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**MINISTRY OF FINANCE
AND CORPORATE RELATIONS**

Revenue Verification for the Social Service Tax



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Sir/Madam:

I have the honour to transmit herewith my Performance Audit Report to the Legislative Assembly on Revenue Verification for the Social Service Tax.

This audit was carried out within the Ministry of Finance and Corporate Relations.

George L. Morfitt, FCA
Auditor General

Victoria, British Columbia
June 1996

Revenue Verification for the Social Service Tax



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Auditor General's Comments



Auditor General's Comments



This report, my fourth to the Legislative Assembly for the 1995/96 year, contains the results of my office's performance audit of the administration of the social service tax, also known as the provincial sales tax.

The Ministry of Finance and Corporate Relations collects provincial taxes. For the 1994/95 fiscal year, the ministry collected over \$2.8 billion in social service tax. This represents about 24% of total provincial taxes collected and about 13% of total provincial revenues.

Clearly the social service tax is a major source of revenue for government and contributes significantly to funding many programs. It is therefore important that government collects the taxes it is entitled to. This involves having all eligible vendors register, all vendors collect the correct amount of tax on all taxable sales, and vendors remit all taxes collected on a timely basis.

The social service tax in British Columbia is based on the principle of voluntary self-assessment—trusting that taxpayers will meet their legal responsibility to remit the correct amount of taxes at the appropriate time. The controls and processes that government uses to administer the program aim at maintaining the integrity of the system and taxpayers' confidence in its fairness.

In this audit, we assessed the methods used by the ministry to maximize social service tax revenue to determine if they were producing reasonable results for the effort. We also looked at whether the ministry is estimating the amount of taxes that are due but uncollected. This information, although difficult to come by, can be valuable in helping the ministry determine the actions it must take to collect those taxes and the resources it must commit to carry out the task.

Based on our audit work, we concluded the ministry's efforts for identifying unpaid revenues are cost-effective. Its auditors collect substantially more money in additional taxes than the ministry spends administering the program. Indeed, we believe there is



significant scope for collecting additional revenues, and we recommend that the ministry develop a long-range resource planning strategy for enforcement work which considers the cost and benefits of such work.

I wish to thank staff and executive of the ministry for their assistance and cooperation throughout the audit. We were provided with all the information and explanations required.

*George L. Morfitt, FCA
Auditor General*

*Victoria, British Columbia
June 1996*



Highlights



Revenue Verification for the Social Service Tax



An audit of the revenue verification activities for social service tax by the Ministry of Finance and Corporate Relations.

Audit Purpose and Scope

The purpose of this audit was to assess whether the methods used by the ministry to maximize social service tax revenues while maintaining the integrity of the tax administration system are cost-effective, and whether the ministry is reliably estimating the size of the gap between tax revenues collected and those that are due.

Our audit examined activities taking place from April 1994 to November 1995, as well as the initiatives underway during that time. We did not examine routine remittance and recording arrangements for social service tax payments, ministry measures to enforce collection of outstanding debts once they had been identified, or activities related to other consumer taxes administered by the ministry.

Our examination was performed in accordance with value-for-money auditing standards recommended by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

Overall Conclusion

We concluded that the ministry's methods for maximizing social service tax revenues and maintaining the integrity of the tax system are cost-effective. The ministry provides sufficient information and education to taxpayers to ensure that they are aware of their responsibilities. Its enforcement staff conduct audits and inspections that identify non-compliance and unpaid taxes. This work is carried out according to clear and consistent strategies and appropriate procedures by qualified staff. However, the results of work in identifying unpaid taxes indicate that significant amounts of tax revenue, well in excess of the estimated cost of employing the additional resources required to find them, remain to be identified.

There is also scope for improvement in a number of other areas which would assist the ministry still further in its efforts to use its existing resources in the most efficient way. First, the ministry has

not made the most effective use of its powers to prosecute offenders for non-compliance. However, to be able to counteract the recent growth the province has experienced in instances of serious non-compliance with the tax legislation, the ministry has recently developed policy options and made recommendations for legislative changes. Second, the ministry should improve its management information systems. Only with relevant and timely information can it more efficiently manage the program, and measure performance against objectives. Third, the ministry has not carried out extensive work on estimating the size and nature of the gap between taxes collected and those that are due although it has done some work in this area. It is not unique in this regard, as other tax jurisdictions are also exploring how to obtain this information. We encourage the ministry to continue with its efforts in this area.

Finally, we concluded that the ministry should provide more information on its performance to the Legislative Assembly and the public.

Key Findings

The ministry's efforts for identifying unpaid revenues are cost-effective; however, more resources dedicated to this purpose would generate significant amounts of additional revenues

It is clear that the enforcement work carried out by the audit and inspection staff available at current resource levels is cost-effective. In 1995, the ministry's auditors and inspectors carried out approximately 3,000 audits and identified \$45 million of tax non-compliance. The average value of unpaid revenues assessed by each auditor in 1995 was \$535,000; the average salary and benefits cost of each auditor was \$50,000.

The ministry has used various models to determine the optimum number of staff needed to collect revenues in industry sectors where the degree of compliance is known; however, staff have not been made available to meet those optimum levels. Although the return on work carried out by existing staff indicates that it would be cost-effective to employ additional resources to further reduce the extent of non-compliance and increase revenues, the ministry in 1995 reduced the number of enforcement staff.

The ministry has effective procedures in place to identify and respond to non-compliance

The ministry's enforcement work is carried out in accordance with clear strategies. These include an audit and inspection process, as well as appropriate procedures to identify and respond to a failure

to file and make full payment, and to under-report tax due. Auditors and inspectors are appropriately qualified and have a clear understanding of their roles and responsibilities. The audit process followed by staff is clearly defined and provides for management review before assessments for unpaid taxes are issued to taxpayers.

The ministry is currently reviewing and formalizing its existing procedures for the planning and targeting of enforcement work, including a method of audit selection that is designed to focus on areas with the greatest risk of non-compliance.

The ministry provides sufficient information and advice to taxpayers on how to comply with their responsibilities

Information is available to taxpayers in a variety of forms. The *Social Service Tax Act (1979)* and the supporting regulations set out the responsibilities of taxpayers and the ministry. To supplement the legislation, the ministry publishes a wide range of bulletins on a variety of social service tax matters and makes these freely available to taxpayers. It also operates a free telephone help line, and taxpayers can book personal visits from ministry staff.

In addition, the ministry targets potential, new, and existing registrants to receive information any time that major changes to the scope of the tax are introduced. It similarly targets groups of registrants when a problem is identified, such as the widespread non-compliance with obtaining a certification from purchasers of adult-size clothing for children. Clothing is only exempt from tax if it is purchased for a child.

Education and information is also provided to taxpayers by ministry auditors and inspectors. Inspectors spend some 30% of their time on education work, and auditors educate taxpayers in the process of reviewing the results of their audits.

The ministry does not make the most effective use of its powers to prosecute offenders for non-compliance

The *Social Service Tax Act (1979)* provides the ministry with extensive powers to prosecute offenders, and stipulates a range of court-imposed monetary fines and prison terms for different types of offences. To date, the ministry has not used these powers; rather, it has applied administrative penalties and interest for non-compliance. However, the ministry is finding that relying on administrative enforcement measures alone is inadequate to counteract the recent growth in the underground economy and other instances of serious non-compliance with the tax legislation. The ministry has identified this as an issue, and recently completed a study of the policy options, and made recommendations for legislative changes.



The ministry's management information systems are inadequate, and limit the ability of management to measure its performance in meeting its objectives

The ministry's existing management information systems are outdated. The systems do not allow management easy access to data, nor opportunity to easily manipulate that data so as to be able to measure its efficiency in managing the program and its success in meeting program objectives. Where possible, information is downloaded from the system onto personal computers, then reformatted as needed. Some useful information is produced, although this is an inefficient process.

The ministry has not measured the size and nature of the gap between revenues collected and those which are due, although it has done some work in this area

Determining the size of the gap between revenues collected and those which are due involves estimating the nature and size of the underground economy as well as considering other factors relating to each industry sector. It requires obtaining reliable information and having the necessary systems to process the data. Obtaining reliable information is difficult and the process of calculation is complex, and to our knowledge no tax jurisdictions have made significant progress in this area.

The ministry recognizes that information on the size and nature of the revenue gap would help in determining the extent to which it is maximizing tax revenues and the level to which it is maintaining compliance across all industry sectors. It would also help the ministry to set specific targets for compliance and for revenues to be collected, as well as assist the ministry in determining the level of resources it requires and how best to use them to meet its targets. The ministry has already done some work in this area. It has been developing methods to determine the nature and size of specific areas of the underground economy and other factors leading to the identification of non-compliance by industry sectors. We encourage the ministry to continue with these efforts.

The ministry does not adequately report on its performance to the Legislative Assembly

The ministry has a clear set of objectives governing its administration of the *Social Service Tax Act* (1979), although they do not extend to specific compliance and other targets against which performance can be easily measured. In addition, the ministry makes very little information available to the Legislative Assembly and general public, so these stakeholders are unable to determine how well the ministry is meeting specific objectives and whether overall, it is administering a fair, equitable, and consistent tax system.



Detailed Report



About the Tax



Historical Background

The social service tax was introduced in British Columbia in 1948 under the *Social Security and Municipal Aid Tax Act*. Since then, the legislation has undergone numerous changes (Exhibit 1), including recently the application of the tax to legal services in 1992, and to certain installation, repair, and maintenance services in 1993.

In the 1994/95 fiscal year, \$2.8 billion was collected in social service tax revenues, almost double the \$1.5 billion collected in 1988

(Exhibit 2). In 1948, the rate of tax was set at 3%. In 1954 it was increased to 5% and in 1976 to 7%. It has varied considerably since then, but is currently 7% (Exhibit 3).

Legal Framework

The *Social Service Tax Act* (1979) is the legislation now in effect. It imposes a social service tax on purchases and leases of tangible personal property and certain services within the province. Together, the Act and supporting

Exhibit 1

Key Dates in the History of the *Social Service Tax Act*

- 1948 – Social service tax introduced under the *Social Security and Municipal Aid Tax Act*.
- 1953 – Name of Act changed to *Social Services Tax Act*.
- 1955 – Statutory requirement to allocate one-third of revenue to municipalities repealed.
- 1971 – Tobacco removed from the Act and taxed separately.
- 1974 – Exemption of certain printed and bound books introduced.
- 1979 – Name of Act changed to *Social Service Tax Act*.
- 1982 – Definition of sale price amended to include processing costs and expenses where goods are processed outside the province.
- 1985 – Exemption of certain goods for aquaculturists and manufacturers introduced.
 - Clarification of definition of computer software.
- 1987 – New exemptions and refunds for the mining industry introduced.
- 1988 – Tax on liquor imposed at 10%.
- 1989 – Enactment of statutory “temporary use in province” provisions.
- 1990 – Imposition of environmental levies on certain items.
- 1992 – Tax on legal services introduced.
 - Tax on certain processing and manufacturing services introduced.
- 1993 – Tax broadened to cover installation, repair, and maintenance services.
 - Tax on parking introduced.

Source: Ministry of Finance and Corporate Relations

regulations specify detailed provisions relating to the powers of the ministry to audit and inspect books and records, make tax assessments, and levy penalty and interest charges in the event of non-payment. Certain offences under the Act may lead to fines or imprisonment. Also included in the legislation are appeal processes for use by taxpayers, and provisions for refunds of tax to be paid under certain specified circumstances.

