Zambia Institute of Chartered Accountants

POST GRADUATE DIPLOMA IN TAXATION

PAPER PGDT 7: TAX AUDIT AND INVESTIGATION

SERIES: PILOT PAPER 2024

TOTAL MARKS – 100 TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading and planning time. Use it to study the examination paper carefully so that you understand what to do in each question. DO NOT write in your answer booklet during this TIME. You will be told when to start writing.
2. This paper has TWO Sections. There are NINE questions. Section A is compulsory. Attempt any THREE questions from Section B.
3. The marks shown against the requirement (s) for each question should be taken as an indication of the expected length and the required depth of the answer.
4. Present legible and tidy work.
5. No books, files are permitted in the examination room. Students are permitted to use an electronic calculator
6. Graph paper (if required) is provided at the end of the answer booklet.
7. **DO NOT OPEN THIS QUESTION PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.**

SECTION A: COMPULSORY

QUESTION 1

a. Legal Framework for Tax Audits (5 Marks)

Identify and explain five (5) main elements of the legal framework governing tax audits and investigations.

Model solution

i. Record-keeping obligations - for audit purposes Taxpayers must maintain accurate financial records.

ii. Access to books/records **-** Tax authorities have statutory power to examine taxpayer documents.

iii. Third-party information access **-** Auditors can obtain data from banks, suppliers, or other entities.

iv. Sanctions for non-compliance **-** Penalties for fraud, evasion, or refusal to cooperate.

v. Information-sharing between agencies – there is **c**ollaboration between customs, immigration, or other foreign tax bodies.

b. Tax Audit vs. Investigation (5 Marks)

Differentiate between tax audits and investigations, stating three objectives of each.

Model solution

Tax Audit - Focuses on verifying compliance through routine checks.

Objectives could be:

i. To confirm accuracy of tax returns.

ii. To identify unintentional errors.

iii. To educate taxpayers on compliance.

Tax Investigation - Targets suspected fraud or evasion.

Objectives could be:

iv. To uncover deliberate underreporting.

v. To gather evidence for prosecution.

vi. To recover unpaid taxes through penalties.

c. Audit Techniques (5 Marks)

Outline four techniques used in tax audits.

Model solution

i. Risk-based sampling - Prioritizes high-risk areas (e.g., large transactions).
ii. Third-party verification **-** Cross-checking data with banks or suppliers.
iii. Forensic accounting – Tracing hidden assets or irregular cash flows.
iv. Capital reconciliation - Comparing declared income with lifestyle/assets.

d. Mining Sector Audit Issues (5 Marks)

Discuss three audit challenges specific to the mining sector.

Model solution

i. Capital expenditure classification **-** Disputes over deductibility of exploration vs. development costs.
ii. Transfer pricing **–** possible manipulation of prices in transactions with related entities in tax havens.
iii. Royalty calculations **–** possible underreporting of mineral volumes or values exported.

e. Transfer Pricing Audits (5 Marks)

Identify four challenges in transfer pricing audits.

Model solution

i. Lack of comparable **-** Difficulty in finding arm's-length benchmarks for unique transactions.
ii. Documentation gaps **-** Missing contemporaneous transfer pricing reports.
iii. Cross-border complexity **-** Coordination with foreign tax authorities.
iv. Dispute resolution **-** Protracted negotiations/litigation with multinationals.

f. Ethical Issues (5 Marks)

Evaluate three ethical dilemmas tax auditors may face.

Model solution

i. Conflict of interest **-** Auditing clients with personal/ familial ties.
ii. Confidentiality breaches **-** Unauthorized disclosure of taxpayer data.

iii. Pressure to compromise **-** Coercion to overlook discrepancies for bribes or political reasons.

g. Banking & Telecom Sector Issues (5 Marks)

Describe two audit issues each in banking and telecommunications.

Model solution

Banking

i. Loan loss provisioning **-** Overstated allowances to reduce taxable income.

ii. Interest income underreporting **-** Concealment of offshore deposits.

Telecom

i. Interconnect fees **-** Manipulation of charges between operators.

ii. VAT fraud **-** Fake invoices for infrastructure purchases.

h. Practical Audit Steps (5 Marks)

Explain three steps in managing a tax audit.

Model solution

i. Pre-audit planning **-** Review taxpayer history and identify risk areas.

ii. Fieldwork/interviews - Conduct on-site inspections and question key staff.

iii. Interim reporting - Update supervisors on findings and seeks guidance.

