ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES

ASSESSMENT OF UNDER INVOICING VALUATION SYSTEM: THE CASE OF PROFIT TAX AND ACCOUNTING PRACTICE

BY: TIGEST GEREMEW

OCT 2017

ADDIS ABABA, ETHIOPIA

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A THESIS PROPOSAL SUBMITTED TO ST.MARY'S UNIVERSITY, SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION IN ACCOUNTING AND FINANCE

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APPROVED BY BOARD OF EXAMINERS

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Dean, Graduate Studies	**Signature**
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Advisor	**Signature**
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External Examiner	**Signature**
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Internal Examiner	**Signature**

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List of acronyms/abbreviations

ACV	Agreement on Customs Valuation
CIF	Cost, Insurance and Freight
CVC	Customs Valuation Code
CUP	Comparable Uncontrolled Price
DPV	Duty Paid Value
ETB	Ethiopian Birr
ERCA	Ethiopia Revenue and Customs Authority
EU	European Union
FCY	Foreign Currency
IAS	International Accounting Standards
GATT	General Agreement on Tariff and Trade
MNC	Multinational Companies
NBE	National Bank of Ethiopia
OECD	Organization for Economic Cooperation and Development
TV	Transaction Value
TVI	Transaction Value Identical goods
TVS	Transaction Value Similar goods
US	United State
VAT	Value added tax
WTO	World Trade Organization

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Abstract

Ethiopia is one of the countries with excessive challenges in under invoicing import. The inflated cost of imported item in custom valuation database and foreign exchange crisis in Ethiopia has become a major constraint for under invoicing. The focus of this thesis is the impact of under invoicing in profit tax and accounting practice. The methods adopted in the study include documentary analysis, and in-depth interview. The results suggested that the under invoicing valuation method affect the determination of profit tax and the recording of accounting principles There is also risk of revenue loss to the government due to under invoicing of imports, since the foreign currency crisis, transfer pricing and Tariff classification are not adequately developed. Therefore, the Government of Ethiopia needs to improve the process of determining dutiable value of the goods, foreign currency availability and the controlling of transfer pricing, since Profit Tax revenue is one of the major revenue for the federal government in Ethiopia.

Key Words: Profit tax, Under Invoicing Import, Account practice

CHAPTER ONE

INTRODUCTION

1.1. Background of the study

A sound tax system should contribute in the economic development of a country. Effective tax administration minimizes compliance cost and increase revenue, minimizes distortion of resource allocation and simplifies its administration (World Trade Organization 2003).

A customs valuation system established pursuant to the Customs Valuation Code (or GATT Valuation Code) negotiated during the Tokyo Round of the General Agreement on Tariffs and Trade. The system is based on the "transaction value" – or the price actually paid or payable for the imported goods subject to permitted adjustments, such as certain additional costs – as the primary method of valuation for imported goods. The system has substantially replaced the Brussels Definition of Value. The detailed rules for valuing goods for customs purposes are now contained in the Agreement on Customs Valuation (Article VII of GATT 1994).

Customs valuation is the determination of the amount up on which the rates of duty and tax are applied to calculate the value of customs taxes liability of a tax payer. While these rates are unambiguously fixed by the statute in a tariff schedule, the declared value of imported goods may vary from transaction to transaction. The fluctuating tax base has important implications for the customs tax policy of a country. An importer engages in under invoicing and misrepresenting the value of shipment to reduce his/her duty and tax liabilities.

The customs valuation system in Ethiopia is in line with the agreement on customs valuation. The current system of customs valuation reflects the experience of developed countries which is based on built in incentives for compliance by importers and on the use of electronic information management. Nature of under invoicing Valuation fraud is a

fundamental problem in most countries particularly in developing countries that have relatively high rates of duties and other various taxes on imported goods. (Zafar,etal (1993),) WTO valuation rules require an administration to accept the declared transaction value (even when clearly unreasonable), unless the authenticity of the supporting invoice can be unequivocally disproved by the authorities. Evasion of duty through undervaluation or miss-description of imports is an acute problem for custom administration in developing countries. (King, etal ,2003)

The reasons for value manipulation are well known. In the developing countries, where the import duty rates are usually high, the importers tend to undervalue the consignments to reduce their duty liability.

Customs valuation is the procedure used by customs officials to determine the value of the imported goods for the purposes of calculating the right import duty. The customs value is essentially the transaction value that an importer pays for the goods, but can include other additional costs such as commission, packaging and royalties. Where an ad valorem tariff applies to goods, customs officials need to know the value of the goods in order to work out the amount of duty the goods are subject to. The question of value arises only in cases of ad valorem tariffs, as opposed to specific tariffs. This is because specific tariffs are levied on specific amounts of goods and the tariff amount does not depend on the value of the good concerned. In the case of ad valorem tariffs, the tariffs are levied as proportions of the value of the good.

According to Ethiopia custom directive no. 70/2004, VAT proclamation 285/2002 Article 15, and Circular IRA-54/69, (2004), Cost of imported item is determined by adding Cost, insurance and freight (CIF) and other additional cost incurred for the items up to importer warehouse, this method is applied for all type of goods imported, merchandise or a fixed asset. (Directive on Customs Valuation No. 70/2004). The dutiable value for imported goods shall be the actual total cost of the goods up to the first entry point to the customs territory of Ethiopia. (Proclamation 859/2014, Article 89)

The transaction value of imported goods shall be the transaction value that is paid or payable for the goods when sold for export to Ethiopia, and adjusted where necessary, as Article 90 of the Proclamation, (Custom Proclamation 859/2014, Article 91).

In determining the customs value of imported goods in accordance with Article 90 of the Proclamation, the following costs shall be added to the price paid or payable for the imported goods:

a) expenses incurred by the buyer, and not included in the price paid or payable for the goods, in respect of:

(1) commission and brokerage charges except buying commission;

(2) the cost of packages which are treated as integral part, for customs purposes, of the goods;

(3) the cost of packing, whether for labor or materials

(4) the transport, loading, unloading, handling and insurance costs associated with the transport of the goods to the port of entry into the customs territory;

(5) notwithstanding the provisions of sub-article (I) (a)(4) of this Article where goods are transported by air, one-third of cost paid for air transport;

Where the transaction value of imported goods cannot be determined based on Article 90 of the Proclamation, it shall be determined by taking the transaction value of identical goods sold for export to Ethiopia at the same commercial level and in substantially the same quantity at or about the same time as the goods being valued. (Custom Proclamation 859/2014, Article 91).

Business Profit Tax is the tax imposed on the taxable business income /net profit realized from entrepreneurial activity. Taxable business income is determined per tax period on the basis of the profit and loss account or income statement, which shall be drawn in compliance with the generally accepted accounting standards. Corporate businesses are required to pay 30% flat rate of business income tax. For Unincorporated or individual businesses, the business income tax ranges from 10% - 35%. Mesfin, e tal, (2009). This study will assess the proclamation and directives with respect to the practice of determining the cost of imported goods and related profit tax and accounting practice.

To conclude, there are few studies conducted in Ethiopia related to customs valuation. Even though there are some studies, they dealt only with the legal aspects, policy and operational practice issues of the customs valuation system. None of these studies make assessment of under/over invoicing problem on imported Fixed assets and practical problems related to the tax system. This study mainly aimed to make assessment on under/over invoicing impact on Fixed assets and to examine the difficulties associated with profit tax system and accounting practice in Ethiopia.

1.2. Statement of the problem

Under invoicing is the act or practice of stating the price of goods on an invoice as being less than the price paid. Under invoicing occurs if the importer and/or exporter wish to reduce a tariff or if a buyer and/or seller wish to reduce their apparent profits so as to pay less in taxes.

