2.45 The ANAO reviewed a number of the ATO's compliance research initiatives that may impact on future INB compliance management strategies, including audit. These initiatives are described below. One aspect of the audit was an assessment of the extent to which the results of the research were used to contribute to the development of compliance strategies by INB. In general, we were unable to determine whether there was any substantial contribution involved.

Environmental analysis

2.46 The ANAO noted that INB had commissioned an 'environmental scan' to better link intelligence efforts, as mentioned in paragraph 2.11, into more strategic analysis of taxpayer behaviour and the influences on that behaviour. An initial draft of the report was issued in October 2000. It discusses the impact that globalisation of business and personal activities, aggressive tax planning, the blurring of distinctions between individual and small business activities and expanding investment options for individual taxpayers have had and may have on taxation compliance by some elements of the INB component of the population.

2.47 On the basis of an examination of the report, the ANAO considers that it represents comprehensive and professional coverage of a number of important issues, the influence of which INB needs to address in its risk treatment strategies such as taxpayer audit and compliance management. This initiative is an important means by which INB can become, and remain aware, at a corporate level, of influences on taxpayer behaviour in a changing business and community environment.

Integrated Compliance Study

2.48 The ATO initiated the Integrated Compliance Study with the Commonwealth Scientific and Industrial Research Organisation (CSIRO) in May 1999 to look at compliance behaviour of INB taxpayers and the impact that certain 'life events' have on that behaviour. The report covers taxpayer behaviour over a period of three years.

2.49 As part of this project, modelling has been completed that allows for the probability of non-compliance to be estimated and taxpayers to be ranked in order of established compliance risk. The ANAO notes that this provides the ATO with a significant step towards evidence-based management of taxpayer compliance.

2.50 The ANAO was informed that the ATO considers that it is too early to use the study's findings directly and plans to continue to refine the research and to encompass the results into INB audit processes. Continuation of such research appears justified. The additional intelligence gained in establishing an indicative profile of individual taxpayers should increase INB's effectiveness in targeting its compliance management functions, including taxpayer audit.

Taxpayer attitudes

2.51 The ATO is currently conducting joint research with the University of Teeside (in the United Kingdom) and the University of Melbourne on taxpayer attitudes. The aims of the research include:

- find out what people think about the taxation system;
- measure the quality, fairness and efficiency of ATO services to taxpayers;
- provide improved assistance to taxpayers who are disadvantaged;
- understand peoples' experiences with tax returns and the ATO; and
- increase taxpayers' knowledge of the tax system.

2.52 The findings of this research project were not available at the time of the audit. However, the ANAO considers that this research has the potential to help identify and treat individual taxpayer behaviour as well as improving the use of compliance strategies, including audit.

Centre for Tax System Integrity

2.53 The Centre for Tax System Integrity (CTSI) is a jointly funded initiative of the ATO and the Australian National University. Its work includes conducting research in a range of tax compliance areas. CTSI current and prospective research are on such issues as:

- Survey of individual taxpayer attitudes relevant to the ATO Compliance Model;

- Monitoring of Taxpayer Risk Management Systems; and
- Experimental Non-Field Approaches to Leveraging Compliance.

2.54 From our examination of the details of some 23 planned CTSI projects supplied to the ANAO during the course of the audit we believe that they have the potential to contribute to future INB compliance management, particularly in the use of targeted audits.

Research Compendium

2.55 During the course of the audit the ANAO was provided with access to a comprehensive Research Compendium, maintained by the ATO's Strategic Research Unit. The Compendium provides a collection of summaries on the outcomes of current research.

2.56 The ANAO considers that the Research Compendium is an effective tool that can assist INB, and I&C staff in particular, in their consideration of research findings when undertaking strategic and risk management processes.

Conclusion

2.57 INB is undertaking a range of compliance research projects that have the potential to contribute to more effective targeting of compliance functions, including the use of audit. However, the ANAO was not able to establish the degree to which this research had been or would be taken into consideration during INB strategic and risk management planning processes. The ANAO considers that, to benefit fully from such compliance research, INB needs to ensure that research outcomes are integrated into INB's strategic and risk management planning processes.

Recommendation No. 2

2.58 The ANAO recommends that, to target compliance functions more effectively in the future, the ATO establish mechanisms to ensure the integration of compliance research outcomes with INB's strategic and risk management planning processes.

ATO Response

2.59 The ATO agrees with the recommendation. The recently established INB Research Steering Group, which is a sub-committee of the INB Executive, will play an integral role in this regard ensuring that strategic and compliance research undertaken is relevant, timely and value adding. This forum will also ensure that all research outcomes are available, considered and, where appropriate, incorporated into INB's strategic and compliance risk management planning processes.

3. Operational Activities

This chapter discusses the operational aspects of audit activities carried out by INB. It describes the different kinds of audit and how they are selected. In particular, it discusses the outcomes of the audit activity and a range of issues relating to its management effectiveness, including the organisation of audit work, quality assurance and quality control practices, and the support training and tools provided to audit staff. Taxpayer perceptions of INB's audit activity are also discussed.

INB's audit functions

3.1 Tax officers and individual taxpayers may differ on what is the definition of an audit. For example, some taxpayers consider a request from the ATO asking for more information as being audited, though this would not necessarily be seen as audit by the ATO.

3.2 We have taken the term 'audit' to cover the range of activities carried out by INB from telephone inquiries through automatic matching of data to full investigation of a taxpayer's return. The primary focus of the audit function is to review the income tax returns lodged by the taxpayer. Checking is carried out to see if taxpayers have declared the correct amount of income and claims for deductions and rebates are accurate.

3.3 In considering how INB carried out its audit activities, we looked at:

- the various kinds of audit carried out by INB;
- the outcomes of the audits including Taxpayers' Charter obligations and handling of complaints;
- a range of management issues relating to audits, including the organisation of audit work, use of the data warehouse, quality assurance and control procedures, quality of correspondence with taxpayers and staff training; and
- taxpayer perceptions of INB audit activity.

Identifying audits

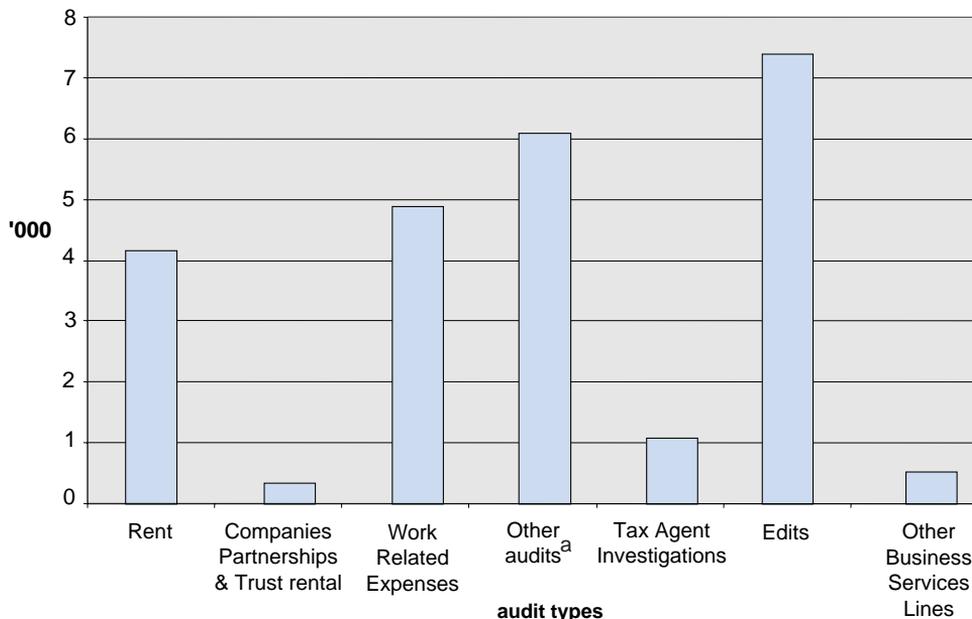
3.4 INB uses a range of automated and manual methods to help check selected aspects of returns. The focus of audits can be on individuals, on categories of taxpayer, types of information included on tax returns, called labels, or other issues identified through the ongoing risk assessment process.

3.5 A range of audits completed by INB in the 1999–2000 financial year is shown in Figure 3.1. The figure excludes data from IMS.³² There are four main kinds of audit activity:

- label and issue audits;
- edits;
- audits arising from the Income Matching System; and
- tax agent investigations.

Figure 3.1

Number of audit cases 1999–2000



Note: (a) Other audits is a combination of various audits, including some other audits relating to tax agents, other self-preparer audits, other label audits and those based on community information.

Source: ANAO depiction of information drawn from ATO sources.

Label and issue audits

3.6 These audits continue to be an important part of compliance activities. INB's range of audits covers most income tax labels, income deduction and rebate items. The audits may be general or issue specific.

³² IMS figures have been excluded to give a clearer graph of other methods of audit. The large number of IMS cases (178 000) and the resultant change in tax (\$72 million) would distort the graph.

Edits

3.7 Edits are a form of audit that result from a number of different automated error codes. On submission, tax returns are subjected to a series of computerised checks for consistency with a set of predetermined criteria. If an edit error occurs, an automated error alerts teams to the need to investigate the claim. The taxpayer is sent a questionnaire, which, when completed, is used to determine whether the taxpayer's claim is sustainable. The automated edit work involves fewer staff than label based audit work.

Income Matching System

3.8 The IMS matches external and internally sourced data with tax returns to identify non-compliance. An example would be the matching of the interest paid by a bank to the amount of interest that person has disclosed in their tax return. Most of the externally sourced data (for example, information from employers, financial institutions, other government agencies, and health insurance funds) is provided to the ATO under a legislative requirement. When data matching discloses a discrepancy, the relevant correspondence and the amended notice of assessment are issued with no intervention by staff unless the taxpayer challenges the assessment.

3.9 Cases are selected based upon the overall compliance objectives and strategies that are determined by the CMS and the I&C Executive. The overall risk to revenue posed by the identified cases and the available resources for the work are key factors in the decision. The IMS teams are currently resourced to process 180 000 cases in a year. Cases are worked on in batches to promote an even flow of work, the complexity of cases also being taken into account. The IMS coordinator selects categories of cases available for actioning. However, cases likely to bring about the greatest change in revenue often are the most complex,³³ for example, they may have a large number of discrepancies and a number of data problems. IMS staff scrutinise these cases before they are released to the taxpayer.

3.10 There is necessarily a time lag between when a taxpayer provides a return and when the IMS can check for discrepancies. Such a lag is caused by the time taken by the various third party organisations to provide their data and the lodgment of tax returns by taxpayers or their

³³ Arising from discussions with INB staff who recognise the need for I&C to expand coverage to the more difficult cases.

agents. Experience over recent years has indicated that this is generally a period of between nine to 13 months after the close of the financial year to which the data relates. The timing of the case processing is not fixed and takes into account that factors may change from year to year, such as the availability of resources.

3.11 Our coverage of IMS was intended to enable description of what is a component of INB's audit methodology and place it into the audit context. ATO has advised that IMS is undergoing a major upgrade to enable support of the new tax system. Therefore, although such computer-based support for managing compliance is important, we consider that a full-scale audit of information/income matching is not appropriate at this stage.

Tax agent investigations

3.12 Tax agents are responsible for the preparation and lodgment of 75 per cent of individual taxpayer returns. Tax agents are an important focus of audit as they are a key leverage point in influencing individual taxpayer behaviour. The Tax Agent Investigations Unit (TAIU) has been established within I&C to:

- identify and investigate unregistered tax agents who are preparing income tax returns and charging a fee for this service;³⁴ and
- investigate registered tax agents who are not fulfilling their obligations.

3.13 The TAIU uses internal data, such as from the data warehouse and other internal sources from within the ATO, to identify unregistered agents. It also acts on information received from the Tax Agents Board (TAB) and from external sources such as tips received from the community through the Community Information, Storage, Communication and Observation (CISCO) system.³⁵ In an attempt to discourage taxpayers from using the services of unregistered agents, the TAIU may issue warnings to the unregistered agent and to affected taxpayers. TAIU staff may prepare a brief for submission to the ATO's Prosecution Investigation Unit, for consideration of prosecution action.

³⁴ It is an offence under section 251L of the *Income Tax Assessment Act 1936* to prepare tax returns for a fee while not being a registered tax agent.

³⁵ The CISCO system records information received by the ATO from members of the community ('dob-ins') and disseminates advice, particularly on major issues raised by community informants, to appropriate areas within the ATO for action. Some INB audit cases arise from CISCO information; that is, individuals and/or tax agents named in telephone calls or in correspondence as representing a compliance/revenue risk, are followed up during targeted audits.

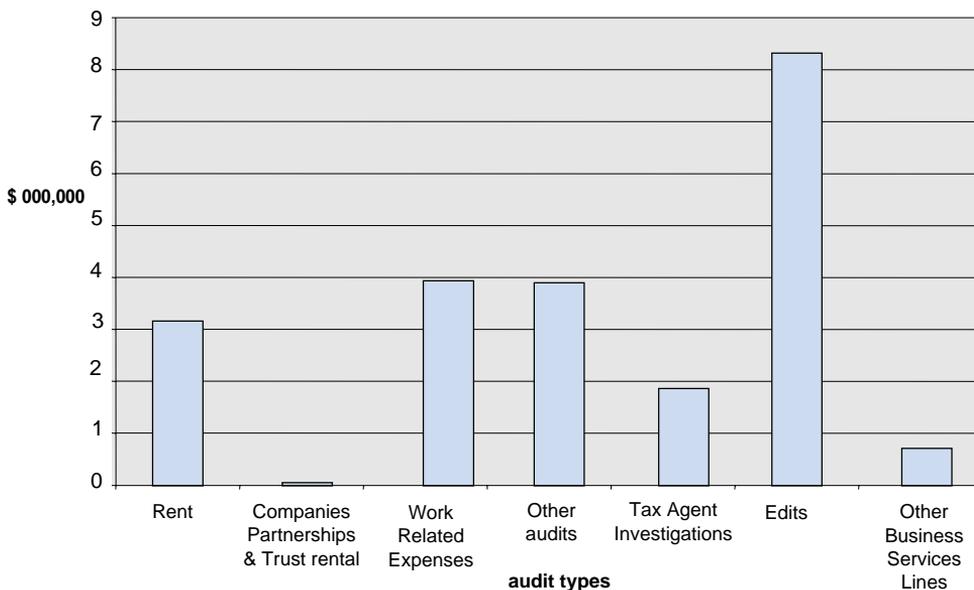
Performance outcomes

3.14 In Chapter 2 we discussed the framework of reporting mechanisms (from paragraph 2.44). Here we examine the performance reporting on a number of compliance issues where risk treatment strategies include audit work. The outcomes of the conduct by I&C of label audits, edits and tax agent investigations for the 1999–2000 tax year are shown in Figure 3.2 and a comparison of outcomes for the tax years 1998–99 and 1999–2000 are shown in Table 3.1. As can be seen in Table 3.1, IMS audits produce the largest amount of change in revenue (\$72 million); that is, the difference made to tax revenue from the use of audit methods. As noted in paragraph 2.34, costs per \$100 of revenue collected from audit activity range from eight cents for highly automated edits to \$29 for manual follow-up of community information.

3.15 The ANAO notes that I&C has handled approximately the same number of cases in each of these years, though the mix of audit types is different between the years. We found only a relatively minor increase in the number of adjusted, (that is productive) cases. However, I&C has achieved an almost 50 per cent increase in the amount of tax adjusted. This performance suggests improved effectiveness in audit activities. However, I&C has only been recording performance information in this format for the last two years. Collection of longer-term performance information would place the ATO in a better position to assess the effectiveness of its audit program.

Figure 3.2

Change in tax resulting from audit activity 1999–2000



Source: ANAO depiction of information drawn from ATO sources.

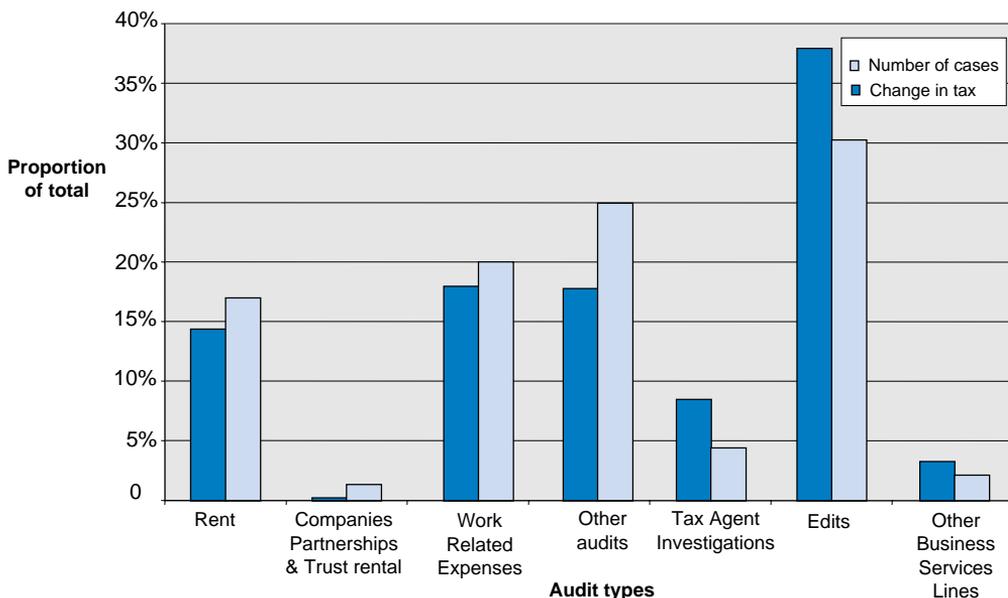
3.16 In reviewing this performance data, the ANAO found that some data had been combined across financial years, for example the financial data for one year mixed with data for the following year. The ANAO considers that, when reporting performance data, data must be clearly identified and separated into respective tax years. This enables management to monitor staff effectiveness and the effectiveness of taxation compliance strategies for a given year and also allows comparison between years.

3.17 The ANAO also observed examples of information inaccuracies between different reports and suggests that, in order to maintain data integrity and consistency in the preparation of reports, specialised expertise available within the various INB elements should be consulted. Moreover, the ANAO would suggest that INB take steps to ensure that clear communication between its units is maintained in the reporting of performance results.

3.18 Figure 3.3 shows in percentage terms the change in revenue recorded against a range of compliance activities undertaken by INB. This figure indicates that edit work per number of cases undertaken creates a larger per cent gain in revenue than other audit work. Apart from the low level activities covering tax agent investigation and other business line referrals which also show a higher percentage change in tax returned, the merit of INB's reliance on the high volume of edit work as part of its approach to compliance activities is demonstrated.

