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## Managing A Tax Audit

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# 1 Overview

There is no right answer on dealing with the Australian Tax Office (ATO) either at the time of managing a tax audit or frankly, at any time.

There is no such thing as dealing with the ATO. You are dealing with individuals. The great unknown is how to deal with the particular ATO officer on the other side. You must understand you are dealing with a person who has their own personality, training, commercial understanding, prejudices, ethnic and cultural backgrounds, financial circumstances, language ability particularly on technical issues, and just day-to-day pressures. The ATO officer may have, for some reason, lost the open capacity to consider rigid facts to the shifting sands of the law.

Dealing with officers of the ATO and finding some rapport is a matter of chance. But you must work on it. Above all, you need to appreciate that the ATO officer may be on under \$100,000 per annum, working four days a week and looking after a child as a sole parent. Now consider how you can argue a debt waiver application under section 34 of the Financial Management & Accountability Act 1997 where the client:

- Cannot pay \$383,000 of ATO debt being income tax and General Interest Charge (GIC).
- Has \$3.5 million of property and \$4 million of bank debt.
- Earns \$500,000 per annum and finds it impossible to meet expenses including interest.

How do you explain to the ATO officer that your client is in financial hardship?

Senior management within the ATO will tell you that the effort in training has been the major focus over recent years. The ATO wants to provide a consistent response to make sure that the tax issues relating to the same facts are decided in the same way. The ruling system, PSLAs and internal training manuals, all aim to provide a consistent outcome. But, how is a consistent outcome possible, when the factual positions change; where the ATO officer's personal circumstances may cloud their judgement; or where the taxpayer or taxpayer's adviser acts in a certain manner?

How you succeed on behalf of your client with the ATO will depend upon your communication skills, mostly written, but more now involving some face-to-face or phone-to-phone contact.

## 1.1 ATO review and audit triggers

Criteria for the ATO to begin reviewing a taxpayer's affairs include:

- (a) substantial difference between the taxpayer's financial or tax performance and industry patterns,
- (b) substantial variation in the amounts or pattern of tax payments compared to previous periods, economic indicators or industry trends,

- (c) lack of alignment between the taxpayer's economic performance, productivity and tax performance,
- (d) losses or effective tax rate that differs substantially from industry patterns,
- (e) a history of aggressive tax planning for the taxpayer or the taxpayer's related entities, officers, executives or advisers, the taxpayer has a structural, procedural or governance weakness in their approach to tax compliance, or
- (f) information obtained by the ATO from various sources including media reports, other government bodies both domestically and internationally, anonymous tip-offs.

## 1.2 Types of review and audit activity

There are many different levels of ATO review or audit activity. A number of different categories of audit and review activity are listed below.

- (a) Data matching: Information matching with various media publications, Centrelink, State Revenue Offices, Land Titles Offices, AUSTRAC, ASIC, ASX, Department of Immigration records, motor vehicle, marine and aircraft Registries and other sources. The ATO analyses the information and undertakes risk classification.
- (b) Research audits: Industry or activity research enquiries are undertaken to gather intelligence, profile industries and trends in taxation compliance.
- (c) Desk audits: the ATO requests receipts, invoices and other documents to substantiate the tax returns lodged. The ATO may conduct interviews. The ATO analyses the information and undertakes risk classification. Desk audits can be subcategorised into:
  - (i) substantiation review – rental deductions or work related expense claims verification;  
or
  - (ii) source deduction review – PAYG withholding verification;
- (d) Risk reviews: Risk reviews are becoming increasingly common and are commenced with a questionnaire, followed by ATO analysis, detailed expert opinion and risk classification. After review the matter is closed or escalated to an audit. Risk reviews can be subcategorised into:
  - (i) preliminary risk review – general questionnaire;
  - (ii) comprehensive risk review – detailed issues questionnaires with informal or formal interviews and document access; and
  - (iii) specific review – specific issue questionnaires with informal or formal interviews and document access;
- (e) Audits: Audits generally commence with an audit notification letter including a request to make voluntary disclosure. The ATO generally undertakes informal or formal interviews and document access, analysis, expert opinion and risk classification under an information

gathering process. Based on the risk classification, the ATO may proceed to an audit process that can be subcategorised into:

- (i) specific issue audit – detailed specific issue or issues information and document exchange, interviews, taxpayer systems review and analysis, ATO analysis, expert opinion, position papers exchange, audit findings paper, closure or escalation to amended assessment;
  - (ii) comprehensive audit – detailed issues information and document exchange, interviews, taxpayer systems review and analysis, ATO analysis, expert opinion, position papers exchange, audit findings paper, closure or escalation;
  - (iii) complex audits – strategic and complex industries, international groups, tax issues;
  - (iv) special audits – serious non compliance activities with a prosecution emphasis (such as Project Wickenby);
- (f) Continual monitoring: Specific taxpayer can be requested to provide expanded or special purpose tax returns. A common example is the High Wealth Individual (HWI) expanded tax returns. First contact by the ATO is to either the taxpayer or the tax agent.<sup>2</sup>

## **2 The ATO Contact**

### **2.1 Treat first contact as the beginning of an audit**

The ATO does not generally regard the first contact as being part of the audit, but it is good practice for a tax agent to regard the first contact as being the commencement of an audit.

#### **2.1.1 Develop an audit strategy**

It is vital to develop an audit strategy at the onset of any audit activity. The objective of the audit strategy is to (in no particular order):

- (a) define clear and achievable outcomes, time frames and procedures;
- (b) define clear lines of communication;
- (c) promote objectivity, focus and relevance of the audit process;
- (d) objectively, efficiently and effectively settle the matter with no or minimal tax adjustment;
- (e) minimise time investment and resource utilisation in the audit process;
- (f) proactively present relevant facts, tax analysis and policy considerations in a systematic manner to influence the audit outcomes; and

- (g) extract from the ATO as much ATO intelligence on the matter before the matter becomes contentious.

There is an art to audit management where reasonable and experienced practitioners can have diametrically opposed legitimate opinions. The essence is to prepare thoroughly for likely contingencies. In particular ensure the ATO operates within their administrative parameters, identify weaknesses and strengths in both sides of the argument, fight only those battles with real prospects of success, do not concede matters until an overall settlement is under consideration, do not make mistakes and do not miss the moment for settling the matter.

There are some specific matters that should be considered at this early stage

- (a) Consider the scope of the audit as expressed in the ATO audit letter and take into account possible voluntary disclosures as this may attract the 80% voluntary disclosure concession. (MT 2008/3).
- (b) Identify the likely points of contention and review these from the ATO's perspective. Identify what information the ATO is looking for and tailor the responses accordingly.
- (c) Establish the ultimate aim of the taxpayer. It may be preferable to concede on primary tax liability if the quantum is small and focus on penalties and interest remission coupled with the reduction in professional fees incurred.
- (d) Where possible, establish one person to liaise with the ATO. This assists in managing what, and how much, information is provided to the ATO.
- (e) Note the audit commencement date and the scheduled finalisation date to set the period after which shortfall interest charge or general interest charge can be remitted (PSLA 2006/8).
- (f) Advise all affected entities (for example, business partners, advisers, insurers) of the audit as their participation may be relevant and in any event may be the next to be audited.

