



Performance Audit

Reviewing VAT Liability : VAT Investigations and Credit Control Exercises

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Abbreviations used in this Report

EU	European Union
GDP	Gross Domestic Product
IFAC	International Federation of Accountants
ISA	International Standards of Auditing
NAO	National Audit Office
TCU	Tax Compliance Unit
VAT	Value Added Tax

Executive Summary and Recommendations



Executive Summary and Recommendations

1 The audit was concerned with the VAT Department's efforts to ensure the accuracy of self-declarations submitted by taxpayers through the undertaking of VAT Investigations and Credit Control Exercises.¹ The audit focused mainly on the period January – December 2004. The audit objectives were to:

- i. Determine whether adequate measures are in place to ensure that potential defaulters who pose the largest risk to VAT revenue are targeted for an audit.²
- ii. Evaluate whether the audit procedures adopted by the Department provide reasonable assurance that the traders' VAT liability is accurately determined.
- iii. Evaluate the extent to which the outcomes of VAT audits relate to Departmental and other targets.

2 Various policy statements outlined Government's concern with tax evasion. The Budget speech for financial year 2006 stated that Government sees the evasion of taxation as nothing less than theft. The same document further stipulates that Government will aggressively continue to curtail tax evasion.

3 In 2004, VAT revenue collected by the Department grossed Lm164 million out of which Lm22.4 million were paid in refunds. Consequently, net VAT revenue for 2004 totalled Lm141.6 million.

1 The VAT Department carries out such exercises to validate VAT credit claims by taxpayers prior to effecting the ensuing refund.

2 Audit may refer to both an Investigation and Credit Control Exercise.

Net VAT revenue collected in 2005 amounted to Lm168.2 million.

4 As at end 2004, 66,460 persons were listed on the Department's register. However this audit was mainly concerned with the 30,010 taxpayers who were considered to be the taxpayers that were generally active within the Maltese economy during 2003 and 2004, and whose trading activities generated most of the VAT yield (92.4 per cent of total net VAT). For the purpose of this study, annual figures quoted in respect of these taxpayers are an annual estimation that was based on 2003 and 2004 VAT declarations.³ Chapter 1 of this report provides a detailed description of the characteristics of these 30,010 taxpayers.

Targeting potential defaulters for VAT Investigations and Credit Control Exercises

Targeting for VAT Investigations

5 When targeting for a VAT investigation, the Department attempts to identify taxpayers that pose a potential risk to VAT revenue. In most cases, these investigations tend to focus on output tax, that is, they are mostly concerned with under declared sales. During 2004, the Department targeted 257⁴ taxpayers for investigations. By March 2006, 97 of these investigations were concluded. Twenty-two (22) of the 97 (23 per cent) concluded investigations yielded a nil assessment.

6 For the purpose of this study the targeting approaches utilised by the Department for an investigation

3 This approach had to be resorted to since the periods stipulated for the submission of VAT Returns are not based on a calendar year.

4 Refers to cases selected by the Department for an investigation from the 30,010 active taxpayers (vide chapter 1 paragraph 13). It is to be noted that during 2004 the Department carried out a total of 304 investigations, of which 245 cases were concluded (source: Monthly Management Report VAT Department December 2005).

have been categorised as targeting through the Department's Risk Analysis Module and targeting through Management's value judgement.

The Risk Analysis Module

- 7 The Risk Analysis Module is a computerised system which ranks potential defaulters automatically according to the resultant risk posed to VAT revenue. The major benefit of this approach is that it allows the Department to optimise its resources by aiming to obtain the highest possible rate of return.
- 8 The risk analysis criteria are mainly based on accounting ratios and taxpayers' compliance with regards to the VAT legislation. However, the effectiveness of the Risk Analysis Module has been reduced since there is no ongoing scientific study of trends and the effectiveness of ratios by appropriate specialists on which the risk analysis criteria and relevant parameters and weightings are devised.
- 9 From the date of Malta's accession to membership of the European Union in 2004, changes in the VAT Return necessitated the relevant adjustments to the Risk Analysis System. These adjustments to the Risk Analysis application were delivered to the Department by MITTS in two phases – February and October 2005.
- 10 The VAT Department did not adhere to the risk rankings as compiled by the Risk Analysis Module. Although, as at end 2004, the Module identified 2,934 candidates, only 88 taxpayers from this list were selected for an investigation. A further 106 taxpayers listed as candidates were selected for an investigation between 2000 and 2003. This situation occurs since the Department subjects potential candidates for a VAT investigation to a 'sifting' process. The importance of the sifting process is that it enables the Department to decide whether candidates pose sufficient risk to be subjected to an investigation. The Department was not fully or systematically documenting the reasons leading to deviations from the list specified by the Risk Analysis Module. It is to be noted that when informed by the NAO, the Department took immediate action to rectify this situation.

Targeting for a VAT Investigation on the basis of Management's value judgement

- 11 The Department's Management also utilises its value judgement to target taxpayers for an

investigation. Such a situation occurs since, as a management tool, the Department's Risk Analysis Module predominantly ranks candidates according to risk based on accounting ratios and compliance with VAT legislation. Consequently, Management has to complement information provided through the Risk Analysis Module with other sources of information and observations available to the Department.

- 12 Management's value judgement is generally based on various factors, including failed fiscal receipt inspections, complaints about the taxpayer from the public, a negative outcome arising through the Department's audit trail exercises or through the existence of reasonable doubt that the taxpayer is in default.
- 13 However, practices relating to the selection of taxpayers for an investigation indicating the criteria as to when Management should exercise its value judgement, are not documented. Written procedures in this regard are being prepared by the Department.
- 14 On the basis of its value judgement, the Management selected 169 taxpayers for a VAT investigation during 2004. All of the 169 audits selected were not being considered as candidates for an investigation by the Risk Analysis Module. It is to be noted that in 2004 the Risk Analysis Module was not being fully utilised by the Department since the system was being upgraded to cater for the new VAT registration format which came into effect following Malta's accession to European Union membership (vide paragraph 2.12).
- 15 The 169 taxpayers subjected to an audit on the basis of Management's value judgement were reviewed by the NAO in terms of the number of failed fiscal receipt inspections.⁵
- 16 During 2004, the Department carried out 13,508 fiscal receipt spot check inspections out of the 30,010 taxpayers being studied for the purpose of this audit. These inspections involved 4,838 different taxpayers. Four thousand and forty-three (4,043) out of the 13,508 inspections resulted in negative reports (a failed inspection). The failed inspections involved 2,746 taxpayers. In 760 of instances involving the failed inspections the Department either sought to negotiate a

5 The Inspectorate Unit of the VAT Department carries out inspections at business premises to primarily ensure that fiscal receipts are being issued to customers.

'*compromise penalty*'⁶ or referred the matter for court action. Another option available to the Department is to subject the defaulting taxpayer to a VAT investigation if the taxpayer repeatedly fails fiscal receipt spot checks inspections.

- 17 However, the NAO review revealed that the Department could be more consistent when utilising the latter option. In fact, the Department is upgrading its internal policies in this regard.

Investigations referred to the Tax Compliance Unit (TCU) and private auditors

- 18 Audits that in the opinion of the Department's Management necessitate that such reviews are carried out by professional auditors are forwarded to the Tax Compliance Unit (TCU) or farmed out to private auditors. During 2004, the Department referred 70 cases to the TCU or private auditors. The selection process regarding which cases are to be referred to the TCU and the private auditors is generally dependant on the section's Assistant Director's personal value judgment.

- 19 The opportunity exists for the Department to compile guidelines which define the instances when a case is to be referred to the TCU, contracted out to private auditors or assigned to the in-house Inspectorate Section. Since the conclusion of this report, the Department has taken this matter in hand.

Targeting for Credit Control Exercises

- 20 The Department also performs credit control exercises relating to credit claims by taxpayers. Such exercises mainly focus on input tax declarations. Up to end 2004, the selection of taxpayers for credit control exercises was mainly based on the materiality of credit claims. However, such practices were not documented. During 2005, the Department improved its selection practices for credit control exercises by increasingly basing its targeting on accounting ratios together with the materiality of credit claims.

- 21 Over half of the credit control exercises (117 out of the 226) undertaken during 2004 yielded a nil assessment. The Department maintains that such an incidence of nil assessments results as the department, up to 2004, was basing its

6 Defaulters have the option to pay a fine for failing to issue a fiscal receipt instead of appearing before the courts.

selection criteria for credit control exercises on the materiality of credit claims. Moreover, the Department insists that potentially correct claims were also subjected to credit control exercises if such claims were considered material.

Auditing taxpayers' VAT liability

- 22 Investigations and credit control exercise are performed by the Department's Inspectorate Unit and, if required, reviewed by the Reviewing and Investigations Section. These Units employ 52 persons, 31 of whom may carry out VAT audits and reviews. The qualification requirements specified by the Management and Personnel Office (MPO Circular 101/2005) are that applicants for the post of VAT Inspectors must possess four Ordinary Level Certificates (Maltese, English, Mathematics and Accounting), where preference would be given to applicants with an Advanced Level standard. However, all VAT Inspectors attended various courses related to their duties, particularly with regards to the interpretation of the VAT Act.

