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Tax audit and tax productivity in Lagos state, Nigeria

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Abstract

Purpose – The purpose of this paper is to examine the impact of the tax audit on tax productivity in Lagos state, Nigeria. Specifically, the study analyzed trends of tax audit and tax productivity, and the impact of Desk audit, Field audit and Back-duty audit on tax productivity in Lagos state.
Design/methodology/approach – The study made use of both primary and secondary data. Primary data used in the study were collected with the use of questionnaires administered to 350 randomly selected staffs of Lagos state Internal Revenue Services, while secondary data used in the study were sourced from Federal Inland Revenue Service and Lagos Internal Revenue Service audit division in Lagos state over the period spanning from 2000 to 2015. Data collated in the study were analyzed descriptively using inferential methods such as unit root test, and estimation techniques such as Fully Modified Least Square (FMOLS) co-integration regression and Logit regression analysis.
Findings – The study revealed that Field tax audit, desk tax audit and Back duty tax audit exert a significant positive impact on tax productivity with reported estimate of 0.530454 ($p = 0.0044 < 0.05$) for FIDAUD, 0.774450 ($p = 0.0085 < 0.05$) for DEKAUD, 1.244317 ($p = 0.0001 < 0.05$) for BAKAUD.
Research limitations/implications – Relevant tax authority (RTA), tax auditors and FIRS staff members should have full knowledge of modern audit tools like Computer Aided Audit Tools (CAATs) to enhance performance and maximum tax revenue generation.
Practical implications – The study concluded that tax audit enhances the level of productivity of tax administration in Lagos state and that any form of tax audit has the tendency of influencing revenue accruing to the government from taxation positively. Hence, tax audit should be carried out on a routine basis to ensure that actual revenue collected is what the RTA remits to the government. Tax audit department should be given autonomy to carry out their responsibilities effectively.
Social implications – Tax audit should be carried out on a routine basis to ensure that actual revenue collected is what the RTA remits to the government. Tax audit department should be given autonomy to carry out their responsibilities effectively.
Originality/value – This tax audit and tax productivity in Lagos state, Nigeria, fulfills an identified need to study how brand-supportive behavior can be enabled.

Keywords Logit regression, Back duty, Co-integration analysis, Desk tax audit, Field tax audit, Tax productivity

Paper type Research paper

1. Introduction

Taxation is not a new word in the world as a whole. In Nigeria, taxation has been in existence even before the coming of the colonial men or the British. Tax is one of the major sources of revenue to all levels of government. Taxation can be defined as a system of imposing a compulsory levy on all income, goods, services and properties of individuals, partnership, trustees, executorships and companies by the government (Samuel and Simon, 2011). In Nigeria, it is a factor to be reckoned with in Federal government's budget, the taxes so

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collected come back to the taxpayer in form of services. This has over the years encouraged or discouraged some activities in the private sector; this depends on whether the policy of the government is toward discouraging or encouraging such companies. Taxation is recognized as a very important tool for national development and growth in most societies. It has been viewed as a major vehicle for the long-term development of infrastructures of the state (Brima and Festus, 2014).

Tax is as a veritable source of revenue to the government which is as good as nothing when prospective and potential taxpayers default in payment. Naturally, the taxpayer is always unwilling to pay his tax liability and therefore it needs to be motivated seductively or by force into paying what is expected from them. Thus, the use of tax audit has, however, helped in the generation of revenue to the government (Onoja and Iwarere, 2015). Kircher (2008) stated that tax audit is the examination of tax report of an individual or organization by the relevant tax authorities in order to ascertain compliance with applicable tax laws and regulations of the state. In furtherance to this, he reported that tax audit is a process where the Tax Authorities (Federal Inland Revenue Service and State Board of Internal Revenue Services) confirm the numbers that you have put on your tax return.