Under invoiced imports use miss-invoicing to: (1) avoid or reduce import duties and restrictions, (2) dump foreign produced goods at below market prices to drive out domestic competition and, (3) smuggle goods into a country to avoid paying taxes and fees.

An importer may engage in under invoicing and misrepresenting the value of shipment to reduce his/her duty liabilities. Unless the under invoicing practices are detected and remedial actions are taken, the government revenues will be at risk and the importer receives unfair advantages over its competitors. Seifu, T. (2009)

Buyers and sellers in import and export business agree on the price of a good or service that is imported /exported. Often, this price which the importer and exporter agree on, is not properly indicated in the invoices that are processed through banks and are used for tax purposes. Ether prices are understated (under invoicing) to reduce taxes and duties or over stated (over invoicing) to decrease reported profit and hence profit tax.

The transaction value of imported goods shall be the transaction value that is paid or payable for the goods when sold for export to Ethiopia, and adjusted where necessary, as Article 90 of the Proclamation.

Using the price on a declaration for fixed assets that are depreciable is higher has the effect of reducing collectible tax to the government. This is because the base for depreciation will be higher than what it will be if the base of the depreciation was the invoice which is a lower amount. The principle is for Ethiopian Revenue and Customs Authority to use either the invoice or the price in its database whichever is higher. The reason for this is basically because government thinks that importers practice under invoice to lower customs taxes and the higher value will enable the government to collect greater amount of customs tax.

While the above holds true in most instances, it also has a downside when it comes to import of fixed/Fixed assets/ assets which are duty free and account a significant portion of the cost of importers in their financial statements, i.e., depending on whether we use the invoice or the amount in the declaration, the depreciation expense will be remarkably different, especially for machineries that are bought in millions of Birrs.

The problem is more acute these days because there is a huge import of machineries into the country because of increased opportunities for new investment and expansion of existing ones by both Ethiopians and foreigners. While government's target is to collect greater amount of tax from customs duties when the goods are imported, this objective is defeated for most of the fixed asset imports that are duty free. So, government ends up collecting lesser amount of profit tax because importers have a greater asset base to calculate depreciation expense.

The fact that Ethiopian Revenue and Customs Authority/ERCA/ automatically tends to take over invoiced prices might tend importers with duty free privileges to intentionally engage in such practices of overstating prices in collaboration with exporters and take the depreciation expense advantage. Although this is not easy to do because it requires

conspiring with the exporter and the exporter will also be subject for a higher tax in its home country for an alleged high value of sale, the incentive here can tempt the parties in the transaction to consider over stating. So, assessing this problem at length is at the heart of this research.

The accounting treatment of the difference between the amount on the importer's commercial invoice and the declaration (the custom valuation CD) is another problem. Under invoicing proclamation requires the difference to be kept as Customs Declaration Variance in the book of the importer's account. Ethiopian Revenue and Customs Authority/ERCA/ considers this difference as the value which the importer understated purposely for tax evasion. There is no way to eliminate this amount from the book of the importer. Exploring this issue is the other focus of the research.

1.3. Research question

1. Dose the custom valuation proclamation examine the proper valuation of the cost of imported item?
2. What are the basis of valuing cost of imported item by Ethiopian Revenue and Customs Authority/ ERCA/?
3. What are the factors and impact of under invoicing on imported Fixed assets and Merchandise goods?
4. What are the impact of under/ over invoicing on profit tax?
5. What are the accounting practice to record and eliminating the difference between the amount on the importer's commercial invoice and the declaration?

1.4. Objective of the study

The general objective of this research is to carry out a complete study of the current practice of applying under/over invoicing on imported goods for profit tax and the unsettled balance of Custom declaration variance account in the book of the importer.

1.4.1 Specific objective

To fulfill the above general objective, the research is expected to accomplish the following specific objectives:

1. To assesses the custom valuation proclamation examines the proper valuation of the cost of imported item?
2. To assess the basis of valuing cost of imported item by Ethiopian Revenue and Customs Authority/ ERCA/?
3. To assess the factors and impact of under invoicing on imported Fixed assets and Merchandise goods?
4. To assess the impact of under/ over invoicing on profit tax?
5. To assess the accounting practice to record and eliminate (offset) the difference between the amount on the importer's commercial invoice and the declaration?

1.5. Definition of Terms

Custom Valuation: - is a customs procedure applied to determine the customs value of imported goods. If the rate of duty is ad valorem, the customs value is essential to determine the duty to be paid on an imported good. (WTO)

Under Invoicing: -the importer and/or exporter wish to reduce a tariff or if a buyer and/or seller wish to reduce their apparent profits so as to pay less in taxes. (Empirical Evidence)

Fixed Assets: - A fixed asset is a long-term tangible piece of property that a firm owns and uses in the production of its income and is not expected to be consumed or converted into cash any sooner than at least one year's time. Example, buildings, computer equipment, software, furniture, land, machinery and vehicles, (Empirical Evidence)

DPV Variance: - the difference between the amount on the importer's commercial invoice and the declaration (the custom valuation CD), Seifu(2009)

Ad valorem tax: - any tax imposed on the basis of the monetary value of the taxed item. (WTO)

1.6. Significance of the study

While under/ over invoicing customs valuation is a vital issue to be studied, review of literature revealed that very few endeavors were made by other researchers pertaining to customs valuation system in Ethiopia. Therefore, this study beefs up the tiny literature on the area being discussed here by identifying the impacts of the under/over invoicing of imported Fixed assets on profit tax and the unsettled custom variance balance on the book of the importer's.

The study could also be used as an initiation for those who are interested to conduct a detailed and comprehensive study regarding the under/over invoicing impact on tax system in Ethiopia.

1.7. Scope of the study

Initially this study kept itself to interviewing and document analysis of the purposely sampled cases of importers. The general aim of the study is to assess impact of under/over invoicing system on imported Fixed assets and the unsettled custom variance balance on the book of the importer's, in Ethiopia limiting its scope to importers in Addis Ababa.

1.8. Organization of the Study

The research comprises five chapters five. The first chapter introduces some essential points about the project including, back grounds of the study, statement of the problem, basic research questions, and objectives of the study, significance, scope and limitation of the study. The second chapter presents theoretical and empirical review of literature on the subject. In the third chapter, the methodologies applied in the study are thoroughly explained. The fourth chapter shows the results of the study and discusses them in detail. Finally, the conclusions and recommendations are presented in chapter five.

CHAPTER TWO
LITERATURE REVIEW

2.1. Customs valuation

Customs valuation refers to the process and method used by customs authorities to determine the value of a imported/exported good. Since tariffs are usually calculated as a percentage of the value of the goods (i.e., ad valorem), the method used to determine value will directly affect the amount of tariff duties collected on a particular import item. Due to this, customs valuation has historically been “a jealously guarded function of government regarding international trade.” For many countries, the discretion given to customs authorities in valuing trade for the imposition of tariffs and duties has been an important source of revenue.

A customs valuation system established pursuant to the Customs Valuation Code (or GATT Valuation Code) negotiated during the Tokyo Round of the General Agreement on Tariffs and Trade. The system is based on the “transaction value” – or the price paid or payable for the imported goods subject to permitted adjustments, such as certain additional costs – as the primary method of valuation for imported goods. The system has substantially replaced the Brussels Definition of Value. The detailed rules for valuing goods for customs purposes are now contained in the Agreement on Customs Valuation (Article VII of GATT 1994).

Customs valuation methods are established in the World Trade Organization’s (WTO) Customs Valuation Code (CVC). Member States have transposed that regulation in their internal law. The main valuation method is Transaction Value (TV). According to this method, valuation is based on the price in a sale for export to the importing country, with some adjustments.

2.2. Nature of Under invoicing imports

Under invoicing is the act or practice of stating the price of goods on an invoice as being less than the price paid. Under invoicing occurs if the importer and/or exporter wish to reduce a tariff or if a buyer and/or seller wish to reduce their apparent profits to pay less in taxes.