- 23 On the basis of a review of 104 cases out of the 502 audits (investigations and credit control exercise) concluded during 2004, it transpired that generally accepted auditing practices relating to audit planning, the collation of audit evidence and supervision are not being fully followed in the Department's audit work. On an individual basis, as non qualified auditors, the staff employed by the Department are not obliged to follow international auditing standards. However, the audit approach was further hindered as the staff were not guided through check lists and/or guidelines as these were not in-built in the VAT audit process.

- 24 The Department is addressing the above situation, and has already provided staff performing VAT audits with hands on training from accountants employed at the Tax Compliance Unit. The Department recently also started introducing checklists to guide staff through the audit process.

Outcome of VAT Investigations

- 25 Through a case study approach, the NAO reviewed 50 out of the 152 VAT investigations which were randomly selected among those concluded by the Department during 2004. These 50 investigations yielded incremental assessments of Lm60,144 or an increase of 51 per cent on the net VAT declared.

However, 18 of the investigations reviewed did not yield any incremental increase in net VAT.

- 26 Each investigation reviewed by the NAO related to an average period of about 2.8 years. Thus, on average, each year under investigation yielded an additional assessment of around Lm428.
- 27 Taxpayers are entitled to challenge assessments raised through an investigation. The following results refer:
- i. In 36 cases, taxpayers were issued with provisional assessments.
 - ii. In 23 out of these 36 cases, the taxpayer accepted the assessment raised.
 - iii. In 13 cases, the taxpayer objected to the issued provisional assessment. Following the review and Appeals Board stages, the assessments were reduced.
- 28 The Department explained that the situations discussed in the preceding paragraphs occur, as in many cases, the taxpayers did not fully cooperate with the Department during initial audit work, mainly by not submitting trading records. This situation prompts the Department to cancel the input VAT being claimed in the ensuing provisional assessment. Such assessments are later reversed when the relevant documentation is presented by the taxpayer. The lack of co-operation by taxpayers is hindering the VAT investigation process
- 29 In order to deter non-submission of business records, the Department is currently working on legislative amendments to the VAT Act, namely by proposing that taxpayers must present requested information within a defined timeframe.

Outcome of Credit Control Exercises

- 30 The NAO reviewed 148 randomly selected credit control exercises out of the 350 audits completed in 2004. These results are only indicative of the workings undertaken by the Department. The 148 credit control exercises reviewed by the NAO, with credit claims amounting to Lm2,597,408, yielded incremental VAT assessments of Lm175,636.
- 31 However, 72 out of the 148 credit control exercises reviewed by the NAO did not yield any incremental assessment. Moreover, 54 out of 148 credit control exercises yielded less than Lm1,000.

The average assessment of these 54 credit control exercises amounted to around Lm239. There were only eight exercises out of the 148 reviewed which had an incremental assessment of over Lm5,000.

- 32 The 148 credit control exercises, on average, were concerned with reviewing a period of about 2.54 years. Thus, on average, Lm466 VAT was assessed per case per year of investigation.
- 33 Taxpayers subjected to a credit control exercise are entitled to the same '*objection*' rights as those relating to VAT investigations. Taxpayers were generally accepting assessments arising from credit control exercises more readily than those resulting from investigations. However, where objections were registered, significant downward revisions took place. On the basis of the 148 cases reviewed by the NAO, 83 taxpayers were served with a provisional assessment, out of which 62 accepted outright the provisional assessments. In 21 cases, the taxpayers objected to the assessment. During the objections process (from review up to appeals board stage), the assessment raised on seven taxpayers was reduced to nil.
- 34 The Department maintains that the above situation mainly results due to the non-cooperation of taxpayers and ensuing departmental action as discussed in paragraph 3.20.

Cost Efficiency of VAT audits

- 35 A general trend emerged whereby the longer the duration of audit work the lower was the average assessment per month of audit work. These trends indicate that the Department has to find the appropriate balance between delving deeper into a case, and therefore ensuring that all dues to the Department are identified, or concluding a case on existing evidence where the payback would be relatively higher. The opportunity cost of the latter option, however, is foregoing that each and every taxpayer's VAT liability is fully determined.
- 36 Since 2003, the Department has registered a significant improvement in the rate of return of audit work undertaken. In fact, in 2005 the additional VAT liability assessed⁷ amounted to Lm7.50 for every Lm1 (against the Lm5.2 for every Lm1 in 2004) the Department spent on audits carried out. This indicates a 44 per cent

⁷ In this context, VAT liability assessed refers to final assessments raised, that is before any appeals board hearings.

improvement in the Department's efforts related to audit work over the previous year.

- 37 The contribution of audit work to the total VAT revenue in 2003, 2004 and 2005, amounted to 0.9, 1.3 and 1.3 per cent respectively of the total revenue collected by the Department during these years: additional assessments amounted to Lm1.1 million out of LM123.9 million, Lm1.9 million out of Lm141.6 million and Lm2.2 million out of Lm168.2 million in the three years respectively.

Overall conclusions

- 38 In the light of a recent statement by the Central Bank of Malta that tax evasion is still widespread, it is questionable whether the 1.3 per cent contribution of the VAT audit process towards the 2005 VAT yield relates to the extent of the informal economy. The VAT audit process is intended to identify VAT defaulters and ensure that revenue due to Government is duly assessed and collected.
- 39 Despite the improvements towards the annual VAT revenue yield through its audit work, the opportunity exists for the Department to enhance the effectiveness of such activities through better targeting of potential defaulters, an increase in the number of qualified staff employed by the Department, and a more methodical approach to investigations and credit control exercises.
- 40 The targeting of taxpayers for an audit was hindered since the Department lacked the resources to scientifically develop its risk assessment of taxpayers. The Department utilises a number of methods to target potential defaulters for a VAT investigation or a credit control exercise. However, policies in this regard need to be more focused to encompass proven methods of case selection that take into consideration the staff resources available to perform VAT audits and the estimated level of VAT revenue at risk.
- 41 Efforts to complement the experience of the existent staff by drafting professionally qualified personnel, as well as further hands on training, need to be sustained. This would provide the department with the opportunity to be more methodical by applying recognised auditing standards in their work. In turn, this would ensure that the Department is in a stronger position to deal with VAT defaulters.

Recommendations

- 42 In view of the foregoing the National Audit Office proposes the following recommendations:
- i. The Department should appoint specialists to scientifically develop criteria and relative weightings utilised by the VAT Department in order to rank taxpayers according to the potential risk posed to VAT revenue. Moreover, the Department should evaluate on an ongoing basis the effectiveness of the targeting criteria and their weightings in order to ensure their reliability, integrity and appropriateness with regards to the changing economic circumstances.
 - ii. Recent Departmental efforts to document reasons for any deviations from the Risk Analysis Module are to be sustained.
 - iii. Records with details of any taxpayers selected through Management's value judgment should be maintained, indicating reasons for the selection. The Department should also document guidelines that are to be followed when selecting taxpayers for an investigation based on Management's value judgment.
 - iv. The Department should improve the co-ordination of various initiatives intended to target taxpayers for a VAT investigation or a credit control exercise. Such an approach would further contribute towards subjecting the riskiest taxpayers to VAT audits, and indicate when such cases are to be referred to the TCU or private auditing firms.
 - v. The Department should include professional personnel within its staff complement particularly where VAT audits are concerned. The Department has recently embarked on this route through the engagement of managers within the Department's Inspectorate Unit. Moreover, the opportunity exists for the Department to establish its own staff development programme. This would ensure that the experience gained by existing staff are complemented by formal academic training.

- vi. The VAT audit process is to be strengthened by adhering to recognised auditing standards. In this regards International Standards of Auditing (ISAs) of the International Federation of Accountants (IFAC) could be used as a model, particularly for audit planning, collation of audit evidence, standardization of working papers and supervision. Recent Departmental efforts to guide staff to adhere to auditing practices through the introduction of checklists and manuals are acknowledged.

- vii. The Department should strive to quantify the '*VAT gap*'. By identifying this gap, the Department would be able to set realistic enforcement plans and targets, which could be used as a yardstick to measure its own performance. It is to be noted that the Department is currently involved in European Union initiatives to develop harmonised '*VAT gap*' guidelines for all member states.

Chapter 1

Introduction



Chapter 1 – Introduction

Background

- 1.1 Value Added Tax (VAT) collected during 2004 amounted to Lm141.6 million. This constitutes 17.41 per cent of Government's ordinary revenue and amounts to 7.7 per cent of the local gross domestic product (GDP). The net VAT collected in 2005 totalled Lm168.2 million or 8.7 per cent of the GDP.
- 1.2 VAT is a self-assessed tax and is collected by VAT registered traders on their supplies of goods and services. Net VAT relates to the difference between the resultant Output Tax (VAT levied on Sales) and Input Tax (VAT incurred on Purchases) made for the purpose of running the business. In this way VAT is ultimately incurred by the final consumer.
- 1.3 The Department's efforts to ensure the accuracy of self-declarations submitted by traders is considered to be critical to the overall process of collecting VAT revenue. To this end, the Department undertakes a range of activities, namely inspections to ensure that traders are issuing VAT receipts, surveillance to monitor business activity and the auditing of traders that are considered to pose a risk to VAT revenue.
- 1.4 The Department undertakes a range of activities designed to detect trading activities being carried out by non-registered persons. Moreover, the Department also applies verification mechanisms such as audits in instances where traders request a de-registration from the VAT register. The Value Added Tax Act also empowers the Department to inflict '*compromise penalties*'⁸ and to initiate legal action in cases of non-compliance and VAT fraud.