Tax audit just like financial audit involves the gathering of information and processing it for determining the level of compliance of an organization with tax laws of the territory (Adediran *et al.*, 2013). They stated further that tax audit and investigation includes desk audit which is one in which the whole activity of the audit takes place within the confines of the office of the tax officials, field investigation which involves physical verification of documentary evidence and materials at the premises of a taxpayer so as to confirm the facts and figures of the tax returns filed by corporate taxpayers and back duty audit which is instituted when the following occurs: failure to disclose or include in full, any income or earning in the return made available to the tax office: doubtful claim of capital allowance in respect of current or previous year; reduction in the profit in the returns files in tax office, where the tax charged or assessed is less than what it ought to be. The system of tax auditing is imperative because it assists the government in collecting appropriate tax revenue necessary for budget, maintaining economic and financial order and stability, ensuring that satisfactory returns are submitted by the taxpayers, organizing the degree of tax avoidance and tax evasion, ensuring strict compliance with tax laws by taxpayers, improving the degree of voluntary compliance by taxpayers and ensuring that the amount due is collected and remitted to government (Nyakamba, 2014).

Due to the urge for an increase in revenue generation, FIRS made a reform that merged its audit department with the investigation and intelligence division with the following mandate investigation of civil and criminal cases and violations of tax laws; installation of an effective database and efficient intelligence network; prosecution of violators of the tax laws to serve as deterrence; and fostering closer working relationships with other government agencies (Federal Inland Revenue Service, 2012). This as earlier said will have an informed impact of the second generation of Nigerian government revenue. Onoja and Iwarere (2015) disclosed that over the years, revenue derived from taxes has been very low and no physical development actually took place. This cannot be far-fetched from the quality of revenue administration which influences the investment climate and private sector development, because firms consider the tax system when considering investments, so also there is a high incidence of corruption within the taxes and customs administrations, which makes the government suffer major revenue leakages, as a result, dishonest revenue officials which allow unjustified tax breaks to willing tax evaders.

Reform of the revenue administration that includes efficient and effective tax audit may be needed to enable it to keep up with the increasing sophistication of business activity and tax evasion schemes. With globalization, goods and services are produced by taxable entities in multiple countries. This presents vast opportunities for manipulating

transactions to reduce the tax burden. Without a matching increase in the professional and technological capacity of the revenue administration, the existence of corruption, tax havens and increasing use of electronic financial transactions will continue to pose major challenges in enforcing the tax laws. This will further reduce the chances of monitoring taxable activity and countering tax evasion. For this reason, tax audit plays an important role to increase the capacity of revenue generation (Opoku, 2015). Based on the above, this study examines the impact of tax productivity in Lagos state, Nigeria.

2. Literature review

2.1 Tax audit

Adediran *et al.* (2013) opined that tax audit just like financial audit involves the gathering of information and processing it for determining the level of compliance of an organization with tax laws of the territory. For a successful audit, it is necessary that the auditor organizes his work in such a way that the assignment is accomplished completely and efficiently. According to Chude and Chude (2015), tax means "money that you have to pay to the government so that it can be paid for public services." He also defined Audit as "an official examination of business and financial records to see that they are true and correct." The Association of Chartered Certified Accountants defined an audit as an exercise which provides assurance to the shareholders and other stakeholders of a company on the financial statements because it is independent and impartial. Onoja and Iwarere (2015) opined that tax audit and investigation which involves the inspection and treatment carried out by tax agencies authorized by law on the level of compliance of taxpayers to the law through the review of its financial records has helped the government in the generation of revenue.

2.2 Theoretical literature

2.2.1 Theory of tax performance/theory of tax productivity. In the assessment of tax productivity or performance, two measures are normally applied. These are buoyancy of tax revenue and income elasticity of tax. The former could be defined as the positive response of tax revenue to the combined effects of automatic growth, i.e. growth emanating from economic activities and the growth resulting from discretionary changes in tax rates and rules. The latter refers to changes in tax revenue due to changes not only in income but also other discretionary changes in tax revenue due to changes in tax policy. Most of the studies so far undertaken have directed their attention at the built-in flexibility of the tax structure either with the application of discretionary measures or when the rates are constant. Examining the income elasticity of the Indian tax structure, Sahota utilized the regression equation:

$$Y = \alpha X \beta,$$

or:

$$\text{Log } Y = \text{Log } \alpha + \beta \log X,$$

where the coefficient "α" denotes the level of the tax yield on Y when the independent variable X is zero, and the coefficient "β" gives the elasticity. According to him, the β coefficient signifies the percentage of change in the independent variable X. This model is the basic performance or productivity approach to determining the elasticity or otherwise of individual tax sources and the tax structure as a whole with respect to tax bases and GDP. Though several refinements have been embarked upon, they could be regarded as cosmetic as they have not drastically altered the intention or end product of the above model.

The productivity or performance model adopted in this study is akin to that employed by Kusi for the estimation of the Ghanaian tax system. The point of departure of the present study is the replacement of buoyancy for elasticity in the decomposition process of tax to base and base to income, thereby eliminating the elasticity approaches which require the isolation of the impact of discretionary tax measures. This approach was preferable, partly for the peculiar reasons advanced above and mostly because discretionary tax change is a pervasive phenomenon in Nigeria's budgetary process. Pervasive because in 1987, the company income tax rate was reduced from 45 to 40 percent, capital allowances and tax-free dividends were provided for manufacturers. In 1993, excess duty was abolished, except those on tobacco and alcohol, while annual income under N 5,000 because tax free with the highest marginal rate stepped down from 45 to 35 percent. Excise duties were re-introduced on some products in 1994 and value-added tax came into effect the same year. Also, withholding tax rents, interest, and dividends among others were raised from 5 to10 percent in the same 1994 budget. This pervasion in the Nigeria tax system has a long history from 1980 to date.

The productivity or performance model was directed at investigating the buoyancy of the Nigeria tax system, through a detailed assessment of the contributions of individual taxes to total tax collections and to GDP. The choice of buoyancy criterion is informed by the apparent deficiencies observed in purging tax revenues of the impact of discretionary tax changes through the proportional adjustment method which was originally developed by Presto in (1962) and the dummy variable technique utilized by Khan. Like the Sahota model, proxy bases were also adopted for the buoyancy methodology mainly due to the decomposition of income buoyancy into tax-to-base buoyancy and base-to-income buoyancy. The proxy base taken for petroleum profit tax was the total value of crude oil, and for Company Tax, it was Corporate Current Income. The proxy base for customs and excise duties is a combination of the total value of imports, exports, and manufacturing, while the proxy bases taken separately for excise and imports duties were total value added tax that was the total consumption expenditure.

The model utilized in our evaluation of the performance or ability of the Nigerian tax system to generate expected revenue is the buoyancy criterion. The buoyancy of each tax was broken into two components: the buoyancy of the tax to the base and the buoyancy of base income. The model was applied to a time-series data from 1981 to 2009, covering the pre-and post-structural adjustment program periods. Proxy bases for the total value of import and the total value of manufacturing were chosen for import and excise duties, respectively. Ordinary least squares (OLS) technique was utilized in estimating the equations.

2.3 Review of empirical literature

Anyaduba and Modugu (2014) studied the impact of tax audit and other qualitative attributes on the tax compliance level of companies in Nigeria. Questionnaires were administered to staff of sampled companies in selected states from five geopolitical zones of Nigeria. Ordered Logistic Regression technique was employed to analyze the responses. The result showed that there exists a positive relationship between tax audit and tax compliance. The result also revealed that the probability of being audited, perception on government spending, penalties and enforcement, the joint effect of tax audit and penalties have a tendency to significantly influence tax compliance in Nigeria. Badara assessed the effect of the tax audit on tax compliance in Nigeria – a case of Bauchi State Board of Internal Revenue. The methodology employed for data collection is the only primary source, which involved the use of questionnaires, in which 48 questionnaires were administered to the staff of Bauchi State Board of Internal Revenue, some selected individuals taxpayers and corporate bodies within Bauchi State out of which only 42 questionnaires were completed

and returned. The data generated for the study were interpreted using simple percentage. The main findings of the study are that: the Relevant Tax Authority (RTA) employed tax audit toward achieving target revenue, tax audit reduce the problems of tax evasion and taxpayers do not usually cooperate with tax audit personnel during the exercise. Adediran *et al.* (2013) examined the impact of tax audit and investigations on revenue generation in Nigeria. Data were collected from the primary sources from 410 respondents who are the staff of the Federal Inland Revenue Service and Edo State Board of Internal Revenue and tested with Pearson Correlation Coefficient. The findings are that tax audit and investigations can increase the revenue base of the government and can also stamp out the incidents of tax evasion in the country. Onoja and Iwarere (2015) explored the effects of the tax audit on revenue generation in Federal Inland Revenue Service. The population of the study consists of the staff of the Federal Inland Revenue Service, Abuja, and Taro Yamane sampling technique was used to determine the sample size. The questionnaire was used to generate the data and was tested using Analysis of Variance (ANOVA). Findings revealed that: tax audit has significant effects on revenue generation in Federal Inland Revenue Service and tax audit has a positive relationship with the revenue generation in Federal Inland Revenue Service.

Soyinka *et al.* (2016) studied tax audit determinants and corporate tax compliance in Nigeria using survey research design, descriptive statistics, correlation and least square regression. The findings revealed a significant impact of tax audit probability and frequency of tax audit on corporate tax compliance. Kennedy (2014) examined the impact of tax audit on tax compliance in Nigeria. Questionnaires were used in gathering data while ordered logistic regression technique was used in data analysis. The result showed that there exists a positive relationship between tax audit and tax compliance. The result also revealed that the probability of being audited, perception on government spending, penalties and enforcement, the joint effect of tax audit and penalties have a tendency to significantly influence tax compliance in Nigeria. Appah and Eze (2013) studied causality analysis between tax audit and tax compliance in Nigeria. Data were derived from both primary and secondary sources. The data were subjected to diagnostic tests and analyzed with augmented dickey-fuller, ordinary least square and Granger causality. The empirical analysis exhibited a significant relationship between random tax audit, cut-off tax audit and conditional tax audit on tax compliance in Nigeria. Despite the empirical pieces of evidence of the impact of the tax audit on tax compliance and tax evasion, the study is faced with challenges of determining the impact of tax audit (desk audit, field audit and back duty) on the tax compliance, productivity and remittance to the tax authority in south-west Nigeria.

3. Research method

Qualitative and quantitative design was used in this study because both secondary and primary data were utilized in the study. The data used in this study are secondary in nature and they are quarterly. Quarterly data adopted in the analysis of this study spanned from 2000 to 2015 and were sourced from FIRS and LIRS audit division in Lagos state. The research instrument was structured questionnaire. The study adopted and modified the questionnaire as stated by Opoku (2015), who studied the role of a tax audit in revenue mobilization in Ghana revenue authority-the case of Ashanti region. The modified questionnaire was structured into five sections. Section A took into consideration the Demographic variables of respondents. Section B considered objective 1, Section C considered objective II, while Section D took into consideration objective III. However, a questionnaire was administered as used by Mutarindwa and Rutikanga (2014) to measure the growth in tax revenue in Rwanda. The questionnaire was open and close-ended, the response on the latter was ranked using the five-point Likert scale which ranged from "Strongly Agree" to "Agree" to "Undecided to Disagree" and to "Strongly Disagree,"

while the former was on a free opinion of respondents. Both descriptive and inferential statistics were employed in analyzing the relevant data gathered for the study. Descriptive statistics include frequency counts and percentages, while inferential statistics were in the form of ordered logistic regression.

The study adopts the work of Soyinka *et al.* (2016) model which took its roots from classical theory of tax compliance with modification both in the dependent and independent variables. Thus, the model for this study is specified as follows:

$$\text{TAXPROD} = f(\text{DSKAUD, FIDAUD, BAKDAUD}). \tag{3.1}$$

Explicitly, it can be re-stated as follows:

$$\text{TAXPROD} = \beta 0 + \beta 1\ \text{DSKAUD} + \beta 2\ \text{FIDAUD} + \beta 3\ \text{BAKDAUD} + \mu, \tag{3.2}$$

where TAXPROD = tax productivity (tax revenue is used as proxy for tax productivity), DSKAUD = desk audit, FIDAUD = field audit, BAKDAUD = back duty audit, $\beta 0$ = intercept, $\beta 1$ – $\beta 3$ = shift parameters/slope of the regression line, explained (dependent) variable = TAXPROD, Explanatory (Independent) variables = DSKAUD, FIDAUD, BAKDAUD.

