

PARLIAMENT
OF KENYA
LIBRARY



Office of the Auditor-General

Paper laid by the
Deputy Majority Whip
on Thursday 23/3/2017
~~Denay~~²

Performance Audit Report of the Auditor-General

Waiting-time in Payment of Value-Added-Tax Refund Claims

Kenya Revenue Authority

Foreword by the Auditor-General

I am pleased to publish and publicize this audit report that examines the processing and payment of Value-added-tax refund claims by the Kenya Revenue Authority. My Office carried out the audit under the mandate conferred to me by the Public Audit Act, 2003. Section 29(1) of the Act mandates me to assess the economy, efficiency and effectiveness with which the Government, a state corporation or local authority uses its resources.

Performance audits together with financial and continuous audits form the three-pillar audit assurance framework that I have established to give focus to the varied and wide scope of audit work done by my Office. The framework is intended to provide a high-level of assurance to stakeholders that public resources are not only disbursed, recorded and accounted for in the correct manner, but also that their use results in beneficial change in the lives of Kenyans. Therefore, the main goal of our performance audits is to promote effective use of public resources and delivery to Kenyans of public services of outstanding quality.

I have submitted the original copy of the report to the Speaker of the National Assembly to table in Parliament in accordance with Article 229 (7) of the Constitution. In addition, I have remitted copies of the report to the Cabinet Secretary for Finance and to the Principal Secretary at the National Treasury, and to the Commissioner-General, Kenya Revenue Authority.



EDWARD R.O. OUKO

AUDITOR-GENERAL

November 5, 2013

List of Abbreviations and Acronyms

DR	Domestic Revenue
DTD	Domestic Taxes Department
KRA	Kenya Revenue Authority
LTO	Large Taxpayers Office
MOF	Ministry of Finance
OAG	Office of the Auditor-General of Kenya
VAT	Value - Added -Tax

Table of Contents

Executive Summary	vii
Chapter 1: Background to the Audit.....	1
Introduction.....	1
Nature of Value-Added-Tax.....	1
Characteristics of an Efficient Tax Refund System.....	1
Motivation for the Audit.....	2
Chapter 2: Design of the Audit.....	4
Objective of the Audit.....	4
Scope of the Audit.....	4
Methods Used to Gather Audit Evidence.....	4
Assessment Criteria.....	5
Chapter 3: Description of the Audit Area.....	6
Statutory Mandate of the Kenya Revenue Authority on Value-Added-Tax.....	6
Governance and Organizational Structure of the Kenya Revenue Authority.....	6
Strategic Objectives of the Kenya Revenue Authority.....	8
How Value-Added-Tax Refunds Work.....	8
Key Provisions of the Value- Added- Tax Act.....	8
The VAT Refund Process.....	9
Sources of Funding for VAT Refunds.....	10
Chapter 4: Findings of the Audit.....	12
The KRA Does Not Pay Most VAT Refund Claims in Due Time.....	12
Why the KRA Delays Tax Refunds.....	13
The Annual Budget is not Sufficient to Pay all Claims Lodged by Taxpayers.....	13
The System that the Authority Uses to Process Refunds is Inefficient.....	15
Numerous audit procedures slow-down the processing of Claims.....	16
Units of the Authority assigned to process the refunds are understaffed.....	17
The VAT refunds function of the Authority is highly centralized and not properly linked to out-stations.....	18
The Authority is yet to specify the method it uses to prioritize claims for processing and payment.....	19
Some Taxpayers' do not Provide Sufficient Evidence on Claims Lodged.....	19
The Increase in the Number of Zero-rated Goods and Services.....	20
The VAT Withholding-tax Increased the Number of Claims.....	20
Chapter 5: Conclusions.....	22
Chapter 6: Recommendations.....	24
Appendices.....	26
Appendix I: Methods Used to Gather Audit Evidence.....	27
Appendix II: New Zero-rated Goods and Supplies between the 2007/08- /10 Financial Years.....	29
Appendix III: Response of the Kenya Revenue Authority Management on the Findings and Recommendations of the Audit.....	30

List of Charts

Figure 1: Sources of Government Tax Revenue.....	2
Figure 2: How VAT Refund Claims May Arise.....	9
Figure 3: Steps in the KRA's Refund Processing System.....	10
Figure 4: Amounts Claimed Compared To Budgetary Provisions.	15
Figure 5: Payable and Disallowed Claims.....	17

List of Tables

Table 1: Annual Budgetary Provisions for VAT Refunds	11
Table 2: Length of time Taken To Process VAT Refunds.....	12
Table 3: Comparison of VAT Claims and Budgets	14
Table 4: Time Taken To Process Claims.....	16
Table 5: Staff gap analysis in departments and sections dealing with VAT Refunds	18

Executive Summary

Introduction

1. The Kenya Revenue Authority is mandated under the Kenya Revenue Act 1995 to collect all taxes levied by the national Government and administer laws related thereto. While collecting and administering Value-added-tax (VAT) for example, the Authority processes and pays refunds of the tax arising from claims lodged by taxpayers. The refunds relate to one or more of circumstances or events specified under Section 24 of the Value-added-tax Act CAP 465. These include supply of zero-rated goods; tax paid in error; bad debts incurred on sale of goods and services on which Value-added-tax had previously been paid; perpetual credit balances in taxpayers' VAT accounts or decisions made by the Cabinet Secretary for the National Treasury to refund tax in public interest. To qualify for refund of Value-added-tax, the taxpayer must file a claim with the Authority in the prescribed manner to enable the management verify whether the claim is valid and payable.
2. Any tax refund system would be deemed to be efficient and effective if it is administered in a fair and timely manner devoid of inconvenience to the taxpayer and the tax authorities, and if it achieves its objectives at minimal cost. However, in Kenya, business leaders have over many years complained of delays by the Kenya Revenue Authority (KRA) in paying Value-added-tax refund claims.

What the Audit Examined

3. The audit examined the Value-added-tax refund system operated by the Kenya Revenue Authority. The objective of the audit was to establish the extent and reasons for delays in processing and paying Value-added-tax (VAT) refund claims submitted to the Authority by taxpayers. The refund claim balances examined were outstanding on various dates during the period of eight years and nine months ending 31 March 2013.

Why the Kenya Revenue Authority should process and pay claims in a timely manner

4. In authorizing the audit, the Auditor-General considered the important role an efficient tax refund system would play in enabling Kenya attain the purposes for which its tax laws are established:

Delayed refunds impede collection of taxes

- i. Delays by the Kenya Revenue Authority in paying VAT refund claims tie-down entrepreneurs' funds and may compel them to finance their operations through borrowed capital. High borrowing costs impair the capacity of business firms to grow and generate additional taxable income.

- ii. Value added tax is the second largest source of taxes to the Government and contributed about 28% of all taxes collected during the period under review. Further the tax has high potential for increasing government income because it is charged on consumption of goods and services.
- iii. Delays in refunding taxes, frustrate and disillusion business owners because they impede good relations between taxpayers and tax authorities and could tempt some taxpayers to evade taxes.
- iv. Delayed refunds punish businesses that fulfil their legal obligations-those who file returns and pay taxes - but give undue competitive advantage to tax evaders.

Delayed refunds denote an inefficient tax administration system

- v. Delays in refunding taxes contradict the principles of fairness, certainty, efficiency and convenience expected of every good tax administration system. To the contrary, short waiting-times before tax refunds are paid would exemplify an efficient tax system and satisfy the expectations of taxpayers on the quality of services provided to them by the Authority.
- vi. Further, the delays create and sustain negative perceptions on the competitiveness of the country's business environment and thus degrade the image of the country as a favourable destination for investors.

Findings of the Audit

- 5. The Kenya Revenue Authority does not pay the vast majority of tax refund claims within the 60 to 90-day waiting-time period promised in its Taxpayers Charter. Of the total value of claims sampled in the audit, 71% were paid more than 90 days after they were lodged with the Authority. In addition, the Authority paid 22% of the refund Claims after holding them for more than one year. As at 31 March 2013, the Authority had in its records outstanding VAT refund claims totalling to Kshs.26.58billion.

Why the Kenya Revenue Authority fails to process VAT refund claims on time

- 6. The Kenya Revenue Authority mainly delays in paying VAT refunds because it lacks sufficient funds to finance the payments. In addition, the Authority's refund processing and payment system is inefficient. Further, Value-Added-tax policies enacted by the Government over several years have increased the number and value of claims lodged by taxpayers with the Authority. These factors are explained briefly below and detailed in the Chapter 4 of the report:

Financial allocations for VAT refund payments fall short of amounts claimed

- 7. The Kenya Revenue Authority lacks sufficient funds to pay all the claims that it approves for payment. For example, in the period 2004/05 to 2011/12, the Authority set aside Kshs.97.3billion for payment of VAT refunds even though claims lodged by tax-payers totalled to 135.4billion.