8 '*Compromise penalties*' are incurred in cases of non compliance to the VAT Act where the Commissioner of VAT and the offender enter into an agreement in lieu of the relative criminal liability.

- 1.5 The main focus of this audit are the operations undertaken by the VAT Department related to the auditing of self-declarations submitted by registered traders. This audit focused mainly on the period January – December 2004.

- 1.6 This chapter of the report presents the following:

- i. An outline of the VAT registered persons who are considered to be the major contributors to the VAT revenue yield.
- ii. An overview of the Department's activities relating to the targeting and auditing of potential VAT defaulters.
- iii. The objectives of this performance audit.

Audit concerns

- 1.7 Various policy statements outlined Government's concern with tax evasion. Government's fiscal policy refers to Government's intention to improve tax efficiency and enforcement in order to curb evasion. The Budget speech for financial year 2006 reiterated this position, and it was stated that Government sees the evasion of taxation as nothing less than theft. The same document further stipulates that Government will aggressively continue to curtail tax evasion.
- 1.8 Moreover, the Maltese Government outlined its concern that the informal economy in Malta distorts competition and weakens the funding of social and legal protection, in that it contributes to tax evasion.⁹ The Central Bank of Malta remarked that it is a common knowledge that tax evasion is still widespread.¹⁰

9 Joint Memorandum on Social Inclusion in Malta; p15. http://europa.eu.int/comm/employment_social/soc-prot/soc-incl/mt_jim_en.pdf.

10 Quarterly Review 2004:4 of the Central Bank of Malta, page 57.

Table 1.1 - VAT registered persons as at end December 2004

Registration type ¹¹	Description	Number of VAT registered persons	Percentage of VAT registered persons
Registration A	Traders who exceed the minimum threshold turnover for a particular business activity. In this category are also included those who operate below minimum thresholds but decided to be included in the VAT refund scheme.	51,481	77.5
Registration B	Turnover is below the established entry threshold for the business activity. Traders are not eligible to charge or claim deduction of VAT in the course of their economic activity.	14,892	22.4
Registration C	Any person, except register A taxpayers, that opt to be charged VAT at the local rate on the importation of goods from another European Union (EU) member state.	87	0.1
Total		66,460	100

Source: VAT Department.

1.9 Despite such concerns, there is no official Government data showing the extent of the informal economy, including the 'VAT gap'. Currently the VAT Department is participating within a European Union forum, together with other member states, to compile harmonised guidelines concerning the establishment of the 'VAT gap'.

VAT revenue

1.10 The VAT rate was revised from 15 per cent to 18 per cent in January 2004. In 2004, VAT revenue collected by the Department grossed Lm164 million out of which Lm22.4 million were paid in refunds. Consequently, net VAT revenue for 2004 and 2005 totalled Lm141.6 million and Lm168.2 million respectively. It is to be noted that during 2004 a one time shortfall in VAT revenue of around Lm15 million occurred. This resulted following Malta's accession to the European Union whereby VAT on goods acquired from EU states was no longer being paid at the Customs Department but to the VAT Department on the actual sale of the products.

VAT registered persons

1.11 A VAT registered person (taxable person) may be an individual, company or other body. All traders falling within the scope of VAT are obliged to register with the VAT Department, whereby each

trader is issued with a unique VAT number. As at end 2004, 66,460 persons were listed on the VAT Department's register.

1.12 VAT registered persons are classified into three main categories, as indicated in Table 1.1.

1.13 Most of the VAT revenue, however, emanates from the trading activities of 30,010 taxpayers registered under Register A. This situation results as 21,471 Register A taxpayers have either deregistered, applied for deregistration (since they are no longer trading), or consist of Public Administration bodies. Moreover, Register B taxpayers, in view of their relatively low turnover, as defined in the VAT Act, neither charge nor claim any VAT and therefore do not make any contribution to the VAT yield. The amount of VAT due by traders classified in Register C was negligible.

The major contributors to the VAT yield

1.14 This study focused on the 30,010 taxpayers who were considered to be the traders that were generally active within the Maltese economy during 2003 and 2004, and whose trading activities generated most of the VAT yield (92.4 per cent of total net VAT). For the purpose of this study, annual figures quoted in respect of these taxpayers are an annual estimation that was based on 2003 and 2004 declarations in VAT returns for this period.¹²

¹¹ For ease of reference, throughout this report, VAT registration types are being referred as 'A', 'B' and 'C'. These Registration types are based on the provisions of Articles 10, 11, and 12 of the VAT Act respectively.

¹² This approach had to be resorted to since the periods stipulated for the submission of VAT Returns are not based on a calendar year.

Table 1.2 - Businesses turnovers and VAT declared

Economic sector	Number of taxpayers	Percentage of population
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	10,451	34.83
Real estate, renting and business activities	4,671	15.56
Agriculture, hunting and forestry	2,819	9.40
Other community, social and personal service activities	2,405	8.01
Manufacturing	2,267	7.55
Hotels and restaurants	2,050	6.83
Construction	2,017	6.72
Transport, storage and communication	1,725	5.75
Extra-territorial organizations and bodies	490	1.63
Education	350	1.17
Fishing	320	1.07
Health and social work	192	0.64
Financial intermediation	179	0.60
Mining and Quarrying	67	0.22
Electricity, gas and water supply	7	0.02
Totals	30,010	100.00

Source: VAT Department.

Table 1.3 - Annualised business turnover

Turnover brackets	Number of taxpayers	Percentage of taxpayers
Returns not submitted ¹³ / nil returns	9,057	30.17
Lm1 to Lm25,000	11,422	38.06
Lm25,001 to Lm100,000	5,432	18.10
Lm100,001 to Lm500,000	2,856	9.52
Lm500,001 to Lm1m	582	1.94
Lm1m to Lm7m	591	1.97
Lm7m to Lm18m	47	0.16
Lm18m and over	23	0.08
Totals	30,010	100.00

Source: VAT Department.

1.15 It is estimated that, in total the, 30,010 taxpayers declared an annualised average of about Lm82.3 million in net VAT revenue. In addition to this amount, these taxpayers have contributed to an average of Lm48.5 million per year with respect to VAT paid on imports at Customs and the Licensing and Testing Department. Table 1.2 shows the economic sector in which the 30,010 taxpayers under study operate.

13 For the purpose of this exercise, traders who have not submitted a return during 2003 and 2004 are being considered as having nil turnovers. This approach is being adopted since these traders are still registered with the VAT Department and can be subjected to an audit.

Business Turnover

1.16 The total estimated annual turnover of these taxpayers amounted to Lm4,963 million. Table 1.3 presents the number of taxpayers broken down by the estimated annualised turnover.

1.17 The annualised business turnover, for 25,911 taxpayers (86.33 per cent) was below Lm100,000, out of which 11,422 (38.06 per cent) declared a turnover of between Lm1 and Lm25,000. In 9,057 (30.17 per cent) cases, a nil turnover was declared or the VAT return was not submitted.

1.18 Only 661 out of the 30,010 taxpayers (2.21 per cent) declared an annualised turnover of over Lm1 million. Forty-Seven (47) taxpayers (0.16 per cent) declared a turnover of between Lm7 million and Lm18 million. Another 23 taxpayers (0.08 per cent) declared a turnover of over Lm18 million.

Net VAT declarations

1.19 The 30,010 taxpayers, in total, declared annual net VAT revenue of around Lm82 million. This amount does not take into consideration any penalties, fines, arrears or any off-setting that may have been due, and included in the relevant VAT returns, for the period under review. The net VAT declared comprises of VAT returns declaring a net VAT balance of Lm105.1 million and Lm22.7 million in VAT refunds.

1.20 Most taxpayers (85.37 per cent) annualised declared net VAT amounted between a refund of Lm999 and a VAT liability of Lm4,999. This is mainly due to the relative small scale of businesses in Malta. Chart 1.1 categorises the annualised net VAT declarations.

