INVESTIGATION OF AN ERROR IN TAX REVENUE NUMBERS

1 April 2008

Contents

Executive summary

1. This is the report of the investigation into the error in the tax revenues for January 2008, reported in the Financial Statements of the Government for the seven months ended 31 January 2008.

2. The error in January 2008 refers to the accounting treatment of provisional tax payments for company tax and other persons' tax. The accounting treatment requires that a provisional tax accrual be calculated for company tax and other persons (for example, sole traders) tax. An accrual means that the tax revenue is recognised in the accounts when a taxable activity takes place, not the date on which the tax—cash—relating to the activity is paid to the Government. Calculation of this accrual is a complex process; it requires an understanding of how and when each type of tax is paid by taxpayers.

3. The error relates to an estimate of this accrual, not to a difference between the tax received by the Government and the cash reported in the Accounts. The revised accounts released on 18 March show no change to the cash position of the Government.

4. The root cause of the error was that Inland Revenue did not use the accrual calculation agreed by Treasury. Inland Revenue varied the calculation procedure and used out-of-date data. In this regard it was not a one-off event. Incorrect data had been entered into the financial system each month since July 2007.

5. A number of environmental factors contributed to the error:

- There were deficiencies in administrative controls in Inland Revenue.
- The Inland Revenue unit responsible for preparing the provisional tax accrual was under considerable pressure of limited resources, high staff turnover and increasing service demands.

6. We have noted that Inland Revenue had identified these problems prior to detecting the error and had taken reasonable steps to address them, including increasing resources, reducing key person risk and improving administrative controls. These changes have yet to be fully implemented.

7. When the variance between actual tax revenue and forecast tax revenue became pronounced in January 2008, the analysis by Inland Revenue and Treasury was of high quality, covering issues such as the number and value of tax returns filed, technology system-generated errors and economic conditions. But it did not properly address whether the error was caused by an incorrect calculation of the provisional tax accrual for January 2008.

8. In regard to Treasury's decision to publish the Accounts, we concluded that given the unexplained variance between actual and forecast numbers, options such as providing additional information or delaying publication where possible should have been considered.

9. We have made recommendations:

- to improve administrative controls and quality assurance over the process for calculating provisional tax accruals at Inland Revenue,

- to improve communication and coordination between Inland Revenue and Treasury and within Inland Revenue,
- for Treasury to prepare guidance on decisions on publishing the monthly accounts,
- for an independent review within six months of the extent to which the organisational changes made to the Corporate Financial Management and External Reporting Unit of Inland Revenue have minimised the risks to the Crown Revenue reporting process.

10. Finally, we are grateful for the cooperation and professionalism of staff in Inland Revenue and Treasury during this investigation.

Introduction

11. This is the report of the investigation into the error in the tax revenues for January 2008 reported in the Financial Statements of the Government for the seven months ended 31 January 2008. The terms of reference for the investigation are attached as Annex 1.

12. This report is organised so the section "Investigation of the error" responds to "A" of the terms of reference. Specifically, it identifies the facts of the situation, the processes followed and the checking that occurred prior to the release of the Financial Statements. The section "Findings" refers to "B" and "C" of the terms of reference and explains the information revealed by our investigation, specifically where deficiencies in the processes exist and the extent to which the deficiencies meant the error was not identified prior to the release of the statements. Our recommendations respond to "D'"of the terms of reference, that is, the systems, procedures, capability and resourcing that need to be considered by the management of Inland Revenue and Treasury in relation to the above matters.

Investigation team and process

13. The chief executives of Inland Revenue and Treasury appointed Paul Carpinter, Principal Advisor at the Treasury and former chief executive of the Ministry of Economic Development; and Alan Pinder, Chief Advisor to the Deputy Commissioner, People Capabilities and Governance of Inland Revenue to jointly head the investigation, with assistance from Inland Revenue and Treasury staff as required. The investigation team comprised people who were independent of the preparation and reporting of the January 2008 Financial Statements of the Government.

14. The scope of the investigation was determined by the terms of reference. The error in tax revenue in January 2008 was visible from the variances between actual tax revenue and forecast tax revenue for company tax and other persons' tax.[1] Analysis completed by Inland Revenue and Treasury also concluded that the error related to these two tax types. We have not repeated the analysis completed by each agency and we have focused on identifying the error and the systems and processes that caused it.

15. The investigation team interviewed people principally from Inland Revenue and Treasury who were directly involved in calculating and reporting tax revenue for January 2008. The initial interviews informed the extent to which further interviews were necessary. The people interviewed are listed in Table 1.

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[1] Page 22 of the Financial Statements of the Government, released on 6 March 2008 refers.