8. Therefore, the budget fell short of the claims lodged by Kshs.38.1billion. While the management of the Authority asserted that the funds allocated to them by the Treasury to pay VAT refunds each year are not sufficient, officials at the Treasury said that they provide the Authority with all the funds it requests for the purpose.
9. Review of documents and interviews with senior managers of the Authority revealed that the Treasury and the KRA have never established objective criteria for estimating the funds required to finance VAT refund claims in each financial year. Therefore, the allocations are made in a subjective manner.

Numerous processing steps slow down the vetting and payment process

10. The Kenya Revenue Authority applies a long and winding procedure to process VAT refund claims. The system entails at least 34 steps spread over four main stages namely receipt, examination, review and approval for payment. The management of the Authority has not defined the length of time each claim should take in each of the steps or stages. Therefore, the Authority lacks an objective standard for measuring and controlling the efficiency of the system it uses to verify refund claims.
11. Although the Authority subjects all VAT refund claims to a vigorous verification process, analysis of its records revealed that it eventually pays up to 90% of the claims it receives and verifies. Therefore, by adopting a risk-based verification process and profiling taxpayers, the Authority could reduce the pre-payment work it carries out on claims lodged by taxpayers it deems to be trustworthy.
12. Further the Authority's management information system does not share data on taxpayers among various Departments and users. For example, the system does not relate refund claims lodged to tax returns filed and taxes paid by each taxpayer. The Authority has since 2004 been implementing a modernization programme intended to improve its operational efficiency with a view to enhance tax collection and improve the quality of services it provides to taxpayers. Among the stated ambitions of the programme is to enable the various Departments of the Authority to share information on tax payers. The management of the Authority cite shortage of funds as the main reason why the programme has taken so long to implement.

Units assigned to process VAT refund claims are understaffed and have other duties they tend to

13. The number of staff assigned to process VAT refund claims is not sufficient. At the time of the audit, the staff complement in the sections of the Authority assigned to process the refunds was equivalent to only 60% of the number provided for in the Authority's establishment. Further, the main duties allocated to the staff are tax collection and audit, and not processing of refunds. Since appraisals of their job performance mainly consider how well they perform their primary and not secondary responsibilities, the staff dedicate most of their time to tax collection and audit duties.

All the claims are processed at the Head Office through a manual processing system

14. All refund claims including those received at the Authority's regional offices are processed and paid at the KRA head office in Nairobi because the electronic system used by the Authority to process the claims does not function in the regional stations. Therefore, during the refund process, files in manual format have to be moved back-and-forth between the regional stations and the head office. Each movement cycle takes time to accomplish and therefore delays the verification and eventual payment of claims.

Some taxpayers fail to provide the Authority with sufficient evidence on the claims that they lodge

15. Before the Authority pays any refund, it demands sufficient reliable and relevant evidence from the claimant to ensure that the claim is valid in all respects. However, failure or delay by some claimants to submit sufficient evidence prolongs the time that the Authority takes to approve and pay the respective refunds.

Legal Provisions on Withholding Value-added-tax increased the volume of refund claims

16. The Value-added-tax withholding tax system in operation between October 1 2003 and July 1 2011 contributed much to the increase in the number of claims and value of refund claims lodged by taxpayers. Under the system, designated tax agents were required to deduct Value-added-tax on supplies made to them by registered tax payers. The suppliers were still expected to pay the deducted taxes when filing their monthly returns and as a result, the Value-added-tax accounts of some taxpayers remained in credit position perpetually. The taxpayers were entitled to refund of tax from the Authority. The Authority suspended the system in July 2011 as it sought to reduce the high rate increase of VAT refund claims.

Increase in the number zero-rated goods over the years

17. Legislative changes made over the years increased the number and range of zero-rated items allowed under the Value-Added-Tax Act. For example, between the 2007/08 and 2009/10 financial years alone, 18 new items were added to the zero-rated list. As at June 2012 the number of zero-rated items were estimated to be in the range of 300 to 400. Taxpayers dealing in such items are eligible for refunds since they do not pay output tax on the items. The Authority says it has chosen to carry out detailed audits before all such claims are paid after noting that many of the invalid claims it receives relate to zero-rated goods and services. The Government introduced for debate in Parliament early in the 2013/14 financial year a new Value-Added Tax Bill intended reduce the number of zero-rated goods.

Conclusions

18. The Kenya Revenue Authority does not process and pay the vast majority of VAT refund claims within the 90 day-period promised in its service delivery charter. Upto 71% of claims wait for more than 90 days before they are paid. The delays frustrate taxpayers and hinder the Government from running an efficient and effective tax administration system. Further, the delays have increased the burden that taxpayers have to bear to comply with tax laws.
19. The delays are caused by planning and operational weaknesses in the Authority's refund processing system. Firstly, the Authority does not allocate sufficient funds to pay all the claims that it approves for payment in each financial year. In addition, the system used by the Authority to process the claims is inefficient and as a result, much time is required to process each claim before it is paid. Also, some taxpayers do not provide sufficient and reliable evidence to support the claims they submit to the Authority. Further, there are too many goods and services zero-rated for Value-added-tax as a result of fiscal policies enacted by the Ministry of Finance over the years. The volume of claims lodged by traders has therefore risen sharply even as the Kenya Revenue Authority faces resource and operational system constraints that impede timely payment of VAT refund claims.

Recommendations

20. To reduce the long waiting-times endured by tax-payers who lodge VAT refund claims, the Authority's planning and operational framework for VAT refunds should be reformed. Firstly, the Treasury should provide the Authority with sufficient funds to settle the backlog of approved claims and pay future ones in time. Secondly, the Treasury should propose fiscal policy and legislative changes that simplify the Value-added-tax systems by reducing the number of items over which VAT refunds are payable.
21. Thirdly, the management of the Authority should address the organizational inefficiencies that prolong the time taken to vet and pay the claims. In addition, the management should hasten the implementation of the modernization programme expected to quicken the processing of refund claims through adoption of Information Communication Technology (ICT)-based processing systems. Further, the Authority should improve the quality of communication and feedback it provides to taxpayers especially those who have to wait for long periods before their claims are paid.

22. The Auditor-General has recommended several actions that the Treasury and the management of the Kenya Revenue Authority may take to ensure that Value-added-tax refund claims are processed in a timely manner. The recommendations are presented in Chapter 6 of the report. The management of the Authority have read the report and have agreed with its findings and recommendations. Their comments are highlighted in Appendix III.

Chapter 1

Background to the Audit

Introduction

- 1.01 This audit report examines the performance of the Kenya Revenue Authority (KRA) in processing tax refund claims lodged with the Authority by entities who trade in goods and services subject to Value-added-tax. The Auditor-General commissioned the audit under authority given to him in Section 29 of the Public Audit Act 2003. The report shall be tabled in Parliament as outlined under Article 229(7) of the Constitution of Kenya and Section 31 of the Public Audit Act CAP 412A.

Nature of Value-added-tax

- 1.02 Value-added-tax (VAT) is a consumptive tax levied on purchase of taxable goods and services whether produced locally or imported from abroad. It is an indirect tax paid by consumers but collected for the Government by traders who are referred to as Tax Agents. Legal provisions on the tax are contained in the Value-added-tax Act CAP 476 of the Laws of Kenya as well as in related regulations issued by the Commissioner of Value-Added-Tax.
- 1.03 The Value-added-tax Act specifies three rates of tax namely;
- i. 16% - the general rate charged on taxable goods and services other than zero-rated supplies and
 - ii. 12% - the rate is applicable to several items specified under the 2nd Schedule of the VAT Act. Examples of the items include electrical energy, and residual oils and fuels and;
 - iii. 0% - applicable to zero-rated supplies which include various exports, agricultural machinery, pharmaceutical products, educational materials, supplies to privileged persons and farm inputs among other goods.

Characteristics of an efficient tax refund system

- 1.04 Any tax refund system would be deemed to be effective if it is administered in a fair, cost-effective and timely manner devoid of inconvenience to the taxpayer and the tax authorities, and as prescribed in relevant regulations. However in Kenya, the processing and payment of Value-Added-Tax refund claims is deemed by business managers and owners as having failed to attain these qualities.
- 1.05 The Kenya Revenue Authority has over the years been criticised for taking too long to refund VAT refund claims. A preliminary study conducted by the Office of the Auditor-General obtained data that confirmed that indeed prolonged delays occur before the Authority pays VAT refunds.