1.21 The annualised net VAT declarations of 7,284 taxpayers (24.27 per cent) were in credit control

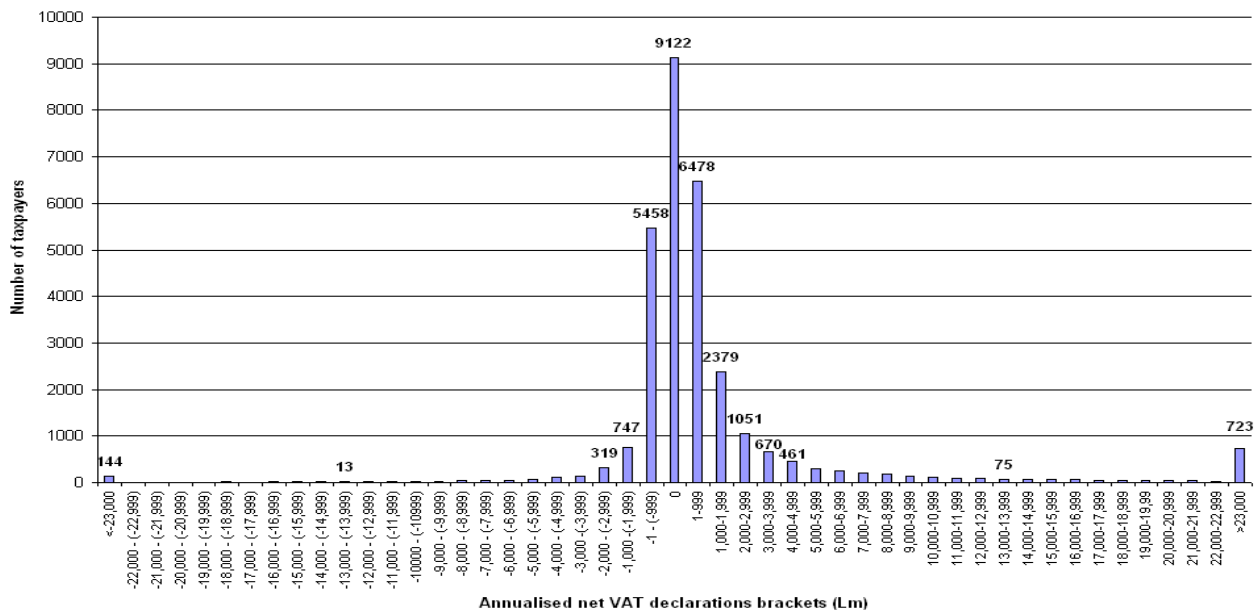
and thus were claiming back refunds from the VAT Department. Out of these taxpayers, 5,458 (18.19 per cent) were claiming VAT refunds of up to Lm1,000. Two Hundred and Ninety-Two (292) taxpayers (0.97 per cent) claimed VAT refunds of up to Lm10,000, which amount to Lm16.9 million (or 74.45 per cent of the total refund claims declared).

1.22 The annualised total credit claims relating to these 7,284 taxpayers amounted to about Lm22.7 million.

1.23 It is to be noted that 9,122 taxpayers (30.39 per cent of taxpayers) either submitted a 'nil' net VAT declaration or did not submit any VAT returns for the period 2003 – 2004. Moreover, 6,478 taxpayers (21.59 per cent) declared an annualised net VAT of between Lm1 and Lm999. The VAT Department explained that a number of nil returns materialised as traders opt to retain their VAT registration even though they would have ceased trading.

1.24 Only 1,519 (5.06 per cent) of the 30,010 taxpayers declared an annualised net VAT of more than Lm10,000. However, declarations of these tax payers constitute 80.6 per cent of the total annualised net VAT declarations. Only eight taxpayers had an annualised VAT declarations

Chart 1.1 - Annualised net VAT declarations brackets



Source: VAT Department.

of over Lm1 million; the highest amounted to Lm9.56 million.

The targeting and auditing of potential VAT defaulters

1.25 The Department attempts to maximise VAT revenue by performing audits on potential defaulters. The revenue maximisation objective is carried out through an audit programme which is based in targeting VAT registered persons who are considered to pose a risk to VAT revenue.

Selection of Taxpayers for audits

1.26 Audits of traders' VAT self-declarations are generally undertaken on the basis of:

- i. **Risk Analysis** - The Department subjects the potential defaulters, as identified by the '*Risk Analysis Module*' to an audit. Potential defaulters are ranked automatically by the computer system according to the resultant risk posed to VAT revenue.
- ii. **A failed fiscal receipt spot check inspection** - During 2004, the Inspectorate Unit of the VAT Department carried out 13,508¹⁴ surprise inspections at various businesses in order to monitor whether taxpayers were issuing fiscal receipts. The risk ranking of defaulting taxpayers is subsequently adjusted accordingly. Moreover defaulting taxpayers may be subjected to an audit, apart from being fined or prosecuted in court.
- iii. **Credit balances** - The Department also monitors VAT declarations claiming a '*Credit*' balance. Potential defaulters are selected on the basis of VAT refund being claimed and the selection officers' value judgement.
- iv. **Management's value judgement** - The VAT Department's Management may, according to its value judgement, recommend that an audit is carried out on the activities of any taxpayer.

14 Inspections directed towards the 30,010 active traders.

Audits

1.27 Audits of potential defaulters are either:

- i. Carried out by the Inspectorate of the VAT Department;
- ii. Farmed out to audit firms; and
- iii. Referred to the Tax Compliance Unit.

1.28 The vast majority of audits are carried out by the Department's Inspectorate Unit. The Department employs 50 audit inspectors. Generally, the more complex cases (usually relating to the larger businesses or companies) are referred to be audited by contracted audit firms or the Tax Compliance Unit.

1.29 Following the selection of taxpayers for an audit, the process undertaken by the VAT Department assumes the following steps:

- i. Authorisation for audit to proceed.
- ii. Taxpayer is informed of audit and requested to submit accounting records.
- iii. Provisional assessments issued, if taxpayer is in default.
- iv. Provisional assessments can be reviewed and consequently appealed.

1.30 Provisional assessments are raised as a result of the audits carried out. The relevant penalties and interest are added to the resultant assessment.¹⁵ Taxpayers have the right to request a '*Review*' of the provisional assessments within a thirty day period. Penalties included in the provisional assessments may be waived in accordance with Departmental guidelines. The Department aims to settle issues regarding individual provisional assessments within six months.

1.31 Once all the procedures regarding provisional assessments have been followed (including a review of this assessment), the taxpayer's account is updated with the final assessment. Final assessments can be challenged by taxpayers at the Board of Appeal.

15 All provisional assessments quoted in this report are net of penalties and interest.

Audit focus and objectives

- 1.32 The main focus of this audit are the operations undertaken by the VAT Department related to the auditing of self-declarations submitted by traders.
- 1.33 The objectives for this audit are to:
- i. Determine whether adequate measures are in place to ensure that potential defaulters who pose the largest risk to VAT revenue are targeted for an audit.
 - ii. Evaluate whether the audit procedures adopted by the Department provide reasonable assurance that the traders' VAT liability is accurately determined.
 - iii. Evaluate the extent to which the outcomes of VAT audits relate to Departmental and other targets.
- 1.34 For the purpose of this audit data relating to 2003 and 2004 from the Department's main computer system, as well as spreadsheets maintained by various Units within the Department, were analysed. In addition, further data was obtained through a sample of 198 out of 502 audits (including credit control exercises) which were completed during 2004.

Methodology

- 1.35 In order to attain the above objectives, the audit team carried out interviews with officials and reviewed taxpayers' files. Various data maintained and submitted to the NAO by the Department relating to VAT investigations, credit control exercises and fiscal receipt spot check inspections were also analysed.

Structure of the Report

- 1.36 The following chapters cover the main issues addressed in this report:
- i. Chapter 2 of this report discusses the Department practices with regards to the targeting of traders for audits.
 - ii. Chapter 3 discusses the Department's activities and results regarding audits concluded in 2004.
 - iii. Recommendations proposed by the National Audit Office are included in the Report's Executive Summary on page 10.

Chapter 2

Targeting Potential Defaulters for VAT Investigations and Credit Control Exercises



Chapter 2 - Targeting Potential Defaulters for VAT Investigations and Credit Control Exercises

Introduction

2.1 The targeting of potential defaulters for VAT audits is a critical function of the VAT Department. This part of the report examines how the VAT Department identifies taxpayers for VAT audits. In this Chapter, the following issues are discussed:

- i. Targeting for VAT Investigations; and
- ii. Targeting for Credit Control Exercises.

2.2 When targeting for an investigation, the Department attempts to identify taxpayers which pose a potential risk to VAT revenue. In most cases, these investigations tend to focus on output tax, that is, they are mostly concerned with under declared sales.

2.3 Credit claims by taxpayers are also considered to pose a high risk to VAT revenue, since the Department will be disbursing monies to taxpayers claiming VAT refunds. These audits mainly deal with the correctness of input tax, that is, the correctness of the taxpayers' declaration with regards to purchases made for business purposes.

2.4 During 2004, the Department targeted 257 taxpayers for VAT investigations and 249 for credit control exercises.¹⁶

¹⁶ Audit cases relating only to the 30,010 (vide paragraph 1.13) active taxpayers.

Targeting for VAT Investigations

2.5 The Department utilises various mechanisms when targeting taxpayers for a VAT investigation. For the purpose of this study the targeting approaches utilised for an investigation have been categorised as follows:

- i. Targeting through the Department's Risk Analysis Module; and
- ii. Targeting through Management's value judgement.

The Risk Analysis Module

2.6 The Risk Analysis Module is a computerised system which aids the Department to identify taxpayers who pose a potential risk to VAT revenue. Combined with the knowledge accrued within the Department of the relative taxpayers' activities, the Department may then subject potential defaulters, as identified by the Module, to an investigation. The major benefit of this approach is that it allows the Department to optimise its resources by aiming to get the highest possible rate of return.

2.7 The management of targeting taxpayers falls under the responsibility of the Sifting Section within the Inspectorate Unit of the Department.

2.8 The Risk Analysis Module identifies potential defaulters and ranks them automatically according to the resultant risk posed to VAT revenue. Those taxpayers who attain a score of 100 points or more are considered as candidates for an investigation. As at end 2004, there were 2,934 out of the 30,010 (9.7 per cent) who accumulated 100 points or more. Although during 2004, 257 taxpayers were targeted for an investigation, only 88 were directly selected from the Risk Analysis Module List (vide paragraph 2.11).

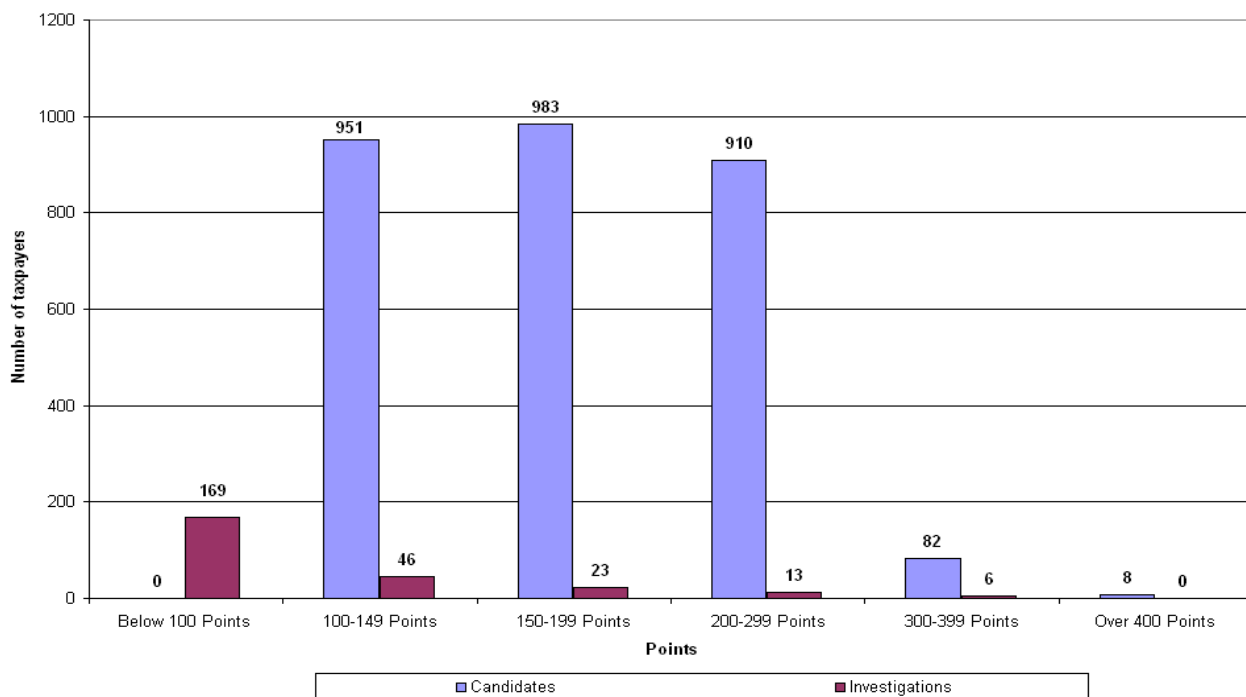
Criteria and relative weightings utilised by the Risk Analysis Module

- 2.9 The parameters and weightings of the risk analysis criteria are mainly based on accounting ratios and taxpayers' compliance with regards to the VAT legislation.
- 2.10 The following concerns regarding the criteria and their relative parameters adopted by the Department with respect to the Risk Analysis Module were noted:
- The criteria's parameters and their relevant weightings are not devised according to specific studies by the appropriate specialists and do not adequately take into consideration the knowledge and experience accrued over the years by the Department's officials.
 - There are no ongoing scientific studies that monitor the effectiveness of the risk analysis criteria, relevant parameters and weightings, as well as other economic trends and their relevance in monitoring VAT compliance. Such studies would ideally also entail comparing tax revenue assessed following an investigation with the taxpayer's assigned risk score

Prioritising taxpayers according to risk posed to VAT revenue

- 2.11 The Department did not adhere to the risk rankings as compiled by the Risk Analysis Module. Although, as at end 2004, the Module identified 2,934 candidates, only 88 taxpayers from this list were selected for an investigation. Chart 2.1 refers. It is to be noted that a further 106 taxpayers listed as candidates were selected for an investigation between 2000 and 2003.
- 2.12 In 2004, the Risk Analysis Module was not being fully utilised by the Department since the system was being upgraded to cater for the new VAT registration format which came into effect following Malta's accession to the European Union. The project was delivered by MITTS in two phases in February and October 2005.
- 2.13 Chart 2.1 illustrates that the Department does not subject to a VAT investigation the taxpayers in the order specified by the Risk Analysis Module. This is particularly evident since:
- One hundred and sixty-nine (169) taxpayers out of the 257 subjected to an investigation were not identified by the Risk Analysis Module as posing any risk to VAT revenue (score below 100 points).

Chart 2.1 – Points accumulated by taxpayers as at end 2004



- ii. None of the eight top ranking taxpayers (accumulated score of over 400 points) were subjected to an investigation.
 - iii. Only six taxpayers out of the 82 who accumulated scores of between 300 and 399 were investigated.
- 2.14 This situation occurs since the Risk Analysis Module serves the purpose of a management tool by ranking potential defaulters to predetermined criteria. Consequently, the Department subjects the potential candidates for a VAT investigation to a 'sifting' process. The importance of this process is that it enables the Department to decide whether candidates pose sufficient risk to be subjected to an investigation.
- 2.15 In some instances taxpayers are not subjected to an investigation, even though they are listed as potential candidates by the Risk Analysis Module, since they would have already been subjected to an audit in the recent past. During the period 2000 – 2004, there were 194 out of 2,934 candidates who were investigated.
- 2.16 Another reason which resulted in taxpayers not being subjected to an investigation despite being listed as candidates is when the officials making the taxpayers' selection for VAT investigations become aware of particular circumstances which artificially inflate the taxpayer's risk ranking in the Risk Analysis Module.
- 2.17 The Department was not fully or systematically documenting the reasons leading to deviations from the list specified by the Risk Analysis Module. Such a situation occurred despite the fact that the Department's main computer system caters for a full audit trail which permits the recording of reasons why a taxpayer considered as posing a potential risk to VAT revenue was not selected to an investigation.
- 2.18 It is to be noted, that when informed by the NAO, the Department took immediate action to rectify this situation, and is now documenting the reasons for deviating from the risk rankings of the Risk Analysis Module.

Economic sectors targeted through the Risk Analysis Module

- 2.19 There was no relationship (proportionality) between the 30,010 taxpayers under review, those taxpayers who had accumulated 100 points or more and those actually selected for a VAT

investigation in a number of economic sectors. Chart 2.2 compares the total taxpayers, taxpayers selected as candidates for a VAT investigation and taxpayers actually investigated (as at end 2004). For comparative purposes, the number of taxpayers in each economic sector is expressed as a percentage of the total taxpayers in all economic sectors.

