



## ASSESSMENT OF VALUE ADDED TAX (VAT) AUDIT PRACTICE IN CASE OF DURAME TOWN, ETHIOPIA

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### **Abstract**

*This paper focuses on assessing Value Added Tax (VAT) audit practice of Durame Town administration Revenue Authority, Ethiopia. Mixed research approach and descriptive survey was employed. The study employed both primary and secondary data. Questionnaire and interview were used to collect data. This research was a survey involving VAT registrant tax payers who are served in Durame town tax authority. The data collected from 74 survey respondents were VAT registrants in the town revenue office and five (5) tax auditors who work in the tax authority and there remaining one tax officials were interviewed. Most tax payers' view the Ethiopian tax law is vague and open to interpretation in different ways for the same case. And low level of tax payers' knowledge and skill to keep proper books of accounts and financial reports. Most taxpayers' attitude towards VAT audit is not supportive and majority of these respondents couldn't understand essence of VAT audit. The tax authority audit case selection method doesn't in collecting data necessary in conducting VAT audit and there is lack of efficient VAT audit service and create impediment in timely payment of the assessed VAT return. Finally, based on the finding there commendations are forwarded. These include conducting extensive types of VAT audit, use and audit risk identification case selection, use audit source successfully, providing adequate education to VAT registrants, building capacity of VAT audit system, implementing well-developed VAT audit selection system, developing and implementing objective monitoring and evaluation of tax audit system so as to improve the value added tax audit practice.*

**Key Words:** *Auditing and Taxation, Value Added Tax, Audit Effectiveness.*

### **Introduction**

Taxation is one of the important elements in managing national income, especially in developed countries and has played an important role in civilized societies since their birth thousands years ago. It becomes an issue of world wide concern, from the time of its inception. This is due, in great part, to effects on the life of virtually every human being. Taxation has gained importance not only as a tool for raising revenue but also help to meet the administrative costs of governance, the provision of public services such as medical care, education, infrastructure, security and maintenance of law and order, but also as a tool available to planners, policy makers and implementers aiming to regulate the economy in order to bring about desired economic development. Developing countries are in difficult situation to provide these basic public goods and services from taxes due to weak tax collection and administration. Recently many poor countries have become pre occupied with improving tax systems. For instance, Ethiopia amended the tax laws with new provisions and procedures to assist the tax payers in complying with self-assessment processes so as to reduce tax evasion there by increasing the revenue generated through tax, such as government placed the sales tax with Value Added Tax (VAT) and Turnover Tax (TOT). The Value added tax audit is an investigation made by the tax authority in order to verify the accuracy of value added tax liability payment and attempt to detect non-compliance behavior and activities. However, the role of an auditor in a modern tax administration goes beyond verifying a tax payer's reported obligations and detection of discrepancies between a taxpayer's declarations and supporting documentation. Tax audit is an examination to determine whether a tax payer has correctly reported and assessed their tax obligations. However, the role of an auditor in a modern tax administration must extend beyond merely verifying a taxpayer's reported obligations and detection of discrepancies between a taxpayer's declaration and supporting documentation. An effective audit program will have significantly wider impact than just raising revenue directly from audit activities. By selecting the highest risk cases, efficiently detecting non-compliance, applying appropriate sanctions, and publicizing results of audit activity (either generally or specifically), tax payers are put on notice that attempting to avoid tax will result in a high likelihood of detection and imposition of significant sanctions. The value added tax audit program also plays an important part in clarifying the law and educating tax payers on appropriate compliance measures, such as filing and payment requirements, record keeping practices, relevant interpretation of the law, and legislative changes. This can be done directly by the auditor either interacting directly with tax payers, or by influencing the tax payer services program in the development of strategies to address areas of non-compliance detected during audits (OECD, 2008). Therefore, the purpose of this study is to assess the VAT audit practice of Durame Town of tax administration effect on non-compliance behavior, awareness of tax payers and revenue rising points. In addition to this, level of voluntary compliance of tax payers and the relationship between tax auditors and tax payers is also assessed.