4. Results and discussion

4.1 Unit root test

Table I reveals that all the variables such as TAXREV, DEKAUD, FIDAUD and BAKAUD are not stationary at levels but they are made stationary at first difference. Therefore, condition for Johansen co-integration is met. This prompts the study to proceed to co-integration analysis. The co-integration analysis is meant to examine the long-run relationship between desk auditing, field investigation auditing and back duty tax auditing and tax revenue.

4.2 Test for co-integration

The above co-integration test was performed using Engle-Granger which is one of the suitable long-run estimators for single equation model. The co-integration result in Table II showed a positive relationship between the explained variable (tax productivity proxy with taxrevenue) and explanatory variables (field tax audit-FIDAUD, desk tax audit-DEKAUD and back duty tax audit-BAKAUD) in the long run as the result of the normalized co-integrating equation indicated as follows:

$$\text{TAXREV} = 7.21 + 0.53\ \text{FIDAUD} + 0.77\ \text{DEKAUD} + 1.24\text{BAKAUD}.$$

The result also showed that a point change in field tax audit, desk tax audit and back duty tax audit will result in 0.53, 0.77 and 1.24 point change in tax productivity of Lagos state in the long run, respectively. All the explanatory variables (FIDAUD, DEKAUD and BAKAUD)

	At levels			At first difference			
Variables	Aaa ADF statistics value	5 5% CV	10% CV	AA11AaADF statistics value	5 5% CV	1 11111 10% CV	Order of integration
TAXREV	−2.11341	−3.75974	−3.32497	−4.88642	−3.82897	−3.36298	I(1)
FIDAUD	−2.07682	−3.75974	−3.32497	−3.78230	−3.93316	−3.92003	I(1)
DEKAUD	−2.67648	−3.79117	−3.34225	−3.37219	−3.79117	−3.34225	I(1)
BAKAUD	−1.54085	−3.75974	−3.32497	−6.06201	−3.79117	−3.34225	I(1)

Source: Author's computation, 2017

Table I. Augmented dickey fuller unit root result

Dependent variable: TAXREV
Method: fully modified least squares (FMOLS)
Date: October 1, 2017 Time: 14:28
Sample (adjusted): 2001 2015
Included observations: 15 after adjustments
Co-integrating equation deterministic: C
Long-run covariance estimate (Bartlett kernel, Newey-West fixed bandwidth = 3.0000)

Variable	Coefficient	SE	*t*-Statistic	Prob.
FIDAUD	0.530454	0.148673	3.567927	0.0044
DEKAUD	0.774450	0.242015	3.200011	0.0085
BAKAUD	1.244317	0.216079	5.758629	0.0001
C	7.213312	0.765173	9.427037	0.0000
R^2	0.983576	Mean dependent var		25.27918
Adjusted R^2	0.979097	SD dependent var		1.052338
SE of regression	0.152146	Sum squared resid		0.254632
Durbin–Watson stat	1.839378	Long-run variance		0.012033

Note: Author's Computation, 2017

Table II.
Co-integrating regression

showed a significant impact on TAXREV in the long run with their respective *p*-values (0.0044, 0.0085 and 0.0001) lesser than 5 percent level of significance. Field tax audit-FIDAUD, desk tax audit-DEKAUD and back duty tax audit-BAKAUD explain 98 percent variation in TAXREV in the long run.

4.3 Descriptive analysis

Table III shows that 202 (57.7 percent) of the respondents are male, while 148 (42.3 percent) are female. This implies that there are more male staff than female in the agency. Item 2 in the table shows that 182 (52 percent) are married, 148 (42.3 percent) are single, while 20 (5.7 percent) are divorced. This indicates that there are many responsible staff in the agency. Table III shows that 42 (12 percent) are OND holders. In total, 98 (28 percent) are HND, 130 (37.1) are BSc holders, 49 (14 percent) are MSc, while the PhD and other professionals are 31 (9 percent) respondents. This implies that the staff members of the agency are well educated.

