

Risk Management
Australian Taxation Office
Performance Audit
Tabled 18 June 1997

Audit Report No. 37 1996-97

Glossary

AS/NZS	Australian and New Zealand Standard
ANAO	Australian National Audit Office
APS	Australian Public Service
ATO	Australian Taxation Office
BSLs	Business and Service Lines
CS	Corporate Services
CSA	Child Support Agency
FBT	Fringe Benefits Tax
FS	Financial Services
HOTSA	Health of the System Assessment
INB	Individuals Non-Business
IT	Information Technology
ITS	Information Technology Services
LB&I	Large Business and International
LBI	Large Business Income
MAB	Management Advisory Board
MIAC	Management Improvement Advisory Committee
NPM	National Program Manager
PAYE	Pay As You Earn
SBI	Small Business Income
SPR	Superannuation
TFN	Tax File Number
The Board	ATO Management Board
TLS	Tax Law Services
WHT	Withholding and Indirect Taxes

Summary

1. The Australian Taxation Office (ATO) is the Commonwealth's primary revenue collection agency and is responsible for collecting over 80 percent of total government revenue. It collected close to \$99 billion in 1995-96 and has budgeted to collect about \$106 billion in 1996-97. ¹

2. In 1986, the ATO introduced a system of taxpayer self assessment. This initiative was designed to help achieve a better balance in compliance strategies. It shifted the ATO's primary focus from processing returns and issuing assessments to assisting taxpayers meet their obligations and taking enforcement action against those who do not. Self assessment is a large scale exercise in risk management which allows the ATO to assign resources freed from assessing taxpayer returns to areas of high compliance risk.

3. Risk management has been defined as:

The systematic application of management policies, procedures and practices to the tasks of identifying, analysing, assessing, treating and monitoring risk. ² (Emphasis added)

4. The ATO was among the first agencies in the Australian Public Service (APS) to introduce a formal risk management process as part of its strategic planning framework. This process is called the Health of the System Assessment (HOTSAs) and has been undertaken on an annual basis across all ATO Business and Service Lines (BSLs) since 1994-95.

Audit objective

5. The objective of the audit was to provide assurance about the ATO's risk management approach and to add value to the ATO's administration by analysing the economy, efficiency, administrative effectiveness, equity and accountability of the related processes employed within the organisation.

Audit scope and criteria

6. The ANAO reviewed the formal risk management process that the ATO uses to deal with all sources of risk for the organisation, not just the compliance risks associated with self assessment. The audit criteria were based on the Management Advisory Board and Management Improvement Advisory Committee (MAB/MIAC) risk management model ³ (now the APS standard) and the Australian and New Zealand Standard on Risk Management. ⁴ The criteria were used as a basis of examining the ATO's risk management processes to determine:

- how the organisation has established both the internal and external context or environment in which it operates;
- what information it has used to identify the risks to the organisation;
- how it has analysed those risks;
- how it has assessed and established priorities for those risks;

- the mix of resources it has allocated to address those risks; and
- how it has reviewed and monitored both the risks and its management of those risks.

7. The ANAO adopted a two pronged approach to the audit. This first report examines ATO-wide risk management operations across all Business and Service Lines at the corporate level. We did not examine in any detail whether the ATO's risk strategies and treatments were appropriate. A second report, expected to be tabled in the Spring 1997 session of the Parliament, will focus in-depth on the actual implementation of risk management in the Small Business Income Line. The ANAO considers that this approach will maximise the value of the audit activity.

8. The findings of this report have been based on the 1994-95 and 1995-96 HOTSAs processes. The 1997, or third round of HOTSAs, was in progress at the time of preparation of this report. Although the ANAO noted a number of significant improvements in the most recent risk management process it was in its early stages. Consequently the ANAO is not in a position to draw overall conclusions on the 1997 process at this time.

Overall audit conclusion

9. The ANAO acknowledges the ATO's considerable efforts in introducing formal risk management principles to a large and geographically dispersed organisation. In particular, the ANAO commends the ATO for seeking to address its risks at a strategic level through the HOTSAs and as part of its corporate governance processes. This increasing commitment to risk management principles has the potential to improve significantly the economy, efficiency, and administrative effectiveness of the tax processes together with the ATO's equity and accountability in its handling of the processes.

10. As a result of the ATO's 1994-95 and 1995-96 HOTSAs processes, the level of risk awareness within the organisation has been enhanced and more detailed analysis of identified risks has commenced. However, the ANAO concluded that the potential benefits of introducing a formal risk management system were not fully achieved in the first two HOTSAs rounds because adequate processes had not been fully implemented. We recognise that the ideal is unlikely to be achieved in the first attempt at formal risk management in such a large and complex organisation. However, we consider that the adoption of a more structured, formal and systematic approach would assist the ATO to attain the most effective risk management outcomes.

11. In particular, actions the ATO could undertake to ensure its management of risk is more comprehensive and cost-effective include:

- enhancing the identification and use of appropriate management information;
- improving the consistency and transparency of the risk management

process and resulting decisions;

- conducting a more comprehensive and better documented risk identification and assessment of risk;
- adopting a better coordinated and holistic approach to treating high priority risks;
- improving performance information to monitor progress; and
- implementing an effective review function for the entire risk management process.

12. The ATO is a complex organisation with about 17 000 staff, that spends more than \$1.3 billion per annum on its operations. It has a wide diversity of taxpayers who are geographically dispersed, ranging from individual salary and wage earners to large multi-national corporations. Even small improvements in ATO's efficiency potentially can lead to significant increases in revenue collected and improvement in service delivery. Such diversity, coupled with the complex legislation that the ATO has to administer, means that effective risk management is essential for the organisation's operations to be cost effective.

13. The ATO needs to build on its recent risk management achievements and to continue its efforts to develop an organisational culture where risk identification and its analysis, prioritisation and treatment are integral elements of management at all levels. This includes setting strategic directions for tax processing. This report specifically recognises that the ATO has made a number of significant improvements in its 1997 HOTSAs but recommends further actions which, if implemented effectively, should improve the effectiveness of overall ATO administration. It is expected that other agencies could benefit from the lessons learnt, particularly those reflected in the ATO's latest initiatives.

ATO overall response

14. The ATO commented that the ANAO report recognises the leading role the ATO is taking with risk management in the APS. It said the report supports the particular steps being taken in the ATO and gives it the confidence to further develop its approach. It also agreed that the recommendations will assist it in this.

15. The ATO also stated that the report should, however, be read with some caution: the formal audit findings are based on the ATO risk assessment processes for 1994-95 and 1995-96 though the discussion acknowledges the considerable progress made in 1997. Given the progress made in 1996-97 many of the findings have been overtaken by time.

Key Findings

Risk management information

16. The ATO has implemented a range of management information systems. Nevertheless, we consider that the ATO would benefit from enhancing these mechanisms to ensure the cost-effective collection of data that assists in the measurement of performance against key indicators. The effective use of this information would improve the ATO's ability to:

- identify, prioritise and assess risks;
- identify appropriate risk treatments; and
- monitor and review progress against achievement of risk management objectives and strategies.

17. Such information would enable the ATO to facilitate the assessment of key results such as the level of client service achieved and cost-effectiveness of its operations.

Risk management process

18. An examination of the ATO's risk management processes for 1994-95 and 1995-96 showed that:

- although these HOTSAs included some consideration of other risks, they concentrated mainly on compliance risks⁵ and as such could not be considered to be comprehensive risk assessment exercises;
- in 1994 the ATO Management Board (the Board) issued directions for the implementation of the HOTSAs process; however, these guidelines were not closely followed. There was also limited documentation of the ATO's processes leading to decisions about its risk management approach. Consistency and transparency suffered as a result;
- the ANAO found that the flexible approaches to HOTSAs at the portfolio or functional levels within BSLs were appropriate, bearing in mind the specific compliance objectives at this level (compared to the broader objectives at the BSL and ATO corporate levels);
- while reviewing HOTSAs documentation, the ANAO did not find evidence that the expectations and requirements of the ATO's major stakeholders, such as taxpayers, the Parliament, tax agents, ATO management, staff members and their unions, had been specifically taken into consideration at the BSL level;
- proposed treatments of risks identified through the first and second HOTSAs rounds were seldom clearly stated. Where strategies for treating risks were mentioned, appropriate action plans to address these risks had not been developed; and
- a formal ATO-wide end-of-HOTSAs evaluation was not undertaken at the completion of either the first or second rounds to review outcomes as

possible inputs to future directions. The ATO advised that the HOTSAs process was informally reviewed prior to guidance being issued for the 1995-96 round.

19. The ANAO noted that ATO planning for the 1997 HOTSAs exercise has reflected action taken at the corporate level which addresses a number of the issues raised during the audit. In particular:

- the guidelines governing the risk management process have been significantly improved;
- a more consistent approach to risk assessment has been adopted at the corporate level;
- the transparency of the process has been enhanced;
- risk identification and assessment at the corporate level has been more comprehensive; and
- considerable emphasis has been placed on establishing the ATO context at the corporate level, including the expectations and requirements of major stakeholders.

Contribution by the audit

20. In general, expected outcomes from an effective risk management process include better allocation of resources, higher standards of accountability, greater creativity and innovation in management practices, as well as enhanced decision making ability and cost effectiveness. Better advice to government to enhance Budget forecasting and increased customer service for taxpayers are specific potential benefits if risk management is applied effectively by the ATO. Perhaps the most significant result of an effective risk management process is the likelihood that there will be increased revenue⁶ for the Commonwealth through the collection of taxation duly payable that is currently being evaded. A reduction in the overall cost of collection ratio is also a potential result from the ATO's introduction of risk management principles. The audit is aimed at assisting the ATO to focus better on the implementation of these principles for better outcomes.

Structure of this report

21. Chapter 1 discusses the background and reasons for the audit together with its objectives, methodology and criteria. Chapter 2 provides an introduction of the ATO's history of risk management and reviews the ATO's HOTSAs process. The HOTSAs process is compared with the major features of a desired risk management process in Chapter 3. The final chapter discusses a six step methodology for risk management and indicates the extent to which the HOTSAs process has been consistent with this methodology.

Recommendations

Set out below are the ANAO's recommendations with the report paragraph reference. The ANAO considers that the ATO should give priority to recommendations numbered 1, 7 and 8.

Recommendation No. 1 Para. 3.22	The ANAO <i>recommends</i> that the ATO identifies the specific types and sources of management information it requires to manage identified risks effectively and establishes procedures to obtain this data on a cost effective basis.
Recommendation No. 2 Para. 3.35	The ANAO <i>recommends</i> that the ATO continues to improve the <u>transparency</u> of its risk management process. In particular, stakeholders such as the Parliament and ATO staff members should readily be able to determine the basis for decisions, the strategies for implementing them and the effectiveness of action taken.
Recommendation No. 3 Para. 3.50	The ANAO <i>recommends</i> that, at each level at which a risk assessment is undertaken, the ATO improves its documentation of the major steps and activities leading to key risk management decisions.
Recommendation No. 4 Para. 4.13	The ANAO <i>recommends</i> that the ATO's risk management processes include an integrated and structured analysis of information on stakeholder objectives at the Business and Service Line level and that these be used in the development of explicit criteria for managing risk.
Recommendation No. 5 Para. 4.31	The ANAO <i>recommends</i> that effective action be taken to ensure the ATO-wide risk management guidelines are followed and the various risk identification exercises undertaken within each Business and Service Line are based on a sound and consistent methodology. This will provide assurance that significant risks are actually being identified and accorded proper priority within the agreed control environment.
Recommendation No. 6 Para. 4.59	The ANAO <i>recommends</i> that the ATO ensures that consistent priorities are determined for identified risks, or logical groupings of risk, based on adequate information and that decisions on resource

allocations take into consideration those risks that have been assigned the highest level of priority.

Recommendation
No. 7
Para. 4.73

The ANAO *recommends* that the ATO pursues a more explicit and transparent cost/benefit analysis of the available options for treating identified risks, or logical groupings of risk. Relevant quantitative and/or qualitative costs and benefits should be identified at each level of the organisation that undertakes a risk assessment within the overall risk profile that has been established as part of the ATO's corporate governance framework.

Recommendation
No. 8
Para. 4.85

The ANAO *recommends* that the ATO enhances its corporate governance framework to ensure that effective systems of monitoring and evaluating performance against risk management plans are implemented and useful management reports are regularly available at all management levels.

ATO Response

The ATO agreed to all of these recommendations. The agency's detailed comments are included in the body of the report.

1

ATO Corporate Plan 1996-99.

2

Australian/New Zealand Standard 4360, 1995 Risk Management (AS/NZS 4360).

3

MAB/MIAC released its Report No. 17 Guidelines for Managing Risk in the Australian Public Service as an Exposure Draft in July 1995. In October 1996 MAB/MIAC issued its final Report No. 22 Guidelines for Managing Risk in the Australian Public Service.

4

AS/NZS 4360.

5

Compliance risks occur when taxpayers fail to comply with their obligations under tax law,

either inadvertently or deliberately and include understating income, over-claiming deductions and failure to lodge tax returns.

6

Risk management may increase total revenue, assist in maintaining the revenue base or reduce the loss that the government would otherwise have to bear.

1. Introduction

This chapter describes the background to the audit and sets out its objective, strategy and methodology.