Scope of the Tax

The tax is levied on purchases, retail sales and leases of tangible

personal property within British Columbia, and on certain services consumed within the province. Tangible personal property is defined as:

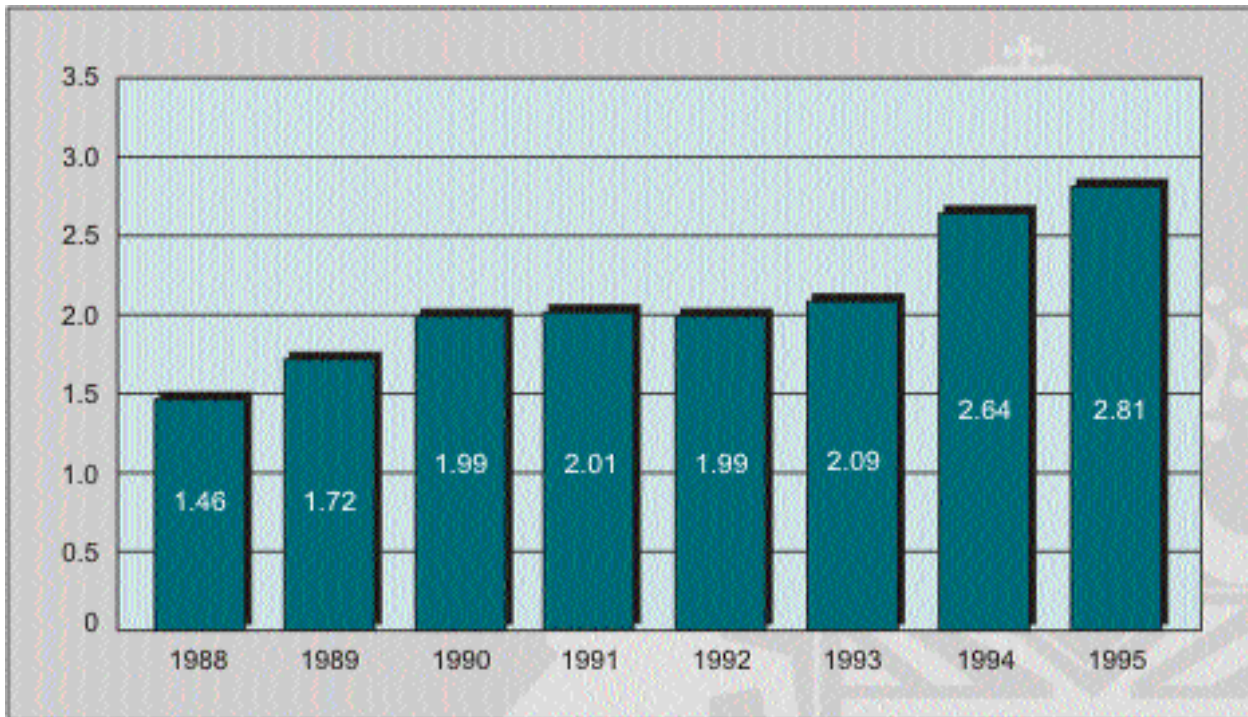
- personal property that can be seen, weighed, measured, felt, or touched or that is in any other way perceptible to the senses, and includes fixtures and natural or manufactured gas;
- software; and
- electricity.

The tax is also payable on the purchase price of legal services, telecommunication services, and certain other services related to the

Exhibit 2

Social Service Tax Revenues, 1988–1995 Fiscal Years

(\$ Billions)



Source: Ministry of Finance and Corporate Relations

installation, repair, and maintenance of tangible personal property. As well, an environmental levy is imposed on certain tires and batteries.

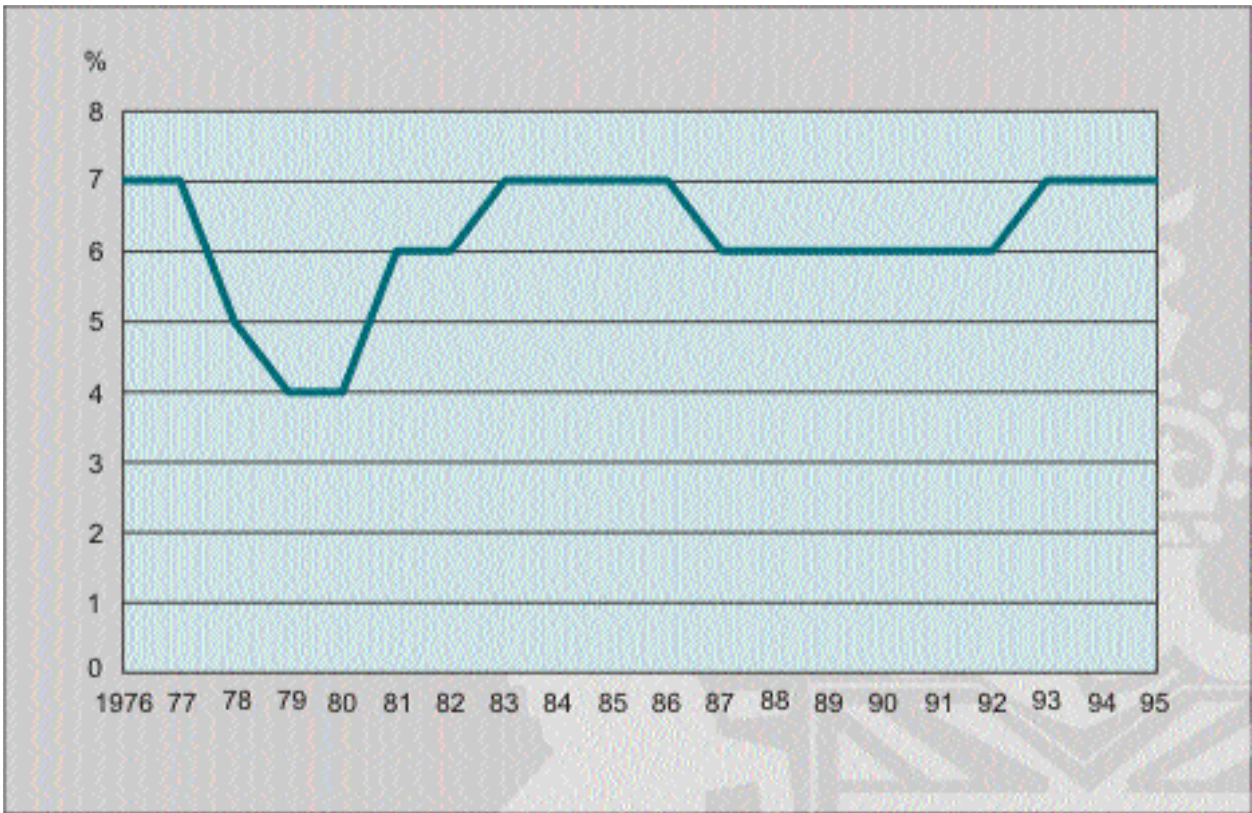
It is the purchaser, lessee, or user of tangible personal property, including taxable services, who pays the tax and usually the vendor who collects it. In some instances, such as when purchases are made outside the province but are brought into British Columbia, the tax must be remitted directly by the purchaser.

Registration and Reporting Requirements

Although the obligation to pay the tax is on the purchaser, for purchases made through retail outlets, the obligation to collect and remit the tax is placed on the vendor as the appointed agent of the Minister. Vendors making regular taxable sales or providing taxable services including legal services are required to register with the ministry. It is an offence under the legislation to make such sales without a valid registration certificate issued by the Consumer

Exhibit 3

Social Service Tax Rates, 1976-1995



Source: Ministry of Finance and Corporate Relations

Taxation Branch. It is in the interest of vendors to register, as they are then entitled to purchase their goods for resale from suppliers on a tax-free basis on presentation of a registration number. Suppliers who only make sales to other vendors for further resale, and vendors selling only non-taxable items, are not required to register as no tax is imposed on such transactions. At the time of our audit there were approximately 90,000 active registered vendors.

Registered vendors, as the agent of the Minister, are required to submit tax returns detailing the value of sales, the tax due, and other relevant details, along with the amount due. Most vendors remit monthly before the 15th of the month following the transactions, but arrangements may be made to pay at different intervals.

In addition to vendors resident within the province, out-of-province vendors may be required to register. The tax is also payable by ordinary residents of the province or non-residents who purchase taxable items outside British Columbia for use within the province. Such persons are not required to register, but are required to notify the tax authorities of the purchase details and pay the appropriate amount of tax.

Exemptions

The purchase or lease of certain classes of tangible personal property or services is exempt from taxation. These exemptions may be categorized into four broad groupings:

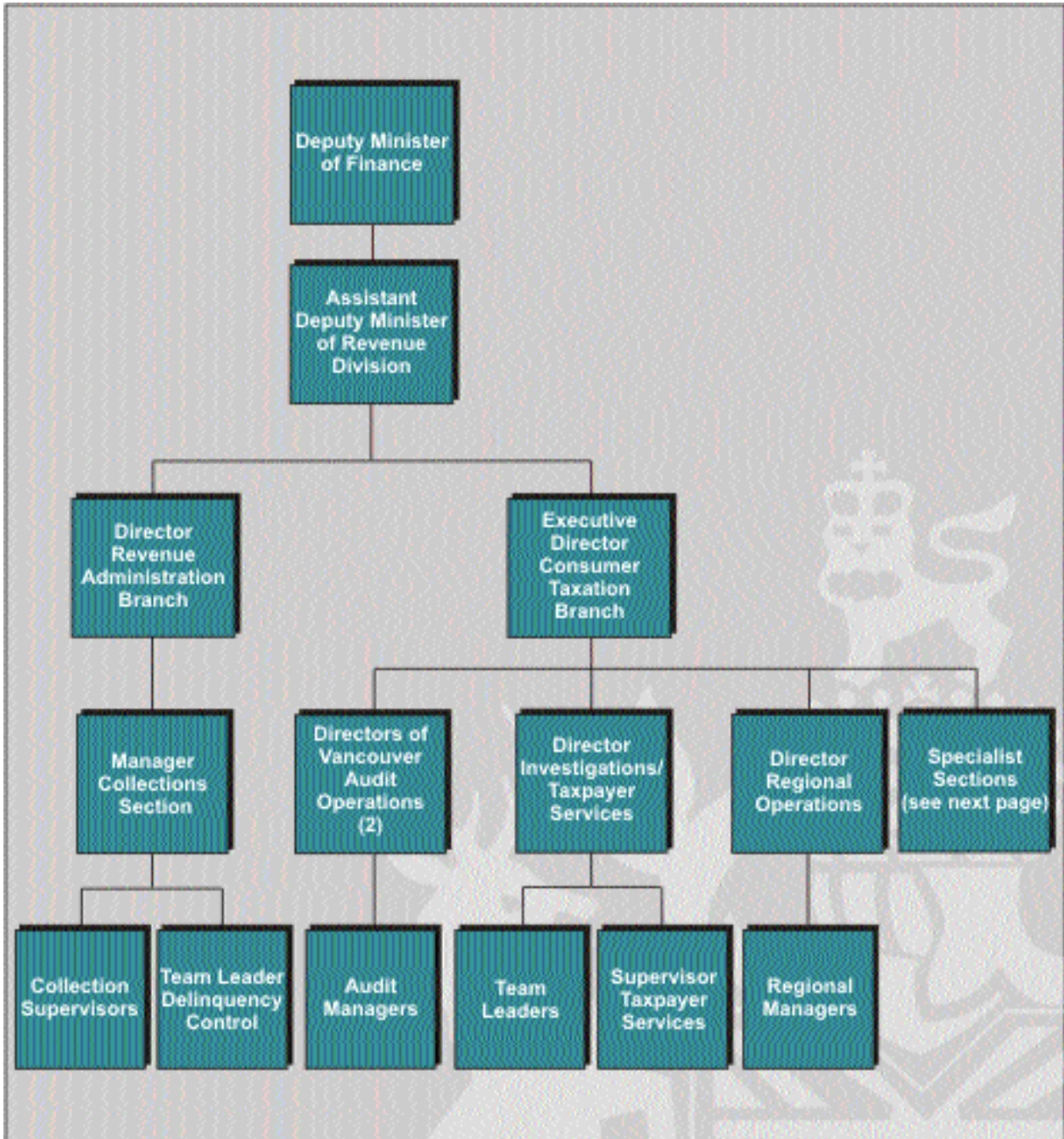
- **consumer goods** – exemptions available to all purchasers on items such as food, books, children’s clothing, drugs and medical supplies, and bicycles.
- **agricultural goods** – exemptions granted to the agricultural and fishing industries for the purchase of items such as fertilizers, feedstuffs, and a wide range of equipment.
- **producers** – conditional exemptions granted to manufacturers or producers for the purchase of raw materials, certain materials consumed in the manufacturing process, and certain exploration equipment for the mining industry.
- **exemptions by class of purchaser or vendor** – conditional exemptions granted to certain classes of purchasers, such as school boards.