Under invoiced imports use miss-invoicing to: (1) avoid or reduce import duties and restrictions, (2) dump foreign produced goods at below market prices to drive out domestic competition and, (3) smuggle goods into a country in order to avoid paying taxes and fees.

An importer is tempted to under invoice importer duties and premium quantitively restricted imports are higher than the premiums on foreign currency that must purchase from the black market to pay foreign sellers in full. When there are no foreign exchange controls, but trade barriers do exist, then clearly there is an incentive to under-invoice imports. There is, however some risk attached both to the under invoicing of imports and to engaging in illegal foreign exchange transactions. Hence, - under invoicing will not occur unless the differential between import duties and premium on black market exchange is greater that the evaluated risk factor, Mahmood, (1997).

Following, Bhagwati (1964,1967), in Pakistan, use the partner country data comparison technique to test for incentives generated under invoicing of imports. In this technique, CIF import values of the country concerned are compared with the FOB export values of the partner country to find unexpected discrepancies. To show such discrepancies, use data available in the commodity trade statics of United Nations (1981,1988).

Normally, one would expect a trading partner country's statistic to show an excess of carriage, insurance and foreign (CIF) import values over the corresponding free on board (FOB) export values of the same trade commodity. But if the observed discrepancy is in

the reverse direction, and there is other reason for the discrepancy, one may conclude the presence of under invoicing of imports, this inference will be more certain (I) that for these commodities tariff rates are higher than the black-market premium on foreign exchange and (II) that these commodities are such that it is relatively easy to under invoice because of the diverse nature of the products. (Mahmood,1997)

Valuation fraud is a fundamental problem in most countries particularly in developing countries that have relatively high rates of duties and other various taxes on imported goods. It is often exacerbated by a generally poor level of tax compliance through-out the country, a tendency for many importers to deliberately maintain poor records and the existence of special relationship with suppliers. WTO valuation rules require an administration to accept the declared transaction value (even when clearly unreasonable), unless the authenticity of the supporting invoice can be unequivocally disproved by the authorities. Developing countries are of the view that requiring customs to accept the transaction value reflected in invoices submitted by importers would impede detection of cases in which imported goods were undervalued to reduce the incidence of duties. (Rege, 2002).

Evasion of duty through undervaluation or mis-description of imports is an acute problem for custom administration in developing countries. King (2003) estimated a widespread under invoicing in Nepal and indicated lack of effective valuation procedure in place in Nepal. The transaction value system also was introduced without adequate preparation, without putting into place the necessary procedural and organizational framework, without adequate training and without an adequate value information system (King 2003). Filmer (2003) on the other hand reports the views of trading community that there is a threat at declaring a higher value and delaying clearance to extract illegal payments from the traders. (Ghimire et al, 2005) reports under invoicing of goods, discretionary power of customs officials and limited data base for value appraisal as the major problems of customs valuation. A limited database for value appraisal is considered as a violation of ACV. A perception survey conducted by Filmer (2003) has also identified custom valuation as one of the key issues of trade facilitation in Nepal.

The reasons for value manipulation are well known. In the developing countries, where the import duty rates are usually high, the importers tend to undervalue the consignments to reduce their duty liability. Some countries also maintain quantitative restrictions based on value. Some others maintain a regime of exchange control. Over valuation of imported cargo is also resorted to repatriate higher amounts of foreign exchange to make compensatory payments on other consignments. Normally over-valuation is noticed in respect of goods, attracting state-subsidized items, zero, or lower rates of import duty to launder money abroad.

Over valuation of imported goods is also noticed as a means of circumventing sliding rates of antidumping duty. In the case of export goods, over valuation is usually noticed for obtaining higher amounts of export incentives whereas under-valuation is resorted to for parking funds abroad. Manipulation in customs value not only causes revenue loss but also creates a hostile trading environment for honest traders, by distorting the market. Value manipulation also provides an easier route for money laundering. Adoption of a valuation system based on the WTO Agreement on Customs Valuations, with its emphasis on acceptance of transaction value, provides a greater scope for mis-declaring the customs value, particularly in a developing country scenario.

Customs administrations in developing countries are usually ill equipped and lack trained personnel and financial resources, and hence find it difficult to cope with problems of value manipulation. Existence of corrupt elements in some administrations does not make the task any easier.

There are four primary reasons of mis invoice trade:

- Money laundering – Criminals or public officials may seek to launder the proceeds from crime or corruption.
- Directly Evading Taxes and Customs Duties – By under-reporting the value of goods, importers can immediately evade substantial customs duties or other taxes.

- Claiming Tax Incentives – Many countries offer generous tax incentives to domestic exporters selling their goods and services abroad. Criminals may seek to abuse these tax incentives by over-reporting their exports.
- Dodging Capital Controls – Many developing countries have restrictions on the amount of capital that a person or business can bring in or out of their economies. Investors attempting to break these capital controls often mis invoice trade transactions as an illegal alternative to getting money in or out of the country.

Trade mis invoicing may be done for the purposes of evading custom duties and restrictions, avoiding paying taxes and fees, avoiding quotas, smuggling, to launder illegally obtained money, or for other unknown reasons. When trade mis invoicing is used as to tool to achieve any of these illicit objectives, economic development can be severely hindered. (Boyrie, etal.2007).

Trade mis invoicing can be used as a tool to move capital in or out of a country to evade taxes and custom duties, to avoid quotas, for smuggling, to launder money, or as a means of capital flight. For whatever reason mis invoicing occurs, the economic development of the given country can be severely hindered. In the case of the African continent, the amount of annual capital outflows to the U.S. between 2000 and 2005 increased by more than 60%. This capital flow occurred mostly through low priced exports which can facilitate tax evasion, launder money, or just move money out of the country (capital flight). High priced imports are also used for capital flows and can be used to mask illegal commissions. Data was examined for deviations from average import and export prices as an indicator of capital flows. Four of the top thirty African countries to move capital to the U.S. are classified as Northern African countries. These four countries (Egypt, Algeria, Morocco and Tunisia) alone moved approximately $6,734 million through trade mis invoicing while the remaining 26 Sub–Saharan countries combined moved a total of $13,408 million. The country moving the most capital to the U.S. through trade mis invoicing was South Africa, a Sub-Saharan country. (Boyrie. et al2007)

2.3. Customs Valuation and Transfer Pricing

Customs valuation is based, primarily, on the price paid or payable for the goods. The customs administration is a third party to the price, and so needs to rely on the price declared by the parties. Nevertheless, Customs can cross-check the value declared with the cost declared for the purposes of the corporate income tax base determination. The need for coherence between these two values is an important control tool for the customs administration, if properly used. The relationship between customs valuation and the inventory cost of the goods is complex, and an adequate understanding of this issue is necessary to make correct use of control tool. (Santiago)

Transfer pricing, in general, is defined as a term used to represent the value of transactions among the subsidiaries operating in different countries (Günaydın,1999: 166). In other words, transfer pricing is defined as the price charged for transferring a corporation's tangible and intangible assets, goods or services, raw materials, know-how and technology to its subsidiaries or branches.

World Customs Organization (2015) explain transfer pricing meaning as "When a Multinational Enterprise (MNE) group establishes itself in a new market by incorporating or acquiring a local subsidiary or establishing a branch, the local subsidiary or branch generally engages in transactions with other members of the group.

A phenomenon that commonly prevails is that tax and customs administrations are each pulling the importer/taxpayer in opposite directions (Jovanovich 2002). This results from the fact that a lower value for imported goods will result in higher potential profit and income tax revenue from the resale of such goods to unrelated customers. In contrast to this, the higher the dutiable value of the imported goods, the greater the customs duty revenue on the goods for the customs authorities.