Figure 3.3

Relative proportion of audit cases and associated change generated in tax



Source: ANAO depiction of information drawn from ATO sources

Table 3.1
Individuals Non Business Interpretation and Compliance
Performance Outcomes from the Application of Compliance Measures
1998–99 and 1999–2000

Audit Work Types	Total Cases		No. of Adjusted Cases		No. of NFA Cases		Change in Tax \$		Penalty \$	
	1998–99	1999–00	1998–99	1999–00	1998–99	1999–00	1998–99	1999–00	1998–99	1999–00
IMS Auto	177 997	192 130	142 788	164 485	35 209	27 645	41 058 714	72 394 691	10 208 701	7 630 541
IMS Manual	518	22 669	361	11 610	157	11 059	323 119	2 170 921	69 487	674 904
Audit – Rent	6 691	4 188	2 415	2 396	4 276	1 792	3 458 472	3 328 480	902 404	859 521
Audit – WRE	17 992	4 907	7 902	2 686	10 090	2 221	5 246 666	3 952 216	1 451 885	959 021
Audit – Other	27 583	5 046	22 345	1 527	5 238	3 519	7 444 432	4 320 170	211 758	488 555
Tax Agents Investigations	1 137	1 077	854	685	283	392	1 452 232	1 875 656	470 015	504 399
Edits	4 459	7 414	3 110	5 668	1 349	1 746	5 898 311	8 448 374	287 440	506 354
Other Business Service Lines	3	411		249	3	162		722 573		85 000
Total – All Work Types	236 380	237 842	179 775	189 306	56 605	48 536	64 881 946	97 213 081	13 601 690	11 708 295

Note: IMS — Income Matching System

NFA — No further action

WRE — Work related expenses

ANAO depiction of information drawn from ATO sources.

Taxpayers' Charter

3.19 The Taxpayers' Charter, launched in 1997, is a service treaty that sets out taxpayers' rights and obligations in relation to the ATO. Service standards associated with the Charter apply to all ATO business lines and encompass commitments by the ATO to process tax returns, reply to correspondence, review objections, answer telephone calls, supply rulings, process registrations, advise the results of audits and deal with complaints within specified timeframes.

3.20 As we have noted at paragraph 2.15, the INB Strategic Statement 2000–03 sets out Taxpayers' Charter standards, INB's targets against those standards and the level of performance recorded against standards for 1999–2000. A number of standards apply to INB, but only some of them are relevant to the I&C functions that were the focus of this audit, specifically:

- the requirement to provide notification of the outcome of all audits within 7 days of making a decision (INB's target for 1999–2000 was 100 per cent; actual performance was 97 per cent); and
- the requirement to complete investigation and response to complaints within 28 days of receipt (INB's 1999–2000 target was 60 per cent; actual performance was 72 per cent).

3.21 The ANAO has examined INB's various reports against the standards and is of the view that Taxpayers' Charter standards are reported adequately to satisfy the requirements of ATO management, and reflect the dealings that I&C, and INB in general, have with individual taxpayer clients.

Taxpayer feedback (complaints)

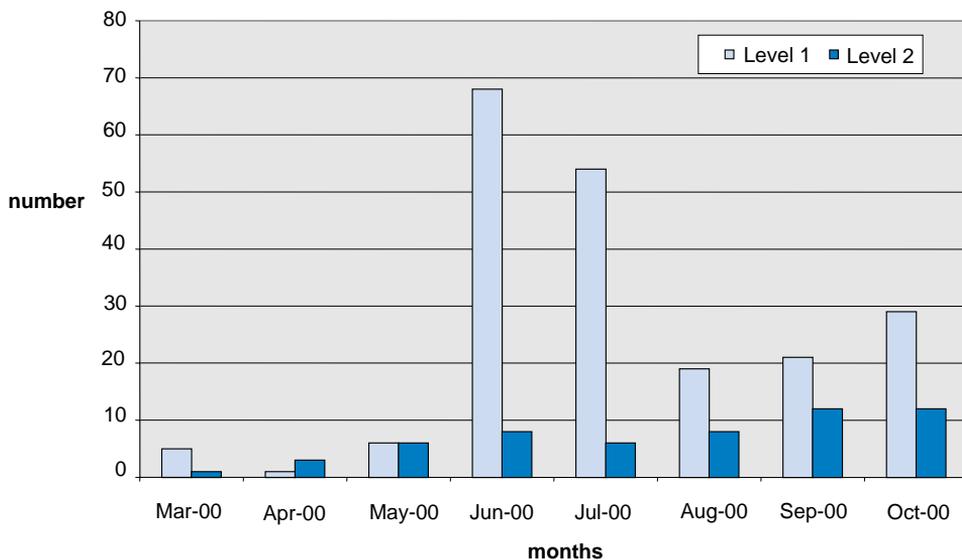
3.22 By their nature, audit processes have the potential to lead to conflict between affected taxpayers and the ATO, resulting in complaints. The ATO has a complaints handling mechanism to deal with the concerns of taxpayers who are not satisfied with the decision the ATO has made about their tax affairs or their treatment by the ATO.

3.23 In its examination of taxpayer compliance functions the ANAO reviewed the ATO's handling of complaints. As shown in Table 3.1, I&C deals with a large number of compliance cases and hence individual taxpayers each year (in 1999–2000 this approached 240 000 cases). Within the ATO, complaints and enquiries, including those arising from advice provided to telephone callers or in correspondence, are dealt with at one of three levels:

- Level 1 — where the original staff member dealing with the client handles it;
- Level 2 — where the supervisor is called upon to resolve the matter; or
- Level 3 — ATO’s Problem Resolution Service (PRS), created as part of the ATO’s implementation of the Taxpayers’ Charter, records and forwards the matter to the appropriate business line for handling and reporting back to PRS.

3.24 Within I&C, Level 1 and 2 complaints have only been recorded since the introduction of the Level One and Two (LOAT) system in February 2000. I&C has taken steps to address some initial difficulties in ensuring that I&C staff record and categorise by type of issue, all complaints that have been raised. Feedback on national LOAT data on both monthly and year to date bases is provided to all I&C Team Managers. Monthly reports include the range of issues identified from complaints recorded and on action that I&C has taken to address them.