Roles and Responsibilities within the Ministry of Finance and Corporate Relations

Responsibility for the administration and collection of the tax falls to the Consumer Taxation and Revenue Administration branches of the ministry’s Revenue Division (Exhibit 4). Both branches’ headquarters are in Victoria and both administer other taxes in addition to the social service tax: the Consumer Taxation Branch administers the hotel room tax, tobacco tax, horse racing tax, and motor fuel tax; and the Revenue Administration Branch collects all of these taxes along with those administered by the Real Property and Income Taxation branches.

Exhibit 4

Partial Organization Chart Depicting the Reporting Relationship with the Revenue Division



Source: Ministry of Finance and Corporate Relations

The Consumer Taxation Branch has a number of specialist sections with clearly defined responsibilities:

- **The Registration section** is responsible for approving and processing applications for vendor registration—approximately 15,000 each year—and for establishing and maintaining files on the 90,000 active registered vendors. This includes processing 45,000 record changes (names, addresses etc.) and responding to related inquiries and correspondence.
- **The Close of Business section** reviews all registered accounts that are cancelled—approximately 14,000 each year—to ensure that all outstanding tax due on the transfer of business assets is remitted to the province.
- **The Boat and Aircraft section** identifies social service tax due on private sales of boats and aircraft—approximately 14,000 transactions are examined annually—and maintains the details of sales of motor vehicles by registered dealers.
- **The Refund section** ensures that refund claims meet the requirements of the legislation and that the approximately 4,000 payments made annually are processed promptly.
- **The Technical Analysis and Litigation section** reviews all complex or contentious audits, assessments, and refunds to ensure that the branch is technically correct in its interpretation of the rules and that taxpayers are treated fairly and equitably. This section

prepares branch responses on appeals to the Minister and supports legal counsel in dealing with appeals to the courts. It maintains records of all audits underway and completed, and prepares statistical information.

- **The Taxpayers Services section** responds to requests from taxpayers for information relating to the tax. These requests are mainly received through a telephone help line, but are also received in writing and in person.
- **The Policy and Legislative section** is responsible for the branch's annual legislative program and for ensuring that advice given to both the public and staff is complete and accurate. This section also researches and analyzes legislation and policy initiatives, and provides policy, legislative, and procedural recommendations to management.

In addition to these Victoria-based sections, the Consumer Taxation Branch operates 14 field offices throughout the province. These are staffed by auditors and inspectors who are responsible for ensuring that taxpayers are complying fully with the requirements of the legislation (Exhibit 5). The largest office is in Vancouver. It operates a satellite office in Surrey, staffs the telephone help line, and provides the centralized audit targeting service.

In 1995, the branch completed 2,968 audits which generated assessments of tax, interest and penalties of more than \$45 million. Staff also provided tax advice to

Exhibit 5

Location of Consumer Taxation Branch Offices in British Columbia



Source: Ministry of Finance and Corporate Relations



the public, obtained payments from taxpayers, and carried out inspections of businesses to ensure that the tax is being properly applied. Although the social service tax is the subject of the great majority of audit and inspection work conducted by the branch, staff are also involved in the enforcement of the other consumer tax statutes.

The Revenue Administration Branch Delinquency Control section, located in Victoria, is responsible for the initial identification of taxpayers who fail to remit tax returns or are late in doing so. **The Collections section** of the branch has a wide range of powers to enforce the collection of assessments arising from both delinquent accounts and audit work.

Corporate Mission and Objectives

The ministry's stated mission is "to continuously improve our leadership, products, planning and services so that we can offer the public and our clients sound management and advice." This it has supported with specific corporate objectives, values, and principles. Within this context, the mission of the Revenue Division is "to manage the collection of various taxes in order to fund services for the citizens of British Columbia." In support of this, the division has in turn identified its own goals, values, vision, and management philosophy.

More specific to the administration of the social services tax are the mission statement and goals of the Consumer Taxation and Revenue Administration branches. The Consumer Taxation Branch mission is "to manage the administration and compliance of consumption tax statutes in a manner that is fair, consistent, equitable and efficient." The Revenue Administration Branch goals include:

- collecting all taxes due in a way that is fair and reasonable to all taxpayers;
- providing friendly and professional service to taxpayers;
- providing value for money for the taxpayer;
- working effectively and harmoniously with business partners; and
- being accountable for performance.

Organization of This Report

We have organized our findings into five sections:

- Providing Information and Assistance;
- Identifying and Collecting What Is Due;
- Administering the Enforcement Process Cost-effectively;
- Evaluating Performance; and
- Keeping the Public and Legislative Assembly Informed.



Providing Information and Assistance



The social service tax in British Columbia is based on a fundamental principle of voluntary compliance and self-assessment—trusting that taxpayers will meet their legal responsibility to remit the correct amount of taxes at the appropriate time. For such a regime to succeed in cost-effectively maximizing revenues while at the same time maintaining the integrity of the tax administration system, it is essential that taxpayers be well informed and have ready access to advice on social service tax matters.

Taxpayers and vendors should have written guidance available to them that is written in plain language and available to all, including minority groups. They should also be informed proactively of major changes to the tax legislation, and should have ready access to ministry staff if they have questions about their tax responsibilities.

We examined the ways in which the ministry seeks to ensure that taxpayers and vendors are properly informed of their responsibilities, and the extent to which it makes advice available on specific problems. We also examined the ministry's actions when major changes to legislation take place.

Conclusion

The ministry fully recognizes the importance of well-informed taxpayers and vendors, and puts a great deal of effort into ensuring that they understand their

responsibilities and have ready access to advice when they require it. The ministry meets this need through a combination of measures, such as providing bulletins on social service tax matters and access to advice through a telephone help line service. On request, staff will also make visits to vendors. As well, the ministry has taken the initiative of advising taxpayers of major changes to legislation by focusing attention on specific categories of businesses to ensure they are aware of, and understand, their responsibilities. The ministry is also looking at improving its service to minority groups.

Findings

Information Available to Taxpayers

Information is available to taxpayers in a variety of forms. The *Social Service Tax Act (1979)* and regulations set out the responsibilities of taxpayers and the ministry's powers.

Bulletins

To supplement the legislation, the Consumer Taxation Branch has published more than 100 bulletins on a wide variety of social service tax matters and makes these freely available to taxpayers (Exhibit 6). These bulletins deal primarily with issues relating to exemptions and, although they have no legal status, provide valuable guidance to taxpayers in how to deal with problems of interpretation on social service tax matters. In 1994, more

Exhibit 6

Examples of Social Service Tax Bulletins

#001	Exemption for non-motorized two-wheel bicycles
#007	Purchase of vehicles by non-residents
#009	Exemption for children's clothing
#023	Exemption for bona fide farmers
#033	Completing the tax return form
#044	Do you need to register as a vendor?
#053	Photographers and photofinishers
#066	Purchases and sales by florists
#072	Contractors and subcontractors
#077	Refunds of overpayments of tax
#081	Coal and mineral mining operations
#105	Motor vehicle parking

Source: Ministry of Finance and Corporate Relations

than 600,000 copies were provided to taxpayers. The ministry has focused on writing the bulletins in plain language to promote easy understanding of even the most complex tax issues. As a result, they are comprehensible and straightforward to follow, given the highly technical nature of some of the subjects covered. An index of bulletins which identifies those that have been updated during the past year is mailed annually to all registered vendors.

Bulletins are available from the ministry's offices and from government agents' offices throughout British Columbia. They can also be obtained by mail through the telephone help line and picked up from consumer tax offices around the province. Through the Ministry of Small Business, Tourism and Culture the branch also distributes bulletins at business

information centers and chambers of commerce. Bulletins are not currently available in languages other than English, although the Consumer Taxation Branch is looking into their feasibility.

Meetings with Stakeholder Organizations

Ministry management meet with representatives from a number of different organizations and industries to keep them abreast of developments and to respond to their concerns (Exhibit 7).

Telephone Help Line

In the 1991/92 fiscal year the ministry introduced a province-wide telephone help line for taxpayers. Information numbers are published in local telephone directories throughout the province. All calls made to the information line, wherever they originate in the province, are routed through to the

Exhibit 7

Examples of Organizations Contacted by Consumer Taxation Branch Senior Management

Tax Executive Institute
Canadian Institute of Chartered Accountants
Certified General Accountants
Various Chambers of Commerce
Downtown Businessmen's Association
North Vancouver Businessmen's Association
British Columbia Shake and Shingle Manufacturers' Association
British Columbia Trucking Association
Lower Fraser Valley Agricultural Association
Molson Indy 500 organizers

Source: Ministry of Finance and Corporate Relations

Taxpayer Services section based in Vancouver. Some 8,000 calls are fielded each month. The telephone system enables staff to log the nature of the calls received. Staff use 75 computerized codes which generally follow the topics of the tax bulletins. On a regular basis this information is passed on to the Policy and Litigation section and is used as an indicator of areas that may need clarification or of bulletins that may require revision. Telephone calls and E-mail messages from auditors and inspectors also provide insight into what is confusing taxpayers.

Before the ministry installed the computerized system in 1994, there was no easy means of tracking any data on phone calls. The new system has allowed the branch to monitor the reasons why taxpayers are calling the help line and to target specific taxpayer groups

for assistance. Three additional telephone staff were added in 1995 to improve the service.

Dealing with Changes in Legislation

The branch is proactive in its education when legislation changes or when an identifiable group of vendors is not complying with a specific aspect of the legislation. For example, when the scope of the tax was broadened to include legal services in 1992, the ministry worked with the British Columbia Law Society to ensure that all law offices were informed of the requirement to collect and remit the tax. Specific categories of registrants may also be targeted for advice when a problem arises, such as the vendors not complying with the requirement to obtain a certification from purchasers of adult-size clothing for children.

As a temporary initiative, the ministry visited newly registered vendors to ensure they understood how to comply with the tax legislation. It found, however, that not all vendors welcomed this approach, some feeling that government was being too heavy-handed at laying down the law. In view of this, and since voluntary compliance is a key factor of the tax system, the ministry decided to make personal visits only on request. Of the typically 1,250 new registrants monthly, only about 12 usually take the ministry up on this offer. This low response rate suggests that the ministry's approach is valid.

