

# **Chapter 16**

**Revenue Canada**

Goods and Services Tax:  
Returns Processing and Audit



# Table of Contents

	<b>Page</b>
<b>Main Points</b>	16-5
<b>Introduction</b>	16-7
GST in general	16-7
Returns processing	16-7
Pre-payment audits	16-8
Post-payment audits	16-9
Focus of the audit	16-10
<b>Observations and Recommendations</b>	16-10
<b>GST Returns Processing</b>	16-10
GST processing centre has improved its efficiency	16-10
The use of performance measures and benchmarking for GST processing is limited	16-11
Reliability and timeliness of performance information are deficient	16-12
Better performance measures will help manage interest costs and improve service to registrants	16-13
GST returns processing is being decentralized	16-15
<b>GST Pre-Payment Audit Program</b>	16-16
Pre-payment audits are an essential part of Revenue Canada's GST enforcement activities	16-16
Revenue Canada can do more to improve the effectiveness of its automated validity checks	16-17
Delays in reviewing and auditing rejected refund claims add to interest costs and reduce service to registrants	16-19
There is a need for up-to-date procedures to review refund claims	16-20
<b>GST Post-Payment Audit Program</b>	16-21
Better data and tools would improve Revenue Canada's audit selection process	16-21
More attention needs to be given to audit planning	16-23
There are areas of strength in audit performance	16-23
Some aspects of audit performance require improvement	16-24
<b>Support for the GST Audit Programs</b>	16-28
Staffing and training needs	16-28
Information needs	16-28
Control over audit files	16-30
<b>Reporting on Performance</b>	16-30
<b>Conclusion</b>	16-30
<b>About the Audit</b>	16-32
<b>Exhibits</b>	
16.1 Processing and Pre-Payment Audit – Summerside Tax Centre	16-8
16.2 Pre-Payment and Post-Payment Audits – Tax Services Offices	16-9
16.3 GST Administration at Revenue Canada	16-10
16.4 Average Time to Process Documents – 1995-96 to 1998-99	16-11
16.5 Fraud Case Illustrating the Importance of Pre-Payment Audits	16-17
16.6 GST Credit Returns for 1997-98	16-18
16.7 Example of a Good Post-Payment Audit	16-24
16.8 Example of a Post-Payment Audit Requiring Improvement	16-25





---

## Revenue Canada

### Goods and Services Tax: Returns Processing and Audit

#### Main Points

**16.1** We found that Revenue Canada's Summerside Tax Centre, until recently its sole GST processing centre, has steadily become more efficient. It has streamlined several processes, enhanced its error correction procedures, reduced unit costs and improved the timeliness of its processing operations. As a prelude to decentralizing the processing of GST returns, Revenue Canada further simplified its processing procedures. The results of a pilot test point to further efficiency gains.

**16.2** At present, standards for returns processing tend to place insufficient emphasis on quality, accuracy, timeliness and unit cost, and the use of performance information is hampered by problems with the availability and reliability of data. Better performance measures would help to manage interest costs and improve service to registrants.

**16.3** Revenue Canada can do more to improve the performance of its set of automated validity checks. These checks are the cornerstone of its pre-payment audit program. However, they are not particularly discriminating in their initial targeting of inappropriate refund claims. Revenue Canada also needs to consider reviewing and auditing returns on which refunds are not requested at the same time as it conducts pre-payment audits of refund requests.

**16.4** Many of Revenue Canada's post-payment audits consume too many staff hours and go on for too long. Revenue Canada needs to help its auditors shorten their audit times by providing closer supervision and by encouraging better planning, execution and control of audit work. Audit performance may also be improved by better selection of registrants for audit.

#### Background and other observations

**16.5** The introduction of the Goods and Services Tax (GST) in 1991 had a huge impact on Revenue Canada's activities. The Department had to develop a completely new processing operation and techniques to verify the accuracy of the returns submitted by almost 2 million registrants, ranging from small entrepreneurs to multinational corporations.

**16.6** In 1993, Revenue Canada opened a new tax centre in Summerside, Prince Edward Island to process all GST returns and rebate forms from non-Quebec registrants. (The ministère du Revenu du Québec administers GST processing and audit of Quebec registrants.) The Summerside Tax Centre employs the equivalent of about 660 employees and has an annual operating budget of about \$28 million.

**16.7** Revenue Canada now processes about 5.5 million GST returns each year, as well as 200,000 domestic rebate forms and 3 million remittances from GST registrants.

**16.8** The Department has begun to decentralize a portion of its GST processing activities to tax centres across the country. The processing of rebate forms will continue to be done in Summerside.

**16.9** While, in general, GST returns processing is a tax centre activity, Revenue Canada's audit programs are performed by auditors in tax services offices across the country. There are two major audit programs. The first is the pre-payment audit program, which accounts for about 25 percent of auditor time. After the data have been processed but before refunds are issued, Revenue Canada applies a variety of automated validity checks to ensure that requests for refunds are appropriate. The checks are designed to capture the requests with the highest risks of non-compliance. The captured refund claims are sent electronically to tax services offices across Canada for review and, in some cases, for audit. In 1997-98, the GST pre-payment audit program resulted in assessments of about \$165 million.

**16.10** Revenue Canada also performs post-payment audits. These audits account for about 75 percent of auditor time and focus not only on particular returns but also on registrants with the highest risk of non-compliance. In 1997-98, this work resulted in assessments of about \$355 million.

**16.11** We examined the efficiency and effectiveness of the GST returns processing and audit functions. The efficient and effective use of resources is important because it has a direct impact on protecting the public purse and improving service to registrants.

**Revenue Canada's responses to our recommendations are included in this chapter. The Department is in agreement with the seven recommendations, and its responses describe a number of actions that have been completed or are in progress to deal with them.**

## Introduction

### GST in general

**16.12** The GST is a multi-stage sales tax levied on taxable goods and services. “Multi-stage” means that the GST applies on each exchange of taxable goods and services, from the initial producers/suppliers through intermediate producers/suppliers to consumers. To ensure that the value added at each stage of the supply chain is taxed only once, a mechanism exists by which suppliers can obtain a refund of GST paid on their purchases. (Suppliers of exempt goods and services are exceptions to the rule; they are effectively treated as consumers.) A claim for recovery of GST paid on a business input is known as an “input tax credit.”

**16.13** GST registrants must submit returns to Revenue Canada on a monthly, quarterly or annual basis, depending on their sales volumes. GST charged to customers and input tax credits claimed on purchases are both recorded on the return. If the total GST charged by a registrant exceeds the input tax credits claimed, the registrant is expected to remit the excess to Revenue Canada. This is known as a “debit return.” If input tax credits claimed exceed the GST charged, the registrant seeks a refund from Revenue Canada. This is known as a “credit return.”

**16.14** Depending on the nature of their operations and their circumstances, registrants may also be eligible for various rebates. For example, municipalities are eligible for a rebate designed to lower the effective rate of GST applied to them. Rebate entitlements may be included in GST returns and, if they are large enough to offset the net GST otherwise payable, they will produce a credit return. In other cases, rebate entitlements are claimed on a separate form.

**16.15** In May 1999, there were approximately 2,411,000 active GST

registrants. Revenue Canada administers the GST for the approximately 1,925,000 registrants outside Quebec. Under a 1991 agreement between the Government of Canada and the Government of Quebec, the ministère du Revenu du Québec administers the GST on behalf of Revenue Canada for approximately 486,000 registrants in Quebec. The ministère uses Revenue Canada’s guidelines and policies but produces its own audit strategies and administrative procedures. The GST administered by the ministère is recorded in Revenue Canada’s databases.

**16.16** The Harmonized Sales Tax (HST) collected in three of the Atlantic provinces is an integral part of the GST program. For simplicity, in this chapter the term GST also includes HST.

### Returns processing

**16.17** The processing of GST returns and rebate forms begins when incoming mail is opened and sorted by type of document (see Exhibit 16.1). At this point, the documents are identified and checked for completeness and special conditions, such as attached correspondence and payments. The returns and forms are placed in batches and sent for document preparation and data capture. Information from the returns and forms goes into the GST mainframe computer system. The documents with errors go to the error corrections section. There, to the extent possible, errors such as incomplete returns, incorrect registrant names and business numbers, incorrect reporting periods, and mathematical errors are corrected. At times, in order to obtain correct information, departmental officers contact the registrant.

**16.18** Until recently, Revenue Canada’s Summerside Tax Centre was responsible for processing all GST returns and rebate forms sent in by non-Quebec registrants. Revenue Canada has begun to decentralize a portion of its GST

**Revenue Canada administers the GST for the approximately 1,925,000 registrants outside Quebec.**

**Revenue Canada has begun to decentralize GST processing.**

**Automated validity checks select about 30 percent of the credit returns and rebate forms; about 97 percent of the items selected are subsequently waived.**

processing activities to tax centres across the country. Rebate forms will continue to be processed in Summerside.

