

The impact of taxpayers' financial statements audit on tax revenue growth

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Key words

Financial statement audit, tax payers, taxes, revenues growth,

Abstract

This paper seeks to explore the role of financial statements audit in promoting tax revenues growth in Rwanda in the broader perspective. Survey questionnaires as primary data collection instruments were distributed to all audit officers of Rwanda Revenue Authority equalling to 100 staff and followed both analytical research design. Secondary data included reports from Rwanda revenue authority from 2006 to 2010

This paper also examines preliminary empirical results on the relationship between financial statements audit and tax growth this paper supports the notion that the practices of audit of final books of accounts for both small and medium enterprises at institutional level are prerequisite for growth of tax revenues in the country. In conclusion, the results not only have the potential to contribute theoretically to public finance but also to the area of institutional performance

1. Introduction

Financial statements audits are conducted in many different forms of organizations today. The purpose of auditing is to discover, check, verify and control some or other aspects in an organization. It can therefore be said that one of the main characteristics of an audit is that it is diagnostic.

Today's tax agencies typically lose some percentage of total revenues due to tax evasion and other types of noncompliance known as the "tax gap" Brown et al , (2003: 4). The primary goal of a revenue body's compliance activity is to improve overall compliance with their tax laws, and in the process instil confidence in the community that the tax system and its administration are fair. Instances of failure to comply with the law are inevitable whether due to taxpayers' ignorance, carelessness, recklessness and deliberate evasion, or weaknesses in administration. To the extent that such failures occur, governments, and in turn the communities they represent, are denied the tax revenues they need to provide services to citizens Forum on tax administration's compliance, (2006). At a time when tax evasion techniques have grown more sophisticated, tax agencies have simultaneously been hit with a cascade of budgetary and staffing restrictions, continually changing tax statutes and more rigorous requirements for privacy. As a result of these pressures, many tax agencies continue to rely on audits of taxpayers' business records and financial affairs to ensure taxpayers have computed their tax payable in accordance with current tax laws and regulations and this implies the tax revenues growth otherwise, tax agencies can lose significant revenues opportunities.

Finally, when tax audit is well conducted, taxpayers understand that their returns will be quickly and scientifically analysed, voluntary compliance rates may rise which could help tax agencies avoid costs and further improve revenue collections, Brown et al, (2003:12). Tax audit and compliance system, a comprehensive, integrated solution designed to improve tax auditor productivity and increase tax revenues.

In Rwanda, taxes are considered as a source for growth and development. The tax revenues audit is a critical issue to the government of Rwanda. Tax revenues and other revenues are central to the current economic development agenda. They provide a stable flow of revenue to finance development priorities, such as strengthening physical infrastructure, and are interwoven with numerous other policy areas, from good governance and formalizing the economy, to spurring growth. Pfister,(2009).

Tax audit will enable the government of Rwanda to control and ensure the taxpayers' compliance with tax laws thus this will increase tax revenue collected from taxpayers. One of the functions of auditing is to detect errors and frauds, RRA's tax audit and investigation aim at stopping the loss which comes from tax evasion, fraud and corruption. If there is a fraudulent event by taxpayers, auditing practices will enable the RRA to find out the taxpayers who had avoided paying tax and paying the tax due with penalties and fines.

2. Purpose of the study

The study aimed at assessing the impact of taxpayers' financial statements audit on tax revenue growth in Rwanda

3. Study objectives

- To find out and show the importance of taxpayers' financial statements audit to the tax revenue growth in RRA.
- To assess whether audit helps the tax officials to identify the tax evasion and other fraudulent intention to deceive.
- To show how taxpayers' financial statements audit leads to taxpayers' compliance with tax laws.

4. Research questions

- How does the taxpayers' financial statements audit contribute to the tax revenue growth?
- How does taxpayers' financial statement audit help to identify the tax evasion and other fraudulent intention?
- How does taxpayers' financial statements audit lead to the taxpayers' compliance with tax laws?

5. Hypotheses

This research is related to Financial Statements Audit and Tax Revenues Growth. This focused on:

H₀: "Tax audit contributes to tax revenues growth"

H₁: "Tax audit does not contribute to tax revenues"

6. Methodology and methods

6.1 Research design

The design of the study was both qualitative and quantitative in the sense that primary data were collected from Audit division staff (audit officers) by means of questionnaire method. The secondary data from the report of RRA was also used to analyse the contribution of taxpayer audit to the tax revenue growth for the periods of 2006 up to 2011.