Table 1: People Interviewed

Position	*Organisation*
Manager, Crown	Inland Revenue
Team Leader, Financial Accounting	Inland Revenue
Manager, Corporate Financial Management and External Reporting	Inland Revenue
Manager Forecasting and Analysis, Policy Advice Division	Inland Revenue
Chief Financial Officer	Inland Revenue
Senior Analyst and Modeller	Treasury
Senior Accounting Policy Analyst	Treasury
Manager, Fiscal Reporting	Treasury
Senior Advisor	Department of Prime Minister and Cabinet
Director and Audit Manager	Audit New Zealand

16. The investigation began on Monday 17 March and concluded 31 March 2008. The investigation timeframes did not permit an extensive review of all aspects of calculating and reporting company tax and other persons' tax, but specific points of inquiry were verified by the reports, manuals and spreadsheets used to prepare the January 2008 Financial Statements. In this regard, our conclusions have a sound evidential basis.

Financial Statements of the Government

17. The Financial Statements of the Government (the Accounts) are prepared for two purposes – to help citizens and Parliament to hold the Government to account for its use of resources, and to provide information that is useful for decision makers, both inside the Government and across the economy.

18. The Accounts have the following features:

a **Consolidated** – all transactions between different parts of the Government are eliminated; what remain are the transactions between the Government and the rest of the economy

b **Accrual** – the Accounts allocate expenditure and revenue to the period when a binding obligation to enter into a transaction is made or arises. This means that tax revenue is recognised in the Accounts when a taxable activity takes place, not the date on which the tax relating to that activity is paid to the Government.

c **Cash** – the Accounts include a statement of cash flows as well as a statement of financial performance (operating statement) and a statement of financial position (balance sheet). In relation to tax revenue, the cash flows refer to the tax received and the later two statements are prepared on an accrual basis.

d **Accounting standards** – the statements are prepared in accordance with the New Zealand International Financial Reporting Standards. The Accounts are prepared on a similar basis to standards used in the private sector and also comply with the Public Finance Act.

19. Treasury is required to prepare consolidated financial statements for the Government on a monthly basis, except for the first two months of each financial year. These interim financial states are not audited. They are required to be released publicly six weeks after the end of the month.[2] A schedule of publication dates is released in advance of publication.[3]

20. The statements are prepared on the basis of the information supplied by departments and other entities to reflect the financial position of the Government. The revenue figures for the statements are received principally from Inland Revenue, but also from other government departments and entities.

21. A forecast of tax revenue is prepared on a biannual basis and is released publicly through the Budget Economic Fiscal Update (BEFU) and the Half-Year Economic and Fiscal Update (HYEFU). The monthly forecast data are available to Inland Revenue in May and November each year. Preparing a forecast of tax revenue on an accrual basis requires an understanding of how and when each type of tax is paid by taxpayers. The tax revenue forecast prepared by Treasury reflects the best available information at the time the forecast is prepared, but the forecast for each type of tax can and does vary across and between years.

22. The method of estimating and recognising provisional tax was developed and put in place from July 2006, in consultation with Audit New Zealand. The method was developed to address concerns that the estimation method used prior to July 2006 was cash accounting rather than accrual accounting. The provisional tax for company tax and other persons' tax that the Government expects to receive on a due date for company and other persons' tax is spread over the preceding three months to reflect an estimate of the underlying income earned.

The nature of the error in tax revenue

23. The error in the Accounts in January 2008 refers to the accounting treatment for estimating provisional tax revenue for company tax and other persons' tax, such as sole traders. The error does not refer to a difference between the tax received by the Government and the cash reported in the Accounts. In this regard, the revised Accounts released on 18 March 2008 show no change to the cash position of the Government and correct solely the error in tax revenue which was calculated on an accrual basis.

[2] Public Finance Act s31A(4) refers.
[3] Treasury media statement dated 10 October 2007 refers.

Table 2: Differences between the financial statements released on 6 March and 18 March 2008

	January 2008			
$ million	Actual	Forecast	Variance	
Tax revenue (accrual)				
Financial statements, 6 March	31,259	31,911	-652	-2.0%
Financial statements, revised	31,851	31,911	-60	-0.2%
Tax receipts (cash)				
Financial statements, 6 March	31,377	31,605	-228	-0.7%
Financial statements, revised	31,377	31,605	-228	-0.7%
Difference				
Tax revenue (accrual)	592	0	592	-
Taxation receipts (cash)	0	0	0	-

24. Table 2 illustrates the point by comparing the tax revenue and tax receipts in the Accounts released on 6 March to those released on 18 March. The tax receipts (cash position) are unchanged, the forecast is unchanged and the tax revenue recognised in January increased by $592 million following the correct entry of two provisional tax accrual numbers.

25. The Accounts are prepared on an accrual basis, that is, they shift the recognition of cash flows to show the taxable activity that took place within a given period. Preparing the Accounts on an accrual basis requires a number of accrual adjustments, which are an estimate of the proportion of cash flows to be shifted from one period to the next. This investigation looks at the accrual adjustment for company tax and other persons' tax as it is applied to monthly tax revenue.