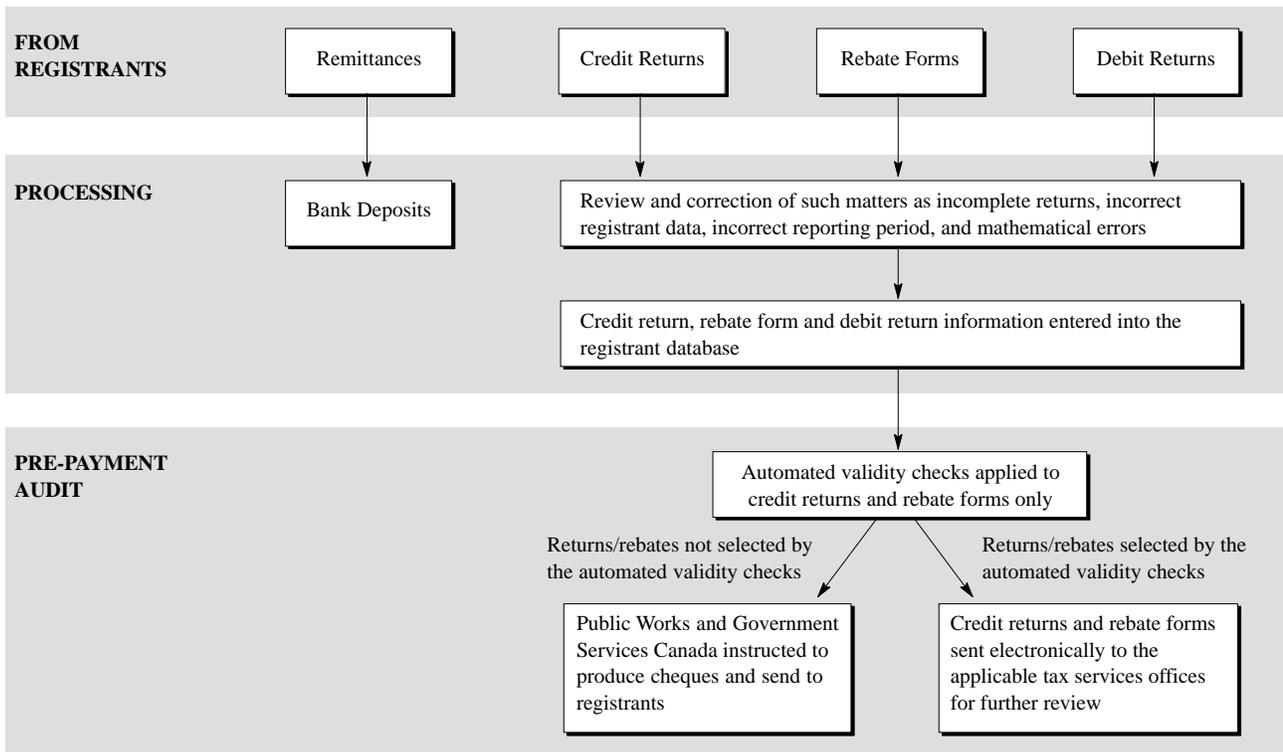
**Pre-payment audits**

**16.19** After data from GST credit returns and rebate forms have been captured in the mainframe computer system, a series of automated validity checks is applied to the data (see Exhibit 16.1). These checks are intended to detect credit returns and rebate forms that may not comply with legislation or that may warrant investigation for some other reason. In other words, automated validity checks are based on the Department's assessment of risk associated with credit returns and rebates, and reflect its policy of periodic scrutiny.

**16.20** Automated validity checks select about 30 percent of the credit returns and rebate forms. These items are automatically referred to tax services offices across Canada according to the registrant's location (see Exhibit 16.2). There, a departmental officer brings up on a computer screen information about the selected items. The officer examines each item, and considers such factors as industry type, prior filing history and prior audit results. The officer then decides whether to pay the amount claimed (called "waiving" the item) or to conduct a more in-depth examination. About 97 percent of the items are waived. Generally, for the approximately 3 percent of items requiring further examination, an officer contacts the registrant to ask for more information and/or documentation. If satisfied, the officer approves the item for

**Exhibit 16.1**

**Processing and Pre-Payment Audit – Summerside Tax Centre**



payment; if not satisfied, the officer adjusts or rejects the item.

**Post-payment audits**

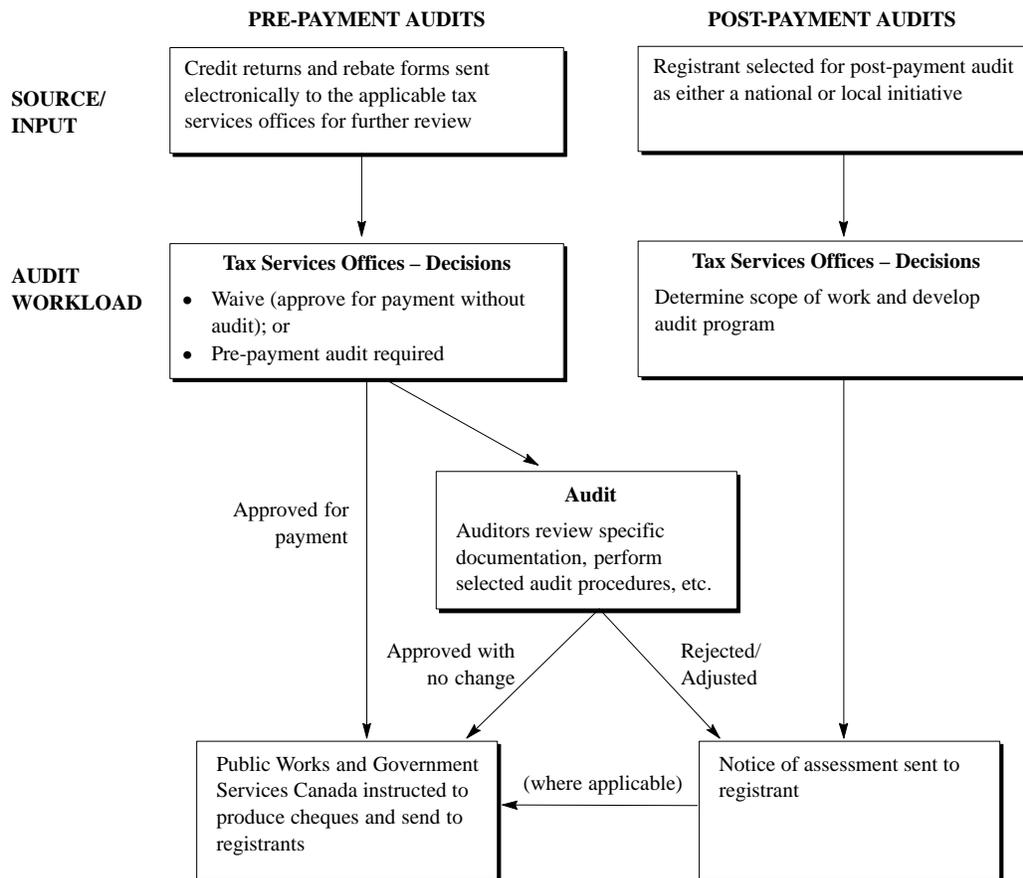
**16.21** Pre-payment audit activity is aimed at preventing inappropriate payment of refunds claimed on credit returns and rebate forms. This means that the activity is focussed on detecting overstated or ineligible input tax credits and rebates. However, Revenue Canada also wishes to find other kinds of non-compliance with the many requirements of the *Excise Tax Act*, and to

find problems with refunds that were paid in the past. This is the purpose underlying the post-payment audit program.

**16.22** Post-payment audits are handled by the tax services offices (see Exhibit 16.2). Relying heavily on their knowledge of the registrant population, external sources, leads from other areas of the Department — for example, pre-payment audit or income tax — and analysis of departmental databases, teams of post-payment auditors select registrants for examination. They normally select registrants who are expected to represent a high risk of non-compliance.

**Exhibit 16.2**

**Pre-Payment and Post-Payment Audits – Tax Services Offices**



**In 1997–98, the GST audit programs resulted in assessments of about \$520 million.**

**16.23** In 1997–98, the GST pre-payment and post-payment audit programs resulted in assessments of about \$520 million. The net revenue assessed was approximately \$624 per direct audit hour.

**Focus of the audit**

**16.24** Exhibit 16.3 illustrates a simplified GST administration framework patterned on Revenue Canada’s official activity structure. Our audit examined the efficiency and effectiveness of Revenue Canada’s GST returns processing and audit activities. Further details are found at the end of the chapter in the section **About the Audit**.

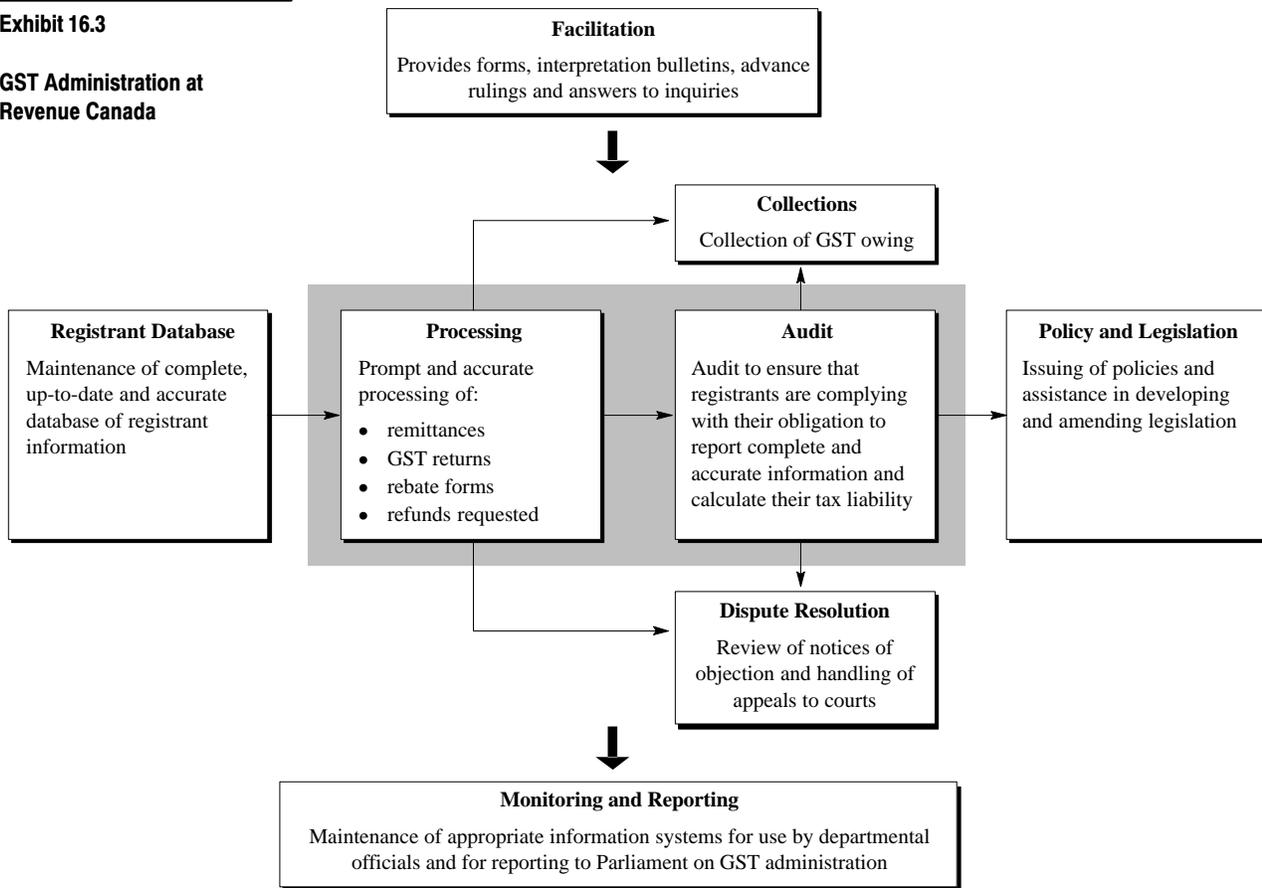
**Observations and Recommendations**

**GST Returns Processing**

**GST processing centre has improved its efficiency**

**16.25** The GST document processing facility, located in the Summerside Tax Centre, started operations in October 1993. In 1998–99, the Centre processed about 5.5 million GST returns, 200,000 domestic rebate forms, and 3 million remittances. It employs the equivalent of about 660 full-time employees, and costs about \$28 million a year to operate. This includes the

**Exhibit 16.3**  
**GST Administration at Revenue Canada**



■ Our audit dealt primarily with the shaded boxes. We did not audit the processing of remittances.

equivalent of about 65 full-time employees and \$1.4 million for income tax and excise tax processing.

**16.26** GST registrants have to file returns monthly, quarterly or annually, depending on their sales volumes. Returns are generally due toward the end of a month, resulting in 12 peak volumes a year, with higher peaks for the quarterly and annual periods. To accommodate this fluctuation, the Department must be flexible when allocating resources. We found that the rate at which documents are processed varies during the year but, as noted in Exhibit 16.4, about 90 percent of the documents get processed within 16 days and most of the remaining workload is processed in the next 45 days. The percentage of transactions processed within 16 days has generally increased.

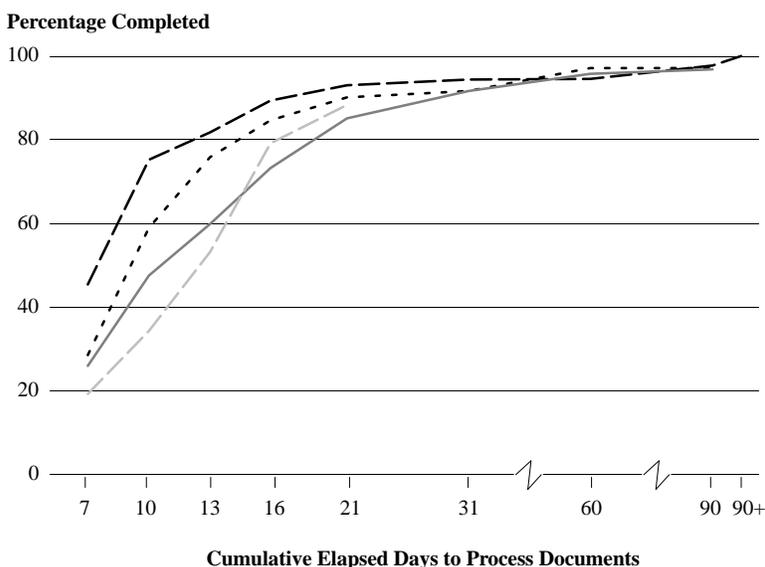
**16.27** Managers and employees in Summerside and at headquarters have worked together to streamline several workflows. Efficiency gains have been made in several areas: mail extraction processes have improved; redundant document preparation work has been eliminated; data capture methods have been improved; and error correction procedures have been enhanced.

**16.28** We calculated that the unit cost of processing a standard return that has no errors fell from about \$0.66 in 1995–96 to about \$0.37 in 1998–99. Similarly, for returns accompanied by a payment but containing errors, the unit cost of processing fell from approximately \$3.48 in 1995–96 to about \$1.91 in 1998–99. Taking 1998–99 document volumes and using the 1995–96 and 1998–99 unit costs, we calculated that efficiency gains between the two years amounted to about \$2 million.

**The use of performance measures and benchmarking for GST processing is limited**

**16.29** Good management of GST returns processing involves handling a given volume of documents according to specified standards for quality, accuracy, timeliness and unit cost. At present, Revenue Canada has a lot of historical information on volumes of production, but less data on quality, accuracy, timeliness and unit cost of processing. Although information on cost and production quantity exists in tax centres and at headquarters, management does not take full advantage of it to optimize the use of resources and further improve efficiency.

**Efficiency gains have been made in several areas.**



**Exhibit 16.4**  
**Average Time to Process Documents – 1995-96 to 1998-99**

— — — — 1998-99  
- - - - - 1997-98  
————— 1996-97  
- - - - - 1995-96

Source: Revenue Canada

**Management does not take full advantage of available information.**

**16.30** About 40 performance standards were recently established for processing operations at the Summerside Tax Centre. However, only volume output information is used. Very few efficiency measures have been developed and reported. Also, standards deal mostly with units completed per hour but do not specify the expected level of quality, such as percentage of errors and percentage completed in a specified time period. Another shortcoming of some standards is that they may be aggregated to a point where relevant information is lost. For example, the focus is on the number of documents in the work-in-progress file as opposed to, say, the age of the work-in-progress items at peak and non-peak times for given types of transactions.

**Since 1993, Revenue Canada has not undertaken benchmarking activities with other large processing centres.**

**16.31** Since 1993, Revenue Canada has not undertaken benchmarking activities with other large processing centres to assess the quality of its practices and technologies. The performance standards have not been compared with similar measures used in other government processing operations such as the ministère du Revenu du Québec, or in private industry. In the context of the new Canada Customs and Revenue Agency, benchmarking against similar organizations could indicate whether some service delivery options — such as contracting out — would further improve efficiency.

**16.32** Revenue Canada should update its GST returns processing standards to include quality, accuracy, timeliness and unit cost, and should measure performance accordingly. Where appropriate, standards should differentiate between peak and non-peak times and among various types of transactions. Standards should presume the use of efficient processing procedures and, where possible, performance should be benchmarked against similar organizations.

*Department's response: The Department fully agrees with the importance of standards for returns processing. In 1997–98 the Department began a project to significantly improve GST/HST returns processing and establish performance measures using the Balanced Scorecard approach. Existing processes were compared with best practices in other revenue lines within Revenue Canada and concepts were imported from elsewhere, in particular the manufacturing industry. These improved processes are captured in the revised GST/HST Accounting and Processing Procedures (GAPP) manual that describes how processing is now being performed. As noted in paragraph 16.54, these changes have already produced measurable improvements.*

*Key activities were identified as part of the development of the new GAPP, and as noted in paragraph 16.30, about 40 performance standards have been established. The next step will be to develop a Balanced Scorecard of standards, including quality, accuracy and timeliness. The first task will be to confirm the desired quality and accuracy characteristics through a survey of client needs, and benchmarking of performance levels attained by other revenue administrations and private industry. It should be noted that the move of GST/HST processing to multiple tax centres provides the benefit of closer internal benchmarking against other revenue lines and between centres.*

*The Department will carefully take this recommendation into consideration as it continues its development of a balanced set of performance standards for GST processing. Service standards and actual performance will be published regularly.*

**Reliability and timeliness of performance information are deficient**

**16.33** Having reliable and up-to-date data is crucial to managing a high-volume processing function like the Summerside

Tax Centre. Managers receive data by activity on labour-hour usage, production, and cost compared with budget. Information comes from various systems that operate on different cut-off periods. Information on labour hours and production quantity is captured simultaneously in ARMS (A Resource Management System). Salary and other operating expenses are initially captured in other systems and are then reflected in ARMS after a three- to five-week delay. ARMS information is most reliable at year-end when all data have come in.

**16.34** We found that there can be wide discrepancies in production information for a given year across systems, and over a number of years. For example, the ARMS production statistics for the months of August 1997, April 1998 and May 1999 showed no production even though the Summerside Tax Centre was operating during those months. Such discrepancies are due to inconsistencies in data input between systems at Summerside, and are not corrected because the data contained in ARMS are not reconciled with data contained in Summerside's local system. Management is aware of the discrepancies between the systems.

**16.35** To establish a unit cost, we relied primarily on data supplied by management at the Summerside Tax Centre, since these data come directly from automated systems that form part of Summerside's regular reporting systems. The data do not have the large time lags that the ARMS data have.

**16.36** Revenue Canada is completing the phased implementation of a Common Administrative System, which will eventually replace the Department's entire Resource Management Information System, of which ARMS is a component. It is still uncertain how many of the currently available financial reports the new system will be able to deliver immediately. The Department plans to temporarily maintain certain processing

and reporting components of ARMS to ensure that the majority of currently available and useful financial reports will continue to be accessible.

**Better performance measures will help manage interest costs and improve service to registrants**

**16.37** The prompt processing of GST returns is a service to registrants. It also reduces the government's interest costs. The *Excise Tax Act* requires that interest be paid to registrants on amounts owed beginning 21 days after the receipt of a credit return. Similar rules apply to rebate claims. According to departmental records, in 1997-98 the interest charges incurred by Revenue Canada for late payment of refund and rebate claims amounted to about \$13 million, about \$3.2 million of which related to transactions processed by the ministère du Revenu du Québec.

**16.38** Monitoring the performance of returns processing operations requires a variety of performance measures. One of these measures ought to be the amount of interest the Department has paid out each year on overdue refunds, compared with a target amount. However, the Department has not set a target for what it would consider a reasonable interest cost of administering GST.

**16.39** Not all of the interest cost is attributable to the Summerside Tax Centre. As well as the number of days it takes to process the documents at the Centre, interest costs are influenced by the number of days required for the tax services offices to review refund claims rejected by the automated validity checks (see paragraphs 16.70 to 16.73) and the number of days required for Public Works and Government Services Canada to issue the cheques. Nevertheless, any reduction in the time the Summerside Tax Centre takes to process its documents would contribute to reduced interest costs and improved service to registrants.

**There can be wide discrepancies in production information.**

**Improving the processing of documents can reduce costs and improve service to registrants.**

**16.40** The Department has carried out studies on how to achieve its turnaround standard for processing documents while maintaining workload at a consistent level, but it has not analyzed its processing activities specifically to find ways to reduce interest costs.

**16.41** Aside from generally improving the timeliness of processing, one way to reduce interest costs would be to give priority in processing and error correction to the large refund claims; these result in high interest costs if they are not processed speedily. This would be consistent with the current practice of giving high priority in the mail extraction procedures to cheques over \$25,000.

**16.42** Using data supplied by Revenue Canada, we found that in 1997–98, refunds were issued to registrants on about 2 million credit returns and rebate forms. The Department estimates that about 30 percent of these refunds included interest. The actual interest expense for the year was \$9.8 million, or about \$16.33 per cheque on which interest was paid. In the management of items awaiting data capture and in the processing of mail received from tax services offices, we calculate that, as a rough order of magnitude, there is scope to reduce interest costs by between \$800,000 and \$4 million per year.

**16.43** Improving the processing of documents can reduce not only interest but also other costs, and can improve service to registrants. For example, after a set date following the end of the filing period, the GST system automatically generates notices to registrants who have not filed their returns. Even if returns have been received, if they are not processed within this timeframe the system automatically generates the notices and incurs additional expenses for printing and mailing. This also results in increased salary costs for client service officers at the Summerside Tax Centre and at tax services offices (who must respond to

phone inquiries from registrants) and error correction staff at Summerside (who must deal with second copies of returns submitted by registrants).

**16.44** While reducing interest costs is a valid objective, it must be balanced against the potential monetary loss associated with the payment of improper refund claims if adequate time is not allowed for examination of the claims.

**16.45 Revenue Canada should monitor and control the amount of its portion of interest charges, and should work with Public Works and Government Services Canada to find ways to better manage interest costs and improve service to registrants.**

*Department's response: The Department agrees with the need to monitor and control interest costs. Interest costs are incurred when all stages of the process — returns processing, pre-payment audit and cheque production — take longer than the time provided for in the Excise Tax Act. Because interest costs are the result of processing delays and not their cause, the Department believes that processing time should be the primary performance indicator and thus the focus of attention for process improvements. Concentrating directly on the reduction of interest costs could unfairly skew the focus of processing; for example, the rapid handling of large-business returns would become more important than small-business returns. The Department will therefore control the level of interest costs by focussing on improved timeliness and quality for all business clients so that a fair allocation of the benefits is achieved.*

*The Department continues to seek process improvements that will reduce the initial processing time, and the time taken to produce the cheque. Improvements in these two areas will allow more adequate time for consideration of the validity of the claim. Taken together, these improvements will reduce the risk of improper payments and the total time*

*taken to process returns. The results of returns processing improvements to date are already evident, as reported in 16.54, and work will continue in this area. The Department also continues to work with Public Works and Government Services Canada (PWGSC) to reduce the time taken to process payments, and significant progress has already been recorded. For example, Revenue Canada now provides PWGSC with daily payment files, and cheques and direct deposits are produced within three business days. In the near future, PWGSC will offer electronic data interchange payments that will provide next-day deposit into the client's bank account.*

### **GST returns processing is being decentralized**

**16.46** In October 1996, the Department announced its decision to “realign” its processing of income tax and GST returns. Under this initiative, the Ottawa Tax Centre will become a national call centre and payment-scanning facility. The personal and corporate income tax returns processed by the Centre are being distributed among the remaining tax centres. Also under the initiative, GST processing is being decentralized: some document handling functions now performed solely by the Summerside Tax Centre will be done at other designated tax centres. Summerside will keep some GST processing and will begin processing income tax returns.

**16.47** We did not audit the entire realignment process. However, we understand that Revenue Canada decided to reduce the number of tax centres that were processing income tax returns because the introduction of electronic filing of personal income tax returns and other initiatives had left an excess of processing capacity.

**16.48** Revenue Canada officials informed us that the rationale for partially decentralizing GST processing when it

realigned income tax processing was management's aim to provide in future a single tax form combining all types of instalments and a GST return, and a single statement of account for all taxes.

Decentralization would also allow each taxpayer to deal with only one tax centre. The Department also wished to ensure that each tax centre, except for Ottawa, would maintain employment at approximately the current level.

**16.49** The Department has told us that it did not perform a cost-benefit analysis of the available alternatives for decentralizing GST returns processing. It wished to put in place a fairly uniform organizational structure among tax centres. This would facilitate the management of all tax streams.

**16.50** We expect that there will be some negative consequences of decentralizing GST returns processing. These consequences include initial start-up costs such as purchasing additional equipment and training staff. Also, the processing of GST rebate forms is to remain at Summerside. This means that registrants who file regular GST returns and rebate forms will have each document processed at a different location. This could cause difficulties in matching documents, increased costs to the registrants and, if there are delays, increased interest costs on overdue refunds and rebates.

**16.51** Decentralizing GST processing means that functions will be performed at several sites across the country, with lower volumes than at Summerside. Moreover, should electronic filing of GST be introduced, the volume of work would decrease further. This raises the possibility that unit costs of processing may increase. Departmental officials informed us that, to deal with the possibility, they conducted a thorough review of Summerside's procedures for processing GST returns and developed a plan to simplify the activity in a way that could be transplanted to other tax centres. This meant, for example, finding substitutes for certain

**The Department did not perform a cost-benefit analysis of the available alternatives for decentralizing GST returns processing.**

local area network-based computer applications that at present can be run only at Summerside.

**16.52** A key aspect of simplifying the process was to pave the way for “lean production” techniques that can achieve low unit cost in an environment characterized by small volumes of a variety of transactions. This will require each tax centre to develop innovative processing techniques to deal with unique situations it may face and, where appropriate, to share such “best practices” with other tax centres.

**16.53** In November 1998, the Department established a GST pilot project at Surrey Tax Centre. This project was not intended to determine whether or not decentralization ought to be undertaken. The project was intended solely to iron out the practical difficulties of transplanting processing operations.

**16.54** To determine the likely impact of decentralization on processing costs, we compared the unit cost of two activities — data capture and error correction — in the Summerside Tax Centre for the period April 1998 to October 1998 (before the pilot project commenced) with the unit costs at both Summerside and Surrey during the pilot for the period April 1999 to June 1999. Our comparison indicates that hourly production rates were higher in both tax centres during the pilot than Summerside had achieved previously. This improved performance may be due to Revenue Canada’s efforts to simplify processing.

### **GST Pre-Payment Audit Program**

**16.55** In general, GST returns processing is a tax centre activity. It consists of performing relatively routine procedures on documents submitted by registrants. Registrants are rarely contacted, and data are not usually verified in detail. By contrast, Revenue Canada’s GST audit programs are performed by auditors in tax services

offices across the country. The work involves verifying the data submitted by registrants. This typically means obtaining additional information, often by visiting the registrant.

**16.56** The pre-payment audit program has been in existence since the GST began. It is intended to prevent the inappropriate payment of refunds claimed on credit returns or rebate forms. Refund claims are subjected to a series of automated validity checks. A claim that fails one or more checks is referred automatically to the appropriate tax services office. There, a departmental official reviews the claim and decides either to waive it (in which case the claim will be paid) or to have it subjected to an in-depth review and possibly a pre-payment audit.

### **Pre-payment audits are an essential part of Revenue Canada’s GST enforcement activities**

**16.57** The pre-payment audit program can detect, on a timely basis, non-compliance by registrants resulting from, for example, bookkeeping errors, duplicate refund requests, a misunderstanding of one of the numerous requirements of the *Excise Tax Act*, or fraud. While post-payment audits can detect the same types of non-compliance, registrants may receive refund payments for several years before being selected for such an audit and only a small percentage of registrants undergo post-payment audits. Furthermore, a post-payment audit may occur too late to recover inappropriate refunds. This would be the case if, for example, the registrant had made fraudulent refund claims and had ceased to be in business before a post-payment audit was conducted (see Exhibit 16.5), or if the registrant were to experience financial difficulties during the post-payment audit.

**16.58** During our visits to tax services offices, officials told us that pre-payment audits are a significant source of leads for

**The pre-payment audit program can detect, on a timely basis, non-compliance by registrants.**

future GST and income tax audits. Our sample of post-payment audits (see paragraph 16.77) indicated that the largest identifiable source of these audits was the pre-payment audit program.

**16.59** As an indication of how effective pre-payment audits are at detecting non-compliance, consider these results. In 1997–98, pre-payment audits prevented inappropriate payments at the rate of \$1,518 per direct audit hour. These included large refund claims that had been requested by some well-known and established businesses, and that were found to be inappropriate and payment prevented after only a few hours of work. The \$1,518 per hour represents a net cash saving: since the pre-payment audits prevent payments from being made, there is no potential for bad debts.

**16.60** We are pleased to note that Revenue Canada is increasing its pre-payment audit activities. Resources allocated to the program in 1999–2000 have increased by 9 percent over 1997–98. In addition, the Department has initiated an enhanced compliance initiative, the main focus of which is to identify and address potentially abusive refund claims.

**Revenue Canada can do more to improve the effectiveness of its automated validity checks**

**16.61** As indicated in Exhibits 16.1 and 16.2, two steps are taken to select refund claims with the highest risk of error. First, automated validity checks are applied to the credit returns and rebate forms being processed by the Summerside Tax Centre. Second, tax services offices review the items rejected by the checks to determine which should be waived and which should be audited.

**16.62** A high percentage of credit returns and rebate forms continue to be rejected by the automated validity checks. Approximately 30 percent of the credit returns are rejected by the automated validity checks (see Exhibit 16.6). This indicates that the checks are not particularly discriminating in their initial targeting of inappropriate refund claims. If the checks were refined to better target the high-risk credit returns and rebate forms, and if the tax services offices could better determine which rejected returns were most likely to be in error, the offices could likely reduce the time spent reviewing the rejected returns. The saved time could be used to audit

**The automated validity checks are not particularly discriminating in their initial targeting of inappropriate refund claims.**

The following case is based on a real case of GST fraud currently being pursued by Revenue Canada. It illustrates the type of GST fraud that Revenue Canada uncovers, and the importance of a well-performing pre-payment audit program.

Several individuals set up corporations and registered them for GST. The corporations then filed credit returns — the input tax credits claimed exceeded the reported GST revenue. Some of the credit returns were rejected by Revenue Canada's automated validity checks, reviewed by auditors and approved for payment. In total, over \$20 million in GST refunds was paid to the corporations.

The filing of credit returns was not unusual given the stated nature of the corporations' business. However, in reality there were no purchases or sales, and the refund claims were fraudulent.

The fraud came to light when one of the corporations was selected for a post-payment audit. Because of the way the individuals structured the corporations' affairs, Revenue Canada has not yet identified any assets that can be used to recover the amounts paid out. Its investigations are continuing.

We believe that one of the best ways for Revenue Canada to deal with schemes such as this is to prevent the refund cheques from being issued in the first place. This is the primary purpose of the pre-payment audit program.

**Exhibit 16.5**

**Fraud Case Illustrating the Importance of Pre-Payment Audits**

**There may be more efficient and effective checks that Revenue Canada could use.**

additional returns or to perform more detailed audit work on the ones rejected.

**16.63** In 1994 we noted that little analysis had been done on the usefulness of each automated validity check. Since then, Revenue Canada has made some refinements to the checks. Some were made in response to legislative changes, such as the introduction of the HST. Others were made to correct errors in the computer logic or to improve the cost effectiveness of specific checks. However, there has still been little analysis of the relative cost effectiveness of each check for the purpose of reducing the number of refund claims being rejected by the system. The percentage of rejected returns is approximately the same as in 1992–93.

**16.64** The automated validity checks used most often are those that determine whether the amount claimed by a registrant on a return (or the cumulative amount claimed on a series of returns) exceeds a pre-determined threshold amount. Increasing these thresholds for the registrants with the lowest risk of non-compliance might significantly reduce the number of refund claims being

rejected by the checks. Other ways to make the current checks more effective include:

- analyzing the amount of revenue assessed from each check to determine which checks are the most effective in detecting amounts that should not be refunded; and
- introducing a point-scoring system to give a weighting to each check. This system could be used both to reduce the number of rejected items — they would need to exceed a certain point score to be rejected — and to better indicate which rejected refund claims should be audited.

**16.65 Other automated validity checks may be more efficient and effective.** While the current checks reject many credit returns and rebate forms, it is possible that they are not detecting some high-risk refund claims. There may be more efficient and effective checks that Revenue Canada could use. To help identify these, Revenue Canada could consider:

- analyzing the results of post-payment audits to identify refund claims that

**Exhibit 16.6**

**GST Credit Returns for 1997–98**

		Number	Percentage	Amount (\$ millions)	Percentage
Credit returns	(A)	1,851,000	100.0	18,379	100.0
<b>Less:</b> automatically approved at the Summerside Tax Centre	(B)	<u>1,325,000</u>	<u>71.6</u>	<u>7,619</u>	<u>41.5</u>
Rejected by automated validity checks	(C)	526,000	28.4	10,760	58.5
<b>Less:</b> Waived for payment	(D)	<u>509,000</u>	<u>27.5</u>	<u>9,854</u>	<u>53.6</u>
Audited	(E)	17,000	.9	906	4.9
Dollars assessed from audit	(F)			157	
Percentage waived of those rejected	[(D) ÷ (C)]		96.9		91.6
Percentage audited of those rejected	[(E) ÷ (C)]		3.1		8.4
Percentage assessed amount of audited amount	[(F) ÷ (E)]				17.3

Source: Revenue Canada

passed the checks but were subsequently found to have errors;

- developing checks based on registrant profiles; and
- selecting credit returns and rebate forms at random for audit, thus helping to determine levels of compliance and possibly identifying new checks that should be added to the system.

**16.66 Debit returns are not part of the pre-payment audit program.** Returns where the GST charged to customers by the registrant exceeds the input tax credits claimed by the registrant are referred to as “debit returns.” While these returns do not result in refunds to registrants, they may contain as much (or more) understated GST revenue or overstated input tax credits as credit returns. Currently, such errors are not identified until a post-payment audit is conducted. However, only a small percentage of registrants undergo post-payment audits, and these may be performed several years after an erroneous return has been filed.

**16.67** One way that Revenue Canada could identify incorrect debit returns at an earlier date would be to develop automated validity checks for these returns. Her Majesty’s Customs and Excise in the United Kingdom is currently using a limited number of such checks to select debit returns for review and audit, and is planning to extend the use of these checks in the future.

**16.68** Another way for Revenue Canada to identify incorrect debit returns at an earlier date would be to expand its Computer Assisted Audit Selection (CAAS) system (see paragraphs 16.82 to 16.86) to select debit returns for review and audit at the same time as it conducts pre-payment audits of credit returns. Revenue Canada officials have informed us that the ministère du Revenu du Québec already has such a program in place.

**16.69 Revenue Canada should enhance its ongoing program to review and revise the automated validity checks. It should also consider reviewing and auditing debit returns at the same time as it conducts pre-payment audits of credit returns.**

*Department’s response: The Department agrees with the recommendation to enhance its ongoing program to review and revise the automated validity checks. As part of this process, the Department will carefully examine the Auditor General’s suggestions in paragraphs 16.64 and 16.65. Additionally, the Department intends to modify the automated validity checks to include the appropriate risk issues identified in the Computer Assisted Audit Selection (CAAS) system. Furthermore, recognizing that one of the key ways in which to prevent fraudulent refund claims is to ensure that at the time of registration only legitimate businesses are registered for GST, departmental staff are working on a number of initiatives in this area.*

*With respect to debit returns, it should be noted that the Department already assesses all debit returns for risk using CAAS and the Department advocates the continuation of its work to further improve the CAAS system for debit returns. This notwithstanding, the Department will examine ways to conduct earlier reviews and audits of registrants identified as high risk. Senior departmental officials will be meeting with officials from other jurisdictions to share audit strategies and approaches for both credit and debit returns.*

**Delays in reviewing and auditing rejected refund claims add to interest costs and reduce service to registrants**

**16.70** Reducing the time required to review and audit rejected credit returns and rebate forms would reduce the amount of interest incurred on refund claims paid after 21 days. It would also improve service to GST registrants.

**Currently, errors in debit returns are not identified until a post-payment audit is conducted.**

**Tax services offices are having trouble keeping up with the workload generated by the automated validity checks.**

**16.71** We noted that tax services offices are having trouble keeping up with the workload generated by the automated validity checks — both at the initial review stage and later, when the work is assigned to auditors. In 1997–98, according to Revenue Canada officials, 72 percent of the pre-payment audits took longer than 30 days to complete and accounted for 13 percent of the amounts paid to registrants. In a sample of 27 pre-payment audits that we selected from among the five tax services offices that we visited, we noted delays in completing 17 of them. Nine took more than 180 days to complete. We determined that the audit delays were caused primarily by the registrant in 7 of the 17 cases and in 10 cases by Revenue Canada.

**16.72** Delays caused by the registrant consisted primarily of the time it took the registrant to provide requested information. Delays caused by Revenue Canada consisted primarily of the interval between rejection of the refund claim by an automated validity check and commencement of the auditor’s work. Tax services officials informed us that these delays were due mainly to the workload created by the large volume of refund claims.

**16.73** If a pre-payment audit were to ultimately prevent a refund cheque from being issued, the fact that it had taken many months to complete would not add to Revenue Canada’s interest costs. However, of the 17 delayed audits in our sample, 15 ultimately resulted in a cheque being issued to the registrant. In total, the registrants’ claims were reduced by 38 percent. While this is more than the 17 percent reduction for all 1997–98 credit returns (see Exhibit 16.6), it means that the registrants received interest for the period of the delay on 62 percent of the amount claimed.

**There is a need for up-to-date procedures to review refund claims**

**16.74** We noted that the Department’s national procedures for reviewing credit returns and rebate forms are not up-to-date. As a result, they are not always being followed. Some tax services offices that we visited have published their own procedures, while other offices have left the matter up to each individual. There is a risk that some reviewers are performing too little work, thus failing to identify inappropriate refund claims, while others are performing too much work — an inefficient use of audit time.

**16.75** Staffing matters are compounding this risk. Officials at three of the five tax services offices that we visited informed us that the units responsible for reviewing the refund claims were experiencing high staff turnover. At two offices, we were informed that there was a move toward using lower-level staff to review the claims. If this were to occur, decisions could be made by staff who lack sufficient knowledge of the office’s registrant population to be able to identify the highest-risk credit returns and rebate forms. Again, the reviewer might perform either too little or too much work on a particular item.

**16.76 Revenue Canada should intensify its review of the procedures used in the tax services offices to review and audit refund claims. This would include reviewing how the offices control their workload, and the number, levels and experience of audit staff performing the various functions.**

*Department’s response: The Department is in agreement with this recommendation and has already completed some work in this regard, and has initiated further study and review activities as suggested by the Auditor General.*

- We have reviewed the procedures used in the tax services offices (TSOs) to

*review and audit refund claims and obtained from them lists of best practices. This information is being included in the updated guidelines that are being developed within the Verification, Enforcement and Compliance Research (VECR) Operational Manuals project. These guidelines will include updated procedures as well as review and audit techniques to process and select credit returns for examination, and updated procedures for setting individual and cumulative thresholds. Increased monitoring will be performed to ensure that thresholds are appropriately set.*

- *As a result of a focus group meeting held in May 1999 to examine ways to improve overall program delivery for all Small and Medium Enterprise programs, guidelines will be issued shortly to all TSOs recommending that the initial review and evaluation of credit returns be consolidated within the Verification and Enforcement area of the TSO responsible for workload selection. This will provide for greater consistency in the way “tax at risk” is identified and further ensure that experienced staff address the review of credit returns. Many TSOs have already moved to this type of approach.*

- *The VECR Branch recently concluded a study relating to team size and will be recommending that TSOs move to smaller teams, which will provide for closer monitoring of the workload by the first line supervisor.*

## **GST Post-Payment Audit Program**

**16.77** The post-payment audit program is a tax services office function. Teams of post-payment auditors select registrants for examination. They generally select the registrants they believe represent the highest risk of non-compliance. The file is then assigned to an auditor who plans the audit, performs the work and, if appropriate, issues an assessment. In this section, we examine each of the three main steps — audit selection, audit

planning and audit performance. Some of our findings are based on a sample of 141 post-payment audits that we selected from among five tax services offices.

### **Better data and tools would improve Revenue Canada’s audit selection process**

**16.78** As a first step in assessing the risk of non-compliance, Revenue Canada groups its registrants into two general categories, based on their annual revenue. “Large files” — those representing the highest revenue — are supposed to have all tax years audited in full. (However, owing to staff shortages, not all tax years are being audited in full in the tax services offices that we visited.) “Small and medium enterprises” — those with lower revenues — are selected for audit using a risk-based approach, taking into account such factors as the results of any previous audits, the industry sector, and how closely the GST they have reported matches industry norms. Small and medium enterprises can be selected for audit through numerous means, including:

- external leads from third parties;
- internal leads or referrals from other units in the tax services office or elsewhere in Revenue Canada;
- Revenue Canada’s Computer Assisted Audit Selection system; and
- judgment based on sources such as industry directories and business listings in the yellow pages of telephone directories.

**16.79** Not all of these selection methods are equally effective at finding non-compliance. Some may work better in some industry sectors or geographic regions than others.

**16.80** **Revenue Canada cannot tell the extent to which the various audit selection methods are being used.** To help determine the most effective selection methods to use for a particular sector or in a particular region, Revenue

**The Department does not have detailed information on how registrants have been selected for post-payment audit.**

Canada needs to know how well various methods have worked in the past. However, the Department does not have detailed information on how registrants have been selected for post-payment audit. The audit selection codes currently captured in the GST mainframe and in the Audit Laptop System are not recorded consistently and are sometimes not specific enough to identify the method of selection. Furthermore, during the period covered by our audit, not all offices were using the selection codes set up in the Department's Audit Information Management System (AIMS) to complement the Audit Laptop System. We understand that the tax services offices have since begun using the audit selection codes in AIMS.

**16.81** One tax services office that we visited had routinely used narrative to complement the audit selection codes, so we were generally able to determine the selection method. In the other four offices, we were unable to determine the selection method for over 40 percent of our sample items.

**16.82 The effectiveness of one of Revenue Canada's audit selection methods is hampered by some data deficiencies and a need for ongoing training.** When Revenue Canada's Computer Assisted Audit Selection (CAAS) system is combined with the Audit Report Generator On-line (ARGO), the system allows auditors to focus on specific industry sectors, geographic locations and audit issues. The system contains GST and income tax data, some provincial sales tax data, and data on importers. Auditors can use this information to identify registrants who do not fit the usual profile of the industry, or whose GST and income tax data appear to be inconsistent.

**16.83** While we consider CAAS/ARGO to have potential for selecting registrants with a high risk of non-compliance, Revenue Canada auditors had used it to

select only 7 percent of the post-payment audits in our sample. Revenue Canada officials at headquarters and some auditors tasked with using the tool cited certain deficiencies in it. For example, information on gross revenues and other pertinent business data for each registrant are not up-to-date. Also, there are no data on export sales. (As these sales are not taxed, they can significantly distort ratios used to highlight potential non-compliance.) Revenue Canada officials identified these and other deficiencies as early as 1996 but, despite their efforts, have not yet been able to resolve them. At present, they are considering adding the reporting of export sales to the GST returns.

**16.84** The effectiveness of CAAS/ARGO is also hampered by missing or incorrect standard industry classification codes used to group registrants by industry sector. The use of CAAS/ARGO to select registrants in a particular industry sector would not capture registrants with missing or incorrect codes. Despite recent improvements, in May 1999 over 10 percent of the registrants in Revenue Canada's database still did not have standard industry classification codes. In our post-payment audit sample, 9 percent did not have codes and, in our view, more than 10 percent of the other registrants had codes that were incorrect.

**16.85** Further, based on interviews conducted in the five tax services offices that we visited, it appears that the effectiveness of CAAS/ARGO is hampered by the lack of training received by some employees tasked with using the system. Revenue Canada officials informed us that high staff turnover may be contributing to this.

**16.86 Revenue Canada should continue to improve its Computer Assisted Audit Selection and Audit Report Generator On-line systems. This would include dealing with the identified deficiencies, ensuring that all**

**There are deficiencies in Revenue Canada's Computer Assisted Audit Selection system.**

**necessary data (such as standard industry classification codes) are available, and providing additional training to staff who are expected to use the system.**

*Department's response: Although Revenue Canada's Computer Assisted Audit Selection and Audit Report Generator On-line systems for GST are relatively new, we have been seeking and will continue to seek ways to improve them. This ongoing process includes incorporating new data from various sources and increasing the completeness and accuracy of currently available data.*

*We recognize the importance of data on export sales and will continue our efforts to obtain such data. We also recognize the importance of standard industry classification codes and are working with officials from Statistics Canada to address this.*

*Although we have been providing ongoing training on the use of these systems, we recognize the need for continuous training and will increase our efforts in this area.*

**16.87 Random audits are needed.** One way to identify the sectors with the highest rates of non-compliance would be to periodically select a random sample of registrants in which all sectors have an equal chance of being represented. This sample could also be used to measure changes in levels of non-compliance over time. After many delays, Revenue Canada has a project under way to select a random sample from one industry sector. Samples were sent to the tax services offices in February 1999, and the first audit results are due in December 1999.

#### **More attention needs to be given to audit planning**

**16.88** Once a registrant has been selected for audit, the file is assigned to an auditor. The auditor is then responsible for developing an audit plan, performing the

work and, if appropriate, issuing an assessment.

**16.89** While good selection techniques will help to ensure the selection of registrants with the highest risk of non-compliance, they must be followed by good planning to ensure the efficient and effective use of audit resources.

**16.90 Documentation of planning is limited.** To assist in the planning process, Revenue Canada's Audit Laptop System contains suggested planning procedures. The procedures are not designed to deal with many industry sectors or complex issues. Given these limitations, Revenue Canada requires its large file auditors to augment the planning procedures in the Audit Laptop System with written audit plans. However, of the eight large file audits that we believe needed an audit plan, only four had a written plan.

**16.91** Revenue Canada officials have informed us that the Department also requires its auditors of small and medium enterprises to augment the planning procedures in the Audit Laptop System with written audit plans. However, most of the audit files in our sample did not contain these plans.

**16.92** Revenue Canada's Quality Assurance Division also concluded that more documentation of planning would be beneficial. It also noted that better training — both through courses and on the job — would help to improve the planning process.

#### **There are areas of strength in audit performance**

**16.93** Once the audit has been planned, the auditor performs the work. This includes completing the work described in the plan and reaching appropriate decisions as to which issues should be pursued and which should be dropped. It also includes documenting, either in the Audit Laptop System or in hard copy working papers, the work performed and the key decisions made. Exhibit 16.7

**Most files in our sample did not contain audit plans.**

**Thirty-two percent of the audits had been under way for more than 180 days; these accounted for 70 percent of the cumulative GST audit hours.**

contains an example of what we consider to be a good post-payment audit.

**16.94** We noted areas where *all* tax services offices were performing well. For example, on most audits:

- there was evidence in the working paper files (Audit Laptop System or hard copy) that auditors had taken into account previous experience with the registrant when determining which issues to audit;
- there was no evidence in the files that issues raised were not adequately addressed; and
- the files contained support for the amounts being assessed.

**16.95** We also noted areas where *some* tax services offices were performing well. For example, two offices had expanded their audits of registrants to incorporate audits of related parties, in the majority of the cases where this work appeared to be appropriate. Auditing related parties concurrently can determine whether transactions between the parties were handled correctly for GST purposes.

**16.96** We also noted that some tax services offices have enhanced the standard audit support tools. For example:

- one office has developed a software application to facilitate monitoring of the

work in progress and a standard audit program to be used on its smallest registrants;

- another office has developed guidelines for dealing with requests under Revenue Canada's audit "fairness package" and a course dealing with net worth audits and reasonability tests; and
- a third office has developed a comprehensive set of audit programs and a working paper index for large file audits.

#### **Some aspects of audit performance require improvement**

**16.97** Our sample of post-payment audit files revealed some areas in need of improvement. Many audits took many months and many hours to complete. There was usually no evidence of active participation by the team leaders. Some policies were not followed and some procedures were not performed. These are discussed below. In addition, the audit described in Exhibit 16.8 provides examples of needed improvements.

**16.98 Many audits took many months to complete.** A national report of GST audits in progress on 22 March 1999 showed that 32 percent of the audits had been under way for more than 180 days. These accounted for 70 percent of the cumulative GST audit hours. This means that audits begun in the past six months

#### **Exhibit 16.7**

##### **Example of a Good Post-Payment Audit**

The auditor began by comparing GST revenue, as reported by the registrant on its GST returns, with the sales amount reported in the registrant's financial statements. The auditor noted an unexpected decline in GST revenue, and adjusted his audit program to deal with this. This work revealed clerical errors and sales invoices on which GST had not been charged correctly. These errors totalled approximately \$90,000.

The auditor also checked for clerical errors in the input tax credit account. He discovered that the registrant was entitled to input tax credits in respect of purchases on which GST of approximately \$50,000 had been paid.

A review of other selected general ledger accounts and bank statements did not reveal any further anomalies, so the auditor did not perform any more detailed tests. The audit work was completed in approximately 100 hours, and less than two months elapsed between the file's assignment to the auditor and the issuance of the notice of assessment. The audit working papers contained a complete index, a section that provided an overview of the audit and a summary audit program, and schedules that clearly supported all amounts being assessed. An income tax compliance checklist had also been completed.

accounted for only 30 percent of the audit hours.

**16.99** In our own audit sample, 67 of the 141 post-payment audits had taken more than 180 days, and 14 had lasted more than two years. The average duration of the 67 audits was 495 days — about 16 months.

**16.100** The extensive length of these audits was the result of delays caused by either Revenue Canada or the registrant or both. Delays by Revenue Canada were due primarily to conflicting priorities of the auditors involved. Delays caused by registrants were primarily due to a failure to respond to requests for an initial meeting or to provide requested documentation on a timely basis.

**16.101** Some of the delays caused by Revenue Canada could have been avoided by better audit planning and increased monitoring of the work in progress. In one tax services office, we were told that audits had not been monitored because team leaders were being rotated every few months. Detailed monitoring was performed only after permanent team leaders had been assigned. Another office told us that for various reasons there had been no detailed monitoring, so many audit files had been outstanding for more

than 180 days. We were also informed that to make the workload more manageable, a number of old files had been reviewed and a decision made to discontinue work on those expected to generate low or no assessments.

**16.102** Registrant delays can add significantly to the cost of the audit, and are often beyond Revenue Canada's control. It can penalize registrants who do not provide requested data promptly. While we understand that the Department does impose these penalties, and some files in our audit sample indicated that it had threatened to impose them, it had not done so in any of our sample items.

**16.103 Some GST audits were not efficient.** Audits that take many hours but yield only small assessments are not necessarily poor audits. Very large, complex registrants may take hundreds of hours to audit, and may turn out to be in compliance with the *Excise Tax Act*. On the other hand, a pattern of such audits could be a symptom that they were poorly done.

**16.104** To determine whether audits that take many hours but yield only small assessments are good or poor audits, we reviewed the 25 audits in our sample that had taken more than 100 hours and had yielded a revenue recovery of less than

**Registrant delays can add significantly to the cost of the audit.**

The audit file was assigned to the auditor in November 1992. The auditor completed his field work and sent a proposed assessment to the registrant in May 1995. For various reasons, the notice of assessment was not issued until December 1997 — more than 18 months after the proposed assessment and more than five years after the assignment date. Almost 800 hours had been charged to the audit. The assessment was for about \$31,000. Penalty and interest had been reduced due to the excessive time between the completion of the fieldwork and the issuance of the assessment.

Most of the assessment dealt with inappropriate input tax credits on employee automobile benefits. Other miscellaneous matters were assessed, including \$200 of unreported GST on sales to employees. In our opinion, the extent of testing and documentation to support the amounts assessed appeared excessive.

During the five-year period, there was a change in the team leader assigned to the audit. There was no evidence that either team leader had been actively involved in the audit.

The working papers did not indicate how or why the registrant had been selected for audit. There was no evidence that any reasonability tests had been performed.

The audit had been recorded on the GST mainframe as a large file audit; this was not the case.

**Exhibit 16.8**

**Example of a Post-Payment Audit Requiring Improvement**

**Team leader involvement in audits is limited.**

\$100 per hour. We found that in over 75 percent of the cases, the time spent appeared to be excessive in relation to the size and complexity of the registrant and the scope of the audit work. This not only represents an inefficient use of resources but also adds to the burden on the registrants being audited.

**16.105** Revenue Canada officials have informed us that post-payment audits that had taken more than 100 hours and yielded a revenue recovery of less than \$100 per hour constituted only 5 percent of the audits completed in 1997–98. Nevertheless, we believe that excessive audit time is a matter that Revenue Canada needs to pursue. We found in sample items other than the 25 just noted that audit time had been excessive in relation to the size and complexity of the registrant. In addition, Revenue Canada’s Quality Assurance Division also reported that it found many audits conducted in 1996 and 1997 that had taken an excessive length of time in relation to the audit scope, and that many audits went on far too long. The report concluded that better audit planning and greater management participation would reduce the time spent on audits.

**16.106** One way to control the number of hours spent on an audit would be to budget at the planning stage for a certain number of hours. Ideally, budgets would be tailored to each set of circumstances to provide a better basis for managing and controlling audit performance. This is not being done. Instead, tax services offices often use national averages, developed by Revenue Canada as part of its annual budgetary exercise. These national averages fail to account for the unique characteristics of each audit. One tax services office that we visited now requires staff to sign “performance communications”, stating that, among other things, they will normally complete their audits in less time than the national averages. While we understand that these documents were implemented to provide

the office’s management with greater control over the number of hours spent on each audit — a commendable goal — we are concerned that this approach could lead staff to unduly limit the scope of their audits.

**16.107** Another way to control the time spent on an audit would be to increase active participation by team leaders. This would also help to ensure that audits do not drag on too long and are performed as planned. Seventy percent of our post-payment audit files showed no evidence of such participation.

**16.108** In a recent report, Revenue Canada’s Quality Assurance Division also reported that team leader involvement in audits is very limited. The report cites various contributing factors, such as group size and the heavy demands of other responsibilities. The Department is considering reducing the size of groups and redefining the roles and responsibilities of team leaders.

**16.109** **Revenue Canada should enhance its efforts to reduce the duration of its audits and the hours required to complete them. These efforts should include enabling team leaders to be more actively involved in their audits, and providing greater support to auditors in planning and performing their work. Efforts should also include making more use of penalties to deter delays by registrants.**

*Department’s response: As described below, Revenue Canada has already taken action to improve overall program delivery in the areas identified in this recommendation.*

- *In the budget exercise for 1999–2000, very specific accountabilities have been put in place to ensure the achievement of overall program objectives. The tax services offices (TSOs), through the regional offices, will report to headquarters starting with the six months ending September 1999 on the progress achieved in relation to meeting agreed-to*

objectives. The report will include comments on the reasons for any variances and the action plan to address the variances. This will include status reports on files outstanding for more than six months.

- The Department has completed a *Team Size study*, which recommends a reduction in team sizes. This will be discussed with regional and tax services office management with a view to formal implementation in 2000–2001. Implementing the recommendations from this study will enable the team leaders to spend more time with the auditors and become more actively involved in the audits. Most TSOs have already implemented the smaller team size structure recommended in this study.

- In collaboration with the Small Business Advisory Group, the Department developed an audit pamphlet, which will be provided to all taxpayers/registrants when an audit is started. The pamphlet clearly sets out the responsibilities of the taxpayer/registrant and the auditor in the audit process. With everyone having a clear understanding of their responsibilities, there will be fewer delays on audits.

- In May 1999 the Department held a focus group session involving staff from TSOs to develop an action plan to improve overall program delivery. The recommendations from this focus group are being implemented this fiscal year. One of the recommendations coming out of this focus group is to make more use of formal requirements where taxpayers/registrants or tax practitioners are not providing information within reasonable time frames. Prosecution action will be initiated where there is non-compliance with the requirements. In addition, the Department will look at the possibility of increased use of civil penalties for failure to provide information.

**16.110 The audit period often exceeded Revenue Canada’s policy without justification.** One of Revenue Canada’s policies is to restrict the coverage of each GST audit to the two preceding tax years, along with returns filed during the current year. Earlier years are to be audited only in limited circumstances, and only on the approval of the team leader. This policy is designed to improve audit efficiency and reduce the burden on registrants.

**16.111** We noted that the audit period for 76 of our 141 post-payment audits exceeded the period called for in the policy, in a large number of cases without justification. The Department has issued a directive to its auditors of small and medium enterprises to reinforce the policy.

**16.112 Incorporating a compliance review of income tax into GST audits is not a common practice.** The strategy for audits of small and medium enterprises calls for the integration of income tax and GST audits to the extent possible. In cases where only one tax is audited, a “compliance review” of the other tax is generally required. This work entails examining specific indicators of the second tax to determine the level of compliance. Compliance reviews offer increased coverage, which should lead to greater deterrence and increased revenue recovery.

**16.113** Using the Department’s own criteria, we concluded that an income tax compliance review checklist had been warranted in 77 of the post-payment audit files we reviewed. Fifty-two of these files contained no evidence that these checklists had been completed. Departmental officials have informed us that they recently made changes to the Audit Information Management System to provide management with the information needed to ensure that compliance reviews are done when necessary.

**In cases where only one tax is audited, a “compliance review” of the other tax is generally required.**

## Support for the GST Audit Programs

### Staffing and training needs

**16.114** The success of the pre-payment and post-payment audit programs depends on the availability of enough qualified, well-trained and well-equipped staff. The ideal number and mix of staff in terms of knowledge, skills and experience varies among tax services offices, depending on the characteristics of the registrant population served by each office.

**16.115** Senior managers in all five tax services offices that we visited stated that they do not have the ideal complement of audit staff and equipment. Two offices have a surplus of auditors at the AU-1 level (who typically audit smaller corporations) and a shortage of “generalist auditors” at the PM-2 level (who typically do both GST and income tax audits of small unincorporated businesses). Three offices have a shortage of senior auditors (AU-3 level) who audit large corporations.

**16.116** Senior managers and auditors in the five tax services offices informed us that the shortage of senior auditors is made worse by high turnover, due to staff transfers within the Department as well as staff departures. Auditors often do not perceive that they have a promising career path in the GST stream, and prefer to switch to the income tax stream. This perception has its roots in differences in the job descriptions of auditors, predating the consolidation of the former departments of Taxation (which administered the income tax) and Customs and Excise (which administered the GST). For example, the job descriptions call for GST auditors at the AU-2 level to perform audits of the larger small and medium enterprises, while the income tax audits of these enterprises are done by more senior auditors, at the AU-3 level.

**16.117** As for training, the generalist auditors at the PM-2 level in the five tax services offices claimed that their training was excellent. Other GST auditors informed us that they lacked training in specialized areas. In particular, some auditors told us that they felt ill-prepared to audit complex and specialized organizations, such as public sector bodies (for example, municipalities). In some offices, technical advisors have augmented the official training program. When time permits, these experts in legislative interpretation give presentations on technical topics of local interest.

**16.118** Departmental officials have informed us that they have commenced a number of initiatives to attract and retain knowledgeable staff.

### Information needs

**16.119** To improve its GST pre-payment and post-payment audit programs, Revenue Canada needs to know which activities are working well and which ones need improvement. This means that the Department needs consistent and reliable information that can be aggregated and compared with GST assessments.

**16.120 Problems in the consistency of the data.** In previous reports, we have commented on problems of data consistency. In this audit, we again encountered inconsistent data. Until Revenue Canada can assure itself that the data are consistent, it will not know which variances in audit results — among tax services offices and year to year — are attributable to errors and inconsistencies and which are attributable to “real” performance factors that should be followed up. These data problems will limit Revenue Canada’s ability to improve its pre-payment and post-payment audit programs.

**16.121** We noted the following problems:

- inconsistencies in recording the time spent initially to review the

**Auditors often do not perceive that they have a promising career path in the GST stream.**

audit-worthiness of a particular return or registrant;

- inconsistencies in recording audit types; and
- recording different audit times in the Audit Laptop System and the Audit Information Management System in four of the five offices we visited. (In the fifth office, differences were being reconciled.)

**16.122 Some necessary data are not being captured, or are not being captured in ways that can easily be aggregated.** Revenue Canada does not have aggregated data on the kinds of non-compliance being identified during post-payment audits, or on the scope of its post-payment audits. (These may be full audits or restricted to specific issues.) If these data could be aggregated and matched in aggregate to resulting assessments, Revenue Canada would be better able to determine the most prevalent forms of non-compliance and the effectiveness and efficiency of its audits.

**16.123 Some aggregated data are not readily available.** In order to make good audit selections, management needs information such as the number of registrants in each industry sector or in various ranges of sales revenue, prior audits of each registrant, audit hours and amounts assessed by industry sector, and adjustments to assessments made by the Appeals Branch. Although this information exists in various databases and reports, it is sometimes difficult to access and analyze. In these cases, management must rely on special ad hoc reports and registrant tape files that are updated and distributed every six months.

**16.124 Revenue Canada should continue to improve the timely availability of data needed to manage the GST audit programs effectively. To that end, the Department should resolve inconsistencies in the data-capturing methods, ensure that missing data are**

**obtained, and ensure that data can be aggregated and analyzed.**

*Department's response: The Department agrees with this recommendation; some work has been completed and other work is under way to address these issues.*

- *GST audits were included in the Audit Information Management System (AIMS) to enable managers in the tax services offices and in the regions to better manage program delivery. The Department will continue to modify AIMS to provide more information on GST audits, such as the reasons for audit selection.*

- *The Department is using state-of-the-art technology to develop applications (GST Power Play Cubes using Impromptu), which will enable all levels of management to more easily aggregate and analyze information on GST audits completed and in process. The Department is also developing applications for managers using Electronic Business Intelligence System software that will enable all levels of management to more easily benchmark progress in relation to key performance indicators. These initiatives will facilitate increased effectiveness in the management of the GST audit program.*

- *The Department is in the early stages of developing a comprehensive Management Information System to meet the information needs of all programs within the Verification, Enforcement and Compliance Research Branch and to fully implement the Management Information Agreements that have been put in place. This system will provide considerable data relating to program delivery and also more information on the types and dollar values of non-compliance identified by audits.*

- *The Department is also developing a Corporate Performance Measurement Framework based on the Balanced Scorecard methodology for all programs. Building this system will entail the*

**Revenue Canada does not have aggregated data on the kinds of non-compliance being identified.**

**The Department is in the early stages of developing a comprehensive management information system.**

*redesign of the Department's entire measurement system, from the development of corporate measures to how measures are used and interpreted by management and employees.*

**16.125 Revenue Canada makes few comparisons with other revenue administrations.** Comparing Revenue Canada's audit selection, planning, performance and results with those of similar organizations could help it to measure current success and identify best practices, thus leading to improvements.

**16.126** While the ministère du Revenu du Québec uses all of Revenue Canada's systems and policies, it sets its own audit strategy. Revenue Canada officials informed us that, while they maintain open communication with the ministère on operational and administrative matters, they do not verify the completeness or accuracy of the data received from the ministère or perform detailed analyses of its audit results. Revenue Canada is close to finalizing an updated agreement with the ministère that provides for a more structured sharing of audit strategies, work plans and audit results.

**16.127** As for other organizations, Revenue Canada officials informed us that they have ongoing dialogue and attend international gatherings with similar organizations in other countries with GST (value-added tax); however, they have not formally compared their compliance efforts with those countries.

**Control over audit files**

**16.128** Revenue Canada needs to be able to locate its audit files when registrants appeal their assessments. However, for 8 of the 168 pre-payment and post-payment audits in our sample, the hard copy working papers could not be located. Similarly, for audits of 17 registrants, the Audit Laptop System diskettes either could not be found or were unusable.

**16.129** The primary reason given for the lost and misplaced hard copy files was the absence of an electronic control log to track who in Revenue Canada has the GST audit files when they are transferred among various units — for example, Appeals Branch, Special Investigations, headquarters or other tax services offices. The primary explanation for the unusable diskettes was that they malfunctioned during the audit and the audit working papers contained therein could not be retrieved. Departmental officials have informed us that they are currently addressing these matters.

**Reporting on Performance**

**16.130** Under its governing legislation, the new Canada Customs and Revenue Agency will be required to establish and report on performance in relation to its objectives and performance expectations. We found that production data for the GST processing function are collected and made available in a relatively timely manner. However, we found very few instances of these data being used to arrive at accurate performance measures. As for audit, the Department is in the early stages of developing a comprehensive management information system to meet the needs of its Verification, Enforcement and Compliance Research Branch, which is responsible for the GST audit function. It is important that the Department correct the deficiencies we have noted throughout this chapter with respect to the availability, consistency and reliability of data and that it complete the information system it is developing. Otherwise, the new Agency's ability to report on performance as required by its Act may be jeopardized.

**Conclusion**

**16.131** Returns processing and audit are two core functions of GST administration. Our audit of these functions revealed both examples of good performance and areas

for improvement. In the audit function particularly, we noted that Revenue Canada has identified several areas for improvement and has launched improvement initiatives, but the results of these measures are not yet known.

**16.132** The timeliness with which documents are processed at the Summerside Tax Centre has improved since the Centre opened in 1993. Our examination of the timeliness of post-payment audits revealed that many audits have extended over many months and have taken many hours to complete. Pre-payment audits by their nature do not last as long as post-payment audits, but these, too, are prone to delays. Both Revenue Canada and the registrants themselves have contributed to delays in the completion of audits. We believe that further improvements are possible in the speed with which documents are processed and that additional steps can be taken to reduce the delays experienced in audits. This would result in better service to registrants and, in some situations, reduced interest charges on refunds paid after the 21-day grace period. Document processing, pre-payment audit and post-payment audit activities are linked, and the persistence of problems with timeliness suggests that performance in this network of activities has not yet been optimized.

**16.133** Revenue Canada has made progress in establishing performance standards and expectations for its returns processing and audit activities, and is undertaking a major overhaul of its management information systems. At present, however, standards for returns

processing tend to place insufficient emphasis on quality, accuracy, timeliness and unit cost, and the use of performance information is hampered by problems with the availability and reliability of data. In the Department's audit activities, the use of performance information is hampered by problems with the availability and consistency of data.

**16.134** The Department faces a significant challenge in maintaining a sufficient complement of GST staff with appropriate knowledge, skill and experience. Staff transfers within the Department and staff departures contribute to shortages of staff in particular activities. Training for staff who must perform new functions has not always kept up with the need.

**16.135** Prompted by the decision to decentralize the processing of GST returns, formerly performed only at the Summerside Tax Centre, Revenue Canada recently simplified its procedures. This follows efficiency gains made over the years in Summerside. Revenue Canada has also improved the automated validity checks it uses to select, for possible pre-payment audit, credit returns with the highest risk of non-compliance. However, we believe that further improvements are possible to make the checks more effective, and that the Department should consider reviewing and auditing debit returns at the same time as it conducts pre-payment audits of credit returns. Also, the performance of both pre-payment and post-payment audits could be improved by the consistent application of existing or strengthened procedures.

**Our audit revealed both examples of good performance and areas for improvement.**



## About the Audit

### Objective and Scope

The objective of the audit was to assess the efficiency and effectiveness of Revenue Canada's GST returns processing and audit activities.

The audit took place at Revenue Canada headquarters in Ottawa and at various tax centres and tax services offices throughout the country.

### Criteria

We expected that:

- processing and audit of GST returns, and payment of refunds and rebates, would be done on a timely basis;
- management would work continually to optimize the performance of the entire network of GST functions and activities;
- performance expectations for GST returns processing and audit activities would be set out in departmental plans. Management information systems would track related performance information;
- the Department would have recruited, trained, developed and maintained a sufficient complement of staff with appropriate knowledge, skill, and experience;
- operations would be designed and carried out using efficient systems, processes, procedures and work methods. The performance of risk assessment criteria and audit methodology would be regularly monitored, assessed and updated; and
- adequate information systems would be in place that ensure the reliability, consistency, availability and security of key information used in GST processing and audit.

### Audit Team

Assistant Auditor General: Shahid Minto  
Principals: Scott Milne and Jim Ralston  
Directors: John Pritchard and Richard Quesnel

Terence Brown  
Thérèse Desjardins  
Nisha Goyal  
Patricia Smith

For information, please contact Scott Milne.