Information and Assistance Provided by Auditors and Inspectors

Auditors, and particularly inspectors, acknowledge they have an educational role to play in assisting taxpayers understand the social service tax. Inspectors consider a major part of their role to be educating and advising taxpayers. According to the Consumer Taxation Branch's time-keeping system, inspectors spend over 30% of their time carrying out vendor education activities. Auditors also have a role in education when they review the results of their audits with the taxpayer and explain any errors in the way the taxpayer is collecting or remitting the tax. The ministry also monitors the results of audit and inspection work for the emergence of any patterns of non-compliance, requiring some updating of existing bulletins or issuing of new ones.

Other Measures

At present, information is available only in English. To further improve services, the ministry is considering the use of ethnic newspapers and community newsletters to reach significant minority groups such as the British Columbia Chinese community.



Identifying and Collecting What is Due



While informed taxpayers and the ready availability of advice is a fundamental requirement of any tax system based on self-assessment and voluntary compliance, also essential are measures such as taxpayer audits and penalties for non-compliance to ensure that all taxes due are collected. These are necessary if taxpayers are to retain confidence in the system. An important factor in determining the scope and nature of this work is the size and nature of the gap between taxes collected and those that are due.

Accordingly, we expected the ministry to have planned and targeted enforcement work, qualified and trained staff, an audit methodology that is clear and adhered to, and proper management review of audit work. We also expected that those who fail to comply should be penalized appropriately but fairly. We also expected the ministry to be working towards measuring the revenue gap.

Conclusion

The ministry is carrying out its enforcement work according to clear and consistent strategies based on the experience and knowledge built up by staff over many years. Appropriate procedures are in place for selecting and targeting audits and the ministry is currently improving and formalizing these still further. Staff performing all aspects of enforcement work

are appropriately qualified and experienced to carry out their work and have clear guidelines as to how the audits should be undertaken.

The ministry has done limited work toward measuring the gap between taxes collected and those that are due. We recognize that the ministry is proceeding cautiously because there are difficulties—experienced by all tax jurisdictions—when activities involve estimating the nature and size of the underground economy and other factors leading to non-compliance in the various industry sectors. In addition to the complexities involved in gathering the information, the ministry does not have the necessary systems to process the information needed to calculate the gap. It has recently received approval to review options for replacing the main computer system.

The ministry has not made full use of its powers to prosecute offenders for non-compliance. It has recently completed a review of the policy options and made recommendations for legislative changes.

Findings

The Nature of Enforcement Work

Enforcement work in the ministry is undertaken by both the Revenue Administration and Consumer Taxation Branches. The Revenue Administration Branch deals with registered vendors who

fail to file tax returns by the due date. These are known as delinquent accounts. The Consumer Taxation Branch employs inspectors and auditors to identify non-compliance with the requirements of the legislation by both registered and non-registered individuals and companies. This includes identifying taxpayers who fail to register and those who are not applying the tax correctly.

Identifying Delinquent Accounts

An important part of reducing non-compliance is identifying those vendors who fail to remit tax returns and to make full payment by the due date. Failure to identify such vendors at a sufficiently early stage can make it difficult to secure future compliance and can possibly encourage future non-compliance. We found that the ministry is aware of these dangers and has taken steps to limit the risks involved.

The Delinquency Control section of the Revenue Administration Branch deals initially with those registered vendors who fail to file tax returns by the due date or who fail to file at all, and it is also responsible for collecting debts of less than \$300. On average, 5,500 active vendors were identified each month in 1994 and 1995 as delinquent, some of whom are already delinquent from earlier months. At the end of March 1995, the Delinquency Control section was seeking to recover nearly \$700,000 in outstanding debts less than \$300.

If the vendor failing to remit by the due date does not owe tax

from earlier months, the Delinquency Control section contacts the vendor to obtain payment or establish the reason for non-payment. Should this approach be unsuccessful, an assessment of tax, penalty, and interest due is estimated, an accounts receivable set up against the vendor's account number, and a notice of assessment is sent requesting payment. If payment is still not received, then the file is passed to the Collections section for further action. In cases where there is already an outstanding tax liability and further delinquency is identified, the case is passed to the collector already handling the file to ensure the amounts involved are covered by existing collection action.

The Audit and Inspection Process

The bulk of the ministry's enforcement efforts for social service tax is undertaken by auditors and inspectors employed in the Consumer Taxation Branch. The branch's overall strategy in carrying out its enforcement work must fit in with its mission to manage the administration of, and compliance with, the consumer tax statutes in a manner which is fair, consistent, equitable, and efficient. Although the large majority of British Columbia taxpayers comply voluntarily with the statutes, the branch recognizes that it still must maintain comprehensive, flexible and targeted enforcement programs. Such programs are aimed at achieving a balance between enforcement that improves or maintains voluntary compliance, and enforcement that simply produces revenue.

Inspection Work

The primary purpose of inspection work is to make taxpayers aware of their responsibilities under the legislation and to identify areas of possible non-compliance. For example, inspectors identify new businesses established in their districts and ensure that, if appropriate, they are registered for the tax.

In addition, inspectors are involved in verifying claims for refunds of the tax and in carrying out special projects and small audits as directed by branch management. An example of a specific enforcement project is the construction industry, where inspectors will identify details of contracts let in their areas and identify the main and sub-contractors. If the contractors are British Columbia based, they are covered under the normal audit process. If out-of-province contractors are involved, the inspector contacts them individually and ensures that tax is being paid on any equipment or materials brought into the province for the project. Similarly, in the case of special events held in the province, (such as major theater events and exhibitions or sports events like the Indy 500 race held in Vancouver), the inspector contacts the promoters and identifies any vendors selling goods at the events. Any unregistered vendors are contacted to ensure that they meet their tax liabilities.

Projects such as these cover significant areas of potential non-compliance and we believe the ministry's efforts to target them are appropriate.

Audit Work

The primary purpose of audit work is to identify non-compliance, assess unpaid taxes and secure future compliance in accordance with the objectives of the Consumer Taxation Branch. Audits are classified into five categories: priority audits, large and inter-office audits, out-of-province audits, special project audits, and deterrence audits.

Priority audits are to be undertaken as quickly possible for a variety of reasons, such as when an audit lead has indicated that a firm has a known or possible substantial tax liability, when there is a risk that a vendor is in financial difficulty and the business may be about to close, or when a vendor has been consistently delinquent in filing tax returns and remitting tax collected.

Large and inter-office audits are audits primarily of national and international firms that carry on interprovincial and international trade. The companies audited are those with large trading volumes or multiple locations.

Out-of-province audits are those conducted outside British Columbia and involving companies that carry out business in the province but maintain their business records elsewhere.

Special project audits are those targeted at specific industry sectors or taxpayers with specific characteristics. They often require specialized industry or technical knowledge by the audit and inspection staff involved.

Deterrence audits are selected and scheduled to encourage

continued compliance by all taxpayers with the statute to protect existing revenues, prevent erosion of the tax base and protect future revenues.

The audit inventory is maintained by the Consumer Taxation Branch office in Vancouver. All potential audits arising from whatever source are entered into the inventory and allocated to the appropriate regional and audit managers. The managers then allocate the audits to individual staff and monitor their progress in carrying them out. Exhibit 8 lists some of the sources of information for audit and inspection.

Planning the Audit Work

The Consumer Taxation Branch has recently formalized a comprehensive planning framework

based on an assessment of the risk of non-compliance. The approach involves the development of a five-year general audit plan and a more detailed annual audit plan. Both of these plans address a variety of risk areas, beginning with the three main categories related to the collection and remittance of tax: failure to collect tax, failure to remit tax, and failure to self-assess taxes due. Other risks to be considered include loss of voluntary compliance, changes in technology or business environment, and other governments' legislation, policies, or procedures directly affecting the branch's ability to ensure compliance.

Implementation of the plans will be overseen by an audit steering committee and an audit working committee. The steering committee's responsibilities will

Exhibit 8

Sources of Information for Audit and Inspection

- The audit targeting system based on past audit history and remittances.
- Audit leads arising from information discovered during the course of an audit or inspection or from other sources such as the general public, which may indicate that an audit of another taxpayer may be appropriate to recover a tax liability or correct errors in tax application.
- Information from Revenue Canada under an exchange agreement signed in February 1995.
- Information from records held at either the Consumer Taxation or Revenue Administration branches, such as past audits or the tax return system.
- Applications for refunds.
- Trade journals, newsletters, and other business publications.
- Close of Business section of Consumer Taxation Branch.
- Information received from the Taxpayer Services section within the Consumer Taxation Branch, or from the Delinquency Control and Collections sections of the Revenue Administration Branch.

Source: Ministry of Finance and Corporate Relations

include defining long-term goals, setting measurable objectives and overseeing the working committee. It is currently refining the audit selection process and expects to have it ready for implementation in early 1996.

The audit working committee's responsibilities will include preparing the annual audit plan, specifying types of audits and their location, staffing, coordination with other branches, and expected results. The committee will also monitor audit results and resources, identify significant tax issues for referral to the audit steering committee, and report regularly to that committee. We believe that if implemented as planned, these arrangements should ensure the ministry makes still more effective use of its audit resources.

Recommendation

The ministry should continue its efforts to set clear targets for the different categories of audit carried out by the Consumer Taxation Branch and individual offices. Performance against these targets should be closely monitored to measure the extent to which they are achieved.

Maintaining the Quality of Enforcement Work

In undertaking enforcement work, it is essential that staff have appropriate qualifications and training, that audit methodology is sound, and that management review the work carried out to ensure that the procedures and policies are being applied in a fair, consistent and equitable manner.

Staff Qualifications and Training

Enforcement staff must be fully aware of their responsibilities and appropriately qualified and trained to fulfill them. Only in this way can the credibility of enforcement work be maintained and costly appeals against assessments minimized.

We found that ministry staff are qualified to carry out their work and are well informed of the ministry's priorities and objectives. Although not all long-standing audit staff have accounting designations—as policy now requires—those without have a wealth of experience in auditing social service tax. Inspectors, as well as staff working in collections and in specialist areas such as policy and litigation, are also appropriately qualified and experienced.

Although formal training is provided, staff learn mainly through practical experience. The ministry considers that using trained and experienced staff in a mentoring role during the early months of a new staff member's time in the organization is the best way to train such staff in the standards and skills required of them. We believe this to be a sensible approach and was endorsed by staff members during our interviews.

Manuals and other tools are kept up to date and accurately reflect the requirements of the legislation. The training accountability system recently developed by the Consumer Taxation Branch identifies two categories of training courses for each staff position: core and

developmental. The system keeps records on each staff member, allowing managers to track who has completed what courses, and to decide how training requests can be ranked branch-wide.

In addition to providing training for its own staff the ministry has developed a training manual for government agents' staff who provide some assistance on behalf of the ministry to taxpayers and vendors throughout the province. The manual covers vendor registration (forms and procedures), social service tax collection, and internal processing, and exposes staff to various reference materials and the different forms processed through the Consumer Taxation Office. Given that government agents' staff are often the first source of information available to the taxpayer, the availability of this manual fulfills an important need.

Audit Methodology

We found well-established procedures for the audit process described in staff manuals, and our review of audit files indicated that these procedures were being adhered to. In each audit, representative transactions are selected and the results extrapolated to produce the final assessment of tax due. The period selected is discussed with the taxpayer to ensure that it is as representative as possible and avoids any seasonal fluctuations in business activity. Standard documentation must be included in every audit file. Statistics of the results of audit work are maintained so that the level of recovery, time taken on audits and

recovery rates can be reported to management. The outcome of audits are communicated quickly to taxpayers and are also well documented in audit files.