Background to the audit

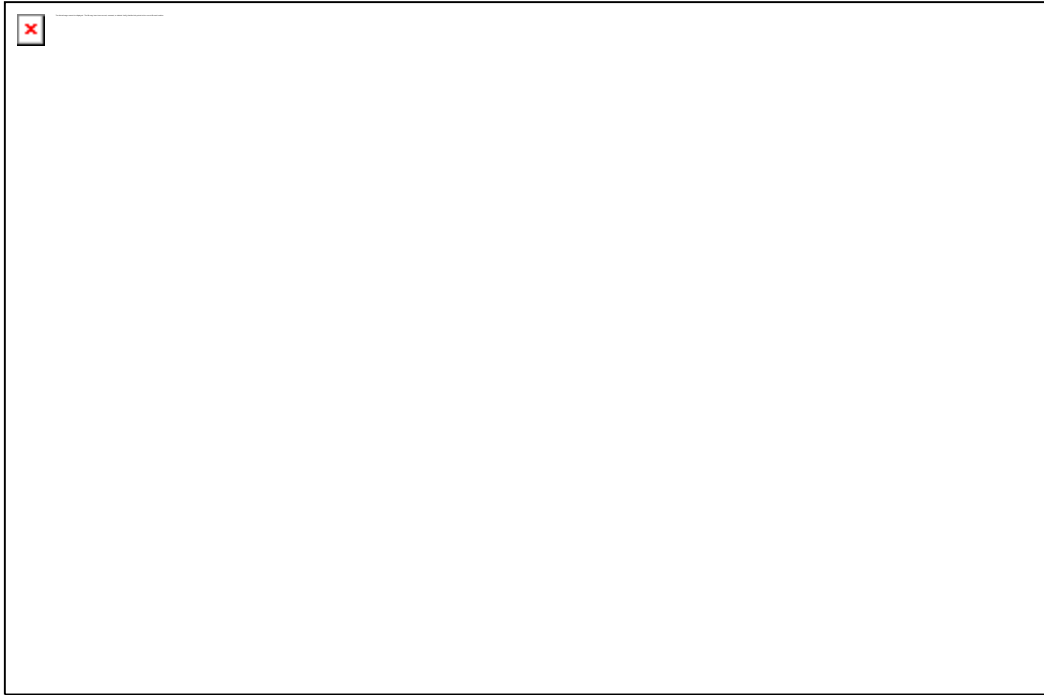
1.1 The ATO has stated that its main objective is:

To collect revenue, properly payable, so as to fund services and support for the people of Australia. ¹

1.2 The organisation is the Commonwealth's primary revenue collection agency, being responsible for collecting over 80 per cent of total government revenue. The ATO collected close to \$99 billion in 1995-96 and has budgeted for collections of about \$106 billion in 1996-97. ²

1.3 At 30 June 1996, the ATO had 18 212 ³ staff located across Australia in 25 branch offices, 17 regional offices ⁴ and a national headquarters in Canberra. It held assets of about \$220 million, principally consisting of computers, plant and equipment. The ATO spent more than \$1.31 billion on its operations during 1995-96 and the major components of this expenditure are outlined in Figure 1.1 below. A schematic representation of the ATO's organisational structure showing staffing and expenditure for each Business and Service Line (BSL) is included at Appendix 1, together with descriptions of the particular client groups served by each BSL.

Figure 1.1 - ATO Operational Expenditure Components 1995-96



1.4 From 1986, the ATO progressively introduced a system of taxpayer self assessment.⁵ The essential difference with this new approach was that the ATO largely ceased the examination of returns by technical officers, known as assessors, prior to raising assessments and issuing notices to taxpayers. This initiative was designed to help achieve a better balance in compliance strategies. It shifted the ATO's primary focus from processing returns and issuing assessments to assisting taxpayers meet their obligations and taking enforcement action against those who do not. Essentially, self assessment is a very large scale compliance risk management venture. Compliance risks occur when taxpayers fail to comply with the tax law, either inadvertently or deliberately. They include the understatement of income, overstatement of deductions and failure to lodge tax returns.

1.5 Risk management has been defined as:

*...the systematic application of management policies, procedures and practices to the tasks of identifying, analysing, assessing, treating and monitoring risk.*⁶ (Emphasis added)

1.6 Managing risk is a logical and systematic process which can be used when making decisions to improve the efficiency and effectiveness of performance. It is a management tool to identify and prepare for future contingencies. Managing risk involves taking action to avoid or reduce unwanted exposure to the costs or other effects of these events, or to maximise the potential of any opportunities identified.⁷

1.7 Expected outcomes from an effective risk management process include better allocation of resources, higher standards of accountability, greater creativity and innovation in management practices, as well as enhanced decision making ability and cost effectiveness.⁸ When effective risk management is applied to an agency such as the ATO, potential improvements include increased revenue for the

Commonwealth through the collection of revenue duly payable that is currently uncollected, better advice to government to enhance Budget forecasting and increased customer service for taxpayers. A reduction in the overall cost of collection ratio is also a potential result from the ATO's introduction of risk management principles. The audit is aimed at assisting the ATO to focus better on the implementation of these principles for better outcomes.

1.8 The Australian Public Service (APS) generally has experienced more than a decade of ongoing reforms including increased decentralisation, devolution of responsibility, a greater focus on results and accountability and mandatory efficiency dividends. In this environment of continuous change and constrained resources, the ATO was among the first APS agencies to introduce formal risk management principles to its strategic planning framework.

Reasons for the audit

1.9 The sheer size of the ATO and the large amounts of money it is responsible for collecting mean that even small improvements in effectiveness and efficiency can have very large implications in terms of additional dollars raised for the Commonwealth. The ANAO undertook this audit to ascertain the scope for the ATO to improve its revenue collection and overall effectiveness through the more productive and effective use of the resources already available to the organisation.

1.10 The ATO currently undertakes a range of activities designed to maintain or improve compliance levels. In an environment of self assessment and shrinking resources, it is vital that the ATO determines where its greatest risks lie and establish the most appropriate and cost effective treatment and controls for these risks. The effective use of risk management principles contributes to the most efficient use of limited resources.

1.11 The ATO introduced a formal risk management process in 1994-95, a less extensive exercise was undertaken in 1995-96 and a third round was underway at the time of preparation of this report. The audit reviewed the introduction and progressive implementation of risk management processes and offers recommendations to improve the management of risks in the ATO. Audit findings generally relate to the 1994-95 and 1995-96 Health of the System Assessment (HOTSAs) processes although preliminary comments have been provided in some instances on the 1997 round.

Audit objective

1.12 The objective of the audit was to provide assurance about the ATO's risk management approach and to add value to the ATO's administration by analysing the economy, efficiency, administrative effectiveness, equity and accountability of the related processes employed within the organisation.

Audit methodology

1.13 A preliminary study of the ATO's self assessment regime began in May 1996.

At the conclusion of this study it was decided that an efficiency audit should proceed looking at the ATO's management of risk. The ANAO reviewed the risk management processes that the ATO uses to deal with all sources of risk for the organisation, not just the compliance risks associated with self assessment.

1.14 The ANAO adopted a two pronged approach to the audit. This first report examines risk management operations across all BSLs at the corporate level. We did not examine in any detail whether the ATO's risk strategies and treatments were appropriate.

1.15 A second report, expected to be tabled in the Spring 1997 session of the Parliament, will focus in-depth on the actual implementation of risk management in the Small Business Income Line (SBI). The ANAO considers that this approach will maximise the value of the audit activity.

Figure 1.2 The Risk Management Cycle ⁹



1.16 The audit criteria were based on the MAB/MIAC risk management model (now the APS standard) and the Australian and New Zealand Standard (AS/NZS 4360) on Risk Management. The criteria were used as a basis of examining the ATO's risk management processes to determine:

- how the organisation has established both the internal and external context in which it operates;
- what information it has used to identify the risks to the organisation;
- how it has analysed those risks;
- how it has assessed and established priorities for those risks;
- the mix of resources it has allocated to address those risks; and
- how it has reviewed and monitored both the risks and its management of those risks.

1.17 The ANAO recognises that AS/NZS 4360 was only in draft form when the HOTSAs process started and that the draft MAB/MIAC Guidelines (Report No. 17) had not been issued. However, many organisations have been practising the principles outlined in both these publications for some time. Both guides are now available. The process they describe is robust and flexible and it can be applied in most organisational settings.

1.18 As indicated above, the ANAO focused on the first and second tiers of the ATO's risk management, that is, the ATO-wide risks and the results of annual HOTSAs exercises as presented to the Board ¹⁰ by each BSL. Our coverage of the third tier, that is, the operational function or activity level was limited to SBI and is to be the subject of a further audit report relating to risk management in the ATO.

1.19 The ANAO engaged the services of an internationally recognised risk management expert, Dr Dale Cooper of Broadleaf Capital International, to assist the audit team in its analysis of the ATO's risk management plans and activities.

1.20 Field work was undertaken in each of the ATO's four regions involving visits to 14 branch offices between September and December 1996. The audit also included examination of several functions performed at the national office in Canberra. In addition, the ANAO consulted representatives of a number of taxpayer and professional bodies. An issues paper was provided to the ATO in December 1996. The paper made a number of detailed recommendations for ATO consideration and the draft report was provided for ATO comment in April 1997.

1.21 The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of \$327 000.

Other reviews

1.22 A number of reviews which were relevant to risk management in the ATO have been conducted since 1984. The findings of the more significant reviews were taken into consideration during the audit and are summarised below.

1.23 An ANAO efficiency audit of the Processing and Assessment of Income Tax Returns, tabled in the Parliament in December 1984, suggested that the ATO

move to a system of self assessment. This was so that staff subsequently released from the assessing function could be more productively engaged on other activities of the ATO designed to enhance the level of compliance by taxpayers with their obligations under the taxation laws. ¹¹

1.24 An internal evaluation conducted by the ATO, which reported in December 1989, concluded that there were benefits flowing from the introduction of the self assessment system. ¹²

1.25 There has been no other specific performance audit coverage of risk management by the ANAO since the inception of the self assessment regime, other than an efficiency audit of the Fringe Benefits Tax (FBT) tabled in May 1992 (Report No.33 of 1991-92). That report found that the ATO had rightly adopted a risk management approach to its task of administering tax legislation but had failed to undertake adequate assessment of the risks involved or to follow through by monitoring the effects of decisions made. ¹³

1.26 The Joint Committee of Public Accounts Report No. 326 *An Assessment of Tax*, tabled in November 1993, evaluated the self assessment system and called for increased support from the ATO to assist taxpayers to satisfy their obligations. ¹⁴

1.27 The report on the ANAO's 1995-96 financial statement audit of the ATO stated that taxation revenue is unavoidably affected by the incidence of tax evasion and other breaches of the taxation law. The report also stated that the ATO's risk management framework represents an appropriate means by which the risk of non-compliance can be addressed. ¹⁵

2. Risk Management in the ATO

This chapter provides a background to the introduction of formal risk management in the ATO.

Background

2.1 The ATO's task of collecting the tax legally due and payable from taxpayers is a large and complex one. In doing so, the ATO relies on voluntary compliance by taxpayers. The level of compliance within the community, however, is influenced by many factors including the perceived equity, simplicity and effectiveness of the tax collection system. Where taxpayers perceive that the system is inequitable, such as where others in the community are able to avoid or evade tax, there is likely to be a reduced willingness to meet individual obligations.

2.2 No taxation system is one hundred percent effective and there will always be some element of a cash economy and a proportion of the revenue due that is not collected. In a taxation context, the *cash economy* refers to those taxable cash transactions not brought to account for tax purposes. This may result from deliberate, careless or inadvertent acts, and collectively form part of *tax evasion*.

2.3 The difference between the tax legally payable under the law and the tax

actually paid is commonly known as the *tax gap*. The challenge for any revenue collection agency is to minimise this gap. Risk management principles can be an effective way of addressing this challenge. Neither the ATO nor revenue agencies in other countries have been able to develop a methodology to measure the *tax gap* accurately. However, we note that in recent years the Australian Bureau of Statistics increased the gross operating surplus in the national accounts by approximately \$5.5 billion per annum to take account of the understatement of income associated with the tax gap (note the discussion in paragraph 1.27 in the context of the ATO financial statements).

2.4 Before the 1986-87 financial year, the ATO had the role of assessing every tax return submitted by every taxpayer, whether that taxpayer was an individual, partnership, trust or company. However, in reality the assessment process was little more than *tick and flick*.¹⁶ With approximately 10 million income tax returns to assess annually¹⁷ and with quotas applying to assessors, it had been calculated that, on average, an individual taxpayer's return would have received less than 2.5 minutes of scrutiny by the ATO. A similar calculation suggested that business returns would have been considered, on average, for eleven minutes each.¹⁸ It was also established that the cost of reviewing every tax return was more than the additional revenue that resulted from this scrutiny.

2.5 This labour intensive system of assessment was compounded by a proliferation of highly elaborate tax avoidance mechanisms, such as the *Bottom of the Harbour* schemes and by the early 1980s there were more than 100 000 disputed ATO assessments before the Courts.¹⁹ Disputes resulted in a substantial amount of assessed tax remaining unpaid; in 1983-84 the level of outstanding, uncollected taxes stood at 26 percent of the collectable revenue.²⁰ These cases were often protracted, tying up ATO resources for many years.

