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# The effect of audit case selection on tax audit effectiveness in south rift valley region, Kenya

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**Abstract**
Ineffective tax audit has been considered as one of the many reasons behind non-compliance to tax laws and revenue loss. Therefore, the present study evaluated the effect of audit case selection on tax audit effectiveness in South Rift Valley Region, Kenya. The study was premised on Hoffman's Tax Planning Theory. The study used descriptive research design targeting a population of 80 tax officers in South Rift Valley Region; therefore, it adopted a census method. Pre-tested questionnaires were used to collect data. Data was analyzed using descriptive statistics and inferential statistics. The findings revealed that audit case selection ($\beta = 0.487$, $p < 0.05$) was directly related to tax audit effectiveness in South Rift Valley Region. The study recommends that there is need to improve on the audit case selection procedures that can be applied on both large taxpayers in formal sector and small taxpayers in informal sector.

**Keywords:** Kenya revenue authority, tax audit, tax officer

## Introduction

Tax may be defined as a mandatory payment to government, a definition differentiating it from other government actions which have an equivalent economic effect, thus it is neither inclusive nor exclusive (Thuronyi, 2003). Therefore, taxation is not only the compulsory payment but also the conveying of funds from citizens to government charged as per the tax laws in order to accomplish some of the nation's economic and social objectives. Taxation is geared towards generating revenue for government in order to cater for its expenditure (Badara, 2012). In fact, according to Gbadago and Awunyo-Vitor (2015) [24], tax revenue has been recognized as the main sources of finance to the government. Consequently, modern economies have establish robust tax systems that assist in efficient collection of taxes to ensure that the supply of public goods and services and also boost public confidence to the government, while guaranteeing that there is equity and fairness in distribution of tax implication.

In developed nations like USA and Canada employs tax collection sytems which are not only effective but efficient resulting in optimal collection of expected tax revenues (Beekes and Brown, 2008). In contrast, a study by Edward (2009) [15] depicted the difficulties in collecting tax revenue in developing countries were more pronounced as compared with the developed countries. According to the IMF (2011), extensive tax evasion and avoidance is the main challenge to domestic tax base expansion in many African nations. Notwithstanding the fact that poor tax compliance is becoming a major problem in nations around the world (McKerchar & Evans, 2009), developing states especially those in Sub-Suharan Africa are mostly affected (Fuest & Riedel, 2009) [22]. The explanations behind tax revenue losses are many, although most authors tend to agree that system inadequacy, corruption, poor internal control systems and corporate governance among others are to blame for the state of affairs. For example, Fati (2014) [17] study in Ghana revealed that the tax revenue performance has been unstable due to lack an all-inclusive register for all the business activities that are subjected to taxes. In addition, they used manual system to record the transactions and thus making it difficult to track all business activities from invoicing to payment. Moreover the use manual system not only resulted in huge revenue loss but also led to exposure to corrupt practices In order to improve the transparency and accountability of revenue officers and elected officials measure have to be put in place and implemented (Fjeldstad and Haggstad, 2012) [20].

Revenue collecting bodies have insufficient resources to come up with the tax owed by the taxpayers and thus they implement self-assessment system as a to foster voluntary compliance, where taxpayers declare their income and expenses for tax purposes since they have all the information of their business transactions and financial activities. In self-assessment system the taxpayers compute the taxes payable and remit them without the help of tax officers. Where the self-assessment returns are done inappropriately, or are not filed on time then penalties and interest and administered in accordance with tax laws. The revenue collecting institutions who adopts the self-assessment systems employs selective and target based forms of verification, such as risk based audits, third party information or intelligence to scrutinize the information in the tax returns, and thus it minimizes the administration cost (IMF, 2014) [33]. In Kenya, the Kenya Revenue Authority i a bid to improve tax compliance has overtime come up with revenue enforcement and preventive measures such as taxpayer audit.

### 1.1.1 Tax Audit

Tax audit can be termed as a verification of a tax return by tax officers to check and confirm that the income reported and expenditure claimed from the same are correct. It involves examination of tax returns in relation to the taxpayer's records and books of accounts. Tax returns in Kenya consist of Income tax return-IT1 & IT2, VAT Return, Excise Return, PAYE Return, WHT Return and Agency tax Return. Taxpayers' audits are statutory audits and thus right to audit taxpayer's records is governed by the various Acts administered by the Commissioner of Domestic Taxes and Customs. Therefore, tax auditors operate within the framework of the tax statutes.