Advances have been made in the use of computers for audit work and further work is being done to enhance this capability. All audit staff and most inspectors have laptop computers which enable them to make quickly what were previously complex, time-consuming calculations of tax due and penalty and interest charges. The Consumer Taxation Branch has established an electronic data processing audit group in Vancouver which is developing programs to electronically audit sales tax transactions. This audit approach promises to increase the efficiency of large audits and will provide a stronger basis for justifying audit assessments, as the larger sample sizes can be examined over longer periods of time. As of October 1995, the branch had completed implementation of an electronic information database to replace branch manuals. Loading the information onto staff's laptop computers enables better access and makes updates easier.

Management Review and Control of Enforcement Work

Audit and inspection staff are given considerable freedom to operate independently. Although audits are allocated from the central inventory, it is not uncommon for auditors in the field to return them on the grounds that the vendor is out of business, or the business cannot be found.

Cancellation of an audit in this way, however, requires review and formal approval by the Regional Manager or Audit Manager.

Managers visit new staff in the field and assist auditors when audit difficulties arise or if there are problems to be resolved with a taxpayer, such as a dispute over the value of an assessment. However, for the most part the ministry relies on the professionalism of qualified staff to handle themselves appropriately. The results of field audits involving assessments greater than \$10,000 or 40 hours work (\$75,000 or 75 hours for Vancouver-based staff) are reviewed by the managers. All other audit work is reviewed by the Technical Analysis section before the assessment is formally issued to the taxpayer. This review is based on the audit file prepared by the auditor during the audit and is aimed at ensuring that the proper policies and procedures have been adhered to and that the final assessment is sound. We believe these review procedures are appropriate.

The Tax Gap

The ministry currently does not have information about the revenue gap between taxes that are payable under the law and the amounts actually collected. It is not unique in this regard, as other jurisdictions are also exploring how to obtain this information. Measuring the gap is a complex undertaking and to our knowledge no tax jurisdiction has made significant progress in that area. It includes estimating the nature and size of the underground economy and other factors by industry sector,

which presents difficulties in both gathering the necessary information and processing it in a meaningful way.

The ministry recognizes that information on the size of the gap would improve its knowledge about its success in maximizing revenues and in maintaining compliance. It would also help in determining the level of resources required and in identifying how they should be allocated. The ministry has already done some work in this area. It has recently calculated the amount of tax owing by reviewing certificates of transfer resulting from motor vehicles sold and compared them to taxes paid, to establish the amount that should have been collected. Taxes owing were pursued by the ministry. The ministry is also, in conjunction with Revenue Canada, looking at ways of identifying activities and significant non-compliance in specific areas of the underground economy and industry sectors.

The ministry recognizes that its information systems must be enhanced to be able to carry out the necessary tax gap calculations. In a recent proposal to examine the replacement of the social service tax information system, it identified the need to meet the demands and challenges of the present-day business climate and those of the future. The ministry has recently received approval to review the options for replacing the main computer system.

Recommendation

The ministry should continue its efforts to estimate the size of the gap between taxes due and those collected.

Offences, Penalties, and Prosecutions

To support the effectiveness of the audit and inspection work, appropriate policies must be in place for prosecuting offenders and applying penalties consistently when offences take place. The *Social Service Tax Act (1979)* defines a wide range of offences and gives the ministry powers to levy penalties, charge interest and prosecute offenders.

Administrative Penalty and Interest Powers

The *Social Service Tax Act (1979)* has a comprehensive range of administrative enforcement powers and penalties that are communicated to taxpayers through ministry information bulletins and to staff through ministry manuals. The Act gives the ministry powers to cancel, suspend, or refuse to issue a registration certificate and to establish liens in respect of tax owed. Section 25 empowers the ministry to charge penalties and interest in the event of non-compliance:

“The commissioner may:

- *where he is satisfied that a person willfully fails to remit tax collected as required by this Act or the Regulations, assess against the person a penalty equal to 100% of the amount not remitted;*
- *where he is satisfied that a person evaded the payment of tax by willfully making false or deceptive statement or by willful default or fraud, assess against the person a penalty equal to 25% of the amount evaded; or*

- *in any case, other than a case referred to in paragraph (a) or (b), where he is satisfied that a person failed to remit or pay any tax as required by this Act or the regulations, assess against the person a penalty equal to 10% of the amount not remitted or paid.”*

Under the same section, and irrespective of whether a penalty has been assessed or not, interest may be charged on the unremitted or unpaid taxes for the period during which the tax should have been remitted or paid.

In the March 1994 budget, the Minister announced an amnesty program from March 22 to June 30, 1994, under which businesses that voluntarily disclosed and paid tax liabilities and interest would not be subject to penalties or prosecution. The Minister also announced that, at the conclusion of the amnesty program, a 10% penalty would apply to second-time errors. However, until the ministry performs repeat audits on these vendors, it will not be able to determine how effective this focus on second-time errors has been.

Under section 27(3) of the Act, the ministry, in circumstances where it appears that tax should have been collected but was not, must impose a penalty and interest on the person who has failed to collect the tax. The penalty consists of an amount equivalent to the tax that should have been collected. This provides a significant reminder to vendors that responsibility for collecting the tax on sales rests with them and that they are liable for any failure in carrying out that responsibility.

Overall, our examination of the administrative powers available show that the ministry's policies in applying these powers are consistent. We were unable to determine the dollar value of penalties assessed at each of the 10%, 25% and 100% rates because the ministry does not accumulate the information in that manner. However, through discussions with the ministry and our review of assessment files, we determined that the 10% penalty is the most widely used and is applied when registered vendors' are delinquent in remitting tax and when tax audits reveal that tax was accumulated in the vendors' records but was not remitted.

The 25% penalty is applied when a false statement has been made about a purchase, or a willful decision has been made not to pay the tax. By its nature, proof that these acts have taken place is more difficult to obtain and thus the penalty is less likely to be applied. However, in one circumstance for example, the ministry has secured this proof by printing a penalty warning on the top of the automobile transfer/tax form which is completed for insurance and tax requirements when private sales of vehicles are made. Then, if the purchase price is recorded at something less than the actual price paid, completion of the form provides the proof needed to apply the penalty.

We have been informed that the 100% penalty that is to be applied when a person willfully fails to remit tax collected as required by the Act is rarely used. The ministry would assess this

penalty only in extreme cases preferring to use the lower penalties to encourage ongoing compliance with the legislation. As well, the 100% penalty requires strong evidence demonstrating a wilful intent to defraud the government, and it is often difficult to obtain this evidence.

The ministry explained that in the past few years the province has seen a growth in the underground economy and instances of serious non-compliance with the tax legislation as well as a growing social acceptance of evasion. As a result, the ministry recognizes that administrative penalties do not provide a sufficient deterrent to counteract the potential monetary gains from tax evasion by these willful offenders who operate outside of the law. To address these concerns, the ministry has recently developed a policy of pursuing court prosecutions and is making recommendations for legislative changes.

Recommendation

The ministry should collect information on the amount of penalties imposed by type, to aid it in assessing the extent to which penalties are applied.

Court Prosecutions— Offences and Penalties Punishable by Fine, Imprisonment, or Both

Section 33(1) of the Act lists a number of sections of the Act which it is a criminal offence to contravene. These sections deal primarily with what taxes are payable, at what rates, and how they should be calculated. A contravention is subject to a maximum fine of \$500 on a first

conviction and \$2,000 on a subsequent conviction. Section 33(2) makes it an offence for a person not to collect taxes imposed under the Act. This offence draws a maximum fine of \$1,000 on a first conviction and \$2,000 on a subsequent conviction.

Under section 33(2.1) of the Act, a variety of actions related to the willful attempt to evade payment of taxes due, or to conspire to evade compliance, are punishable by significantly higher fines. Anyone convicted of such offences is subject to a maximum fine of \$10,000 or imprisonment of up to 2 years (or both) plus a fine equal to the amount of the tax not paid, collected, or remitted, including penalties and interest.

No prosecutions under the Act have been pursued in the last 13 years. The ministry informed us that it has not been pursuing prosecutions because of the difficulties inherent in gathering sufficient evidence to prove willful fraud or default to the satisfaction of the court. Legal counsel has advised the ministry that generally, where evidence is non-conclusive, court decisions tend to favour the taxpayer rather than the government. We were told that other provinces also do not aggressively pursue prosecutions. As mentioned above, the ministry is currently considering a number of options for dealing with this situation and establishing a clear prosecution policy for the future.

Recommendation

The ministry should implement an effective prosecution policy and communicate it to taxpayers.

Collections Work

The ministry has many powers to enforce collection of unpaid taxes once they have been identified. After an assessment has been prepared, following an audit by the Consumer Taxation Branch or the identification of a delinquent account, the file is passed to the Collections section of the Revenue Administration Branch. At the end of March 1995, the section was seeking to recover more than \$35 million of consumer tax debt from more than 6,000 accounts representing debts over \$300.

When a debt has been identified, the collector issues a legal notice letter demanding payment of the due amount. If on notification the debtor pays the amount owed, then the account is cleared. If the debtor appeals the assessment within 90 days, then collection action is normally suspended although interest continues to accrue. Should the appeal be successful, the debt is cancelled. If the debt is not cleared, then a range of legal actions comes into play. This may result in closure of the business or cancellation of the vendor's registration, which means he or she can no longer make taxable sales in the province.

The Collection section's policy and procedures manual sets out the detailed steps to be followed by staff under the different circumstances that may arise in trying to collect the debt. The manual also guides staff on how to proceed when extended payment terms may be agreed. Ultimately it may be necessary to write off debts which prove to be uncollectable. In 1994/95, this happened with 8,559 accounts totaling \$4.16 million. Of



this number only 725 of the accounts (with a total value of \$3.95 million) were for amounts over \$300. Therefore, the vast majority of write-offs are for small amounts that would be administratively costly to collect.

A detailed review of the ministry's application of its powers to enforce collection was outside the scope of our audit. From our limited review, however, it appeared that clearly defined procedures are in place and that these are well understood by the staff involved.



Administering the Enforcement Process Cost-effectively

Critical to achieving cost-effective, fair, and consistent enforcement is having an appropriate level of staff resources devoted to enforcement work. It is important that staff levels are based on a sound estimate of the extent of non-compliance. Also that the location of staff should reflect both the ministry's wish to maintain a presence throughout the province and its assessment of where the risks of non-compliance lie.

Also important is that the ministry ensures that the liaison arrangements it has with other organizations within and outside the ministry are managed well so as to improve the efficient administration of the tax.

Conclusion

The ministry's enforcement activities are effective and result in the recovery of additional revenues that well exceed the cost of enforcement. However, the level of resources currently available for enforcement work is well below the optimum and significant revenues remain to be identified and recovered.

The ministry is seeking to improve both its internal and external liaison arrangements, to help it maximize the efficiency and effectiveness of enforcement work.

Findings

The Cost of Administration and Enforcement

The cost to the ministry of administering and enforcing the social service tax in relation to the total tax revenue it collects is small. In the 1995/96 fiscal year, total costs, including staff, accommodation, and legal and computer costs are estimated to be \$22 million and total social service tax revenues are expected to be around \$3 billion. Of this \$22 million approximately \$12.5 million is spent by the Consumer Taxation Branch, mainly on enforcement and related work. The total tax assessed through audits and inspections was approximately \$57 million in 1995. In addition, the Boat and Aircraft and Close of Business Units recovered \$17 million.

Staff Resources

Over the past seven years, audit staff have each carried out around 40 audits annually, although the number is steadily falling from more than 50 in 1988 to 34 in 1994 as the length of time to undertake audits has increased. The ministry attributes this trend to the broader tax base and increased complexity of the tax and of businesses' accounting records. Total social service tax audit assessments have increased over the period 1988 to 1995 from \$15.9 million to \$45 million (Exhibit 9), even though the number of audits undertaken

has fluctuated during the same period (Exhibit 10).

