REPUBLIC OF THE MARSHALL ISLANDS

OFFICE OF THE AUDITOR-GENERAL

EVALUATION REPORT

Tax Auditing Program within Division of Revenue & Taxation, Ministry of Finance

AUDIT NO: OAG 04/11-2600

MAY 12, 2014
Date

P.O. BOX 245
MAJURO, MH 96960
REPUBLIC OF THE MARSHALL ISLANDS

REPUBLIC OF THE MARSHALL ISLANDS
Office of the Auditor-General
P.O. Box 245 ~ Majuro ~ Marshall Islands ~ 96960
Phone No. (692) 625-3390 ~ Fax No. (692) 625-5135 ~ Email Address: patrjun@ntamar.net
Website: www.rmioag.com

Hon. Jack J. Ading
Minister of Finance
Government of the Republic of the Marshall Islands
Majuro, MH 96960

Executive Summary

Dear Honorable Minister:

Enclosed herein is our report entitled "Evaluation Report on tax auditing program by Tax Auditing Office" within the Division of Revenue and Taxation.

The purpose of our evaluation was to assess the effectiveness of the tax auditing program by the Tax Audit Office to ensure that all businesses operating in the Republic of the Marshall Islands (RMI) have proper licenses and all taxpayers are paying the correct amount of taxes owed to the RMI Government. This review was conducted pursuant to the authority vested in the Auditor-General and in accordance with the Quality Standards for Inspections and Evaluations issued by the Council of the Inspectors General on Integrity and Efficiency of the United States.

As a result of our evaluation, we found that improvements are needed to ensure a more effective and efficient tax auditing program. More specifically, we found: roles and responsibilities of tax auditing staff are not clearly defined, lack proper maintenance of listing of businesses, tax audits are not completed in accordance with plan, there are risks involved in the current practice of selecting businesses for audit and thus business may not subject to scrutiny, and lack of proper maintenance and security of tax data. Additionally, we found that certain standard operating procedures have been instituted to guide the auditing staff; however, these procedures have not been officially adopted and followed consistently.

Pursuant to the Auditor-General Act of 1986, we provided the Secretary of Finance, Assistant Secretary and Chief of Revenue and Taxation with a copy of our draft report requesting their responses in writing. We also discussed our report during an exit meeting on December 20th, 2013. We appreciate the two set of responses

provided by the Secretary of Finance which we have included in our report as Appendix A and B.

The most important outcome of any audit or evaluation is the correction of past deficiencies and improvement in the operation. We believe that implementation of our recommendations is a step in that direction. This Office maintains a "Follow Up" system and in order for this report to be closed we would expect the actions detailed in Appendix D to be taken by your Ministry.

We wish to express our sincere appreciation to the Secretary of Finance, Assistant Secretary for Customs, Treasury and Revenue and Taxation, Chief of Revenue and Taxation, and their staff for their cooperation during the course of the review.

Sincerely,

Junior Patrick
Auditor-General

May 12th, 2014

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INTRODUCTION

Background

The Division of Revenue and Taxation within the Ministry of Finance is the Government of the Republic of the Marshall Islands (RMI)'s principal revenue collection and tax enforcement agency. The Tax Enforcement Unit (or Tax Audit Unit) was established within the Division of Revenue and Taxation in 2005 to implement provisions under the RMI Income Tax Act of 1989, as amended, found in Title 48 MIRC, Chapter 1, which requires all businesses operating in the RMI to have proper licenses and all taxpayers are paying the correct amount of taxes owed to the RMI Government.

The Tax Auditing Unit routinely performs audit of businesses to determine whether taxes payable to RMI Government are collected, reported, and paid correctly. The objectives of these audits conducted are to:

- Determine the voluntary compliance of taxpayers
- Ascertain the correctness of tax returns filed and paid
- Establish amount of tax liability (if any)

Tax Audit Office works closely and collaboratively with the Tax Compliance Office to determine and identify taxpayers that need to be scrutinized. The selection of taxpayers or businesses for audit is determined through review of past records, revenues reported and tax amount declared and paid, knowledge of business, and comparison with other businesses in similar size and operation. For each of the taxpayer identified for audit, the Tax Audit Office develops detail audit program and performs the audit. Findings resulted from tax audit reviews are reviewed by Chief of Revenue and Taxation who would then communicate with the respective taxpayer(s) for resolution in accordance with the relevant RMI tax laws.

In carrying out the tax auditing works, certain standard operating procedures (SOP) have been instituted to guide the Tax Audit Office or tax auditors. The SOP includes a compliance model to assist businesses and individuals to comply with their tax responsibilities and setting out a penalty regime where compliance does not occur. Additionally, on February 15, 2006, the Division of Revenue and Taxation through the Secretary of Finance entered into a Memorandum of Agreement (MOA) with the Marshall Islands Social Security Administration, Majuro Atoll Local Government, and

Kwajalein Atoll Local Government to enable parties to meet periodically to share information to improve overall compliance with RMI tax laws and local ordinances. Specifically the prime objective of the MOA is to:

- improve internal revenue generation in the RMI to promote fiscal stability;
- address the non-compliance tax issues in the Division of Revenue and Taxation of these four entities;
- improve the capability to control all businesses established in the RMI or the respective local government jurisdictions; and
- Coordinate closely a free flow of information between these entities to promote a more effective system of monitoring compliance to tax laws, regulations, ordinances and related requirements.

Since the establishment of the Tax Audit Office the total sum of approximately $3M in tax liability has been identified and recovered through its audit program. During our review, the Tax Audit Office has three staff; one (1) full time Auditor and two (2) part-time Auditors.

OBJECTIVE, SCOPE AND METHODOLOGY

Objective

The purpose of our evaluation was to assess the effectiveness of the tax auditing program by the Tax Audit Office to ensure that all businesses operating in the Republic of the Marshall Islands (RMI) have proper licenses and all taxpayers are paying the correct amount of taxes owed to the RMI Government.

Scope and Methodology

In conducting our evaluation, we reviewed tax laws, policies and procedures, taxpayer files, and interviewed personnel from the Tax Audit Office, Tax Compliance Office and management of the Division of Revenue and Taxation. We also examined business listings maintained by Marshall Islands Social Security Administration and Majuro Atoll Local Government for comparison purposes. We reviewed the financial reports and documentations related to gross revenue taxes and reconciled the amount to the amount reported in the audited financial statements for the RMI Government for the fiscal year ending September 30, 2010. We judgmentally selected taxpayers to determine if they have proper licenses and if their quarterly tax payments are reported and paid correctly. We also performed testing and walked-through the audit procedures being instituted and followed by the Tax Audit Office, and performed other tests that were necessary under the circumstances. Our evaluation focused on tax activities and tax audits undertaken by the Tax Audit Office during the period from October 1, 2009 through September 30, 2010.

Our evaluation was conducted in accordance with the *Quality Standards for Inspections and Evaluations* issued by the Council of Inspectors General on Integrity and Efficiency of the United States, and pursuant to the authority vested in the Auditor-General as codified under Title 3, Chapter 9, Section 903 of the RMI Revised Code, which states in part:

> "*The Auditor-General shall from time to time make such other audits of the government agencies, activities, contracts, or grants as are possible within the budget provided for him and he deems to be in the public interests….*"

Prior Audit Coverage

This is the first evaluation conducted by the Office of the Auditor-General on tax auditing program by the Division of Revenue and Taxation.

CONCLUSION

Based on our evaluation, we found that improvements are needed to ensure a more effective tax auditing program. More specifically, we found: roles and responsibilities of tax auditing staff are not clearly defined, lack of proper maintenance of listing of businesses, tax audits are not completed in accordance with plan, loopholes in the current auditing program, risks involved in the current practice of selecting businesses for audit and thus business may not subject to scrutiny, and lack of proper maintenance and security of tax data. Additionally, we found that certain standard operating procedures have been instituted to guide the auditing staff; however, these procedures have not been officially adopted and we found lapses in complying with these procedures.

Our findings, based on our evaluation, along with our recommendations are discussed in the accompanying pages.

FINDINGS AND RECOMMENDATIONS

Finding No. 1: Roles and Responsibilities are not defined clearly

We performed a review of the organizational structure of the Tax Audit Office and noted that there are no written roles and responsibilities for all three of the tax auditors. There exists an organizational chart that labels official titles of the tax auditors and where they fit in the organizational structure. However, beyond this there are no written roles and job descriptions to provide them with a clear definition and understanding of their role, function, and responsibilities. Evidently, the only written mechanism in place to guide the tax auditors to perform their day to day work are found in the standard operating procedures which generally lay out the procedures to perform tax audits. However, as reported in our Finding No. 6, the SOPs have been in draft form and yet to be officially adopted as working document of Tax Audit Office.

In addition, we noted one tax auditor (SS No. 04-211599) has an official title of Budget Officer I. It is our understanding that this tax auditor was formerly a budget officer and was transferred to become a tax auditor without a change to official title.

The effect of the above conditions may result in lack of understanding of job and tasks they are to perform and expectation out of them as individual, and can create disputes and misunderstandings over authority.

Cause: The cause of the above conditions is due to lack of policies and procedures requiring written roles and responsibilities for auditing staff.

Recommendation: It is recommended that the Chief of Revenue and Taxation and Assistant Secretary of the Revenue and Taxation Division work with the Public Service Commission to develop official job descriptions for each audit staff to establish clear line of work and responsibility and expectation. The job descriptions should be linked to the overall objective of the Tax Audit Division. We also recommend that:

- Upon creation of official job descriptions, formal orientations are to follow to ensure auditing staff are acquainted with their roles and responsibilities and the expectation out of them.

- Tax auditor with the title of a Budget Officer is given an official audit title in accordance with the organizational structure.

Finding No. 2: Improvements Needed in the Tax Audit Program

Improvements are needed in the tax audit procedures and processes currently being practiced by tax auditors contained in the standard operating procedures. The SOP lays out the process and tasks required to complete an audit. Two most important components of any audit function to ensure integrity and objectivity in planning, conducting and reporting audit works are independence of auditors and supervisory review of audit works.

Our review of audit procedures contained in the SOP revealed that auditors assigned to perform tax audit works are not required to disclose personal impairment or relationship with business owners or management which audits are performed. Specifically, we reviewed audit work papers of 4 audits and noted that tax auditors assigned to carry out the audits did not document personal impairments to indicate they have no conflicts of interest. Accordingly, it was not evident that such audits were performed without any impairment. Additionally, our review of work papers did not evident proper supervisory review of audit works performed by tax auditors contrary to what we were told. We also noted that audit reports indicated that the audits were performed in accordance with the *generally accepted government auditing standards* but ignored auditors' independence and adequate supervisory review, both of which are required under the standards.

The effect of the above conditions may affect the integrity and quality of audit works.

Cause: The tax audit procedures does not address auditors' independence and supervisory review of audit works, and are not performed in accordance with best auditing practices.

Recommendation: To improve the current tax audit procedures, we recommend that the SOP be expanded to include procedures to address auditors' independence declaration and supervisory review of audit works performed. Specifically, consider:

- Developing an Independence Statements that each auditor assigned to perform audit of business must fill out to indicate whether or not there are impairment issues. The Independence Statement should also contain a review section to be completed by the Chief of Revenue and Taxation.

- Developing supervisor review guide and checklist for use by supervisor in reviewing audit works.

We also recommend that Tax Audit Office familiarizes itself with requirements contained in the *generally accepted government auditing standards* to determine the

appropriateness of using those standards as basis to perform and report tax audit works.

Finding No. 3: Tax Audits are not completed within timeframe scheduled

Adequate resources are needed to ensure tax audits are completed in a timely manner. The objectives of the tax audit as indicated in the plan are to (1) determine the voluntary compliance of taxpayers (2) ascertain the correctness of tax returns filed and paid, and (3) establish amount of tax liability (if any).

During the period under review, the Tax Audit Office planned to audit 25 businesses within the span of six (6) months beginning April and ending in September 2010. Review of the tax payer files indicates that 3 of the 25 businesses were closed or no longer in operation. Review of the Audit Status Report indicates that none of the 25 businesses planned to be audited were completed during the 6 months period.

For comparative purposes, we looked at the 2009 and 2011 audit status reports maintained by the Tax Audit Office and noted also that number of businesses planned to be audited during those periods were also not completed in accordance with the audit plan, as indicated at Table A below.

Table A: Comparison of Audit Plan versus Audits completed

Fiscal Year	# of Business in audit plan	# of Business audited within FY (% completed)	Closed	# not audited within FY (% not completed)
2009	8	3 (37.5%)	0	5 (62.5%)
2010	25	0 (0%)	3	22 (88%)
2011	30	8 (26.67%)	3	19 (63.3%)

(Source: Revised Audit Status Report provided by Tax Audit Office)

The effect of the untimely completion of audit results in businesses not being scrutinized in a timely manner which means there may be tax liabilities that are not being identified and collected in a timely manner.

Cause: The cause of the above is lack of proper planning and adequate staffing to perform these audits. It was also identified that audit are sometimes postponed because businesses are too busy to attend to auditors and such hinders the completion of the audit in a timely manner.

Recommendation: To ensure that businesses are audited in a timely manner, the Tax Audit Office should develop proper audit plans. The audit plan should consider the size of businesses and nature of operation, how the audits are to be performed, resources required and timeframe to complete the audit. A good audit planning will ensure a focused field work by the audit team and also facilitate monitoring and reviewing of the audit progress by the supervisors. Additionally, the Tax Audit Office should recruit the additional personnel and acquiring other resources required for the effective functioning of its audit function. Specifically, consider:

1. Converting the two part-time auditors to full time auditors

2. Providing and exploring capacity building trainings for tax auditors to broaden their auditing skills (introduce audit techniques, etc)

3. Providing other resources (e.g. hardware, software, etc) to enable tax auditors to carry out the audit works more effectively.

4. Notifying businesses well ahead of time to ensure they are available throughout the audit engagement.

Finding No. 4: Risk in the selection of business for audit

We recognized a risk involved in the current system of selecting businesses for audit and scrutiny to determine compliance with RMI Tax laws. Currently, the Tax Compliance Office determines which businesses are to be audited. The selection of business for audit starts from the Tax Compliance Office's review of taxpayer files following steps laid out in the standard operating procedures. As indicated in the SOP, it is the responsibility of the Tax Compliance Officers to go through the tax forms to ensure accuracy of tax declarations, filed and paid in accordance with RMI Tax laws. Specifically, the steps to follow are listed below:

"1. Examine the tax forms brought in to file by the taxpayer
- *Ensure the forms are filled out legibly and correctly*
- *Assist taxpayer in filling out the tax forms*
- *Educate taxpayer about proper filing procedures, if required*

2. Re-calculate the totals to verify the computations on the tax forms
- *If Calculation errors or irregularities are found, question the taxpayer to determine if it is a genuine mistake.*

- *Inspect taxpayer's previous records to verify eligibility for tax credits or additional payment.*
- *If fraud or misrepresentation is detected, document it in the taxpayer's file."*

In the event Tax Compliance Officers come across discrepancies and/or inaccurate tax declarations, Tax Compliance Office develops a list of these taxpayers and refers it to Chief of Revenue and Taxation. Upon satisfaction of review by Chief of Revenue and Taxation of findings by Tax Compliance Office, the list is then forwarded to the Tax Audit Office for audits.

We performed a review of the current system of selecting businesses for referral to the Tax Audit Office for audit and scrutiny. Upon an interval sampling test of 60 taxpayer files (Form 090), we found 6 files that overpaid or underpaid their tax dues. **Exhibit A** on page 15 presents a more detailed analysis of these incorrect tax calculations. Our further review disclosed that these businesses were not being referred to the Tax Audit Office for scrutiny. Additionally, we were unable to verify tax calculations for 13 of the taxpayer files as these were missing. Accordingly, we were unable to determine whether the tax calculations for these taxpayers were accurate or needed to be referred to the Tax Audit Office for scrutiny.

The effect of the above conditions is that businesses are not paying tax dues in accordance with tax laws but such are unknown to Tax Audit Office and they fall outside its audit scope, resulting in tax dues to the RMI Government not being recovered.

Cause: The cause of the above condition is due to lack of policies and procedures governing review and calculation of taxes and independent review of these works.

Recommendation: To improve on the current practice of selecting business for referral to audit by Tax Audit Office, Tax Compliance Office should carefully review gross revenue quarterly reports (form 090) for appropriateness of the tax computations. Independent review of tax calculations should also be performed to ensure accuracy of tax declaration and payment. Additionally, consider:

- Changing the current selection of business for audit scheme to allow Tax Audit Office to independently review taxpayer files and judgmentally select the businesses for audit.