In the past non-compliance have been exclusively addressed by enforcing the regulation procedure in place through risk based audits. Therefore, taxpayer audits have remained a key measure for dealing with compliance risk. In many revenue collecting bodies audit forms a biggest initiative in terms resources deployed to administer tax laws and regulations. The objective of revenue bodies is majorly to optimize revenue collections under the tax laws and increasing the levels of voluntary compliance in ways that instill public confidence (OECD, 2006) [46]. Poor tax audit has been cited as being among one of the many reasons behind non-compliance and also revenue loss in the case of compliance. The financial reporting systems for most businesses enterprises are sub-standard and, hence, this possess a significant challenge to the tax auditor. Furthermore, the intricacy of tax auditing procedures, and the impression that the tax rates are high has contributed greatly to upsurge in non-compliance (Kiabel & Nwokah, 2009) [38].The strength of audits differs from one country to another. Germany and Japan have the most intensive field audits, and then followed by the U.S, but the potency of audit in U.K. is low. In addition, the nature of the tax audit procedures varies from one country to another, such that Common law countries tend to have a fairly informal procedure for assessment of tax (Thuronyi, 2003).

Badara (2012) in his study evaluated the impact of Tax audit on tax compliance on internal revenue in Bauchi State Nigeria.The findings revealed that the Tax Authority use tax audits in order to achieve target revenue, that tax audit mitigates tax evasion, and that there is lack of cooperation of tax payers with tax audit staff during audit process. Harelimana (2018) [29] investigated the relationship between Tax audit and the revenue collection in Rwanda. The study revealed that the audit of taxpayers is positively related to the revenue collected, therefore, as the tax audits increases the revenue collected also increases. Nurebo *et al*. (2019) [43] carried out a study in Kembata Tembaro Zone –Southern Ethiopia to assess factors affecting tax audit effectiveness. The study found out that the support from the management, quality of audit, awareness of taxpayers, and the system of tax administration are directly related to audit effectiveness, whereas complexity of tax law and accounting/reporting of taxes are inversely related to tax audit effectiveness. Chalu and Mzee (2017) [6] carried out a research on the factor affecting the effectiveness of tax audit in Tanzania. The study revealed that: implementation of tax auditors' recommendations by management, adequacy of resources in tax audit unit, taxpayers' attitude, availability and application of regulation/ audit standards, and leadership in place and tax regimes for tax audit are vital factors for tax audit effectiveness. Mirera (2013) studied the effects of tax audit on tax revenue in Kenya Revenue Authority (Nairobi West Tax station) and found that there is a direct relationship between tax audit and tax revenue collected.

### 1.1.2 Audit Case Selection

Alm, *et al*. (2005) examined the factors of state audit selection and the ensuing compliance with sales tax by the firm in New Mexico, using secondary data. They adopted a type of selection with two stages to approximate the factors of the State's audit case selection criteria and the entities' subsequent declaration results for the entities selected for an audit. The results from the first-stage audit selection process depicted that tax returns are selected methodologically by the state for audit, by considering the income 17 and expense items reported by the corporate taxpayers on their returns for taxes. On the other hand, the second-stage corporate taxpayers tax return's declarations findings revealed that business entities that shows significant deviation in tax deductions, the service sector firms, firms that that file late returns, and the ones that the mailing address outside the state have a low levels of compliance. Gupta and Nagadevara (2007) [26] in their study found out that data mining algorithms are the most effective and efficient tax audit case selection methods that the revenue institutions can employ to check the evasion and improve compliance. They further supported their findings by pointing out that the auditing of taxpayers is costly to both taxpayer and revenue institution, and thus there is need to minimize cost of auditing while maximizing the compliance.

The tax compliance in Kenya is estimated at 65% being the weighted average of registration-60%, filing-55.5% and payment rates at 79.9 per cent, respectively (KRA, 2015). The cases of non-compliance results from low risk of detection and inefficient preventive measures such as tax audit. Kenya Revenue Authority has also allocated resources necessary to implement its revenue initiatives but tax audit has never been given enough resources and attention it requires. Ineffective tax audit has been considered as one of the many reasons behind non-compliance. Additionally, the complexity in the tax auditing procedures, as well as the perception that taxes are extremely high, has led to the increase of tax evasion (Kiabel & Nwokah, 2009) [38]. In a bid to improve tax compliance KRA has overtime come up with revenue enforcement and preventive measures such as taxpayer audit. The taxpayers that were audited during year 2010-2015 in Kenya Revenue Authority Specifically in South Rift valley region in relation to the total number of taxpayers mapped to the region is barely 3%. However, there is scant research on effectiveness of audit case selection the tax audit function in tax collection. Therefore, the objective of this paper was

To assess the effect of audit case selection on tax audit effectiveness in South Rift Valley Region, Kenya.