### **Review of Literature**

Biber(2010)noted that,there are different VAT audit program.These are desk auditor verification,field audit ,registration check audit,advisoryVATaudit,record keeping audit,refund audit,issue-oriented audit,comprehensive or full audit,fraud investigation and deregistration Audit.

According toTait (1988),effective tax auditing minimizes tax evasion and also helps tax agencies to achievevenue objectives that ensure the fiscal health of the country and individual states.It derives voluntary compliance and generates additional tax collections ,both of which help tax agencies to reduce the tax gap between the taxes due and the amount collected.

Biber, (2010) Accurate and timely self-assessment and compliance with tax by tax payers is achieved only through highly visible and effective audit programs, including the consistent application of strong sanctions where noncomplianceis encountered.Tax payers must feel that there is a good chance that unreported liabilities and other forms of non-compliance have been detected during an audit.

Biber(2010) noted that, there are different approaches to investigate and review the organization record depending on upon the are a of risk, nature of the tax payers operation and the taxpayers'condition.The decision regarding the type of tests to be under taken as well as the records needed by the auditor to address specificissuesis influenced by the nature of the tax payer's operations, adequacy of books and records and materiality of potential adjustments.

Yesegat(2008) adopted an in-depth interview conducted with tax officials and surveys of tax payers and tax practitioners conducted using semi-structured questionnaires.The main findings of the study regarding VAT audit is that theVAT audit rate is low that may be due to resource constraints,and the cases subject to audit are selected by audit selection committee based on acriteria including credited clARATION, non-filing and unusual filing patterns, nil VAT declaration,and information from third parties.The study further revealed that the quality auditors(VAT administrators at large) are poor to achieve efficient and effective audit program.Based on the survey results,the study stated that tax administrators are not capable of handling audit cases quickly,lack confidence to make decisions and not have willingness to help tax payers.

### **Statement of Problem**

Audit is the core of any tax system,especially of essentially self-assessed taxes likeVAT.In most countries,the data exist to begin to design sound audit design policies for those already in the tax net.A strong VAT audit program needs,among other things, an appropriate audit case selection method. Jantscher(1990)noted that cross checking purchases and sales data by various tax payers would provide an effective tool for selecting VAT tax payers for audit and hence improve audit results.

James and Alley(2004) describe tax compliance as the extent to which tax payers comply with tax law.The success of VAT,as a self-assessment tax system a large extent,reston proper record keeping by traders and accounting of the tax to the VAT service. VAT evasion is the commission or omission of an act knowingly,with the intent to deceive,so that the VAT liability reported by the tax payer is less than the tax payable under the law (Dymond,2004).It significantly reduces the amount of collectible taxes,that is, the amount of compulsory payment to governments.Inreality,under in adequate tax audit system, the potential amount of tax revenue indeveloping and transitional countries has not been collected in an efficient and equitable manner (Edmistonand Bird,2004).One factor that significantly contributes to tax evasion islackofintensive audits and absence of pre-determined audit criteria.These means that some tax procedures have to be conducted manually,making it harder to detect evasion (ERCA,2010). The taxpayers due to the lack of competences of auditors skill, Increasing operating expenses,exaggerating non-VAT sale,low tax collection,the complexity of tax law, long period time of audit, awareness of tax payer to the audit, non-compliance of tax payers, tax evasion,and audit case selection problem were happen in tax authority due to this all the fruitiness of tax audit is not enough (Earnestand Young,1995).To solve the above problem effective VAT auditing is so vital.Therefore,a successful audit program will implement which is capable to investigate,detect and prevent evasion of VAT revenue.To the greatest possible extent,tax systems will support by clear and straight forward laws and procedures that facilitate revenue collection,develop taxpayers' awareness,and minimize taxpayers'effort and compliance costs.The VAT administration will provide with appropriate enforcement tools, including conduct of effective VAT audit (Ebrill,et.al.2001). However,attention may not be given toward understanding precisely how effective value added tax audit influence tax payer's non-compliance behaviorin DurameTown.Hence,the influence of tax auditon non-compliance behavior of tax payers and awareness of tax payers towards audit must be investigated and the findings of this study canbe used to inform and act accordingly by the respective government institution of Durame Town in particular the region and the federal government at large.