This research aimed at understanding how the financial statements audit can lead to tax revenues growth by examining the factors affecting them.

In this study the researcher adopted a case study approach; where by Rwanda Revenue Authority was particularly chosen. It is in this regard that RRA was chosen because the researcher was interested in tax agencies.

6.2 Population and sampling

Under this study, the population was solely the RRA's Audit division Staff (audit officers). The population under this research comprises RRA's audit officers who are 100 audit officers.

6.3 Sample and sampling technique

A sample of 80 staff was obtained from the population of 100 staff using the Kreijce and Morgan (1970) table assuming the margin of error to be 5% (with confidence level)

To get this sample, simple random sampling technique was used to give all audit officers equal opportunity to be selected.

Table 1: The Distribution rate

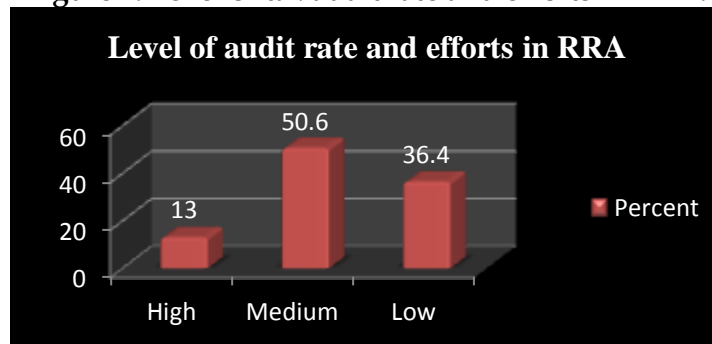
Questionnaires	Frequencies	Percentage
Responded	77	96.25
Not Responded	3	3.35
Total	80	100

Source: Primary data

As it is shown in table1, the response rate from employees of RRA's audit division is good 96.25%. This table here above shows the Results that out of 80 Questionnaires distributed as the sample, 77 Questionnaires were collected for Analysis and interpretation.

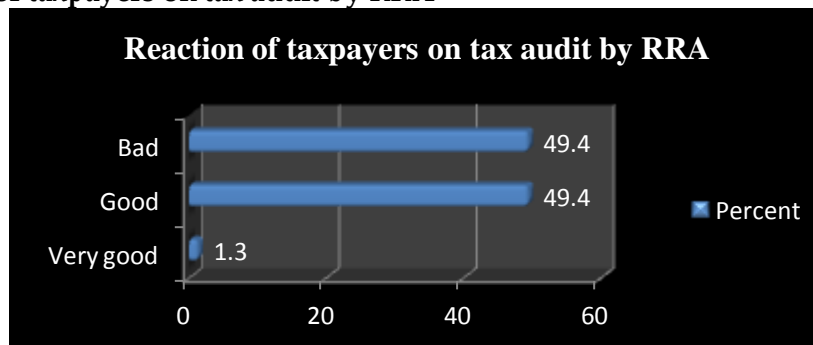
Presentation of results

Figure 2: Level of tax audit rate and efforts in RRA.



Estimation results suggest that a higher audit rate and efforts lead to more compliance and higher audit rate discourages evasion. Figure 2 show that 50.6% of the respondents agreed that the level of audit rate and efforts is medium. Basing on the findings from different respondents, conclusions can be drawn that t RRA tries its best to reinforce the audit activities.

Fig 2: Reaction of taxpayers on tax audit by RRA



Source: Primary Data

Results shows that, still most of the tax payers are not compliant with tax audit it is shown in the graph, 49.4% of the respondents revealed that taxpayers are not compliant which affect negatively the compliance strategies of RRA. In addition to the findings from the respondents, one of the interviewee was quoted as saying *"in case of tax audit, the taxpayers are still hiding their income, misapplication of accounting principles with intention of underreporting income to the RRA"*

Table 2: Responses about if non compliant taxpayers pay penalties and interests regularly.