2.6 In order to cope with the ever increasing work load and in recognition of the above factors and concerns raised by the ANAO's December 1984 performance audit report (see paragraph 1.23) the ATO moved to a system of partial self assessment. ATO staff released from the assessing function were transferred to activities designed to enhance taxpayers' levels of compliance with their obligations under the taxation laws. Taxpayers are now responsible for calculating their own taxable income and allowable deductions without these calculations being individually scrutinised by the ATO prior to issue of assessments. Only companies and superannuation funds have a full self assessment system where they calculate their tax liability themselves.

2.7 In order to treat the potential risk to the revenue that arose from the introduction of self assessment the ATO adopted the risk management strategy of creating a large and well trained audit capacity. The then Commissioner spoke of trying to achieve a two percent audit coverage of the taxpaying population each year.²¹

2.8 However, the ATO knew that it could not use audit alone as a means of ensuring taxpayer compliance. It therefore endeavoured to improve the targeting

of its approaches, believing that audit based compliance strategies were not always the most effective use of resources. The ATO found that individual audits that were not accompanied by wider education strategies ran the risk of being *hit and miss* and would therefore not improve overall compliance.

2.9 Traditionally, the ATO had an approach and organisational structure which segregated the administration and collection of various taxes such as income tax and sales tax. Following the introduction of self assessment, the ATO structured itself according to functional requirements in 1987. The main functions were Policy and Legislation, Taxpayer Audit, Taxpayer Assistance, Appeals and Review, Revenue Collections (which included returns processing and debt collection), Sales Tax, Systems, Corporate Services and Child Support. However, this meant that taxpayers interacting with the ATO often had to approach many different parts of the organisation which were not necessarily all in the one building.

2.10 The ATO identified that there were seven major forms of possible taxpayer behaviour under which these risks could be classified. ²² These are listed in Figure 2.1 below.

Figure 2.1 Major Taxpayer Behaviour Risks



2.11 Growing community concerns regarding the complexity of tax law and the costs of compliance contributed to the ATO's realisation that risk management strategies were broader than simply service and enforcement. Appendix 2 lists a number of significant developments that occurred in the period 1987 to 1994 to manage the risks associated with self assessment.

2.12 The identification of continued compliance gaps posed questions about the provision of taxpayer information, a need for law clarification, actual changes to the law, expanded withholding systems for certain industries and the appropriate level of auditing and prosecution.

2.13 It became apparent by the early 1990s that the answers to these questions varied between different client segments. The ATO concluded that functional approaches to administering the tax system were not as appropriate as differentiating between taxpayer groups.

2.14 In recognition of this, a business line structure was introduced from 1 July 1994. It segmented taxpayers into Individuals Non-Business (INB), Small Business Income (SBI), Large Business Income (LBI) ²³ and Withholding and Indirect Taxes (WHT). The Child Support Agency (CSA) also received business line status at that time.

2.15 Four service lines retained functional responsibility for Corporate Services (CS), Financial Services (FS), Tax Law Services (TLS) and Information Technology Services (ITS). Superannuation (SPR), which had been part of WHT, became a separate business line on 1 July 1996. The ATO's Business and Service Line structure is shown at Appendix 1.

2.16 Individual business lines further segmented into various taxpayer specialisations using teams to deliver the appropriate response for that segment. These responses include:

- recommending changes to tax law;
- undertaking research;
- issuing public and private rulings;
- carrying out client education and awareness campaigns;
- performing specific issue audits, industry based audits or pre-lodgement inquiries;
- enforcing tax return lodgement;
- conducting prosecutions and imposing penalties;
- enhancing staff skills and qualifications; and
- maintaining and developing information systems.

2.17 Risk management is a tool used by all managers, whether implicitly or explicitly, and has been practiced by the ATO for a number of years as evidenced by the introduction of self assessment and the business line structure. As part of the evolution of its risk assessment processes, the Board introduced a formal risk management process known as the Health of the System Assessment (HOTSA) in 1994-95. This represented a formalisation of the ad hoc approach to risk management previously practiced at various levels within the ATO.

Risk management through the HOTSA process

2.18 The objective of the HOTSA process was to improve business management across the ATO. This required each of the Business and Service Lines to address their major areas of risk, establish plans to manage those risks within anticipated funding levels and to justify how these conclusions were reached. Resources were to be allocated according to these risk assessments and the review and evaluation of the risk management process was to be an integral part of managing the tax system.

2.19 A second round of HOTSA exercises was undertaken in 1995-96, although it was not as extensive as the first round in most Business and Service Lines. The exception to this was LBI where a more structured and systematic risk analysis commenced.

2.20 The Board specified that criteria for the HOTSA process were to be based on the four focus areas identified in the 1994-95 ATO Corporate Plan. These were to:

- improve compliance with the various laws the ATO administers;
- reduce the cost to the community of meeting their tax obligations;
- act fairly and professionally; and
- achieve a committed and productive workforce.

2.21 The Board designated the same focus areas for the subsequent HOTSA rounds.

2.22 The ANAO examined the 1994-95 and 1995-96 HOTSA processes across all Business and Service Lines and acknowledges the ATO's significant efforts in introducing risk management principles to a large and geographically dispersed organisation. The ANAO also recognises the complexities involved in managing the ATO given the diverse nature and geographical spread of its taxpayers, from individual salary and wage earners to large multi-national corporations.

2.23 It was noted by the ANAO that although the 1994-95 HOTSA process included consideration of other risks, it concentrated mainly on compliance risks and as such should not be considered an exhaustive risk assessment exercise. The ATO itself recognised that much of the risk analysis involved in the first round of the HOTSA exercise was qualitative and stated that:

...there was a need to develop quantitative measures of risk to replace, augment or supplement current methods of analysis. ²⁴

2.24 However, the ANAO considers that the 1994-95 HOTSA process was a commendable beginning to the introduction of formalised risk management in the ATO.

2.25 The ATO has continued the HOTSA risk management approach in 1997. In response to issues raised by the ANAO during this audit, the Commissioner of Taxation advised the ANAO in January 1997 that he had already made it clear (within the organisation) that it was time for a major refreshing of the risk management process in the lead up to the ATO's resourcing and planning for 1997-98 and succeeding years.

2.26 The ANAO observed a marked improvement in the planning for the 1997 round of HOTSA exercises. This was particularly noticeable in the establishment of the strategic, organisational and risk management contexts and the guidance to BSLs, which was more comprehensive and structured than in previous rounds. Revised guidelines issued to BSLs took up a number of ANAO suggestions including:

- the importance of explicit stakeholder analysis;
- improved documentation of the HOTSA process;

- a greater emphasis on external and internal risk identification; and
- the need to consider the impact of existing controls on the level of risk.

2.27 The ANAO was advised in May that the 1997 ATO-wide HOTSA process includes nine steps which encompass:

- setting the ATO strategic direction (based on stakeholder research including individual taxpayers, government officials, Ministers' staff, tax professionals, ATO staff and the use of scenarios);
- BSL risk assessment;
- assessment of BSL performance against current plans, including areas for improvement;
- BSL risk assessment presentations to Commissioners by National Program Managers;
- synthesis of corporate risks and key leverage points or treatments;
- review and refinement of corporate risks and leverage points by Commissioners and National Program Managers;
- Commissioners settle the draft ATO Plan, resource allocations and BSL direction statements;
- BSLs test the workability of the above; and
- final adjustments are made based on feedback from BSL testing of the Plan and resources.

Current ATO environment and challenges

2.28 In addition to the matters referred to above, there are several other features of the environment and challenges facing the ATO that should be taken into consideration in assessing the performance of the organisation. These are briefly described below.

2.29 The ATO is required to administer a system of highly complex tax law and legislative obligations in an environment of rapidly changing social and economic conditions and related community expectations.

2.30 Since 1989, the ATO has been undertaking significant changes to its computer infrastructure, business systems, management structures, work arrangements and operational structure. In addition, the ATO plans to introduce a Taxpayers' Charter during 1996-97 which will address the rights of taxpayers, the service they can expect and their responsibilities as taxpayers.²⁵ The ATO has also experienced an emerging gap between its accommodation costs and available resources to meet those costs which led to a planned nationwide rationalisation of ATO accommodation. This will see the downsizing of several branch offices and

the amalgamation of others.

2.31 The ATO has experienced a general reduction in staff numbers during recent years and few new officers have joined the organisation. It recognises that the suitability of its current staff skills and profile may not be keeping pace with changing requirements. The organisation is also faced with replicated staffing structures in many branches that do not reflect variations in client base and workloads.

2.32 Like many other organisations the ATO is faced with the challenge of rapidly changing technology. The Internet and electronic commerce allow the purchase of goods and transfer of funds worldwide with little if any record of these transactions. The ATO is currently researching the potential implications of this technology for its role in collecting the revenue.

Context for audit findings

2.33 This chapter outlined the ATO's history of risk management and the introduction of the HOTSAs process. The remainder of the report discusses the ANAO's findings based on the 1994-95 and 1995-96 HOTSAs rounds. These should also be considered in the context of the ATO's environment and challenges as outlined in the preceding paragraphs. The ANAO does not expect an organisation as large and complex as the ATO to realise the full benefits of risk management principles during its first attempts at introducing a formalised risk assessment process such as HOTSAs. However, several issues have been identified, which if addressed appropriately, could strengthen the use of formal risk management principles in the ATO. A number of recommendations have also been made that are designed to help to address these issues.

3. Risk Management Process

This chapter outlines the major features of a sound risk management process, compares the ATO's first two rounds of the HOTSAs process with those features and recommends action which the ATO could take to improve its performance.

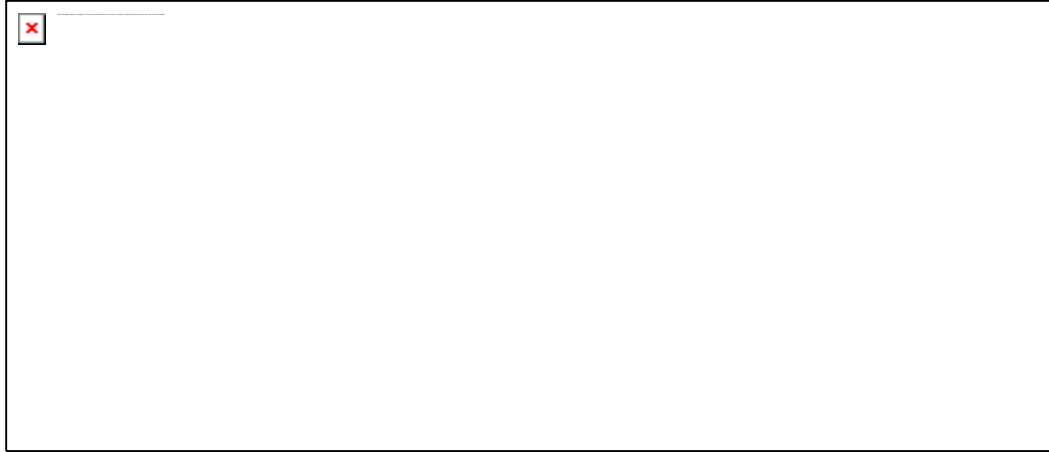
Comparison of the HOTSAs process with a sound risk management process

3.1 Certain features are integral to an efficient and effective risk management process. The ANAO considers that risk management should demonstrate the following characteristics:

- consistent strategic approach across all parts of the organisation;
- transparency and visibility;
- flexible approaches while maintaining consistent risk management criteria;
- documentation of the process; and
- evidence of a integrated and managed process.

3.2 These characteristics should be integrated into an agency's risk management process taking into account that agency's environment and context.

Figure 3.1 Features Integral to an Effective and Efficient Risk Management Process



Consistent strategic approach for managing risks

Sound features

3.3 In order for a risk management approach to be effective in an organisation, it should be implemented in a consistent and strategic manner across the organisation's various components. In terms of the ATO, this would include the organisation's corporate level, each of its ten BSLs and the industry based portfolios or functional areas within the Lines.

3.4 It is good practice for the events that might hinder or enhance the achievement of organisational objectives (that is, risk and opportunities) to be recognised and examined at different levels, according to the management focus. For example, risks to the attainment of the ATO's strategic vision may be different to compliance risks in a particular Business Line, industry portfolio or functional area. ATO-wide risks should be managed at the highest level of the organisation whereas functional risks may be best addressed within a particular BSL.

3.5 A consistent approach promotes:

- comparability of outcomes;
- transfers of learning and experience;
- understanding of processes and outcomes;
- equitable decisions; and
- aggregation and comparison across the organisation.

3.6 A consistent strategic approach, based on common criteria, understandings, methodology and procedures that applies across all areas involved in the risk management exercise, should minimise unnecessary subjectivity in the decision

process. The consistent use of inputs, including criteria, procedures and data will promote the production of comparable outputs, such as identified risks that are prioritised according to a common measurement scale.

3.7 Say, for example, that both SBI and LB&I identify separate tax evasion schemes in their client population as major risks that require shifts in resources ²⁶ to address them. The Board should be able to compare these risks and assign resources accordingly. However, in order for informed decisions to be made, the processes that the business lines undertook which resulted in these risk ratings should be based on common criteria, for instance, the revenue at risk over time, number of taxpayers involved, the level of complexity or effect on public perceptions.

3.8 Although there is a need for consistency at the corporate level in undertaking risk management, the process should not be rigid as a certain degree of flexibility is required at the BSL level to implement risk management according to individual circumstances. It should also be noted that consistency and flexibility are not mutually exclusive concepts (see discussion on flexibility at paragraphs 3.37 and 3.38).

ANAO findings

3.9 Whenever an organisation as large and complex as the ATO introduces a management process such as HOTSAs, it is reasonable to expect that some inconsistencies and methods to improve and streamline the exercise will be highlighted. The ANAO identified a number of these which are discussed in the following section as they may be instructive for further action, particularly by other agencies.

Application of guidelines

3.10 For the first round of the HOTSAs process, the Corporate Directions Branch (within the Corporate Services Line) developed guidelines to help achieve consistent approaches across BSLs when developing their respective HOTSAs reports. A proforma and process was distributed to Business and Service Lines in December 1994. However, it was left to the NPMs to determine the procedures their Line would adopt for its respective HOTSAs exercises.

3.11 Each NPM was to present the Board with a documented assessment of the health of the tax, CSA and superannuation system (or Service Line equivalent) in respect of their client base and in terms of the ATO's four focus areas (see paragraph 2.20). The assessments were to be based on:

- the Continuous Improvement/ Australian Quality Council assessment framework;
- ABCD Planning approaches; ²⁷
- the Draft Australian/New Zealand Standard for Risk Management (AS/NZS 4360); and

- the Department of Finance running costs system ²⁸ and the three year budgeting framework. ²⁹

3.12 The ATO's guidelines contained a risk assessment proforma and stated that the HOTSAs process would be an integral part of BSL planning. Each Line was required to identify:

- how present resources were being used and what was being achieved with them;
- the major risks (including baseline measures of compliance for at least the key risks) and how well they were being addressed within present resource allocations;
- what the low risk areas were and how they were being managed;
- what was planned (strategies, shifts of emphasis and resources) to improve performance within current funding levels;
- major areas of concern that could not be addressed within present constraints;
- major infrastructure investment opportunities or needs;
- the key messages from corporate research and evaluation; and
- where the Line expected to be against the four focus areas in three years time (that is, in 1997-98).

3.13 When reviewing the April 1995 HOTSAs submissions to the Board, the ANAO found that rather than following the format provided by the Corporate Directions Branch, the various Lines developed their own approaches to the HOTSAs process. None of the BSLs provided all the information originally requested in the proformas.

3.14 For example, in relation to the first dot point, *how present resources were being used and what was being achieved with them*, the guidelines requested information on BSL resources deployed in each focus area. The Board later determined that the costs involved in collating the information did not warrant the investment and that:

...raw direct cost data did not necessarily give the full picture of operational matters. ³⁰

3.15 The ANAO recognises that:

- information in addition to cost data is required to gain a comprehensive picture of the effectiveness of operations; and
- there may initially be a high cost to collating information on such items as revenue collected per Business Line and the cost of Business Line activities.

3.16 However, the introduction of effective management information systems would allow the cost-effective collection of data with which to measure whether the ATO's resources are being applied efficiently and effectively. The effective use of such information would assist the ATO in identifying, analysing, assessing, prioritising and addressing the risks that it faces.

3.17 Each BSL provided the Board with information on their perceived risks. However, this information would have been more useful if it was based on common criteria and shared assumptions across Lines. More consistent information would have made it easier to make comparative decisions about risks both between and within Lines.

3.18 Many risks were identified in the 1995 HOTSAs exercise, although the risk identification stage of the process could have been more comprehensive as some substantial risks were not mentioned (see *Identification of Risk* at paragraph 4.25). Risks that were identified were not presented consistently or uniformly in relation to the four focus areas, nor did they reflect consistent levels of detail.

3.19 Most BSLs were unable to provide evidence that priorities had been set for identified risks, nor did they discuss controls that were in place which might mitigate the risks. This lack of common and consistent criteria and information would significantly increase the difficulty of comparing risks both within and across Lines. The appropriate level and cost-effectiveness of risk treatment would therefore also have been hard to determine, especially in an environment of limited resources.

3.20 Comparable information would greatly assist the ATO in making decisions on the allocation of resources between these identified risks. For example, an indication of the levels of compliance within each Line, or at least the change in compliance levels over time, would greatly assist the ATO in determining the potential revenue at risk. This would have allowed the ATO to establish priorities for compliance risks and weight the allocation of scarce resources accordingly. Reliable and valid information is needed in order to make informed decisions.

3.21 The ANAO noted that new guidelines, including detailed risk assessment criteria, were issued in 1997 and the application of these guides appeared to be more consistent. However, the ATO needs more management information on such items as revenue collected by Business Line, cost of activities and other operational issues in order to ensure reasonably informed resourcing decisions and to demonstrate achievements.

Recommendation No. 1

3.22 The ANAO *recommends* that the ATO identifies the specific types and sources of management information it requires to manage identified risks effectively and establishes procedures to obtain this data on a cost effective basis.

ATO response

3.23 Agreed. The ATO is currently implementing arrangements to gather

intelligence that could lead to the identification of new risks.

Consistency through each level of risk management

3.24 Like most large organisations, the ATO has a hierarchy of objectives and desired outcomes. However, the ANAO found that the 1994-95 HOTSAs process was undertaken primarily within each BSL, although the ATO stressed that the HOTSAs process was a corporate activity rather than an individual Line activity. The ANAO considers that, for the ATO's risk management effort to be effective, it needs to be addressed at a minimum of three levels:

- the ATO level: strategic objectives and outcomes;
- the Business and Service Line level: business or operational objectives, plans and outcomes; and
- the portfolio, workteam or function level: tactical implementation of plans and resulting outcomes.

3.25 While risks may be identified at any level of the organisation the corporate level should drive the management of those risks and this should be reflected in a hierarchy of management plans. The ATO does have plans at the Corporate and Business Line levels. However, Business Line plans for 1995-96 could have been more clearly linked to Corporate Plans by stating how they would address risks identified at the ATO-wide level.

3.26 Corporate Plans at the ATO-wide level should set the direction for business plans at the BSL level and these business plans should form the basis of operational plans at the functional level. For example, the ATO Corporate Plan identified the four focus areas (see paragraph 2.20) as the areas in which the ATO needs to direct its activities. Business plans and operational plans should therefore specifically address these focus areas. Management and performance information should also reflect results achieved against each of these areas.

3.27 The ANAO considers the ATO would benefit from adopting a consistent risk management approach throughout its hierarchy of plans. The management responsibility for treating risks should be easily discernible in the plans that relate to each particular level of the organisation. In this way risks that affect the corporate level should be addressed in the corporate level plans, risks that affect the BSLs should be reflected in their individual business plans and risks that are to be addressed at the functional level should be clearly stated in operational plans.

3.28 The ANAO noted that a more consistent approach to risk assessment has been adopted at the ATO-wide or corporate level during the 1997 HOTSAs. The new guidelines also required that individual Business Line plans clearly demonstrate direct links to each of the components of the ATO Corporate Plan.

Transparency

Sound features

3.29 Transparency may be defined, simply, as the clear expression of the reasons for a decision. An effective risk management process allows informed/considered management decisions to be made and implemented. Transparency promotes more effective and equitable allocation of resources, justification for the decisions and explanation of the outcomes. It also allows a common understanding of the process and enhances acceptance of decisions by those charged with implementing them. Such transparency should also mitigate the effect of individual biases on the decision making process. It is the essence of accountability.

3.30 Any decisions taken in isolation of the risk management process or which are based on inconsistent information will not be transparent. With an increasing emphasis on accountability and corporate governance within the APS, it is important that the reasons behind key decisions are documented and justifiable (this is discussed at paragraphs 3.43 to 3.45).

ANAO findings

3.31 The ANAO found that decisions based on the first and second HOTSAs rounds lacked transparency. This applied both internally and externally. The ANAO recognises that, on occasion, it may not be in the public interest to be as specific in the latter context as in the former.

3.32 Although BSLs did list risks in their HOTSAs presentations to the Board, they did not establish priorities for identified risks within their respective lines, nor did the Board set priorities for risks at the ATO level. For example, the risks identified by INB included revenue loss from undisclosed income and over-claimed deductions. Another risk was that tax information is simply too complex for many INB taxpayers to understand. In contrast, some of the risks identified by SBI included significant levels of undeclared income in businesses where income is received in cash. Moreover, SBI disclosed that it did not have adequate knowledge of the needs and behaviour of the small business sector. However, the ANAO did not find that any additional quantitative or qualitative information was given to the Board with which to compare and set priorities for these identified risks within or between INB and SBI.

3.33 The ANAO considers that transparency could have been improved in the risk assessment process if:

- the ATO's HOTSAs guidelines were followed more closely;
- recommended proformas requesting data for comparative purposes had been completed;
- consistent documentation had been provided; and
- priorities for identified risks had been established.

3.34 The ANAO observed improvements in each of these four issues at the corporate level during the 1997 HOTSAs. The ATO should ensure that similar improvements are made at the BSL and functional levels of the organisation.

Recommendation No. 2

3.35 The ANAO *recommends* that the ATO continues to improve the transparency of its risk management process. In particular, stakeholders such as the Parliament and ATO staff members should readily be able to determine the basis for decisions, the strategies for implementing them and the effectiveness of action taken.

ATO response

3.36 Agreed. The ATO will continue to improve the transparency of its risk management process while recognising that, with certain stakeholders, transparency may increase ATO risks and be counterproductive for outcomes.

Flexibility

Sound features

3.37 A flexible approach to risk management in the ATO will allow individual BSLs and work teams to use supporting tools and techniques specific to their areas, while maintaining a consistent, comparable and transparent structure across the organisation. This would entail using consistent criteria upon which to base the risk management process while allowing each individual BSL and work team to tailor its process according to its own circumstances.

3.38 For example, if one of the criteria is the potential loss of revenue and the identified risk is the non-lodgement of returns by taxpayers, the approach which individual Business Lines take in the analysis, assessment, setting priorities for and treatment of this risk can be flexible. LB&I may approach this risk on an industry-by-industry basis, SBI may look at the size and structure of the taxpaying entity while INB may address this risk by occupational category.

ANAO findings

3.39 The ANAO found substantial differences in the risk management approach adopted by various BSLs. Business lines were using risk approaches at the industry portfolio or functional level that were specific to the risk issues at the Line level, that is, targeting perceived high risk taxpayer groups. The ANAO considers that this flexibility is appropriate, bearing in mind the specific compliance objectives at this level (compared to the broader objectives at the BSL and ATO levels).

3.40 For example, a detailed risk ranking from 1 to 34 for industries within SBI may be appropriate for assessing and establishing priorities for compliance risk within SBI itself. However, across the ATO this level of risk ranking detail will probably not be appropriate in INB, Service Lines or at the ATO corporate level, especially when dealing with risks other than compliance risk. The ANAO

considers that the flexible approach to risk management across Business Lines was appropriate but emphasises the importance of having consistent criteria (as discussed at paragraph 3.6).

3.41 A sound risk management process should have assessment criteria that are agreed upon by decision makers at the outset of the process and are applicable across all BSLs. For example, the first focus area on which the HOTSA criteria were based was:

To improve compliance with the various laws the ATO administers. ³¹

3.42 If various Business Lines identify non-disclosure of income as a risk, the criteria to measure the level of risk may include, but not be restricted to, the dollar value (consequence of occurrence) and the number of taxpayers involved (frequency of occurrence). Flexibility will be required in the manner in which the Line gathers the information to analyse the risk, the level of detail it pursues and the method it introduces to treat the risk. Flexibility in approach is important and can be achieved without undermining the underlying risk management criteria. This will allow decision makers to assess key focus area risks across all areas of an organisation (see discussion at paragraphs 3.19 to 3.21).

Documentation

Sound features

3.43 AS/NZS 4360 states that each stage of the risk management process should be documented. Matters to be documented include the assumptions, methods, data sources and results.

3.44 The benefits of adequate documentation are that:

- it provides a record of risks;
- personnel are required to structure and clarify their thoughts and approach, thus promoting a more efficient, effective and accountable process;
- justifications for outcomes and recommendations are supported by evidence;
- it provides decision makers with a plan for approval and implementation;
- it promotes communication and facilitates transparency;
- it allows continuity and corporate memory when/if changes in personnel occur; and
- the process may be reviewed for quality assurance and audit.

3.45 A sufficient level of documentation should be maintained to show evidence of the major steps and activities leading to key risk management decisions. ³² Cost-benefit considerations should be taken into account when determining the

appropriate level of documentation required.

ANAO findings

3.46 In examining the material prepared by each BSL for the first two HOTSAs rounds the ANAO observed substantial variety in the quality and extent of documentation. Little of the risk management process or its outcomes was documented in a form compatible either with the HOTSAs guidelines or formal standards established under AS/NZS 4360 and the MAB/MIAC guidelines.

3.47 It was noted by the ANAO that the BSLs had not been given specific instructions on the documentation required to show evidence of the HOTSAs process. The resultant lack of documentation meant that the ANAO could find little evidence of the processes followed or the outcomes obtained.

3.48 From the documentation available for the first two rounds of HOTSAs it was not possible for the ANAO to determine if a thorough risk assessment had actually been undertaken at the corporate level or whether it had been undertaken but not well documented. The ANAO concluded that the ATO should enhance documentation of its risk management process in order to achieve the benefits listed above.

3.49 The ANAO was invited to observe the 1997 Business and Service Line HOTSAs presentations to the Board and noted that guidelines for and documentation of the corporate level planning process was far more extensive than in earlier HOTSAs rounds.

Recommendation No. 3

3.50 The ANAO *recommends* that, at each level at which a risk assessment is undertaken, the ATO improves its documentation of the major steps and activities leading to key risk management decisions.

ATO response

3.51 Agreed. The ATO will continue to improve its documentation.

Integrated process

Sound features

3.52 Risk management should be integrated with other organisational planning and management techniques.

3.53 Responsibility for effective risk management rests with every member of an organisation. However, to be effective, a risk management system may need to be driven by a senior manager who has the necessary authority to establish, implement and maintain the system. It follows that managers at each stage of the process should have a good understanding of the process, be able to effectively integrate it with other planning systems and have clear accountability arrangements in place. A well managed process promotes:

- coordination;
- effectiveness and efficiency;
- timeliness;
- concentration on the organisation's core processes and issues; and
- integration with decision making and resource allocation processes.

3.54 The ANAO observed that a number of private and public sector organisations have found value in appointing a senior manager to drive and facilitate the risk management process throughout the organisation. This function may also be accomplished by a small team of risk management specialists or an external facilitator. Internal auditors should work closely with any such individual or team. This role could both provide sustained impetus and give practical assistance for the introduction of a consistent and integrated risk management system.

3.55 As an example, the Australian Customs Service has designated a senior executive and a small support team to facilitate the introduction of formal risk management principles and processes throughout the organisation. The senior executive is responsible for establishing the process for managing risk throughout Customs and the Risk Management Coordination Unit provides advice and service assistance on risk management matters. ³³

ANAO findings

3.56 As discussed earlier in this chapter, the Board instigated the introduction of risk management to the organisation. It instructed the Corporate Directions Branch to take responsibility for producing guidelines and proformas for all BSLs. However, these guidelines were not closely followed during the 1994-95 and 1995-96 HOTSA rounds and the consistency and transparency of the risk management process suffered as a result. National Program Managers were responsible for the conduct of the HOTSA exercises within their individual business or service lines. However, it was not apparent that a particular individual or team was dedicated to facilitating risk management throughout the organisation.

3.57 ATO staff involved in the HOTSA advised the ANAO that they recognised the inherent value of risk management principles generally and the HOTSA process in particular. They stated that it raised the level of risk awareness within the organisation and encouraged a greater analysis of identified risks. However, the ANAO was also advised that there was a degree of confusion about the risk management process during the first two HOTSA rounds.

3.58 The ANAO recognises that the BSLs had only been established for six months and as such were still in their infancy during the first HOTSA round. We also recognise that there were staffing changes, including some NPMS during the first HOTSA round. We consider that it is the responsibility of all members of an

organisation to manage risk. However, the ATO could explore a number of options to facilitate the practical implementation of risk management within BSLs as outlined at paragraph 3.54 above.

3.59 The ANAO observed a strong commitment to the risk management process at the Board level for the 1997 HOTSAs and recognised significant improvements to the HOTSAs guidelines and proformas. We encourage the ATO to undertake a formal evaluation of the 1997 exercise to determine if additional improvements can be made in the implementation of risk management and its integration to the overall management process (see paragraphs 4.75-4.84).

1

ATO Corporate Plan 1996-99.

2

ibid.

3

At the time of preparing this report staffing had reduced to about 17 000.

4

Fifteen of these regional offices were closed during 1996-97, Darwin and Alice Springs remain.

5

Self assessment initially applied only to business partnerships and company taxpayers. It was extended to cover all taxpayers except superannuation funds by July 1987. Companies, superannuation funds, approved deposit funds and pooled superannuation trusts have had a full self assessment system from 1992-93 and are required to calculate their own tax liability in addition to their taxable income and allowable deductions.

6

AS/NZS 4360.

7

MAB/MIAC Report No. 22.

8

ibid.

9

Adapted from AS/NZS 4360 and MAB/MIAC Report No. 22.

10

The ATO Management Board was chaired by the Commissioner of Taxation and its membership up to April 1997 included the three Second Commissioners, National Program Managers, representatives from the regions and union delegates.

11

Report of the Auditor-General on Efficiency Audits, *Processing and Assessment of Income Tax Returns*.

December 1984, pp. ii & iii.

12

Report of the Program Evaluation of Self Assessment - Management Improvement and Evaluation Branch, ATO, December 1989.

13

at p. x.

14

at p. xix.

15

Results of the 1995-96 Financial Statement Audits of Commonwealth Entities

Audit Report No. 19, 1996-97, pp. 126-7.

16

Report of the Auditor-General on Efficiency Audits, *Processing and Assessment of Income Tax Returns*, December 1984, p. 16.

17

The number of returns was 11.07 million in 1995-96. (*ATO Annual Report 1995-96*, p. 19).

18

Report of the Auditor-General on Efficiency Audits, *loc. cit.*

19

By 1990 the number had reduced to 2000. See Mathews, John *The Australian Taxation Office: Modernisation through People, Structures and Technology*, University of New South Wales 1992, p. 33.

20

This amount had dropped to 14 percent by 1992. *ibid.*, p. 2.

21

Boucher, Trevor Self-Assessment of Income Tax, *Australian tax forum: a journal of taxation policy, law and reform*. Vol. 3 No. 1, 1986, p. 51.

22

ATO paper: *Risk Management in the ATO* by Tom Storey and John Wickerson, October 1992.

23

The Large Business Income business line became the Large Business and International business line in April 1997.

24

Adding Value - Managing Risk - Speech given by Moira Scollay (Second Commissioner, ATO) at the launch of MAB/MIAC Report No. 22, October 1996.

25

ATO Annual Report 1995-96, p. 111.

26

Shifts in resources to address a particular risk may mean the reallocation of a number of staff, assigning one or more specialist(s), or changing existing expenditure on technology, developing legislation or communicating with stakeholders.

27

ABCD Planning involves analysing these four steps: 1)Current situation, 2)Desired state, 3)Strategy

to obtain desired state, and 4)Steps to achieve strategy.

28

The running cost system is the process under which salaries and other administrative resources are provided to budget-dependent agencies. It involves the determination of various running cost measures by agency managers so that resources are allocated according to changing priorities.

29

This involves the preparation of three-year forward estimates supported by explanations of the authority underlying the estimates, the nature of the commitments and the goals and targets of the particular expenditure.

30

ATO Board Minutes, 31 January 1995, p. 6.

31

ATO Corporate Plan 1994-95.

32

For a further discussion of appropriate levels of documentation refer to MAB/MIAC Report No. 22, pp. 19-20.

33

Australian Customs Service Risk Management Policy, March 1996, p. 3.

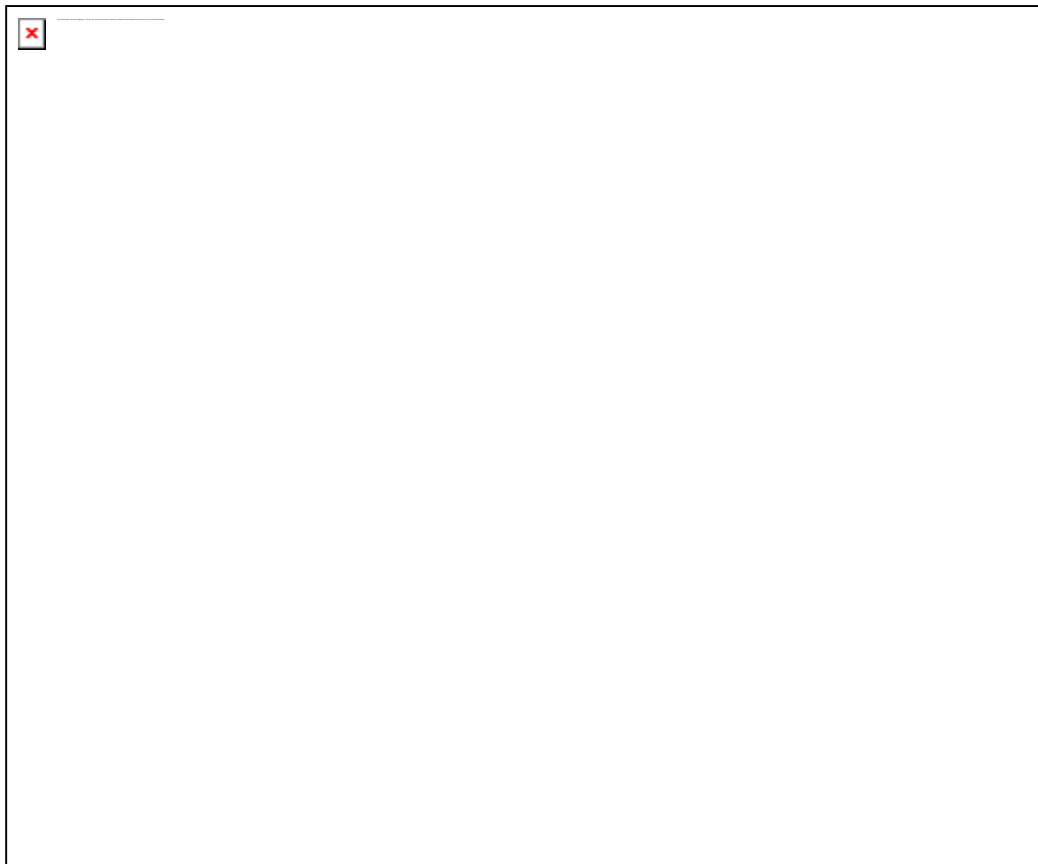
4. Risk Management Methodology

Both AS/NZS 4360 and the MAB/MIAC guidelines describe a six step methodology which will assist an organisation to introduce risk management successfully. This chapter discusses each of these steps briefly and identifies the extent to which the ATO's HOTSAs process was consistent with this methodology. Recommendations have been made which should assist the ATO to improve its risk management regime.

4.1 The previous chapter discussed five features of a desired risk management process. The consideration and adherence to each of these features while implementing the six structured steps discussed in this chapter will enhance the outcome of the risk assessment exercise.

Step 1: Establishing The Context

Figure 4.1 - Establishing the Context



Sound features

4.2 All managers take risks into account when making decisions. It should not be difficult to incorporate risk management processes into a manager's activities. To ensure appropriate rigour and quality and to meet broader management objectives, a detailed specification of the context in which the risk management process is to take place should be developed. The AS/NZS guidelines recommend that a risk management exercise be undertaken within the framework of an organisation's strategic, organisational and risk management contexts (see Figure 4.1).

Strategic context

4.3 The strategic context defines the relationship between the organisation and its internal and external environment, identifying its strengths, weaknesses, opportunities and threats (SWOT analysis). SWOT analyses can be an important contributor to understanding the strategic context. This stage of the process should also involve identifying and communicating with the organisation's major stakeholders and determining their expectations and requirements. Stakeholder analysis should be explicit and should lead to a defined set of stakeholder objectives.

Organisational context

4.4 The organisational context requires an analysis of the entity's goals, objectives and policies which then contributes to the establishment of criteria for the risk assessment process. The consequences of goals and objectives not being achieved should be considered at this stage. Criteria provide the framework upon which analysis and priorities of identified risks can occur and decisions regarding appropriate treatment of risks can be made. They also form a common, consistent basis with which to compare seemingly different risks across various parts of an organisation. These procedures also complement the *transparency* principle and ensure that assessments can be made without risk of individual bias.

Risk management context

4.5 Establishing the risk management context involves determining the goals, objectives, strategies, scope and parameters of the actual risk management process itself. It is advantageous to define the structure of the process by separating the risk analysis into a set of manageable elements. Resources required and documentation to be kept should be specified at this stage after consideration of the need to balance the costs and benefits of documentation. The risk management context also examines the need for information and research. This is particularly relevant at the BSL industry portfolio or functional level within the ATO.

4.6 An important consideration for the ATO in undertaking the risk management process should be whether staff had the necessary expertise, training, readily available data, tools and techniques to assess and rank risks effectively.

ANAO findings

Strategic context

4.7 The ANAO interviewed staff from each Line involved in the first two HOTSA rounds and concluded that there was a wide variation in the levels of understanding of risk management principles. A more uniform understanding may have been reached if staff had been provided with some form of risk management training.

4.8 Stakeholder analysis is recommended in the APS guidelines and AS/NZS 4360. The ATO's second focus area is on reducing the cost to the community of meeting tax obligations and as such the ATO did consider this major class of stakeholders. However, from the available documentation it was difficult to determine whether any consideration had been given to other classes of stakeholders at the BSL level. Taking into account the perspective of significant stakeholders such as the Parliament, tax agents, ATO management, staff members and their unions, the APS generally as well as the community as a whole may have improved outcomes.

4.9 In commenting on this issue, the ATO advised the ANAO in February 1997 that:

...extensive stakeholder analysis had been undertaken in identifying the client segments

for the Organisation Review which resulted in the establishment of the business and service lines. It was therefore decided to limit the consultation with stakeholders as the information was already available.

4.10 However, it was not apparent to the ANAO that the expectations and requirements of the ATO's major stakeholders had been specifically taken into consideration by all BSLs during the first two HOTSAs.

4.11 Following the first HOTSAs, the Board asked SBI to improve its knowledge and understanding of the risks inherent in the small business segment. As a result SBI revised its risk management approach. The level of stakeholder analysis conducted by LBI also greatly increased after the first HOTSAs round. The ANAO concluded that this increased stakeholder consultation was a positive outcome resulting from the first HOTSAs round.

4.12 The ANAO found that not all BSLs sought input and feedback from internal stakeholders in branch offices during the first two HOTSAs rounds. In order to obtain the maximum input, both internal and external stakeholders could have been consulted. A more widespread assessment against expectations with branch offices across all BSLs may have improved the outcomes by identifying additional risks, verifying the assumptions on which priorities were based and by providing more information on risk treatments.

Recommendation No. 4

4.13 The ANAO *recommends* that the ATO's risk management processes include an integrated and structured analysis of information on stakeholder objectives at the Business and Service Line level and that these be used in the development of explicit criteria for managing risk.

ATO response

4.14 Agreed. The ATO substantially addressed this point at the Corporate level in the 1997 risk assessment.

Organisational context

4.15 The Board determined that the HOTSAs criteria should be based on the four focus areas as defined in the ATO Corporate Plan. These four areas are externally focused and as a consequence the HOTSAs process concentrated mainly on external risks, such as risk to the revenue and compliance risks. The ANAO found BSLs developed criteria that were not always compatible with these focus areas. By focusing on criteria other than those established by the Board, BSLs may have undermined the usefulness of the risk assessment process. The importance for decisions to be made based on consistent criteria was discussed at paragraphs 3.3 to 3.8.

Risk management context

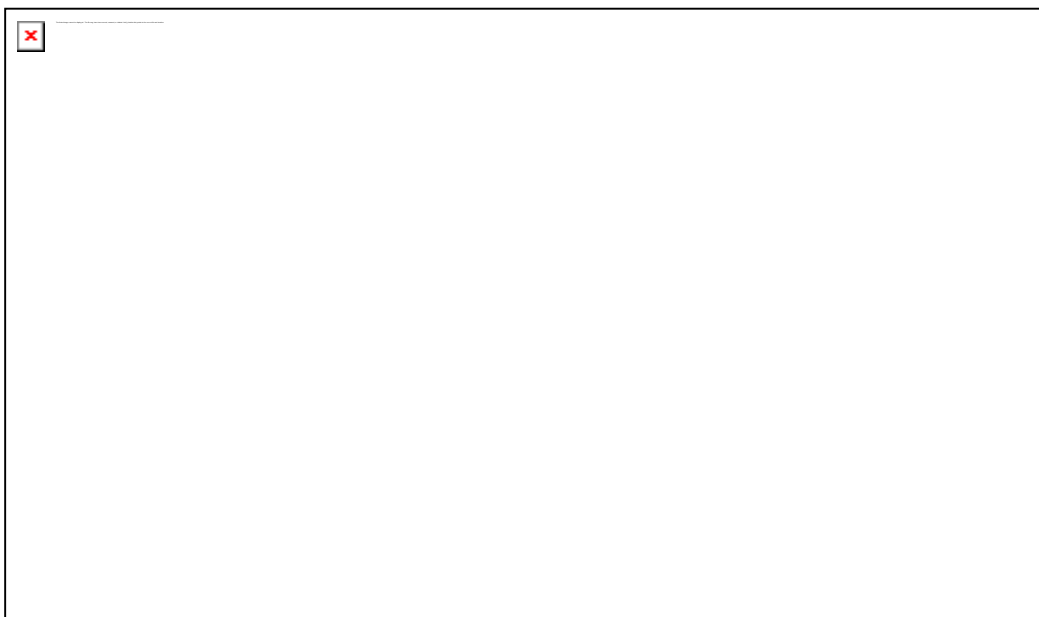
4.16 After examining the documentation from the first HOTSAs round, the ANAO

concluded that the risk management context could have been developed more thoroughly. In addition, the risk assessment's scope, goals and objectives could have been better defined. The processes to be followed, resources to be used and records to be kept were also not clearly stated. In effect, it was left to each BSL to design the process themselves. Although flexibility is necessary the ANAO concluded that the process would have benefited from a greater degree of rigour.

4.17 The ANAO noted a marked and promising improvement in establishing the strategic, organisational and risk management contexts during the third HOTSAs round which was underway as this report was being prepared.

Step 2: Risk Identification

Figure 4.2 - Risk Identification



Sound features

4.18 The aim of this stage of the risk model is to generate a comprehensive list of relevant risks and to document what each risk involves. Risk identification must be comprehensive because unidentified risks cannot be treated, of course, and may pose a major threat to the organisation. A structured approach is strongly recommended.

4.19 Risks need to be identified whether or not they appear to be under the control of the organisation and all risks should be considered from its perspective as well as from the perspective of stakeholders. The scope and depth of risks should be determined as should the need for research and the resources required to undertake that research. Records should be kept for use during future risk identification exercises.

4.20 Good quality information is important for the identification of risks. While information should be comprehensive, accurate and timely depending on cost and data sources, in reality complete data rarely are available. Some risks will not

lend themselves to objective analysis or observation and the costs incurred in collecting all data might be too great for the benefits provided. It is the responsibility of each level of an organisation's management to determine the extent of detailed information required.

4.21 Managers should be aware that staff may be reluctant to report all risks, fearing that it might reflect poorly on either themselves or the program. Failure to openly disclose all risks may undermine the ability of management to address and treat those risks with resulting serious consequences for the organisation.

4.22 All identified risks should be documented. This documentation should contain a brief description of these risks, including possible causes, initiating events, potential outcomes and existing controls. MAB/MIAC and AS/NZ 4360 refer to this documentation as a risk register.

4.23 Commonly used methods to identify risks which may be appropriate for the ATO include:

- 'brainstorming', preferably with a multi-disciplinary team (a wide range of views is usually recommended);
- analysis of gaps between the pre-conditions for achieving focus areas and current practice;
- stakeholder questionnaires;
- benchmarking, particularly as a specific form of gap analysis;
- system mapping; and
- checklists, once the risk management process has been implemented for some time and comprehensive risk lists have been compiled.

4.24 Initially, 'brainstorming' is recommended, with checklists used to confirm or augment the 'brainstorming' outcomes. Checklists are not recommended for areas that are new or important, as they tend to constrain original thinking.

ANAO findings

4.25 Many risks were identified during both the first and second HOTSAs. However, they were predominantly risks relating to compliance. For example, potential risks such as cuts to the public sector, industrial action or advances in information technology were not considered at any length. Few explicit risk lists were included in the HOTSAs summaries prepared by the BSLs and presented to the Board. Those that did were neither detailed or comprehensive.

4.26 The ANAO found that few guidelines were issued to the BSLs on how to conduct a comprehensive risk identification process. Most BSLs were unable to provide documentation which showed any detail or background to the risk identification process undertaken (see paragraphs 3.43 to 3.49).

4.27 The available documentation indicated that some BSLs used gap analysis as a basis for identifying risks. For example, Corporate Services distributed a document to its line Executive (of whom each member had responsibility for a particular function) outlining the process of how to do a risk assessment, which included the process of identifying gaps and hence risks for the Line. LBI formed industry groups in order to identify risks, SBI used its industry and issues-based portfolios and INB examined risks by focus areas.

4.28 The ANAO concluded that the degree of effort and the level of detail involved in identifying risks varied substantially across BSLs. Unless the appropriate level of effort is applied to the risk identification stage by all BSLs the overall process will be less effective since unidentified risks cannot be analysed, assessed, prioritised or treated. Continuing development of the ATO's risk management guidelines, expertise, relevant data and stakeholder analysis should contribute to a more comprehensive risk identification process.

4.29 It would appear from the ANAO's observation of the 1997 corporate level HOTSAs that the risk identification stage has been more consistent and comprehensive. Guidelines were significantly improved, risks identified were focused more broadly than just compliance risks and explicit risk lists were provided to the Board.

4.30 It should be noted that the ANAO has only observed the 1997 HOTSAs at the corporate level. The risk identification process at the BSL and functional level will be examined more closely in the Small Business Income Line audit report to be tabled in Parliament in the 1997 Spring Session.

Recommendation No. 5

4.31 The ANAO *recommends* that effective action be taken to ensure the ATO-wide risk management guidelines are followed and the various risk identification exercises undertaken within each Business and Service Line are based on a sound and consistent methodology. This will provide assurance that significant risks are actually being identified and accorded proper priority within the agreed control environment.

ATO Response

4.32 Agreed. The ATO notes that adherence to ATO-wide risk management guidelines substantially improved in 1997. ATO guidelines will be reviewed in light of research, evaluation and experience gained to date.

Step 3: Risk Analysis

Figure 4.3 - Risk Analysis



Sound features

4.33 The purpose of the risk analysis stage is to estimate likelihood and effects (consequences) of risk events and to combine these to develop risk levels as a precursor to setting risk priorities. The analysis should include a description of each risk and how it might arise, possible initiating factors, the main assumptions and a list of the principal sources of information.

4.34 It is important that existing controls be considered, as they influence the estimates of likelihood and effects. Controls are designed to make risks less likely or to mitigate their consequences and hence should be considered in terms of problems identified and what is going to be done about them. They include:

- management systems and procedures, formal processes and quality assurance;
- human systems, including effective recruitment, training and education;
- physical barriers; and
- commercial and legal controls.

Likelihood and consequences

4.35 Different methods of estimating likelihoods and consequences are appropriate for analysing the risks at different levels in the organisation. At the ATO and BSL level, the most effective methods are likely to be qualitative, using nominal or descriptive scales. Quantitative methods may be more appropriate for analysing risks within functional areas for particular purposes. For example, SBI has developed a generic scoring system for comparing compliance risks across specific client groups.

4.36 The appropriate balance of qualitative and quantitative information upon which to base the risk analysis should be determined by an organisation's Executive.

4.37 Examples of risk areas at different levels of the organisation that require various kinds of measurement are set out in Table 4.1 below.

Table 4.1 Examples of Risk Areas at Different Levels of the ATO

LEVEL	RISK
ATO	Risks associated with the management of a diverse, dispersed organisation Budget restrictions Legislative and regulatory complexity Taxpayer attitudes Broad non-compliance issues
BSL	Budget allocations Risks associated with the specific taxpayer or client group General non-compliance risks Business management risks
Portfolio or function	Risks associated with specific or functional groups Specific non-compliance issues

4.38 In estimating the likelihoods and consequences of identified risks, it is appropriate to use a rating scale for each. The likelihood scale should reflect the frequency or the probability of a risk event occurring; whereas the consequence scale should reflect the effect or damage of a risk event, were it to occur, on the risk assessment criteria determined in Step 1 - *Establishing the Context* (see paragraphs 4.2 to 4.6).

4.39 AS/NZS 4360 and the MAB/MIAC guidelines each advocate the use of a five-point scale for both the likelihood and the consequence. Five-point scales work well in practice. They give more discrimination than three-point (high-medium-low) scales and are still simple enough to use. However, each organisation should tailor a scale according to its particular circumstances and this scale should be used across all parts of the organisation in order to promote consistency and comparability.

Risk levels

4.40 Once the estimate of the likelihood and consequence of a particular risk event has been established, the likelihood and consequence measures are combined to generate an initial risk level for that risk event. If a five-point qualitative scale is used a simple matrix can be applied to generate the risk labels.

Table 4.2 Determining the Level of Risk ¹

Likelihood	Consequences				
	<i>Very High</i>	<i>High</i>	<i>Moderate</i>	<i>Minor</i>	<i>Negligible</i>
<i>Almost certain</i>	Severe	Severe	High	Major	Significant
<i>Moderately likely</i>	Severe	High	Major	Significant	Moderate
<i>Possible</i>	High	Major	Significant	Moderate	Low

<i>Unlikely</i>	Major	Significant	Moderate	Low	Trivial
<i>Rare</i>	Significant	Moderate	Low	Trivial	Trivial

Key:

<i>Severe risk</i>	Must be managed by senior management with a detailed plan
<i>High risk</i>	Detailed research and management planning required at senior levels
<i>Major risk</i>	Senior management attention is needed
<i>Significant risk</i>	Management responsibility must be specified
<i>Moderate risk</i>	Managed by specific monitoring or response procedures
<i>Low risk</i>	Managed by routine procedures
<i>Trivial risk</i>	Unlikely to need specific application of resources

4.41 The outcomes of the analysis (that is, the likelihood and consequence ratings and the initial priorities) should be recorded in the risk register, as should the controls in existence.

ANAO findings

4.42 The ATO's corporate planning proforma for the first HOTSA round indicated that likelihood and magnitude of consequences should be used as measures of risk. However, these guidelines could have been more effective by providing information on how to measure likelihood and consequences (for example, scales) and by providing guidance on how to use these measures to generate a risk level.

4.43 Those BSLs that had undertaken some form of risk analysis procedure tended to follow a three-point (high-medium-low) scale in classifying the risk. However, there was little evidence that likelihood or consequence estimates had been determined.

4.44 Although several controls were mentioned in the HOTSA reports to the Board, BSLs did not undertake a systematic analysis of existing controls. The absence of a comprehensive risk identification stage (see paragraph 4.18-4.30) may have prevented a thorough analysis of controls; it is difficult to consider controls if the risks that they mitigate have not been identified.