## 2.2 ATO contacts the taxpayer

It is the practice of the ATO to, in many cases, contact a taxpayer directly. That can cause all sorts of issues as the taxpayer is invariably not prepared for such contact and without having proper advice, may well go on to answer questions, or give information which may or may not be accurate.

All clients should be told that if the ATO contacts them directly, they should politely say that their tax agent or other relevant adviser is the person who should answer the ATO questions and provide the information.

### 2.2.1 How the taxpayer should respond to the ATO phone call

- The taxpayer should note the ATO officer's name and contact details and say that these details will be passed onto their tax agent and/or adviser.

- If the ATO officer does not wish to provide contact details, then the taxpayer should give to the ATO officer the tax agent's phone number.
- the taxpayer should immediately ring the tax agent and provide details of the phone conversation.

## 2.3 ATO contacts the tax agent

We have all heard those terrible words:

*"Hello, my name is XX and I am ringing from the tax office, wanting to speak to Mr Abbott".*

For a moment, your heart sinks and you ask *"Is it in respect of a client?"*

### 2.3.1 How to respond with the ATO officer's phone call

The first thing to note in respect of a call from an ATO auditor is that the officer concerned is trained as to how to handle questions from you. For example, the ATO officers are provided with a manual giving suggested responses to standard questions. Two examples are provided below.

(i) A question put by you such as

*Why am I subject to audit?*

Will result in the following response

*This is a new audit product undertaken by the Small & Medium Enterprise Business Line in the ATO to review the taxpayer's compliance. Your client has been selected on the basis that their entity has large deductions/low profit etc. (State the relevant risks) We wish to check the accuracy of the claims being made.*

(ii) *Does this mean my client has done something wrong?*

Will then receive the reply

*As you know, the Tax Office conducts a number of compliance activities including different kinds of audits. We try to match the audit method with the identified risks. In cases like these we have found it beneficial to all parties to use less intrusive methods rather than a full compliance audit. Being selected does not imply your client has done the wrong thing. The ATO operates on a risk management basis and we allocate resources based on risk.*

*In your client's case we'll conduct a one or two day inspection of the journals and source documents supporting the claims made for "Repairs & Maintenance", "Bad debts" and/or "All Other expenses" and complete a short questionnaire. Our aim is to check the accuracy of the claims being made.*

It is extremely important at this point to have the ATO officer explain in as much detail as possible as to what is to be looked and why. Information at this point gives you some comfort, because you now know where to look to make sure that the tax treatment of the issue under review has been properly



treated.

### 2.3.2 Recent ATO officer review query to Adrian

It was only two weeks ago, when I received a call from an officer in the ATO who in response to my question said that the review was in respect of two large GST refunds, one in 2011 and one in 2012. I did not have any idea what the refunds represented and I could not imagine why my client had received the two large refunds. My client is a commercial property company which receives commercial rent.

The ATO officer wanted to ask questions about the background of the company and about why the large refunds had occurred. The ATO officer had a prepared script. I gave the background, but asked that the other questions be emailed to me. The email came the next day.

I did not want to ask the obvious question, namely how large were the refunds, just in case that led to other questions.

As it turned out, the “*large*” refunds were not that large in the context of the activities of the client, \$500,000 and \$600,000 respectively. My client has \$100 million of property investments. Refunds were the input tax credit from the acquisition of two properties where the properties were not going concerns and where GST had been paid to the vendor under the contract.

But that is not the end of the story. There were other refunds mixed up in the amounts mentioned and the full reply to the question necessitated supplying to the ATO a spreadsheet listing the components of the refund and the relevant paperwork to support the amount of the refund.

The point being, obtain as much information from the ATO at an early stage. In the above matter it was not the two credit items that were the real issue (though they stimulated the ATO enquiry) but rather the compliance procedures of the client were being tested and a quick and detailed response avoided any further escalation of that enquiry.

### 2.3.3 Options available for answering ATO officer questions

There are two schools of thought on answering questions from the ATO:

The first is to answer the questions by phone and thus gauge the ATO officer’s responses. Maybe it would be a quick and easy answer that would lead to no further questions (as was the case described above).

- The ATO officer will record the questions and answers into the ATO’s messaging system. The major problem with this is of course whether the ATO officer’s summary of the questions and the answers are accurately recorded.
- Whatever is transcribed by the ATO officer of such conversations will be considered “absolutely correct” by officers who subsequently are involved in the matter.
- When you can hear the ATO officer typing into a computer, you should speak slowly and encourage the officer to take down your answer in full.

- It is good practice for you to ask the officer to read back the question and the answer. It is our experience that the ATO will not provide copies of transcripts when concurrently sought. The only way is a subsequent FOI application (a very important tool that should never be forgotten).

The second is to make sure that all communications dealing with reviews or audits are in writing.

- It is too easy to give quick glib answers which may be only partially correct or interpreted in a manner not intended.
- Inconsistencies in answers or answers which subsequently are proved to be wrong, can never be erased from the file or from the thinking of the ATO officer.

As a matter of principle, never answer detailed questions by phone (or at an interview) to an ATO officer. It is acceptable to give a general background to the client's business as a verbal response, however, any detailed questions should always be requested to be put in writing. The reason for this is clear.

Most importantly written questions and written responses ensures that the ATO officer clearly states the question and gives you the opportunity to make a reasoned response.

These two points (clear questions and reasoned responses) will ensure that the statement of facts (if it ever comes to such a situation) are correct from both the point of view of the ATO and your client. There is an accepted adage which should always be kept in mind, cases are more often than not won on facts not law – the law is generally settled but the facts are usually never so settled. Get the facts right and the legal outcome will hopefully follow.

#### 2.3.4 Information and client records

Ideally a tax agent would review a client's records on a regular basis and ensure that any major transactions or transactions not in the ordinary course are properly treated for tax purposes.

But, time being what it is and assuming the tax agent has not conducted a review of the client's records relatively recently, then it is critical to do so at the time of the review or the audit.

The tax agent should concentrate on large transactions and check that the actual forms lodged and the allocations within those forms accurately reflect the transactions and that any anomalies be identified and explained.

In a recent BAS/GST review the ATO requested information as to why the G3 heading on the BAS had \$7 million when the company only earned relatively small rental income. On considering the client's records, it was obvious that the \$7 million was a dividend received by the company and should not have been recorded on the BAS at all. While the miscoding did not result in underpayment of GST, or for that matter overpayment, it nevertheless did not give a good impression to the ATO officer, that there could be in one BAS a \$7 million category error.

By the way, G3 is meant to reflect expenses which do not bear GST such as government rates and taxes.