Investigation of the error

26. The investigation team identified five issues that were relevant to the error in the January 2008 Accounts, these were:

a calculating tax revenue

b detecting the error

c roles and responsibilities

d the decision to publish the Accounts

e organisational issues.

27. The facts of the situation as they relate to processes, roles and responsibilities are discussed in turn below.

Calculating tax revenue

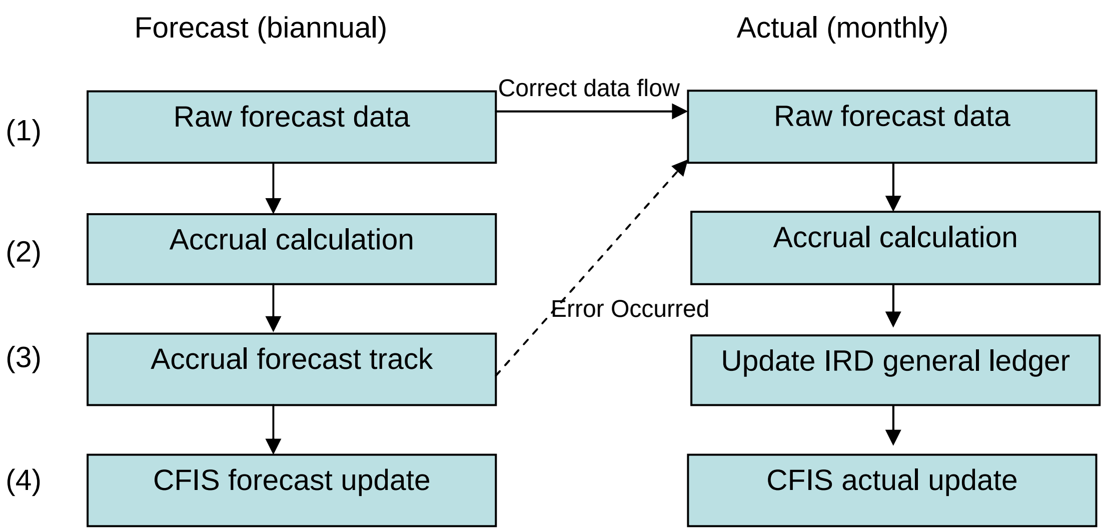
28. The root cause of the error in January 2008 was that the monthly provisional tax accrual process used by Inland Revenue differed from the process which had been agreed between Inland Revenue and Treasury in July 2006. Table 2 shows the resulting accruals used in January 2008 and the forecast accrual which should have been used by Inland Revenue in its place.

Table 2: Difference between the agreed accrual and the accrual used in January 2008

Provisional tax, $ million	Actual accrual entered	Agreed accrual not entered	Difference	
Other persons' tax	355	645	-290	-45%
Company tax	974	1,276	-302	-24%
Total	**1,329**	**1,921**	**-592**	**-31%**

29. Box 1 explains the processes that should have been followed.

Box 1: Explanation of the processes that should have been followed when preparing forecast and actual accrual data



Biannual process: The raw forecast data, on a non-accrual basis, are calculated by Treasury (1) and sent to Inland Revenue where the agreed method is applied to the data to calculate a provisional tax accrual for company tax and other persons' tax for each month of the financial year. (2) The monthly accruals are returned to Treasury for them to confirm the forecast track. (3) The forecast track is then sent to Inland Revenue so they can enter it into the Crown Financial Information System (CFIS) (4) which completes the process for calculating the forecast accrual. The process (1 – 4) is undertaken following the BEFU and HYEFU each year. Once the forecast track is entered into CFIS, Treasury can view the information on CFIS.

Monthly process: The raw forecast data for the provisional tax accrual number for company tax and other persons' tax is used by Inland Revenue to calculate the actual provisional tax accrual when Inland Revenue compiles monthly tax revenue data. The accrual numbers are entered into Inland Revenue's general ledger and upon completing the compilation of tax revenue for the month, Inland Revenue transfers that data to CFIS.