(Total: 40 marks)

SECTION B: ATTEMPT ANY THREE QUESTIONS

QUESTION 2

You are an audit team leader responsible for the tax audit of Gunduzani Corporation. During your preliminary review, you discover the following issues:

The company has significant transactions with related parties in foreign jurisdictions.

i. There are discrepancies between reported income on tax returns and financial statements.
ii. The company has been consistently reporting losses for the past 3 years despite expanding operations.

Required:

a) Outline 4 key audit procedures you would perform to investigate these issues. (8 marks)

b) Explain 3 potential red flags for tax evasion or avoidance that these issues may indicate. (6 marks)

c) Describe 2 challenges you may face in conducting this tax audit and how you would address them. (6 marks)

(Total: 20 marks)

Model Solution

a) Key audit procedures to investigate the issues in regard to reviewing and analysing related party transactions:

i. Obtain a detailed list of all related party transactions
ii. Examine transfer pricing documentation
iii. Compare transaction terms to arm's length principles
iv. Verify proper disclosure in financial statements
v. Reconcile tax returns with financial statements:
vi. Prepare a detailed reconciliation of book income to taxable income
vii. Investigate material reconciling items
viii. Review tax adjustments and supporting documentation
ix. Assess consistency of treatment across years

Analyze reported losses:

i. Review detailed profit and loss statements for each year
ii. Examine major revenue and expense categories for unusual fluctuations
iii. Assess reasonableness of losses given business expansion

iv. Compare performance to industry benchmarks

Conduct third-party verifications:

i. Circularize major customers and suppliers
ii. Obtain bank confirmations for all accounts
iii. Review contracts for major transactions
iv. Verify existence and valuation of significant assets

b) Potential red flags for tax evasion or avoidance:

i. i. Related party transactions may indicate attempts to shift profits to low-tax jurisdictions through transfer pricing manipulation
ii. Discrepancies between tax returns and financial statements could suggest deliberate underreporting of income for tax purposes or aggressive tax positions
iii. Consistent losses despite business expansion may indicate artificial suppression of profits through inflated expenses or unreported revenues

c) Challenges in conducting the tax audit and how to address them:

i. Limited access to information on foreign related parties
ii. Request assistance from tax authorities in relevant jurisdictions through information exchange agreements
iii. Thoroughly review any available transfer pricing documentation and contracts
iv. Complex transactions and accounting treatments:
v. Engage tax specialists or industry experts as needed
vi. Develop a detailed understanding of the business model and significant transactions
vii. Use data analytics tools to identify anomalies and patterns in large datasets

QUESTION 3

You are a senior tax auditor at the Zambia Revenue Authority (ZRA). You have been assigned to audit a medium-sized retail business, Ujeni Traders Limited, which has been operating for the past five years. Upon initiating the audit, you discover that the company has either no records or severely inadequate records for the tax years under review (2021-2023). The company's management claims that most of their records were lost during a recent relocation of their office.

As the senior tax auditor, address the following points in your preliminary audit report:

i. Explain the importance of proper record-keeping for businesses and its relevance to tax compliance. (4 marks)

ii. Outline the specific challenges you will face in conducting this audit due to the lack of adequate records. (4 marks)

iii. Describe three methods you would employ to reconstruct the company's income and expenses for the audit period. (5 marks)

iv. Discuss the potential tax implications and penalties that Lusaka Traders Limited may face due to inadequate record-keeping. (4 marks)

v. Propose recommendations to help the company improve its record-keeping practices for future compliance. (3 marks)

(Total: 20 marks)

Model Solution

Tax compliance is synonymous with proper record-keeping for businesses:

a) Accurate Tax Reporting - Comprehensive records ensure that businesses can accurately report their income, expenses, and tax liabilities, reducing the risk of errors or unintentional non-compliance.

b) Evidence for Claims - Well-maintained records provide evidence to support tax deductions, credits, and other claims made on tax returns, protecting businesses during audits.

c) Financial Management - Proper records help businesses track their financial performance, make informed decisions, and demonstrate their financial position to stakeholders.

d) Legal Requirement - In Zambia, the Income Tax Act requires businesses to maintain adequate records for at least 6 years, making it a legal obligation for tax compliance.

e) Audit Efficiency - Good record-keeping facilitates smoother and more efficient tax audits, saving time and resources for both the business and tax authorities.