Figure 3.4
Number of I&C Level 1 and 2 complaints

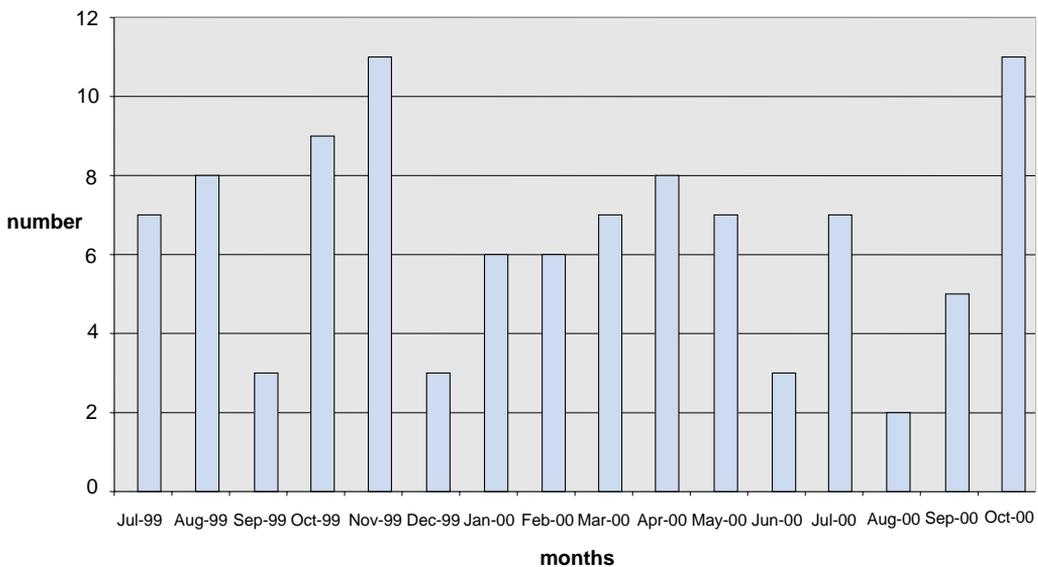


Source: ANAO analysis of ATO quantitative data.

3.25 Information on complaints received from March 2000 to October 2000 is shown in Figure 3.4. The ANAO found that the large increase in Level 1 and 2 complaints in June and July 2000 was primarily due to letters and schedules sent to some taxpayers with rental income. Some taxpayers who had been selected to complete a schedule for the 1998 and/or 1999 program were also required to complete a schedule for the 2000 program. The ANAO notes that I&C has taken steps to ensure that this particular matter was addressed, reflecting the need to respond when complaints raise common issues.

3.26 Level 3 complaints are also recorded by I&C upon receipt from PRS. As can be seen from Figure 3.5, the number of Level 3 complaints is relatively low, averaging fewer than 10 for each month in 1999–2000, and to October in 2000–01. We found that I&C conducts analysis on the issues raised in such complaints, and takes steps to address them. Some 64 per cent (16 out of 25) of the cases recorded in the year to that date related to the compliance function and that, of these, 63 per cent (10 out of 16) related to IMS audits. The ANAO noted that the results of analysis of the content of such complaints had been raised with IMS management.

Figure 3.5
Number of I&C Level 3 complaints



Source: ANAO Analysis of ATO quantitative data.

3.27 The notification of the numbers of complaints received and the issues raised in complaints to both I&C team and stream management is an effective means for promoting the Charter obligation that complaints are acted upon and that issues of concern are addressed. Compliance activities are, by their nature, more likely to result in complaints than would other INB functions. Given that I&C deals with a large number of individual taxpayers when conducting its compliance activities (nearly 240 000 in 1999–2000), the ANAO found that the level of complaints is relatively low (at less than 300), although we note that there may be some reluctance on the part of the taxpayer to complain. Advice from a number of stakeholders contacted during the audit confirmed that a minimal level of complaints relating to audits of individual taxpayers was received.

External view of INB audit

3.28 In early 1998, the Commissioner of Taxation implemented a research program to evaluate the performance of ATO staff in achieving professional standards of service agreed between the ATO and the community, as articulated in the Taxpayers' Charter and the ATO Agency Agreement. The ANAO examined this research as it included the opinions of people audited by INB.

3.29 The research program elicited the views of both ATO staff and various segments of the ATO client population, as to what constituted professionalism in field operations and debt collection. Research methodology included the selection of people who had been audited, reviewed or involved in an action by the ATO to collect outstanding debts during the four month period preceding each current survey. In the surveys, questions to clients covered the areas of courtesy, consideration, competence, willingness, responsiveness, openness, honesty and respect. While the questions remained the same, research methodology changed over the years. The external research report did acknowledge that those interviewed may not necessarily reflect the views of all taxpayers.

3.30 ANAO analysis raised a number of observations regarding the report:

- the surveys were conducted at various points during the year with differing time intervals, this allows for a potential distortion in reporting if the differing time periods are not taken into account;
- approximately 150 people were surveyed in each report. The ATO reported that the original contract did not give a rationale for the sample size; and
- the methodology in the fifth and sixth reports changed, thus making the cross-sectional analysis inconsistent. An unfavourable drop in overall professionalism identified in report four led to closer examination in the following reports in order to identify the problem, which necessitated a change of sample selection from report five.

3.31 The ANAO suggests that the analysis and results arising from the report may be considered to be indicative of professionalism trends, if accurately portrayed.

3.32 The professionalism report is used by INB to reassure business line management and to report to parliament on the public's perception of its treatment by tax officers when being audited or reviewed. In its 1999–2000 Annual Report,³⁶ the ATO used movements in survey responses

³⁶ *ATO Annual Report 1999–2000*, p. 51. Figure 3.10 depicts 'Overall Professionalism', but the ANAO notes that the parameters illustrated in the figure are not adequately explained within the preceding text and that the axes are not labelled.

between the latest reports as evidence of increased professionalism. The ATO misinterpreted the data and showed an increase in 'Overall Professionalism' where the actual results were more level. It is clearly important to ensure consistency and integrity of data especially when long-term surveys are undertaken, in order to retain credibility of reporting.

Management effectiveness issues

How audit work is organised

3.33 As described in Chapter 2, I&C's risk assessment process is designed to provide for the timely identification and investigation of emerging issues. It enables I&C to target appropriate audit work as part of its compliance effort. Discussion of risk assessment processes can be found from paragraph 2.26.

3.34 I&C Operations teams carry out a range of operational functions,³⁷ not exclusively those relating to audits, as part of their Compliance duties. Other tasks, categorised as Interpretation responsibilities, comprise:

- responding to requests for tax rulings;
- handling correspondence in relation to I&C matters;
- answering taxpayer enquiries by telephone or in person; and
- handling disputes raised by taxpayers.

3.35 Using a matrix style of management to deal with multiple tasks performed in multiple locations, each task may have a different manager with their own different management control. The ANAO found that the complexity of management control was not supported by a clear process for allocation of compliance work to the various teams and sites. The ANAO acknowledges that allocations of particular tasks to teams were made through negotiations between the CMS network and the National Business Manager Operations, and that I&C staff at all levels seemed to understand their responsibilities. However, the ANAO considers that the complex management arrangements represent a risk that tasks may not be performed properly or accord with the priorities set. Such complexity could be better handled by a more formal arrangement that allows for a common and agreed understanding of priorities and responsibilities, thereby reducing the risk of lowered performance.