- Adopting a formal risk analysis scheme to determine the priority or order of businesses for scrutiny.

- Developing other means of selecting business for audit: use of hotline to engage business community and general public, professional judgment base on knowledge of businesses, and performing spot checks.

Finding No. 5: Lack of proper maintenance of Business Listing

The Tax Audit Office relies on a complete listing of businesses in order to effectively monitor and track activities. To ensure a complete account of all businesses conducting business in the RMI, Division of Revenue and Taxation through the Secretary of Finance, entered into a Memorandum of Understanding (MOA) with the Marshall Islands Social Security Administration, Majuro Atoll Local Government (MALGOV) and Kwajalein Atoll Local Government to share information to effectively monitor businesses to increase compliance in national tax laws and local government ordinances. Specifically, under the MOA, the two local governments are to inform the Division of Revenue and Taxation and MISSA of newly established business in their jurisdictions. The information includes the name of the business, location, owners, nature of the business and contact information. Similarly, the MISSA is to notify Tax Audit Office and the local governments of newly registered businesses with the assigned employer's identification number, name of the business, location, owner, nature of the business and contact information.

We performed a comparison of business registry (listing) maintained at the Division of Revenue and Taxation with MISSA business listing, and noted the following:

Revenue and Taxation	**914 businesses**
MISSA	**755 businesses**

- Business listing maintained at the Division of Revenue and Taxation has not been updated and reconciled with the MISSA business listing on a regular basis. For instance, we found businesses with the identification numbers **00970404, 01031004**, and **01077204** on the Division of Revenue and Taxation's business listing but are no longer with MISSA. Our further review disclosed that these businesses are no longer in operation. This indicates lack of sharing of information between the Division of Revenue and Taxation and MISSA.

- Business listing maintained by the Division of Revenue and Taxation indicated duplicate recording of businesses. For instance, we found one

business with the identification number **00007404** that was recorded 5 times on the business registry and three businesses with the identification numbers **00484804**, **01031204**, and **01066704** that were recorded twice on the business registry. In addition, we noted also business maintained by the Division of Revenue and Taxation does not contain establishment date of businesses on its listing making it difficult to determine as to how long a business has been in operation.

- Our further review of business listing between Division of Revenue and Taxation and MISSA disclosed that only 350 businesses are recognized between the two which indicates the possibility of Division of Revenue and Taxation missing businesses that have been registered with MISSA and have been assigned EINs.

The effect of the condition above results in lack of a complete listing of all active businesses. Additionally, this indicates the possibility that businesses may have been registered and assigned EINs by MISSA but are unknown to the Division of Revenue and Taxation, and therefore they may not be subject to audit and scrutiny by the Tax Office.

Cause: The cause of the above condition is a result of lack of reconciliation of business listing by the Division of Revenue and Taxation with business listing maintained by MISSA on a regular basis, and poor implementation of MOA.

Recommendations: Tax Audit Office should reconcile business listing with business listing maintained at MISSA on a regular basis to ensure a complete account of all active businesses that have been granted EIN numbers. We also recommend that:

- Establishment dates of businesses are included in the business registry to determine how long they have been in operation.

- Division of Revenue and Taxation should work closely with MISSA to ensure a free flow of information to effectively monitor and track business activities.

Finding No 6: Audit Procedures have not been formally adopted and followed consistently

We reviewed the audit procedures contained in the standards operating procedures (SOP) being instituted that tax auditors are to follow to complete an audit. The SOP contains 11 steps that the audit would need to go through to determine compliance with tax laws and an additional 8 steps for non-payment of tax audit findings. We specifically performed a walked-through on 9 businesses audited to determine if audit procedures were being followed as stipulated in the SOP. Out of the 9 business audit files that we reviewed, we found 5 audit files that did not contain a copy of the business licenses and 2 audit files did not contain the EIN, both of which are required to be maintained within each audit file pursuant to the SOP. In response to the missing EINs and business licenses, the tax audit staff states that they do not regularly obtain copies of business licenses and EIN but instead they only make note of their existence.

Our review further revealed that the SOP is still a work-in-progress and yet to be formally adopted as a working document. Contrary to best practice, the SOP has been developed and based entirely on processes and procedures that are being practiced by the tax auditor as opposed to a set of audit procedures that auditors are to follow when performing audit works.

The effect of the above conditions result in inconsistencies in the way audit works are performed which may in turn affect the quality of the audit works.

Cause: The cause of the above conditions is due to lack of a formal and mandatory audit program to guide the auditors in performing audit works.

Recommendation: In order to ensure that the tax auditors are properly guided in performing audit works, it is recommended that the SOP are finalized and formally adopted as a working document. Additionally, consider:

- Developing audit procedures and processes based on best auditing practices.
- Mandate that supervisory review is performed throughout and on all audit works to ensure all audit procedures are being followed and complied with.

Finding No. 7: Tax Data are at risk of loss

A comprehensive data backup strategy needs to be in place to ensure security of the tax data. The process of inputting taxpayers' information at the Tax Compliance Office is by manual entry on a hard copy ledger, which are then stored in the taxpayers' respective files. The data are then transferred and stored in the EZ Tax program; a database that was acquired to store all the taxpayer information from the tax forms and ledgers. Essentially, it is the digital copy of all the taxpayers' files and it provides staff with a convenient and timely access to taxpayer files and information.