### 2.3.5 What the ATO may already know

As you would expect there is a manual provided by the ATO to its officers, which covers the review and audit process. That manual provides that prior to contact with the taxpayer or the agent, the officer should consider the following areas:

- The ATO officer may have made enquiries to identify the taxation risks involved by assessing the industry in which the taxpayer operates, the source of income, the types of expenses and the compliance record of the taxpayer.
- It is more likely than not that the officer has undertaken an analysis of financial statements including possibly ratio analysis, being gross profit for sales, net profit for sales, expenses to income, wages to sales, sales to debtors/creditors and net profit to total equity. The analysis should have covered four years.
- In extreme cases the ATO officer may have already researched the taxpayer's history by reviewing websites, facebook, google and other search engines including media reports. Particular sites that may be used by ATO officers to gather information on taxpayers include:
  - Austlii and Wordlii for court cases locally and overseas. The ATO will review non tax case as they are instructed that such cases may have tax implications.
  - Government Corporate sites such as ASIC and international sites such as the US Securities and Exchange Commission , the New Zealand Companies Office and the UK Companies House.
  - IBIS which can provide financial ratios for particular industries and an explanation of past and future economic issues facing certain industries.
  - TERC which is the Tax Evasion Referral Centre. Anonymous information is referred here and stored.
  - Media reports in local and financial newspapers.
- Questions will already have been framed and are at the ready to be asked.

By the time of the initial contact, the ATO officer will know a great deal about the taxpayer.

## 3 The interview

This aspect of a review or audit is treated seriously by the ATO. For whatever reason the ATO officer requesting an interview, has very good reason for doing so.

### 3.1 Who should not attend the interview

From our perspective, unless a section 263 notice has been issued – serious stuff, the interview should never include the client taxpayer. Why?

- Because the ATO officer will focus the questions on the client and not the tax agent.
- The client will not necessarily understand the importance or relevance of questions posed by the ATO.
- The client often may be nervous and answer questions accordingly. This will lead to suspicion by the ATO officer.
- The client may be trying to double guess what the ATO officer is asking and the reason why the question is asked.
- The client may well give a wrong answer, which once given can never be taken back.
- When a question is asked which is difficult to respond to immediately then the opportunity to be able to say “*I will need to ask my client and will get back to you*” is a safety net.

## 3.2 Who should attend the interview

The answer is simple. A minimum of two people and probably never more than three persons.

The two as a minimum should be the tax agent and one other person probably from the same firm. The second person is very important and it should be someone who is a good note taker as that is the important role at the interview. The ATO will have their “note taker” member of the team and invariably is a junior officer with little understanding of the matter and the issues. Their note taking will often reflect that background.

Tax agents too often in our view overlook the importance of note taking at such interviews. Never rely on the assurance that the ATO will give being “*You don't need to take notes as we will give you a copy of ours*”. A good note taker for the taxpayer will produce a different statement than what the ATO will produce. As indicated earlier in the paper, full and correct statement of the facts will be critical in the matter if a dispute results.

Before the meeting starts, you should tell the ATO officers that you would like a copy of their notes at the end of the meeting. Because the factual circumstances are important, what is contained in the ATO officers notes will be the foundation of the file and again, if not corrected, the errors will taint the opinion of the ATO officers going forward.

The other importance of a note taker is that it allows the tax agent/adviser for the taxpayer to concentrate on the questions posed and the answers to be given. When two of you attend, the one allocated to answer the questions (usually but not always the tax agent) should not take notes, or be distracted from eye-to-eye contact with the ATO officers. The ATO officer's reactions to the questions and to the tax agent's answers are critical.

The question often faced prior to the interview is whether a lawyer for the taxpayer should attend. The argument for a lawyer attending is that it gives the ATO the impression that the taxpayer takes the matter seriously, encourages the ATO officer's to restrain their enquiry and ensures that the lawyer is fully aware of the progress of the audit in the event that the audit subsequently escalates.

The argument against a lawyer attending is that it could be perceived as a suggestion the taxpayer has something to be concerned about and raises the so-called ante of audit.

### 3.3 What preparation should you do for the meeting?

#### 3.3.1 You need to be perfectly prepared.

To do that:

- You must understand prior to the interview what the ATO are seeking
- If you have been successful in clarifying the matters that the ATO wish to address at the interview then you should be ready aware and be ready to answer those matters with supporting documents.
- Any material supplied should look professional, organised and complete. There should be three copies, two for the ATO and one for you. The material should have numbered pages and have dividers and clear headings. What you provide the ATO will obviously depend on what they are seeking, but the better you can supply information and the more ordered form, the better the chance you have of a quick and successful review or audit.
- What should not happen at the interview is that you provide a long diatribe of facts, red herrings, or issues of law. Anything you say should be able to be backed up by the written presentation materials that you have before you.
- Do not assume that the ATO officer has the materials already, or if the ATO officer does, then the file may be passed onto others who may not have that access.
- Repetition of the relevant facts and relevant issues is essential.
- At the interview, if there are errors or anomalies that you have noted in your preparation, then those should be explained early in the interview and the material should also explain the errors and the anomalies.
- The review of the clients tax issues surrounding the review should be understood and any anomalies able to be explained.

#### 3.3.2 Questions you can expect the ATO to ask you or your client

Prior to an interview the tax agent should make themselves familiar with the basic issues of the client's business including:

- (i) The nature of the business activities?
- (ii) Are sales in the form of cash, cheque, credit sales, eftpos, or from internet sales?

- (iii) Are invoices issued for each sale, how are they recorded in the accounts and how soon after the sale are they usually recorded in the accounts?
- (iv) How are cash sales recorded?
- (v) Is the cash used to pay out business expenses incurred?
- (vi) What are the trading terms for credit sales? Provide a trade debtors list.
- (vii) Is there trading stock on hand at years end? Does it consist of Work in Progress, finished goods, and goods in transit?
- (viii) How closing stock on hand valued?
- (ix) The date the books of account are ruled off?
- (x) The major types of purchases undertaken by the business and from whom?
- (xi) Are accrued expenses claimed as a deduction for income tax purposes?
- (xii) Bad debts claimed.

### 3.3.3 ATO use of ratio analysis

The ATO regard ratios as helpful in that the ATO compares them to industry averages (which may be accessed from IBIS) or even against ratios of a similar sized entity operating as a competitor in the same industry. Ratio analysis help the ATO to identify tax issues and this may become apparent where the analysis is undertaken over a number of years.

Ratio analysis is only as good as the figures presented in the financial statements. Unfortunately, the preparation of financial statements is not common in approach and often the ATO overlook these differences. For example, one taxpayer may state the assets in the balance sheet at cost price and another at market price. Various ratios calculated by the ATO will obviously contain distortions.

#### **Some ratios that the ATO may consider using are**

- (a) Gross Profit/Sales – the ATO will use this ratio to indicate whether the operating margins are improving or not. A low ratio is taken to indicate a number of possible concerns. For example, the ATO may believe as a result that sales may be understated, purchases overstated, or closing stock understated.
- (b) Net Profit/Sales - the ratio may indicate whether or not expenses are over inflated for a particular year/s or capital costs have been expensed.
- (c) Business Expenses/Total Business Income – used by the ATO to calculate profit before extraordinary items are brought to account and before dividends and drawings are paid.

- (d) Wages/Sales - indicates how efficient staff are in generating business income. The ATO will argue that a high ratio may indicate a poorly run business or inflated wages which may cover other tax issues.
- (e) Cost of Goods Sold/Average Inventory - indicates how many times in a year stock is turned over. A low turnover is taken to mean that a higher mark-up would be applied to stock and high turnover stock would have a lower mark - up applied. The ratio is used by the ATO in determining how much of the direct and indirect production costs not already allocated to cost of sales may be added back to the stock at end value.
- (f) Net Credit Sales/Average Trade Debtors - indicates how many times a year debtors are turned over. The ATO use this by comparing the ratio to the terms offered to customers in order to indicate bad debt issues.
- (g) Net Profit/Total Equity - the ratio indicates what the return on funds invested. The ATO adopt a view that this figure may indicate transfer pricing issues occur or losses may have occurred in the past or even that there is a version of “transfer pricing” being engaged in with related onshore entities.

Taxpayers should be aware of these various ratios in their own business and have prepared explanations as to why their particular ratio may be out of what the ATO regard as ordinary. An early explanation may prevent a misconception by the auditor and ensure that an “unbending” attitude is not formed by that auditor. Once a conclusion is reached by an auditor it is that more difficult to convince the auditor that such a view may in fact be based on a wrong assumption.

The financial statements will be used by the auditor as a source document. The auditor’s job is to analyse a number of years of financial statements to identify revenue or expense items that are incorrectly claimed along with unexplained movements in assets.

The auditor will be looking at, for example, rounded expense claims which may indicate the expenses are estimated or false. In addition, unusually large items may invite further review.

A review of the taxpayer’s Balance Sheet figures may reveal to the auditor unexplained increases in assets or liabilities or permanent negative cash flows which would no doubt raise concerns.

### 3.3.4 What is the Tax agent’s aim for the interview?

To make sure that the ATO officer has all questions answered accurately or will be supplied with the answers within a short period of time. The aim should be for the ATO auditor to leave the meeting knowing that the tax agent is credible and reliable.

The tax agent achieves that by answering the questions in a non-emotional and non-aggressive and factual manner. Concentrating on fact is the key to a successful interview.

Under no circumstances should the tax agent interrupt the ATO officer. It is more beneficial to hear what the ATO officer says than for the tax agent to act as the advocate for the client. The exercise is not to defend the client, but the exercise is to present the facts and how those facts assist the client’s position.

### 3.3.5 When the interview involves facts as applied to questions of law

Facts are the most important thing and the facts should be the tax agent's focus. The secret of a good adviser for the client at this stage of the audit process is to not only know the facts but to have an understanding as to the application of the law to the facts.

Let us take an example:

- There are two 40% shareholders in a company and a 20% shareholder.
- One of the 40% shareholders is selling their shares in the company.
- Because of control issues it may be that the assets of the company will be included as the assets of the vendor shareholder and thus the assets of that shareholder may exceed the \$6 million small business concession (Section 328-125 ITAA 1997).
- But there is a discretion available for the Commissioner to determine that the 40% vendor shareholder does not control the company and that there are other shareholders who do control the company.

So the focus of the interview will be on two things:

The factual position as to whether your client, the vendor shareholder, did or did not

- Control the company and
- Whether the remaining 40% shareholder and 20% shareholder, did or did not control the company.
- Whether the evidence can show that your client did not control the company, but the other two shareholders did.

The evidence in support of your client's position

- Minutes of meetings of directors and shareholders where your client was outvoted
- Correspondence showing that your client's wishes have not been accepted. For example when considering the annual budget, your client requested that the CEO remuneration should be reduced, but that was rejected.
- That the other two shareholders took the day-to-day control of the operations of the company, while our client was frozen out of that joint control.
- In other words, your client was treated as a minority shareholder which reflected the actual position.

The legal position

The legal position involves interpretation of the section and understanding the provisions which provides for the look through of the company's assets to aggregate those with the assets of the client.



Further the legal position as to the Commissioner's discretion, section 328-125 (6) ITAA 1997 understanding when the Commissioner can exercise the discretion drawing on the rulings and case law on the matter.

### In Summary

The tax agent attending the interview should concentrate on the factual position. If the tax agent does not feel confident as to explaining the law, then a taxation consultant, whether that be an accountant or a lawyer, should attend the interview.

There is a dichotomy between the factual position and the legal position and both must be answered separately and completely.

### 3.3.6 Where should the interview be held?

A very important question and one where there is some debate, is whether the interview should be held at:

- The place nominated by the ATO officer.
- The residence of the client.
- The business premises of the client.
- The office of the tax agent.
- The tax office.
- An independent meeting room.

The ATO's preferred place for the interview is the taxpayer's business premises and the officers are to ask that they be taken on a tour of the business premises. The officer is asked to observe for obsolete stock, new plant and equipment or plant and equipment that has been repaired. The officer will know stock levels and will know what plant and equipment has been bought and repaired over say the four year period of an audit.

For the above reason the interview should never be at the residence or business premises of the client. The question is whether it should be at the tax agent's office, or the tax office.

By far the best place is a meeting room within the tax office. That gives the ATO officers the most comfort and the most familiar of surroundings. The difficulty with the tax office is that the meeting rooms are small and the tables narrow, so that the space between you and the ATO officers can become strained.

The final decision on the meeting place is important and sets the tone for the ongoing relationship.

What about if the tax office and the ATO officers are in different states or cities?

- If the tax agent is requesting the interview, it may mean travel to another city.

### 3.3.7 The ATO preparation and preference on the interview

The initial audit interview is regarded by the ATO as the start of the audit process. The purpose of engaging in the interview is to “*verify the income tax returns of the taxpayer*” and obtain information.

ATO officers go through a training program so that they fully appreciate the sensitivities of the audit and the interview. They are specifically instructed:

- To ask questions directly
- Ask one question at a time and let the taxpayer focus on the issue at hand.
- Project themselves in a confident manner.
- Not to lead the taxpayer in answering questions.
- To stick to the topic.
- Not to assume anything from a reply. The ATO officer is told to test at a later time answers given at the interview.
- To listen to the taxpayer and not to interrupt.
- Ensure the taxpayer has received a copy of the charter.

Frankly, clients and tax agents can do well to adopt the same rules as set out above for ATO officers.

The books and records of the taxpayer that the ATO will typically ask for include

- the chart of accounts;
- the general journal;
- general ledgers;
- bank statements;
- trial balances;
- debtors/creditors list;
- stock sheets;
- directors minutes (where these are available );
- trustees resolutions;

To assist in verifying particular transactions the auditor may also ask for

- receipts;
- delivery dockets;
- invoices; and,

- contracts.

## 4 When the audit has commenced

### 4.1 Voluntary disclosure

You will always know when an audit has commenced because the ATO officer will tell you so. It matters little whether an audit has commenced or not.

A voluntary disclosure should be made immediately an error or misstatement has been identified. One realises that there are white, grey and black errors, but where those errors are clear there must be disclosure. The tax agent does not have the luxury of choice.

We are all familiar with the grey area and under current thinking, so long as the tax agent points the grey area out to the client and gives the client a choice, then disclosure is not necessary unless the client so determines.

A tax agent's obligation under the Tax Agents Services Act is a cornerstone for the tax agent's responsibility. Besides if you do not disclose errors then the penalties jump the scale and guess who may be sued?

Grey areas will frequently arise. For example, a sale of the shares in the client's company has occurred during the period under audit and the client is unable to give you evidence that all of the shares were acquired before September 1985. The reason for this is that the records are inadequate and there clearly has been some shares issued during the mid-1980's. The question is whether or not to disclose this fact to the ATO auditor or to steer the enquiry away from this issue?

### 4.2 Control of the audit process and information flow

The client should appoint one person to act as the focal point of contact with the ATO and for the funnelling of information to and from the ATO. One person must know everything about the audit and the information. Ideally, that person from the client's team should identify and come to an agreement with an ATO officer to adopt a similar role. It is then up to the taxpayer's team leader to maintain a dialogue with that ATO representative.

Managing the information and preparing and delivering the factual position to the ATO is probably the most critical of all functions that should be managed at the time of the audit.

### 4.3 Information required

An important aspect is to determine what information is available from the records of the client that revolve around the issues under examination by the audit.

Just to take a fairly simple example, say the audit is involving travel expenses. First question is to find out what travel records have been kept over the period of the audit enquiry. Analyse those records personally. Do not take the opinion of an internal accountant that the records are complete and comply with the substantiation rules.

The tax agent should then check whether there is a PSLA or a ruling on those travel expenses and if so, read that ruling carefully and make sure that the records kept comply with that ruling. If the answer is that the records are deficient, then work out what can be done to rectify the shortfall of information. Perhaps obtaining duplicate invoices, obtaining travel diaries and travel agent itineraries. But it might be trite to say it, you need to have the documentation in good order to hand over at the time of the audit when requested.

There are three types of facts:

- Background facts - which just set the scene.
- General facts – about the circumstances covered by the audit.
- Critical facts – these critical facts will be what, if needed, to satisfy the onus of proof should the audit escalate into Tribunal or Court proceedings. But the tax agent must always have their eye on what are the critical facts in answer to the ATO queries and issues. It is the communication of these critical facts which will turn the possible failure of an audit to success.
- By way of an example: If there was an FBT audit in respect of motor vehicle expenses, the key question and foundation question, is whether that motorcar was provided “*In respect of employment*” (section 136 of the FBTAA). The critical factual position might be documents showing who controls the employer, what is the use of the car and its relevance to the business and its relevance to the employee and its relevance to the employees remuneration. Documents determining the remuneration of the employee and how that compares to employment terms and conditions for employers in similar activities, either within the same employer or with different employers and whether there was documentation showing between that remuneration and the employment.

## 4.4 Position Paper

If you are lucky enough to be in position after a review or an audit of a position paper, you will have the opportunity to see at what factual circumstances have been relied on by the ATO. It is of great importance that any errors in the position paper be pointed out to the ATO and acknowledged and if possible corrected.

The growth in the use of position papers is a good thing in the ATO. The difficulty is that the ATO officers quote large slabs of rulings and or PSLAs to substantiate the conclusions they have reached. This causes two problems. The first is that the ATO officers give the weight of law to such rulings and PSLAs. These rulings of PSLAs are only a guide in understanding the critical factual positions, would be able to demonstrate to the ATO officers, a degree of relevance that should be afforded the ruling or PSLA.

It would be a great advance if position papers were written by an independent body which was part of the ATO framework, but quite separate from the audit teams.

## 4.5 How should you respond to an ATO position paper?

The thing you should do upon receipt of an ATO position paper is to review the paper as thoroughly and as carefully as possible, identify any errors of fact and questionable interpretations of law.

The next step is to decide whether or not to respond to the position paper. There are two questions to be considered here:

1. Do you want to correct or add to any of the facts set out in the position paper?
2. Do you want to respond to the ATO's position on the application of the law to the facts?

When making these decisions, you need to bear in mind as to where your response to the position paper fits into the overall process within the ATO. Any response to a position paper you provide will go to the audit officer who wrote the position paper. They will consider your response, and then make their decision whether to issue an assessment. If they decide to issue an assessment they will create written reasons for their decision, which are kept on record at the ATO. If you lodge an objection to an assessment, then the written reasons go to the ATO officer who is considering the objection. In essence, the written reasons for the decision present the "for" case for making the assessment, and your objection presents the "against" case.

If you make no response to a position paper, the written reasons for the decision will most likely be much the same as the position paper. If you do respond to the position paper, and that response fails to change the ATO officer's view that an assessment should be issued, then any written reasons will take into account your response to the position paper.

As mentioned elsewhere, cases are more often than not won on facts not law. For this reason, if there are any significant facts that the ATO have wrong or have failed to include, you should correct those facts. Similarly, you should consider whether there are any relevant facts that the ATO is simply not aware of. This may be the case particularly where the position paper introduces a new argument that had not been raised earlier in the audit process.

If there are any significant facts wrong or omitted from the position paper then you should respond to the position paper to correct or introduce those facts. Even if this will not change the ATO's position and prevent an assessment being issued, you will have at least tried to correct the record. This can influence how the facts are presented in the ATO officer's written reasons for the decision, which can in turn affect the outcome of any objection.

There is generally no disadvantage in correcting the facts, so there is a strong case for responding to a position paper to correct the facts.

When it comes to the ATO's interpretation of the law as it applies to the facts, the question whether or not to respond is not as clear cut.

An important point to remember here is that your response to a position paper will go to the ATO officer who wrote the position paper. It is natural for any person to be inclined to think that their position is correct, especially where they have spent a number of hours forming that position and committing it to writing. This natural inclination is most likely enhanced by the fact that by this stage the audit officer has put a lot of time and resources into the audit, and may not want to come out of it empty handed. Added to this is the fact that once the ATO has come to a position on a point of law it is notoriously difficult to convince it that it is wrong, as evidenced by the number of ATO rulings that the Commissioner has neglected to withdraw even in the face of adverse court decisions.

A further complication is the measure of performance that the ATO officers now need to meet. The pressure placed on ATO officers in respect of 'KPI's' (key performance indicators) is in the authors' view not generally recognised. In particular, if an ATO officer has met his KPI's in conducting the audit and issuing the position paper it is difficult for that officer to reverse his position on a response to his own position paper if that then impacts on the performance criteria previously achieved. The role that KPI's have is in the authors' view little understood and could play a significant role in the expansion of contested issues arising through the audit process. This leads to inefficient tax administration and greater costs to taxpayers generally.