### Objectives

The main objectives of the study were

1. To identify the type of VAT audit frequently used in the revenue administration.
2. To assess VAT audit case selection techniques in the Town revenue administration.
3. To investigate factors that affect effective VAT audit program in the Revenue Authority.
4. To assess the adequacy of tax audit staff monitoring and evaluation system in the Town revenue Authority.
5. To investigate the awareness of taxpayers' in relation to their obligations during auditing.

### Methodology

Durame is a town and separate woreda in southeastern Ethiopia. The administrative center of the Kembata Tembaro Zone of the (SNNPR), this town has a latitude and longitude of 7°14'N 37°53' E with an elevation of 2101 meters above sea level. It is surrounded by Damboya woreda. According to the SNNPR's Bureau of Finance and Economic Development, Durame's amenities include digital telephone access, postal service, 24-hour electrical service, two bank branches (Global bank and Commercial Bank of Ethiopia), and a hospital. Forth is study, there searcher applied a survey was carried out using the attached questionnaire (annex-1 and annex-2) and collect opinions via interview questions (annex-3) with the goal to assess VAT audit practice in Durame Town Tax Administration. Structure survey questionnaire was circulated 74 tax payers and 5 tax auditors and their response rate is 100%. Along with some range of the closed-ended questions were a five score likert scales to provide respondents a wider range of alternatives with end points where "5", the level of agreements are represented by number 1 to 5. Strongly agree is represented by 5, agree is represented by 4, no comment is represented by 3, disagree is represented by 2, and strongly disagree is represented by 1. VAT audit function and proficiency excellent is represented by 5, very good is represented by 4, good is represented by 3, satisfactory is represented by 2, and unsatisfactory is represented by 1. Secondary data were collected from the already produced material like individual audit reports, documents of Durame Town tax authority, World Bank, IMF and other organizations various related study and working papers, Books, and various internet documents.

The Target de-population constituted two target set so fun its. Five Tax audit staff and 74 VAT registrant tax payers of the authority of Durame Town out of 356, representative sample size from the VAT registrants, there searcher employed the formula:

$$n = z^2 p q / d^2 \text{ -----, If } N \text{ is greater than or equal to } 10,000$$

$$fN = n / (1 + n / N) \text{ -----, If } N \text{ is less than } 10,000.$$

Where,

N=Target population

n=Desired Sample size

z=Standard normal variance at there quired confidence level

(z-Statistics)

p= estimated characteristics of target population

q= 1 - p

d= Level of statistical significance (marginal error).

In this study, the proportion of the target population with an incidence of rate of 0.5 (50%) where taken, since there was no previous research study on the incidence of VAT audit practice. The z-statistics was 1.45 (92.65%) and the desired accuracy at 0.0735 levels and then the sample size was determined as follows:

$$n = z^2 p q / d^2, n = (1.45 * 1.45) * (0.5 * 0.5) / (0.0735 * 0.0735) = 93$$

$$\text{The next formula, } fN = n / (1 + n / N) = 93 / (1 + 93 / 356) = 74$$

Therefore, by using a random sampling technique, respondents selected via probability sampling system from the lists of VAT registered tax payers in the authority. In analyzing the data, the quantitative data will analyze by Statistical Package for Social Science (SPSS), where as the qualitative data analysis describe qualitative data by themes.