During our review of security of tax data, we noted that following:

- The SOP does not contain procedures to address security of tax data or to protect the data from loss caused by hardware and software failures, fire and other disasters.
- On December 2012 the EZ Tax program crashed and all data were lost. This system took 5 months to fix. During this time, the staff relied on hard copies to obtain taxpayers files and ledgers to keep track of the vital tax data. We also had to rely on these hard copies to complete our fieldworks.
- Tax information that are being inputted and stored into the EZ Tax program don't always matched with tax information in the hardcopies. For instance, we found taxpayer files where receipt numbers were missing from the hard copies ledgers although they were in the tax files and EZ program.

The effect of the above conditions may result in unavailability and/or permanent loss of tax data which would impede any attempt to audit or scrutiny of tax payers to determine taxpayers' dues to the Government.

Cause: The cause of the above conditions is due to lack of policies and procedures requiring a comprehensive data backup system in place to ensure security of the data.

Recommendation: To ensure security of tax data we recommend that the Division of Revenue and Taxation develops a formal policy governing data security and backup. We recommend also that SOP is expanded to include procedures for backups. Specifically, digital copies are recommended as they are easy to backup, store and retrieve. Additionally, consider:

- Routine backup using external hard drives to store data in each tax auditor computer and test back up periodically.

- Online backups to avoid risk of hardware and software failures and risk against fire and other catastrophe.

EXHIBIT

Exhibit A

Additional information on incorrect tax calculations discovered during the review

Business EIN	Amount Over Paid	Amount Under Paid	Total
11237-04		$52.48	$52.48
11507-04*	A*	A*	A*
11572-04	$218.00		$218.00
11656-04	$50.00		$50.00
11042-04		$300.00	$300.00
12491-04	B*		B*
Total	**$268.00**	**$352.48**	**620.48**

A= in 2009 quarter 4 there was an over payment totaling the due amount to $2,898.46. The following quarter, 2010 Quarter 1 there was a due amount of $2,943.72. An adjustment was made so that the Taxpayer only had to pay $45.26. Due to the adjustment made no variance was recorded although it is still categorized as an incorrect calculation on GRT in over payment*

B = in 2010 quarter 1 an amount of $9,600.00 was present. The same amount was then declared in quarter 2 but not 3 and 4. This was explained that the quarter one amount should not have been present because the business started in quarter 2. Staff stated the mistake was made because of lack of understanding on the taxpayer. During quarter 2 staff made an amendment and total tax declarations were balanced, thus no variance is present and was not recorded by the team. This was still categorized as an incorrect calculation of GRT in over payment.*

APPENDIX

Appendix A Ministry of Finance Responses per Letter April 28, 2014

REPUBLIC OF THE MARSHALL ISLANDS
OFFICE OF SECRETARY OF FINANCE
MINISTRY OF FINANCE
P.O. Box D
MAJURO, MARSHALL ISLANDS, MH 96960
TEL: 625-8320/7420 Fax: 625-3607

Office of the Auditor General
RECEIVED
APR 28 2014
Republic of the Marshall Islands

April 28, 2014

Junior Patrick
Auditor General
RMI Office of the Auditor General
Republic of the Marshall Islands

Re: Response to Draft Evaluation Report on Tax Auditing Program

Dear Mr. Auditor General:

Kommol tata for your letter of February 13, 2014 which reflected the suggested changes during the exit meeting, and re-writing of finding no. 5 business listing, based on updated information we subsequently provided you.

We have reviewed the above changes and attached are our responses, including responses to the other findings which we provided in our January 13, 2014 letter, but do not seem to have been reflected in the attached report.

We hope that you will consider our responses and reflect the changes, as well as eliminating finding no. 2 which we believe do not justify as a finding.

We sincerely apologized for the rather late response.

Ilo wot kautiej,

Bruce Bilimon
Acting Secretary of Finance

Cc: Assistant Secretary of Finance
Chief of Revenue and Taxation

Official Responses to Republic of the Marshall Islands Office of the Auditor General Evaluation Report on Ministry of Finance' Tax Auditing Program

1. Finding No.1: Roles and Responsibilities are not defined clearly;

We partially agreed to this finding and suggest re-wording of finding No.1 to the following; "Roles and Responsibilities requires PSC official endorsement or approval".

For additional information and clarification, please refer to our letter of January 13, 2014

2. Finding No.2: Absence of a Comprehensive Tax Audit Program;

We disagree with this finding. Therefore, we seek the indulgence of the Office of the Auditor General to remove this finding.

For additional information and clarification, please refer to our letter of January 13, 2014

3. Finding No.3: Tax audits are not completed within timeframe scheduled;

We agreed with this finding and gave explanations and reasons per our letter of January 13, 2014. However, we disagreed with your Draft Evaluation Report Table A: Comparison of Audit Plan versus Audits completed as provided in our response per our letter of January 13, 2014. We suggest you use our table provided as it reflects a correct analysis.

For additional information and clarification, please refer to our letter of January 13, 2014

4. Finding No.4: Risk in the selection of business for audit;

We partly agreed with this finding, however for the recommendations, we generally agreed and shall integrate and follow through with them.

For additional information and clarification, please refer to our letter of January 13, 2014

5. Finding No.5: Lack of proper maintenance of Business Listing;

We agreed with this finding and also with the recommendations, and shall integrate and follow through with them.

6. Finding No.6: Audit Procedures have not been formally adopted and followed consistently;

We agreed with this finding and also with the recommendations, and shall integrate and follow through with them.

7. Finding No.7: Tax Data are at risk of loss;

We accept and agreed with this finding including the recommendations, and shall integrate and follow through with them.