Thus, tax administrations will generally insist on a low transfer price and customs administrations on a high import price to ensure each revenue department maximizes their revenue stream from the import transaction. As stated by Jovanovich (2002), the result is that the importer/taxpayer could be squeezed in the middle if neither customs nor tax law recognized transfer pricing as agreed to under the other disciplines. As set out above, the origin and development of the income tax transfer pricing regimes compared to those of the customs valuation system have been radically different, leading to tax and customs laws and authorities often having contrasting objectives and applying different principles. These inherent differences create barriers for the process of harmonizing the existing tax and transfer pricing valuation methods and principles.

The objective of international transfer pricing focuses on minimizing taxes, duties, and foreign exchange risks, along with enhancing a company's competitive position and improving its relations with foreign governments. Transfer pricing is a recent corporate tax happening in India. Prompted by the growing participation of multinationals in India, the government introduced "transfer pricing" regulations in the Finance Act of 2001 to ensure that Indian companies report "reasonable, fair and equitable" profits and taxes on transactions with "associated enterprises" such as a foreign parent company. When one subsidiary of a corporation in one country sells goods, services or know-how to another subsidiary in another country, the price charged for these goods or services is called the transfer price. All kinds of transactions within corporations are subject to transfer pricing, including those involving raw material, finished products and payments such as management fees, intellectual property royalties, loans, interest on loans, payments for technical assistance and know-how and other transactions. The rules on transfer pricing require MNCs to conduct business between their affiliates and subsidiaries on an 'arm's length' basis, which means that any transaction between two entities of the same MNC should be priced as if the transaction was conducted between two unrelated parties. (www.esupportkpo.com).

2.4. Cost of Imported item related with Profit tax

The landed costs/cost of imported item/ are the costs involved in importing purchased goods. They are the total cost of a landed shipment including purchase price, freight, insurance, custom duties and other costs up to the importer warehouse.

The value of imported goods will be relevant for the determination of the profits taxed by corporate income tax. The lower the customs value, the lower the inputs cost and, hence, the higher the profit taxed by corporate income tax.

According to IAS (2, 2001), The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other related items are deducted in determining the costs of purchase.

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Cost should include all: [IAS 2.10]

- costs of purchase (including taxes, transport, and handling) net of trade discounts received
- costs of conversion (including fixed and variable manufacturing overheads) and
- other costs incurred in bringing the inventories to their present location and condition

Inventory cost should not include: [IAS 2.16 and 2.18]

- abnormal waste
- storage costs
- administrative overheads unrelated to production
- selling costs

- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms.

2.5. Accounting standards and taxation

James (2009) states although accounting principles and practice normally form the basis for tax assessment, there are reasons why there should be variations between the figures used for commercial accounting and tax assessment. These include the different purposes of commercial accounting and taxation, difficulties in defining economic concepts and the administrative effectiveness required of a tax system. The purposes and requirements of commercial accounting principles and taxation are not always the same. Accounting involves the preparation of information for the purposes of control and decision-making and may require interpretation as well as simply recording information.

The main purpose of taxation is usually to raise revenue, but it is also used as an instrument of government economic and social policy. For a tax system to operate successfully within the law it requires a degree of certainty that may not always be appropriate for commercial accounting.

Furthermore, there may be alternative methods of preparing accounts that are equally acceptable in terms of accounting standards but the choice of which might be influenced by the taxation implications in an inappropriate way Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the [Inland Revenue] Ordinance, no further modifications are required or permitted.

At first sight, it might be thought that the calculation of variables such as revenue, expenditure and profits should be the same for the purposes of both commercial accounting and taxation. Quite often this is true, but there are circumstances in which different figures are appropriate. The fundamental point, of course, is that accounting and taxation exist for several reasons. One clear view from the US held that: 'financial accounting and tax accounting are not the same.

They have different objectives, are subject to different rules and serve different purposes'. There are several reasons why financial reporting rules and practices might not always be appropriate for determining final tax liability. These include the purposes of accounting and taxation, difficulties in defining economic concepts and administrative effectiveness.

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled.

The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets'.

William E. Simon, a former Secretary of the US Treasury, once said that 'The Nation should have a tax system which looks like someone designed it on purpose' (US Treasury,1977). In the case of an income tax, that the tax base does not always match accounting or economic definitions of income. In the UK, the Meade Committee (1978: 70) pointed out that the UK income tax had features, such as the treatment of much industrial investment and pension funds that made the effects of tax in some cases like those of an expenditure tax.

2.6. Customs valuation in Ethiopia

Polyakov et al (2006) noted that the current system of customs valuation reflects the experience of developed countries (the US, in particular) and is based on built-in incentives for compliance by importers and on the use of electronic information management.

The agreement followed by the 1950 convention on the valuation of goods for customs purposes, establishing the BDV and the 1979 agreement on implementation of article VII

of the GATT, resulting from the Tokyo Round. WTO customs valuation rules emphasize that customs value should be based on the actual value of the imported goods or like goods. If the transaction value cannot be used and found, then certain secondary bases are considered in order of precedence: transaction value of identical merchandise; transaction value of similar merchandise; deductive value; and computed value.

Most customs authorities have considered related party prices for the importation of goods as being acceptable without much enquiry. In fact, not much effort has been made by customs administrations to check the bona fides of related party contractual prices. On the other hand, customs valuation systems determine international trade practice by a country as it is the basic element of trade facilitation. The customs valuation system in Ethiopia is in line with the ACV.

The current system of customs valuation in Ethiopia reflects the experience of developed countries which is based on built-in incentives for compliance by importers and on the use of electronic information management. It is not feasible to apply ACV in a non-compliant environment since evasion of duty through undervaluation or miss-description of imports is an acute problem for custom administration in Ethiopia. This makes the customs valuation systems currently applied in Ethiopia more susceptible of undervaluation and poor compliance by importers. (Seifu, 2009)

2.7. Under invoicing in Ethiopia

Polyakov et al (2006) also noted that undervaluation is generally the rule of the game for smaller importers (comprising up to 90 percent of all importers in Ethiopia) who generally trade small lots, with variable consignment contents. This makes the customs valuation systems currently applied more susceptible of undervaluation and poor compliance by importers.

With the intention of reducing the payments for duties and taxes, importers usually declare invoices containing small product price. The ways of under-invoicing may vary

depending on the nature of the importing firm, the type of product imported, and the product's country of origin.

The commonly occurring ways of under-invoicing in Ethiopia are adjusting invoice price, using third country's certificates of origin, and falsification of product's grades. Seifu T2009)

While the duty/tax rates are unambiguously fixed by the statute in a tariff schedule for any imported commodity, the declared value varies from transaction to transaction for the same item. The fluctuating import value has important implications for the duty/tax revenue from foreign trade in a country. An importer may engage in under invoicing and misrepresenting the value of shipment to reduce his/her duty liabilities. Unless the under invoicing practices are detected and remedial actions are taken, the government revenues will be at risk and the importer receives unfair advantages over its competitors.

2.8. Cost of Imported Item in Ethiopia

According to VAT Proclamation 285/2002 and Circular IRA-54/69, (2004), the value of a taxable import is the customs value of the goods, determined in accordance with the customs legislation of Ethiopia, plus the sum of duties and taxes payable upon the import of the goods into Ethiopia, excluding VAT and income tax withholding.

Custom directive no. 70/2004 noted that Cost of imported item is determined by adding Cost, insurance and freight (CIF) and other additional cost incurred for the items up to importer warehouse, this method is applied for all type of goods imported, merchandise or a fixed asset.

Directive on Customs Valuation No. 70/2004). The dutiable value for imported goods shall be the actual total cost of the goods up to the first entry point to the customs territory of Ethiopia. (Proclamation 859/2014, Article 89). The transaction value of imported goods shall be the transaction value that is paid or payable for the goods when sold for

export to Ethiopia, and adjusted where necessary, as Article 90 of the Proclamation, (Custom Proclamation 859/2014, Article 91).