Challenges faced in conducting the audit due to lack of adequate records:

a) Income Verification - Without proper sales records, it becomes difficult to verify the accuracy of reported income, potentially leading to underreporting of taxable income.

b) Expense Substantiation - Inadequate expense records make it challenging to validate claimed deductions, which may result in disallowed expenses and increased tax liability.

c) Cash Flow Analysis - The lack of records hinders the ability to perform a comprehensive cash flow analysis, making it difficult to identify potential unreported income or overstated expenses.

d) Asset Valuation - Without proper documentation, it becomes challenging to accurately value assets for depreciation purposes or to verify capital gains or losses.

e) Time and Resource Intensive - The absence of records necessitates extensive reconstruction work, significantly increasing the time and resources required for the audit.

Ways & Methods to reconstruct the company's income and expenses

a) Bank Statement Analysis - Obtain and analyze the company's bank statements to trace deposits (potential income) and withdrawals (potential expenses). This method can provide a baseline for financial activity.

b) Third-Party Information - Gather information from third parties such as suppliers, customers, and government agencies to corroborate income and expenses. This may include issuing third-party confirmations or utilizing data from the ZRA's information sharing agreements.

c) Industry Benchmarking - Compare the company's reported figures with industry standards and ratios to identify discrepancies and estimate reasonable income and expense levels for a business of similar size and nature.

Potential tax implications and penalties

a) Estimated Assessments - The ZRA may issue estimated assessments based on the best available information, which could result in higher tax liabilities for the company.

b) Disallowed Expenses - Expenses that cannot be substantiated may be disallowed, increasing the company's taxable income and tax liability.

c) Penalties - Under Zambian tax law, failure to keep proper records can result in penalties of up to 10,000 penalty units per charge or 10% of the tax payable, whichever is greater.

d) Interest Charges - Additional tax liabilities arising from the audit may be subject to interest charges, further increasing the financial burden on the company.

e) Increased Scrutiny - The lack of proper records may flag the company for more frequent future audits and closer monitoring by the ZRA.

Recommendations for improving record-keeping practices

a) Implement a robust accounting system - Invest in a reliable accounting software that can track income, expenses, and generate necessary financial reports.

b) Establish clear record-keeping procedures - Develop and document clear procedures for recording all business transactions, including sales, purchases, and expenses.

c) Regular Backups - Implement a system for regular backups of financial data, both digitally and in hard copy, to prevent loss of information during unforeseen events.

d) Staff Training - Provide training to relevant staff members on proper record-keeping practices and the importance of maintaining accurate financial records.

QUESTION 4

Ndiswe Corporation has recently undergone a tax audit by the local tax authority. As part of the audit, the tax authority has requested the following financial statements for the years ending December 31, 2022, and December 31, 2023:

1. **Income Statement**

2. **Balance Sheet**
3. **Cash Flow Statement**

The Income Statement shows the following figures:

Item	**2022 (ZMW)**	**2023 (ZMW)**
Revenue	500,000	600,000
Cost of Goods Sold	300,000	360,000
Gross Profit	200,000	240,000
Operating Expenses	100,000	120,000
Net Income Before Tax	100,000	120,000
Income Tax Expense (30%)	30,000	36,000
Net Income	70,000	84,000

The Balance Sheet shows the following figures:

Item	**2022 (ZMW)**	**2023 (ZMW)**
Assets		

Item	2022 (ZMW)	2023 (ZMW)
Current Assets	150,000	200,000
Non-current Assets	350,000	400,000
Total Assets	500,000	600,000

Liabilities
Current Liabilities	100,000	120,000
Long-term Liabilities	150,000	180,000
Total Liabilities	250,000	300,000

Equity
| Common Stock | 100,000 | 100,000
| Retained Earnings | 150,000 | 200,000
| Total Equity | 250,000 | 300,000

The Cash Flow Statement provides the following information:

i. Cash Flow from Operating Activities:

   2022: ZMW 90,000

   2023: ZMW 110,000

ii. Cash Flow from Investing Activities:

   2022: ZMW (50,000)

   2023: ZMW (60,000)

iii. Cash Flow from Financing Activities:

   2022: ZMW (20,000)

   2023: ZMW (30,000)

Required:

1. **Identify and calculate the following for both years:**

   i. Gross Profit Margin

ii. Net Profit Margin

iii. Current Ratio

iv. Debt to Equity Ratio

2. **Based on your analysis of these financial ratios and statements:**

   i. Discuss any potential red flags that could arise during a tax audit.

   ii. Suggest areas where Ndiswe Corporation should focus on improving its financial practices to minimize audit risks.

(Total: 20 marks)

Model Solution

Financial Ratios Calculation

1. Gross Profit Margin is calculated as:

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Revenue}} \times 100$$

For year 2022:

Gross Profit Margin is calculated:

$$\text{Gross Profit Margin} = \frac{200{,}000}{500{,}000} \times 100 = 40\%$$

For 2023:

Gross Profit Margin is calculated:

$$\text{Gross Profit Margin} = \frac{240{,}000}{600{,}000} \times 100 = 40\%$$

2. Net Profit Margin is calculated as:

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Revenue}} \times 100$$

For year 2022:

$$\text{Net Profit Margin} = \frac{70,000}{500,000} \times 100 = 14\%$$

For year 2023:

$$\text{Net Profit Margin} = \frac{84,000}{600,000} \times 100 = 14\%$$

3. Current Ratio is calculated as:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

For year 2022:

$$\text{Current Ratio} = \frac{150,000}{100,000} = 1.5$$

For year 2023:

$$\text{Current Ratio} = \frac{200,000}{120,000} = 1.67$$

4. **Debt to Equity Ratio is calculated as**:

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

For year 2022:

$$\text{Debt to Equity Ratio} = \frac{250,000}{250,000} = 1$$

For year 2023:

Debt to Equity Ratio = $\frac{300,000}{300,000}$ = 1

Analysis and Discussion

Potential red flags during a Tax Audit:

i. High Operating Expenses: The increase in operating expenses from ZMW 100,000 in 2022 to ZMW 120,000 in 2023 could raise questions regarding their legitimacy and necessity.

ii. Consistency in Margins: While stable gross and net profit margins can indicate consistency in operations; they may also suggest potential underreporting of revenue or overreporting of expenses if not supported by detailed documentation.

Suggestions for Improvement:

i. Enhance Documentation Practices: Ndiswe Corporation should maintain thorough records of all transactions and expenses to support claims made in financial statements.

ii. Review Expense Categories: Regularly review and categorize expenses to ensure they are necessary and justifiable.

iii. Tax Compliance Training: Implement training programs for staff on tax compliance and best practices to reduce errors that could lead to audits.

QUESTION 5

You are a senior tax investigator at the Zambia Revenue Authority (ZRA). You have received a detailed whistleblower report about potential tax evasion by a large manufacturing company, Diamond Industries (DI). The whistleblower, a former accountant at DI, alleges that the company has been systematically underreporting its income and inflating expenses for the past three years. The report includes specific dates, transaction details, and names of key personnel involved.

As the senior tax investigator, address the following points in your investigation plan:

i. Outline the initial steps you would take to verify the credibility of the whistleblower's report. (3 marks)

ii. Describe three specific investigative techniques you would employ to gather evidence of the alleged tax evasion. (4 marks)

iii. Discuss the potential risks you might face during this investigation and how you would address them. (5 marks)

iv. Explain the legal considerations and procedures you must follow when conducting this tax investigation. (3 marks)

v. If the allegations are proven true, describe the potential consequences for Diamond Industries and the individuals involved. (3 marks)

vi. Propose recommendations to improve the ZRA's ability to detect and prevent similar cases of corporate tax evasion in the future. (2 marks)

(Total: 20 marks)

Model Solution

Preliminary investigation to verify the credibility of the whistleblower's report:

a) Review the whistleblower's background - Verify the former accountant's employment history with DI and assess their access to the reported information.

b) Analyze the report's details - Scrutinize the specificity and consistency of the information provided, including dates, transaction details, and personnel names.

c) Preliminary data analysis - Compare the reported figures with DI 's tax returns and any available industry benchmarks to identify significant discrepancies.

d) Internal consultation: Discuss the report with senior ZRA officials to determine if there have been any previous concerns or investigations related to DI.

e) Discreet third-party verification - Cautiously verify some of the report's claims through third-party sources without alerting DI to the investigation.

Specific investigative techniques used to gather evidence

a) Financial Analysis - Conduct a comprehensive review of DI 's financial statements, tax returns, and bank records for the past three years. Compare reported income and expenses with actual bank transactions to identify discrepancies.

b) Digital Forensics - Obtain and analyze electronic records, including emails, accounting software data, and digital financial records, to uncover evidence of manipulated figures or hidden transactions.

c) Supplier and Customer Interviews - Conduct discreet interviews with DI's major suppliers and customers to verify reported transactions and potentially uncover unreported or misreported business activities.