### Results and Discussions

The key source of revenue for the government is tax. However, the potential tax revenue is not collected due to absence of taxpayers' compliance with the tax law both deliberately and unknowingly. Base don the analysis of the study, the following findings were identified and summarized:

Majority of Tax auditors are at higher level of education and have less than two years work experience on the current position in the authority. With regard to the tax payers, most of them are at the primary school level of education and started trade before tax audit began that they were able to evaluate the situation before and after conducting VAT audit.



Appropriate audit selection is a key to the effectiveness of VAT audit program. Durame Town Revenue Authority selects tax payers for audit based on associated risk. The Town Revenue Authority selects cases based on deviation from previous period's VAT returns (under reporting of sales) and they think that it is an indicator of evasion. Economic factors, firm performance, management skills and others are factors for reduction of VAT returns but the authority was not considering the mentioned issues. As BPR manual the Town Revenue Authority has standard risk identification criteria (Risk matrix) but not implemented. However, case review method, data mining system, risk-based audit program, were not yet in place, and the audit functionality of SIGTA Sis not being fully utilized for risk assessment.

Durame Town Revenue Authority VAT audit activity is not properly supported by intelligence team product, even if the authority has intelligence department. And also, there is a delay in audit coverage of selected tax payers due to these, there is an obstacle to improve revenue collection performance and tax compliance. Tax payers were not willing to provide sufficient information for tax auditors and assessors regarding their business. The Authority gets information from third party and business profile.

The effectiveness and efficiency of Audit work was affected by staff qualification, experience and resources for audit. Auditors have the ability to interpret rules and laws, analyse the compliance behavior of tax payers, investigative and advisory skill. The survey and the interview result revealed that Town Revenue Authority recruit qualified but less experienced audit staffs.

The venue authority has not enough resource and equipment like computer and suitable office to conduct audit work. Regarding auditors' capability, the in-depth interview with tax officials showed that tax auditors have not standardized knowledge regarding clarification of unclear VAT rules and regulations, and are incoherent in giving information regarding identical tax issues. In addition, tax auditors lack willingness to give advising services to tax payers rather they simply intimidate them by raising the consequence of not being compliant.

The standard time frame on the BPR manual was not sufficient to perform and conclude complex cases. Individual Auditors might not properly detect non-compliance due to time scarcity and there required audit quality might not be achieved; whereas auditors those expected to complete simple cases might complete even before the time of stated period and might consume working time improperly so that feasible audit coverage might be reduced.

The awareness of tax payers in relation to their obligations revealed that majority of VAT registrants' view the Ethiopian tax law (that is some articles in the VAT regulation) is vague and open to interpretation in different ways for the same case. For instance, reclamation No 285/2002 Article 22 sub-article (6) and (7).

The tax payers' attitude towards tax audit is the major factors that contribute to the success of a VAT audit objectives. In light of this fact the survey result shows that the VAT registrants' attitude to and cooperation with the tax system and tax audit not support the VAT audit objectives. Again, the aim of conducting VAT audits is to ensure that the essence of voluntary compliance for affair tax system is being implemented; and not aimed to 'find fault'.

### **Recommendations and Conclusion**

To achieve the objectives of government revenue objective a well-structured VAT audit program is vital to ensure the fiscal health of the country, and sustain the health of the tax system by reducing tax gap through voluntary compliance improvement and additional tax collections.

Further, it might provide valuable support in identifying areas of the tax law that require clarification or addressing deficiencies in the law, and to influence compliance across the broader tax payer community.

This paper has attempted to analyze current status, the performance of VAT audit practice of the Durame Town Revenue Authority. In particular, the study explored types of VAT audit performed, and effectiveness of VAT audit, risk identification criteria for case selection, responsibilities, and awareness and compliance issues of tax payers' practices and significance of tax audit staff monitoring and evaluation performance.