In determining the customs value of imported goods in accordance with Article 90 of the Proclamation, the following costs shall be added to the price paid or payable for the imported goods:

a) expenses incurred by the buyer, and not included in the price paid or payable for the goods, in respect of:

(1) commission and brokerage charges except buying commission;

(2) the cost of packages which are treated as integral part, for customs purposes, of the goods;

(3) the cost of packing, whether for labor or materials

(4) the transport, loading, unloading, handling and insurance costs associated with the transport of the goods to the port of entry into the customs territory;

(5) notwithstanding the provisions of sub-article (I) (a)(4) of this Article where goods are transported by air, one-third of cost paid for air transport;

Where the transaction value of imported goods cannot be determined based on Article 90 of the Proclamation, it shall be determined by taking the transaction value of identical goods sold for export to Ethiopia at the same commercial level and in substantially the same quantity at or about the same time as the goods being valued. (Custom Proclamation 859/2014, Article 91).

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1. Research methodology

Considering the nature of the study and the type of data required in this study, the researcher collected primary data by conducting key informant in-depth interviews with a help of well prepared and thorough check list, and secondary data by consulting documents relevant to the subject at hand. The researcher, interviewed Senior Auditors of Ethiopian Revenue and customs Authority /ERCA/ working in tax offices, senior finance officers in Audit firms, import company owners and looked at importers financial statement, customs valuation legislative documents (proclamations, regulations and directives), and tax decision from appeal commission, as sources of data.

3.2. Research Design

The research is designed in such a way that to collect primary data by deploying key informant interviews and secondary data by consulting relevant documents. The information collected from both sources was analyzed through narration. Design employed in this study is descriptive. The study also involves analyze different documents that defines and explains what are the impact of under invoicing valuation system on profit tax and the accounting practice.

3.3.Population and Sampling techniques

The key informant interviewees were purposely selected based on the position they possess in their organization, knowledge and experience regarding the research questions this research aimed to answer about under invoicing. A total of 23 individuals were identified for the interview to collect the relevant data. The companies and the organizations covered in by this research for the data collection were selected purposely based on their accessibility and relevance for the research. 8 people from Ethiopian Revenue and Customs Authority, 3 people from Independent audit firms, 12 people from Import companies were entertained for the interview.

3.4.Source and Types of data

Both primary and secondary sources were used for the study. The primary sources include key informants. Secondary data sources that are relevant to the research work were consulted too. The main sources of secondary data were financial statements of import companies and tax appeal cases from tax appeal office. Qualitative data is collected and analyzed through narration here in this research.

3.5.Procedure of Data Collection

The data collection method used to collect primary data was conducting key informant interviews while enough documents of tax appeal cases were thoroughly referred as secondary data source.

The relevant organizations (companies) were identified and a checklist (questions) to guide the interviews were prepared based on the objectives of the research and the research questions. Each of the interviewees was asked for their willingness to participate in the research and their full consent was obtained. A kind of in-depth face to face interview with each of the 23 interviewees was conducted by the researcher. The researcher captured well enough all the responses from the interviewees and analyzed them through narration by triangulating with the information collected from the secondary source.

3.6. Method of data analysis

The primary data collected through the key informant interviews were well captured and analyzed through narration by triangulating them with what is obtained through the secondary data source. The analysis is done from the perspective of unfolding the impact of under invoicing valuation system on profit tax and accounting practice. It is used, in this study, for describing the impact of under invoicing valuation system on profit tax and its accounting practice. A review of proclamation and directives, tax decision of appeal commission, and financial statements of the importer serves as documentary sources. The most important use of this documentary source is to validate and enhance evidence from other sources.

CHAPTER FOUR

RESULTS AND DISCUSSION

Under this part, the study entertained about Customs valuation and transfer pricing, and factor of under invoicing. The study also tried to compare the impact of under invoicing on Profit tax, Ethiopia Trade law, Corruption, Market Inflation, and Accounting Practice.

4.1. Customs valuation and Transfer pricing

Customs valuation is one of the challenging bottlenecks to trade facilitation. The existing rules virtually allowed customs authorities to exercise a large amount of discretion. Accurate, reliable and timely information is costly to acquire, and the rules fail to provide specific instructions when to use one valuation rule over another. The virtually multiple valuation rules regime subject businesses to uncertainty and compel importers to make deals with customs authorities to secure the most privately profitable terms for their businesses.

According to the response obtained from the in-depth interview and document analysis of tax appeal cases it was stressed that there is a problem in the custom valuation system of Ethiopia. The practice of valuation system doesn't adhere to the custom proclamation. Let's look at what exactly stated in the custom proclamation. According to custom proclamation 859/2014, "duty means a charge levied and collected on any imported or exported goods in accordance with the Customs Tariff Regulations issued pursuant to the Proclamation and the International Convention on the Harmonized Commodity Description and Coding System; (Article 89: 2-3)". "The dutiable value for imported goods shall be the actual total cost of the goods up to the first entry point to the customs territory of Ethiopia, and the dutiable value for export goods shall be the actual total costs of the goods up to the final exit point from the customs territory of Ethiopia".

The transaction value of imported goods shall be the transaction value that is paid or payable for the goods when sold for export to Ethiopia, and adjusted where necessary, as set forth in Article 97 of the Proclamation. Where the buyer and seller are related, the

transaction value shall be considered as the basis for valuation of duty if it is accepted by the Authority.

In contrary to the proclamation stated above the transaction value which is paid for the goods by the importer is not accepted and considered by the custom office, paradoxically the office has its own database for price of items and transaction value method. This leads the under invoicing problem and high tax to be paid by the importer.

4.2. Factor of under invoicing import

Under-invoicing is a phenomenon which can be defined as provision of an invoice that states less price than the paid one. This may reduce the import duty on the product that will be collected by an ad valorem tariff. The favorite items which have soaring prices in the country and having high import duty and taxes are more prone to under-invoicing and considered major reason for revenue loss. There are thousands of cases in which the importers declare less-value of the product and do under-invoicing which decreases import duty.

Table:4.2.1 Factors of Under invoicing import

Company Name	**Branch Tax Offices**	**Audit firms**	**Importer**	**Tax Appeal Case.**
No of Interviewer	8	3	**12**	**6 cases**
Position of the interviewer	Tax Audit Team coordinator and Senior Auditors	Chartered Certified Auditors	Finance managers and Owners	
Form of Organization	Government Tax office	Chartered Certified Auditors	Partnership	
Years of Experience	3-5 Years	6 years	5-10 Years	
Factors of under invoicing import	Shortage of foreign currency	Exporter didn't want to give the invoice based on the exact value of the goods	Foreign currency / LC/ approval process	Transfer pricing
	High value of customs duty and Identical goods valuation system,	Shortage of Foreign currency and LC approval process	Custom valuation HS code and country of origin of the goods	Exchange rate
	country of origin of the goods			Customs tariff classification
	Exchange rate 285/61	Exchange rate according to VAT proc 285/61	Exchange rate according to VAT proc 285/61	Custom valuation database

Source: Depth Interview and Document

Based on the data collection result, there are a lot of factors that leads under invoicing:

4.2.1. Tariff classification

The rate of duty depends on the Harmonized System (HS) of product classification, a system developed and maintained by the World Customs Organization (WCO), in which traded products are assigned internationally standardized HS codes and commodity descriptions.