How to address potential risks

a) Risk 1- Destruction or alteration of evidence

Solution - Act swiftly to secure relevant documents and digital data through court orders or surprise inspections.

b) Risk 2- Uncooperative company officials

Solution - Leverage legal powers granted to ZRA investigators and consider involving law enforcement if obstruction occurs.

c) Risk 3- Complex financial transactions designed to hide evasion

Solution - Assemble a team of forensic accountants and financial experts to unravel sophisticated evasion schemes.

d) Risk 4- Potential leak of investigation details

Solution - Implement strict confidentiality measures and limit information access to essential personnel only.

e) Risk 5 - Intimidation of witnesses or the whistleblower

Solution - Ensure proper witness protection measures are in place and maintain the whistleblower's anonymity.

f) Risk 6 - Legal challenges from DI

Solution - Work closely with ZRA's legal department to ensure all investigative actions are legally sound and properly documented.

Legal considerations and procedures

a) Obtain proper authorization - Ensure all investigative actions are authorized by appropriate ZRA officials and comply with the Zambia Revenue Authority Act.

b) Respect due process - Follow all legal procedures for information requests, interviews, and evidence collection to ensure admissibility in potential legal proceedings.

c) Maintain confidentiality - Adhere strictly to taxpayer confidentiality laws throughout the investigation.

d) Document all actions - Keep detailed records of all investigative steps, findings, and decisions to support potential legal action.

e) Preserve evidence integrity - Establish a clear chain of custody for all collected evidence to maintain its admissibility and reliability.

Potential consequences if allegations are proven true

a) Financial penalties - DI may face substantial fines and be required to pay all evaded taxes plus interest.

b) Criminal charges – Identified key individuals involved in the evasion scheme may face criminal prosecution, potentially resulting in fines and imprisonment.

c) Reputational damage - Public disclosure of tax evasion could severely damage DI's reputation, affecting its business relationships and market value.

d) Increased scrutiny - DI would likely be subject to enhanced monitoring and more frequent audits by the ZRA in the future.

e) Civil asset forfeiture - The ZRA may seek to seize assets acquired through the proceeds of tax evasion.

Recommendations to improve detection and prevention of corporate tax evasion:

a) Enhance data analytics capabilities - Invest in advanced data analysis tools and train staff to identify patterns and anomalies indicative of tax evasion.

b) Strengthen inter-departmental cooperation - Improve information sharing and collaboration with other government departments to detect complex evasion schemes.

c) Implement a robust whistleblower program - Develop a comprehensive whistleblower protection and reward system to encourage reporting of tax evasion.

QUESTION 6

You are a senior tax investigator at the Zambia Revenue Authority (ZRA). You have been assigned to lead a comprehensive tax investigation into Copperbelt Minerals Corporation (CMC), one of the largest copper minerals companies in Zambia. There are suspicions that CMC may be engaging in transfer pricing manipulation and potentially underreporting its mineral production and exports. Your investigation covers the tax years 2020-2022.

As the lead investigator, address the following points in your investigation plan:

i. Outline the specific areas of focus for this mining sector tax investigation and explain why they are important. (4 marks)
ii. Describe four investigative techniques you would employ to gather evidence of potential tax evasion in the mining sector. (5 marks)
iii. Discuss the challenges specific to auditing mining companies and how you would address them. (4 marks)
iv. Explain the importance of international cooperation in this investigation and provide two examples of how you would utilize it. (3 marks)
v. If evidence of tax evasion is found, describe the potential consequences for Copperbelt Minerals Corporation and propose recommendations to improve mining sector tax compliance. (4 marks)

(Total: 20 marks)

Model Solution

Specific areas of focus for the mining sector tax investigation:

a) Mineral Production Reporting - Accurate reporting of mineral production is crucial as it forms the basis for royalty calculations and income tax assessments. Underreporting can lead to significant revenue losses for the government.

b) Export Volumes and Pricing - Verifying the accuracy of reported export volumes and prices is essential to ensure proper valuation of mineral sales and prevent undervaluation of exports.

c) Transfer Pricing - Scrutinizing transactions between CMC and its related parties abroad is critical to prevent profit shifting through manipulated prices of goods, services, or intangible assets.

d) Capital Expenditure - Examining large capital expenditures is important to ensure they are legitimate business expenses and not inflated to reduce taxable income.

e) Operational Costs - Analyzing operational costs helps identify any inflated or fictitious expenses that could be used to reduce taxable income.

f) Mineral Valuation - Verifying the accuracy of mineral valuation methods used by CMC is crucial for ensuring correct calculation of royalties and income tax.

g) Tax Incentives and Exemptions - Reviewing CMC's use of tax incentives and exemptions helps ensure they are applied correctly and not abused.