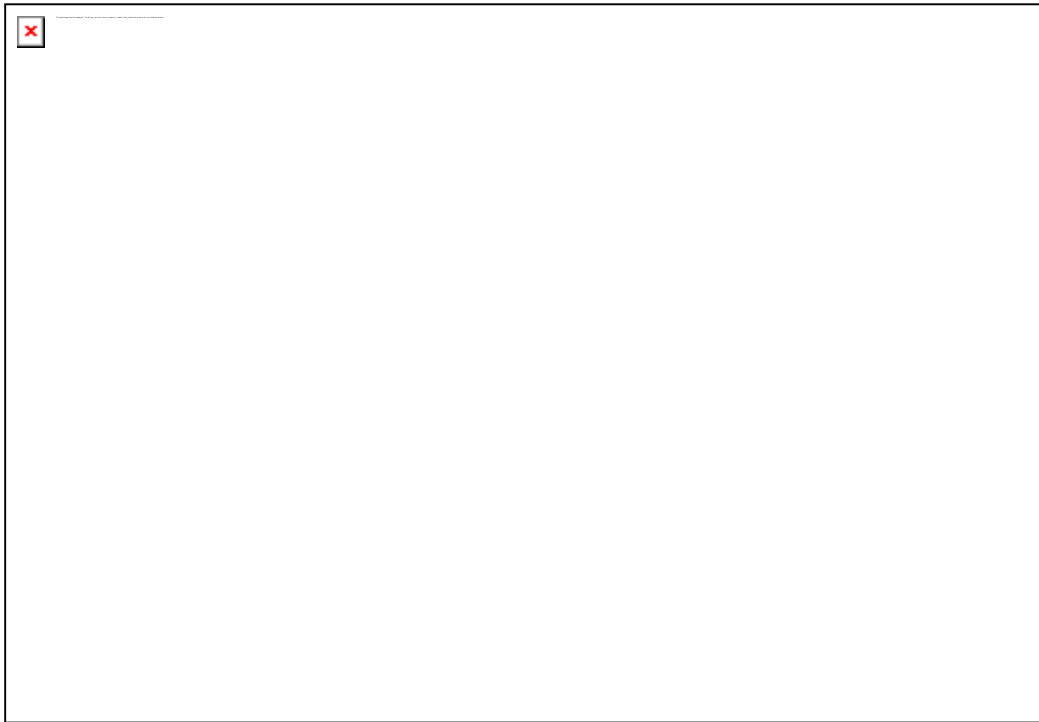
4.45 The analysis of risks could have been more structured and better documented during the first and second rounds of the HOTSA process. Risks which are not sufficiently analysed may be assigned an inappropriate priority for risk treatment. This may result in severe risks remaining untreated while scarce resources are directed at the treatment of relatively minor risks.

4.46 The ANAO noted that the guidance for the third HOTSA round was more comprehensive and structured than for the preceding rounds. Instructions included a discussion of controls and specific scales for ranking consequences and likelihood. HOTSA presentations to the Board also included an analysis of the likelihood and consequences of risks. The soundness and adequacy of the

analysis has not been assessed by the ANAO. However, this aspect will be included in our more detailed examination of the Small Business Income Line.

Step 4: Assessing and Setting Priorities of Risks

Figure 4.4 - Assessing and Setting Priorities of Risks



Sound features

4.47 The risk assessment stage involves decisions about whether risks are acceptable or unacceptable. The output from the risk assessment stage should be a list of acceptable risks, showing the reasons why they are considered acceptable, together with a list of unacceptable risks, in priority order, both currently being actioned and requiring further action. The process usually involves a comparison of likelihoods, consequences and initial risk levels with the risk management criteria, determined in Step 1 (see paragraphs 4.2-4.6), for assessing whether or not a risk is acceptable (see Figure 4.4).

4.48 All organisations, including the ATO, face a multitude of risks. Having the right criteria for ranking unacceptable risks is crucial. In the ATO's case this is especially relevant in relation to comparing a risk that is rated as high in one BSL, industry portfolio or functional area with a similarly ranked risk in another area. Possible criteria include a BSL's share of total assets, agreed dollar amounts and public perception factors.

4.49 Ranking scales have limitations, so it is beneficial through a review process to perform reality checks on the rankings that have been assigned. The review process should determine an agreed priority rating and assign responsibility for treating each identified risk to staff at appropriate levels of the organisation. The outcomes of the review should be recorded in the risk register.

4.50 The review process is usually conducted by the appropriate management team. This promotes comparability of risk priorities across the organisation and generates ownership of risk treatment responsibilities.

4.51 Often the review process generates a priority triage:

- *Major risks* are generally likely to arise and have severe effects. Treatment actions for these risks should be highly visible to senior management and formal written treatment plans are usually required.
- *Moderate risks* may be less likely to arise, or have severe effects, but not necessarily both. Senior management should know they are being treated, but responsibility often may be delegated and senior management may not need to see detailed plans.
- *Minor risks* are those that can be managed using standard or routine procedures and for which little further senior management action may be needed, although ultimate responsibility remains with the organisation's Executive.

ANAO findings

4.52 The ANAO found that during the 1994-95 and 1995-96 HOTSAs the ATO focused on major risks without explicit consideration of whether existing controls mitigated these risks. The guidance notes for the HOTSAs process asked for back-up detail on lower level risks to be made available by BSLs as required. However, no definitions of major and low risks were provided in these notes.

4.53 This implies that the Board expected some form of priority setting of risks to be carried out, notwithstanding that the guidance notes did not provide any clear criteria on how to undertake this priority setting process, either across or within BSLs.

4.54 It is noted, however, that BSLs would have been required to undertake some degree of priority setting of the identified risks in order to determine which were the major risks.

4.55 As discussed in previous sections of this report, the ANAO found that a more comprehensive risk assessment would have resulted from the first and second HOTSAs rounds if all significant sources of risk had been identified and priorities assigned to those risks. Acceptable risks were not listed nor were priorities established for unacceptable risks. In addition, reasons for not actioning unacceptable risks had not been documented nor made transparent to those responsible for treating these risks.

4.56 The ANAO also considers that if the ATO had utilised some form of consistent measurement criteria, such as percentage of total assets, dollars of revenue, public perceptions, or numbers of taxpayers it would have been better able to assess and prioritise its identified risks across the agency. This was discussed in Chapter 3.

4.57 The ANAO concluded that the ATO's risk assessment and priority setting stage could have been undertaken in a more consistent and systematic manner during the first and second HOTSAs rounds. This would have reduced the risk that decisions regarding the allocation of resources may not be soundly based. Recommended improvements in consistency, transparency and documentation outlined in Chapter 3 will enable the ATO to improve this element of the risk management process.

4.58 The ANAO considers that at the corporate level the structure for the risk assessment and priority setting stage of the 1997 HOTSAs was substantially better than for the first two rounds.

Recommendation No. 6

4.59 The ANAO *recommends* that the ATO ensures that consistent priorities are determined for identified risks, or logical groupings of risk, based on adequate information and that decisions on resource allocations take into consideration those risks that have been assigned the highest level of priority.

ATO response

4.60 Agreed. The ATO accepts these basic concepts. Our application of these concepts has significantly improved over time.

Step 5: Risk Treatment

Figure 4.5 - Risk Treatment



Sound features

4.61 Risk treatment should be linked to business planning processes. Treatment should involve the identification and evaluation of options for resourcing identified risks and the preparation and implementation of appropriate plans.

These activities are standard management activities, not just particular to risk management. Figure 4.5 depicts the risk treatment process.

4.62 After available controls are considered, the highest level of risk should normally receive the highest level of attention, whether through additional resources or other methods of treatment, until such time as that risk has attained an acceptable level of control. This approach is especially important in an environment of diminishing resources.

4.63 When management is identifying options for treating risks, they may select one of four classes of responses:

- i) *Risk prevention* - responses directed to eliminating a source of risk, or reducing the likelihood of its occurrence;
- ii) *Effect mitigation* - responses directed to reducing or coping with the consequences of a risk event;
- iii) *Risk transfer* - responses directed to transferring the risk to another party, or sharing it; and
- iv) *Risk retention* - retaining or accepting the risk.

4.64 Several factors should be considered in determining the most appropriate treatment options. These may include the costs and benefits of implementation, the extent to which risk will be reduced, opportunities created by risk and the prevailing perceptions of risk. It is beneficial to complete a Risk Treatment Schedule and Action Plan before risk treatments are performed (see Figure 4.5). Without this documentation it is difficult for management to make informed decisions regarding the appropriateness and quality of risk treatments or the resources required to manage identified risks. Furthermore, it is important that responsibility for risk treatments be clearly assigned and accepted.

4.65 There is scope within the ATO to consider transferring certain risks. For example, the risk of information not being captured in a timely fashion could be transferred by contracting external data entry personnel during peak periods. However, the transfer of any risk creates secondary risks which must be managed. For example, in the case of contracting data entry personnel secondary risks may include privacy implications, costs involved and quality of service.

4.66 Risk treatments rarely eliminate risks, so there will usually be some residual risk. This may be unacceptable and may require further action.

ANAO findings

4.67 The ANAO appreciates that there is considerable work being undertaken across all BSLs and at all levels of the organisation to treat risks. These risks include, among others, staffing risks resulting from the current downsizing, research and information risks and the multitude of complex compliance risks. Much of this work is innovative and of high quality. There are potential benefits

to the ATO, however, by adopting a more coordinated approach to the treatment of risks.

4.68 Many areas of the ATO have already introduced appropriate treatment for some risks, yet these methods have not been readily applied to other areas. For example, INB introduced a comprehensive audit program which targets tax agents rather than individual taxpayers. This methodology has been highly successful according to INB and yet, despite plans over some years to introduce it to SBI, this has not occurred, although the ATO advised the ANAO in May 1997 that work is currently underway to adapt the INB concept to SBI risks.

4.69 Risk treatments may need to be coordinated at the corporate level of the ATO. For example, as a group, tax agents deal with taxpayers from each of the ATO's business lines: LB&I, WHT, SBI, INB and SPR. If each Business Line were to adopt a strategy of leveraging compliance efforts through tax agents, a coordinated approach would have to be undertaken to maximise the compliance benefits and to minimise the costs for both the ATO and the tax agents involved.

4.70 The ANAO found that proposed treatments of risks identified through the first and second HOTSAs were seldom clearly stated. Where strategies for treating risks were mentioned they had not been developed into action plans. For example, stated risk treatments included that the ATO would continue successful leverage activities, explore regional arrangements, continue its rulings program, work with tax agents, industry groups and small business and minimise data collection costs, etc. Stating how these strategies would be implemented, the resources required, and the time frames in which they were to be undertaken at the BSL level would have improved this step in the process.

4.71 The inclusion of the costs of risk treatments and the methods to measure whether the nominated strategies were successful would also have enhanced the process. This would have assisted in determining whether the most appropriate treatments were being employed.² The ANAO concluded that there was considerable scope to improve the links between the ATO's identified risks and the activities it undertakes to treat them.

4.72 While risk treatments were stated in the business plans developed by each Line following the first HOTSAs round, the level of detail varied greatly across BSLs. Some assigned individual responsibility, levels of resources, timeframes and measures of success for treatments while others only mentioned strategies for risk treatments generally. Explicitly aligning activities or risk treatments with risks and costing those activities will help the ATO focus on its core business and improve the overall cost-effectiveness of its operations. This approach should result in decisions based on sound information and enhance the ability of managers to monitor, review and ultimately improve risk treatments.

Recommendation No. 7

4.73 The ANAO *recommends* that the ATO pursues a more explicit and transparent cost/benefit analysis of the available options for treating identified risks, or

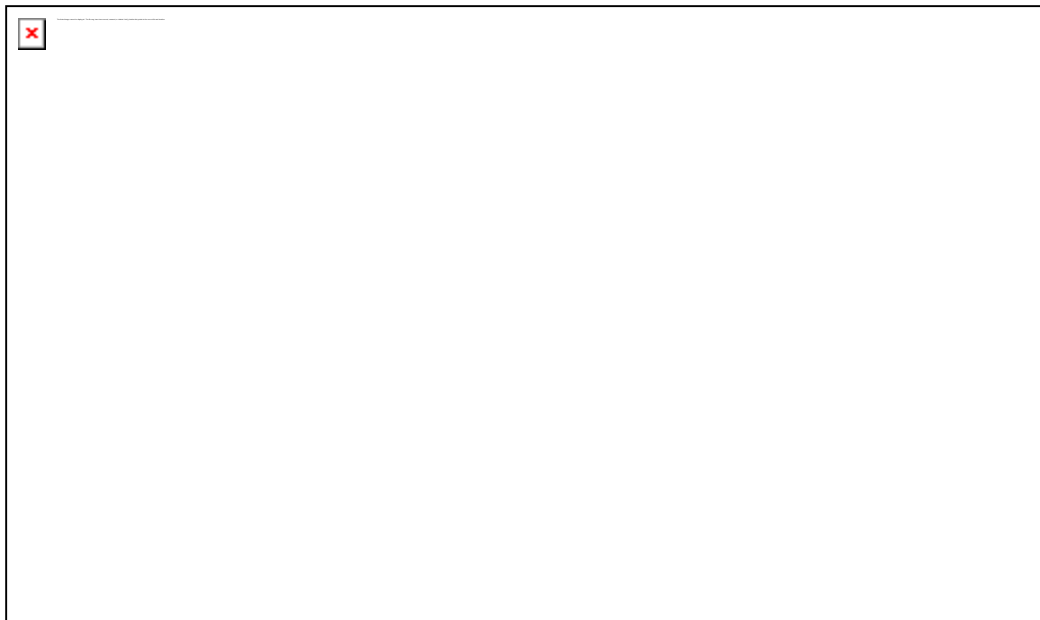
logical groupings of risk. Relevant quantitative and/or qualitative costs and benefits should be identified at each level of the organisation that undertakes a risk assessment within the overall risk profile that has been established as part of the ATO's corporate governance framework.