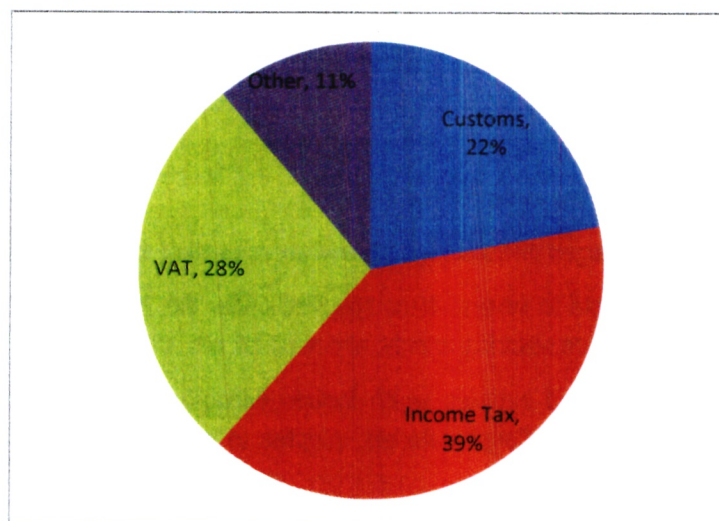
Motivation for the Audit

- 1.06 The Auditor-General authorized the audit after having considered the following factors:

Value-Added-Tax is a significant contributor to total ordinary revenue collected by the Government

- i. Value-added-tax forms a significant portion of the total tax revenue collected by the Government. For example, records of the Ministry of Finance indicated that Value-added-tax contributed Kshs.808.3billion to total tax revenue collected by the Government between 2004/05 and 2010/11 financial years. This was equivalent to about 28 % of the aggregate sum of Kshs.2.92trillion collected from all taxes.

Figure 1: Sources of Government Revenue Tax 2005/06-2011/12:



Source: OAG Analysis of KRA data

Among all the taxes collected by the Government between the 2005/06 and 2011/12 financial years, VAT collections are the second largest after Income Tax.

Delays in refunding VAT claims are detrimental to business operations and could affect Government revenue and the welfare of citizens

- ii. Delays by the Kenya Revenue Authority in paying VAT refund claims deny taxpayers access to their working capital. The delays may compel tax-payers to borrow at high costs to finance their operations and thus inflate prices of goods and services to the detriment of the welfare of citizens. High costs may precipitate reduced business activity and thus constrain the capacity of businesses to generate tax revenue for the Government. Further, high costs compromise the competitiveness of the economy internationally and may therefore hamper the attainment of national development goals.

Complaints by traders over delays by the KRA in refunding VAT Claims

- iii. Tax-agents have over the years complained about delays in payment of VAT refunds. They consider the delays to be unfair since the Authority penalizes them when they fail to pay taxes on time but does not compensate them when it delays the refunds. A preliminary study conducted by the Office confirmed that there were indeed long delays before the Authority paid claims lodged by taxpayers.

Delays in paying VAT refund Claims hinder the development of an effective tax administration system

- iv. Long waiting times disillusion taxpayers and may tempt them to avoid or even evade paying taxes. In addition, the delays contradict the principles of convenience, fairness, certainty and efficiency that any good tax administration system should exemplify. To the contrary, short waiting times would denote efficiency on the part of the Authority and satisfy the expectations of taxpayers on the quality of services due to them from the Authority.

Chapter 2

Design of the Audit

Objective of the Audit

- 2.01 The objective of the audit was to establish the extent and causes of delay by the Kenya Revenue Authority in processing and paying Value-Added-Tax claims filed with the Authority by taxpayers.

Scope of the Audit

- 2.02 The audit examined the system used by the Domestic Revenue and the Large Taxpayers Offices of the Kenya Revenue Authority to process VAT refund claims during the period of eight-and-a-half years ended 31 December 2012. The final balances of refund claims considered were those outstanding as at 31 March 2013.

Limitation of Scope

- 2.03 Our findings should be considered in light of the constraints we faced in conducting this assignment. The scope of the audit was hampered by the inability of the audit team to access all the data and records maintained by the Authority on the refunds. The team examined only 301 refund claim files that represented approximately 35% of the scientifically generated sample of 864 files requested from the KRA management. The management said they were unable to submit the remainder 545 files for audit because they were in use in various Departments of the Authority.

Methods Used to Collect Audit Evidence

- 2.04 The audit was conducted in accordance with Performance Auditing Guidelines issued by the International Organization of Supreme Audit Institutions (INTOSAI) and audit policies and procedures established by the Office of Auditor-General. The guidelines and policies conform to the requirements of International Standards on Auditing.

- 2.05 To understand the system applied by the Kenya Revenue Authority in processing VAT refund claims, the audit team examined various documents and records and interviewed managers responsible for administering the Authority's Value-Added-Tax refund system. A scientific sample of taxpayer files was drawn and data on time taken to process and pay the claims recorded and analysed. Analysis of the data provided much of the evidence on waiting-time discussed in the report.
- 2.06 The methods used to gather audit evidence are explained in detail in Appendix I of this report.

Assessment Criteria

- 2.07 Audit criteria used to measure the performance of the Kenya Revenue Authority were drawn from service standards set by the management of the Authority and published in its Tax Payer's Charter. The Charter contains waiting-time standards on processing and payment of refund claims lodged by taxpayers. In instances where the Authority had not established quantifiable performance targets, we referred to good management principles on planning, staffing and queue management to measure the Authority's performance in processing the refund claims. The specific criteria used to assess the performance of the Authority are highlighted against the respective audit findings in Chapter 4 of this report.

Chapter 3

Description of the Audit Area

Statutory Mandate of the Kenya Revenue Authority

- 3.01 The Kenya Revenue Authority (KRA) was incorporated in 1995 under the Kenya Revenue Authority Act for the purpose collecting tax revenue for the Government and administering laws on taxation. The Authority pays the collections into the Consolidated Fund which is managed by the National Treasury. The receipts are thereafter allocated to various national needs as prescribed in the Constitution and appropriated by Parliament in the annual national budget.

Organization Structure of the Kenya Revenue Authority

Governance and Executive Arrangements

- 3.02 The Authority is a corporate agency of the Government with perpetual succession and a common seal. The affairs of Authority are supervised by a Board of Directors made up of ten members. The Chairman of the Board is appointed by the President of Kenya.
- 3.03 The Chief Executive of the Authority is the Commissioner-General who is appointed by the Cabinet Secretary for the National Treasury under Section 11(1) of the Kenya Revenue Authority 1995 Act. He exercises authority over the operations of the Authority subject to the general supervision and control of the Board of Directors.
- 3.04 The members of the Board are prescribed in Section 6 of the Act. In addition to the Commissioner-General, the Board has nine other members namely; the Attorney-General and the Principal Secretary, National Treasury (or their respective representatives); six other persons appointed by the Cabinet Secretary for the National Treasury by virtue of their knowledge and experience in Accountancy, Commerce, Law, Taxation, Business or Public Administration; and a Secretary appointed by the Board.

Departmental and Regional Structure of the Authority

- 3.05 The Authority is organized into nine departments each of which is assigned specific roles and responsibilities. Three of the Departments namely; Customs Services, Domestic Taxes and Road Transport collect taxes and administer the respective tax laws. Each of the three departments is headed by a Commissioner who reports to Commissioner-General. The remainder six departments provide managerial and administrative support services needed to run the operations of the Authority. The departments are:
- i. Customs and Excise Services Department
 - ii. Domestic Taxes Department
 - iii. Road Transport Department
 - iv. Support Services Department
 - v. Human Resource Department
 - vi. Internal Audit
 - vii. Marketing and Communication
 - viii. Investigation and Enforcement
 - ix. Information and Communication Technology
- 3.06 In addition to its head-office located in Nairobi, the Authority operates five cross-functional regional offices. Each of the offices is headed by a Regional Representative appointed by the Commissioner-General at the level of Deputy Commissioner or Senior Deputy Commissioner. The regional offices are as follows:
- i. North Region
 - ii. Southern Region
 - iii. Rift Valley Region;
 - iv. Western Region
 - v. Central Region
- 3.07 Matters relating to Value-Added-Tax are administered by two Departments of the Authority. The Customs and Exercise Department collects and accounts for taxes (including value-added-tax) levied on imports while the Domestic Taxes Department is responsible for taxes levied on goods and services traded locally. As for Value-added-tax refunds, it is the Domestic Taxes Department that takes responsibility for their processing and payment.