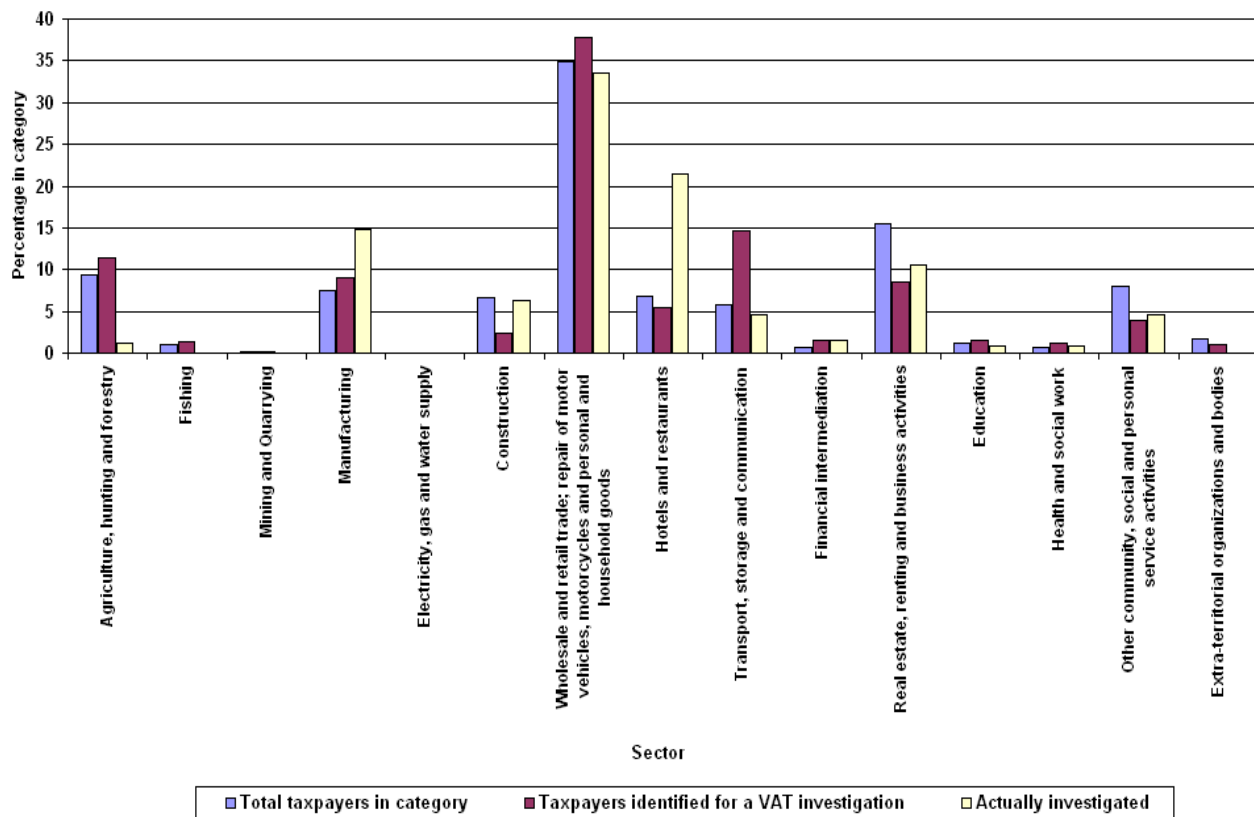
2.20 Chart 2.2 raises the following concerns about the identification of candidates and selection of taxpayers for an investigation through the Risk Analysis Module:

- i. The most significant difference between the list of candidates as generated by the Risk Analysis Module and the taxpayers who were actually subjected to an investigation pertained to the Hotels and Restaurants sector. In fact, over 21 per cent of investigations related to this sector when the list of candidates comprised only 5.5 per cent of taxpayers operating in this sector. The Department contends that this situation occurs due to the potential VAT revenue risks associated with this industry, as well as the relative high value added of this sector.
- ii. Taxpayers operating in high value added economic sectors such as Manufacturing, Real Estate, Renting and Business Activities, and Wholesale and Retail trade made up 58.75 per cent of all taxpayers selected for an investigation.
- iii. The economic sectors relating to agriculture, fishing and extraterritorial organisations may be over represented in the candidates list. Most of the business within these sectors are registered as 'exempt with credit', that is, that due to their economic activity they are exempt from charging VAT but are allowed to claim VAT incurred on purchases.

Targeting for VAT Investigations in accordance to Management's value judgement

- 2.21 There are various reasons which may prompt the Department's Management to exercise its judgment to subject a taxpayer for an investigation. Such a situation occurs since, as a management tool, the Department's Risk Analysis Module predominantly ranks candidates according to risk

Chart 2.2 – Comparison between total taxpayers, taxpayers selected as candidates for a VAT Investigation and tax payers actually investigated (as at end 2004)



based on accounting ratios and compliance with VAT legislation. Consequently, Management has to complement information provided through the Risk Analysis Module with other sources of information and observations available to the Department.

2.22 Other reasons for subjecting taxpayers to an investigation according to Management's value judgement include failed fiscal receipt inspections, complaints about the taxpayer from the public, through the Department's audit trail exercises or through the existence of reasonable doubt that the taxpayer is in default.

2.23 In addition to the 88 selected on the basis of the Risk Analysis Module, the Department's Management selected a further 169 taxpayers for an investigation during 2004. Policies quoting criteria as to when Management should exercise its value judgement to subject a taxpayer to an investigation are currently being developed.

Failed Fiscal Receipt Spot Check Inspections

2.24 The 169 taxpayers subjected to an investigation on the basis of Management's value judgement were also reviewed by the NAO in terms of the number of failed fiscal receipt inspections.¹⁷

2.25 During 2004, the VAT inspectorate unit carried out 13,508 Fiscal Receipt Spot Check Inspections from the 30,010 taxpayers being studied for the purpose of this exercise. These inspections were targeted at 4,838 different taxpayers. Four thousand and forty-three (4,043) inspections out of the 13,508 involving 2,746 taxpayers resulted in negative reports (a failed inspection).

2.26 In 760 instances involving failed inspections, the Department either sought to negotiate a 'compromise penalty'¹⁸ or referred the matter for court action. Another option available to the Department is to subject the defaulting taxpayer

¹⁷ The Inspectorate Unit of the VAT Department carries out inspections at business premises to primarily ensure that fiscal receipts are being issued to customers.

¹⁸ Defaulters have the option to pay a reduced penalty for failing to issue a fiscal receipt, instead of appearing before the Courts.

to a VAT investigation if the taxpayer repeatedly failed Fiscal Receipt Spot Check Inspections.

- 2.27 Once a report of a failed inspection has been logged in the VAT main database, the Risk Analysis Module automatically increases the risk assessment of the relative taxpayer. Therefore the points allocated in these cases serve to build the taxpayer's risk profile. Moreover, the Department has the obligation to collect the under-declared VAT detected from the non-issue of fiscal receipt spot check inspections. Consequently the Department is tackling failed inspections through a number of parallel approaches.
- 2.28 Table 2.1 shows the amount of failed inspections by individual taxpayers and whether such taxpayers were subjected to an investigation.
- 2.29 Table 2.1 shows the following:
- i. Although having failed a Fiscal Receipt Spot Check Inspection, 2,656 taxpayers were not subjected to an investigation. Ninety-three (93) of these 2,656 taxpayers failed between four and fifteen inspections during 2004.
 - ii. Out of the 169 taxpayers who were subjected to an investigation on the basis of Management's value judgement only 61 had failed a Fiscal Receipt Spot Check Inspection. Thirty-six (36) of these taxpayers had failed only one inspection.
- 2.30 Despite the actions taken by the Department regarding failed Fiscal Receipts Spot Check Inspections, Table 2.1 suggests that the Department should give more weight to the repetitiveness of failed Fiscal Receipt Spot Check Inspections when considering cases for investigations. The Department is currently in the process of upgrading its internal policies in this regard.

VAT Investigations yielding a nil assessment

- 2.31 Out of a total of 257 investigations¹⁹ which commenced during 2004, only 97 were concluded by March 2006. Twenty-two (22) of the 97 (23 per cent) concluded investigations yielded a nil assessment.

¹⁹ Refers to cases selected by the NAO for an investigation from the 30,010 active taxpayers (vide chapter 1 paragraph 13). It is to be noted that during 2004 the Department carried out a total of 304 investigations, of which 245 cases were concluded (source: Monthly Management Report VAT Department December 2005).

- 2.32 There are a number of factors that could have influenced nil assessments – including targeting practices. Other factors which could lead to nil assessments following an investigation are discussed in paragraph 3.20 of this report.

Investigations referred to the Tax Compliance Unit (TCU) and private auditors

- 2.33 Cases of investigations that in the opinion of the Department necessitate that such reviews are carried out by professional auditors are forwarded to the Tax Compliance Unit (TCU) or private auditors (through a contractual agreement with the Department). During 2004, the Department referred 70 cases to the TCU or private auditors.
- 2.34 It is the Sifting Section's task to determine, through the application of his experience and knowledge, which investigations should be referred to the mentioned parties. Generally, factors such as the potential risk posed to VAT revenue, whether the case in question relates to a sole taxpayer or a company and the materiality involved are taken into consideration, on a case by case basis.
- 2.35 Once identified by the sifting section, these cases are routed to the Auditing and Reviewing Section, for onward transmission to the TCU or private auditors. At this stage the head of section classifies the audits into two groups: those to be assigned to the TCU and those to be assigned to the private auditors. Classification is generally based on the value judgment of the Section's Assistant Director.
- 2.36 The opportunity exists for the Department to document guidelines which define the instances when a case is to be referred to the TCU, contracted out to private auditors or assigned to the in-house Inspectorate Unit.
- 2.37 Since the conclusion of this report, the Department has taken this matter in hand.

Credit Control Exercises

- 2.38 The VAT Department also reviews taxpayers' credit claims. Such exercises mainly focus on input tax declarations. Credit claims result when the taxpayer claims of a VAT refund with respect to purchases exceed the VAT collected by the taxpayer from customers on sales.
- 2.39 The approach to target taxpayers for a credit control exercise entails that a monthly list of

Table 2.1 – Failed Fiscal Receipt Spot Check Inspections and VAT Investigations

Frequency of failed inspections	Number of taxpayers	Sum of failed inspections	Subjected to an investigation on the basis of management's discretion	Subjected to an investigation through the risk analysis module	Not investigated
1	1,902	1,902	36	12	1,854
2	574	1,148	15	10	549
3	170	510	6	4	160
4	59	236	4	1	54
5	26	130	0	1	25
6	6	36	0	1	5
7	1	7	0	0	1
8	4	32	0	0	4
9	3	27	0	0	3
15	1	15	0	0	1
Total	2,746	4,043	61	29	2,656

Source: VAT Department.

taxpayers claiming VAT refunds is generated and forwarded to the Officer in Charge of Credit Control Exercises. This Officer selects from this list those taxpayers who are considered to pose the highest risk.