In Table IV, it could be inferred that if the explanatory variables (FIDAUD, DEKAUD and BAKAUD) signified a positive effect on the explained variable (TP) which implies a unit

S. No.	Item	Respondents	%
1	Gender	–	–
	Male	202	57.7
	Female	148	42.3
	Total	350	100
2	Marital status	–	–
	Married	182	52
	Single	148	42.3
	Divorced	20	5.7
	Widow/widower	Nil	Nil
	Total	350	100
3	Educational qualification	–	–
	OND	42	12
	HND	98	28
	BSc	130	37.1
	MSc	49	14
	PhD/ACA/other professionals	31	8.9
	Other specify	Nil	Nil
	Total	350	100

Table III.
Demographic information

Variable	Coefficient	SE	Logit model *t*-Stat.	*p*-value	
Const	7.11604	0.573092	12.4169	< 0.00001	***
FIDAUD	0.459339	0.122421	3.7521	0.00276	***
DEKAUD	0.812875	0.138348	5.8756	0.00008	***
BAKAUD	1.31235	0.209242	6.2719	0.00004	***
Mean dependent var	25.12919		SD dependent var	1.180465	
Sum squared resid	0.245085		SE of regression	0.142912	
R^2	0.988275		Adjusted R^2	0.985344	
F(3, 12)	1014.146		*p*-value(F)	1.08e-14	
Log-likelihood	10.72691		Akaike criterion	−13.45381	
Schwarz criterion	−10.36346		Hannan-Quinn	−13.29556	

Notes: Model 1: OLS, using observations 2000–2015 ($T = 16$); Dependent variable: TP (proxied by VAT for FIDINV, PIT for DEKAUD& WHT for BAKAUD) HAC standard errors, bandwidth 1 (Bartlett kernel)

Table IV.
Regression analysis on tax audit and tax productivity in Lagos State Nigeria

change in any of the explanatory, it will result in a positive effect on tax productivity. The coefficient of field tax audit-FIDAUD is 0.459 (SE = 0.122, $t = 3.75$ and $p < 0.05$ level of significance). This depicts that an increase in the use of FIDAUD which involves limited desk audit through the examination of accounts and returns than any other type of tax audit will result to 0.459 significant positive effects on VAT in Lagos state. Desk tax audit -DEKAUD depicts a significant impact of 81.2 percent ($p < 0.05$) on PIT in Lagos state. This implies that a unit change in the whole activity of the audit takes place within the confines of the office of the tax officials where the tax office may simply request the taxpayers to provide some additional documents to his office to enable him clear some issues in the returns submitted that will result to 81.25 percent significant change in personal income tax (tax productivity). Back duty tax audit-BAKAUD which arises as a of failure to disclose or include in full any income or earning in the return made available to the tax office, doubtful claim of capital allowance in respect of current or previous year, reduction in the profit in the returns files in tax office and where the tax charged or assessed is less than what it ought to be and thereby have a direct impact on revenue performance as agreed indicates 1.31 (SE = 209 and $p < 0.05$ level of significance) impact on withhold tax (tax productivity) in Lagos state.

5. Conclusion and policy recommendations

Based on the findings of the study, it is concluded that tax audit variables enhance the level of productivity in tax administration in Lagos state which implies that adequate utilization of any form of tax audit will positively influence the revenue accruing to the government from taxation as a result of a reduction in the level of tax evasion, avoidance and an increase in voluntary compliance. Tax audit and investigation are critical to causing the taxpayer to be on their toes. This is particularly true for the taxpayer who is marginally complying and can easily be moved to the realm of tax evaders. Tax audit and investigation is also a means to protect government resources and make sure that defaulters do not go free for their offenses. In respect of the research findings, the study recommends that tax audit in the form of field, desk and back duty should be carried out on a routine basis to ensure that actual revenue collected is what the RTA remits to the government. Internal mechanism to check and monitor the staff of the tax audit department should be put in place to minimize the level of corruption and enhance the effectiveness of the tax audit. Tax audit department should be given autonomy to carry out their responsibility effectively as specified in Federal Inland Revenue Service Establishment Act 2007. RTA, tax auditors and FIRS staff members should have full knowledge of modern audit tools like Computer Aided Audit

Tools (CAATs) to enhance performance and maximum tax revenue generation. All relevant authority should encourage tax audit for an increase in tax revenue, in order for the government to keep up with its obligation to her citizen.

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