Strategic Objectives of the Kenya Revenue Authority

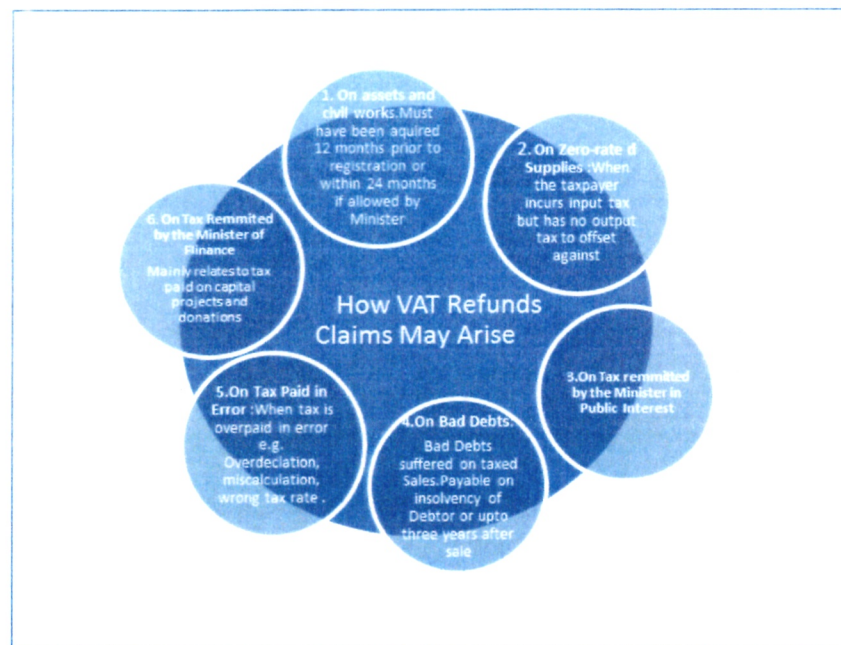
- 3.08 The Fifth (2012/13-2014-15) Corporate Plan of the Kenya Revenue Authority, restates the Authority's commitment to develop a dedicated professional team, embrace modern processes and technologies, and deliver customer-focused services that enhance compliance with tax laws and increase revenue collection. Among the strategic goals of the Authority during the period is to enhance efficiency and operational effectiveness, raise performance standards and lower tax collection costs and improve customer services to meet international best practice.
- 3.09 The ambitions were carried over from the Authority's Second(2003/04-05/06),Third (2006/07-2008/09) and Fourth (2009/10 -2011/12) Corporate Plans which had sought to modernize tax administration by automating and integrating key functions to attain high levels of operational efficiency. Among the objectives set by the management of the Authority under the programme was to obtain and use all useful information obtained on each taxpayer and thus create a 'single-view' of the taxpayer. In addition, the modernization programme was intended to promote tax compliance and meet revenue collection targets at least cost.

Key Legal Provisions on Value-Added-Tax

- 3.10 Value-Added-Tax is collected and administered as specified in the provisions of the Value-Added Tax Act CAP 476. Consumers of chargeable goods and services pay the tax to suppliers whom the Value-Added-Tax Act has designated as tax collection agents of the Commissioner of Value-Added-Tax.
- 3.11 The Sixth Schedule of the Act prescribes the annual sales turnover thresholds at which traders in goods and services should register as Value-added-tax agents. The traders must have supplied or expect to supply taxable goods or services, whose value is five million shillings or more in a period of twelve months. However, any trader whose sales turnover fell below the threshold may still register as a tax agent. Further, some businesses, for example, dealers in motor vehicle spare parts, electronics, timber, jewellery and professional services, are required to register as tax agents irrespective of their turnover in sales.

How Value-added-tax Refunds Arise

- 3.12 Section 24 of the Value-Added-Tax Act outlines the circumstances under which traders in designated goods and services may claim refund of Value-added-tax paid to the Kenya Revenue Authority. The illustration below shows the six main ways in which VAT refunds become payable to the traders:



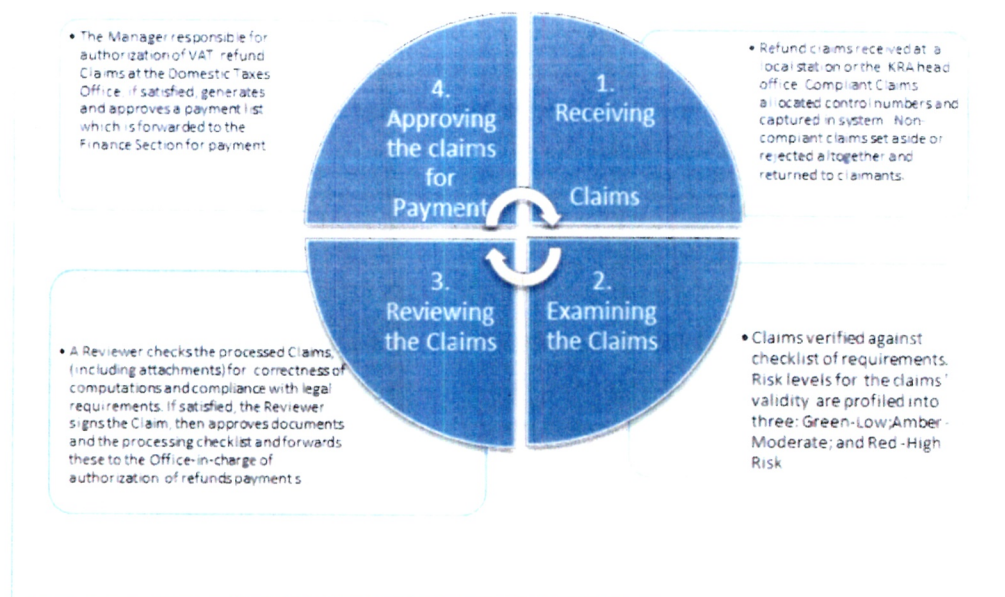
Source: OAG Analysis of the Provisions of the VAT Act

Figure 2: How VAT Refund Claims arise- in one of six main ways.

- 3.13 A taxpayer may also claim refund of Value-added-tax in the event that his Value-added-tax account remains in credit for long. This happens often with tax-payers who make supplies to designated withholding tax agents. The agent deducts the VAT charged on the supplies and remits the tax to the Kenya Revenue Authority. The supplier will still be required to file returns and pay all the tax due including the sum deducted by the withholding tax agent. When such claims remain pending for long, the taxpayer may claim the credit balance by filing a refund claim in the manner prescribed in the Value-added-tax Act. However the VAT Withholding tax regulations were rescinded in July 2011.

The Value-Added-Tax Refund Process

- 3.14 The management of the Authority verifies each claim before it is paid. The verification process involves numerous steps undertaken through the four stages namely receipt, examination, review, and approval. The four stages are illustrated in Figure 3 below:



Source: OAG Analysis of the KRA VAT refund System.

Figure 3: Steps Followed By the KRA in Processing VAT Refunds

Sources of Funding for the Authority

Financing Operational and Capital Expenditures

- 3.15 The mode of financing for operational and investment activities of the Authority is provided for in Section 6 of the Kenya Revenue Act CAP 469. The Section provides that the Funds of the Authority shall consist of;
- Amount of between one and two per cent of total revenue collected by the Authority each year as may be determined by the Cabinet Secretary for the National Treasury. The funds are payable to the Authority by the National Treasury on or before the beginning of each month.
 - Bonuses equivalent to 3% of the excess of the total amount of taxes collected over the estimated sum in any three-month period of the financial year. The bonuses are payable within one month of the end of the three-month period.
 - Loans and grants received by the Authority with approval of the Cabinet Secretary.
 - Any other monies as may be approved by the Cabinet Secretary received or made available to the Authority for the purpose of performing its functions.

- 3.16 Funds not used at the end of the financial year are placed in a reserve to be expended in future as provided in the budget of the Authority.

Financing Refunds of Value-Added-tax

- 3.17 Records maintained by the National Treasury and the Kenya Revenue Authority indicate that it is the management of the Authority that sets the annual budget for VAT refunds. The Authority thereafter requests the Treasury to authorize the Central Bank of Kenya to transfer the funds from the VAT Collection Account to the VAT Payment Account.
- 3.18 Over the nine financial years to June 2012, the Ministry of Finance provided a total of Kshs.98.8 billion to the Authority for use in payment of VAT refunds. The sum was made up of a total of Kshs. 97.3 billion in annual provisions and an emergency allocation of Kshs.1.5 billion made during the 2006/07 financial year as shown in Table 1 below. Therefore, the average sum allocated in each of the eight financial years was Kshs.12.35billion.

Financial Year	Provision for VAT Refunds in KRA's Books (KShs. millions)	Amounts Received from Treasury for Refunds (KShs. Millions)
2004/05	8,400	8,400
2005/06	10,328	10,328
2006/07	12,300	12,300
2007/08	12,169	12,169
2008/09	14,160	14,160
2009/10	14,160	14,160
2010/11	12,912	12,912
2011/12	12,912	12,912
Total	97,341	97,341

Source: OAG Analysis of KRA data

Table 1: Annual Budgetary Provisions for VAT Refunds

Chapter 4

Findings of the Audit

The KRA does not pay most VAT refund claims in due time

- 4.01 The Taxpayers Charter of the Kenya Revenue Authority commits the management of the Authority to fulfil the expectations of taxpayers on delivery of tax administration services. As concerns Value-Added-Tax refunds, the Charter promises that any valid refund claim received by the Authority shall be processed within 60 days of its receipt so long as it is accompanied by an audit tax certificate together with the relevant supporting documents, and is complete in all other respects. Should the Authority require additional information from the taxpayer before it approves the claim, the Charter states that the waiting-time from the filing of the claim with the Authority to its payment should not last more than 90 days.
- 4.02 However, an analysis of the sample of refund claims examined by the audit team revealed that only 29% of the claimants were paid within the extended waiting-time period of 90 days stipulated in the Service Charter. Therefore, the KRA failed to pay 71% of VAT refund on time. The table below shows the various lengths of delay revealed by examining a sample of 294 claims lodged with the Authority between the 2007/08 and 2009/10 financial years alone:

Waiting Time	07/08 % of Claims in Sample	08/09 % of Claims in Sample	09/10 % of claims in Sample	As a % of all Sampled Claims Processed over the three-year Period
≤ 90 Days	23%	10%	100%	29%
91-180 Days	33%	31%	-	30%
180-270 Days	13%	15%	-	12%
271-360 Days	6%	10%	-	7%
>360 Days	19%	33%	-	22%

Source: OAG Analysis of KRA Data

Table 2: Length of time taken to Process and Pay VAT Refunds: From the audit sample, only 29% of claims lodged with the Authority were processed within the 90-day upper limit waiting-time standard set by the Authority

- 4.03 The KRA says in its current strategic plan that it will strive to provide timely, reliable and affordable services to taxpayers. However, as the data in Table 2 shows, the Authority has not fulfilled its commitment to traders who file VAT refund claims. As at 31 March 2013, its records reflected longstanding VAT refund claim balances totalling to Kshs.26.6 billion.
- 4.04 Delayed refunds tie-down taxpayers' funds for long periods and thus deny businesses access to affordable working capital. Taxpayers may, as a result, have to borrow costly working capital to keep their operations going and this may have adverse effects on business turnover and profit and eventually on quantity of tax payable to the Government.