In short, you are either very lucky or very skilled if you are able to produce a response to a position paper that successfully persuades the author of the paper to change his mind on a question of fact let alone an interpretation of the law.

This being the case, it may not be worth responding to the Commissioner's interpretation of the law at all. Instead you can wait until the Commissioner makes a decision (usually by making an assessment) and putting your legal argument in the objection to the decision.

One advantage to this approach is that it does not reveal your argument to the ATO until the objection stage, when it will be considered fresh by a different ATO officer in a different department (sometimes in a different state) who has no personal stake in the arguments presented in the position paper. Another advantage is that it takes away from the audit officer the opportunity to respond to your argument in their written reasons for the decision by presenting a counter-argument. This may weaken the "for" case presented to the ATO officer making the objection decision.

For these reasons, it may only be worthwhile responding to the interpretation of law in an ATO position paper if there are genuine prospects of changing the audit officer's mind on the interpretation.

## **5 Inherent Conflict**

It is not a surprise for anybody to say that there is an inherent conflict between the tax office and the taxpayer and their agent. While the ATO is only interested in collecting the correct tax, not a dollar more and not a dollar less, that is not the perception held by taxpayers or tax agents.

The perception is that the ATO looks to maximise its revenue gathering and takes a hard line in grey area disputes. But the harshest and most inherently conflicted position rests with penalties and GIC. By way of an example, a taxpayer did not pay PAYG withholding on staff employed from 1999 through to 2003. There was justification for not paying such PAYG in that there was a dispute

between the taxpayer and his brother as to who was responsible for the PAYG. In the end it was not paid. The amount of the PAYG was something in the order of \$20k. With GIC and penalties that has grown to over \$150k.

In another example, where there was a failure to disclose income of \$20 million over an eight year period from 2002 to 2008 the debt with penalties and GIC has grown to \$45 million. The compound in nature of GIC and the ability to impose 50% (reckless), 75% (disregard) and a 20% non-cooperation uplift is totally crippling, particularly when the original tax debt is disputed. What about where the ATO is taking a harsh view when the law provides for a Commissioner's discretion. Wherever there is a Commissioner's discretion, should not that discretion be applied with the benefit of doubt to fall with the taxpayer.

A good example would be where there is an excess contribution to a superfund, because there was a mix-up between a payment made on say the 30th June 2012 but the funds did not arrive at the superannuation company until the 1st July 2012. The Commissioner has the discretion but appears to rarely exercise that discretion to allow the 1st July 2012 receipt to belong to the 30th June 2012 year. Why would the Commissioner not exercise his discretion easily in favour of the taxpayer?

The Commissioner always says that the key focus is protection of revenue and the treating of taxpayers equally. Why is that such a focus when Parliament has given the discretion? If all taxpayers had to be treated exactly the same, then there would be no need for a discretion.

## **6 Specific answers to questions raised in the program**

### **6.1 What happens from the moment the ATO makes contact?**

The tax agent goes into review mode, checking to ensure that the client's tax position has been properly recorded for the period under audit.

The tax agent allocates one person to head the audit information and response team.

Make sure that the questions from the ATO officer are put in writing and are answered in writing.

Keep good relationship and good communication contact with the ATO officer.

Continue to satisfy their questions and needs no matter how repetitive.

### **6.2 How to ensure your client's rights are protected?**

- Ensure that legal professional privilege and the accountant's concession are not breached.
- Where there has been misstatement or possible fraud, to make sure that legal advice is obtained so that no admissions are made by the client or the tax agent.

### 6.3 What do you need to be on guard against?

- Providing inaccurate or incomplete information.
- Not maintaining a cordial relationship with the ATO officers.
- Not giving ATO officers a feeling that the tax agent is honest in the information provided.
- Not understanding the particular factual position or legal position which will discharge the onus of proof if the matter ever went to a Tribunal or Court.

### 6.4 Determining whether an audit has commenced

- The ATO believe the audit commences with the interview.
- In my opinion the audit commences when the ATO ask a question about a current or past transaction or position.

### 6.5 What are your choices once the audit has commenced?

- There is no choice. The taxpayer's position should be put as clearly as possible, with evidence of the factual position. That position needs to be communicated.

### 6.6 Should you make a voluntary disclosure and when?

- Yes, a voluntary disclosure must be made as soon as it is clear that there is a misstatement or error which will lead to a tax shortfall. For that matter, even where there is no tax shortfall.
- Waiting for a review or an audit before making a voluntary disclosure is foolhardy.

### 6.7 How should you respond to an ATO position paper?

- As thoroughly and as carefully as is possible.
- Every error, particularly factual errors should be highlighted and responded to.
- An interview with the ATO officer and their team leader should be arranged for the purpose of explaining the errors of fact and law. It should not be assumed irrespective of the length of the position paper, that the ATO officer has considered all of the facts and legal position. Frequently the ATO officer does a cut and paste analysis of the factual position supplied (but perhaps missing an important element) and cuts and pastes from rulings and PSLAs which may or may not be applicable.



## 6.8 Tips and best practice during the review and audit process?

- Preparation of the materials to support the client's contentions, communicating the client's position and cooperating with the ATO officers is best practice.

## 6.9 What to do if things are starting to stall?

- Seek to have the matter escalated to a team leader or director level.
- Seek an interview.
- Make a formal complaint through the ATO's complaint section.

## 6.10 Fact Finding

- This is critical. If there is a difference between the correct facts and the ATO then resolution of any dispute would be difficult. Both the tax agent and the ATO must be on the same page.

## 6.11 Control managing stakeholders and the ATO

- The stakeholders are your client and the ATO. Managing your client is a matter of explaining why the audit has occurred and how you will be able to resolve that issue with the ATO. It is then for the tax agent to keep the client up-to-date as to the issues being raised and resolved during the dispute.
- When it is clear that the dispute will not be resolved, then explaining to the client the processes through to the Tribunal or Court Appeal.
- Estimating costs for the client is not an easy task as the whole exercise is an information providing exercise. Seeking clients to pay monies to a trust account and providing regular monthly invoices setting out precisely the work undertaken, is a way that the client will be able to gauge the risk or reward.

# APPENDIX

## AUDIT OF SPECIFIC ITEMS

### SALES

#### How do you record for cash sales?

Where there is a possibility that the business makes cash sales, the ATO will most likely ask what the procedures are for recording cash sales. They will ask:

- Is it on a daily basis?
- Are amounts taken out of cash and used to purchase goods? (or used for other purposes) Is this added back to sales before being recorded as daily sales in a cash book?
- Who does the cash sales and the reconciliation of daily takings? Who does the banking, and how regularly? If it's the one person there is the possibility of undeclared sales.

They will be looking for practices such as:

- car dealers where cheques were received for half the sale price of the car (this was naturally recorded in the books of account) and the balance was received in cash, and surprisingly not recorded as a sale
- a cleaning company that received proceeds from cleaning large office complexes where the funds were deposited direct to the owners account.