The annual average assessment per auditor exceeded \$535,000 in 1995, compared with just over \$300,000 in 1988 (Exhibit 11). This compares favorably with the cost of employing audit staff, which in 1994 was about \$50,000 per auditor per year (excluding administrative and overhead costs). It is also important to recognize the deterrent benefit of enforcement work, even if it is difficult to measure. This high level of assessments generated by each auditor indicates that there remain significant revenues to be identified and collected and suggests

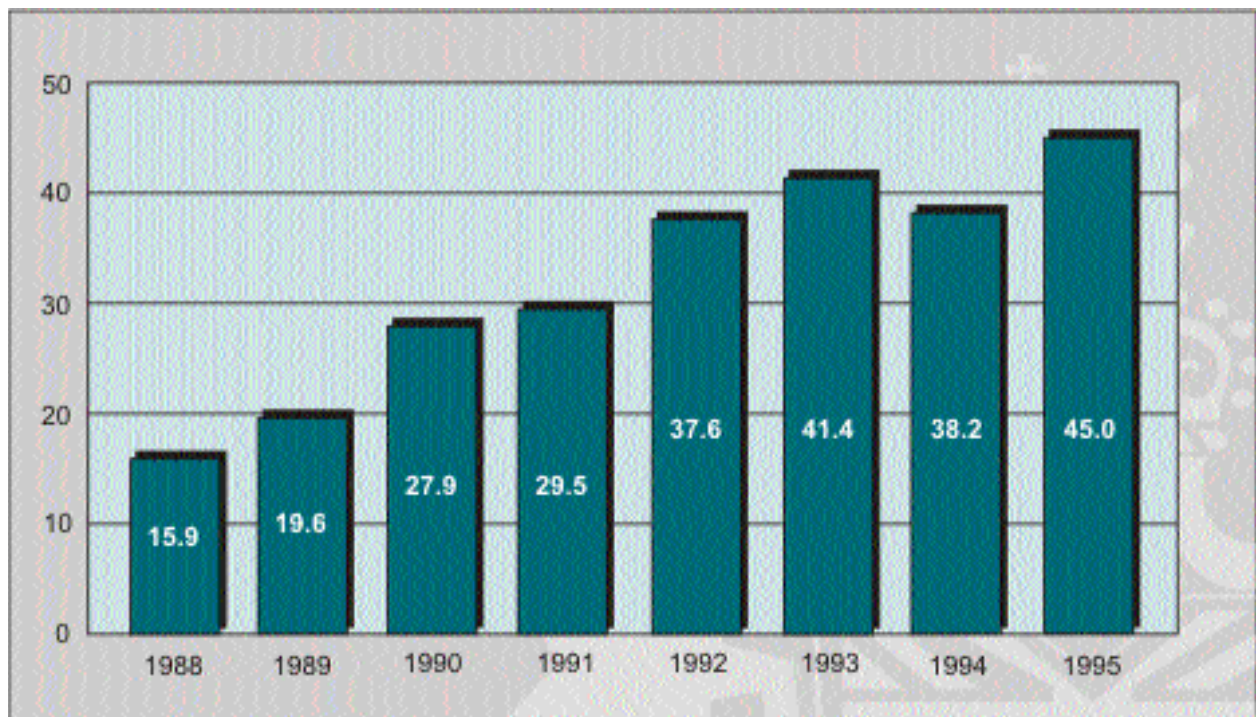
there is a long way to go before an optimum staffing level is reached.

From time to time the ministry has recognized the benefits of having additional audit staff and has responded to statistics that show that the returns gained from additional audit resources significantly outweigh the staff costs. In 1994, for example, it recruited an additional 20 audit staff with the aim of identifying an additional \$5 million in unpaid revenues. Despite achieving well in excess of this target, nine auditors were let go (through attrition) in 1995. Such abrupt shifts in resource numbers make long-term planning of enforcement difficult.

Exhibit 9

Total Social Service Tax Audit Assessments, 1988 to 1995

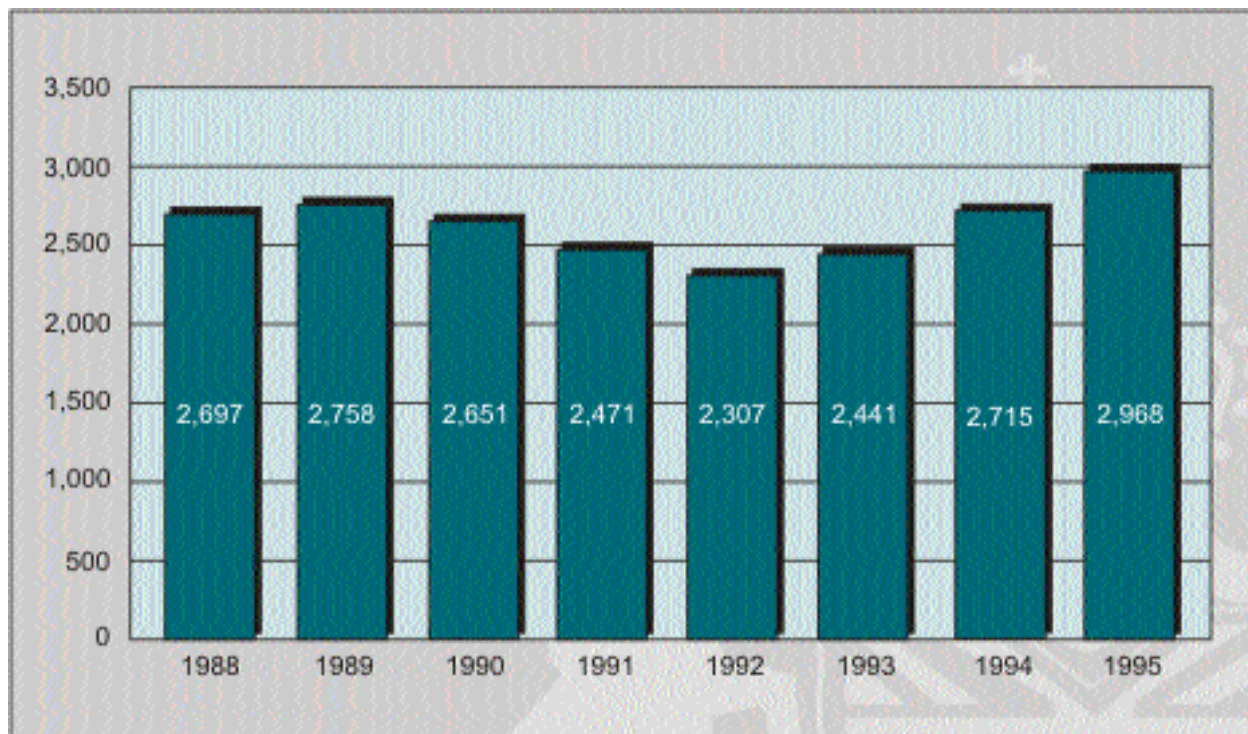
(\$ Millions)



Source: Ministry of Finance and Corporate Relations

Exhibit 10

Total Number of Social Service Tax Audits Carried Out, 1988 to 1995



Source: Ministry of Finance and Corporate Relations

It was clear from our visits to the districts that they do not have sufficient resources to carry out the number of audits allocated to them from the audit inventory. The situation has been exacerbated by the loss of staff. In accordance with the ministry's current required staff reductions, field auditors and inspectors who leave the field offices are not being replaced. Recently in Prince George, for example, the complement of three auditors was reduced to one. There have also been reductions in other offices. Most of the auditors, inspectors, and managers we interviewed agreed that significant additional revenues could be

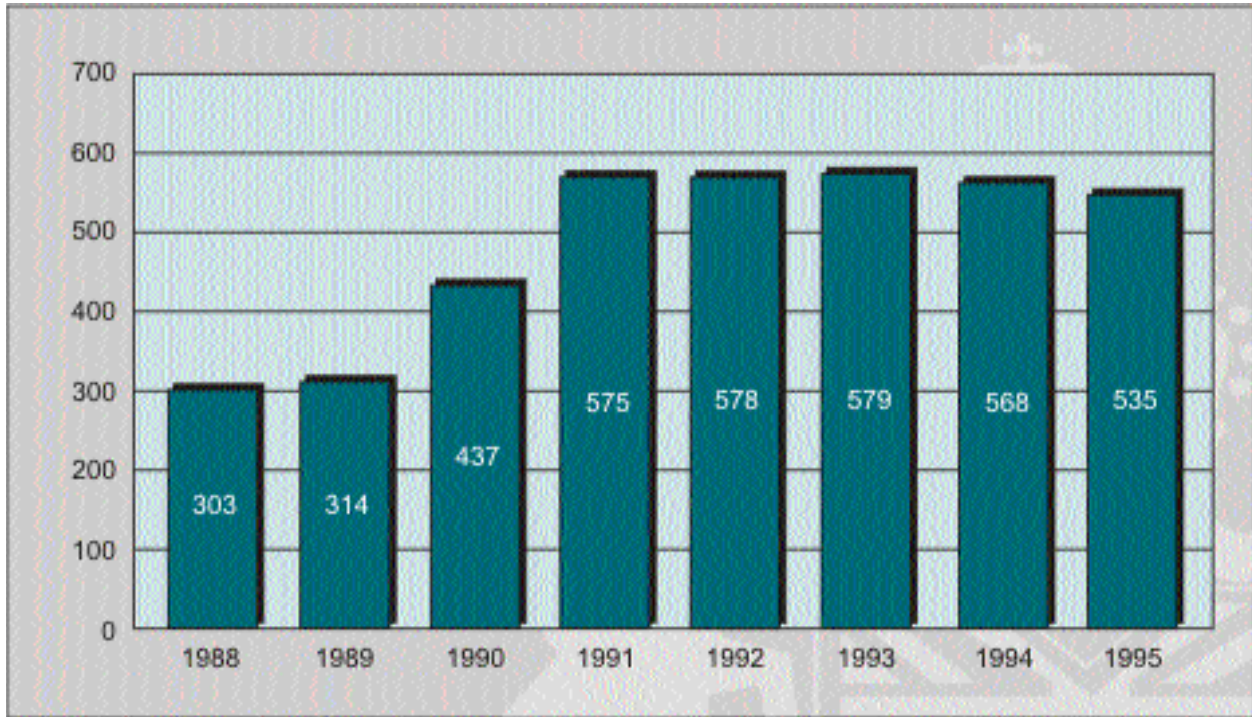
collected if the resources were available to track them down. This view is supported by the level of non-compliance identified by current staff.

At the ministry's request, in October 1995, the Analysis and Evaluation Branch of Treasury Board produced a report that aimed to answer the question "What is an appropriate number of auditors?" The paper presents a number of different answers that vary according to the assumptions used and the different methods of calculation. Nevertheless, whatever approach is used, clearly the optimal number of auditors is significantly greater than the current level of 99.

Exhibit 11

Annual Average Assessment per Auditor

(\$ Thousands)



Source: Ministry of Finance and Corporate Relations

The lowest reported optimal figure is 150. The same exercise is used to calculate the net additional revenue (after recruitment, training, and salary costs have been deducted) that employing 25 additional auditors would generate. Again, depending on the model used, the results vary between just over \$4 million to as high as \$33 million. Even at the lower figure, this would represent a significant net benefit.

Deployment of Audit Staff

The main reason for the current staff deployment of the Consumer Taxation Branch is to maintain an enforcement presence

across British Columbia and provide a quality and accessible information service. Not surprisingly, the bulk of resources are located in the lower mainland but there is also a network of regional and district offices in a number of the larger population centers throughout the province. The Revenue Administration Branch is based in Victoria.