Why the Kenya Revenue Authority Fails to Pay VAT Refund Claims in Due time

- 4.05 Analysis of evidence collected during the audit revealed that delays by the Kenya Revenue Authority in refunding VAT were caused by the following factors;
- i. Failure by the Authority to allocate sufficient funds to finance payment of the refunds;
 - ii. Inefficiency of the system used by the Authority to process the refund claims;
 - iii. Failure by taxpayers to observe regulations governing the submission of VAT refunds claims;
 - iv. Increase over the years in the number of goods and services zero-rated for VAT and;
 - v. Provisions allowing traders to file refund claims under Withholding Value-added-tax regulations applicable up to 30 June 2011.
- 4.06 These factors are discussed in detail in the remainder of the findings of the report:

The Authority's annual budget for VAT refunds is not sufficient to pay all claims filed by taxpayers

- 4.07 Comparison of the Authority's annual budgets for the period under review revealed that on average, provisions for VAT refunds made by the Authority catered for 73% of the total claims lodged by traders in each financial year. As Table 3 shows, the Authority set aside only Kshs.97.341 billion to pay VAT refund claims between the 2004/05 and 2011/12 financial years even though claims lodged by taxpayers during the period totalled to Kshs.135.435billion. This resulted in a deficit amounting to Kshs 38.094billion which was equivalent to 29% of the the claims lodged. Clearly, the annual provisions made by the Authority to cater for VAT refunds were not sufficient to pay all the claims lodged by taxpayers.

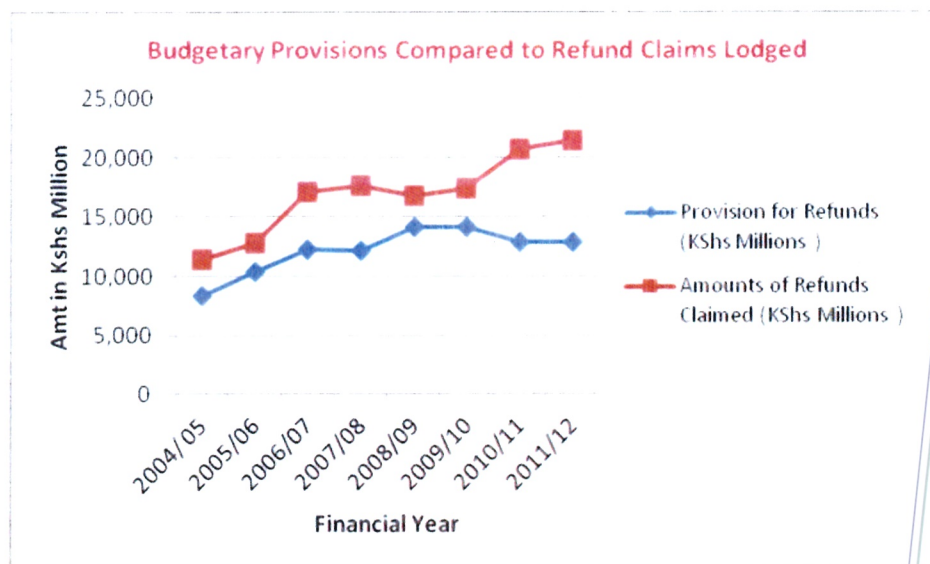
- 4.08 Further, while allocations for VAT refunds made during the period grew at the rate of 7%, the annual rate of growth in claims lodged was 10%. Unpaid claims brought forward from previous years worsened the situation.

Financial Year	Provision for Refunds (KShs. Millions)	Amounts of Refunds Claimed (KShs Millions)	Shortfall (KShs Millions)	% of Provisions to Claims Lodged
2004/05	8,400	11,469	(3,069.00)	73%
2005/06	10,328	12,829	(2,501.00)	81%
2006/07	12,300	17,129	(4,829.00)	72%
2007/08	12,169	17,633	(5,464.00)	69%
2008/09	14,160	16,838	(2,678.00)	84%
2009/10	14,160	17,441	(3,281.00)	81%
2010/11	12,912	20,682	(7,770.00)	62%
2011/12	12,912	21,414	(8,502.00)	60%
Total	97,341	135,435	(38,094.00)	72%
Average	12,168	16,929	(4,761.75)	73%

Source: OAG Analysis of KRA data.

Table3: Comparison of VAT Claims and Budgets 2004/05 – 2011/12: Budgetary allocations amounted to 72% of the amounts required to pay the claims lodged by taxpayers during the period under review.

- 4.09 The funds that the National Treasury provided to the KRA to pay VAT refunds increased from Kshs 8.4billion in 2004/05 to Kshs 14.160billion in 2008/2009, then reduced to 12.912 billion in 2011/12. In addition, the Ministry granted the Authority Kshs1.5billion in the financial year 2006/07 to settle the backlog of unpaid claims brought forward from previous years. Still, the provisions together with the emergency allocation could not match the total value of the outstanding claims and as a result, the deficit increased in each new financial year. For example, the budgetary provisions for VAT refunds made by the Authority for the year 2012/13 amounted to Kshs. 12.912billion. However, as at 31 March 2013 or three months to the end of the financial year, new claims filed with the Authority in the year totalled to Kshs.13.54billion. Therefore, claims for the first nine months of 2012/13 financial year had already surpassed the annual provision by Kshs. 640million with three months of the year still to go.
- 4.10 The under-allocations resulted in a large backlog of unpaid claims. Copies of correspondence between the Authority and the National Treasury revealed that it is the management of the KRA that sets the budgetary provision for VAT refunds in each financial year and thereafter requests the Treasury to authorize and provide for the funds. After authorizing the budget, the Treasury instructs the Central Bank of Kenya to transfer the funds from the VAT Collection Account to the VAT Payment Account as the need to replenish the Account may arise during the financial year.



Source: OAG Analysis of KRA data

Figure 4: Amounts Claimed compared to Budgetary Provisions: The Value of claims surpassed the budgets for refunds in each of the years under review.

- 4.11 However, the method that the Authority uses to estimate the sum it requires to finance the refund claims in each new financial year is not clear. Officials of the Economic Affairs Department of the Ministry of Finance confirmed to the audit team confirmed that no objective criterion or formula had been set for estimating the annual budget for payment of VAT refunds. Therefore, the allocation is not based on any objective analysis of expected changes in economic activity or projected growth in Value-Added-Tax collections or any other measurable consideration.
- 4.12 Instead, the allocation is negotiated between the Treasury and the management of the Authority. While management were of the view that the funds allocated by Treasury in each financial year are not sufficient to pay all VAT claims lodged in the year, the officials of the the Ministry asserted that they always provide the Authority with the funds that it asks for.

Inefficiencies in the Authority's VAT refund system slow-down the processing of claims

- 4.13 In addition to budgetary shortfalls, several operational weaknesses in the system used by the KRA to process VAT refunds hamper timely payment of the Claims. The weaknesses are explained in paragraphs 4.15 to 4.37 below:

(i) Numerous audit procedures slow-down the processing of Claims

- 4.14 VAT refund procedures applied by the KRA entail at least 34 (thirty-four) steps spread over four stages, namely Receipt, Examination, Review and Approval. The steps are illustrated in Figure 3 on Page 10 of this report. The receiving process is undertaken in six(6) steps, examination and processing in thirteen(13), reviewing in four (4) and the final stage-approval and forwarding- in eleven (~1) steps. A claim under process has to pass through each of the four phases before it is approved for payment. The stages and steps are followed sequentially and many are executed by different units of the Authority. Therefore, to access any claim, the examiner has to wait until it is cleared at the preceding stage. In the event that the validation of a claim is halted for whatever reason, the process has to stop until the claim file is released from where it was docked. Inevitably, the very large number of sequential steps prolongs the time taken to pay refund claims.
- 4.15 A review of the sampled claimants' files obtained for audit revealed that the claims were delayed in each of the stages. On average, it took 212 days to examine a claim, 25 days to review it, a further 18 days for the claim to be authorized for payment, 13 more days to approve it, and finally nine(9) days before the approved claim was paid. As the data in Table 4 below shows, the sample revealed that an average of 277 days went by before each claim was processed and declared as payable. Therefore, taxpayers waited much longer than the 60 to 90 day promised in the Authority's Taxpayers Charter:

	2007/2008	2008/2009
Activity/Procedure	Average No. of days	Average No. of days
Receipt to examination	212	176
Examination to review	25	20
Review to Authorization	18	21
Authorization to approval	13	8
Approval to payment	9	7
Waiting-time from Lodgement to Approval for Payment	277	232

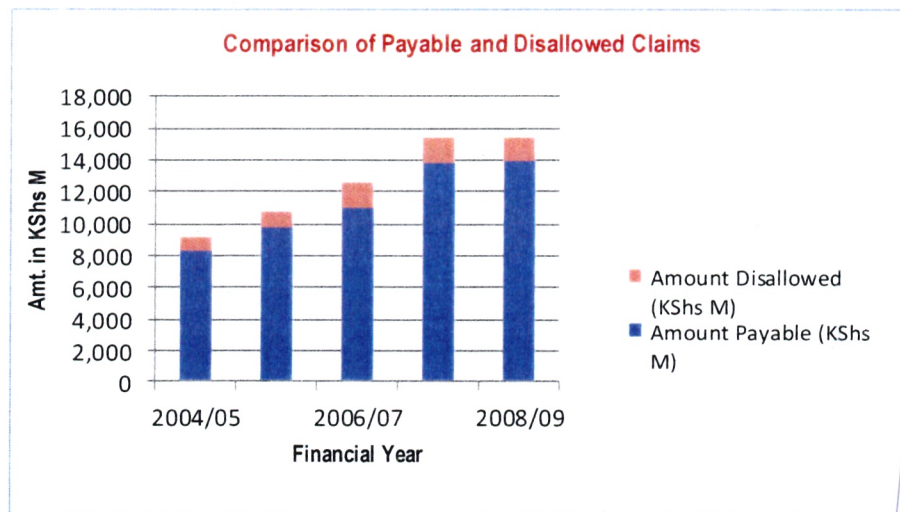
Source: OAG Analysis of Claimants Files.

Table 4: Average No. of Days taken to process a Claim: The turnaround time for each step or Phase of the refund process is not stated.

- 4.16 Although the Taxpayers Charter stipulates that every VAT refund claim received by the Authority shall be processed within 60 days if it is accompanied by an audit certificate (or in not more than 90 days if it arrives uncertified), the Authority's VAT Refund Operational Manual does not state the standard time each claim should take in each of the four stages or in the numerous steps included in each stage. Therefore, staff who process the refunds are not required to complete their respective tasks within a standard time-frame.

As a result, they have no compelling incentive to process the claims quickly. Further, in the absence of a time standard, the efficiency of the employees cannot be controlled.

- 4.17 Records maintained by the KRA on the refunds indicated that out of the total claims totalling Kshs.63.372billion that the Authority processed between the 2004/05 and 2008/09 financial years, claims totalling to Kshs 56.796billion (or 90%) were eventually approved for payment. Therefore, only a paltry 10% (Kshs.6.576 billion) of the total claims filed by taxpayers were found not to be valid. Thus, the Authority could opt to conduct post-audit of claims lodged by its trusted taxpayers instead of subjecting their claims to vigorous pre-audits that delay payment of the refunds and thus frustrate claimants, including those who pay the largest amounts of taxes and observe all tax regulations.



Source: OAG analysis of KRA data

Figure 5: The Authority accepted as payable 90% of the VAT Refund Claims Lodged. Therefore the could thus change its approach and rely more on risk-profiling of taxpayers in choosing the claims to audit before payment and conduct post payment audits of claims received from trusted taxpayers

(ii) Units of the Authority assigned to process the refunds are understaffed

- 4.18 KRA managers interviewed for the audit cited shortage of staff as a major cause for delay in processing VAT refunds. At the time of the audit, the Large-Tax-Payer and Domestic Revenue Departments were, respectively, five and seven officers short of the number of technical staff provided for in the Authority's staff establishment.
- 4.19 Similarly, the Kisumu KRA Office had seven (7) staff members only performing taxpayer audits (VAT refund and Income Tax audits) even though nineteen (19) were prescribed for the Station in the staff establishment. Therefore the Station had shortfall of twelve (12) staff members:

Staff Resource Gap Analysis in VAT Refund Processing

Department/Station		Ideal Staffing	Actual No. of Staff Deployed	Shortfall
Large taxpayers office(LTO)		20	15	5
Domestic Revenue (DR)		22	15	7
Kisumu		19	7	12
Meru		11	7	4
Mombasa North		16	9	7
Staffing Levels	Totals	88	53	35
	Percentage	100%	60%	40%

Source: OAG analysis of KRA data

Table 5: Staffing levels in select KRA Stations: On average, the stations had only 60% of the number staff they required to carry out their responsibilities

- 4.20 Further, besides processing of VAT refund claims, the staff are assigned additional duties that include taxpayer education, registration and recruitment as well tax collection and audit. Staff assigned tax collection duties prioritize such work because it counts for their performance appraisals and therefore not only enhance their job security but also influences their prospects for promotion to higher grades.
- (iii) The VAT refunds function of the Authority is highly centralized and not properly linked to out-stations
- 4.21 The Authority processes and pays all VAT refund claims at its head office in Nairobi. Regional stations receive VAT refund applications from taxpayers, vet them for validity, completeness and accuracy, and then forward them to the head office for pre-audit, processing and finally, payment.
- 4.22 Claims certified by taxpayer auditors are forwarded to the head office upon receipt at the stations while those without the certificates are first audited before they are sent to the head office for further processing and payment. Therefore, except for auditing, all other refund processing procedures are carried out at the head office.
- 4.23 However, the software program that the Authority uses to process VAT refunds is installed at the head office but not in the outstations. The head office and the stations therefore work under two different operational platforms- electronic and manual. The mismatch is compounded further by lack of full automation at the head office.
- 4.24 The shortcomings hinder the attainment of efficient and effective communication and co-ordination between the head office and the stations on the status of refunds under: Since, the stations have no real-time access to information on the progress achieved by the head office in processing the files that they send there; they are unable to provide taxpayers with timely feedback on the status of the claims sent to the head-office for verification and

payment. This adds to taxpayers' frustration with the system. In addition, much time is wasted moving files between the head office and the stations.

- 4.25 The Authority has over the last ten or so years been implementing a modernization programme that seeks to enhance efficiency in its operations through, among other means, use of Information Communication Technology in its tax administrative functions. The Authority's Second, Third and Fourth Corporate Plans implemented in three-year cycles between the 2003/04 and 2011/12 financial years had all emphasised the need for the Authority to adopt modern technology in its operations. The plans outlined various strategies and activities aimed at using technology to attain what the management called 'a single view of the taxpayer'. The current plan (2012/13-14/15) has restated these ambitions. Some of the processes of the Authority have been automated but many, including those relating to VAT refund claims, have not.

(iv) The Authority has not specified the method it uses to prioritize claims for processing and payment

- 4.26 Common practice in management requires that the First-in-First Out(FIFO) method be followed in providing services to ensure fairness in service delivery. For the KRA, it may be assumed that tax refund claims that are received first would be processed first. However, the Authority has made no such undertaking to taxpayers. Therefore, there is risk that priority in processing claims could be given to late claimants at the expense of deserving ones made to wait for long before they are paid.
- 4.27 Examination of claim files sampled by the audit team revealed that the time to process and pay claims received by the Authority ranged from seven (7) to 3,003 days or about eight years. It was not clear why some claimants were served very fast while others were made to wait for so long. Lack of measurable standards on waiting-time and insufficient clarity on the order in which claims are to be processed may hinder objectivity and encourage malpractices in the refund payment process.

Some taxpayers do not provide the Authority with sufficient evidence in support their claims

- 4.28 The Authority verifies all claims before it pays them. Section 12 (1) of the VAT Regulations 1994, specifies the documents that should accompany each VAT refund claim filed with the Authority and the general conditions to be met before each claim is paid.
- 4.29 However, in all the KRA stations that the audit team visited, the managers cited failure by the claimants to provide key documents in support of their claims as one of the main challenges faced by the Authority in processing VAT refund claims. In instances where supporting evidence is lacking or insufficient, delay in processing claims follow as the Authority seeks for more information from the respective taxpayers.

