RISK MANAGEMENT

RISK MANAGEMENT PROCESS FOR TAX AUTHORITIES

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INTRODUCTION

In an ideal law-abiding society, people would pay the taxes they owe. Revenue authorities would only facilitate citizens to carry out their responsibility. That would be excellent!

No such society exists.

Compliance with tax laws must therefore be created, cultivated, monitored and enforced in any society.

The objective of risk management is to enable tax administration accomplish its mission by helping management make better decisions.

INTRODUCTION

Risk management is a structured process, consisting of well-defined steps:

- ❑ **Systematic risk identification**
- ❑ **Risk analysis**
- ❑ **Risk evaluation**
- ❑ **Risk prioritization**
- ❑ **Risk treatment**
- ❑ **Risk monitoring and review**

Risk Management guides us in making the best possible choices each time we have to make decision.

INTRODUCTION

Risk management is a deliberate choice with cogent arguments for and against.

Usually, this can be seen as a human instinct. For instance, when we have to make a choice between the different line-ups at the polling station, where we detect the shortest line.

Revenue authorities have to deal with large number of risks. For example, risk of non-compliance including risk of tax fraud or risk of weaknesses in the revenue authority.

INTRODUCTION

The term 'risk management' can have many different meanings but all have one thing in common:

- **It helps us treat risks which threaten our objectives and also provides us with a level of assurance for our actions.**

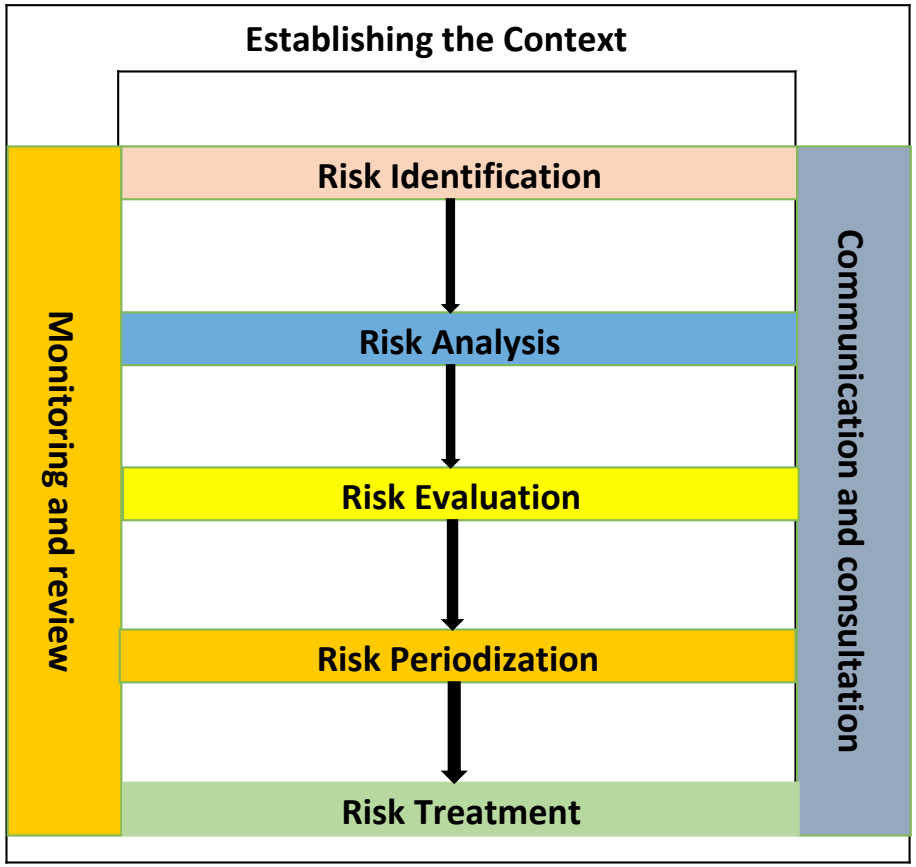
Risk management helps to identify the different steps in a decision-making process and allows us make explicit and more educated decisions.

INTRODUCTION

Risk management also helps us to:

- Achieve equal treatment of taxpayers;
- Focus the burden of audit to non-compliant taxpayers;
- Best use of the available resources;
- Increase the level of voluntary compliance;
- Adjust available resources to the level of risks; and
- Be aware that a compliant taxpayer could become noncompliant.

INTRODUCTION



ESTABLISHING THE CONTEXT

The operating context defines the objectives, scope, strategies and the internal and external influences on the organization.

Objectives define the general goals that the organization exists to achieve.

Scope defines the nature and extent of products or services and geographical coverage.

Strategies are course of actions that the organization adopt to achieve its objectives.

ESTABLISHING THE CONTEXT

Compliance risk management can only be discerned within the operating context in which the tax administration takes place.

Establishing the context sets the boundaries within which compliance risk mitigation strategies can occur.

The context needs to be continually monitored in an effort to detect changes that might consequentially affect compliance risks.

ESTABLISHING THE CONTEXT

In practice, many factors may directly bear on compliance risk management. For example:

- **Limited financial resources that may substantially affect capacity to deal with major compliance risks identified;**
- **Weaknesses or shortages in staff skills and capacities that may seriously impede ability to deal with certain major compliance risks; etc.**

ESTABLISHING THE CONTEXT

Key factors in the operating context may include, (not exhaustive):

- **Objectives, strategies, policies, processes and procedures;**
- **Cultural and socio-economic factors;**
- **Laws and regulations;**
- **Health of the economy;**
- **Advances in information technology and globalization;**
- **Relationships, perceptions and expectations of stakeholders;**
- **Public opinion and perceptions;**
- **Organizational capabilities, resources and**

RISK IDENTIFICATION

Risk identification is the systematic recognition and description of potential events and vulnerabilities that pose threats to objectives.

Risk identification can be a top-down techniques, such as macro-economic analysis or bottom-up processes such as case-based risk identification.

Appropriate client segmentation is fundamental to achieving a thorough identification of risks.

RISK IDENTIFICATION

Risk identification begins be determining the compliance gap – the difference between the potential compliance level and the actual compliance level.

The aim of risk identification is to identify the specific risks that a revenue authority must confront as comprehensively as possible, minimizing the possibility of oversight and facilitating subsequent in-depth analysis.

RISK IDENTIFICATION

Risks identification at the strategic level requires extensive and carefully managed interventions, whilst those at the operational level can be dealt with as day-to-day business.

Consideration of existing tax legislations often represents the most appropriate place at which to begin identification of strategic risks.

This needs to be supported by evidence-based policymaking, treatment strategies and quantification of revenue at risk.

RISK IDENTIFICATION

Most tax laws throughout the world are of a highly prescriptive nature and tend to cover all possible consequences.

Unfortunately, it is rare to be able to conceive all possible situations that might arise based on the application of the law.

It is therefore almost impossible to create a law that is both clear and entirely unambiguous.

RISK IDENTIFICATION

This ambiguity provides scope for non-compliance as taxpayers seek to operate in those 'grey' areas of the law.

There will always be taxpayers determined to identify and exploit the gaps in the law in their efforts to gain personal advantage.

In addition, prescriptive legislation tends not to allow sufficient flexibility to keep pace with developments in the business community.

RISK IDENTIFICATION

Risk identification often entails identifying matters that, if left untreated, could pose a risk to the long-term viability and sustainability of revenue collection.

At the case-based or operational level, the aim is to identify individual cases or taxpayers that represent specific examples of clients who collectively make up the strategic level risks that the revenue authority is proposing to address.

RISK IDENTIFICATION

In case-based or operational systems, the characteristics of selected taxpayer and account transactions are examined to produce an objective measure that reflects the comparative level of risk that is posed by that taxpayer relative to other taxpayers.

Some case-based systems identify the type of risk involved and may estimate the amount of tax revenue that is at risk.

However, on its own, the value of a single piece of data in determining a compliance risk is somewhat questionable.

RISK IDENTIFICATION

Most commonly, it is analyzed from the perspective of the individual taxpayer.

However, it can also be analyzed from the perspective of an industry grouping, or from a socio-economic or even psychological perspective.

Many revenue authorities tend to segment taxpayer population into groups with similar characteristics and identify compliance risks at these segment levels.

RISK IDENTIFICATION

Knowledge	Intelligence	❑ Individual social/psychological behavior profile including client relationship management information ❑ Intelligence gathering tolls – local knowledge and business intelligence ❑ Rated using future probability of noncompliance	❑ Behavior based on industry, social/ psychological profiles ❑ Business intelligence – categorization and synthesis ❑ Monitoring risk populations ❑ Feedbacks from audit programs ❑ Knowledge based on rules ❑ Moderator/analyst capability	❑ Compliance context – strategic intelligence from environmental scans and scenarios ❑ Senior executive considerations ❑ Risk impact measured using reputation, costs of compliance and revenue
	Information	❑ Integrated databases – centralized case selection process ❑ Taxpayers profiles of tax obligations ❑ Success criteria – e.g. previous audit results, risk indicators/ ratios, etc ❑ Public information – e.g. utilities, law enforcement agencies ❑ Rated using weighted attributes	❑ Whole of tax population profiles including views by segments ❑ Tax issue profiles ❑ Third party information used ❑ Technology tools enabling data matching ❑ Resources allocated by risk ❑ Trend analysis ❑ Confidence ranges/reliability indicators attached to risk ratings	❑ Macro-economic information, economic time series ❑ Effective average tax rates ❑ Multiple taxes profile ❑ Corporate risk culture
	Data	❑ Single case by case selection using tax return data ❑ Processing checks – e.g. high risk refunds or credits ❑ Paper-based selection methods	❑ Industry tax profiles ❑ Technology tools enabling case selection based on tax data – e.g. data warehouse ❑ Comprehensive risk coverage including register, file, report, payment, etc. ❑ Deviations from populations norms	❑ Data mining ❑ Automated exception cases ❑ Macro level statistical analysis ❑ Neural networks
		Transaction/Case	Aggregated	Strategic
		Focus		

RISK IDENTIFICATION

In order to ensure that the most significant risks are addressed, the strategic risk identification needs to occur before operational or case-based risks are identified.

Just as environmental scanning sets the context within which strategic risks can be effectively identified, identification of strategic risks represents the context within which operational or case-based risk identification occurs.

RISK IDENTIFICATION

Strategic risk identification done through the continuous accumulation of data that is progressively transformed into intelligence and knowledge.

This data accumulation can often occur, in part, because of past operational risk treatments. Analysis of anomalies is a useful way to ensure continuous improvement in the risk identification process.

RISK IDENTIFICATION

Finally, good channels of communication between risk strategists and frontline compliance staff are necessary to ensure validation and identification of risks.

This two-way feedback process will enhance the overall risk identification strategy.

RISK ANALYSIS

Risk analysis is the systematic examination of detailed taxpayers information to discover patterns and common characteristics.

The number and category of risks and risky taxpayers, likelihood that the risk materializes and potential consequence on tax revenue are analyzed and grouped according to similar characteristics .

RISK ANALYSIS

Finding out what is occurring and who is doing it is not enough. Risk analysis should include the why question: what is the reason for non-compliant behavior in the specific areas.

This is important because it contributes to the assessment and the choice of the most efficient and effective treatment strategies.

For example, if the reason for non-compliance is the complexity of a specific part of the tax legislation, a possible treatment strategy can be education.

RISK ANALYSIS

Risk analysis is done on the bases of data gathered from different sources:

- **Economic and tax data, for example, ratio's about the economic growth, average wages;**
- **Data supplied by taxpayers, for example, tax return(s);**
- **Tax data acquired by administrations, for example, the date of last compliance activity, number of returns filed late;**

RISK ANALYSIS

- Data supplied by a third party, for example, a bank statement;
- Information from law enforcement agencies; and
- Information available on the Internet.

During the analysis, the risks are examined in order to discover essential components and features.

Risk analysis is performed by logically manipulating and matching data, human knowledge and intelligence.

RISK ANALYSIS

Data put together results in information that gives meaning. Knowledge is a deeper understanding of this information.

It is like a big jigsaw puzzle. The data are the pieces. When put together with the picture, information arises. With the understanding of the meaning of the picture, knowledge is born.

Data on their own have no 'value'. They get their value by being compared or related with others, often referred to as data matching.

RISK ANALYSIS

In risk analysis, specific knowledge is necessary and the use of techniques such as data mining and data warehousing acquire knowledge on EDP.

Development in automation means that possibilities in this area is wide open.

RISK ANALYSIS

Risk can also be analyzed at the operational, case by case level where frontline personnel examine detailed documents and data of a taxpayer.

Traditionally, when looking at registration risk, the aim of revenue authorities has been to ensure that anyone making taxable supplies is identified and registered at the appropriate time.

RISK ANALYSIS

It is imperative that checks are made to ensure that the applicant has a lawful reason to become registered.

As part of the registration process, a revenue authority may wish to compare a new applicant with such items as:

- **Other registrations at the same postal code;**
- **Known addresses;**
- **Mobile phone;**

RISK ANALYSIS

- Bank accounts;
- Suspect databases;
- Credit reference agencies;
- Other government department data, etc.

Early contact with a taxpayer to establish that he exists can be considered in an attempt to thwart fraud.

RISK ANALYSIS

Notwithstanding this, there are strategies for treating potential risks even before a taxpayer becomes registered.

These will include the provision of clear and helpful advice and education. A prevention rather than cure approach.

Except for advice and education regarding filing, payment and declaration risks, intervention can only take place when the possibility of a risk materializes and that is after registration.

RISK ANALYSIS

There are several opportunities for risk analysis. When returns from a taxpayer are received, it is possible to carry out a number of 'rule based' checks:

- **The inter-relationship of different figures on the return can be checked to test both accuracy and the credibility of the tax declared;**
- **The return received can be compared with previous returns submitted by that taxpayer to highlight apparent inconsistencies;**

RISK ANALYSIS

- Comparisons can be made with other taxpayers who have a similar profile (size, type of trade, mark up, etc.); and,
- Comparisons with industry, norms and standards.

These checks are particularly useful when a tax refund or credit is being claimed.

The results of any check will inform the decision process on the type of action needed to address the perceived risk.

RISK ANALYSIS

Sometimes the sources for analysis are not structured. In that case, the analysis has to be carried out as soon as possible after the data are obtained.

In the end, risk analysis results in the knowledge about one or more from the following areas:

- **The characteristics of the taxpayers involved;**
- **The reasons for taxpayer behavior;**
- **The likelihood or frequency of the risk;**

RISK ANALYSIS

- The indicators/ selection rules and parameters;
- The consequences;
- The trend, i.e. is the risk becoming more or less severe;
- Possible treatment strategies; and
- Cost of treatment.

RISK EVALUATION

Risk evaluation is a process of carefully assessing the likelihood, consequences and severity of risks identified and analyzed.

The central goal of risk evaluation is to facilitate informed and evidence-based decisions about risk treatment strategies and available resources.

RISK EVALUATION – Likelihood Measure

Risk Rating	Likelihood measures	Illustrative definitions to help determine the likelihood rating	
		Subjective definitions	Objective definitions
1	Rare	May occur only in exceptional circumstances	Likely to occur once in 25-50 years
2	Unlikely	Could occur at some time	Likely to occur once in 10-24 years
3	Moderately likely	Might occur at some time	Likely to occur once in the next 3 years
4	Likely	Will probably occur in most circumstances	Likely to occur more than once in the risk three years
5	Almost Certain	Is expected to occur in most circumstances	Likely to occur this year or at frequent intervals

RISK EVALUATION –Consequent Measure

Risk criteria	Consequence Rating				
	1 **Low**	**2** **Medium**	**3** **High**	**4** **Very high**	**5** **Extreme**
Revenue risks	Variation of..				
	Less than $50m	Between $50m and $250m	Between $250m and $500m	Between $501m and $1b	More than $1b

RISK PRIORITIZATION

Risk prioritization is the ranking of risks in terms of likelihood and consequences and prioritizing risks to be treated subject to available resources.

In practice, the prioritization requires the consequences and likelihood assessments to be brought together in an attempt to determine a relative rating of the risks.

RISK PRIORITIZATION MATRIX

Consequence						
	Extreme	High	High	Severe	Severe	Severe
	Very High	High	High	High	Severe	Severe
	High	Significant	High	High	Severe	Severe
	Medium	Moderate	Significant	High	High	Severe
	Low	Low	Moderate	Significant	High	High
		Rare	Unlikely	Possible	Likely	Almost certain
		Likelihood				

RISK PRIORITIZATION

It might be tempting to think that classification of identified risks according to a carefully constructed risk rating matrix is the end of the risk management process.