Investigative techniques for gathering evidence:

a) Data Analytics - Utilize advanced data analysis tools to examine large volumes of financial data, production reports, and export records to identify anomalies or patterns indicative of tax evasion.

b) Physical Inspections - Conduct on-site visits to CMC's mining operations to verify production capacity, inventory levels, and the accuracy of reported mineral extraction volumes.

c) Third-Party Confirmations - Obtain information from CMC's customers, suppliers, and shipping companies to verify reported sales, purchases, and export volumes.

d) Forensic Accounting - Employ forensic accounting techniques to trace complex financial transactions, particularly those related to transfer pricing and intercompany transactions.

Risks specific to auditing mining companies and solutions:

a) Risk 1 - Complex pricing mechanisms for minerals

Solution: Engage mineral valuation experts to assist in understanding and verifying the pricing methodologies used by CMC.

b) Risk 2 - Technical nature of mining operations

Solution - Include mining engineers or geologists in the investigation team to provide expertise on production processes and mineral grades.

c) Risk 3 - International scope of operations

Solution: Collaborate with tax authorities in countries where CMC's related parties are located to obtain relevant information and conduct joint audits if necessary.

d) Risk 4 - Difficulty in verifying actual mineral production

Solution: Implement surprise inspections and utilize satellite imagery to monitor mining activities and corroborate reported production figures.

e) Risk 5 - Sophisticated tax planning structures

Solution: Assemble a team with diverse expertise, including international tax specialists, to unravel complex corporate structures and identify potential tax avoidance schemes.

f) Risk 6 - Rapid fluctuations in mineral prices

Solution: Develop a comprehensive database of historical mineral prices and engage commodity market experts to assess the reasonableness of reported sales prices.

g) Risk 7 - Long production cycles and large-scale investments

Solution - Adopt a long-term perspective in the audit, considering the entire life cycle of mining projects when assessing tax compliance.

Importance of international cooperation

International cooperation is critical in mining sector investigations due to the global nature of the industry and the prevalence of multinational corporations. It helps in tracking cross-border transactions, identifying hidden assets, and addressing transfer pricing issues.

International cooperation/collaboration

a) Exchange of Information - Utilize tax information exchange agreements to request data on CMC's transactions with related parties in other jurisdictions, helping to verify transfer pricing arrangements.

b) Joint Audits - Collaborate with tax authorities in countries where CMC's parent company or major subsidiaries are located to conduct simultaneous tax examinations, sharing information and resources.

Consequences and recommendations

Potential consequences for Copperbelt Minerals Corporation:

a) Substantial financial penalties and payment of evaded taxes with interest.

b) Criminal charges against company executives involved in tax evasion schemes.

c) Revocation or suspension of mining licenses.

d) Reputational damage affecting investor confidence and business relationships.

e) Increased scrutiny and more frequent audits by tax authorities.

Recommendations to improve mining sector tax compliance:

a) Implement a sector-specific tax monitoring system using real-time data on mineral production and exports.

b) Enhance capacity building for ZRA staff in mining sector taxation and transfer pricing.

c) Strengthen legislation to require mining companies to provide more detailed financial and operational reports.

d) Develop a specialized mining sector audit unit within the ZRA with technical expertise in the industry.

e) Improve coordination between various government agencies involved in mining sector oversight.

f) Implement a beneficial ownership registry to increase transparency in the mining sector.

g) Encourage the adoption of the Extractive Industries Transparency Initiative (EITI) standards in Zambia.

h) Establish regular dialogue between the ZRA and mining companies to address compliance issues proactively.

QUESTION 7

You are a senior tax auditor at the Zambia Revenue Authority (ZRA) assigned to conduct a tax audit of Ganizani Bwino Manufacturing Ltd for the 2023 tax year. During your initial review, you notice the following:

i. The company reported a gross profit margin of 15%, which is significantly lower than the industry average of 25-30%.
ii. There are large unexplained cash withdrawals from the company's bank account totaling ZMW 500,000.
iii. The company claimed deductions for "consulting fees" of ZMW 750,000 paid to an offshore company, but there is limited documentation supporting these services.
iv. Several sales invoices appear to be missing from the sequence.

Required:

a) Outline 4 key steps you would take in planning and conducting this tax audit. (8 marks)

b) For each of the 4 issues identified above, explain:

i) The potential tax implications

ii) What specific audit procedures you would perform to investigate further

(3 marks per issue, 12 marks total)

(Total: 20 marks)

Model Solution

a) Steps taken in planning and conducting the tax audit: (8 marks)

i. Perform risk assessment and develop audit plan
ii. Review prior year returns and audit history

iii. Analyze financial statements and tax computations
iv. Identify high-risk areas based on initial findings
v. Determine audit scope and procedures
vi. Issue formal audit notification to taxpayer
vii. Request relevant documents and records
viii. Schedule opening meeting with company management
ix. Conduct initial interview and tour of business premises
x. Gain understanding of business operations and accounting systems
xi. Observe and document relevant information about facilities, inventory, etc.
xii. Perform detailed examination of records
xiii. Trace transactions through accounting system
xiv. Reconcile tax returns to financial statements and source documents
xv. Apply audit techniques like analytical procedures, sampling, etc.

b) Analysis of specific issues:

Low gross profit margin **(3 marks)**

Potential tax implications:

i. Underreporting of sales revenue or overstatement of cost of goods sold, leading to underpayment of income tax

Audit procedures:

i. Perform detailed analysis of sales and cost of goods sold accounts
ii. Review pricing policies and compare to actual sales invoices
iii. Conduct inventory count and valuation testing
iv. Analyze gross profit trends by product line

Large unexplained cash withdrawals **(3 marks)**

Potential tax implications:

i. Unreported cash income or personal expenses being paid through the business, resulting in understated taxable income

Audit procedures:

i. Trace withdrawals to supporting documentation and final disposition of funds
ii. Review bank statements and cash books for unusual patterns

Perform cash T-account analysis

i. Interview relevant personnel about purpose of withdrawals

Offshore consulting fees **(3 marks)**

Potential tax implications:

i. Improper tax deduction if services not actually rendered
ii. Potential transfer pricing issue if not at arm's length
iii. Withholding tax obligations on payments to non-residents

Audit procedures:

i. Request and examine contracts, invoices, proof of work performed
ii. Assess commercial rationale and arm's length nature of fees
iii. Verify withholding tax compliance on payments
iv. Consider whether anti-avoidance provisions may apply

Missing sales invoices **(3 marks)**

i. Potential tax implications:
ii. Unreported sales revenue leading to understated income tax and VAT liabilities

Audit procedures:

i. Perform gap analysis on sales invoice sequence
ii. Reconcile total sales per invoices to reported revenue
iii. Review shipping records and customer orders
iv. Consider use of indirect methods to estimate unreported sales

QUESTION 8

You are a senior tax auditor at the Zambia Revenue Authority. You have been assigned to conduct a tax audit of BDM Manufacturing Ltd, a medium-sized company that produces and sells furniture. The company has been selected for audit based on discrepancies identified in their recent tax returns.

As the lead auditor, outline the key steps you would take to plan and execute this tax audit, including:

a. Initial preparation and information gathering
b. On-site audit procedures
c. Analysis of findings
d. Concluding the audit

Required:

Explain your rationale for each step and any potential challenges you may encounter during the audit process.

(Total: 20 marks)

Model Solution

Initial Preparation and Information Gathering

The first step is to thoroughly review BDM Manufacturing Ltd.'s tax file and recent returns. This effectively includes:

i. Analyzing past tax returns, financial statements, and any previous audit history
ii. Identifying potential risk areas or discrepancies in reported income, expenses, or tax calculations
iii. Researching the furniture manufacturing industry to understand typical financial ratios and business practices

Second step, I would prepare an audit plan outlining the scope, timeline, and specific areas of focus. This plan would be reviewed with my audit manager before proceeding.

Thirdly, I would then send an official audit notification letter to BDM Manufacturing Ltd, requesting relevant financial records and scheduling an initial meeting with company management.

On-site Audit Procedures

During the on-site portion of the audit, key steps may include:

i. Conducting an opening meeting with company management to explain the audit process and address any questions
ii. Touring the manufacturing facility to understand operations and inventory processes
iii. Examining source documents such as sales invoices, purchase orders, and bank statements to verify reported figures
iv. Reviewing the company's accounting systems and internal controls
v. Interviewing key personnel about financial processes and any unusual transactions

I would pay particular attention to areas such as:

i. Revenue recognition practices
ii. Inventory valuation methods
iii. Classification of capital vs. expense items
iv. Related party transactions
v. Compliance with VAT regulations