These investigations were addressed by employing survey questionnaires, semi-structured and structured interview given to tax officials and reviewing published and unpublished documents. Finally, on the basis of qualitative and quantitative analysis of data, the findings of this study are summarized as follows:



DurameTown Revenue Authority audit used intensively comprehensive VAT audit and the audit program is unchanged and not used different types of audit in relation to simplicity and complexity of cases. Tax payers are selected for audit based on risk criteria, and selected audit cases are expected to be completed within 15 day period regardless of the complexity of audit cases and the size of the tax payers. Taxpayers might be repetitively audited if there is an indication of serious VAT fraud and when they report less VAT return than previous return. As a result, there is unreasonable consumption of audit resources as well as increase the burden associated with repetitive audits for fully compliant tax payers. Corruption might also arise due to repetitive contact between the same tax payers.

Durame Town Revenue Authority did not adopt segmentation approach this result in low customers satisfaction, and increases both tax payer compliance costs and tax administrative costs. However, VAT audit program is mainly focusing on Category of "A" taxpayers which large tax potential with less emphasis to medium and small category of taxpayer's community.

In addition, the audit coverage is unsatisfactory that might be due to inappropriate audit type adopted and resource constraint. Case selection was only based on associated compliance risk.

The Revenue Authority of Durame town Revenue Authority not fully used automate disk score system and previous case selection system (random selection). Regarding audit staff, there is no competency assessment model, and less emphasis is given for continuous upgrading the capability and knowledge of staff resources once they have given and held a particular position.

Further, because of the lower level of tax payers' knowledge and skill to keep proper books of account and financial reports the practice of VAT audit isn't at there required level to promote voluntary compliance.

The right tax payers' attitude towards tax audit is the major factors that contribute to the success of a VAT audit objectives. In light of this fact the survey result shows that the VAT registrants' attitude to and cooperation with the tax system and tax audit not support the VAT audit objectives. Again, the aim of conduct VAT audit is to ensure that the essence of voluntary compliance for a fair tax system is being implemented; and not aimed to 'find fault'. However, majority of respondents are perceived that VAT audit aim to detect tax evasion and avoidance, and penalize tax payers instead of educating them. In this particular study it is observed that the VAT audit selection process of Durame Town Revenue Authority is under developed, because of lack of clearly stated and acceptable auditing standards, lack of well-integrated risk based case selection, poor integration and exchange of information, in applicable risk management techniques.

Generally, these clear findings lead us to conclude the tax authority audit cases election method isn't in a position to create fruitful data which is supportive for the VAT audit. This in turn, makes the work of tax auditors not to target on those key non compliant and there by pave the way to increase number of non compliant and evaders. Accordingly IMF(2005) that significant association was observed between efficient audit service and speed of VAT return payment. However, because of insufficient number of tax audit staff, in adequate training, limited knowledge of international business practices and capacity of tax audit staff, the function of VAT audit was poor and finalized with out customers' satisfaction. Generally, it would be possible to conclude that there is lack of efficient audit service and create an impediment (obstacle) in the timely payment of VAT returns. More over, create a serious problem in the VAT audit objectives and a loss of credibility of the tax administration.

On whether the adequacy of the tax audit staff monitoring and evaluations system exist or not; summary of figures from the respondents indicated that, because of inadequate VAT audit views, lack of clearly stipulated VAT audit scope and low audit frequency, poor communication and inter personal relationships, and un satisfactory monitoring and performance evaluation system the practice of VAT audit adversely affected and thus, it is not in a position to promote voluntary compliance. Finding of the research indicate that, VAT audit practice to timely filing and reporting of required VAT liability information, the correct self-assessed taxes owed, and the timely payment of those taxes without enforcement actions was very low when it is compared to the extent of work expected.

In light of the afore mentioned (previously) conclusions of the study, there searcher wish to make the following recommendations to minimize the problems of Durame Town Administration Revenue Authority VAT audit program so that to improve voluntary compliance and to meet there venue needs of the Town for public expenditure.