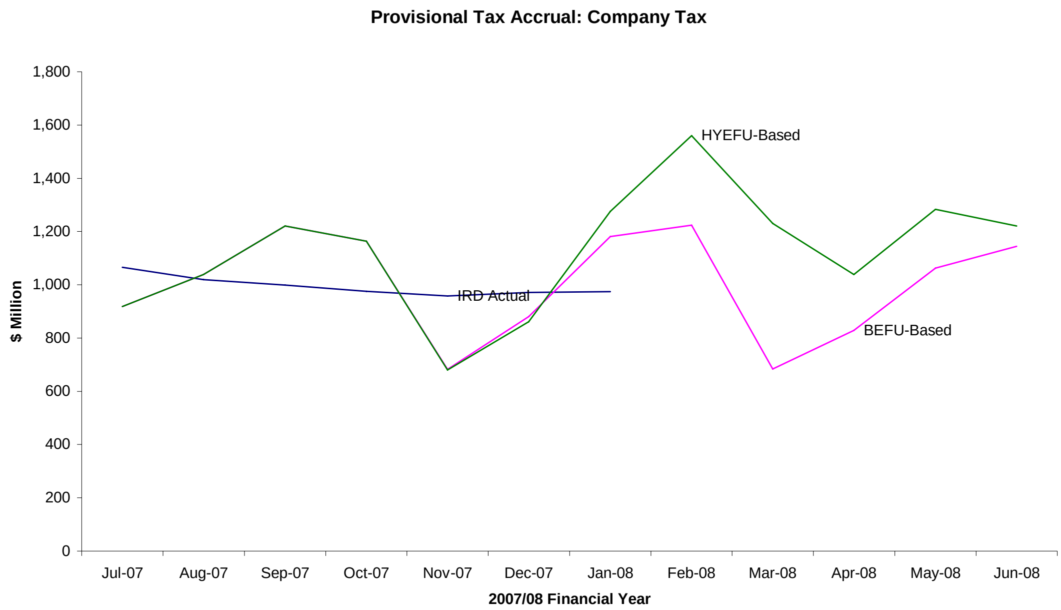
30. Inland Revenue entered correctly the forecast accrual for company tax and other persons' tax (steps 1 – 4 in Box 1), but it did not follow up that task by calculating correctly the actual accrual. The accrual for the monthly actual result should have been the same as the forecast accrual but was not. The error occurred because Inland Revenue varied the calculation procedure, shown by the dotted line

in Box 1, and used out-of-date data within that procedure, which resulted in incorrect numbers being entered into Inland Revenue's financial system.

31. Graph 1 shows the differences between the numbers Inland Revenue used for the company tax accrual relative to the numbers that should have been used in the 2007/08 financial year. The lines labelled BEFU and HYEFU refer to the numbers that should have been used and the third line shows the incorrect numbers that were used in their place.

32. Treasury was not aware that Inland Revenue had used the incorrect accrual numbers in the monthly results for company tax and other persons' tax until Treasury discovered the error after the January 2008 financial statements were released.

Graph 1: Comparison of the accrual numbers used and the correct numbers



33. Based on the errors we detected, the provisional tax accrual was incorrectly entered by Inland Revenue for a seven-month period from the start of the 2007/08 financial year. We also looked at the provisional tax accrual records for 2006/07 for the same errors, but did not find that the same error had occurred. We found small differences between the accrual figures calculated by Inland Revenue and the accruals entered into Inland Revenue's financial system, with the largest of these occurring in June 2007. However, in our view these differences did not materially impact on the 2006/07 end-of-year position of the provisional tax accrual which was audited by Audit New Zealand.

Detecting the error

34. One of the benefits of the Accounts is that they provide a regular test of the quality of the forecasts and systems that contribute to their preparation. Variance analysis, which compares actual results with forecasts, can provide important information about the performance of the economy. Both Inland Revenue and Treasury regularly use the Accounts for that purpose with their own in-house expertise. In this instance, the analysis led to uncovering the error.

35. Given the that the error existed for seven months, we gave particular attention to the processes in Inland Revenue and Treasury that should lead to detecting an error of this nature. These are expanded upon below.

36. The variance in tax revenue against forecast in January 2008 was in value much greater than variances reported in the previous seven months. Further, the variance was contrary to an established pattern of over-performance relative to forecast. These two factors caused Inland Revenue and Treasury to place considerable resources into analysing the variance to understand its cause.

37. In general, variances might be attributed to four causes:

a The number of tax returns filed in a given month

b The value of those returns: These can be from changes in economic conditions, such as strong commodity prices or drought conditions

c Changes to the tax system: These occur from legislated changes such as introducing tax pooling, KiwiSaver or portfolio investment entities (PIEs), which may cause variations in timing and the amount of tax remitted

d An error in the calculation of the tax revenue numbers.

38. Inland Revenue and Treasury bring different, but complementary, skills to analysing the variances. Inland Revenue is able to analyse unconsolidated data relating to taxes it collects, whereas Treasury can analyse all revenue types and give greater emphasis to changes in economic conditions.