	Frequency	Percent	Cumulative Percent
Yes	1	1.3	1.3
No	22	28.6	29.9
Both	54	70.1	100.0
Total	77	100.0	

The relevant range of penalty rate, compliance increases but only slightly with increases in the fine rate on unpaid taxes. A higher fine rate leads to marginally more compliance. As it is indicated in this table 2, 70% of audit officers agreed that in the case of noncompliance, some taxpayers who failed to pay taxes as it is required by tax laws do not pay penalties and interests regularly and others do so and 29% of the audit officers revealed that they do not do so. This indicates that the problem of noncompliance is still being there and it discourages the tax revenues to be collected by RRA.

Table 4: Responses about the contribution of taxpayers in the use and allocation of tax revenues

	Frequency	Percent	Cumulative Percent
Yes	16	20.8	20.8
No	61	79.2	100.0
Total	77	100.0	

Source: Primary Data

Compliance is affected by the uses of tax revenues and the decision process by which these uses are chosen. It is found that subjects pay more in taxes revenues when they choose via voting the use of their taxes than when the identical use is imposed upon them, that compliance is somewhat greater when the vote is decisive than when the vote is close, and that compliance is significantly and dramatically lowered by the imposition of an unpopular program. As it is indicated in this table, 79% of audit officers confirmed that the taxpayers do not contribute to the uses and allocation of tax revenues and 21% of audit officers confirmed that taxpayers are involved in the decision making of the uses and allocation of tax revenues and this affects negatively the compliance to tax laws and the growth of tax revenues is not ensured because the rate of involvement is still low.

Table 5: Responses about the necessity of tax audit in RRA

	Frequency	Percent	Cumulative Percent
Yes	77	100.0	100.0
No			

The table here above shows that 100% of audit officers agreed that the tax audit is necessary. Because the taxpayers' compliance is still less and generally it negatively affects the tax revenues growth, the financial statements of taxpayers should be analysed until they show a true and fair view of a Company's Affairs.

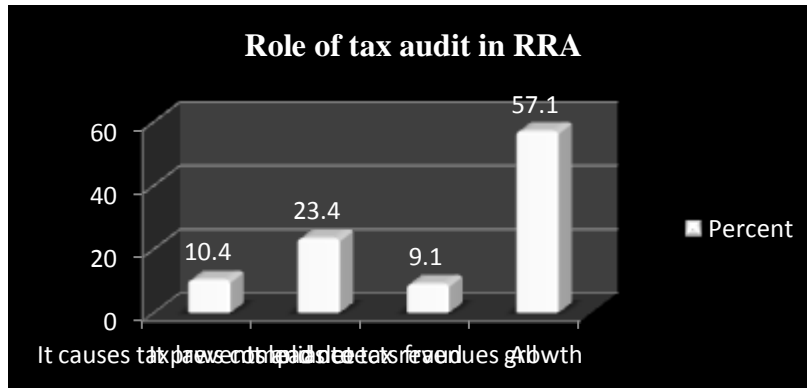
Table 8: Responses about the sufficiency of tax audit officers in RRA.

	Frequency	Percent	Cumulative Percent
Sufficient	24	31.2	31.2
Insufficient	53	68.8	100.0
Total	77	100.0	

Source: Primary Data

The findings here above show, 69% of the respondents agreed that the number of tax audit officers is not sufficient and this prevents the RRA to conduct the tax audit to a large number of taxpayers and 31% of the respondents agreed that the number is sufficient but the rate of sufficiency of tax audit officers, it is still harming the target of RRA in terms of tax revenues to be collected.

Fig 3 Role of tax audit in RRA



Source: Primary Data

These findings show that 57% of the Respondents confirmed that the tax audit plays the role in all factors, 10% of them revealed that tax audit causes compliance to tax laws, 23% of respondents agreed that it prevents and detects fraud and 9% of respondents confirmed that it leads to tax revenues growth. This indicates that the tax audit increases the compliance rate which will impact positively the tax revenues

The following are the tables showing the variation of tax revenues by self- assessment and tax revenues after audit for LTO and SMTO Year to year basis.

