Supplementary Submission No. 4-2 (ATO)

File re: 05/151

11 September 2006

Mr Russell Chafer
Secretary
Joint Committee of Public Accounts and Audit
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Mr Chafer

I refer to your letter of 4 July 2006 to the Commissioner regarding Audit Report no. 21, 2005-06 *(Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005)*. The Commissioner has asked me to respond on his behalf.

Overall, during 2005-06 the Tax Office has undertaken a considerable amount of work to address audit findings and resolve a number of financial issues. This has occurred through the continuation of:

- a Financial Statements Program of Work across the Office. The program includes rectification of all Audit Office findings and addressing potential risks to the financial statements that have been identified by management;
- the Financial Management Steering Committee. The committee is responsible for the oversight of the Financial Statements Program of Work for 2005-06. It includes two Second Commissioners and other responsible senior executives and is chaired by the Second Commissioner Law (who also chairs the Tax Office Audit Committee); and
- including the financial statements as a regular agenda item at all Tax Office Audit Committee meetings.

In addition, the Tax Office continues to work closely with the Australian National Audit Office (ANAO) to identify and resolve issues as and when they arise. While the ANAO is not a member of the Audit Committee they are present at all meetings.

In response to your specific questions I provide the following:

Have you finally resolved the problem you encountered in 2003-04 with the General Interest Charge not being applied to all company and superannuation funds? (Audit Report, p. 224)
The problem is largely resolved.

In late 2004-05 the Tax Office commenced the posting of the General Interest Charge (GIC) to the affected taxpayer accounts. As this process was not completed for the 2004-05 financial statements a simulation program was used to calculate the amount of accrued un-posted GIC revenue and associated GIC remission expense expected to be posted to taxpayer accounts. A total of $1,856m of GIC revenue and $1,056m of remission expense was brought to account using the simulation process in 2004-05. These amounts comprised both 2004-05 and prior year amounts. It also included a change in accounting policy whereby GIC was included on disputed debts.

During 2005-06, significant progress was achieved in both posting the accrued GIC and remission expense to taxpayer accounts and ensuring that regular, automated reviews of accounts for GIC occurred. There will, however, be a number of taxpayer accounts that continue to be managed manually due to the complexity of those accounts.

To 30 June 2006 the following percentages of taxpayer accounts had been reviewed and GIC and remission expense posted to their accounts:

- 98.80% of companies and superannuation funds;
- 99.93% of individual and trust accounts; and
- 99.40% of Fringe Benefits Tax (FBT) accounts.

In the 2005-06 financial statements most GIC revenue and remission expense was brought to account based on amounts in taxpayer's accounts. The simulator was used to calculate the amount outstanding between the last update on the taxpayer account and 30 June 2006 and for those accounts where regular reviews are still not occurring. GIC revenue of $232m and $17m of remission expense was included in the 2005-06 financial statements from the simulation process.

In the course of posting GIC and remission expense to taxpayer accounts during 2005-06, it became apparent that the remission expense calculation included in the 2004-05 financial statements was overstated. The simulation program calculated the maximum amount of remission expense assuming all cases would be eligible for remission due to delays in notification of the GIC obligation to taxpayers. The actual amount of remission to be applied to a taxpayer's account where GIC had been incurred but not imposed or notified within a reasonable time, was determined on an individual basis in accordance with Tax Office operational policies including reference to the interactions with taxpayers where they were advised of their GIC obligations. These policies allowed tax officers to exercise discretion in deciding whether amounts of GIC should be remitted. The exercise of this discretion resulted in lower amounts of remission expense being posted to taxpayer accounts than the maximum amounts calculated by the simulator. Because of the considerable level of activity which occurred across approximately 670,000 accounts it is impractical for the Tax Office to quantify the amount of the overstatement. This prior year overstatement is a one-off event and has been recognised in the 2005-06 financial statements as a reduction in expenses.

Once the error was discovered, was the GIC applied to those taxpayer accounts in retrospect?

In updating the taxpayer accounts, GIC was applied retrospectively. The GIC was subsequently remitted for amounts that had accrued over a substantial period of time, where the taxpayer had paid off their account balance but had not been notified of the accruing GIC liability.

What steps have you taken to improve the validity of supporting documentation for the financial statements? (Audit Report, p. 224)

The Tax Office has made considerable progress in 2005-06 to substantially improve the documentation of the estimation methodologies for administered items. A four way management review and sign off process has also been established.