39. Inland Revenue and Treasury prepared reports to analyse the tax revenue in January 2008. Reports prepared by Treasury were coordinated across its Fiscal Reporting and Tax Forecasting teams to provide an explanation of the movements in tax revenue.[4] Similarly, Inland Revenue's Forecasting team prepared a report analysing the variances.[5] Both reports were sent to each department's respective Minister. A further joint report by Inland Revenue and Treasury was prepared and sent to both the Ministers of Finance and Revenue.[6]

40. The reports demonstrated the difficulty of analysing the causes of variances within any given month. A number of causes for the variances relating to (a) – (c) in paragraph 37 above were explained in the reports, but a variance of $520 million could not be attributed to a specific cause. However, Inland Revenue offered a credible explanation of the possible cause of over half (57%) of the variance. Treasury advised us that a professional judgement had been reached that there had been fluctuations in the company tax and other persons' tax revenue relative to forecast in the months prior to the January 2008. The fluctuations were typically small and did not raise concern at Treasury.

41. Inland Revenue checks for the completeness of its data entries, potential errors caused by system changes and other routine causes of possible errors. Treasury asked Inland Revenue whether the company tax and other persons' tax accrual had been entered and Inland Revenue confirmed that the accrual entries had been completed. However, the reports prepared by both Inland Revenue and Treasury did

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4 T2008/287 refers

5 PAD 2008/29 refers

6 T2008/241, PAD 2008/37 refers

not address whether the accrual entry was in fact calculated correctly. Our investigation revealed that incorrect accrual numbers had been entered.

Roles and responsibilities

42. The Treasury's Fiscal Reporting team pulls together information from across the activities of the Government and prepares the three principal financial statements — the cash flow statement, the operating statement and the statement of financial position. Each government agency is responsible for filing its monthly actual results on CFIS as the necessary precursor for that work to be completed.

43. Owing to the size and complexity of government, this in itself is a substantial task. Inland Revenue is the major contributor to the revenue side of the Accounts and the Treasury is dependent on receiving timely and accurate data at the end of each month from each agency. Even so, the Treasury team regularly query particular results from individual agencies, including Inland Revenue, and seek to understand and explain variances from forecasts.

44. Inland Revenue and Treasury perform different roles in preparing the Accounts. Inland Revenue calculates and compiles tax revenue information and Treasury prepares the Accounts. For the Accounts to be prepared without incident, each agency needs to be aware of the other agency's roles and responsibilities in relation to the Accounts.

45. We could not find adequate documentation within Inland Revenue regarding its responsibility for calculating the provisional tax accruals. In July 2006, when Treasury and Inland Revenue designed the calculation process, this documentation should have been prepared to give guidance to the staff implementing the process.

The decision to publish the Accounts

46. After considerable internal discussion, Treasury published the Accounts for January 2008, with a note explaining the reasons for the variance, shown in Box 2.

Box 2: Explanation of core Crown revenue variances

Item/indicator	Variance	Key drivers
Core Crown		
Core Crown revenue (excl. NZS Fund revenue)	- $1.1 billion (lower than forecast)	• Core Crown tax revenue (excluding the NZS Fund) was $0.7 billion (2.3%) lower than forecast. The largest variances were in: - other persons tax ($0.4 billion lower than forecast) - corporate tax ($0.2 billion lower than forecast) - GST ($0.2 billion lower than forecast), and - source deductions ($0.1 billion higher than forecast). The reasons for these variances were: - timing effects associated with tax pooling and the PIE regime have resulted in about $0.4 billion of tax revenue that was expected to have been recognised in this period, but is now not able to be recognised as revenue until later in the fiscal year - terminal tax assessments for the 2007 tax year and provisional tax assessments for the 2008 tax year were below expectations - weakening domestic demand has contributed to the shortfall in GST, and - continued strength in the labour market has contributed to the positive variance in source deductions. • Other core Crown revenue was $0.4 billion lower than forecast. Interest revenue was lower than forecast by $0.3 billion primarily due to timing issues with the phasing of interest earned on the Crown settlement account. The impact was partially offset by a related variance in interest expense.

47. The monthly Accounts refer to unaudited statements, but the note in Box 2 does not refer to the uncertainty of the findings, the variance that could not be explained, nor does it refer to Treasury's concern that further adjustments may be necessary. A further note on page 2 of the Accounts, shown below, is the extent to which a qualification was identified by Treasury in the Accounts.

> "Tax revenues from month to month can be inherently variable. A portion of these tax revenue variances was due to timing effects associated with tax pooling and the PIE regime. Tax receipts were only $0.2 billion lower than forecast. A clearer picture of the likely impact of this month's result on the full year position will be developed for the Economic and Fiscal Update incorporated in Budget 2008."[7]

48. Based on the analysis completed by Inland Revenue and Treasury, there was no firm basis to suspect that the Accounts were misrepresented. The most significant issue in the Accounts was the financial result of the Crown Financial Institutions, such as the New Zealand Superannuation Fund, following the lower than expected financial returns in global equity markets.

49. The statements are required to be published within six weeks of the end of the month. The dates for releasing the statements are published months in advance, but do not always extend to the maximum permitted time. In the case of January 2008, a further five days were available, although if used, it would have deviated from the

7 Finance Statements of the Government, released on 6 March 2008.

published schedule. Treasury needed to make a decision whether a further four days would have materially altered the Accounts.