## 2. Hoffman's Tax Planning Theory

The Hoffman's Tax Planning Theory was first proposed by Hoffman in 1961. According to Hoffman (1961). Tax planning by the taxpayers is often geared towards diversion of income to other related corporate entities that would have been tax and remitted to the government. Tax planning transactions are done objectively to reduce income to be subjected to taxes to the lowest levels, with little or no change in accounting income, since the taxes due are based on the taxable income rather than accounting income. Therefore, the key issue is to increase the transactions that can reduce taxable income but does not relate directly to the accounting profit. This theory acknowledges the fact that tax planning activities are directly related to the financial performance of a business entity. Hoffman (1961) noted that the tax cost plays a role during tax planning transactions.

This theory thus explains that tax planning benefits are more than the tax cost such since there is direct relationship between firm's performance and tax planning itself.

However, the extent of this theory does not take into account the ever changing characteristics of tax planning and the performance of the market. The scope of the Hoffman's tax planning theory does not address the dynamics of tax planning and market performance. Due to changes in capital markets and globalization issues and detachment of firms control and ownership, a robust tax planning theories are inevitable, even though the challenge can be dealt with using empirical point of view rather than theoretical position (Inger, 2012). The present study recognizes that from the taxpayers perspective tax planning is an imperative while from the taxman point of view, good auditing techniques are instrumental in uncovering the tax planning strategies. Therefore, in the context of the present study, the theory will be instrumental in providing insight on how through understanding tax planning strategies by the tax payer leads to effective audit case selection by the tax auditors.

## 3. Materials and Methods

This research study employed descriptive research design. Descriptive research is preferred since it gives current information of the subject under study and illustrates the conditions in a situation. Descriptive research design is normally used as a predecessor to quantitative research designs to give an outline of the variables that can be quantitatively tested. The study was conducted in Kenya Revenue Authority-South Rift Valley Region consisting of Nyahururu, Naivasha, Nakuru, Narok, Maralal and Kericho. The selection of this area of study has been informed by the fact that the region is expansive and diverse and as such is likely to be information rich for the study. The study, therefore, targets, the Kenya Revenue Authority- South Rift Valley Region based in Nakuru County. The station has 80 tax officers in both the Nakuru Station and the satellite stations. Therefore, the entire accessible population under consideration in this study comprises 80 persons. This population was chosen due to their conversance with the tax audit process and is expected to be familiar with the variables being investigated in this study. Census method was used for the present study because the respondents are specific persons in the organizations that are involved in the tax audit planning, executions and management of the audit functions in South Rift Valley Region- KRA. Furthermore, the population is composed of only 80 respondents which is small.

Data was obtained from primary sources using questionnaires.The questionnaires used was structured in order to capture the respondents' views on the research problem. Piloting was undertaken in KRA Eldoret-North Rift Valley Region, before the questionnaires were used to check accuracy and correctness using 10 respondents who were purposively selected; however, this population was not included in the actual study. Validity was tested by reviewing the research instrument design in relation to the objectives of the study to ensure that it is up to the standards. The questionnaire was also given to independent experts to verify the validity of its contents and ensure that there clarity of all items and that is no biasness in examining the variables. The internal consistency method was used to test for the reliability of the questionnaire. The Cronbach's alpha coefficient for the instrument was $\alpha = 0.833$ which was high enough and acceptable for the research. According Bhattacherjee (2012), the correlation coefficient above 0.7 is adequate and indicates good reliability of data in social science research. The data was analyzed using both descriptive and inferential statistical methods. Descriptive analysis was done to explain the basic features of the population by specifically computing the standard deviations, mode and means; inferential statistics was used to determine the nature of relationships between the variables using bivariate regression analysis.

## Results & Discussion

### 4.1 Audit case selection and tax audit effectiveness in South Rift Valley, Kenya

The first objective of the study was to establish the the effect of audit case selection on tax audit effectiveness in South Rift Valley, Kenya. This objective was measured using constructs of profiling and risk assessment. The responses were rated on a 5 point Likert scale ranging from; 1 = strongly disagree to 5 = strongly agree. The results are summarized in Table 1.