Appendix B Ministry of Finance Response per Letter January 13, 2014

Finding No.1: Roles and Responsibilities are not defined clearly;

Official Response;

We partially agree with this finding. Whereas roles and responsibilities are clearly laid out and exercised internally, the lacking of Public Service Commissions' official endorsement or approval of roles and responsibilities is the main reason for this finding therefore this office shall work and seek PSC's guidance and approval for a clearly defined roles and responsibilities of the auditors.

As such, we suggest rewording of finding # 1 to the following heading – Roles and Responsibilities require PSC official endorsement or approval.

Recommendation: It is recommended that;

1.1 The Chief of Revenue and Taxation and Assistant Secretary of Revenue and Taxation Department work with the Public Service Commission to develop official job descriptions for each audit staff to establish clear line of work and responsibility and expectation. The job descriptions should be linked to the overall objective of the Tax Audit Division.
1.2 Upon creation of official job descriptions, formal orientations are to follow to ensure auditing staffs are acquainted with their roles and responsibilities and the expectations out of them.
1.3 Tax auditor with the title of a Budget Officer is given an official audit title in accordance with the organizational structure;

Supplementary Response;

We agree with this recommendation (1.2) and shall act accordingly. Formal orientation per working policy and procedure are being carried out by the Public Service Commission. In this connection, new employees are and shall be accorded with proper orientation program as required. Additionally, the Tax and Revenue Chief and Assistant Secretary provide a more in depth orientation entailing not just on job description but also engaging short-term training/orientation with Division's (Customs,Treasury, Revenue and Taxation) across-the-board roles, objectives and duties so to broaden the new auditor(s) scope and knowledge of the general works and expectations concerning taxation in general.

We accept and shall make the adjustments to reflect change of title from Budget Officer to Tax Auditor/Administrative Officer.

Finding No.2: Absence of a Comprehensive Tax Audit Program

Official Response;

We disagree with this finding. The comprehensive audit program requirements were adopted in 2005 as part of the establishment of the audit regime. We believe attached requirements of documentations meet the minimum requirements of a comprehensive audit program. Therefore, we seek the indulgence of the Office of the Auditor General's to remove finding No.2

Recommendation: To improve the current tax audit procedures, we recommend;

2.1 That the SOP be expanded to include procedures to address auditor's independence declaration and supervisory review of audit works performed. Specifically consider;
2.2 Developing an Independence Statements that each auditor assigned to perform audit of business must fill out to indicate whether or not there are impairment issues. The Independence Statement should also contain a review section to be completed by the Chief of Revenue and Taxation.
2.3 Developing supervisor review guide and checklist for use by supervisor in reviewing audit works.
2.4 Tax Audit Office familiarizes itself with requirements contained in the generally accepted auditing standards to determine the appropriateness of using those standards as basis to perform and report tax audit works.

Supplementary Response (inclusive 2.1 – 2.4)

We acknowledge the draft Ministry of Finance Standard Operating Procedures (SOP) does not address or contain the auditor's independence and supervisory review of audit works. Again, these are addressed in attached separate documents for auditor's independence;

- **Statement of independence Forms and Annual Independence Checklist For Auditors Form, for supervisory review;**
- **Tax Audit Status Report. However, as mentioned earlier, there is an existing Tax Audit Program/ Checklist for All Taxes and Specific Taxes Procedures plus other documents attached, which form a Comprehensive Tax Audit Program.**
- **Since a comprehensive tax audit program is in place, the heading of Finding No.2 is inaccurate and therefore we request change to reflect the true nature of the audit program.**

At the start of the audits in June 2005, these forms were used but have fallen into disuse in recent years, or the way they were used has changed a little. However, in practice they are still used and applied. In the case of auditor's conflict of interests, a different auditor is assigned when the auditor verbally declare their conflict. For supervisory review of audit works, if there is an issue regarding an audit, they are normally discussed verbally between the auditors and the Chief of Revenue& Taxation and or the Assistant Secretary of Finance if the auditors felt it's a bigger issue for them to handle.

The cause is not so much in not addressing the issues in the SOP or not developing the checklist, but more of continue practicing them and ensuring the existing forms are used to document the actions taken.

Regarding the recommendations, generally, we agreed with those that we don't have in our existing documentations such as a review guide and checklist for use by the Supervisor and the Chief of Revenue& Taxation. Additionally, we request the Auditor General Office to provide a genuine copy of the Generally Accepted Government Auditing Standards to assist in performing and reporting tax audits and thereby incorporating it as part of our SOP.

Finding No. 3: Tax Audit are not completed within timeframe scheduled:

Official Response:

We agree with this finding though we wish to acknowledge that auditing work depends on myriad factors, which oftentimes lead to inconsistent completion of audit as desired, planned or scheduled. As expressed in our exit meeting, the tax office has been over the years functioning more or less with fewer than the required number of auditors, regardless the results yielded satisfactory return to the Government. Likewise, the responses and reactions to the tax audit fieldwork from the business (es)

being audited at times prolong the audit process therefore the Auditor General's Office should also take consideration to these realistic circumstances/factors.

Furthermore, the Tax Audit Office staff at the directive of the Management also engages in other activities or functions as to support the overall mission of the Division. These involved dual responsibilities as specialists to foreign Investment Regime, Tobacco and Alcohol Regime, and general administrative support to the Office of the Assistant Secretary especially during Nitijela sittings.

Substantially, we take note the finding and shall exercise more prudent approach to ensure audit works are at least completed at scheduled. But again, we seek the support of the OAG to emphasize that inconsistency in competing audits timely is the nature of the audit work especially in considering staffing, business environment and political , cultural and social realities.