Organisational issues

50. From an organisational perspective, the error occurred in an area of Inland Revenue that was under-resourced relative to the demands placed upon it. Inland Revenue's management had recognised that pressure in August 2007 and had already taken substantial action, employing additional expertise, strengthening the reporting relationships, and placing emphasis on improving systems and documentation. As at 31 March 2008, these changes have been substantially, but not yet fully, implemented.

Findings and recommendations

51. The error occurred from the process used by Inland Revenue to calculate the provisional tax accrual. The calculation process used by Inland Revenue from July 2007 until January 2008 differed from the process that had been established in July 2006. In this regard, the error in January 2008 was not a one-off event. Our investigation showed that the error commenced when Inland Revenue took the forecast data from BEFU 2007 and calculated the provisional tax accrual. Our findings and recommendations focus on the deficiencies in the systems and processes relating to the error and the duration it remained undetected.

Calculating tax revenue

52. Regarding the way in which Inland Revenue calculates the provisional tax accrual, our findings relate to four issues that underpin the occurrence of the error:

a Inadequate documentation increased the risk of an error occurring and remaining undetected and made it more difficult for Inland Revenue and Treasury to review the process. While Inland Revenue maintained a process manual for completing the monthly results, it had not been updated since 2006 and had been written for an expert user.

b The control procedures for using spreadsheets in this instance were inadequate. There was a lack of clarity within Inland Revenue's Crown Reporting team as to which spreadsheet contained the correct data. This stemmed from:

- maintaining multiple versions of spreadsheets
- ambiguity over file names and labels within spreadsheets
- inadequate protocols on access and ownership of spreadsheets.

c Inland Revenue's monthly processes for compiling tax revenue are completed under relatively tight timeframes, which creates a pressured environment. We found few quality assurance procedures to verify the accuracy of the work completed and, in some instances, the people who compile the monthly results are also the people who sign off the same work.

53. The overall objective should be that critical data and processes are entered once only, and then accessed under strict protocols by those who need to use them.

There should be no question of multiple spreadsheets circulating between and across organisations.

Recommendation

54. We recommend that Inland Revenue:

a Document the process for calculating the provisional tax accrual for company tax and other persons' tax to ensure Inland Revenue staff have clearly stated procedures to follow each month. The documentation should refer to the information received from, and passed to, other parts of Inland Revenue and externally to Treasury. The documentation should be written from the perspective of a new staff member and assign responsibility for maintaining the documentation.

b Strengthen the control of spreadsheets, including:

- version control and naming protocols
- defining ownership and access
- instructions on the spreadsheets to identify process steps.

c Increase the quality assurance mechanisms relevant to Inland Revenue compiling the monthly tax revenue information, including a sign-off process and the delegations held by each manager.

Detecting the error

55. The analysis performed by Inland Revenue and Treasury to understand the variances in tax revenue actual results relative to forecast was of high quality and supported by access to comprehensive information and sound expertise. The reports also demonstrated the difficulty of analysing the causes of variances within a given month.

56. The analysis by Inland Revenue and Treasury was reported to senior managers in both organisations and the Ministers of Finance and Revenue. The analysis was available prior to publishing the unaudited Accounts, but did not identify the eventual cause of the variance. Further analysis and investigation following publication revealed the principal causes for the variances in company tax and other persons' tax, which informed the scope of the terms of reference in this investigation.

57. The tax forecasting teams in Inland Revenue and Treasury collaborated effectively in analysing the issues. However, we discovered limited collaboration between the relevant teams within Inland Revenue. To some degree time pressures prevented greater collaboration, but we consider that the Forecasting team is able to perform a data assurance role to increase the accuracy of the tax revenue numbers submitted to Treasury each month. Closer collaboration between the Forecasting and Crown Reporting teams within Inland Revenue could have helped to identify a broader range of circumstances that may have caused the variances, for example, an examination of the source data for the calculation of the accrual numbers.

58. Our investigations revealed that assessing actual data relative to forecast is a complex undertaking and one that occurs under considerable time pressure. Changes to the tax system, changes to economic conditions and changes in the

behaviour of taxpayers introduce variables that by their nature are difficult to explain in any given month. To the extent that tax revenue data can be extracted from Inland Revenue's computer system, FIRST, earlier each month than is current practice, Inland Revenue's Crown Reporting and Forecasting teams would have a longer period of time to analyse the data to ensure its accuracy.

59. In our view, the error remained undetected for seven months because the provisional tax accrual entered into Inland Revenue's computer system often varied by only a small value each month relative to tax revenue at a national level. In addition, Inland Revenue could demonstrate that an accrual number had been entered and not omitted from the data entry processes. It was when the February 2008 Accounts were being prepared by Treasury that a substantive variance was detected for both January and February 2008, alerting Treasury to the prospect that the variance was caused by a reason other than those that had previously been investigated by Inland Revenue and Treasury.