Table 6: Variation of tax revenues for LTO. (Large Taxpayers Office)

Years	Tax revenues by self-assessment (before audit) in RWF	Tax audit cases		Net collections in RWF (after audit)	Percentages
		Number of cases	Amount in RWF		
2006	78,022,463,035	214	9,384,497,383	87,406,960,418	10.73655615
2007	104,997,660,231	202	10,876,400,210	115,874,060,441	9.386397757
2008	141,122,567,952	529	9,988,456,781	151,111,024,733	6.610011942

2009-2010	144,536,412,344	145	14,104,113,770	158,640,526,114	8.890612075
2010-2011	159,685,701,537	189	18,903,268,350	178,588,969,887	10.58479052
Total	628,364,805,099	1279	63,256,736,494	691,621,541,593	

Source: Secondary data RRA reports from 2006 up to 2011

As it is mentioned here above for LTO, the table shows that there is growth in tax revenues, in 2006 after audit there is an increase of 10.73%, an increase of 9.38% has been shown in 2007, a growth of 6.61% took place in 2008, a positive variation of 8.89% has been reflected in 2009- 2010 and in 2010-2011 an increase of 10.58% has been shown. Apart from the basis of variations before and after audit, the contribution of tax audit to tax revenues growth has been reflected in net collections on year to year basis.

Table 8 Variations in tax revenues for SMTO

Years	Tax revenues by self-assessment (before audit) in RWF	Tax audit cases		Net collections in RWF (after audit)	Percentages
		Number of cases	Amount in RWF		
2006	24,192,132,358	244	2,979,194,643	27,171,327,001	10.96447974
2007	24,404,961,091	191	12,886,013,807	37,290,974,898	34.5553149
2008	50,249,447,511	147	5,153,019,704	55,402,467,215	9.301065391
2009-2010	83,737,461,003	316	8,074,226,724	91,811,687,727	8.794334325
2010-2011	116,437,244,457	140	6,946,708,205	123,383,952,662	5.630155344
Total	207,209,558,693		36,039,163,083	335,060,409,503	

Source: Secondary data RRA reports from 2006 up to 2011

This findings reflect that for SMTO, the tax audit has contributed to growth in tax revenues 10.96% of increase took place in 2006, 34.55% of increase in 2007, 9.30% of growth in 2008, 8.79% of increase in 2009- 2010 and 5.63% of growth in 2010-2011. Basing on net collections from year to year a tax revenues growth has been revealed.

The growth in tax revenues took place because of financial statements audit as it is indicated by the table below in terms of targets and real net collections shown by different rates in the table and in terms of comparison from year to another. Table 8: Variations of tax revenues between targets and net collections by year to year basis.

Tax revenues targets and net collections for LTO					Tax revenues targets and net collections for SMTO			
Years	Targets	Net collections	Variations	rates	Targets	Net collections	Variations	rates
2006	80,411,598,711	87,406,960,418	6,995,361,707	8.00	19,453,000,000	27,171,327,001	7,718,327,001	28.40
2007	100,255,400,187	115,874,060,441	15,618,660,254	13.47	30,740,000,000	37,290,974,898	6,550,974,898	17.56
2008	131 315 163 807	151 111 024 733	19,795,860,926	13.10	44,254,000,000	55,402,467,215	11,148,467,215	20.12
2009-2010	150,596,444,396	158,640,526,114	8,044,081,718	5.07	82,947,502,971	91,811,687,727	8,864,184,756	9.65
2010-2011	164,155,717,238	178,588,969,887	14,433,252,649	8.08	101,123,455,331	123,383,952,662	22,260,497,331	18.04

Source: Secondary data RRA reports from 2006 up to 2001

Table 9: the relationship between tax audit efforts and tax revenues growth**Inferential statistics and link of variables****ANOVA^b**

Model	Sum of Squares	Degrees of freedom	Mean Square	F	Significance	Decision		
1 Regression	.017	1	.017	1.344	.250 ^a	H ₀ Accepted		
Residual	.970	75	.013					
Total	.987	76						

Source: Primary Data

a. Predictors: (Constant), Level of tax audit rate and efforts

The findings showed the P- value of 0.250 which is greater than the level of significance of 5% or 0.05; this justifies the first objective which accepts the impact of tax audit rate on tax revenues growth at a rate of 13.3% as stated by the correlation among these variables. This agrees with the failure to reject the null hypothesis H₀

Table 10: Level of tax audit rate and efforts * Role of tax audit Cross tabulation

	Role of tax audit			All	Total
	It causes tax laws compliance	It prevents and detects fraud	It leads to tax revenues growth		
Level of tax rate and High efforts	2	3	0	5	10
Medium	6	8	5	20	39
Low	0	7	2	19	28
Total	8	18	7	44	77

Source: Primary data

This cross table above shows that though the efforts are still critical, they are expected to positively contribute to the accomplishment of RRA missions and the expected growth of tax revenues takes place because of strengthening audit activities by RRA.