Recommendation:

3.1 To ensure that businesses are audited in a timely manner, the Tax Audit Office should develop audit plans. The audit plan should consider the size of business and nature of operation, how the audits are to be performed, resources required, timeframe to complete the audit. A good audit planning will ensure a focused field work by the audit team and also facilitate monitoring and reviewing of the audit progress by the supervisors.

Supplementary Response:

We take note of this recommendation and wish to point out that our Office is very mindful of the shortage of manpower and resources to effectively and efficiently carry out audit of RMI business landscape. Therefore again as noted in our exit meeting, we systematically adopted a methodology where tax compliance unit selects businesses to audit (based on tax returns comparing industry index), review and approve by the Chief of Revenue and Taxation with concurrence from the Assistant Secretary.

3.2 Additionally, the Tax Audit Office should recruit the additional personnel and acquiring other resources required for the effective functioning of its audit function. Specifically, consider;
Converting the two – part auditors to full time auditors
3.3 Providing and exploring capacity building trainings for tax auditors to broaden their auditing skills (introduce audit techniques, etc);
3.4 Providing other resources (e.g. hardware, software, etc) to enable tax auditors carry out the audit works more effectively and efficiently
3.5 Notifying businesses well ahead of time to ensure they are available throughout the audit engagement

Supplementary Responses:

We welcome this recommendation and have already taken measures/steps to address this need for a fully functioning tax audit unit.

FY	Planned	Completed	Pending	Uncompleted	AG's %
2009	8	6	0	2(25%)	50%
2010	25	14	5	6(24%)	85%
2011	30	12	6	12(40%)	60%

We cannot agree more on your statement; 'Adequate resources are needed to ensure tax audits are completed in a timely manner.'

The narrative comparison of audit planned against audit performed or completed and as indicated in Table A on page 7 we are not sure exactly what basis is used. Our figures are;

The above figures include pending column, which is audits that have been completed but pending referral to Attorney General's for prosecution failing the procedures. The pending column figures if added to the completed column figures if added to the completed column will have a much lower percentage of uncompleted audits as indicated. Auditor General Incompletion rates for comparison purposes are on the far right column.

The rather high figures of uncompleted audits plus pending in 2010 and 2011 also was due to the sudden mass exit of four (4) auditors (2 auditors and 2 volunteer auditors) left the Division in 2010 for various reasons. Additionally, during 2010 one of the largest taxpayer was audited this time and took almost 2 years to complete continuing over to 2011. As a result of these reasons, the original audit plan was severely impacted and therefore a higher incompletion rate of 40%.

While it is acknowledged that documentation of tax audits needs to be improved, the cause is not so much due to lack of proper audit planning, but lack of adequate staffing to continue perform these audits. It is also true to some extent that audits are sometimes postponed because businesses are too busy to attend to auditors and such hinders the completion of the audits in a timely manner. It is also true audits are postponed because auditors and staff of the Division at times are busy with the Divisions' other function for the Ministry of Finance as a whole.

We generally agreed to the recommendations. Also when tax reform is implemented it is planned that more staff and hardware resources will be assigned to the taxpayer audit function. Also, tax auditor capacity building training through the assistance of the IMF and PAFTAC is planned as soon as the new Tax legislations are passed.

Finding no. 4: Risk in the selection of business for audit:

Official Response;

We partly agree with this finding because we deem our current method in selecting business for audit integrates some degree of independent review, selection process based on tax returns indexing similar business industries and knowledge of RMI business environment. In other words, RMI business environment is small for the Tax Compliance Unit to readily grasp the inherent risks and non-compliance implications surrounding identifying and selecting business for audit.

Recommendation:

4.1 Independent review of tax calculations should also performed to ensure accuracy of tax declaration and payment. Additionally, consider;
4.2 Changing the current selection of business for audit scheme to allow Tax Audit Office to independently review taxpayer files and judgmentally select the businesses for audit
4.3 Adopting formal risk analysis scheme to determine the priority or order of businesses for scrutiny
4.4 Developing other means of selecting business for audit; use of hotline to engage business community and general public, professional judgment base on knowledge of businesses, and performing spot checks

Supplementary Responses:

While it is acknowledged the current system of selecting businesses for audit as reported has inherent risks and needs to be improved, we have also used other techniques as recommended in the report. Because our current system is mainly manual, plus the limited resources and equipments we have at our disposal, we felt that the current systems of selecting businesses for audit we use are appropriate and practical for now until the new tax reforms are implemented. As part of the new tax reforms, it is planned to adopt a formal risk analysis system to determine case selection for audits, and will be supported by a modern IT system.

The new tax system will require new audit approaches to be developed for the new consumption and excise taxes as well as the new net profit tax. New case selection approaches based on risk assessment methods will also be developed and it is planned that an audit committee approach to case selection will be used involving staff from all relevant section.

As noted on your sampling test of 60 taxpayer files on page 8 and further detailed on Exhibit B page 15, cases with apparent minor discrepancies on their GRT returns are risk assessed and not all are necessarily subjected to audit review due to many other reasons. So it is no surprise that minor discrepancies were found in a few returns. This approach is consistent with a self-assessment system we have where the returns filed by taxpayers are in the main accepted as filed with subsequent audit scrutiny, as appropriate.

We generally and partially disagree with the cause mentioned as just mentioned as just explained in the above paragraph, due to how a self-assessment system works and subsequent scrutiny action followed.

As for the recommendations, we generally agreed and shall integrate and follow through with them.