ATO response

4.74 Agreed. The ATO will particularly emphasise the identification of relevant qualitative and/or quantitative costs and benefits of possible risk treatments at the ATO and BSL level. We are improving our systems to provide better data to support this analysis.

Step 6: Monitoring and Review

Figure 4.6 - Monitoring and Review



Sound features

4.75 As risks and organisational priorities change through time and a changing environment, risks and risk treatments should be monitored as part of the management cycle. Ongoing review is essential to ensure that management plans remain relevant. It is also beneficial to monitor the effectiveness of risk treatment plans and strategies as well as the management system set up to control implementation of treatments.

4.76 The responsibilities, resources, accountability mechanisms, reporting requirements and timeframes for monitoring and reviewing risk management should be clearly articulated. Adequate performance indicators need to be devised to measure and monitor (either frequently or periodically) the critical success factors. The validity of assumptions used in undertaking the risk assessment also should be reviewed periodically (see Figure 4.6).

4.77 All six steps of the risk management cycle should be repeated regularly so

that changes in the internal and external environments can be monitored. This will allow the identification of emerging risks, alterations in risk priorities as circumstances change and the introduction of innovations in the treatment of ongoing risks. It should not be necessary for each cycle to have the same level of resources dedicated to the process. However, an effort should be made to review the risk management process on a regular basis.

ANAO findings

4.78 Responsibility for risk management is now part of the ATO's corporate governance regime. Corporate governance is concerned with structures and processes for decision-making as well as accountability, controls and behaviour within organisations. In the public sector context, it is about the control and monitoring mechanisms that are put in place to enhance stakeholders' confidence in the performance and integrity of the organisation.

4.79 The ATO is using this mechanism to monitor progress and achievement against Corporate Plans which are based on the risk management process. Each quarter, every National Program Manager is required to sign a corporate governance statement which the ATO Audit Committee, the Commissioner and the ANAO all use as increased evidence of the quality of management disciplines, including the management of identified risks.

4.80 National Program Managers certify that their respective programs have been managed in accordance with the Corporate Plan and risk management disciplines. This certification also includes an assurance that appropriate financial controls are in place. The first corporate governance statements for each BSL were certified in August 1996.

4.81 The ongoing monitoring and evaluation of results and progress against plans would be further enhanced by the development of appropriate management information which measures performance against key indicators. As discussed in paragraphs 3.13 to 3.21, some examples of appropriate management information include revenue by business line, the costs of risk treatment and other operational factors.

4.82 Management information of this nature will facilitate assessment of such things as the levels of client service achieved and cost-effectiveness of operations.

4.83 In relation to the evaluation of the HOTSAs process itself, the ANAO found that some evaluation within business lines had been undertaken. WHT undertook an evaluation of its first HOTSAs round and the ANAO was advised that LBI planned an evaluation of its second round as part of its Continuous Improvement program.

4.84 A formal ATO-wide end-of-HOTSAs evaluation was not undertaken at the completion of either the first or second rounds to review outcomes as possible inputs to future directions. However, the ATO advised the ANAO in May 1997 that an informal review did take place prior to the 1995-96 process. Despite the

resource intensiveness and importance of the HOTSAs exercise, the ATO did not plan for the conduct of a structured evaluation. The ANAO strongly urges the ATO to undertake structured evaluations of the 1997 and future HOTSAs exercises. Such evaluations will provide assurance that processes remain appropriate and are followed consistently by all Business and Service Lines. Maximum benefit will be achieved if independent reviews are undertaken at each level of the organisation which participates in the risk assessment process. The scope, coverage and frequency of evaluations to be conducted should be determined by the organisation's Executive.

Recommendation No. 8

4.85 The ANAO *recommends* that the ATO enhances its corporate governance framework to ensure that effective systems of monitoring and evaluating performance against risk management plans are implemented and useful management reports are regularly available at all management levels.

ATO response

4.86 Agreed.

Overall conclusion

4.87 The ANAO acknowledges the effort that the ATO has invested in introducing a risk management process to a large and geographically dispersed organisation. However, the ANAO concluded that the potential benefits of formal risk assessment were not fully realised by the ATO during its first two HOTSAs rounds.

4.88 The ATO needs to build on its recent risk management achievements and to continue its efforts to develop an organisational culture where risk identification and its analysis, prioritisation and treatment are integral elements of management at all levels, including setting strategic directions to tax processing.

4.89 A more structured and disciplined risk management process based on AS/NZS 4360 and MAB/MIAC Report No. 22 would provide a coherent and widely accepted structure for use as the basis for risk management in the ATO. In this regard, we noted that the ATO planning for the 1997 HOTSAs exercise reflected a number of the issues raised during the audit. Finally, the ANAO supports the manner in which responsibility for risk management has been integrated into the ATO's corporate governance regime. It is a lesson for all APS agencies.



1

Adapted from MAB/MIAC Report No. 22, p. 26.

2

The ATO has plans to introduce an enhanced costing system which will allow it to identify costs and attribute them to specific activities. The current lack of such data is a contributing factor in risk treatments not being accurately costed.

Appendix 1

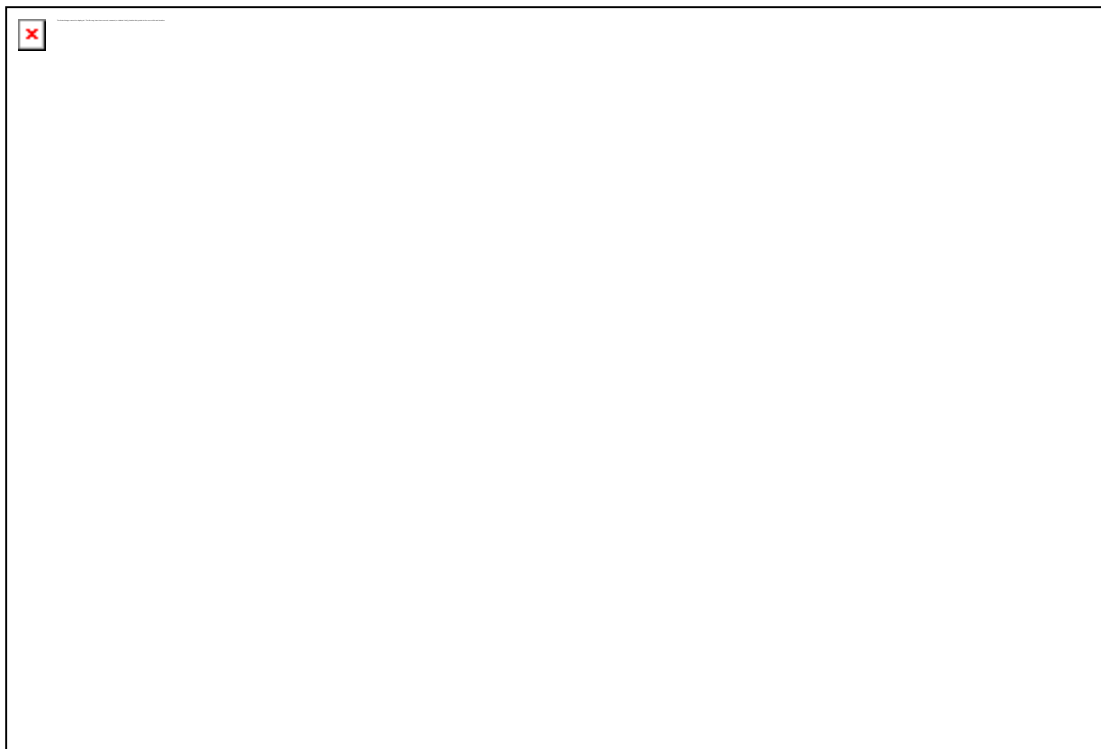
ATO Business and Service Line Structure

1. The ATO has based its organisational structure around particular client groups. In addition, it has established a specialist tax law program and created specialist functional groups to assist the client group programs.
2. The ATO's client group programs as at April 1997, around which the organisation focuses its program delivery, are listed below:
 - *Individuals Non Business*: deals with salary and wage earners and investors;
 - *Small Business Income*: taxpayers are businesses with annual turnovers of less than \$10 million; also deals with fringe benefits tax matters for all taxpayers;
 - *Large Business and International Income (called Large Business Income from 1994 to April 1997)*: taxpayers are large corporate groups with annual turnovers in excess of \$10 million; also deals with international tax;
 - *Withholding and Indirect Taxes*: includes prescribed payments, sales tax and Pay-As-You-Earn (PAYE);
 - *Superannuation*: responsible for relevant superannuation policy and administration of Superannuation Guarantee and Reasonable Benefit Limit; and
 - *Child Support Agency*.
3. The ATO has set up the following separate support programs to take responsibility for the tax technical service delivery:
 - *Legislative Services Group*; and
 - *Tax Counsel and Practice Management Group*.

4. The corporate, financial and information technology needs for the client group programs are provided by the following support programs:

- *Financial Services;*
- *Corporate Services;* and
- *Information Technology Service.*

5. The ATO stated that it expects that this organisational structure will be of benefit by enhancing output and placing greater emphasis on taxpayer compliance strategies, taxpayer education, and being accountable for outcomes.



Appendix 2

Relevant ATO developments from 1987 to 1994

There were a number of significant ATO developments not specifically mentioned in the body of the report that occurred in the period 1987 to 1994 to manage the risks associated with self assessment. The ATO advised that these initiatives resulted from consideration of the then existing compliance environment and determination of the most appropriate responses. It provided the ANAO with the following chronology.

Tax Reform - The Fringe Benefits Tax and Capital Gains Tax provisions were introduced in 1985-86 *et seq.* These amendments were introduced following concerns expressed by the ATO to Government that significant taxable fringe benefits and capital gains were not being declared by taxpayers in their "self-assessed" income tax returns as required by the Act then in place.

Large Corporate Audit Program - Additional resources, new audit approaches and auditing arrangements were introduced in 1987 and covered the top 100 corporate groups in Australia.

Tax File Number (TFN) Provisions - The introduction of the TFN provisions, systems enhancements and additional resources enabled enhanced matching of income to the TFN's quoted by taxpayers in a variety of situations. A significant amount of additional revenue was collected through this initiative.

Lodgement Amnesty - In 1988, a lodgment amnesty for income tax clients was introduced. Over half a million taxpayers took the opportunity to bring their return lodgement obligations up to date.

Self Assessment Priority Tasks - A series of initiatives introduced over 1991 and 1992 designed to provide a more supportive legislative and administrative environment. These initiatives included reviewable and binding rulings, a new interest and penalty regime, extended review rights, a review of Commissioners' discretions and removal of the requirement to lodge elections.

Record-keeping - A new program of examining the books and records of small business was introduced in 1992 from an internal resource allocation. It was subsequently expanded with resources approved by Government as part of the Compliance Enforcement Strategy.

Compliance Enforcement Strategy - A variety of compliance improvement measures were announced in 1992 and introduced progressively in the following two years. Specific initiatives included expansion of law clarification and audit activities for large businesses; record-keeping, reportable payments system, expanded auditing for small business and enhanced income matching for individuals. An additional \$1.7 billion is estimated to have been gathered from these activities.

Work-related Expenses - a mix of integrated strategies (including tax agent claims analysis, pre-lodgement awareness notices and employment related rulings) were introduced in 1992-93, designed to improve compliance in this area. These have been progressively refined in subsequent years.

Appendix 3

Performance Audits in the Australian Taxation Office

Set out below are the titles of the reports of the main performance audits by the ANAO in the Australian Taxation Office tabled in the Parliament in the past three years.

Audit Report No.12 1993-94

Administration of the 150% Taxation Incentive for

Industry Research and Development

Department of Industry, Technology and Regional Development

Australian Taxation Office

Audit Report No.24 1993-94

Management of Appeals and Review: Australian Taxation Office

Audit Report No.39 1993-94

Management of the Child Support Agency

Audit Report No.3 1994-95

Project Audit - Wool Tax

Audit Report No.6 1994-95

Australian Taxation Office - Information Technology Security

Audit Report No.28 1994-95

Insurance and Superannuation Commission

Superannuation Industry (Supervision) Act

- Administrative Arrangements

Audit Report No.1 1995-96

Income Matching System: Australian Taxation Office

Audit Report No.16 1995-96

Assessable Government Industry Assistance: Australian Taxation Office

Audit Report No.13 1996-97

Tax Debt Collection: Australian Taxation Office

Audit Report No.22 1996-97

Client Service: Australian Taxation Office