Recommendations

60. We recommend that Inland Revenue increase the coordination and alignment of resources between the Crown Revenue team and the Forecasting team before the monthly actual results are transferred to Treasury to assist with identifying variances as they arise.

61. Investigate the practicality and cost of extracting tax revenue data from FIRST earlier each month than is currently performed so that Crown Revenue team and the Forecasting team in Inland Revenue have a longer period than at present to analyse the monthly tax revenue figures.

Roles and responsibilities

62. Our investigation found that at an operational level within Inland Revenue there was insufficient clarity of Inland Revenue's responsibility to sign off the actual tax revenue result before transferring it to Treasury.

63. We found that when the procedure to calculate the provisional tax accrual was jointly designed and implemented by Treasury and Inland Revenue in July 2006, neither agency gave sufficient consideration as to whether the procedure would alter Inland Revenue's responsibility for the data it provides to Treasury.

64. In our view, Treasury has the greater responsibility relative to Inland Revenue to ensure that the responsibility for data is established and communicated clearly. Our view is based on Treasury's responsibility under the Public Finance Act to prepare the Accounts and administer the basis on which financial data is received from Inland Revenue and other agencies across the public sector.

Recommendation

65. We recommend that Treasury expressly state that Inland Revenue is responsible for any financial calculations, explanations and data it produces when Treasury is involved in designing and implementing procedures jointly with Inland Revenue.

The decision to publish the Accounts

66. This report has noted the importance of the Accounts, and functions they perform—enhancing accountability and providing useful information for decision-makers. Given the circumstances of the variance in company tax and other persons' tax, we consider that Treasury should have given a more concise explanation in the January 2008 Accounts in relation to these two tax types.

67. We found no clear documentation about the circumstances in which changes in content or timing for the Accounts should be considered. In this regard, Treasury could have considered at least the following options depending on the materiality of the circumstances:

a Proceed with no note to the Accounts.

b Proceed with a note to the Accounts.

c Delay publication of the Accounts until further work could be done on the issue. The Treasury was working to its published schedule and had five working days before reaching its statutory limit.

d Proceed with publication, based on best professional judgement of the number, and with a note to that effect. The error in question in this investigation is in the forecast accruals and is some distance from the solidity of cash. So, the company and other persons' tax revenue in the Accounts is therefore the result of professional judgement in the first place.

Recommendation

68. We recommend that Treasury prepare guidance on the circumstances and judgements that may need to be balanced before publishing the monthly Accounts, including the supporting comments and qualifications to accompany the Accounts.

Organisational issues

69. Inland Revenue identified in August 2007 that limited resources and increasing service demands were placing pressures on the performance of the Crown team within the Corporate Financial Management and External Reporting unit. In this regard, Inland Revenue had identified an organisational issue and taken reasonable steps to address the issue. However, staff turnover has impaired the Inland Revenue's ability to fully implement the changes.

70. Our investigation revealed that the changes had increased resources, reduced some of the key person risks, and that administrative controls were being implemented, although the control environment remains incomplete. We found that the changes were being implemented in an area of the organisation that operates under considerable pressure.

71. While the organisational changes have yet to be fully implemented, we consider that these changes are necessary and should be completed as a matter of priority. An independent review of the organisational changes should take place within the next six months.

Recommendation

72. We recommend that Inland Revenue complete an independent review of the organisational changes to the Corporate Financial Management and External Reporting unit by 30 September 2008, to assess the extent to which the implemented changes minimise the risks to the Crown Revenue reporting process.

Paul Carpinter Principal Advisor The Treasury	Alan Pinder Chief Advisor to Deputy Commissioner Inland Revenue
Andrew Blazey Advisor to the Chief Executive The Treasury	David Chan Area Manager, Assurance Inland Revenue

Annex 1: Terms of reference

Investigation of an error in tax revenue numbers: Terms of reference[8]

This note sets out the terms of reference for an investigation into the error in the tax revenues for January 2008 reported in the Financial Statements of the Government for the seven months ended 31 January 2008, which also occurred in the numbers for February 2008 provided by Inland Revenue to Treasury on March 12, 2008. This investigation is to report jointly to the Secretary to the Treasury and to the Commissioner for Inland Revenue. The purpose of this investigation is to discover how the error occurred in the January tax revenue numbers, why it was not detected until the preliminary February numbers were supplied in March, and what changes need to be made to prevent similar errors occurring in the future. Specifically, the investigation is to cover:

A. The facts of the situation: what process was followed, including what quality assurance, before the numbers were provided in February to Treasury, and what further checking was carried out prior to the numbers being released in the Financial Statements of the Government for the seven months ended 31 January 2008.