The HS code is comprised of 6 digits, which designate the chapter, heading and subheading to which a commodity belongs. However, member countries of the WCO can further subdivide the HS nomenclature beyond 6 digits, and to set their own rates of duty at the level they classify goods. WCO (2006)

The rates of duty may also differ depending on the country of manufacture of the imported goods. Preferential duty rates may apply where a Free Trade Agreement exists between two or more transacting countries. On the other hand, additional anti-dumping duties may be levied on products that originate in countries that are believed to price certain goods below fair market value. Article 102 of the proclamation state that,

1/ Duties on goods imported into the customs territory shall be paid at the rates specified by the Customs Tariff Regulation.

2/ Where classification of goods and drawing up of goods declaration becomes difficult due to a consignment containing goods falling under different tariff classifications, the Ministry may, at the request of the person presenting the declaration, allow that the customs duty for the entire consignment be charged based on the tariff classification of the good which are subject to the highest rate of customs duty.

3/ Documents prepared by the World Customs Organization in relation to classification of goods shall be taken as conclusive evidence. This proclamation is not comparing in line with the income tax and Vat proclamation. The custom office only focuses on collecting high amount of duties on imported goods.

The main problem of tariff classification rests on country of origin of the goods., Article 104 states about , determination of country of origin, as "Where two or more countries are involved in the production of a product, the origin of the product shall be the country

in which the last substantial manufacturing or transformation process of economic value took place; provided, however, that such process was carried out in a plant equipped for this purpose and led to a substantial transformation of the product or the creation of a new product altogether".

However, the importers argue and do not accept this country of origin determination method made by custom office. Let us see the argument of the importers by example here. The importers complain that regardless of the quality and the country of origin of (for example; textile item from china) , the custom office by default values the item based on European standard which leads to the vicious circle of under invoicing problem.

Table 4.2.2.: Major source countries of imported Items

Company Name	**Branch Tax Offices**	**Audit firms**	**Importer**
No of Interviewer	8	3	**12**
Position of the interviewer	Tax Audit Team coordinator and Senior Auditors	Chartered Certified Auditors	Finance managers and Owners
Country, majority of import item	China, Dubai, turkey	China and Dubai	China, Dubai

Source: Result of depth interview

According to the annual report of 2014/15 by NBE/National Bank of Ethiopia/ and the collected data, most of the goods are imported from china.

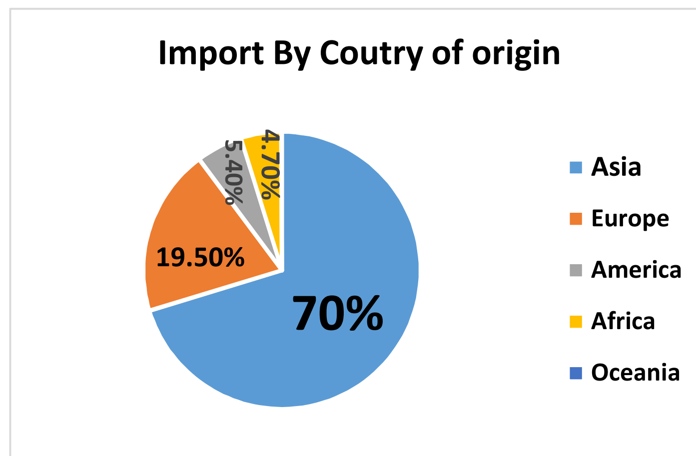

Figure.4.2.1. ***Source: Annual report of 2014/15 : NBE***

As per the above chart 70% of goods are imported from Asia, specifically, china and UAE.This shows that the price of the goods is less than the European country, this leads to under invoicing on imports.

An analysis of import value discrepancies in Pakistan's imports from the UAE conducted by Pakistan Business Council (PBC) revealed that major discrepancy in prices has been witnessed on imports from UAE in various sectors. The country loses about Rs 150 billion each year to under invoicing in imported goods. This is part of the Rs 600 billion lost each year due to tax evasion (smuggling), and misuse of concessionary duties. Mahmood (1997).

4.2.2. Foreign currency and exchange rate

According to Proclamation 859/2014 article 10: Exchange Rate is defined as," The customs value of imported or exported goods shall be calculated based on the official exchange rate declared by the National Bank of Ethiopia on the day the goods declaration has been registered."

Foreign currency transactions are sensitive to fluctuations in the exchange rate. A price agree with a customer or supplier on one day could rise or fall if the exchange rate changes. This is especially true in the current economic climate where currency is fluctuating daily making it more difficult to keep track of exchange rates. Yewondwossen, (2015)

In Ethiopian weekly newspaper called capital Yewondwossen (2015), it was heralded that foreign currency supply in Ethiopia by the financial institutions is facing severe shortage while its availability in the black market is triumphing. The importer interviewees who participated in this study also restated this fact of shortage of foreign currency in this country.

The forex shortage is so critical that opening a Letter of Credit (LC) takes as long as one year or even more, and even then, there is no guarantee that the requested amount of foreign currency will be availed, the importer complained.

Due to this fact the importers who were interviewed and case document from tax appeal for this research stated that the banks are not approving the requested amount of foreign currency, and hence the importers will be obliged to understate the invoice amount of the goods to get foreign currency approval. One of the interviewees said the below regarding the problem of shortage of foreign currency

"I have imported many used cars. The price of a single was 1000 USD. However, the bank did not approve the LC based this actual price of the car and hence I was forced to purposely reduce the price of the car to 500 USD so that total amount of foreign currency requested will be so small to get approval."

4.2.2. Transfer Pricing

A transfer price is defined in a WTO document as what one part of a company charges another part of the same company for goods or services. The significance of transfer prices for taxpayers and tax administrators is very immense as they determine income/expenses and hence taxable profits

Transfer pricing influences the level of both direct and indirect taxes that governments collect. The price of cross-border transactions is the starting point for assessing customs duties and for determining profits arising to each party involved and therefore the allocation of tax bases among countries. Transactions between related parties or associated enterprises are not always subject to the same market forces as transactions between independent actors. Consequently, there is a potential for manipulation, through under or over-pricing, of the customs duties basis and allocation of taxable profits.

The tax collected by the government is dependent on the transfer price of commodities. The transfer price of commodities, particularly of those cross-border transactions, is highly subjected to manipulation by the mutual consent of the two parties (seller and buyer) in such a way that either through under or over pricing. This practice of under or over pricing will have big implication on tax to be collected by the government as it will take a quite toll on company's profits and for this reason the dimensions of transfer

pricing are now attracting the attention of the respective stakeholders for example government and businesses.

Let’s see here the potential impact of under or over pricing taking as an example capital goods. For example, if imported capital goods are overpriced, the government will lose profit tax as the depreciation of capital goods will be high. Therefore, a sound and robust system that counter act this act of fraud should be put in place in the country.

For tax purposes, transfer pricing determines the amount of income While the importance of transfer pricing is increasingly appreciated, the focus has traditionally been on direct taxation and transfer pricing still largely remains a subject for tax specialists. In the past decade, however, it has become obvious that the customs duties and, more recently, the VAT (value added tax) dimensions of transfer pricing can also take quite a toll on a company’s profits and on government revenues, and they are now increasingly attracting the attention of governments and businesses. (OECD 2006/ 2007.)

A transfer price is what one part of a company charges another part of the same company for goods or services. It is a mechanism for distributing revenue between different divisions which jointly develop, manufacture and market products and services. Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services or the use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing exists to communicate data which will lead to goal-achieving decisions and to evaluate performance and motivate managers to make goal-achieving decisions.

4.3. Impact of under invoicing

It is widely recognized that one of the objectives of tax reforms is to improve the efficiency of the tax administration and hence reduce tax evasion. Although the empirical evidence is mixed it seems that tax reform measures in some developing countries have not helped to reduce tax evasion (Fjeldstad. et al, 2003). One key area where tax evasion has been reported to be a severe problem in sub-Saharan Africa(SSA) is customs duties (Levin et al, 2007).

