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Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries
Chapter XX: Issues and Best Practices in Auditing Oil, Gas and Mining Activities

Note by the Secretariat

Summary

The purpose of this chapter is to provide developing countries with an overview of the issues that are encountered during audits and to provide insights on "best" practices that can be used by officials in developing countries when auditing the extractive sector. The chapter will also aim to provide practical examples employed by countries in dealing with issues arising from the audit of the extractive industry.

This text is an outline that does not necessarily follow the sequence the final chapter may have. The chapter will also be drafted to be consistent with and not overlap or duplicate the work of the Sub-committee on Associated Enterprises on Audit and Risk Assessment. The latter is a chapter in the UN Practical Manual on Transfer Pricing for Developing Countries which is being updated as well.

Moreover, to efficiently use the expertise within the Subcommittee with the limited remaining time for this membership of the Committee, the chapter will contain a detailed section on trade mispricing in the extractive industries instead of a separate chapter on trade mispricing.

This outline is presented for review and DISCUSSION and seeks the Committee's input and guidance on other crucial issues in the area on audit and mispricing to be included in the Handbook.

CHAPTER XX: ISSUES AND BEST PRACTICES IN THE AUDIT OF OIL, GAS AND MINING ACTIVITIES

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1. Introduction

1. The aim of this chapter is to provide developing countries with an overview of the issues that are typically encountered during tax audits of the extractive industry. The chapter also provides insights on "best" practices that can be used by tax officials in countries when auditing the extractive sector. It goes on to describe possible tax administrative arrangements in handling the extractive sector, and highlights the processes and issues arising during an audit.

2. The pros and cons of various audit choices are also highlighted in recognition of the growing international use of joint audits, simultaneous audits and capacity building arising from such arrangements, including the work of Tax Inspectors Without Borders that is jointly spearheaded by the United Nations Develop Programme (UNDP) and Organization For Economic Cooperation and Development (OECD).

3. The inherent benefits of cooperative compliance in the audit of the extractive sector is examined. The chapter also lists key skills required in conducting efficient and effective tax audits across various tax types, including corporate income tax, indirect tax, customs, property tax and payroll tax.

2. Tax Administration Arrangements

4. Some countries have a dedicated office dealing with the extractive industry with a good mix of competences and qualifications of audit staff, including officials with accounting, economics, law, mining engineering and metallurgy backgrounds.

5. Tax administrators in developing countries have tended to have a general approach to tax administration. Taxpayers are generally grouped by size (e.g. small, medium and large) using a metric such as revenue as a basis for allocation. Where a dedicated tax office is established, it may cover the entire extractive industry taxpayer population regardless of respective size of taxpayer.

6. However, for specialized industries such as extractives, a dedicated approach to tax audits is highly recommended, not least because of the peculiarities associated with the industry. Often the extractive industry is subject to tax based on specific tax rules and regulations, some of which are a departure from general tax rules. There is also often an overlay of Petroleum Agreements, Development Agreements and other specific contracts which have provisions which supersede local tax law and regulations.
7. The benefits of having a dedicated team to address the peculiarities of each industry cannot be understated.

Country examples of general vs specific tax rules relating to fiscal depreciation

Country	**Ghana**	**Zambia**	**TBD**	**TBD**
General tax rules	Tax depreciation generally on a reducing balance basis with specific rates highlighted in the tax law	Tax depreciation generally on straight line basis with specific rates highlighted in tax law		
Oil and Gas	5-year straight line basis	N/a		
Mining	5-year straight line basis	100% for exploration; 5-year straight line basis for mining operations		
Agreements	Depending on the type of agreement, there are different bases of tax depreciation which supersede local laws	None in place		

8. Taking this a step further, there could be peculiarities related to oil and gas which do not fit into a mining framework and would require a change in audit approach. An example of this is ring-fencing in oil and gas, which can be vastly different from ring-fencing in mining due to the nature of the operations: offshore, onshore, underground or surface. ***[to be expanded further using country examples***

9. Having a dedicated team which is focused on mining and/or oil and gas can help bridge the gap in application of relevant tax laws and regulations.

The Right Staff Mix

10. Moving on from the dedicated industry approach, the staff mix can also be critical.

11. Officials with long standing industry experience are often very relevant in terms of understanding the rationale and background for changes in laws and regulations and how such background overlays with current application and practice. This is especially beneficial in tax administrations that have limited history in dealing with the sector

12. Coupled with the above, there is a need to ensure continuity and consistency of approach and technical experience which is reinforced by officials with industry relevant and applicable professional or academic backgrounds (such as accounting, economics, law, mining engineering and metallurgy). Such technical backgrounds provide a strong basis for understanding industry specific terms that those who operate day to day may take for granted but may seem alien to new entrants or those who are not familiar with the industry. It helps set up a platform for constructive dialogue and also helps reduce the general suspicions between the two parties: taxpayers and tax administrators. Taxpayers may feel administrators probe too much with questions they do not consider necessary whilst administrators may feel taxpayers are not providing the right answers in order to hide relevant information.