However, such confidence would be premature: risk prioritization cannot be reduced to an objective, mathematical science.

The initial rating must be revisited and confirmed following consideration of other relevant, perhaps contextual issues.

RISK PRIORITIZATION

In addition, compliance risk management is an iterative process and any one step in the process is influenced by other steps.

The context of the organization continually changes. This will lead to changes in risks. Some risks will reduce and new risks will emerge.

RISK TREATMENT

Risk treatment refers to actions and strategies taken by the organization to mitigate the potential likelihood and consequences of risks.

There are generally four risk treatment strategies:

- **Risk avoidance (mitigation) strategy means that the organization does not undertake the activity or make the decision which poses the risk;**

RISK TREATMENT

- Risk transfer (sharing) strategy means that the activity that poses risks is transferred to a third party;
- Risk acceptance (retention) strategy means that the organization undertakes the activity which poses risk by informed decisions; and
- Risk covering (reduction) strategy means that the organization takes steps to reduce the likelihood or consequences of specific risk.

RISK TREATMENT

Decisions about which risks to treat and which to monitor will potentially be determined by:

- **Internal capability;**
- **Is there an effective treatment;**
- **Is there an effective capability to implement the treatment;**
- **Risk rating and risk level;**
- **The rate of risk infection or risk rating deterioration;**

RISK TREATMENT

- The current return of treatment (recover revenue this year);
- The ongoing return of treatment (recover revenue in every year into the future);
- Public perceptions of administration around the risk;
- The cost and benefits of proposed treatments; and
- The wider context of the risks as a group.

RISK TREATMENT

Some good principles of proactive risk treatment strategies:

- ❑ **Build confidence;**
- ❑ **Act with fairness and integrity;**
- ❑ **Deal with taxpayers and issues directly, respectfully and failry;**
- ❑ **Pursue a flexible and customized approach;**
- ❑ **Make taxpayers' obligations clear;**
- ❑ **Make it easy to comply;**
- ❑ **Exercise sanctions when appropriate;**
- ❑ **Make power, authority, responsibility and activity visible;**
- ❑ **Provide incentives;**

RISK TREATMENT

- Bolster integrity through identifier, withholding and reporting systems;
- Promote effective record -keeping;
- Promote openness and accountability;
- Build partnerships;
- Escalate severity of enforcement;
- Take actions that are consistent with words (talk the talk and walk the talk); etc.

COMMUNICATION AND CONSULTATION

Internal and external communication and consultation with relevant stakeholders is important to effective risk management.

Internally, risk and control information should be communication with responsible parties to facilitate informed decisions and actions in carrying out their responsibilities.

In addition, there should be consultation with external stakeholders to get their involvement and participation in the risk identification and possible treatment strategies.

RISK MONITORING AND REVIEW

Risk monitoring is a continual check to determine the suitability, adequacy and effectiveness of risk treatment strategies.

Monitoring can be applied as a risk management framework, risk management process or risk management control.

It is important to note that risk treatment strategies can lead to new risks. For example, reputational risk posed by the transfer of a function to a third party.

RISK MONITORING AND REVIEW

There should be periodic review of performance to appraise accountability and responsibility of all stakeholders.

The results of risk monitoring and review are fed back into the risk management continuous loop and the cycle of risk identification through to risk treatment revolves.

CONCLUSION

- Risk management helps revenue authorities make informed decisions that facilitate achievement of objectives.
- Successful revenue authorities are those with the greatest number of voluntary compliance.
- Understanding why is as important as understanding what.
- Knowing the cause of risks helps determine effective and efficient treatment strategies.

CASE STUDY

A revenue authority is undertaking its risk assessment process to set compliance risk management objectives for the coming operating year. It needs to identify the risks and treatment strategies associated with the following segment of taxpayers:

- **Artisanal miners of gold and diamond.**
- **Foreign airlines with local branch offices.**
- **Petty traders operating in woodcrafts and arts.**
- **Fast food restaurants.**
- **Telecom companies.**

In a group of five persons, identify two strategic risks and two operational risks and treatments strategies for each segment of taxpayers

Thank You!