³⁷ At the time of the audit, some I&C operational staff had been allocated to assist with workloads arising particularly from tax reform initiatives; for example, assistance was being provided to the ATO's 'Reply-in-Five' facility.

3.36 The ANAO sees the desirability of the CMS³⁸ and Operations elements of I&C agreeing on an appropriate method for allocation, management and reporting on compliance functions such as audits. The ANAO notes that such an agreement would enhance transparency, accountability and management of the compliance functions performed by I&C Operations staff. An agreement could be in the form of a service level agreement or similar. The ANAO notes that some initial work has been carried out on such an arrangement.

Recommendation No. 3

3.37 The ANAO recommends that, to enhance the management of its compliance functions, INB develop a service level agreement, or similar, between its CMS and Operations streams, for management of compliance functions performed by Operations staff.

ATO Response

3.38 The ATO agrees with the recommendation. A formal memorandum of understanding between the CMS network and the I&C Operations area has now been drafted to facilitate the effective and efficient carriage of audit based work 'contracted' out by the former to the latter. This document covers aspects such as funding, location, skilling, reporting, scheduling, quality and competing priorities.

The data warehouse

3.39 The ATO DWH (previously mentioned in paragraph 2.8) supports strategic research and analysis, which in turn supports operational level activities, particularly in relation to compliance. The DWH enables a large amount of the information gathered by the ATO to be analysed in order to identify and assess risks. ATO internal reporting noted that in its first three years of operation, the use of the DWH, aside from other benefits such as improved availability and access to information, resulted in an overall increase to revenue of \$231 million.

3.40 As well as relying on the DWH for compliance risk assessment on which audit activities are based, INB uses the DWH for research and analysis, management information, management reporting, revenue monitoring and operational reporting. In carrying out these activities, INB expects to use 30 per cent of the resources provided by the DWH.³⁹

³⁸ The ANAO notes that, at the time of the audit, I&C was undertaking a review of CMS processes. The outcome of such a review may well have implications for the relationship between CMS and I&C Operations, for some form of Service Level Agreement between these areas.

³⁹ Only the SB line uses a higher proportion at 37 per cent, with most other ATO functional areas using far less of the DWH resources.

3.41 The ANAO notes that internal ATO business planning documentation suggests that, with an increase in demand from GST and tax reform initiatives in particular, the DWH's storage capacity is under continuing pressure. While this audit did not focus on the DWH and its operations, the ANAO notes, as discussed above, that INB is dependent on the DWH for a range of services, including audit, that support its compliance functions. The ANAO considers that any recommended upgrading and/or expansion of the DWH to meet current and foreseen needs in the medium and longer term should take place as soon as possible.

3.42 The timing and extent of any upgrade to the DWH is significant to INB given its high level of use. A lack of capacity and/or functionality may result in INB audit processes and other compliance functions being compromised. The ANAO considers that INB should also address, within its risk management strategy, any possible associated risks of the DWH becoming a less effective tool.

Case Actioning System

3.43 The Case Actioning System (CAS) generates a letter automatically to taxpayers whose cases have been selected from IMS due to omissions of income, overstatement of tax credits, rebates etc. Query letters are issued in bulk through Automated Document Dispatch. Amendments are then issued automatically, through a link with the ATO processing systems. The types of cases actioned on CAS are not limited to IMS. Other case types actioned are, for example, WRE and CMS audits, rental cases, medicare levy surcharge, private health insurance rebate, Tax Agents Investigation Unit cases, and Schemes cases.

3.44 Cases actioned under the CMS case types are loaded into CAS via an Excel spreadsheet. However, certain cases cannot be loaded via an Excel spreadsheet.⁴⁰ Consistency and reliability of systems intended to support compliance functions is an important factor influencing effectiveness. The ATO is aware of the need to continue to update and integrate systems to prevent additional workloads.

⁴⁰ Due to the fact that pre-issue cases are actioned using a Schedule of Work Expenses case type, it is part of the auditors procedures to simultaneously key the details into CAS. The details are not loaded to the Tax Return Data Base at that point in time so it is not possible (at present) for the DWH to obtain details of labels and create a spreadsheet for uploading to CAS.

Conclusion

3.45 The current workload for INB and continued growth requires that computer systems are highly functioning and accurate. As described from paragraph 3.39, concerns about the reliability and adequacy of support of specific systems have arisen. INB need to be aware of the possible consequences of the loss of taxpayer data, staff downtime or additional work in case of the failure of such systems. The ANAO found that these concerns were not specifically addressed in INB's risk management plan and that INB need to recognise, assess and mitigate this risk.

Recommendation No. 4

3.46 The ANAO recommends that, in recognition of its significant reliance on computer systems for carrying out its functions, INB address in its risk management plan the reliability of specific operating systems and the risks to operational effectiveness associated with system failure.

ATO Response

3.47 The ATO agrees with the recommendation and is currently updating the risk management plan. By way of example, the risk that systems such as the data warehouse will not effectively support strategic research, intelligence and knowledge needs has been incorporated into the INB Risk Management Plan 2000–01. This risk is also now reflected in the ATO Risk and Intelligence Report where two key internal capabilities, IT and intelligence, are acknowledged as risks.

Quality assurance and quality control

3.48 Quality control and quality assurance mechanisms are essential to sound corporate governance. The I&C Quality Management Strategy is applied to all I&C functions including audit activities and has three components:

- the Pre-issue Quality Assurance Review (PIQAR) Process;
- the Post-issue Quality Assurance Review (POQAR) Process; and
- Quality Work Practices and Systems.

3.49 PIQARs and POQARs are conducted and reported on in accordance with directions given by the Commissioners to all business lines to ensure that adequate quality control processes are in place to improve accuracy, consistency and timeliness of technical decision-making.⁴¹ Both PIQAR and POQAR processes use a model to

⁴¹ INB defines a technical decision as one made as to whether a taxation law applies to a decision, the manner in which it applies or where a discretion could be exercised under such a law. This definition also includes situations where there is a guideline, Practice Statement or ruling covering the operation of that taxation law.

assess the quality of staff decision-making against an objective standard of quality on four elements (that is, the Question asked, the Answer given, the Reasoning followed and the Expression used (QARE model)).