Durame Revenue Authority must adopt different ranges of audit types to increase the audit coverage and voluntary compliance having in adequate staff resources; the Town Revenue Authority should adopt a wide range of audit



methodologies rather than an use of full comprehensive VAT audit because to address risk and audit quality. The spot (issue) audit should be widely applied to increase the audit coverage, and education type audits that are not yet in place should be implemented to improve tax payers' awareness and voluntary compliance. In addition, Durame Revenue Authority should give emphasis and assign adequate resources for investigation audit.

The Revenue Authority should design pre audit procedure to select highly risky business. In addition to pre-auditing the authority should use data mining, case review and full risk-based audit selection strategy that rewards tax payer compliance with a light touch approach and openly demonstrates that valuable tax payer resource is being deployed against the non-compliant.

The Authority should use set and audit risk identification criteria to give priority for highly risky businesses and to encourage compliance tax payers by minimizing tax payers' compliance cost.

The Revenue Authority should perform audit activity in cooperation with the intelligence information and should use Audit manual for better efficiency.

Durame Town Revenue Authority should revise the stated 15 days audit period with the consideration of the complexity of the cases and the size of the tax payers to be audited. The authority should dispense more time for complex cases and audit of large tax payers to properly detect non compliance and achieve the required audit quality.

To make effective audit the Durame Town Revenue Authority audit should increase number and capability of audit staffs through appropriate need assessment and employees and identified gap. Auditors should have been taken continuous training so that their skills are kept up-to-date and relevant. Further, the authority should supply sufficient computers and other necessary audit resources for auditors.

The most understandable requirement for the successful of VAT audit practice is supportive awareness and sufficient knowledge of tax law. Awareness is a cornerstone as far as VAT audit and its role in voluntary compliance is concerned. Therefore, Durame Town Revenue Authority is required to devise and adopt additional education and information dissemination programs and techniques (like mass-media, preparing brusher and using different structures (School, church, and Keble 1 to 5 approach) for providing necessary information to VAT tax payers regarding the rights and obligations, so as to build and develop a citizen who has better value in tax. In addition, providing technical information through a tax payer education program, the tax law, the declaration forms and procedures must be sufficiently simple and transparent so as to encourage voluntary compliance.

Durame Town Revenue Authority should sufficiently use an investigative approach to check the accuracy of VAT returns to establish what have not been recorded in the accounting system. It should use an investigatory approach to establish the completeness, accuracy, timeliness, credibility and validity of tax payers' declarations, disclosures, and other financial arrangements.

It was discussed in the literature review part that tax payers' attitude towards tax audit is the major factors that contribute a lot to the success of VAT audit objectives. Also understanding the aim of VAT audit and creating smooth relationship with VAT registrants are very crucial. Therefore, the authority has to try its level best to use tax audit and other departments to educate registrants to the extent of persuade the existing audit as a fact finding perceptions and capitalize on smooth partnership to VAT audit.

Because of under developed audit case selection system the authority's value added tax audit practice in promoting voluntary compliance is very low. To minimize this problem and maximize in promoting voluntary

### **Compliance The Tax Authority Should Take The Following Specific Action**

The authority has to develop and implement clearly state and accepted auditing standards (mainly audit manual). The authority should create accurate and comprehensive tax payer information stored in an integrated computer system by staffing appropriate personnel, investing in technology infrastructure and delivering appropriate training is also essential in enhancing the capacity of VAT audit case selection process. Such a system has a tremendous impact on voluntary compliance and tax revenue. Because of that, tax payers who "caught" in under reporting of sales and when other tax payers become aware that the computer system can automatically and accurately detect tax evaders, and under reporting of sales so that it will be perceived as strong and powerful by the VAT registrants.



To maximize the VAT audit practice in promoting voluntary compliance the authority has to improve the existing risk management techniques by applying modern risk modeling. Insense that cases trackings hould provide the status and details on the progress of casesat all times.

The application should have flexible audit selection options that allow for the identification of tax payers to be audited based on risk analyses stored in the tax transaction database.

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