Table 11: Chi- Square Test**Chi-Square Tests**

	Value	Degrees of freedom	Asymp. Sig. (2-sided)	Decision
Pearson Chi-Square	7.600 ^a	6	.269	H ₀ Accepted
Likelihood Ratio	11.016	6	.088	
Linear-by-Linear Association	3.300	1	.069	
N of Valid Cases	77			

Source: Primary Data

The p-value represents the probability of observing a difference as large as that obtained or larger given the null hypothesis is true.

The above evidence is well signified by the Chi-square of 0.269 greater than the level of significance of 0.05 which proves that the level of tax audit and efforts contributes to the tax revenues growth. There is enough evidence to accept null hypothesis H_0 .

This means that the tax audit leads to the tax revenues growth. And we fail to reject our null hypothesis H_0 .

Discussion of findings

To find out and show the importance of taxpayers' financial statements audit to the tax revenues growth in RRA

Findings indicate that the tax audit increases the compliance rate which will impact positively the tax revenues to be collected by RRA. Because the taxpayers' compliance is still less and generally it negatively affects the tax revenues growth, the financial statements of taxpayers should be analysed until they show a true and fair view of a Company's Affairs. This is in agreement with Brown et al, (2003:) and Robert et al, (2003) who said that tax audit and Compliance System are the comprehensive, integrated solution designed to improve auditor productivity and increase tax revenues.

To assess whether audit helps the tax officers to identify the tax evasion and other fraudulent intentions to deceive.

The findings revealed that, tax audit discourages and helps to identify evasion and fraud in taxation procedures due to deep investigation and analysis of taxpayers' financial statements until they find out the taxpayers who underreport their income thus, this lead to tax revenues growth because non-compliant taxpayers pay penalties and fines in addition to the principal amount of taxes due. This is in agreement with Shanmugam, (2003) and Dubin, (2004) who illustrated that audits have a positive impact on tax evasion and fraud.

To show how taxpayers' financial statements audit leads to taxpayers' compliance with tax laws.

According to findings, if there are the payments of penalties and fines in the case of noncompliance, all taxpayers in general try to conform to tax laws even those who are not audited. Different tables specifically in secondary data showed the increase in tax revenues from a year to another, this indicates that the compliance to tax laws is also increasing on year to year basis as the audit is strengthened by RRA. This is in agreement with Henrik, (2011), Martin, (2011) and Claus, (2011) who said that the effects of tax enforcement (audits, penalties) and tax policy (marginal tax rates) on evasion will be larger for self-reported income than for third-party reported income.

Conclusion

The efficiency and effectiveness of a tax agency's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.

Tax audit policies and procedures should be based on principles of accuracy, efficiency, fairness, objectivity, transparency, completeness, consistency, and defensibility.

The efficiency and effectiveness of tax audit activities can be greatly facilitated by a broad range of support tools. Without competent staff tax audit activities will not achieve their objectives.

This study explores the relationship between financial statements audit and tax revenues growth.

The study found out that taxpayers' attitudes towards tax audit is still negative and results showed that the tax audit greatly influences the tax revenues collected by RRA as it is indicated and identified by tables from primary and secondary data.

Study limitations

Through the research was completed, there were some problems encountered by the researcher and these made the task difficult

- Lack of information and documentation
- The time allocated to the project was too short
- It was not easy to undertake the research project while attending classes.
- The research required much money spent by the researcher

Areas for further researches

The research was not able to cover all the subject matters in this domain. Further researchers are encouraged to go on with the following gaps:

- The analyses of tax evasion have examined the factors that lead individuals who file tax returns to underreport their incomes. However, there is now some evidence that non-filing of tax returns is also a serious problem. More analysis of non-filers is an important area for further researches.
- Individuals may cheat on the taxes they pay to government, they also may cheat on the benefits they receive from government, and especially for welfare transfers and benefit program need much attention.
- The way in which tax agencies and taxpayers can share information merits further work.

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