B. What deficiencies, if any, existed in Inland Revenue's processes that led to the error?

C. What deficiencies in process, if any, existed in Inland Revenue or Treasury that meant the error was not identified when the fall in revenue was queried prior to the release of the Financial Statements?

D. What, if any, changes to systems and procedures, capability or resourcing need to be undertaken by Inland Revenue or by Treasury to give confidence that future numbers, including those for February 2008, will be reliable?

The investigation will be conducted by:

- Paul Carpinter, Treasury, and
- Alan Pinder, Inland Revenue

with assistance from Treasury and Inland Revenue staff as necessary.

8 http://www.treasury.govt.nz/publications/media-speeches/media/18mar08a/

Annex 2: Chronology of events

Date	*Event*
Jul 2006	Treasury and Inland Revenue developed a method where the forecasted provisional tax due on a particular date gets spread over the preceding months so that tax is accrued in the month in which the underlying income is earned, calculated as 25% in month 1, 50% in month 2 and 75% in month 3. Each month, the previous month's accrual is reversed and replaced by a new accrual. Treasury provides the forecast non-accrual provisional tax figures to be applied by Inland Revenue in an agreed accrual spreadsheet. The first provisional tax accrual calculation was finalised in August 2007 and recognised for the 2005/06 Accounts.
Jul 2007	Treasury supplied a forecast for provisional tax as part of the May 2007 BEFU update and Inland Revenue then calculated the provisional tax accrual and sent the accrual figures to Treasury. When Treasury returned the confirmed accrual figures to Inland Revenue, Inland Revenue repeated the accrual calculation in error. Inland Revenue used the incorrect repeated accrual calculation in preparing the July 2007 monthly accounts.
20 Nov 2007	Treasury provided a further update to the provisional tax accruals by way of an email to Inland Revenue (HYEFU).
27 Nov 2007	Inland Revenue responded in an email back to Treasury on 27 November with a spreadsheet that included the correct provisional tax accrual amounts. The confirmed provisional tax figures were then sent back to Inland Revenue. Inland Revenue did not undertake any further action regarding the updated information.
24 Jan 2008	Treasury report on the Accounts for November 2007. No concern as variance between forecast and actuals not significant.
11 Feb 2008	Treasury report on the Accounts for December 2007. No concern as variance between forecast and actuals not significant.
12 Feb 2008	Inland Revenue's Crown Revenue team submitted the January 2008 month-end actuals into CFIS. Prior to these figures being submitted the Crown Revenue team reviewed the numbers focussing particularly on tax pooling and interfaces with FIRST system, which identified a fall in assessments and timing delays arising from tax pooling. Treasury noticed that the tax revenue was well below forecasts with negative variances of $300 million in company tax and other persons' tax. The variance led to a number of discussions between Treasury and Inland Revenue officials. On 18 February Inland Revenue's Forecasting team reviewed and analysed the January 2008 Revenue Outturns and also identified the significant variance that needed further analysis.

19 Feb 2008	Treasury and Inland Revenue staff (Forecasting and Crown) met to discuss the variance analysis completed and also agree what further action was required to satisfy that the variance could be explained appropriately. The outcome of the meeting was that further analysis would be completed on economics, IT changes (PIE and GST-provisional tax alignment), and the pooling account. In-depth analysis was undertaken by the Inland Revenue Forecasting, supported by the Inland Revenue Crown team.
22 Feb 2008	After a series of meetings and discussions between Inland Revenue and Treasury and further variance analysis completed, Inland Revenue and Treasury reported jointly to the Ministers. That report noted all the explanations concerning the variance but also identified a $520 million unexplained variance that was accounted for as being partly due to timing issues and drop in income of smaller taxpayers.
28 Feb 2008	Treasury report on Crown Accounts for January 2008, pretty much based on the same information reported jointly a week earlier. The report again notes the $520 million unallocated variance.
11 Mar 2008	Inland Revenue submitted provisional February 2008 month-end actuals to Treasury, which showed a continued significant negative variance. This raised concerns both with Inland Revenue and Treasury officials. Inland Revenue advised that further analysis would be undertaken of these results over the next two days. Further analysis was completed by both agencies.
13 Mar 2008	One significant analysis completed by Inland Revenue's Forecasting team was around other persons' tax and specific accounting entries, which highlighted a separation between the amounts forecasted and the journaled figures. In a meeting between Treasury and Inland Revenue, the analysis completed by Forecasting was tabled, which led to Treasury asking for the background estimation figures. The Crown team had some of this information on hand and tabled these at the meeting. Treasury advised that the numbers provided did not look correct and asked the Crown team to check this further. Crown Revenue shortly verified that Inland Revenue had not used the correct November updated provisional tax accruals for January and February based on the November HYEFU update. Instead, Inland Revenue had continued to use the incorrect re-spread May provisional tax calculations for those months.