In many instances a sales docket/invoice is prepared to record the sale prior to it being entered as cash receipts. If this is the case the ATO will want to test check the sales dockets/invoices, and will look for invoices not being consecutively numbered, missing, altered or cancelled pages, and the frequency of recordings.

The ATO will check the accuracy of trade debtors with the individual debtor balances.

#### Checking flaws in computerised accounting packages

Most taxpayers maintain computerised records with double entry recordings. Accordingly all sales should be recorded in the cash receipts or sales journals and then posted to the ledgers. If you suspect that there are flaws in the computerised accounting package you may need to audit through the accounts. This can be done two ways:-

- Trace a sale through the accounts; or,

- Create a dummy transaction and get the taxpayer to show you the process of how it is recorded from a sales invoice into the journals and ledgers into the taxpayer's bank account.

Debits to the sales ledger. What are they?

Look for any debits made to the sales ledger as this will reduce the Gross Income for income tax purposes, ask why this transaction arose.

These debits may arise because goods were returned. If that is the case check to ensure the goods were delivered back into the warehouse. A discount for prompt payment may be allowable to the client, check the terms and conditions attaching to the sale. You may want to contact the customer to verify the sale depending on the quantum involved, the return of the goods or the discount he obtained on payment for the goods.

Other debits may arise as a result of balance day adjustments or the reclassification of sales as unearned income. You may need to check the explanation for this.

Evidence of bartering transactions.

Sometimes the taxpayer will enter into bartering transactions. The taxpayer is likely to deny this. Where this is evident the auditor may need to check with the other party to the transaction to get a valuation. Sometimes this can be determined because the other party to the trade will try to claim a deduction for his costs.

A review of the Gross Profit or Net Profit Margin may also give you an indication that something is not right.

Check the tax reconciliations to see why sales have been reduced.

## PURCHASES

How are purchases determined?

- Check that purchases have been incurred
- Check that private expenses have not been included in the purchases figure. Amounts larger than or disproportionate to the value of the taxpayer's normal purchases could indicate that these items are of a private or capital nature.
- Check that closing creditors from the previous year have been reversed and excluded from this year's purchases.
- Check the accuracy of trade creditors at end with the individual creditor's balances

Verifying the deduction for purchases.

The following procedures should be followed to verify purchases :-

- check the purchase invoice to the creditors balance.
- was the purchase incurred in this financial year?

- was it from a regular supplier to the taxpayer? Unusual suppliers might indicate it was not a purchase.
- check purchases in favour of suppliers at irregular intervals. Accounts are usually paid monthly. This might indicate private or capital expenditure.
- if you are unsure that the purchase was made in the year subject to review check the delivery docket. Invoices are raised on or after delivery date not before. Check the delivery docket to see if the item was delivered to a business premise or to a private address. Cross check it to the stock take sheets to see if it was declared as stock on hand at end.
- ensure the invoice clearly indicates whom was invoiced and the amount payable.
- Check that purchases are not from related parties at inflated prices, this may be a method for the profits to be shifted to the other entity.
- An inflated purchase may also be an indicator that there may be “kickbacks” to the purchaser in some form. This is unlikely to be declared as income or as a reduction to expenses.
- Check accrued expenses to see if the taxpayer was definitely committed to the expense and that it is quantifiable with reasonable accuracy.
- Check to ensure that the same invoice hasn't been entered twice. Cross check to see if these invoices have been paid, if so to whom.

## TRADING STOCK AT END

### Auditing trading stock

An understatement in stock at end will have the effect of reducing Gross Profit and ultimately the taxable income figure.

Test checks of invoices should be undertaken as stock purchases are usually one of the biggest expense claims of any business. Check that the purchase is from a regular supplier, that the goods have been delivered to a business premise and not to a private address, and that the invoice clearly states the item purchased and its cost. Above all remember, you can confirm these purchases by contacting the supplier.

Taxpayers employ either a perpetual stock system in their accounts or they will usually perform a stock take on the 30th of June. A perpetual system records sales and purchases of stock contemporaneously so that in theory the taxpayer knows what type and how much of a particular item is on hand at a point in time. A physical stock take at the 30th of June in conjunction with the perpetual stock take will allow the taxpayer the chance to adjust his stock valuation to allow for thefts, obsolescence, and spoilage etc.

When counting stock, goods in transit (inwards where you have the right to sell it and outwards where it's moving between the taxpayer's premises), or on consignment must be included. Where you hold goods on consignment they are generally NOT your trading stock unless you have the power to

dispose of them via a sale. Cars held on a floor plan (ie they belong to the manufacturer until sold) are your trading stock, see IT 2472.

Where a stock take has been done as at 30th of June the following checks should be undertaken:-

- check to see what policies the taxpayer has in regards to the physical stock take. The policy may indicate that some types of stock are not to be recorded.
- check to see that all business sites conducted a stock take ( the initial interview will indicate from which sites the taxpayer conducts his business).
- check that large purchases near the 30th of June show up in the stock take. As mentioned previously goods in transit and on consignment should be included as trading stock on hand.
- check that all stock sheets have been provided to you and do a line item check to determine that the correct value has been used in determining the value of that particular stock on hand. Total the stock sheets to check the arithmetic accuracy.
- check the selling price at or near years end with the market selling price used by the taxpayer in his stock take.
- The auditor should also look for large or numerous stock write downs and verify why this has happened.
- Lastly walk the factory/whare house floor and see what they do with obsolete stock. Check sales invoices involving this obsolete stock to determine the sales price and frequency of sales. It may turn out that it's not obsolete or that it was written down too aggressively.

#### Valuation of stock

As mentioned previously stock can be valued at cost. Where this is the case cost includes fixed and variable costs incurred in producing and bringing the stock to a location that does not form part of the selling location. Thus for a manufacturer, cost includes for example the rent on the factory producing the stock, rates and taxes on the factory, depreciation on a factory, salary, wages, payroll tax applicable to the wages of the production staff, sick leave, annual leave etc of the production staff, fuel oil used in the production process that forms part of stock, raw materials etc.

Items forming part of the stock, eg labels, packaging etc are part of the stock on hand. Returnables like packing crates are not stock on hand.

Costs involved in storing finished goods are not included in the valuation of stock on hand at end.

For a more detailed discussion refer to IT 2350 and TR 2006/8.

There will be times when the fixed and variable costs have not been taken into account in determining stock on hand at end.

How will you allocate these costs that have been claimed outright?

A rule of thumb calculation can be made along the following lines. Total the costs that were incurred in producing the goods and then work out the stock turnover ratio. This will tell you how many times a

year the stock was turned over a year. So if stock was turned over say 12 times a year then 1/12th of the costs would still be recognised in stock on hand at years end. Thus 1/12th of the total cost is included in the stock valuations. Alternatively convert the ratio into days eg stock is turned over every 30 days and then include all production costs incurred in the last 30 days into the value of stock on hand.