Trade mis invoicing may be done for the purposes of evading custom duties and restrictions, avoiding paying taxes and fees, avoiding quotas, smuggling, to launder illegally obtained money, or for other unknown reasons. When trade mis invoicing is used as to tool to achieve any of these illicit objectives, economic development can be severely hindered. E. de Boyrieet al. (2007). Over invoiced import transactions may be utilized as a means to evade income taxes, launder money obtained from illegal activities, and facilitate capital flight. Here below the impact of under invoicing different area;

4.3.1. Business Profit tax

A higher transfer price may reduce the taxable income in the country of importation and increase the taxable income in the country of export. The government collect direct and indirect tax, Business (profit) tax is a direct tax which is levied and collected form annual profit of business, the tax imposed on the taxable business income /net profit realized from entrepreneurial activity. According to income tax proclamation no.979/2008, unincorporated or individual businesses are required to pay taxes ranging from 10% to 35% but for the incorporated business they expected to pay tax of fixed rate of 30%. (Tesfay. M, 2014).Both business prepared their accepted financial statement to the tax authority annually and pays their tax liabilities.

Table:4.3.1. Under invoicing impact on profit tax

Company Name	Branch Tax Offices	Audit firms	Importer
No of Interviewer	8	3	**12**
Position of the interviewer	Tax Audit Team coordinator and Senior Auditors	Chartered Certified Auditors	Finance managers and Owners
Under invoicing import impact on profit tax	Government lose more tax, the custom declaration value if greater than the commercial invoice.	Increased the cost of the imported item and decreased the profit margin, then government lose more profit tax	Government lose more tax
	Large companies not paid tax for long time, due to the big of depreciation of their imported Fixed assets	Large companies not paid tax for long time, due to the big of depreciation of their imported Fixed assets	Importers report loss on their financial statement due to the costing system of the goods.
	The law determines the costing method but not the profit margin for each industry	The law determines the costing method but not the profit margin for each industry	

Source: Depth interview and Document analysis

Under invoicing affects profit tax, in two ways;

1. **Merchandise Goods**: if the cost of imported merchandise goods builds up based on the custom declaration according to the VAT 285/2002, the importer will report a loss in its annual income statement, this is incurred the importer build their selling price based on the cost that they paid for the goods not based on the cost of the declaration this leads to report loss on the statement and the government lose profit tax to be collected from the

importer. The VAT proclamation 285/2002 states that the purchase price of imported goods should be valued based on custom declaration which is normally above the actual amount of price paid to buy the goods. This entails at the end of the day a loss report by the importer which in turn results in less profit margin. This therefore lessens the profit tax that the government should collect.

2. Fixed Assets: based on the proclamation the cost of imported goods should build up based customs declaration. Especially Foreign investors import machineries with high value from their country, the practice of custom value determination the custom office will take the value of the goods the highest amount instead of using its database and assess the price of the machine from world trade organization to gain more duty, but the tax office will lose profit tax from the investors. If the cost of the fixed asset is higher, the depreciation will be higher then, the total expense will be higher and the government will lose higher profit tax. The purchase price of capital goods as per the estimate based on the proclamation mentioned above would normally be higher than the actual one. This will make the depreciation value of the capital goods to be higher than it should normally be and hence the profit margin to be reported by the importer will be less. Again this will also makes the profit tax to be collected by the government to be lesser than it should otherwise be.

The research made by Ethiopian Revenue and customs Authority, singled out that importers most often report the cost of imported goods based on the LC value which is very much lower than the cost estimated by the custom office. This practice resulted in higher amount of VAT to be paid to the government by the importer than what actually the importing company collects and therefore the company at the end of the day ask for VAT refund from the government which is the main act that lead to the conception and birth of the VAT proclamation 285/2000 to block VAT refund request., IRA-54/69, (2004), state that the importer report the cost of the imported goods based on LC value this leads to report credit VAT/ requesting VAT refund from government/ all the time, due to this the research conclude that the cost of imported goods should be based on Customs declaration., but this research didn't adhere factors that affects the value of

goods in LC, factors of under invoicing, and custom valuation system and stakeholder only focus on the tax office side.

4.3.5. Cost of Imported Item and Accounting Practice

The landed costs/cost of imported item/ are the costs involved in importing purchased goods. The cost of imported item/landed cost include purchase price, freight, insurance, custom duties and other costs up to the port of destination. The value of imported goods will be relevant for the determination of the profits to be taxed by corporate income tax principle. The lower the customs value, the lower the inputs cost and, hence, the higher the profit taxed by corporate income tax.

As per the VAT proclamation 285/2002, "The value of a taxable import is the customs value of the goods, determined in accordance with the customs legislation of Ethiopia, plus the sum of duties and taxes payable upon the import of the goods into Ethiopia, excluding VAT and income tax withholding"

According to the above proclamation the cost of imported item is calculated based on the custom declaration value(Cost) which encompasses cost , insurance and Freight of the goods : custom duty, transportation, warehouse, and other costs paid for the goods until the importer warehouse. This calculation of cost has got flaws from the perspective of exercising well accepted accounting practices as shown by the example below.

Example: The LC amount of the goods is $10,000 and other costs is Br.20,000, the custom Declaration Value of the goods is $15,000. Therefore, according to VAT proclamation article 61 the exchange rate is the rate at the date of the goods arrived at custom territory. Assume the exchange rate is Br. 23/USD. Then the cost of imported goods based on custom declaration is Br. 345,000 plus other costs Br.20000, the total amount of cost is Br. 365,000. And the cost of imported goods based on LC is Br. 230,000 plus other costs Br. 20,000, the total amount of cost of the goods is Br. 250,000. Then the record will be, under LC recording purchase is debit and cash at bank credit. Under custom declaration purchase account debit and cash at bank and other income will be credit.

DPV variance account is, the difference between the value of goods on LC and custom declaration and or the exchange rate difference at the time of customs declaration and LC payment. But the accounting standards don't support this record and there is no ways of offsetting the amount of DPV variance from the book of the importer. The DPV variance will increase time to time when under invoicing is incurred. The VAT 285/2002 proclamation, only states that the costing method of the imported goods but not specify the recording of the transaction. n. Therefore, importers record the DPV variance in their books as Retained Earning or Long term Payable, or shareholders payable or Custom Valuation Variance/DPV variance/.

CHAPTER FIVE

CONCLUSIONS

Accounting principles and practice normally form the basis for tax assessment, there are reasons why there should be variations between the figures used for commercial accounting and tax assessment. These include the different purposes of commercial accounting and taxation, difficulties in defining economic concepts and the administrative effectiveness required of a tax system.

According to (IAS 2, April 2001), The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other related items are deducted in determining the costs of purchase.

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the item to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Cost should include all: [IAS 2.10]

- costs of purchase (including taxes, transport, and handling) net of trade discounts received
- costs of conversion (including fixed and variable manufacturing overheads) and
- other costs incurred in bringing the inventories to their present location and condition

Inventory cost should not include: [IAS 2.16 and 2.18]

- abnormal waste
- storage costs
- administrative overheads unrelated to production
- selling costs

- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms.

Therefore, as per the IAS, the amount of DPV variance cannot be record as of the cost of the imported item.

RECOMMENDATIONS

I recommend that the amount of DPV variance can be eliminate/offset from the book of the importer in two options;

1. Recording the amount of DPV variance as net income. Based on the previous example on cost of imported item, the transaction will be, under LC recording purchase is debit and cash at bank credit. Under custom declaration purchase account debit and cash at bank and other income will be credit.

This recording doesn't affect the cost of the goods and the selling price as well. The additional amount of the purchase price of the goods from LC amount is Br.115,000 and it is record in the debit side and then Other income will be recorded by the same amount in the credit side, therefore there will no unsettled amount on the book of the importer and government will earn the accurate amount of profit tax.