Effects of the increase over the years in the number of zero-rated goods and services

- 4.30 Legislative changes in the Value-Added-Tax Act have over the years led to a significant increase in the number and variety of the zero-rated goods and services. For example, at least 18 goods and services were zero-rated by the National Treasury between the 2007/08 and 2009/10 financial years. The items are listed in Appendix II of this report. The KRA management indicated that the changes had contributed much to the growth in VAT refund claims. Taxpayers registered for VAT and who trade in the listed goods or services are entitled to input tax deduction but do not pay output tax and are therefore always eligible for refunds.
- 4.31 The rise in the number of goods and services zero-rated for Value-added-tax increased the number and value of eligible claims lodged. As a result, annual allocations required to finance VAT refunds rose. However, since the allocations are not sufficient to pay all the claims lodged by taxpayers (let alone those approved for payment by the Authority) each year, taxpayers have to wait for long before they receive their refunds. The Authority says it has opted to undertake detailed audits before paying the claims after noting that many of the invalid claims it receives relate to zero-rated goods and services.
- 4.32 The National Treasury has since decided to reduce the number of exempt and zero-rated goods and services. After several previous attempts they in the 2013/14 financial year proposed amendments to the Value-Added Tax Act with a view to rescind provisions on zero-rating of goods.

Legal provisions on Withholding of Value-Added-Tax increased the refund claims lodged by taxpayers with the Authority

- 4.33 The Value-added-tax withholding system introduced by the National Treasury on October 1 2003 also contributed to the increase in the number and value of claims lodged with the Authority by taxpayers. The Treasury introduced the system with a view to ensure that suppliers of goods and services declared and paid to the Government all Value-added-tax due on their supplies.
- 4.34 Under the system tax agents appointed by the Authority were required to deduct Value-added-tax on supplies made to them by taxpayers. Institutions appointed as withholding VAT Agents included Government institutions, parastatals, banks, financial institutions, Co-operative Societies, insurance companies and exporters of goods and services.

- 4.35 Both the supplier and the customer (the tax agent) were required to declare the tax. The suppliers were still expected to pay the withheld taxes when filing their monthly returns but could claim the tax paid by filing a return accompanied by the withholding tax certificate issued by the tax agent. In case the Value-Added-Tax accounts of a taxpayer remained in credit position perpetually, the taxpayer was entitled to demand refund of tax from the Authority by filing a claim in the prescribed format.
- 4.36 Therefore the system increased the VAT refund claims lodged with the Authority each year as many businesses, including those who may have may have otherwise opted not to register for VAT, joined the system with a view to claim refunds of excess taxes paid to the Authority. The Authority suspended the system on July 1 2011 as it sought to stem the fast growth of VAT refund claims and simplify tax administration.

Chapter 5

Conclusions

5.01 The Kenya Revenue Authority delays in paying the vast majority of Value-added-tax refund claims lodged with the Authority by tax payers. The sample of taxpayer files examined revealed that only 29% of the aggregate value of claims lodged with the 60 to 90-day waiting-time period promised in the Authority's Tax Payers' Charter. The sample further revealed that at least 22% of the claimants waited for more than one year before they were paid. As a result of the perennial delays, the balance of outstanding Value-Added-Tax refunds keeps growing each new financial year and had reached Kshs.26.58billion as at 31 March 2013. The main reasons why the KRA delays in paying VAT refund claims is as follows:

- i) The Authority lacks sufficient funds to finance all the claims it approves for payment in each financial year.
- ii) The system applied by the Authority to process and pay the claims is inefficient. It entails numerous, lengthy, time-consuming procedures and is highly centralized and thus requires much time and effort to process and pay the claims. In addition, the system is not fully integrated with the VAT and other tax payment systems used by the Authority mainly because the Authority lacks a robust Information Communication Technology (ICT) infrastructure to maximize use of the information it obtains on taxpayers.
- iii) The National Treasury has over the years increased the number of zero-rated goods and services. As a result, the Authority requires more resources including staff and money, to process and pay the increased volume of claims it receives in each financial year.
- iv) Until two years ago, claims submitted by taxpayers under the VAT withholding-tax system applied by the Authority increased outstanding refund balances substantially.

- v) Failure by some taxpayers to provide the Authority with sufficient evidence in support of their claims wastes time as the Authority seeks to verify the claims.
-
- 5.02 The audit nonetheless revealed that the Authority, even after undertaking the rigorous verification processes, eventually pays more than 90% of the total value of the claims that it receives. Therefore, for its trusted taxpayers, the Authority could save time and minimize frustration endured by the taxpayers were it to shift its efforts to post-payment audits as opposed to carrying out detailed examinations of all claims before they are paid-as it does now.
 - 5.03 The operational reforms outlined in the Authority's Third and Fourth Corporate Plans and carried over to the current Fifth appear to have taken longer than expected to create the desired efficiencies in the Authority's operational processes. The management of the Authority consider the reforms as critical to improving the efficiency and effectiveness of Kenya's tax administration system. However, the investments made so far have not enabled full sharing of taxpayer information among the Departments of the Authority. As a result, the 'single-view of the taxpayer' that the Authority has wanted to create over the last ten or so years has not been attained. The management of the Authority cite lack of sufficient funds as the main reason for the slow pace in implementing the reforms.
 - 5.04 The Authority in its Mission Statement identifies the attainment of standards set in the Taxpayer's Charter as a critical factor for maximizing revenue collection at least possible cost. In addition, the Authority's Third Corporate Plan recognizes that high stakeholder expectations translate to demand for exemplary performance. Therefore, the Authority should enhance its efforts to satisfy the expectations of taxpayers who file Value-Added-Tax refund claims.
 - 5.05 Chapter 6 of this report outlines the specific measures that the Auditor-General has recommended for implementation by the management of the Authority and the Ministry of Finance to shorten the waiting-time endured by taxpayers before they receive Value-added-tax refunds.

Chapter 6

Recommendations

6.01 In view of the findings of the audit, the Auditor-General has proposed the following recommendations for Implementation by the National Treasury and the management of the Kenya Revenue Authority:

To ensure that sufficient funds are set aside for payment of VAT refund claims in each financial year:

1. The Kenya Revenue Authority should devise and apply an objective formula for estimating the sum of money it requires to finance the payment of VAT refund claims in each new financial year.

To clear the backlog of unprocessed Claims:

2. The KRA management should undertake a detailed audit of all pending VAT refund claims, remove the invalid ones from its records, and pay the valid ones within a reasonable short time frame agreed with taxpayers.

To reduce the time taken to process VAT refund claims:

3. The KRA management should set time standards for each of the claim processing steps, and further, undertake regular monitoring and control of work processes to ensure that the standards are adhered to.
4. The KRA management should include processing of VAT claims among the duties and tasks over which staff performance is appraised in order to provide the staff with an incentive to process the claims faster.
5. The KRA management should assign sufficient numbers of staff to process refund claims at the head office and in its regional offices.
6. The KRA management should decentralize to its regional offices some of the refund processing functions undertaken at the head office.

7. The KRA management should take advantage of opportunities for use of Information Communication Technology (ICT) to process VAT refund claims that the modernization project it is implementing may provide.
8. The KRA should integrate audits of various tax streams and use the information obtained to verify VAT refund and other claims that may be filed by taxpayers.

To reduce the number of claims that require detailed audit before payment:

9. The Kenya Revenue Authority should;
 - i. enhance further its profiling of VAT refund claimants and thereafter shift most of its attention from pre-payment to post-payment audit of claims submitted by those who consistently comply with the requirements of the Value-Added Tax Act, and,
 - ii. improve the screening procedures it applies before accepting claims to ensure that only valid ones that are complete in all respects are accepted for processing.

To ease the burden placed on the Authority by the large number of zero-rated goods and services:

10. KRA should analyse the impacts on revenue and tax administration in general of the increase in the number of zero-rated goods and services and use the evidence gathered to petition the Treasury to reduce or eliminate the exemptions accorded traders in such goods and services.

To enhance trust in the refund processing system and improve compliance by taxpayers:

11. The KRA management should enhance the content and reach of its tax-payer education programs that focus on requirements that taxpayers have to fulfil before they submit VAT refund claims.
12. The KRA should enhance the quality of its communication and the feedback it provides to taxpayers who file VAT refund claims and especially those who experience delays before their claims are paid.

13. The KRA management should make a publicly undertake to process refund claims in the sequence they are lodged with the Authority.

To fulfil its ambition of 'creating a single-view of the taxpayer'

14. The management of the Kenya Revenue Authority should hasten the completion of its computerization program to allow for electronic filing of VAT claims and enhance the sharing of information on taxpayers among its Departments.
- 6.02 The management of the Kenya Revenue Authority have read the report and submitted to the Auditor-General their comments on its findings and recommendations. The comments are outlined in Appendix III of the report.