Where you cannot determine the cost of each item of stock produced, or made, you can value stock on the

- FIFO method – Under this method, items first purchased are assumed to have been disposed of first. The cost of the trading stock on hand at the end of the year of income is considered to be the cost of the items most recently acquired or produced.
- Standard cost method - predetermined standard costs are used to value the stock. This method is acceptable if the standards are updated regularly.
- Average cost method – stock on hand is valued using weighted average costs. This method will need to be carefully examined as the longer the period between updating the weighting calculation, the more likely an undervaluation of stock.
- Retail inventory method – This method is based on the premise that retailers generally apply a constant percentage mark-up on their goods. In the course of the stocktake, goods are shown on the stock sheets at their retail selling price and the total figure obtained is reduced by the percentage mark-up to arrive at cost price.

Stock on hand can be valued at its market selling price. Thus if you are a wholesaler you use the normal wholesale price charged to a customer (not a forced sale price). If you are a retailer, you use the normal retail price charged to a customer. The stock on hand figure can be verified by looking at sales invoices raised for the stock item towards the end of June. If no sales were made in June, check the sales price in July of the following year.

Stock on hand can also be valued at its replacement value. This means it's the cost to the taxpayer of buying similar stock in his buyers market.

#### Obsolete Stock

In special circumstances you can elect to value your trading stock below the values mentioned above. This occurs where stock becomes obsolete. This is a common method used to reduce Gross Profit. Some factors to take into account will be the quantity of the product written down and by how much it was written down by.

Where the item is material determine the real value of the stock. Check the last time this item of stock was sold, its selling price, whether or not the taxpayer is still buying/producing this type of stock, whether or not a competitor is still making/selling the same type of product etc. Does this type of stock have a scrap value, if so this should be its value at years end.

## REPAIRS & MAINTENANCE

The ATO will be looking to see whether an improvement or a replacement has been claimed as a repair. The taxpayer will either claim it in one lump sum in the ledger or may obtain an itemised invoice and claim the constituent parts in the repairs ledger or through various other ledger accounts. The checks that the ATO will make will be to look through the Business Activity Statement for any capital purchases made during the year and trace it to a ledger account. If it can't be done the possibility exists that it has been broken up and spread through the various ledgers.

Where the expense has been broken down into its constituent parts, look for rounded amounts and for annotations to the ledger transaction with the same names.

Always obtain the invoice to verify the deduction. Furthermore to verify that the work was done on a business site and not a private property you may want to look at the delivery docket for the site the materials are delivered to.

## BAD DEBTS

How does the ATO verify that a debt is bad?

Depending on the size of the entity the ATO takes the view that there should be a written policy that determines when to write off a debt. One check the ATO will do is check that policy against the payment terms of the sales invoice to see if the write off complies with these terms.

Where a debt has been written off but the taxpayer still trades with that debtor then the ATO could conclude that it is not a bad debt.

The ATO adopt a view (incorrectly) that if legal action is still being undertaken then the debt is not considered to be bad.

The ATO in auditing bad debts will

- Match the sales invoice to the sales journal or ledger account to ensure it was actually brought to account as income in a year. Match the GST Payable account amount to the journal/sales ledger transaction to ensure the sale was actually declared.
- Check the debtors' ledger and bad debt ledger to see when the bad debt was written off. A write off will be indicated by a credit entry to debtors ledger account and a debit entry to the bad debt account. As GST will have been payable on the original sale to the ATO the write off will entitle the taxpayer to claim back any GST originally remitted to the ATO. Check the date this occurs (and the BAS statement this occurs on) with the date of any write down occurring. Check if there are further debit entries to the debtors ledger to see if the taxpayer is still trading with this debtor, if so why and are the terms different.
- Check the directors' minutes to see when the decision was made to write off the debtor. (This may indicate a write off after the 30th of June which is then recorded in the ledgers as before the 30th June). Check this against any bad debt write off policy the entity may have. If the write off does not conform with the policy why not?

- Ascertain what action the taxpayer takes to recover the debt. The taxpayer will usually hold a file on the debtor which will detail action taken. Match the date on the last letter to the date the debt was written off and the directors' minutes, if available.
- Finally note that a provision for a doubtful debt is NOT an allowable income tax deduction, the debt must have actually been written off as bad to be considered deductible.

## POOR ECONOMIC PERFORMANCE & ALL OTHER EXPENSES

### Economic Performance (Return on Investment)

If the ROI is currently (and also in the previous 2 years) 3% or less then the ATO will take the view as to why the taxpayer does not sell up and put his money in a term deposit? They will ask why does the business continue to exist?

The taxpayer's financial statements will also help the ATO determine why the ROI is so low and what if any income tax issues may require our attention.

### All Other Expenses

As most tax returns contain an "All Other Expenses" (AOE) item accordingly the ATO will want to understand the nature of deductions claimed and require more details.

### Reviewing poor economic performance

The review of Poor Economic Performance cases will generally have to be done before cases are selected for audit. If this is not the case the auditor will undertake a review keeping in mind the ratios discussed in the paper above.

### Reviewing all other expenses

The possibility exists that under the heading of AOE there will be one or two large deduction claims, for example Management fees, R&D deductions etc.

The following checks will probably be undertaken by the auditor:-

- A check of the journal and ledger entries to see when a particular entry was first made.
- A check to see if it was, at any stage, moved out of a suspense account. An initial entry into such an account will highlight that the taxpayer did not know how to treat this item when it arose. It will indicate that there is a categorisation issue, was it a capital/revenue issue, was it assessable in whole or over an extended period, was it a revenue/capital expense etc.
- Check the relevant invoice and date to match the date it was initially entered into the books. This could indicate an issue as mentioned above but will also tell you if the accounting transaction evidences a contemporaneous transaction, if it doesn't the issue will definitely warrant closer attention. Check that the transaction evidences the terms/conditions mentioned in the contract.
- A large transaction may very well have a contract behind it to evidence the transaction, read the terms and conditions of the contract, it may very well tell you when the CGT event took



place, or when the income can/must be recognised, or whether or not the expense is on revenue or capital account. A reading of the contract will also tell you what if any services are to be performed for the income to be derived/expense to be claimed. Who performs the service, the income may very well be personal services income. Check to see if the transaction was between related entities and was at arm's length. Did the taxpayer obtain a valuation to justify the figures in the contract? Obtain any valuation document supporting the contract figures, read it carefully and look to see what if any questionable assumptions were made in the report that may have been used to substantiate the contract figure. Lastly check the date the valuation report was prepared and compare it to the contract date, if it was prepared some time after the event, why.

#### OTHER TIPS

The auditor must remember the basic principles that in practice where there has been a transaction by the business entity the transactions will be posted firstly to the Journals, then the Ledgers. When the ledgers are ruled off at the end of the year a trial balance is created and from this the Profit and Loss and Balance Sheets are created.

Journals will contain balance day adjustments and accrued expenses and may contain accrued revenue.

There may be more than one trial balance created before the Profit and Loss and Balance Sheet is finalised. A review of all the trial balances will indicate which accounts have been adjusted and therefore which ledgers may need to be looked at more closely.