Appendix C Auditor's Response to Comments by the Ministry of Finance

Finding No.1: Roles and Responsibilities are not defined clearly:

We acknowledge the comments by the Ministry of Finance, Division of Revenue and Taxation, which suggest re-wording of finding 1 heading to the following; "Roles and Responsibilities require PSC official endorsement or approval". However, we retain the original finding heading and we cannot re-word the finding "Roles and Responsibilities are not defined clearly" to "Roles and Responsibilities requires PSC official endorsement or approval" as suggested, as this would fail to portray the complete issue of no written roles and responsibilities within the office. We consider that it is the responsibility of the Division of Revenue and Taxation to actively pursue our recommendation to work with PSC to develop official job description for each tax audit staff.

Finding No.2: Absence of a Comprehensive Tax Audit Program:

We acknowledge the comments and additional supporting documents provided by the Ministry of Finance, Division of Revenue and Taxation which suggest removal of this finding. The additional documents addressing auditors independence that were subsequently provided are the first time this office has been able to acquire, spanning from the beginning of the evaluation of the Tax Audit Office to the exit meeting. However, as indicated in our findings we did not find any evidence of independence declaration for the four audits that we reviewed. It appears, therefore, that independence declaration templates were prepared and never been used for every audit as acknowledged by the Ministry. Discontinued practice of this document can stem from not being a mandatory function of the office and additionally is not a requirement under the SOP.

Furthermore, the other important component of an audit function, as highlighted in the report, is the supervisory review of audit work papers. As reported in our finding, we did not find evidence of supervisory review for the four audits that we tested. The additional documents that were provided to us did not evident that supervisory review of audit work paper template was in place. The documents received in the Ministry response include:

- Assignment proposal format (Exhibit E)
- Standard working paper index (Exhibit E)
- Assignment authorization form (Exhibit F)
- Statement of independence (Exhibit G)
- Annual independent checklist for auditors (Exhibit H)
- Tax audit status report (Exhibit I)

Based on our review of the Ministry response and additional documentations that were provided, we determined that the finding should remain and with modification to the finding heading. The finding heading has been modified from "Absence of a Comprehensive Tax Audit Program" to "Improvements Needed in the Tax Audit Program"

Finding No. 3: Tax Audits are not completed within timeframe scheduled:

We acknowledge the comments and additional information provided by the Ministry of Finance, Division of Revenue and Taxation. The information with respect to number of businesses that were planned for audit and numbers that were not completed as originally produced on the report was based on the information given by the Tax Audit Office Status Report and Audit Plan 2009, 2010, 2011. The response from the Ministry dated January 13, 2014 indicated a different analysis of businesses that were audited and complete. Based on the response from the Ministry we performed additional audit procedures to determine the completion date of each audit that was planned within fiscal year 2009, 2010, and 2011 which was then confirmed by the Tax Audit Office. Based on the additional audit procedures we have amended *Table A: Comparison of Audit Plan versus Audits completed* in our final report.

Upon reviewing the responses, it appeared that the Ministry labeled business audits as completed even though they were outside the audit plan completion date. For example, in 2009 8 businesses were planned and 6 were reported by the Ministry in its response as completed. However, based on our review on the 6 files only 3 were completed within the audit plan. For the remaining 3 audits, 2 were completed in 2012 and 1 was completed in 2010.

Finding no. 4: Risk in selection of business for audit:

The comments from the Ministry of Finance suggest, "Cases with apparent minor discrepancies on their GRT returns are risk assessed and not all are necessarily subjected to audit review due to many other reasons" and "it is no surprise that minor discrepancies were found in a few returns". It is our view that all taxes owed to the government must be collected by the Division of Revenue and Taxation as they become due regardless of amount pursuant to Income Tax Act 1989 [Title 48 MIRC, Chapter 1]. The under/over payment in taxes reported in the finding was based on a sample size of sixty (60) taxpayers tested, however if the sample size increase more with the whole population tested there is the possibility of finding more discrepancies which warrants more scrutiny action.

Further, the Ministry partially disagrees with the cause identified in the report, "due to how a self-assessment system works and subsequent scrutiny action followed." Evidently, and based on our review, the current practice is not adequate to capture all tax miscalculations. Therefore, we recommend to the Ministry to consider implementing our recommended course of action to address the deficiencies identified in our report.

Appendix D Responses Required to Clear Audit from OAG Follow-Up System

No	Findings	Action To Be Taken
1.	**Roles and Responsibilities are not defined clearly.**	1.1 Provide copies of the established job descriptions for each tax auditor requires PSC Official endorsement for approval. 1.2 Provide written confirmation that action has been taken to implement our recommendation. 1.3 Provide copy of employee personal action showing official title in accordance with the organizational structure.
2.	**Improvements Needed for a Comprehensive Tax Audit Program.**	2.1 Provide copy of the approved SOP [to be supported by written policies] to address auditor's independence declaration and supervisory review of audit works performed.
3.	**Tax Audits are not completed within timeframe scheduled.**	3.1 Provide written confirmation that action has been taken to implement our recommendations.
4.	**Risk in the selection of business for audit.**	4.1 Provide written confirmation that independence review of tax calculation is being performed. 4.2 Provide written confirmation that action has been taken as to adopting formal risk analysis scheme.

		4.3 Provide written assurance that action has been taken to implement our other recommendations.
5.	**Lack of proper maintenance of Business Listing.**	5.1 Provide copy of complete and update business listing which reconcile with MISSA and MALG. 5.2. Provide copy of complete business listing which include establishment dates.
6.	**Audit Procedures have not formally adopted and followed consistently.**	6.1 Provide copy of approved SOP including audit procedures used and mandated procedures reflects of today's business environment. 6.2 Provide written assurance that action has been taken to implement our other recommendations.
7.	**Tax Data are at risk of loss.**	7.1 Provide copy of policies and procedures established governing data security and backup and to include these procedures for backup in the final SOP.

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