Analysis of Findings

i. After gathering all necessary information, I would:
ii. Reconcile reported figures with source documents and third-party information
iii. Perform analytical procedures to identify any unusual trends or discrepancies
iv. Quantify any identified tax discrepancies or underpayments
v. Document all findings and supporting evidence thoroughly

To conclude the audit, I would:

i. Prepare a comprehensive audit report detailing all findings and proposed adjustments

ii. Conduct a closing meeting with company management to discuss the findings and allow them to provide any additional information
iii. If discrepancies are found, calculate any additional taxes owed along with applicable penalties and interest
iv. Provide the company with a formal assessment and explanation of their appeal rights
v. Ensure all audit documentation is properly filed and retained according to ZRA policies

Potential Challenges

i. Resistance from the company in providing requested documents or access to personnel
ii. Complex or unclear accounting practices that require additional investigation
iii. Disagreements with company management over interpretation of tax laws or treatment of specific transactions

To address these challenges, I would:

i. Clearly communicate ZRA's authority to conduct the audit and the company's obligations
ii. Seek guidance from technical specialists within ZRA when needed
iii. Maintain a professional and objective approach throughout the audit process

QUESTION 9

As a tax auditor assigned to conduct an audit of a major telecommunications company, what are the key steps you would take to ensure a comprehensive and effective audit process?

Model solution

Conducting a tax audit in the telecommunications sector requires a thorough understanding of the industry's complexities and the specific tax regulations that apply. The following is a step-by-step approach to auditing a telecommunications company:

1. Preliminary Review

I would begin by conducting a preliminary review of the company's financial statements and tax returns. This initial assessment will help me identify potential areas of concern and guide the focus of the audit.

2. Develop Audit Objectives

Establish clear objectives for the audit, considering the specific risks and complexities of the telecommunications industry. The objectives should align with the compliance risk management process and focus on areas such as:

i. Accuracy of reported revenue

ii. Proper application of telecommunications-specific taxes and fees
iii. Compliance with regulatory requirements

3. Review Telecom-Specific Transactions

i. Examine transactions peculiar to the telecom sector, including
ii. Revenue from various services (voice, data, SMS, etc.)
iii. Interconnection charges
iv. Roaming fees
v. Equipment sales and leases

4. **Assess Revenue Recognition**

Scrutinize the company's revenue recognition practices, paying particular attention to:

i. Timing of revenue recognition
ii. Treatment of bundled services
iii. Handling of prepaid services and unused balances

5. Evaluate Tax Calculation and Remittance

Review the company's tax calculation and remittance processes:

i. Verify the accuracy of sales tax, communications services tax, and other applicable taxes
ii. Check compliance with federal, state, and local tax obligations
iii. Examine the company's use of tax calculation software and its integration with billing systems

6. Analyze Regulatory Compliance

i. Assess the company's adherence to regulatory requirements
ii. Review compliance with Universal Service Fund (USF) contributions
iii. Check for proper licensing and registration with relevant authorities
iv. Verify compliance with state-specific regulatory fees and surcharges

7. Conduct Data Analysis

i. Perform detailed analysis of the company's data, focusing on:
ii. Call Data Records (CDRs) to verify service provider-wise liability
iii. Metering and billing system accuracy
iv. Usage patterns and their alignment with reported revenue

8. Review Cost Allocations

i. Examine the company's cost allocation methodologies, particularly for:
ii. Network infrastructure costs
iii. Shared services among different business units
iv. Intercompany transactions and transfer pricing

9. Assess Internal Controls

i. Evaluate the effectiveness of the company's internal control systems
ii. Review processes for identifying and mitigating tax risks
iii. Assess the accuracy and reliability of the company's record-keeping systems
iv. Examine procedures for staying updated on changing tax regulations

10. Conduct Interviews

i. Interview key personnel to gain insights into the company's operations and tax practices
ii. This may include discussions with:
   a. Finance and accounting staff
   b. Tax department personnel
   c. Operations managers

11. Document Findings and Prepare Report

i. Compile all findings and prepare a comprehensive audit report
ii. Detail any discrepancies or areas of non-compliance
iii. Provide recommendations for addressing identified issues
iv. Outline potential tax liabilities or refunds

12. Follow-up and Implementation

i. After presenting the audit findings to the company:
ii. Discuss proposed adjustments and recommendations
iii. Establish a timeline for implementing necessary changes
iv. Schedule follow-up reviews to ensure compliance

Note: Not all points presented in the marking key would be written by the student. Valid responses should be considered beyond the key.

END OF PAPER