2. The record of cost of imported merchandise goods based on LC value by controlling under invoicing, the government can collect accurate profit tax from the importer. In current practice, there is a lot of tax appeal cases on under invoicing issue in Profit tax and VAT, because the government lose profit tax that must be paid by the importer.

The proclamation stated that cost of imported item is calculated based on custom declaration, without specifying the type of item whether merchandise or capital goods. Therefore, the cost of imported capital goods will also be calculated based on custom declaration value. This will affect the government to lose more profit tax and affect the financial institutions.

Foreign investors imported machinery (capital goods) in higher price than the custom office valuation database and the custom office use the higher price to declare the machine instead of using its database. Therefore, the cost of the machine will be higher. This will affect the financial institutions on loan schedule, the investor takes a huge amount long-term loan from financial institutions and the institution take the machinery as a collateral to give loan to the investors, but the cost of the machinery may not worth equivalent to the loan.

The advantages of using a price filter matrix over other methods are that it can be used to estimate the amount of over- and under-invoicing in export/import transactions, can be built for each Harmonizes System (HS) code and country combination, may be highly effective in auditing suspicious individual importers and exporters, and can be used for real-time inspection of cargo.

Limitation of the Study

The main limitation of the study is that it only used key informant interviews and reviewing of relevant documents since tax appeal cases and importer financial statements are the main data inputs for the study to be analyzed. The researcher decided to conduct the face to face interviews by herself to expedite the research work being considerate the short time as the interviewees are of high position in their organization being busy with their tasks and multiple meetings and hence might not be committed to fill out long questionnaires by themselves. This study covers only the impact of under/over invoicing system on imported Fixed assets and the unsettled custom variance balance on the book of the importer's. The study did not consider the customs valuation system of Ethiopia Revenue and Customs Authority. In future, researchers can broaden this study to cover the impact of under invoicing on consumer right, and country economy growth.

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APPENDIXES

List of Tax Appeal Case

S.no	Case Record Number	Case Title	Customer type
1	ከአ663	Profit tax	Importer
2	665	Profit tax	Importer
3	ከ636	Profit tax and VAT	Importer
4	ከመ 605	Profit tax	Importer
5	ከ617	Profit tax and VAT	Importer
6	ከመ634	VAT	Importer
7	ከመ638	Profit tax and VAT	Importer
8	ከገ-798	Custom duty	Importer
9	ከገ-990	Custom duty	importer
10	ከ-964	Custom duty	Importer

St. Mary University

School of Graduate Studies

MBA in Accounting and Finance Program

Questionnaire prepared for Importers

Researcher Name: Tigest Geremew

Contact Address Tel: Mobile + 251-911-16-40-18

Email: tigestelsa@yahoo.com, tigestelsa@gmail.com

Dear Respondents,

This questionnaire is prepared to collect data's for thesis work on the topic of **'Assessment Under invoicing Customs Valuation: the case of Profit tax and Accounting Practice.** The study is to be undertaken for the partial fulfillment of the requirement for MBA in Accounting and Finance program. For the successful accomplishment of the study, your response will be used as valuable input. I assure you that the information you will provide will be used only for academic purpose and will be kept confidential. Therefore, I request you to cooperate for interview to answer the attached questions.

Section I: Back ground information

1. Form of your organization:

   ☐ Sole proprietorship ☐ Partnership ☐ Corporation

2. What is your position in the company? ____________________________

3. What is the type of investment your company engaged?

   Import and export ☐ Manufacturing ☐ Distributer ☐

4. What types of products your company imported?

   Fixed assets ☐ Raw Materials ☐ Merchandise ☐

5. For how long has your firm been engaged in international trade (import transactions)?

   0-5 years ☐ 5-10 years ☐ 10-15 years ☐ >15 years ☐

6. From which of the following continents does your firm get majority of the imported items?

   Africa ☐ Europe ☐ South America ☐
   North America ☐ Asia ☐ Australia ☐

Section II: Opinion on under invoicing issues

7. In your opinion, imports from which continent are more susceptible for under invoicing of import values? Please specify ____________________________________

8. What are the challenges of importing goods?

   ____

   ____

   ____

9. In your opinion, what are the most common factors for under invoicing?

____

____

____

10. What document you are used to prepare the cost of in imported goods? Why?

Commercial invoice ☐ Customs declaration ☐

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____

11. Is there a difference in the value of commercial invoice and customs declaration?

Yes ☐ No ☐

12. If your answer for question no. 10. Is yes; is the difference under/over invoicing?

Under invoicing ☐ Over invoicing ☐ Both ☐

13. What is the reason of under/over invoking?

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14. If your answer for question no. 10 is yes; What is its difference and how do you reconcile/ recorded/ the difference of the value of commercial invoice and customs declaration?

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15. What are the impacts of using the customs declaration value for your cost method to determine the selling price?

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16. If there is an impact on your selling price; How do you compared it with trade law?

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17. How often does your company has been audited by the tax authority? ---------------times

18. If your company had been audited what is your opinion about the audit result conducted on under invoicing import?

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19. What is your opinion on ERCA research circular No. አውግ--54/6 (2004)?

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Thank You for your time and Opinion!

St. Mary University

School of Graduate Studies

MBA in Accounting and Finance Program

Questionnaire prepared for Tax office and Auditors

Researcher Name: Tigest Geremew

Contact Address Tel: Mobile + 251-911-16-40-18

Email: tigestelsa@yahoo.com, tigestelsa@gmail.com

Dear Respondents,

This questionnaire is prepared to collect data's for thesis work on the topic of **'Assessment Under invoicing Customs Valuation: the case of Profit tax and Accounting Practice** . The study is to be undertaken for the partial fulfillment of the requirement for MBA in Accounting and Finance program. For the successful accomplishment of the study, your response will be used as valuable input. I assure you that the information you will provide will be used only for academic purpose and will be kept confidential. Therefore, I request you to cooperate for interview to answer the attached questions.

Section I: Back ground information

1. The Name of the organization______________________________
2. What is your position in the organization? ____________________________________
3. How many number of importers are registered under your tax office? _____________
4. From which of the following continents does get majority of the imported items?

Africa	☐	Europe	☐	South America	☐
North America	☐	Asia	☐	Australia	☐

Section II: Opinion on under invoicing issues

5. In your opinion, imports from which continent are more susceptible for under invoicing of import values? Please specify _____________________________________
6. What are the challenges of importing goods?

____

____

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7. In your opinion, what are the most common items imported in under invoicing?

____

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8. What kind of documents are used to prepare the cost of imported goods on your audit process? Why?

Commercial invoice ☐ Customs declaration ☐

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9. What is the reason of under/over invoicing invoking? Please specify your opinion

____

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10. How do you consider the difference of the value of commercial invoice and customs declaration in your auditing?

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11. Does the under/over invoicing value has an impact on profit tax? Please specify

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12. What are the impacts of using the customs declaration value (CIF) as a purchase price for imported goods to determine the selling price?

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13. If there is an impact on selling price; How do you compared it with trade law?

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14. Do you think using the customs declaration value for imported item purchase price has an impact on profit tax?

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15. What is your opinion on ERCA research circular No. --54/6 (2004)?

____

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Thank You for your time and Opinion!

DECLARATION

I, the undersigned, declare that this thesis (assessment of under invoicing valuation system: the case of profit tax and accounting practice) is my original work, prepared under the guidance of Tiruneh Legess (Ass.Prof). All sources of materials used for the thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in full or part to any other higher learning institution for the purpose of earning any degree.

__________________________ ____________________________

Name Signature

St. Mary's University, Addis Ababa Date

ENDORSEMENT

This Thesis has been submitted to St. Mary's University, School of Graduate Studies for examination with my approval as a University advisor.

______________________________ __________________________

Advisor Signature & Date