2.40 Up to end 2004, that is, the period which this performance audit was concerned with, the selection of taxpayers for a credit control exercise was mainly based on the materiality of credit. However, the selection practices are not documented. During 2005, the Department improved its selection practices for credit control exercises by increasingly basing its targeting on accounting ratios together with the materiality of credit claims.

2.41 For the purpose of this review the NAO focused on 249 out of the 458 taxpayers who were targeted for a credit control exercise during 2004. By end March 2006, the number of concluded cases amounted to 226.

2.42 Over half of the credit control exercises (117 out of the 226) undertaken during 2004 yielded a nil assessment. The Department maintains that such an incidence of nil assessments results since up to 2004 it was basing its selection criteria for credit control exercises on the materiality of credit claims. Moreover, the Department insists

that potentially correct claims were also being subjected to credit control exercises, if such claims were considered material.

Conclusion

2.43 A significant number of investigations and credit control exercises yielded nil assessments. The opportunity exists for the Department to target more consistently those taxpayers who posed the highest risk to VAT revenue.

2.44 Moreover, taxpayers' risk to tax revenue needs to be determined through studies conducted by specialists, which also take into consideration the knowledge and experience accrued by senior officials within the Department.

2.45 The Department's Management has to constantly utilise its value judgement in the process of targeting potential defaulters for VAT audits. For such a purpose, the Department uses a number of techniques to select cases for audits. Policies in this regard need to be more focused to take into consideration the staff resources available to perform VAT audits and the estimated level of VAT revenue at risk.

Chapter 3

Auditing Taxpayers' VAT Liability



Chapter 3 - Auditing Taxpayers' VAT Liability

Introduction

- 3.1 The auditing of taxpayers' VAT declarations is a critical function of the VAT Department. These audits are a mechanism which ensure the taxpayers' compliance with the provisions of VAT legislation with the ultimate aim of ascertaining that all revenue due to Government is duly identified and collected.
- 3.2 This part of the report discusses:
- i. The staffing constraints with respect to employees performing VAT audits (investigations and credit control exercises).
 - ii. The level of adherence by the VAT Department with Generally Accepted Auditing Standards when performing audits.
 - iii. The outcome of audits concluded by the Department during 2004.
 - iv. The cost efficiency of VAT audits undertaken.

Staff performing VAT audits

- 3.3 VAT audits, namely, investigations and credit control exercises, are performed by staff employed within the Department's Inspectorate Unit and, if necessary, reviewed by the Reviewing and Investigations Section. These Units employ 52²⁰ persons, 31 of whom may carry out VAT audits and reviews. The qualification requirements

20 Including 2 Assistant Directors.

specified by the Management and Personnel Office (MPO Circular 101/2005) are that applicants for the post of VAT Inspectors must possess four Ordinary Level Certificates (Maltese, English, Mathematics and Accounting), where preference would be given to applicants with an Advanced Level standard.

- 3.4 All staff attended induction courses related to their duties, particularly with regards to the interpretation to the VAT Act and the implications arising following Malta's membership to the European Union. During 2004, staff attended courses and seminars relating to specialised topics such as Fiscalis²¹ concerning the administration of VAT.
- 3.5 These employees also perform fiscal receipt spot check inspections and perform customer care desk duties on a roster basis. As a consequence of being assigned such a variety of tasks, staff are not always in a position to allocate preference to the VAT audit process as other tasks often demand priority.
- 3.6 In addition, performing a number of different tasks limits the opportunities for staff to specialise in the VAT audit process. It is felt that the lack of specialists performing audits increases the risks to VAT revenue. Nonetheless, the Department must adhere to current policies and parameters employed within the Public Service when recruiting personnel.

Undertaking VAT audits

- 3.7 The NAO sought to establish whether the procedures adopted by the Department to undertake VAT audits were conducive to ensuring the correctness of VAT Declarations.

21 The Fiscalis Programme is a multiannual Community programme, adopted by the European Union, to reinforce the functioning of the indirect taxation system of the internal market

Adherence to generally accepted auditing practices

- 3.8 The reliability of an audit is, *inter alia*, ensured when the process encompasses planning, internal control over the process and procedures involved, and the collating of reliable audit evidence to back conclusions reached.
- 3.9 The NAO reviewed the VAT audit process through a sample of 104 randomly selected cases out of 502²² completed audits in 2004. This revealed that in most cases the Department did not adhere to generally accepted auditing practices such as those stipulated by the International Standards of Auditing of the International Federation of Accountants (IFAC) relating to audit planning, the collation and documentation of audit evidence, supervision and reporting. On an individual basis, and although having received initial training as non qualified auditors, the staff employed by the Department are not obliged to follow International Auditing Standards. The audit approach was further hindered as staff were not guided through checklists and / or guidelines²³ as these were not in-built in the VAT audit process.
- 3.10 The Department is currently addressing the above situation, and has already provided staff performing VAT audits with hands on training from accountants employed at the Tax Compliance Unit. The Department recently also started introducing checklists to guide staff through the audit process.

Outcomes of VAT audits

- 3.11 The outcomes of VAT investigations and credit control exercises were reviewed in terms of their incremental increase in VAT revenue. Results and conclusions presented in this section of the report are on the basis of 198 randomly selected cases out of the 502 concluded audits²⁴ in 2004 (50 out of 152 VAT investigations and 148 out of 350 credit control exercises) and are to be considered as indicative of the outcomes of VAT audit work carried out by the Department.²⁵

22 The 502 audits relate to cases that during 2004 were concluded up to Appeals Board or Court of Appeals Stage.

23 A 'control visit' manual drawn up by the Department which makes some reference to the review of traders' books of accounts is available to staff.

24 For the purpose of this study, concluded audits refer to cases where taxpayers have accepted the assessment, (including a nil assessment); or in cases where taxpayer objected the assessment, an Appeals Board decision was reached.

25 The Department only maintains records of the outcomes of its audit work on a case by case basis in manual files.

VAT Investigations*Incremental increases of VAT Investigations*

- 3.12 Fifty (50) investigations out of 152 cases reviewed yielded incremental assessments of Lm60,144 or an increase of 51 per cent on the net VAT declared. An explanation on the issues influencing the outcome of VAT investigations is provided in paragraph 3.16.
- 3.13 Nineteen (19) cases out of the reviewed 50 yielded an assessed VAT refund of Lm2,428. Investigations on eighteen of these taxpayers did not yield any incremental assessment, while the other investigation resulted in a refund claim of Lm2,428.
- 3.14 Thirty-one (31) cases (out of these 50) generated an additional VAT of Lm62,572, an average of Lm2,018 per case.
- 3.15 It is to be noted that, on average, the period of review for the 50 investigations reviewed by the NAO was 2.8 years. Thus, on average, each year under investigation yielded an additional assessment of around Lm428.
- 3.16 The outcome of these investigations has to be viewed in the light that the majority of tax registered persons are considered as small businesses.²⁶ Moreover, the difficulties experienced by the Department when conducting investigations, namely a lack of taxpayer co-operation (mainly through the non-submission of business records), also impinge on the outcome of investigations.

The Objections' process

- 3.17 Taxpayers are entitled to challenge assessments raised through an investigation. As a first step, the taxpayer can request that the Department reviews the provisional assessment raised following an investigation. Furthermore, the taxpayer can also challenge the outcome of the reviewed assessment, by requesting that his case be reviewed by a Board of Appeal. The VAT Act stipulates a timeframe of 30 days within which the taxpayer can raise an objection. In addition, the same legislation stipulates that a Lm25 administration fee is due together with five per cent of the disputed tax or Lm50, whichever is the higher.

26 Sixty-eight (68) per cent of VAT registered persons have an annualized turnover levels of up to Lm25,000 (including nil and non-submission of declarations).

- 3.18 The review of these 50 cases showed that:
- Fourteen (14) taxpayers were not issued with any provisional assessment;
 - Thirty-six (36) were issued with provisional assessments;
 - In 23 out of these 36 cases, the taxpayer accepted the assessment raised;
 - In 13 cases, objections to the provisional assessments were raised. Following the review and Appeals Board stages, the assessments were reduced.
- 3.19 The Department's recent initiatives to enhance its auditing practices and methodologies (vide paragraph 3.10) should lead to improvements in the compilation of investigation evidence to support findings presented to the Board of Appeals.
- 3.20 Moreover, the Department maintains that its position is jeopardised in the Board of Appeals because taxpayers do not offer their full co-operation from the outset, generally by not submitting the requested documentation and consequently hindering the VAT investigation process. This situation prompts the Department to cancel the input VAT being claimed in the ensuing provisional assessment. Such assessments are later reversed when the relevant documentation is presented by the taxpayer. In order to deter the non-submission of business records, the Department is currently working on legislative amendments to the VAT Act, namely by proposing that taxpayers must present requested information within a defined timeframe.