POQAR

3.50 POQARs are conducted to measure the technical quality of an item of work after the event. In the context of this audit POQAR involves a national review of a representative sample of I&C work output (written or oral), including audits involving taxpayer contact.

3.51 In INB the POQAR process is carried out twice per year by a panel of technical experts including qualified tax practitioners external to the ATO and is supervised by the Office of Chief Tax Counsel (OCTC). The ANAO understands that while the process may lead to the identification of systemic problems and/or point to staff training or information needs, its primary purpose is to measure the quality of technical decision-making for reporting at the national level.

3.52 The results of POQAR evaluations are compiled, analysed to identify trends and then communicated to the Commissioner of Taxation and the ATO's Technical Excellence Forum, through the biannual accountability reports. While the purpose of the POQAR process is not focussed on either individual case officer performance or correction of individual incorrect decisions,⁴² information on the case officer's performance is communicated to them for various purposes including:

- identifying learning needs and preferred intervention strategies, thus working to improve technical quality for the future;
- providing feedback, coaching and mentoring using the quality of each element of the case as the basis for discussion; and
- advising the relevant team manager about the quality performance of the case officer, as a push towards better informed decision-making.

3.53 The ANAO has examined the results of six POQAR reviews of I&C audits conducted since the beginning of 1999. On average, these reviews have shown that some 84 per cent of cases examined have achieved a 'pass' mark, that is, they have provided a technically correct answer and have addressed the client's question. The ANAO noted that internal reports on POQAR findings have identified issues that impact on the need for more consistent decision-making in some cases, and means to address identified shortcomings, such as through recruitment campaigns to replace experienced I&C staff that have been reallocated elsewhere within the ATO.

⁴² ATO guidelines for the POQAR process note that, for example, where an incorrect decision has a very small tax effect, it may not be appropriate to correct it.

3.54 We observed that the POQAR process did not use a random sampling technique. There is a concern that without the use of an appropriate random sampling technique the results may be left open to a skewed and inaccurate assessment.

PIQAR

3.55 POQAR is complemented by the use of the PIQAR process of pre-issue review. PIQARs are conducted by Senior Technical Officers and Team Tax Practitioners on an ongoing basis in each site. They involve a pre-issue sample review of all I&C work types including audits. As a minimum, two cases per officer per month are subject to PIQAR assessment.

3.56 I&C management and staff consider that PIQAR is a useful quality control process, designed to provide a diagnostic functionality at the region/site/officer levels for all written technical products. PIQAR enables correction of cases before the decision is communicated to the taxpayer, identifies training needs, provides technical feedback to staff, measures quality of performance and identifies possible areas necessary for escalation.

3.57 The ANAO examined the results of PIQAR processes in relation to all I&C products, that is, not specifically audit products, over the November 1999 to September 2000 period. The results of PIQAR quality reviews of staff decision-making and advising averaged higher than a 98 per cent pass mark over this period.

3.58 PIQAR processes relate to written work only, leaving an amount of work done through computerised noting and telephone advice that goes unchecked for accuracy. For example, if an inquiry is received by telephone, the IMS team member is required to note the conversation on a computer file to be used for future reference. It was expected that staff would be coached and mentored in giving advice to taxpayers and the subsequent computerised recording of the conversation but there was no formal process for doing so. To ensure accuracy of telephone advice and recording other areas of the ATO use telephone monitoring procedures. However, there was no evidence during the course of the audit of a similar type of monitoring in use by I&C.

Recommendation No. 5

3.59 The ANAO recommends that, to ensure comprehensive coverage by quality review processes:

- all post-issue QA review sampling use an appropriate random selection technique; and
- INB introduce quality control mechanisms for telephone advice to taxpayers and computerised note keeping.

ATO Response

3.60 The ATO agrees with the recommendations. In the recent (March 2001) *National Technical Quality Performance Review (POQAR)*, INB used appropriate random selection techniques in identifying the review sample. The random sampling techniques that were used accord with the guidelines laid down in the OCTC Draft Practice Statement on Technical Quality Performance Reviews.

3.61 The IMS case actioning area has also now introduced quality control mechanisms (PIQAR and POQAR) in relation to telephone advice to taxpayers and the necessary note keeping on the Case Actioning System. As part of the efforts to expand upon the quality control measures in place, a Team Tax Practitioner has been appointed. A major part of their role is the provision of quality assurance and constructive feedback to operatives in relation to the work done.

Quality Work Practices and Systems

3.62 Unlike PIQAR and POQAR processes that look at technical quality in terms of the decision-making process, Quality Work Practices and Systems addresses the procedural and operational aspects of I&C work that impact on technical quality. That is, in a continuous improvement environment such as the ATO, work practices and systems in the workplace must support the staff in their day to day work. This enables staff decision-making and other responsibilities, such as audit, to be undertaken to promote the achievement of quality outputs. Examples of this approach included:

- adoption of a Duplicate Work Management System to, among other things, match incoming cases with appropriate, experienced staff;
- setting out procedural requirements and procedural rules in guideline materials such as Practice Statements and manuals or checklists, so that the achievement of quality outcomes is promoted;
- provision of induction training for new staff to provide them with a base level of skills and knowledge so that they can perform decision-making duties;
- production of specialist product-based training packages, such as when a new audit project is to be undertaken so that staff undertaking the project gain the required skills and knowledge;
- support for operational staff at the team level from Team Tax Practitioners providing tax technical knowledge to support technical decision-making; and
- provision of easy access to targeted decision support tools such as legislation, Taxation Rulings, Determinations and Case Decision Summaries.

3.63 The ANAO notes that INB has in place an accreditation process for technical leaders (Team Tax Practitioners in I&C Operations and Tax Practice Management Network staff). This process recognises that such staff have a crucial role in measuring, maintaining and improving the skills and knowledge of technical staff in INB and associated work practices and systems. This role requires that these technical leaders meet three core competencies:

- possession of highly developed tax technical knowledge and the ability to apply that knowledge, particularly in those areas of the law relating to relevant INB products; alternatively they must be able to quickly acquire and apply such knowledge using available research, decision-support and learning tools;
- possession of an understanding and ability to apply the quality review assessment model, requiring the possession of high levels of judgement and decision making skills; and
- a high level of interpersonal communication skills, with particular focus on feedback, mentoring and coaching skills.

3.64 Competencies for technical leaders are gained and maintained through:

- a Technical Leadership Workshop;
- work-based assessment on technical leadership activities; and
- assessment and evaluation of progress through a mandatory learning plan.