The Collaborative Industry Approach

13. Often the extractive industry players are regulated/scrutinized by different government agencies, ranging from:

- An industry regulator (overseeing the issue of permits, compliance with laws and reporting)
- Tax administrator (collection and implementation of tax rules)
- Ministry of Finance (tax policy reporting and implementation)
- National Oil Company (licensing and regulation)

14. Within the above main agencies are several subsets which are also in charge of (or have oversight of) the same industry players. These include for example: forestry resources, water resources, fisheries, sanitation, shipping, customs and excise. In many jurisdictions, there is a tendency for these agencies to work within the boundaries of their establishing objectives and specific governing laws.

15. As a result, there tends to be a gap in the sense that very often extractive industry players will be providing the same information to each of the oversight agencies, albeit in different forms and using different templates.

16. As part of the audit planning process, a collaborative approach to information gathering and planning would be of assistance. Such that to the extent that there are any gaps in the information collected by each agency, the audit team can utilize the field audit as a means to audit and verify the differing streams of information.

17. This has the advantage of reducing the duplicity of audits conducted on the extractive industry by each oversight agency.

3. Industry Knowledge of the Extractive Industry in the Context of Audits

18. An understanding of the extractives industry will help ensure better audit strategies and approach. This includes:

   - Knowledge of the value chain, operational activities expected at each stage of the value chain, including the corresponding cost structures, cost recovery issues in oil and gas, mineral pricing and off-take agreements etc. An understanding of the different types of extraction methods and their cost implications is

In the context of mining, the value chain will usually be commenced with exploration, which is a search of the mineral resource. Once an economically recoverable resource has been found and determined, the next activity moves into construction and development.

In the context of oil and gas, the value chain generally commences with exploratory drilling followed by development and then production, in the case of a reserve or reserves discovered commercial quantities.

- Use of financial market data in the context of audits as minerals and hydrocarbons are often traded on the financial markets. A good understanding of the functioning of these markets and the quotation methods is very useful for auditing intra-group prices within multinational enterprises.

19. The extractive industry by its very nature requires specific technical and commercial expertise in an approach to audit. Each stage of the extraction process (exploration, development, production and decommissioning/rehabilitation) must be examined in isolation prior to applying any accounting or tax overlay.

20. Having a sound understanding of the extractive process and the importance of costs on strategic decisions helps provide a solid background and approach to audit, as well as helping with an understanding of certain strategic decisions by management and directors.

21. In particular, the extractive industry is characterized by:

i) Ensuring that effective cost control mechanisms are in place.

This is because the extractive industries are largely ‘price takers’, that is, the price of their output is determined by prevailing world prices e.g. of gold or crude. With such dependence on external world prices, cost control can be very critical in ensuring competitive profits.

ii) High capital costs

22. In the exploration and development stages, the levels of capital investment can be overwhelming, especially when viewed from a general tax principles approach. The capital investment required to drill a well or to build a mine are unlike in other industries, coupled with labour and other service costs.

The importance of a Site Visit

23. Where it is safe to do so, undertaking a site or field information visit on an annual or at least every two years is strongly recommended as a means of engaging with the industry and promoting dialogue with field operations.

24. When this is done in the context of information gathering and learning, and not in an audit context, it helps to promote confidence from both taxpayer and administrator perspectives. It provides a means of dialogue for understanding the differing perspectives and approaches of all stakeholders.

25. As enumerated above, it is even more helpful to do this on a multi-agency basis, involving key stakeholders and promoting clarity of understanding across the board.

Overview of Typical costs across the Extractives Industry Value Chain

	Mining	**Oil and Gas**
Exploration	• Drilling • Explosives • Equipment • Surveys • Technical fees (geologists)	• Drilling: drill rigs • Vessels: anchor handling tugs • Oil Country Tubular Goods (OCTG) • Well heads
Development	• Community Relocation (including compensation) • Infrastructure development	• Vessels: Platform Supply • Transportation

	• Crushing • Chemicals and extraction infrastructure • Equipment (trucks, loaders, dozers) • Surface Stripping	• Pipeline development: Oil Country Tubular Goods (OCTG) • Pipeline development: Well heads • FPSO
Production	• Infrastructure development • Crushing • Milling • Chemicals and extraction materials • Equipment (trucks, loaders, dozers) • Technical, Managerial and Administrative • Freight Costs	• Vessels: Tankers • Security Vessels
Decommissioning/ Rehabilitation	• Restoration	• Decommissioning

Use of financial markets data

26. Include a general overview of the typical sources of financial/commodity price data (current and historical):

Mining: **Oil and Gas**

4. Tax Audit Process and Issues

27. These include:

- ➢ Structure of audit routines and work plan for the sector and the benefits of having a well - structured audit process (including step by step guidance on the audit approach).
- ➢ Appropriate legislative framework for audit administration.
- ➢ Information and data collection (powers to collect, and impose penalties to mitigate or prevent delays and non - provision of audit information).