Except in Vancouver and Victoria, the Consumer Taxation Branch offices share space with other ministries in the government agent offices in the larger established business centers. The branch divides the province into four regions:

island, the lower mainland including Vancouver, and the north and south regions.

In 1991, an audit allocation model was developed as a means of providing a more scientific approach to identifying the most appropriate location for audit staff. The model, created jointly by the Revenue Division and Planning and Statistics Division, also offered a better means of selecting taxpayers for audit. It was reviewed by an independent consultant who concluded that it was a valid predictor of audit recoveries. The consultant recommended that the project be fully implemented to include field and Vancouver operations, and that an estimated additional \$2 million in audit recoveries would be made in the first year with an implementation cost of \$150,000. Support funding was not made available to enable the branch to implement the model.

Out-of-province Work

A significant amount of social service tax enforcement takes place outside the province. A number of large companies operating in British Columbia maintain their head offices and accounting records in other provinces, particularly Ontario, Quebec, and Alberta. In 1994/95, staff in the Consumer Taxation Branch spent over \$200,000 on travel to the Montreal and Toronto areas and \$100,000 on travel to Alberta. Additional costs include the auditor's time spent traveling. Between 1988 and 1995, the value of audit assessments made on out-of-province companies ranged from a low of \$6.5 million in 1992 to a high of \$13.7 million in

1993. Clearly, such audits are an important source of additional revenues. However, because of the costs involved in auditing records at these locations, the ministry is currently examining the possibility of opening a permanent office in Toronto as a means of reducing its travel costs and increasing auditor productivity by reducing the number of hours spent traveling.

Recommendation

The ministry should develop a long-term resource planning strategy for enforcement work which takes into account the full cost and benefits of such work.

The Administrative Cost of Exemptions and their Impact on Business

In administering the social service tax, the ministry has to deal with the many exemptions that are allowed to the tax (Exhibit 12). It spends considerable time and resources in ensuring that exemptions are properly applied. It produces a large number of bulletins to educate the public in their use, deals with appeals, makes rulings on representations made by taxpayers and handles problems as they arise.

For business, too, the cost of exemptions can be significant. Most retail businesses sell a variety of goods, some of which are taxable and some exempt. This imposes on businesses the need for accounting systems that recognize the difference between taxable and non-taxable goods. It also involves staff training costs.

To minimize the cost of administering exemptions the

ministry regularly reviews and changes its internal procedures to be more efficient, and liaises with business to solve administrative problems that businesses identify.

Internal and External Liaison

To maximize the effectiveness of its enforcement work and get the most benefit from limited resources, the ministry requires good internal and external liaison.

Both the Consumer Taxation and Revenue Administration branches must work closely with

each other so that the enforcement process can be efficient and effective. We noted, however, that the liaison between the branches could be improved. Collections staff would benefit from more information that audit and inspections staff may have access to. In solving this problem, the ministry has to address concerns about the legality of auditors collecting and sharing information beyond that needed to assess the tax. The branches have already taken steps to improve the cooperation by setting up a working group with representatives

Exhibit 12

Main Categories of Exemptions and Revenues Forgone in 1994/95

	Revenue Forgone \$ Millions
• Food (basic groceries, snack foods, candies, soft drinks, and restaurant meals)	520
• Residential fuels (electricity, natural gas, propane, etc.)	100
• Prescription and non-prescription drugs, vitamins, and certain other health care products and appliances	55
• Books, magazines, and newspapers	50
• Basic telephone and cable television service	35
• Children's clothing and footwear	25
• Livestock for human consumption and agricultural feed, seed, and fertilizer	25
• Exempt purchases by farmers, fishers, and aquaculturists	16
• Specified school supplies	10
• Exempt energy conservation equipment	10
• Exempt safety equipment	8
• Clothing patterns, fabrics, and notions	7
• Labor to repair major household appliances, clothing, and footwear	6
• Two-wheeled bicycles	4

Source: Ministry of Finance and Corporate Relations



from both branches to see how improvements can be achieved. Auditors are now faxing collection summaries to the collection staff right away if quick collection action is required.

Within the Consumer Taxation Branch, regional meetings are held semi-annually. These give auditors and inspectors an opportunity to meet one another, get to know each other's jobs, and ultimately to work more cohesively. This contact is important because staff tend to work on their own a great deal and with minimal supervision. Staff are also encouraged to share ideas and exchange information. Middle managers meet twice a year, permitting them to liaise with managers from other functional areas, develop strategic plans, and jointly resolve issues.

Liaison with external bodies on enforcement work had been limited, but following an agreement signed in February 1995 between the provincial and federal governments concerning the exchange of tax information, a great deal of activity is currently under way between the ministry and Revenue Canada. Joint working groups have been established and exchanges of staff and information are taking place. Consumer Taxation Branch management hope this will significantly improve their ability to target work more effectively in the future. Assistance from Revenue Canada in the areas of audit, anti-smuggling, and auditor training has allowed the ministry to broaden audit coverage without adding substantial costs to the audit operations.

The Executive Director of the Consumer Taxation Branch is a member of the national Council of Provincial Sales Tax Administrators. This forum provides the opportunity to exchange ideas and discuss common problems. At the council's Canadian Interprovincial Tax Conference held in September 1995 the branch was a major contributor, presenting issues such as taxation of interprovincial sales, implementation of a uniform sales tax application for telecommunications, and future opportunities for co-operative tax administration between the federal government and the provinces.



Evaluating Performance



To ensure that the ministry is using its resources efficiently and effectively, it must have the necessary data with which to measure its performance in meeting its objectives. The data in question should be properly evaluated and reported to management on a regular basis so weaknesses can be pinpointed early and administrative improvements made promptly.

Against these expectations, we examined the ministry's mission and objectives in relation to the administration and enforcement of the tax to see if those objectives were clear and measurable. We also looked to see whether appropriate and reliable performance information was collected and reported in a meaningful and timely manner. Finally, we sought evidence that indicated that the process resulted in beneficial changes to the administration and enforcement of the tax.

Conclusion

The ministry has clear objectives relevant to social service tax administration, and these are well known and accepted by staff and reflected in the activities of the two branches involved in administration and enforcement of the tax. The ministry communicates these objectives to stakeholders through regular contact with business and industry associations and with individual taxpayers during the audit process.

Because the ministry does not gather information on the size and

nature of the gap between taxes due and those collected, it is unable to measure its overall success in maximizing revenue. The ministry has not developed specific performance indicators to measure objectives such as fairness, consistency, equity and efficiency, although they do carry out some work aimed at assessing their achievements in these areas.

A major problem is the ministry's inability to obtain good quality management information because of the antiquated information systems staff have to work with. In spite of these difficulties, it has acted positively to make the best of what it has, and has undertaken a number of evaluations of specific parts of its business aimed at improving efficiency.

Findings

Setting Tax Administration Objectives

As noted previously in this report, the ministry has a hierarchy of mission statements, visions, goals, and objectives relevant to social service tax administration. In broad terms these statements recognize the need to maximize revenues cost-effectively, educate taxpayers, and enforce compliance when necessary.

Staff working in both branches demonstrated a clear awareness and understanding of the objectives and of their responsibilities to contribute to the ministry's success in achieving them. The Consumer

Taxation Branch is in the process of formally developing enforcement strategies to ensure that all stakeholders realize enforcement is concerned as much with improving voluntary compliance in all industry sectors as with producing the maximum amount of revenue.

We noted that branch management and staff regularly meet with business and industry associations, as well as with representatives from other tax jurisdictions, to discuss concerns, work out problems, and discuss how goals can best be achieved.

Measuring Achievement of Objectives

Maximizing Revenue

Because the ministry has only very limited information on the size and nature of the gap between taxes collected and those due, it is not in a position to measure its objective of maximizing revenue.

Fairness, Consistency, Equity, and Efficiency

The tax administration system should be fair in targeting compliance activities, consistent in dealing with identified non-compliance, and equitable and efficient in educating taxpayers and enforcing compliance. We found that although the ministry has not yet done so, it recognizes the importance of developing specific performance indicators to determine whether the system has these attributes.

To ensure that fairness, consistency, equity and efficiency are embraced by the staff, branch management review all proposed

audits. Once audits are chosen and carried out, the audit procedures and resulting assessments are reviewed before the taxpayer receives the billing.

Every four months the ministry surveys vendors audited during the previous month. The feedback received is usually positive, particularly about the professionalism, fairness and courtesy of the ministry staff involved. Unfavorable comments are taken seriously and acted upon.

To reduce backlogs in its refund and close of business units, the Consumer Taxation Branch has reviewed all the steps taken to process these transactions and has combined or eliminated certain tasks to reduce the processing time. Other studies and reviews have been done on the branch structure, resulting in changes the ministry feels have improved the way it does business. Although it is difficult to set performance indicators for all the activities carried out to administer the tax system, management continues to identify areas that it believes need improvement.

Currently the ministry does measure its major auditing and collection activities, keeping track, for example, of the number of dollars recovered from audits, the percentage of audits carried out of registered vendors, and the number of collection actions taken. Although this does not tell the ministry how well it is doing at meeting its goals, it does give staff some guidance as to how well they are performing as individuals. At the same time, however, the gathering of this and other activity information sometimes

challenges the ministry's information systems beyond their capabilities.

Difficulties with Management Information Systems

The information systems used by the Consumer Taxation and Revenue Administration branches are antiquated and do not provide management with adequate timely information.

Although the ministry has an information technology strategic plan, we found that it lacked any funding support. The information technology budget is used to cover day-to-day processing costs and programmers' salaries to keep the systems running. This leaves no funding to re-develop the systems on newer, less expensive technology that is more flexible to the information needs of its users.

Both branches are using the current systems to their limits. At the time of our audit, there were 175 outstanding requests for systems work, either to obtain different information than is currently provided or to correct errors or other problems. Among the requests were 15 for new equipment or major system changes.

Given this situation, management has resorted to a process that is time consuming, but necessary to compensate for a system that cannot accommodate all the necessary data.

In January 1996 the ministry approved a proposal to examine in detail the replacement of the social service tax system. This proposal included immediate assignment of some internal resources to this project and a Treasury Board Submission to request funding.

Recommendation

We recommend that the ministry develop an appropriate management information system that will meet the needs of both the Consumer Taxation and the Revenue Administration branches.



Keeping the Public and the Legislative Assembly Informed

The taxpaying public and the Legislative Assembly are the ministry's most important stakeholders. The Legislative Assembly has given the government the responsibility for managing the collection of the social service tax. The government, through the ministry, is accountable to the Legislative Assembly.

We expected the ministry to provide the Legislative Assembly and the public with sufficient timely information on the level of compliance with the social service tax, on the extent to which objectives are being achieved, and on expectations for future periods.

Conclusion

The ministry does not provide the Legislative Assembly and the public with adequate timely information on the level of compliance with the social service tax, on the extent to which objectives are being achieved, or on the expectations it has set for the future.

Findings

The ministry's most recent annual report to the Legislative Assembly, (April 1, 1993 to March 31, 1994), briefly describes the activities of the Consumer Taxation Branch and Revenue Administration Branch. It provides no information, however, on how well the ministry is meeting its objectives in administering and collecting the social service tax and

it makes no attempt to describe its expectations for the coming year. For example, the introduction of more flexible remitting schedules is described as increasing fairness to businesses, but no evaluation is made of whether making tax compliance easier has actually resulted in better compliance. At the same time, what information the ministry does collect, such as the number and value of delinquent accounts and the amount of tax written off because it is uncollectable, is also not reported.

Another problem is the lack of timeliness of the reporting. For example, the ministry's annual report for the year ended March 31, 1994, was not issued until June 30, 1995. Such a delay does not allow the Legislative Assembly to have timely information about the program.

The annual report is the only public reporting of the ministry's activities in administering the social service tax.

Recommendation

The ministry should provide the Legislative Assembly and the public with more detailed and timely information about its performance in administering the social service tax, in terms of both outputs and outcomes achieved.



Ministry Response



Ministry Response



The Ministry of Finance and Corporate Relations is responsible for ensuring that the tax revenues due to the province are properly collected and remitted, as such revenues are a vital source of funding for the government's programs. We appreciate the opportunity to have our operations relating to social service tax revenue verification reviewed by the Office of the Auditor General (OAG). In the fiscal year, ending March 31, 1995, \$2.8 billion in social service tax revenue was collected, and the OAG audit ensures public confidence in the province's administration of the social service tax.

The ministry is pleased the OAG concludes that, overall:

The ministry's methods for maximizing social service tax revenues and maintaining the integrity of the tax system are cost effective. The ministry provide sufficient information and education to taxpayers to ensure that they are aware of their responsibilities. Its enforcement staff conduct audits and inspections that identify non-compliance and unpaid taxes. The work is carried out according to clear and consistent strategies and appropriate procedures by qualified staff.

While the report concludes that the ministry's administration of the social service tax is cost effective, we will continue to evolve as an organization. The ministry

faces an ever-changing business environment, including advances in technology that affect the way business and commerce is conducted, an increasing number of businesses with interprovincial and international operations, government fiscal restraint, and the recent growth in the underground economy. To protect provincial revenues, the ministry has endeavoured to adapt and streamline its tax collection operations to meet these challenges.

The OAG does make a number of recommendations in its report that it feels will help to further improve the ministry's operations. We welcome these recommendations. We have already implemented some of the recommendations and significant progress has been made on others since the OAG's audit. With respect to each recommendation, the ministry's response, and the steps taken to date, are as follows.

Recommendation – The ministry should develop a long-term resource planning strategy for enforcement work which takes into account the full cost and benefits of such work.

The ministry appreciates the OAG's findings that, while the Consumer Taxation Branch's enforcement staff identify unpaid taxes and the methods employed are cost effective, significant unpaid tax revenues remain to be identified, which are well in excess of the cost

of the additional resources required to identify them.

The ministry will be reviewing the long-term resource needs to appropriately administer the collection of provincial taxes and maintain the integrity of the tax system. This review includes an analysis of the costs and benefits of additional resources, and the estimated additional tax recovery. All of this must be completed, however, in the context of government-wide resource constraints.

Recommendation – The minister should implement and effective prosecution policy.

As the OAG's report indicates, the Consumer Taxation Branch has completed a detailed study of policy options on this issue. To address the ministry's concerns with blatant contraventions against the *Social Service Tax Act*, the ministry will be introducing a policy of pursuing court prosecutions for the most serious, willful, or repeated offenses. Examples of such offenses include willfully failing to remit taxes that have been collected, or making sales without a valid social service tax registration certificate. In such situations, both the individual taxpayer and the government are defrauded, and other businesses are placed at a competitive disadvantage. The ministry expects that this policy, along with successful prosecutions, will aid in deterring willful non-compliance with the tax legislation and participation in the underground economy.

Recommendation – The ministry should develop an appropriate

management information system that will meet the needs of both the Consumer Taxation Branch and the Revenue Administration Branch.

The ministry supports this recommendation. The existing information system was developed in the late 1970's when computer technology was limited. The ministry agrees with the OAG that this system no longer meets the demands and challenges of the present day business climate. It does not provide sufficient management information, and its inflexibility forces the ministry to organize its activities around the system's limited capabilities, rather than around the ministry's needs.

The Consumer Taxation Branch has initiated a project to examine the feasibility of replacing the existing information system and to prepare a request for the necessary funding from Treasury Board. An integral part of the review will entail analyzing the costs and process involved in developing a replacement system and designing a system to meet the ministry's vision of how it will conduct its business into the twenty-first century.

The ministry is hopeful that this project will lead to an appropriate and affordable information system that will address the ministry's present and future needs.

Recommendation – The ministry should continue its efforts to set clear targets for the different categories of audit carried out by the Consumer Taxation Branch and individual offices. Performance against these targets should be closely monitored to measure the extent to which they are achieved.

Prior to the OAG's audit, the Consumer Taxation Branch was in the process of developing a comprehensive 5-year audit plan. The ministry has since implemented this plan, which establishes specific objectives for the different categories of audits conducted by the branch. We have also continued to formalize our audit targeting and selection process, which places an emphasis on high-risk target areas. The intent is to achieve greater cost-efficiency in the utilization of resources and to realize greater revenue recovery for the province.

Recommendation – The ministry should continue its efforts to estimate the size of the gap between taxes due and those collected.

The ministry recognizes that knowing the gap between taxes payable and taxes collected can provide an important measure of how well the ministry is doing in collecting provincial tax revenues. As the OAG's report indicates, the ministry has done some work to estimate the gap in selected industry sectors. These initial efforts have been fruitful in identifying uncollected tax revenues and in targeting the ministry's enforcement efforts.

Measuring the revenue gap for the total economy, however, is a very difficult and complex process. This is especially true for that portion of the gap attributable to the underground economy, which by definition, is undetectable and therefore extremely difficult to measure. Because of this difficulty, jurisdictions in North America have not made significant progress in accurately measuring their tax revenue gap.

Nonetheless, the ministry hopes to be able to make further progress in estimating the gap, particularly for sectors where reliable information is available. Whether or not the ministry is able to update its management information system will influence the ability of the ministry to make significant progress on this issue.

Recommendation – The ministry should collect information on the amount of penalties imposed by type, to aid it in assessing the extent to which penalties are applied.

The ministry will consider this recommendation as part of the overall review of its management information system.

Recommendation – The ministry should provide the Legislative Assembly and the public with more detailed and timely information about its performance in administering the social service tax, in terms of both outputs and outcomes achieved.

The ministry appreciates the value in this recommendation. We would be pleased to pursue this matter further and work with the OAG to develop a suitable approach for reporting the ministry's performance to the Legislative Assembly and the public.

The ministry would like to acknowledge the professionalism with which the OAG staff conducted the audit and the efforts taken to understand the nature of this important ministry function.



Appendices





Appendices



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1995/96 Audit Reports Issued to Date

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Report 4

Performance Audit

Ministry of Finance and
Corporate Relations:

*Revenue Verification for the Social
Service Tax*



Appendix B



Office of the Auditor General: Audit Objectives and Methodology

Audit work performed by the Office of the Auditor General falls into three broad categories:

- Financial auditing;
- Performance auditing; and
- Compliance auditing.

Each of these categories has certain objectives that are expected to be achieved, and each employs a particular methodology to reach those objectives. The following is a brief outline of the objectives and methodology applied by the Office for performance auditing.

Performance Auditing

Purpose of Performance Audits

Performance audits look at how organizations have given attention to economy, efficiency and effectiveness.

The concept of performance auditing, also known as value-for-money auditing, is based on two principles. The first is that public business should be conducted in a way that makes the best possible use of public funds. The second is that people who conduct public business should be held accountable for the prudent and effective management of the resources entrusted to them.

The Nature of Performance Audits

An audit has been defined as:

... the independent, objective assessment of the fairness of management's representations on performance, or the assessment of management systems and practices, against criteria, reported to a governing body or others with similar responsibilities.

This definition recognizes that there are two primary forms of reporting used in performance auditing. The first—referred to as attestation reporting—is the provision of audit opinions on reports that contain representations by management on matters of economy, efficiency and effectiveness.

The second—referred to as direct reporting—is the provision of more than just auditor's opinions. In the absence of representations by management on matters of economy, efficiency and effectiveness, auditors, to fulfill their mandates, gather essential information with respect to management's regard for value for money and include it in their own reports along with their opinions. In effect, the audit report becomes a partial substitute for information that might otherwise be provided by management on how they have discharged their essential value-for-money responsibilities.

The attestation reporting approach to performance auditing has not been used yet in British Columbia because the organizations

we audit have not been providing comprehensive management representations on their performance. Indeed, until recently, the management representations approach to value for money was not practicable. The need to account for the prudent use of taxpayers' money had not been recognized as a significant issue and, consequently, there was neither legislation nor established tradition that required public sector managers to report on a systematic basis as to whether they had spent taxpayers' money wisely. In addition, there was no generally accepted way of reporting on the value-for-money aspects of performance.

Recently, however, considerable effort has been devoted to developing acceptable frameworks to underlie management reports on value-for-money performance, and public sector organizations have begun to explore ways of reporting on value-for-money performance through management representations. We believe that management representations and attestation reporting are the preferred way of meeting accountability responsibilities and are actively encouraging the use of this model in the British Columbia public sector.

Presently, though, all of our performance audits are conducted using the direct reporting model, therefore, the description that follows explains that model.

Our performance audits are not designed to question government policies. Nor do they assess program effectiveness.

The *Auditor General Act* directs the Auditor General to assess whether the programs implemented to achieve government policies are being administered economically and efficiently. Our performance audits also evaluate whether members of the Legislative Assembly and the public are provided with appropriate accountability information about government programs.

When undertaking performance audits, auditors can look either at results, to determine whether value for money is actually achieved, or at managements' processes, to determine whether those processes should ensure that value is received for money spent.

Neither approach alone can answer all the legitimate questions of legislators and the public, particularly if problems are found during the audit. If the auditor assesses results and finds value for money has not been achieved, the natural questions are "Why did this happen?" and "How can we prevent it from happening in future?" These are questions that can only be answered by looking at the process. On the other hand, if the auditor looks at the process and finds weaknesses, the question that arises is "Do these weaknesses result in less than best value being achieved?" This can only be answered by looking at results.

We try, therefore, to combine both approaches wherever we can. However, as acceptable results information and criteria are often not available, our performance audit work frequently concentrates on managements' processes for achieving value for money.



We seek to provide fair, independent assessments of the quality of government administration. We conduct our audits in a way that enables us to provide positive assessments where they are warranted. Where we cannot provide such assessments, we report the reasons for our reservations. Throughout our audits, we look for opportunities to improve government administration.

Audit Selection

We select for audit either programs or functions administered by a specific ministry or public body, or cross-government programs or functions that apply to many government entities. There are a large number of such programs and functions throughout government. We examine the larger and more significant ones on a cyclical basis.

We believe that performance audits conducted using the direct reporting approach should be undertaken on a five- to six-year cycle so that members of the Legislative Assembly and the public receive assessments of all significant government operations over a reasonable time period. Because of limited resources, we have not been able to achieve this schedule.

Our Audit Process

We carry out these audits in accordance with the value-for-money auditing standards established by the Canadian Institute of Chartered Accountants.

One of these standards requires that the “person or persons carrying out the examination possess the knowledge and competence necessary to fulfill the requirements of the particular audit.” In order to meet this standard, we employ professionals with training and experience in a variety of fields. These professionals are engaged full-time in the conduct of performance audits. In addition, we often supplement the knowledge and competence of our own staff by engaging one or more consultants, who have expertise in the subject of that particular audit, to be part of the audit team.

As performance audits, like all audits, involve a comparison of actual performance against a standard of performance, the CICA prescribes standards as to the setting of appropriate performance standards or audit criteria. In establishing the criteria, we do not demand theoretical perfection from public sector managers. Rather, we seek to reflect what we believe to be the reasonable expectations of legislators and the public. The CICA standards also cover the nature and extent of evidence that should be obtained to support the content of the auditor’s report, and, as well, address the reporting of the results of the audit.



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