There has been a significant improvement in the quality of supporting evidence for estimates and allocations used in the financial statements. A template and procedures were developed and agreed with the ANAO in advance of the 2005-06 financial statements preparation.

The ANAO found that there was no evidence of management review of the models chosen to estimate the ATO's accrued revenues (Report, p. 225). Is management now involved in reviewing the economic models selected to estimate accrued revenues?

Tax Office management is now extensively involved in reviewing the models and estimates for accrued revenues (and expenses) at various stages of the process.

The revenue analysis area within the Tax Office is responsible for the preparation of the methodology, underlying data requirements and calculation of the estimates. They bring expertise with data mining and economic modelling and have extensive experience in the forecasting of revenues and expenses. The corporate finance area is responsible for the preparation of the financial statements. They review the methodology for consistency with accrual accounting principles and ensure that the data provided is consistent with the financial statement requirements and other financial statement items.

Once completed the estimates methodology is subject to a four way management review and sign off by the following parties:

- Revenue analysis area (at senior executive level);
- Corporate finance (at senior executive level);
- Deputy Commissioner responsible for the revenue or expense product; and
- The Chief Finance Officer.

Would you update the Committee on the progress towards resolving the Category B findings in the financial statement audit (Audit Report, pp. 225 – 228).

Superannuation surcharge revenue exceptions

The majority of the backlog exceptions have now been finalised. Of the 1,213,000 exceptions at 30 June 2005, 5381 backlog exceptions and 8197 immediate prior exceptions remain for attention at 30 June 2006. Exception processing is now part of business as usual activities.

Superannuation Surcharge – Unfunded Defined Benefit Schemes

During 2005-2006 the compliance program focussed specifically on the 32 funds of this type and finalised a further six audits. This brings the total number of audits undertaken since the program commenced in 2004-2005 to 14. Although there have been some findings of non-compliance, none of these occurrences have had any direct impact on surcharge revenue. There continues to be non-material differences between the recorded debt balances held by the Tax Office and this particular category of funds. A reconciliation between Tax Office records and the records of a major fund was undertaken during 2005-06, and this confirmed that differences are mainly attributable to different accounting practices used, amendment of assessments, timing of processing and interest calculations.

Superannuation Guarantee charge revenue and payments
The backlog of exceptions that occurred in the period when the system was not operational (during 2003-04) had been reduced by over 93% as at 30 June 2006, with only $10m remaining to be cleared.

As a result of the above system problems, the Tax Office was unable to process assessments to completion during that time. To ensure employees were not disadvantaged through lost interest as a result of delays, it was determined that compensation would be payable. Superannuation guarantee compensation commenced being paid during 2005-06, with further payments to be made in the first half of 2006-07.

Control self assessment framework
In June 2006 the Tax Office Executive approved an overall financial assurance framework which incorporates an integrated approach to fulfilling governance responsibilities. The integrated approach will use the information gathered by central areas, sub-plan and line executives to fulfil governance responsibilities, at the same time trying to limit overlapping requests for various information. A critical element of the assurance model is the financial control framework that is currently being developed, based on the Committee of Sponsoring Organisations (COSO) model modified to suit the needs of the Tax Office.

Certificate of Compliance – payment of public money
The Tax Office is developing a strategy for an overall financial assurance model. Currently, the certificate of evidence for the payment of public money is being completed on a monthly basis by the relevant SES and a register is being maintained. The Certificate of Evidence is reviewed and provided to senior management in accordance with the Certificate of Compliance requirement.

SAP security – temporary allocation of privileged access
The Tax Office closely monitors the allocation and use of privileged SAP accounts. An initial audit of privileged accesses was undertaken and there is now a process in place whereby access allocations records are reviewed each month.

SAP security – access combination and incompatible roles
The Tax Office has in place an ongoing process to assess all SAP accesses to ensure that they are not contrary to management's intentions. SAP security process documentation has been updated to reflect that positions in the SAP security team have no other conflicting access assigned.

While the Tax Office has made significant progress on addressing all outstanding audit findings the Australian National Audit Office has yet to complete the audit of the 2005-06 financial statements and its review of the status of a number of outstanding findings.

Yours sincerely

Donna Moody
Chief Finance Officer
ATO Finance