**Table 1:** Audit case selection and tax audit effectiveness in South Rift Valley

| | SA | A | N | D | SD | | p- |
|---|---|---|---|---|---|---|---|
| **Statement** | **Freq (%)** | **Freq (%)** | **Freq (%)** | **Freq (%)** | **Freq (%)** | $\chi 2$ | **value** |
| The audit case selection is important in carrying out tax audit | 46(65.7) | 23(32.9) | 1(1.4) | 0 | 0 | 67.16 | 0.000 |
| The case selection methods are well understood by tax officers | 13(18.6) | 31(44.3) | 20(28.6) | 6(8.6) | 0 | 57.55 | 0.000 |
| There is 100% implementation of risk based tax audit case selection procedures over the last five years | 3(4.3) | 29(41.4) | 18(25.7) | 19(27.1) | 1(1.4) | 56.82 | 0.001 |
| The parameters in risk based case selection procedures are enough to determining the level of risk of tax loss. | 2(2.9) | 33(47.1) | 20(28.6) | 14(20.0) | 1(1.4) | 56.25 | 0.000 |
| Audit case selection procedures can be aplied to both individual and Corporate taxpayers. | 18(25.7) | 44(62.9) | 6(8.6) | 2(2.9) | 0 | 71.73 | 0.001 |
| Audit case selection procedures can be applied on both Large taxpayers in formal sector and small taxpayers in informal sector e.g Jua Kali sector. | 9(12.9) | 31(44.3) | 6(8.6) | 22(31.4) | 2(2.9) | 79.06 | 0.000 |

The results in Table 1 suggest that majority of the respondents strongly agreed (65.7%) that the audit case selection was important in carrying out tax audit. The findings also suggest that the audit case selection methods were well understood by tax officers as indicated by most repondents who agreed (44.3%). Also, the was a 100% implementation of risk based tax audit case selection procedures over the last five years as suggested by majority of the respondents who agreed (41.4%). Most respondents were of the view that the parameters in risk based case selection procedures were enough to determine the level of risk of tax loss (47.1%). Majority also agreed that audit case selection procedures can be aplied to both individual and Corporate taxpayers (62.9%). The audit case selection procedures was reported to be highly flexibile as they could be be applied on both Large taxpayers in formal sector and small taxpayers in informal sector e.g Jua Kali sector (44.3%).

These findings generally underscore the importance tax audit case selection has on tax audit effectiveness. Particularly, the finding showing that the audit case selection procedures was highly flexibile and could be be applied on both large taxpayers in formal sector and small taxpayers in informal sector e.g Jua Kali reinforces the effect of the audit case selction process. This is consistent with Alm *et al*.,(2005) who found that business entities audits shows significant deviation in tax deductions, the service sector firms, firms that file late returns, and the ones that the mailing address outside the state have a low levels of compliance.

### 4.2 Tax Audit Effectiveness in South Rift Valley Region

Finally, the study sought to determine the levels of tax audit effectiveness in South Rift Valley Region. This was the dependent variable and was measured by asking the respondents to respond to various statements describing the implementation status along certain constructs namely; Number of taxpayers audited and Revenue/Compliance rates. A 5 point Likert scale ranging from; 1 = strongly agree to 5 = strongly disagree was used to measure the responses to the statements posed. These results are presented in Table 2.

**Table 2:** Tax Audit Effectiveness in South Rift Valley Region

| | SA | A | N | D | SD |
|---|---|---|---|---|---|
| **Statement** | **Freq (%)** | **Freq (%)** | **Freq (%)** | **Freq (%)** | **Freq (%)** |
| Tax audits have contributed to high revenue collection over the period 2010 – 2015 | 13(18.6) | 43(61.4) | 11(15.7) | 3(4.3) | 0 |
| Tax audit contributed significantly to increase in tax compliance rate over the period 2010 - 2015 | 10(14.3) | 48(68.6) | 10(14.3) | 2(2.9) | 0 |
| Tax audit is an important enforcement initiative in revenue collection | 18(25.7) | 47(67.1) | 4(5.7) | 1(1.4) | 0 |
| More than 50% of taxpayers in South Rift Valley Region were audited in 2010 - 2015 | 1(1.4) | 8(11.4) | 30(42.9) | 25(35.7) | 6(8.6) |
| Both corporate and individual business were audited in 2010 – 2015 in South Rift Valley Region | 4(5.7) | 41(58.6) | 10(14.3) | 11(15.7) | 4(5.7) |
| Over 50% of taxpayers audited have complied to tax legislation | 1(1.4) | 36(51.4) | 21(30.0) | 12(17.1) | 0 |
| All the taxpayer audits carried out in 2010 – 2015 resulted in high tax yield in South Rift Region | 5(7.1) | 36(51.4) | 24(34.3) | 5(7.1) | 0 |

The results in table 4.7 suggest that tax audits have contributed to high revenue collection over the period 2010 – 2015 as indicated by majority of the respondents who agreed (61.4%). Further, tax audit contributed significantly to increase in tax compliance rate over the period 2010 – 2015 (68.6%). The findings also indicate that most repondents were of the view that tax audit is an important enforcement initiative in revenue collection (67.1%). However, the results also suggest that there was uncertainty on whether more than 50% of taxpayers in South Rift Valley Region were audited in 2010 – 2015 as indicated by most of the respondents who were neutral (42.9%) regarding this statement. Nevertheless, both corporate and individual business were audited in 2010 – 2015 in South Rift Valley Region (58.6%). Most respondents, however, agreed that over 50% of taxpayers audited have complied to tax legislation (51.4%). The findings also indicate that all the taxpayer audits carried out in 2010 – 2015 resulted in high tax yield in South Rift Region (51.4%). These findings agree with Nurebo *et al*. (2019) [43] who found out that management support, audit quality, taxpayers' awareness, and tax administration system are directly related to audit effectiveness, whereas complexity of tax law and accounting/reporting of taxes are inversely related to tax audit effectiveness. The findings also agree with Badara (2012) who found that the Tax Authority use tax audits in order to achieve target revenue, that tax audit mitigates tax evasion, and that there is lack of cooperation of tax payers with tax audit staff during audit process.

### 4.3 Bivariate Regression

Bivariate regression was performed to establish whether audit case selection significantly affected tax audit effectiveness in South Rift Valley Region, Kenya are given in Table 3.

**Table 3:** Regression of effect of audit case selection on tax audit effectiveness in Kenya

| **Model Summary** | **R** | **R Square** | **Adjusted R Square** | | **Std. Error of the Estimate** | |
|---|---|---|---|---|---|---|
| | .487a | 0.237 | 0.226 | 2.55866 | | |
| ANOVA | | Sum of Squares | df | Mean Square | F | Sig. |
| | Regression | 138.593 | 1 | 138.593 | 21.17 | .000b |
| | Residual | 445.179 | 68 | 6.547 | | |
| | Total | 583.771 | 69 | | | |
| Model Coefficients | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
| | | B | Std. Error | Beta | | |
| | (Constant) | 14.6 | 2.293 | | 6.367 | 0 |
| | Audit Case | 0.469 | 0.102 | 0.487 | 4.601 | 0 |

a Dependent Variable: Tax Audit Effectiveness

b Predictors: (Constant), Audit Case

## Discussions

The results from the regression model in Table 3 indicate that Audit case selection has a statistically significant effect on tax audit effectiveness in South Rift Valley Region ($\beta = 0.487$, $p < 0.05$). Moreover, the relationship was strong and positive implying that the implementers had put considerable emphasis on audit case selection so as to ensure that all high riskt taxpayers were well audited to give better tax yields. These findings concur with Mirera (2013) who found that there was a positive relationship between tax audit and tax revenue collected. These findings also support those of Mirera (2013) whose study on the effects of tax audit on tax revenue in Kenya Revenue Authority (Nairobi West Tax station) revealed that there was an increase in the tax paid after audit, especially for random tax audit, cut-off tax audit and conditional tax audit. The analysis of the tax revenue from a specific firm few years before the audit and two years after the audit depicted an increase in tax collected after the audit.

## Conclusions

Based on the results of the study, it was established that audit case selection was a factor of tax audit effectiveness in South Rift Valley Region. Imperatively, audit case selection was important in carrying out tax audit and was well understood by tax officers. Further, the parameters in risk based case selection procedures were enough to determine the level of risk of tax loss. Also the audit case selection procedures can be aplied to both individual and Corporate taxpayers.

In line with the study findings above the following recommendations are made; Concerning tax audit case selection, it was revealed that audit case selection was a factor of tax audit effectiveness in South Rift Valley Region. The study recommends that there is need to improve on the audit case selection procedures that can be applied on both large taxpayers in formal sector and small taxpayers in informal sector.

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