3.65 The ANAO acknowledges that the processes described are an essential element in maintaining and enhancing the technical quality of INB decision making at the operational level. Further, the ANAO notes that INB is undertaking work to extend accreditation processes to other groups of I&C staff including Operations, CMS and KDA staff. We support introduction of such measures as soon as possible to ensure the continuity of audit quality.

The quality of correspondence to taxpayers

3.66 The ANAO reviewed a typical set of documents sent to a taxpayer who may have omitted income or overclaimed a rebate. To determine how understandable such correspondence is to the taxpayer, the ANAO calculated its reading ease using the following measurements:

- Flesch Reading Ease Score which rates on a 100 point scale with a high score preferred for an easier-to-read document. Most standard documents aim for a score of 60-70; and

- Flesch-Kinkaid Grade level score which relates to the U.S. grade school reading levels and in which a lower score is preferable. For example, the preferred score of 8.0 equates to an eighth grader understanding the document. This level is preferred for the general public to understand letters and documents easily in plain language.

3.67 Our review found that the package, which included a letter of introduction, a discrepancy schedule and a letter explaining audits of income tax returns, rated 54.2 on Flesch Reading Ease and 10.1 on the Flesch-Kinkaid Grade level, seen in Table 3.2⁴³.

Table 3.2
Reading ease

	<i>Ideal Scores</i>	<i>ATO Package</i>	<i>ATO Letter</i>
Flesch Reading Ease	60-70	54.2	54.8
Flesch-Kinkaid Grade level	8	10.1	9.7

Source: Gunning Fog — Flesch-Kinkaid index

3.68 We found that both the individual letter and the document package did not rate well against these measures. As can be seen in Table 3.2, the ATO package was found to be 25 per cent more difficult to read than the recommended grade level score. The ANAO recognises that the Taxpayer Charter requires additional information to be included in the package sent to the taxpayer, thus adding to its complexity. However, a letter from the ATO may be viewed with some trepidation by the general taxpayer. If the letter is difficult to understand there is an increased likelihood of a higher workload being generated by people calling the ATO for clarification. There is also a risk that some people who find the documents confusing and are hesitant to contact the ATO may accept the proposed amendment without question and so be treated unfairly.

⁴³ Another literacy indicator, the Rapid Estimate of Adult Literacy in Medicine found that reading material given to parents was too complex and usually at a tenth grade level. Parents read at a mean of seventh to eighth grade reading level despite finishing school at a mean of grade 11 and five months (Maine AHEC Health Literacy Center (1998) Pfizer Journal Vol. 2 no. 1 Spring, Chapter 4).

Recommendation No. 6

3.69 The ANAO recommends that, to improve communication with taxpayers and reduce the risk of increased workload for the ATO, INB improve the reading ease of letters and documents sent to its clients.

ATO Response

3.70 We agree with the recommendation. IMS letters and other related documentation that are being sent to taxpayers will be reviewed to improve the reading ease.

Guidance and training

3.71 INB has a total staff of 2431 and I&C has a total of some 650 staff members. Clear communication of guidance to staff is crucial to INB's role.

3.72 INB is currently reviewing its audit guidelines as the current guidelines are considered to be large and unwieldy. Though the guidelines are available through the ATO's intranet service to all tax office staff, the ANAO found little knowledge of their existence. The diverse range of audit activities from IMS and call centre activities to full audits requires clearly written, comprehensive guidelines which can be readily accessed by the teams. Audit activities and procedures rely heavily upon the corporate knowledge of existing staff. This is problematic if corporate knowledge is lost due to the movement of a staff member from an area and the procedural guidelines are out of date or not easily located. For example, one area rated poorly in their POQAR assessment due to a lack of information regarding the required audit process.

3.73 Training of staff is documented in the 'Interpretation and Compliance 1999–2001 Training and Development Strategy Implementation Plan' and in the 'Outline of Process for Continually Assuring the Quality of Technical leaders in Individuals Non Business' dated 18 November 1999. These outlines demonstrate necessary planning for the training and reviewing of staff, in particular, technical leaders.

3.74 ANAO found that staff at the operational level had little formal training.⁴⁴ Training and its consistency and effectiveness are recognised as important issues by I&C. Moreover, officers reported little training other than job based and some in-house training. Those with accounting degrees pointed out that they had a requirement for training each year

⁴⁴ The ANAO recognises that lower level staff are required to escalate cases that fall outside their work parameters.

to maintain their qualification. A work based training needs survey was to be conducted of all I&C staff by 31 July 1999. The survey was disbanded upon realisation that the need for staff skilling was greater than expected.

3.75 The ANAO is aware that INB is undertaking a 'Total Skilling Program' (TSP) across all INB staff. The level of effectiveness is to be measured by the quality assurance tools⁴⁵ currently applied by INB. The material and assessments will cover the basics through to the very complex, including:

- foundation skills and knowledge which includes, research interpretation and legal writing, administrative law, tax equation, penalties;
- application of knowledge which includes income and deductions, substantiation, tax offsets, international tax, eligible termination payments, lump sum payments, depreciation, PAYG, family assistance, capital gains tax, medicare levy surcharge, HECS, trusts, FBT, companies, partnerships, accounting, tax reform issues; and
- skills which include auditing for I&C, skilling for technical leaders, community, government and commercial awareness, quality assurance and accreditation, dispute management, I&C systems, and personal management skills.

3.76 The program can be tailored to the needs of staff at all levels. The TSP commenced with products aimed at a group of inductees, which had been identified by I&C as urgent and necessary. However, the TSP is still in the developmental stage.

3.77 The ANAO also found that staff training has little or no mention in annual or monthly governance reports. As for other significant aspects supporting the delivery of I&C's outcomes, monitoring of progress by management is an important factor and should be addressed in corporate governance reports.

⁴⁵ Such as those previously mentioned, the QARE Model, and application of standards in PIQAR & POQAR.

Recommendation No. 7

3.78 The ANAO recommends that, to ensure adequate skilling of its staff and continuing quality of audit work, INB:

- gives a higher priority to staff training; and
- addresses staff training and training issues in INB management reports on performance.

ATO Response

3.79 We agree with the recommendation. In recent months, we have been re-writing the general audit guidelines training document and actively marketing the updated product to our staff. An updated rental audit tax technical guidelines document is also now available. Additionally, our IMS staff now have access to a Team Tax Practitioner. Be that as it may, it is accepted that the broader question of training delivery across INB needs reviewing. This will happen as part of strategic planning for 2001–02. The status of staff skilling and training will also be picked up in our corporate governance performance reports.



Canberra ACT
23 May 2001

P. J. Barrett
Auditor-General

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