Credit Control Exercises

Incremental increases of Credit Control Exercises

- 3.21 The NAO reviewed 148 randomly selected cases out of the 350 completed in 2004. Results presented in this Section of the report relate to the cases reviewed and are to be considered as indicative of the outcomes of credit control work undertaken by the Department. The 148 credit control exercises reviewed, with credit claims amounting to Lm2,597,408 resulted in Lm175,636 incremental assessments being raised. The review of these exercises revealed that:
- Seventy-two (72)²⁷ cases reviewed by the NAO did not yield any incremental assessment.
 - Fifty-four (54) cases yielded less than Lm1,000. The average assessment of these 54 credit control exercises amounted to around Lm239.
 - Eight (8) cases had an incremental assessment of over Lm5,000.
- 3.22 The 148 credit control exercises, on average, were concerned with reviewing a period of 2.54 years. Thus, on average, Lm466 additional VAT was assessed per case per year of investigation.
- 3.23 Generally the higher the net VAT declared, the lower the percentage increase in additional VAT assessed. Table 3.1 refers.
- 3.24 The highest average incremental assessed VAT emerged from 44 taxpayers declaring on average a VAT refund of Lm65,829. On average, in absolute terms, the additional assessed VAT was Lm2,614.

Table 3.1 – A comparison between net VAT declarations and additional VAT assessed through Credit Control Exercises

Net VAT declared Lm	No of traders	Average net VAT declared Lm	Average additional VAT assessed Lm	Percentage increase/ decrease in VAT
(10,000) and lower	44	(65,829)	2,614	4.0
(1,000) to (9,999)	43	(4,087)	806	19.7
(1) to (999)	29	(381)	259	67.9
1 to 9,999	27	2,943	647	21.9
10,000 and over	5	81,282	203	0.2

²⁷ Seven (7) nil assessments resulted following the 'objection.'

- 3.25 The highest increase in assessed VAT as a percentage to declared VAT was attained from 29 taxpayers, each declaring a VAT refund of between Lm1 and Lm999. However this category of taxpayers, on average, in absolute terms, rendered only Lm259 in incremental VAT.
- 3.26 In revenue terms, the incremental increase in VAT revenue resulting from the businesses declaring VAT of between a refund of Lm1 to Lm999 is, on average, significantly smaller than the yields arising following credit control exercises of businesses declaring a refund of more than Lm1,000 and those declaring a VAT liability between Lm1 and Lm9,999.

The Objections process

- 3.27 Taxpayers subjected to a credit control exercise are entitled to the same objection rights as those relating to VAT investigations (vide paragraph 3.17). From a total of 148 cases, 65 were not found to be liable to any additional VAT. Another 62 accepted the provisional assessments raised amounting to Lm143,641.
- 3.28 However, 21 traders with assessments totalling Lm123,064 raised an objection. From the review stage up to the appeals board stage, the assessments of these 21 traders were reduced to Lm31,994 – a decrease of Lm91,070. During the objections process the assessment of seven taxpayers out of the 21 was reduced to nil, increasing the number of nil assessments to a total of 72.
- 3.29 The foregoing suggests that generally taxpayers were accepting assessments arising from credit control exercises. However, where objections were registered, significant downward revisions took place. The Department maintains that the above situation mainly results due to the non-submission of business records²⁸ by taxpayers and ensuing departmental action as discussed in paragraph 3.20.

Payment of additional VAT revenue following audits

- 3.30 As at end October 2005, about 91 per cent of the assessed VAT was recouped. Payment in respect of the assessed VAT following investigations and credit control exercises remained outstanding in just 12 out of the 198 cases reviewed by the NAO. Table 3.2 refers.
- 3.31 Table 3.2 shows that, generally, the Department managed to collect outstanding payments emanating from its audit work.

Cost efficiency of VAT audits

- 3.32 The cost efficiency of audit work undertaken by the Department was evaluated in terms of the following:
- Additional VAT assessed per Lm1 spent by the Department; and
 - Additional VAT assessed per month of investigation.

Additional VAT assessed per Lm1 spent by the VAT Department

- 3.33 The NAO sought to assess the cost efficiency of audit work undertaken by comparing the Department's rate of return over a period of three years. Moreover, the rate of return of audit work carried out was also compared with the rate of return emanating from the total revenue collected by the Department. Table 3.3 refers.
- 3.34 Table 3.3 shows the following:
- Since 2003, the Department has registered a significant improvement in the rate of return of audit work undertaken. In fact, in 2005 the additional

Table 3.2 – Payment of additional VAT revenue following audits

Type of audit	Cases audited	Assessments raised	Cases fully settled	Amount paid	Outstanding cases	Outstanding payments
	Number	Number	Number	Lm	Number	Lm
Credit Control Exercise	148	76	68	165,647	8	11,457
Investigation	50	31	27	51,594	4	10,978
Total	198	107	95	217,241	12	22,435

²⁸ Particularly original invoices which the same traders later present at the review stage.

Table 3.3 – The rate of return of VAT audits

Year	Total VAT revenue collected by the Department	Additional VAT assessments raised following audit work ²⁹		
		Expenditure ³⁰	Additional assessments raised	VAT revenue collected for every Lm1 spent
	Lm	Lm	Lm	Lm
2003	123,931,292	473,865	1,105,988	2.3
2004	141,570,340	363,518	1,906,478	5.2
2005	168,195,933	294,667	2,201,788	7.5

VAT liability assessed amounted to Lm7.50 for every Lm1 (against the Lm5.2 for every Lm1 in 2004) the Department spent on performing audits. This indicates a 44 per cent improvement in the Department's efforts related to audit work over the previous year.

- ii. The contribution of audit work to the total VAT revenue collected amounted to additional assessments of Lm1.1 million (0.9 per cent) out of Lm123.9 million, Lm1.9 million (1.3 per cent) out of Lm141.6 million and Lm2.2 million (1.3 per cent) out of Lm168.2 million in years 2003, 2004 and 2005 respectively.

Duration of VAT Investigations and Credit Control Exercises

3.35 On average, it took over 14 months to conclude a VAT investigation, and over 13 months to finalise a credit control exercise.³¹ For the purpose of this exercise, the duration of audit work was considered to be the period between when an inspector was delegated the case until a final assessment was issued – this includes all stages of review and appeal.

3.36 Table 3.4 indicates that the highest average monthly incremental assessed VAT liability occurred when the duration of audit work was less than four months.

Table 3.4 – Duration of VAT Investigations and Credit Control Exercises

Duration of audit work (months)	VAT investigations			Credit control exercises		
	Number of cases	Average assessment per case (Lm)	Average assessment per month (Lm)	Number of cases	Average assessment per case (Lm)	Average assessment per month (Lm)
0 to 4	6	1,003	555.43	58	949	537.85
5 to 8	10	1,368	222.98	18	2,028	374.44
9 to 12	10	1,012	108.55	12	913	89.21
13 to 16	5	2,102	157.21	5	573	40.14
17 to 20	10	1,045	57.42	12	832	45.53
21 to 24	1	1,229	57.52	10	449	20.39
25 to 28	2	445	17.72	9	82	3.17
Over 28	6	1,208	29.42	24	2,294	62.17
Total	50	1,203	82.13	148	1,187	89.98

29 Based on final assessments issued. Source: Departmental Annual Report 2004 and 2005.

30 Expenditure quoted relates to costs incurred in carrying out investigations and credit control exercises.

31 Based on the randomly selected cases reviewed by the NAO, as discussed in paragraph 3.11.

3.37 In addition, Table 3.4 depicts a general trend whereby the longer the duration of audit work the lower the average assessment per month of audit work. These trends indicate that the Department has to find the appropriate balance between delving deeper into a case and therefore ensuring that all dues to the Department are identified or concluding a case on existing evidence where the payback would be relatively higher. The opportunity cost of the latter option, however, is foregoing that each and every taxpayer's VAT liability is fully determined.

Conclusion

3.38 During the years 2003 - 2005, the contribution of the Department's audit work towards the annual VAT revenue yield has consistently shown an increasing trend. In the light of a recent statement by the Central Bank of Malta that tax evasion is still widespread, it is questionable whether the

1.3 per cent contribution of the VAT audit process towards the 2005 VAT yield relates to the extent of the informal economy.

3.39 Efforts to complement the experience of the existent staff by drafting professionally qualified personnel and further hands on training need to be sustained. This would provide the department with the opportunity to be more methodical by applying recognised auditing standards in their work. In turn, this would ensure that the Department is in a stronger position to deal with VAT defaulters.

3.40 Recent efforts by the Department to improve its practices relating to audit work should, even in the short term, improve results regarding the outcome of VAT investigations and credit control exercises. These efforts, however, need to be complemented with the fine-tuning of the Department's methods of analysing taxpayers' potential risk to VAT revenue.