Appendices

Appendix I: Methods Used to Gather Audit Evidence

1. To understand the statutory mandate, operational framework and activities of the Kenya Revenue Authority related to processing and payment of VAT Refunds, we (the audit team) examined the following list of documents and sources of information:
 - i. The Kenya Revenue Authority Act
 - ii. The Value Added Tax Act (Cap.476)
 - iii. The Kenya Revenue Authority's Third, Fourth and Fifth Corporate Plans;
 - iv. KRA Tax payers Charter
 - v. Domestic Taxes Department's Operations Manual for Refunds Management
 - vi. Domestic Taxes Department's Risk Profiling Framework
 - vii. VAT Refunds Budget for the years 2004/05 to 2011/12
 - viii. KRA Records on VAT Refunds Claim Lodged in 2004/05 to 2012/13
 - ix. Total Processed Claims Payable/Rejected for 2004/05 to 2008/09 financial years
 - x. List of Registered VAT Payers
 - xi. The organizational structure of the KRA
 - xii. Domestic Taxes Department Internal Standards Evaluation, February 2010
 - xiii. The KRA Website: www.kra.co.ke
 - xiv. Ministry of Finance Website: www.treasury.go.ke
2. We used the following methods to gain understanding of the system used by the KRA to process VAT refunds
 - i. The Audit Command Language (ACL) software to generate a representative sample of 864 VAT refund claim files processed by the Authority. The sampled

files were examined to determine the length of time that the Authority took to pay the claims. As stated in paragraph 2.01 of the report, the failure by the management of the Authority to submit for audit 301 of the 864 files chosen for inclusion in the audit sample constrained the scope of the audit.

- ii. To understand the procedures that the Authority uses to process the claims, we observed and recorded the actual process used by the Authority in receiving, vetting, examining and paying the refund claims.
- iii. To obtain knowledge and understanding of the claim processing activities carried out at the Authority's regional offices, we visited (seven) out of 22 outstations located in various Counties country-wide. The sampled stations provided a fair footprint of the national spread of KRA offices and in addition carried both large and small numbers of registered VAT payers.
- iv. To gain in-depth knowledge of the activities carried out by staff at the various stages of the refund process, we interviewed management and staff at the head office and in the seven tax stations that we visited.
- v. We analysed the evidence collected and compared it against service delivery standards set by the Authority and principles of organizational management. All the inferences made in the report were derived from analysis of the evidence collected during the audit.

Appendix II: Zero-rated Goods and Supplies Declared from 2007/08 to 2009/10:

Goods and Services Zero-rated in 2007/08

- i. Leased equipment for repair and maintenance of aircrafts, or sea vessels
- ii. Goods and services used in construction or expansion of private universities

Goods and Services Zero-rated in 2008/09

- i. International air travel in Kenya (Article 93)
- ii. Motorcycles with engine capacity 250 cc (Article 93)
- iii. Bread (Article 104)
- iv. Rice (Article 104)

Goods and Services Zero-rated in 2009/10

- i. Locally produced and ginned cotton (Article 101)
- ii. Television cameras (Article 103)
- iii. Digital cameras (Article 103)
- iv. Video camera recorders (Article 103)
- v. Taxable goods and services offered to film producers (Article 104)
- vi. Power generators and generating sets (Article 112)
- vii. Heat insulated milk tanks (Article 114)
- viii. Taxable supplies for construction of grain silos (Article 115)
- ix. Refrigerated trucks (Article 116)
- x. Parts for agricultural, horticultural and forestry machinery (Article 116)
- xi. Bicycles (Article 118)
- xii. Taxable goods and services to Kenya Red Cross (Article 125)

Appendix III: Response of the Management of the Kenya Revenue Authority to the Findings and Recommendations of the Audit:

Audit Finding	Response By the KRA Management	Comments of the OAG on the KRA Management's Response
Overall Audit Finding: The KRA does not pay most VAT refund claims in due time: Analyses of the claims sampled revealed that only 29% of the claimants were paid within the extended waiting-time period of 90 days stipulated in the Service Charter. Therefore, the KRA failed to pay in due time 71% of refund claims submitted by taxpayers. The main causes of the delays were: - Shortage of Funds - Inefficient operational systems applied by the KRA - Staff shortage - Failure by tax payers to provide the Authority with all information required to process refunds - Fiscal policy changes increasing the number of goods and services over which VAT may be refunded - The Withholding Tax system used between 2003 and 2011 Management responses to each of the Findings and recommendations are highlighted below:	Agreed. The KRA has over several years sought to address the challenges that cause delays in payment of the refunds. Among the various actions taken by the management include numerous communications to the Treasury seeking additional funding, improved procedures, capacity building in refund processing through the annual graduate recruitment programme and taxpayer education on refund requirements.	
Finding: Funds set aside by the Authority in each financial year are not sufficient to pay all claims lodged by taxpayers: Examination of the Authority's budgets for the period under review revealed that on average, provisions for VAT refunds made by the KRA only cater for 76% of the total claims lodged in each financial year.	Agreed. The KRA has sought to address this challenge through numerous petitions made to the National Treasury.	

	Recommendation: To ensure that sufficient funds are allocated for payment of VAT refunds The Kenya Revenue Authority should develop and apply an objective economic formula/model to estimate the total sum of funds required to finance the payment of VAT refund claims expected in each new financial year.	Agreed. This is a good idea and the KRA will liaise with the Treasury to devise an objective formula for use in determining the refunds payable. The formula should take into account potential policy changes that might give rise to refunds.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.
ii	Finding: Inefficient systems used by the KRA to process VAT refund claims delay processing of the claims: VAT refund procedures applied by the KRA entail at least 34 (thirty four) steps spread over four stages. A claim has to pass through each of the four phases and its constituent steps before it is approved for payment. Recommendation: To improve efficiency of its refund processing system ; The KRA management should set time standards for each of the claim processing steps, and further, undertake regular monitoring and control of work processes to ensure that the standards are adhered to.	Agreed. Agreed. This is a good idea that will be taken on board during the review of the KRA internal standards. Monitoring of claims received and paid is done on a weekly basis.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.
iii.	Finding: The units of the Authority assigned to process VAT refund claims are understaffed. On average, the stations had only 60% of the number of staff they required to effectively carry out their responsibilities		

	Recommendation: To address understaffing in refund processing Units The KRA management should assign sufficient numbers of staff to process refund claims at the Authority's head office as well as at its regional offices.	Agreed. The KRA intends to obtain additional members of staff through the annual graduate trainee recruitment programme and to enhance competence through training.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.
iv	Finding: KRA staff has no incentive to process VAT refunds quickly because their performance appraisals consider their performance in their core duties of tax collection and audit but not the work they do in processing VAT refunds. Recommendation: The KRA management should include processing of VAT claims among the duties and tasks over which staff performance is appraised and thus provide the staff with an incentive to process the claims faster.	The Officers are appraised on all duties assigned to them including processing of VAT refunds.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.
v.	Finding: The VAT refunds function of the Authority is highly centralized and not properly linked to out-stations. Except for auditing, all the other procedures for processing VAT refund claims are carried out at the head office. Recommendation: To reduce the time taken to process VAT refund claims; The KRA management should decentralize to its regional offices some of the claim processing functions	Agreed. The Domestic Taxes Department operates a centralized office for all its operations. Agreed. Decentralizing refund processing to the regional Offices is an idea that the KRA can explore.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.

	currently undertaken at the head office. The KRA management should take advantage of the opportunities that the modernization project it is implementing may offer for use of information technology in processing VAT refund claims	Agreed. Some refund processing procedures are conducted manually. The implementation of Phase II of the Tax Management System will offer full automation of all the processes. Phase I has enabled taxpayers to file VAT refund applications online.	
vi.	Finding: The Authority has not defined the methods it uses to prioritize claims for processing and payment. Although the assumption would be that the KRA processes claims in the order that they are received, no such explicit undertaking has been made by the Authority to taxpayers.		<i>No comment submitted by the KRA management.</i>
vii	Finding: Some taxpayers do not provide sufficient evidence in support of the Claims that they lodge. The managers in all the KRA stations visited by the audit team, cited failure by the claimants to provide documents or other supportive evidence as one of the main challenges faced by the Authority in processing the VAT refund claims. Recommendation: To enhance trust in the refund processing system and improve compliance by taxpayers The KRA management should educate taxpayers on the requirements they need to fulfill before they submit VAT refund claims.	Agreed. Agreed. The KRA conducts regular taxpayer education through seminars, tax clinics etc. through which taxpayers are enlightened on tax issues including requirements they need to fulfil before their claims are processed.	The Office will assess the implementation of the audit recommendations during the follow-up audit to be conducted at a date to be agreed with the KRA management.

Viii.	Finding: The increase over the years in the number of zero-rated goods and services has increased the money and the workload required to pay refunds thus precipitating delays in processing and payment of refunds.	Agreed The Ministry of Finance has published a new VAT Bill that proposes the reduction of zero-rated goods.	The Office will assess the implementation of the audit recommendation during the follow-up audit to be conducted at a date to be agreed with the KRA management.
	Recommendation: To ease the burden of the large number of zero-rated goods and services	Agreed Issues relating to the national budget are governed by the Ministry of Finance. KRA has in the past made proposals to the Treasury aimed at reducing the Zero-rated items.	
	The KRA management should study the impacts the high number of zero-rated goods and services on revenue and tax administration and use the evidence gathered to petition the Treasury to reduce the number, if necessary.		