- Post audit reporting and conclusions (including the impact of audit uncertainty on the willingness of taxpayers to make further investments.).

Typical Audit Process

28. Advance planning is essential for a successful audit. Below is a general overview of the typical audit planning process.

Planning/Risk Analysis

29.

- Review financials and prior year audit reports, a minimum of a three-year history would be recommended
- Review submitted compliance returns (monthly, quarterly and annual tax filings)
- Inter-agency collaboration: request supporting data to ensure adequate understanding
- Request preparatory information from tax payer for desk audit review purposes and to augment information already gathered.

Ask questions and obtain responses to help in the planning process

- Identify key risk areas and areas of focus prior to embarking on field audit.

Field Audit Recommendations

30.

- Introductory meeting: identify staff members who would be involved and would be providing pertinent information.
- Provide a clear and comprehensive audit information request, based on planning/risk analysis done prior to embarking on field audit. The information request may be updated however to promote efficiency and transparency and to mitigate management delay; it is recommended that updates are kept to a minimum and should be based on the discovery of new information, not necessarily gathered during planning.
- Ensure there are daily/regular meetings with management to keep them appraised of progress and information gaps.
- Ensure that an audit de-brief session is undertaken prior to leaving the site.

Post audit reporting and issuance of draft reports

31. An initial draft report should be produced and provided to management, so as to allow management an opportunity to comment or provide further information before the report is finalized. This helps promote transparency and fairness in the audit process.

Importance of Reporting Audit Related Liabilities when finalized – the collection gap

32. Country reporting requirements can often mean that audit-imposed liabilities are reported and escalated up the reporting chain to the Ministry of Finance, even in instances when the liability is yet to be agreed by the taxpayer. Such instances create a 'funding gap' especially in instances where the Ministry of Finance reports the expected revenue, leading to pressure to collect. Whilst collection of audit liabilities is critical, it is also critical to ensure that the liability has been finalized, discussed and agreed with the taxpayer before it is reported as the final amount to be collected by the tax administration.

Stock Exchange Disclosure Requirements

33. Some tax authorities have been known to publish or leak draft audit or other reports as a 'shock tactic' in negotiations. However, the amount of tax demanded in the report can trigger disclosure requirements to stock exchanges and to shareholders which would have an adverse effect on share prices and subsequent investment, as well as confidence in the country tax regime.
34. Tax authorities are advised to issue draft reports based on firm and foundational facts to mitigate this level of country exposure.

5. Role of Joint Venture Partners – Oil and Gas Industry

35.

- Role of Joint Venture (JV) partners in reviewing costs particularly in the Oil and Gas industry.
- The discussion will include an overview of
  - How JV partners determine how expenditure is managed. Audit rights JV partners have over operators and the levels of scrutiny already involved
  - The role of cash calls and how these should be audited
  - The deductibility of certain types and nature of costs
  - The role of Big-4 firms in providing assurance as to the certainty and relevance of certain costs.
  - Affiliate charges and what impact they have on costs

6. Tax Audit Choices

36.

- Pros and Cons of Audit Choices -
    - Joint Audits,
    - Simultaneous Audits,
    - Outsourcing of Audits to consultants
    - UNDP/OECD Tax Inspectors Without Borders (TIWB).

Section to be further developed using a table approach for ease of reference.

Audit Type	Definition	Legal Basis	Objective	Comment
Joint Audit		• Tax Treaty • TIEA • AMATM • Domestic Legislation • Memorandum of Understanding supported by Domestic Law		
Simultaneous Audit		• Tax Treaty • TIEA • AMATM • Domestic Legislation		
Outsourcing		• Contract/agreement • Domestic legislation to appoint or delegate powers of the tax administration		
UNDP/OECD TIWB		• Memorandum of Understanding • Domestic Legislation to appoint or delegate		

7. Taxpayer Engagements (Co-operative Compliance)

37.

- This section will highlight of the benefits inherent in practices such as co-operative compliance including examples of the Dutch 'horizontal monitoring' model that is focused on cooperation and upfront communication.

[Section to be developed using a case study approach to discuss the Dutch model]

8. Audit Tools

38.

- Audit equipment and tools to enable efficient and effective audits –
  - E-audit in the extractives industry – how to use computer tools (including electronic audit software for bulk data) to access data on production; cross checking data reported to Tax administrations (e.g. customs, tax returns, mineral royalty returns etc.); cross checking with data in country by country reporting.
  - Use of portable scanners, cameras for audit evidence gathering on taxpayer site.
  - Subscription to extractives industry and other data bases and institutions providing industry information on costs, commodity prices.

9. Capacity Building Possibilities

39.

- Listing of possibilities that can be used for capacity building aimed at improving audit skills –
  - Interviewing skills, negotiating skills, data analysis, audit skills etc.

10. Audit Approach to affiliate Transactions

40.

- This chapter will discuss multinational enterprise (MNE) structures and the role of head-quarters and other group service companies.

- There will also be some commentary on transfer mispricing with a linkage to existing chapters in the Extractives handbook.

References: