

# **Overview of Chinese Tax Auditing Strategies on SMEs**

**23 October, 2007**

# Outline

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- I. Challenges against tax administration on SMEs**
- II. Integrated auditing strategies for strengthening tax administration on SMEs**
- III. Integrated tax auditing practice with application of risk management techniques**
- IV. Expectation**

# I. Challenges against tax administration on SMEs

(I) The quantity of SMEs increases rapidly, while the tax administration resources are relatively insufficient.

	2003	2004	2005	2006
Number of SMEs	66521	78859	89306	100386
Number of Tax Administrators	615	617	622	629
Average number of SME under control	108	128	144	160

(II) The tax auditing mechanism is confronted with changes.

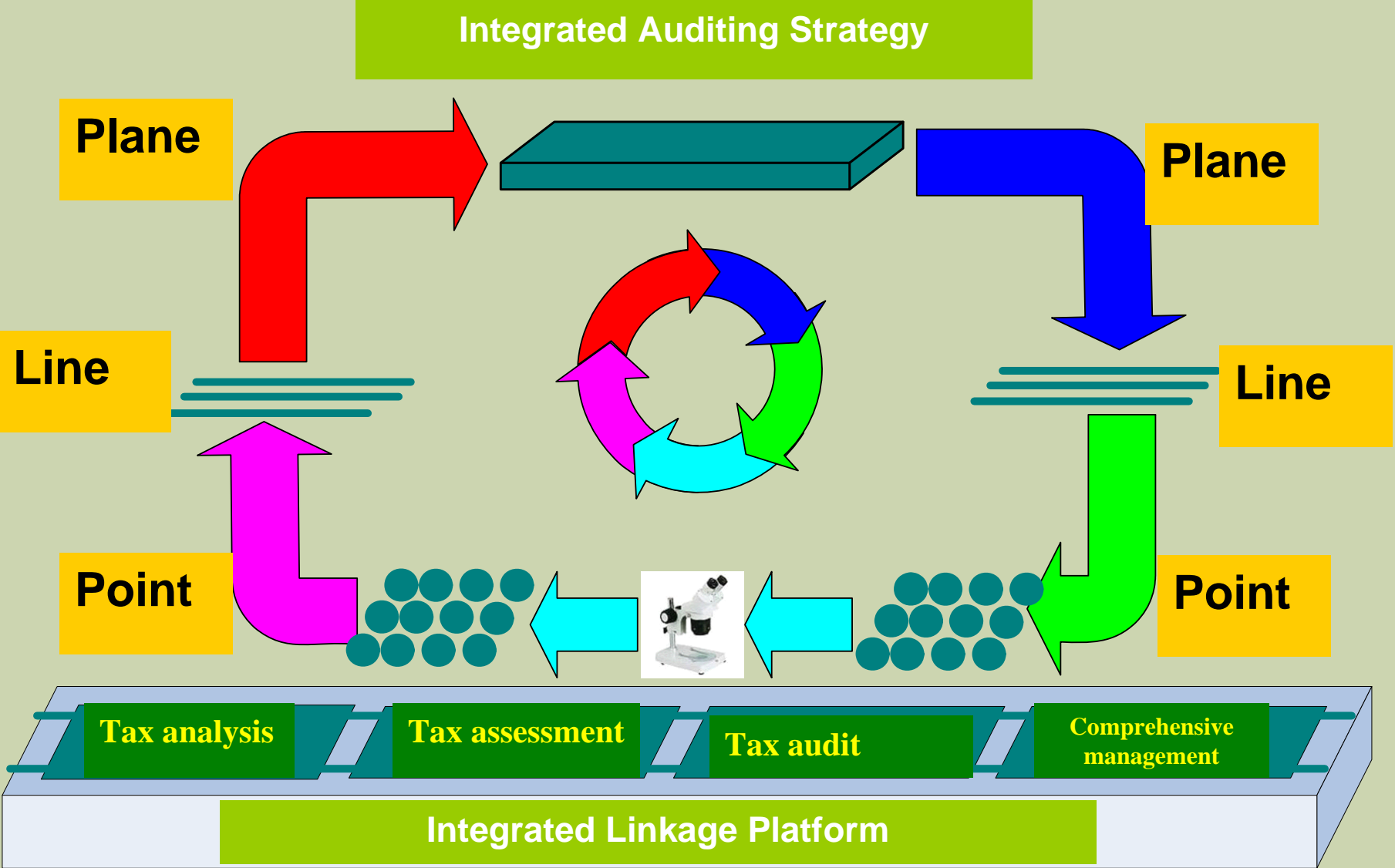
Under the circumstance of low tax compliance, homogeneous tax evasion tactics spread widely in enterprise clusters.

The traditional tax auditing merely focuses on audit of the single enterprise and lacks the summary of industry administration experience. As a result, most SMEs have never been audited for a long time.

## **II. Integrated auditing strategies for strengthening tax administration on SMEs**

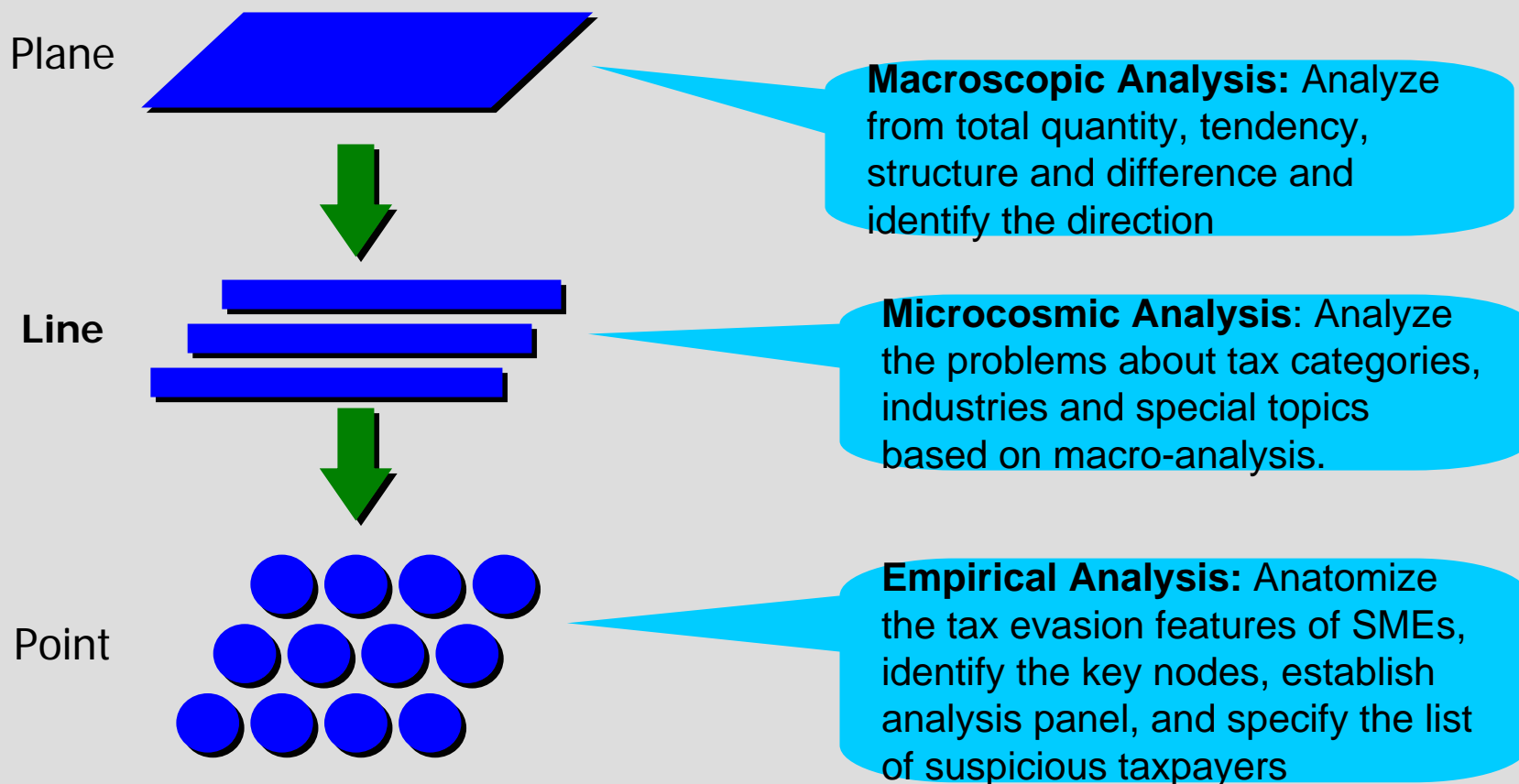
- (I) Identify the suspicious tax evasion groups in SMEs in accordance with the hierarchical “plane-line-point” data analysis method .**
  
- (II) Conclude rules of different industries and formulate the tax administration method according to the hierarchical “point-line-plane” auditing administration mode**
  
- (III) Employ the integrated linkage mechanism**
  
- (IV) Support the workflow and the integrated linkage mechanism by relying on information technology and scientific administrative approaches.**

# II. Integrated auditing strategies for strengthening tax administration on SMEs



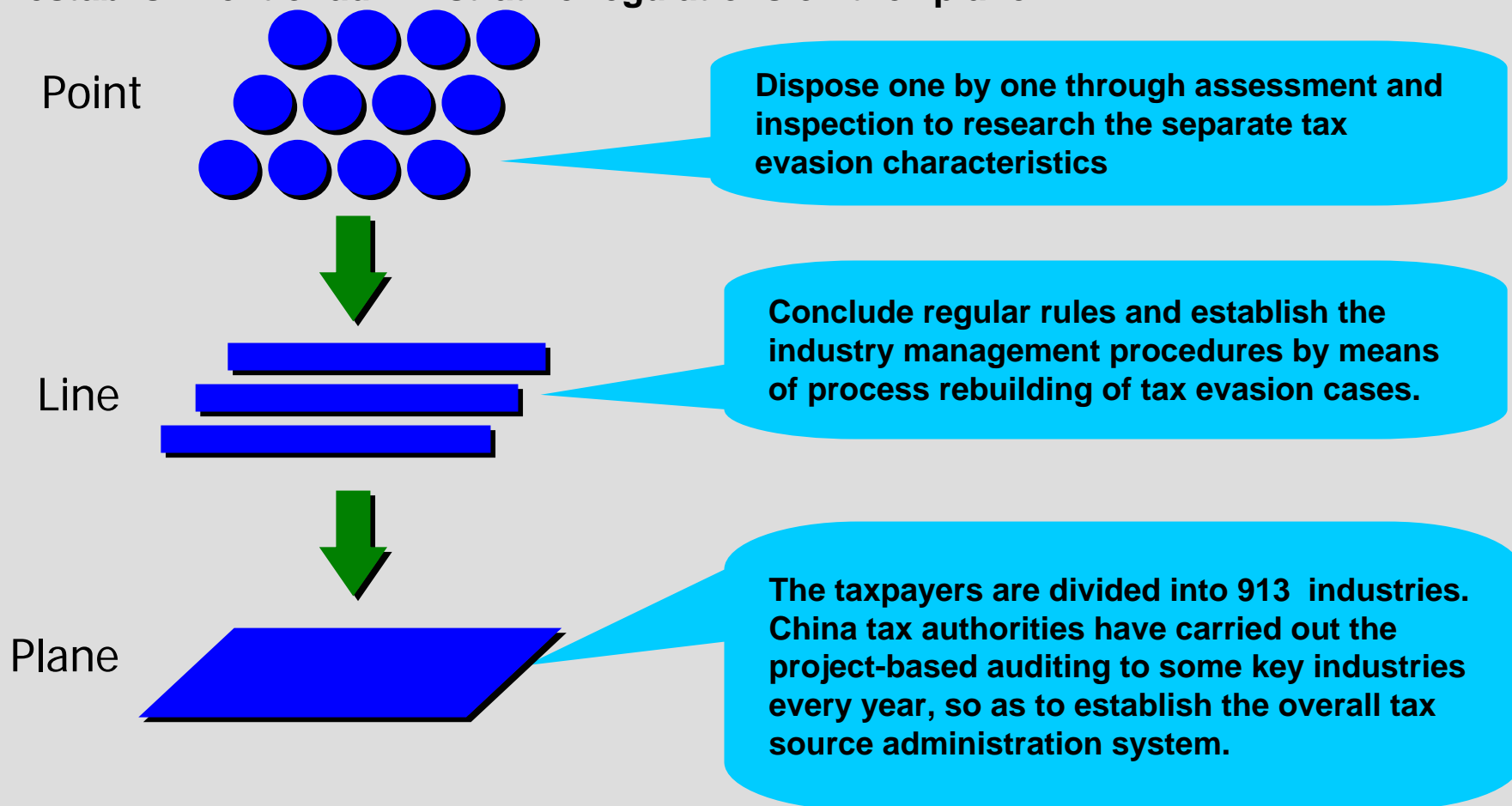
# (I) Identify the suspicious tax evasion groups in SMEs according to the hierarchical “plane-line-point” data analysis method so as to improve auditing efficiency.

The “plane-line-point” hierarchical data analysis method means to carry out data processing and analysis from multiple levels and different aspects ,confirm the administrative direction from the so-called “plane”, find out suspicious taxpayers with common features from the so-called “line” and anatomize the problems about rules from the so-called “point”.



## **(II) Conclude rules of different industries and formulate the tax administration method according to the hierarchical “point-line-plane” auditing administration mode so as to upgrade the auditing effect.**

The “point-line-plane” audit management is realized through the organic combination of solutions on the “point”, research and accumulation of measures on the “line” and establishment of administrative regulations on the “plane”

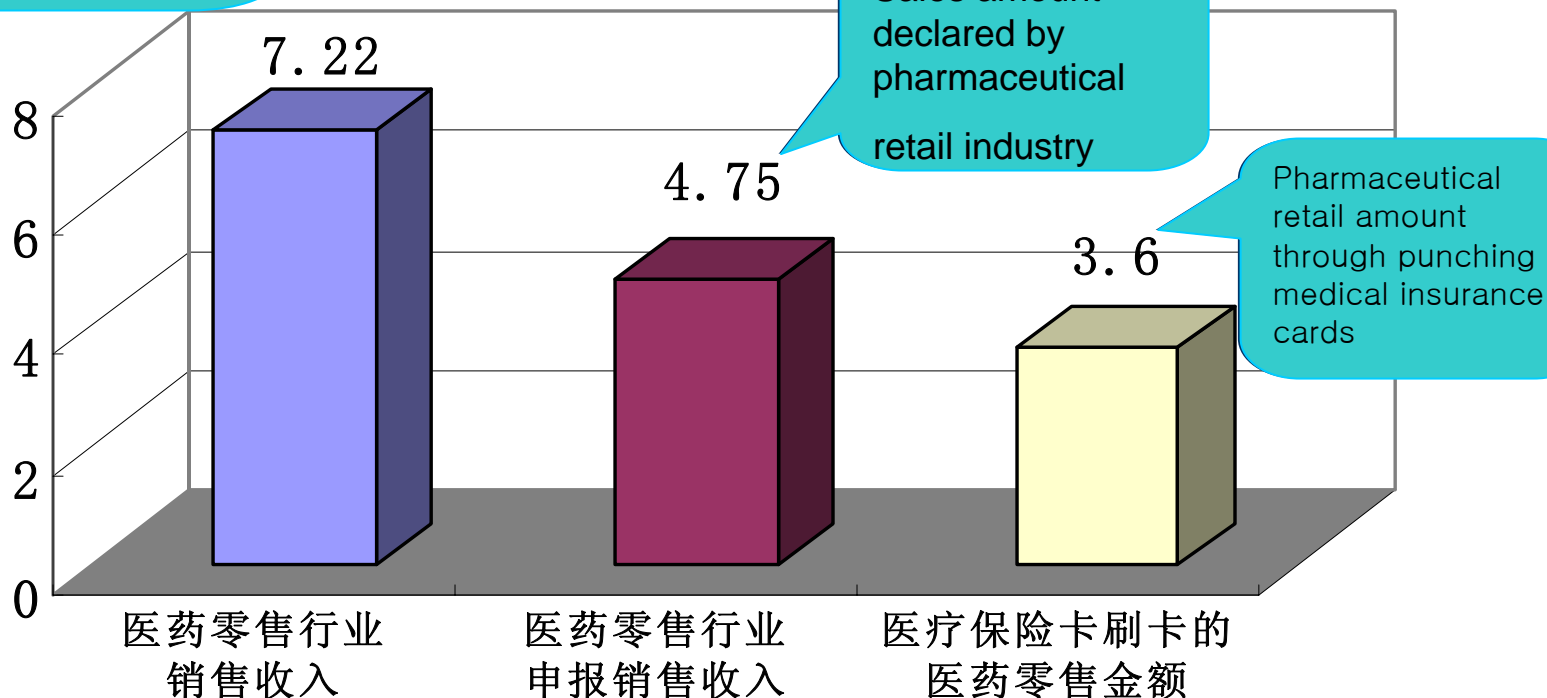


# Case Study: Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

## ① Macro-analysis (from “plane” to “line”)

Sales income of pharmaceutical retail industry announced in year book by statistics authority

**SALES AMOUNT**  
(Unit: 1 million Yuan)



Sales amount declared by pharmaceutical retail industry

Pharmaceutical retail amount through punching medical insurance cards

# Case Study : Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

## ② Micro-analysis (from “line” to “point”)

Access to external information, and estimate level of risk through data comparative analysis

Comparison between medical insurance card income and VAT declared income

(Unit: ten thousand Yuan)

Grass-roots bureaus	Number of registered drugstores ①	Medical insurance card income ②	Declared income ③	Difference ④ = ③ - ②	Estimated tax revenue ⑤
Shinan	24	1073	447	626	3755
Shibei	34	2986	1277	1709	10451
Sifang	26	1914	296	1618	6699
Licang	14	999	449	550	3496
Chengyang	7	273	46	227	955
Laoshan	6	56	7	49	196
Development Zone	9	602	81	521	2107
<b>Total</b>	<b>120</b>	<b>7903</b>	<b>2603</b>	<b>5300</b>	<b>27660</b>

# Case Study : Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

③ Empirical analysis (confirming problems and summarizing the tax evasion rules)

Through empirical analysis, the main tax evasion tactics of pharmaceutical retail industry are summarized as follows:

1. Business transactions and related cash income are outside the account book;
2. Incomplete evidence for keeping accounts and/or setting up “two sets of accounts”;
3. Apply for authorizing tax quota and do not declare the income above the quota;
4. Register in the name of chain operation, but in fact neither declare tax to local tax authorities, nor to the tax authorities where the head companies are located.

# Case Study : Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

## ③ Empirical analysis (confirming problems and summarizing the tax evasion rules)

### Analysis on tax evasion processes of pharmaceutical retail enterprises:

1. During the purchasing process, since the upstream pharmaceutical production and wholesale enterprises have large business scale, pharmaceutical retail enterprises can generally obtain sufficient purchase invoices.
2. During the sales process, many consumers do not claim invoices, so pharmaceutical retail enterprises get lots of income having no need to issue invoices.
3. During the accounting process, due to the small business scale and incomplete accounting books and supporting vouchers in many pharmaceutical retail enterprises, it's very difficult to control their sales income via auditing.

The income structure of pharmaceutical retail enterprises mainly includes cash, medical insurance cards, bank cards, transfer cheques etc. In consideration of the above tax evasion features, we think the key to control the real income of pharmaceutical retail enterprises is how to find out the income not entered into account books and not declared from the above-mentioned four kinds of income.

# Case study: Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

## ④ Collection and administration measures (control tax evasion in key processes)

- Adjust and improve declaration method, and implement classified income declaration in pharmaceutical retail industry;
- Establish the alarming and monitoring system by applying data analysis panels;
- Strengthen the administration on registered enterprises of pharmaceutical retail industry, esp., the verification and approval on branches (chain stores), and clear up tax evaders. Establish the data exchange and comparison system with Industrial and Commercial Administration Departments in charge of enterprise registration;
- Enhance data comparison and tax assessment and carry out analysis on returns to scale.

# case study :Tax Risk Analysis and Auditing Results of Pharmaceutical Retail Industry

## ⑤ Effect

Revenue increased 10.07 million Yuan through auditing

Number of tax registration (drugstores) increased 439 (from 1650 to 2089 year-on-year)

Sales Amount increased 340 million Yuan (from 475 to 815 year-on-year)

## ⑥ Long-term mechanism

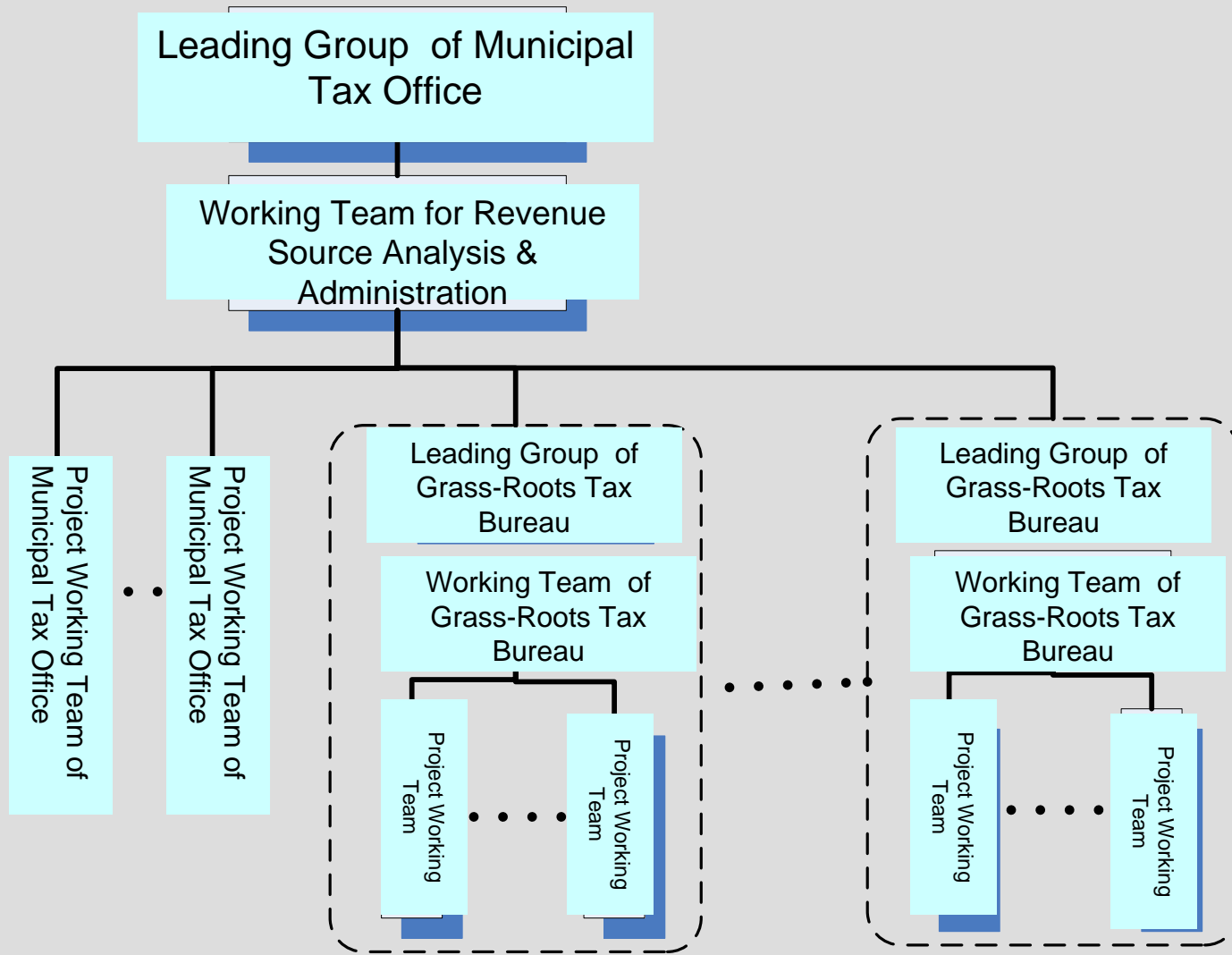
Established Taxation solution of Pharmacy Industry

## **(III) Implement the integrated linkage mechanism so as to ensure the smoothness of “plane-line-point to point-line-plane” workflow in organizational operation.**

- The closed loop “plane-line-point to point-line-plane” workflow breaks the barriers in department duties administrated as per tax categories.**
- China tax authorities begin to implement tax audit work mode of unified planning & coordination and resource sharing at a deeper level among relevant departments to realize the integrated linkage.**
- The integrated linkage includes three levels under administrative organization and four links under operating mechanism.**

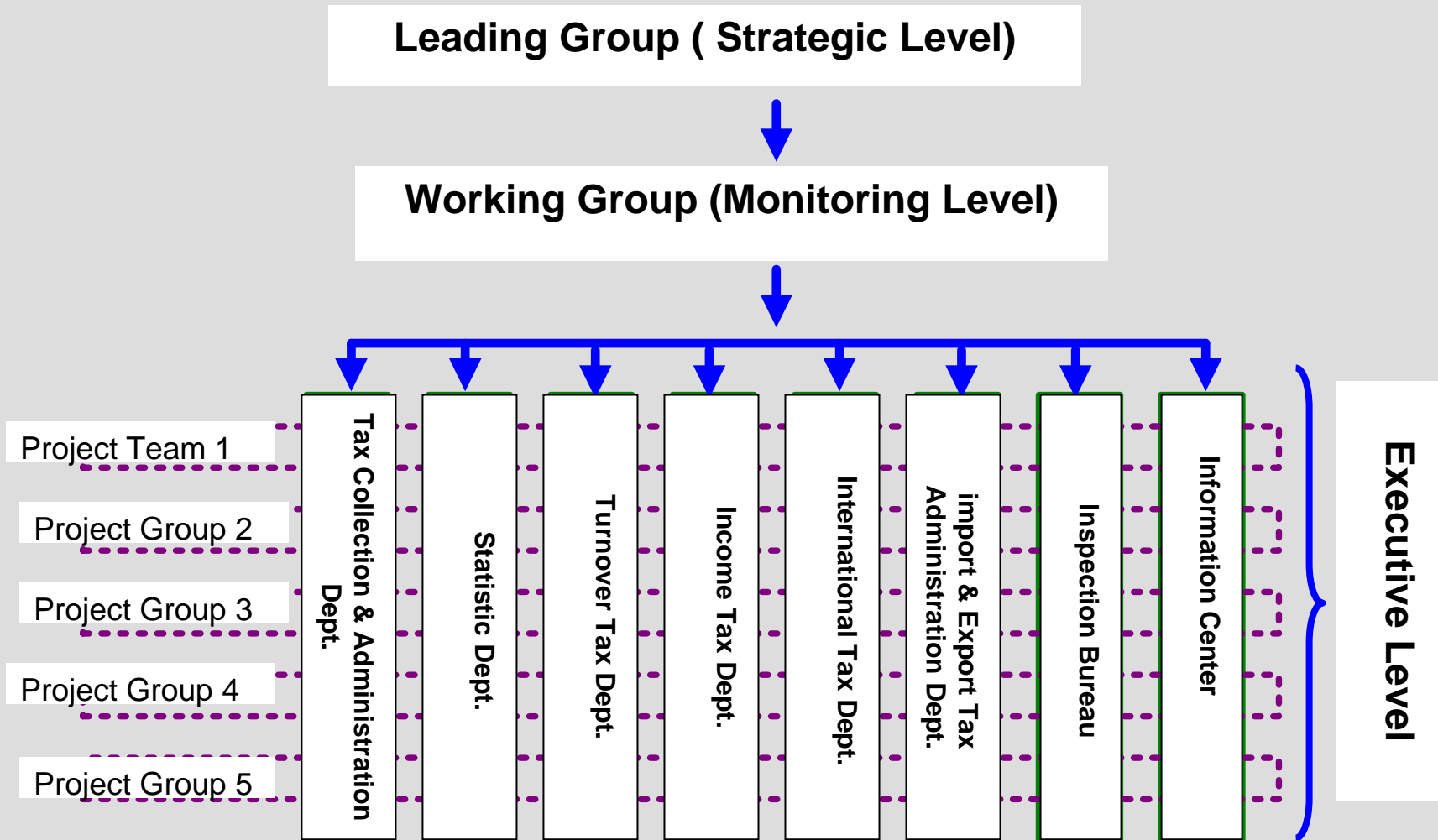
# (III) Implement the integrated linkage mechanism so as to ensure the smoothness of “plane-line-point to point-line-plane” workflow in organizational operation.

## 1. Administrative organization in integrated linkage



# (III) Implement the integrated linkage mechanism so as to ensure the smoothness of “plane-line-point to point-line-plane” workflow in organizational operation.

## 1. Administrative organization in integrated linkage





**(IV) Relying on information technology and exploring into the application of scientific administrative approaches.**

**Support to new workflow and operating mechanism**

**Application of information technology**

- **Operational software**

CTAIS; anti-counterfeit tax control system; others

- **Decision-making support software**

Comprehensive data management system

- **Integrated linkage support software**

**Scientific management system**

- **Tax evasion process rebuilding**

- **Event tree analysis**

- **Industrial supply-chain analysis**

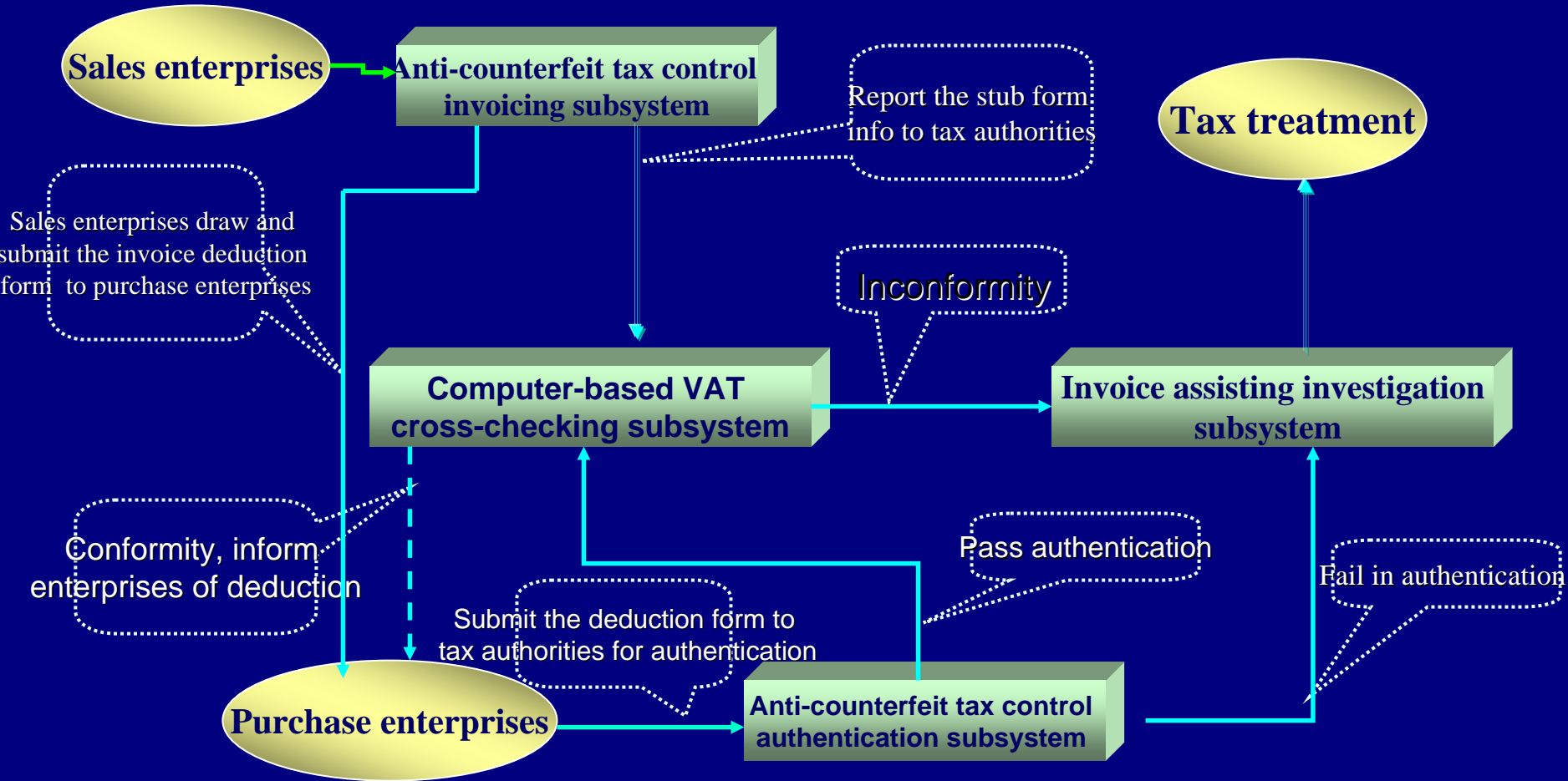
- **Cross checking analysis**

- **Data panel analysis**

- **Other**

**(IV) Rely on information technology and explore into the application of scientific administrative approaches.**

**1. Application of information technology -- Functions of VAT management system**



## (IV) Relying on information technology and exploring into the application of scientific administrative approaches.

### 2. Scientific management methods

- **Tax evasion process rebuilding:** Based on single case analysis and process rebuilding, find out the tax evasion rules and key control points of the same industry , and formulate corresponding tax administration measures.
- **Event tree analysis:** Event tree method can simply and vividly make clear the key risk aspects of routine tax administration.
- **Industrial supply-chain analysis:** The analysis of upstream and downstream industries chains can expose the problems which can not be found in single ones.
- **Cross checking analysis:** China tax authorities compare the purchases and sales of the downstream buyers, and thus control the false declaration such as concealment of income.
- **Data panel analysis and other methods**

# **III. Integrated tax auditing practice with application of risk management techniques**

**(I) Using a number of analytical methods to identify and estimate the tax risk of SMEs with industrial classification**

**(II) Implementing industry-classified tax assessment and tax inspection according to risk estimation level**

**(III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SMEs**

# III. Integrated tax auditing practice with application of risk management techniques

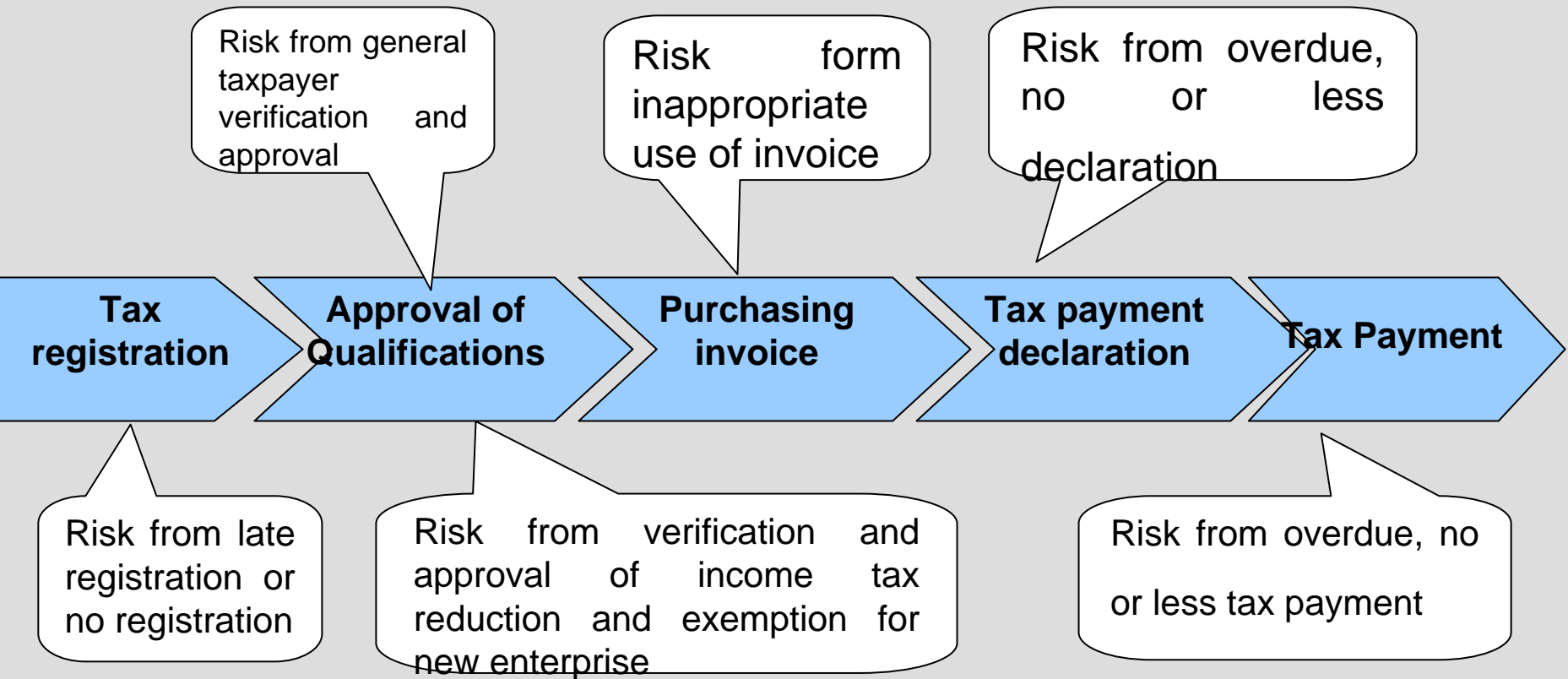
"Identification - estimation - treatment - evaluation" process of risk management	Integrated audit strategy of "taxation analysis, tax assessment, tax inspection and comprehensive administration"	Specific application of risk management techniques
Risk identification	Taxation analysis	Taxation analysis methods such as event tree analysis, industry chain analysis, group supply chain analysis and transfer pricing analysis
Risk estimation		
Risk treatment	Tax assessment and tax inspection	Take the different tax assessment measures of "self-examination, interview, investigation and treatment" or measures of special control and inspection according to different risk levels
Effect evaluation	Formulate industry tax administrative measures or methods and intensify long-term administration on tax sources	ABC three-level effect evaluation method and long-term management mechanism on tax sources

## **(I) Using a number of analytical methods to identify and estimate the tax risks of SMEs with industrial classification**

- 1. Event tree analysis**
- 2. Analysis on industry supply chain**
- 3. Cross-checking analysis**

# 1. Case about event tree analysis

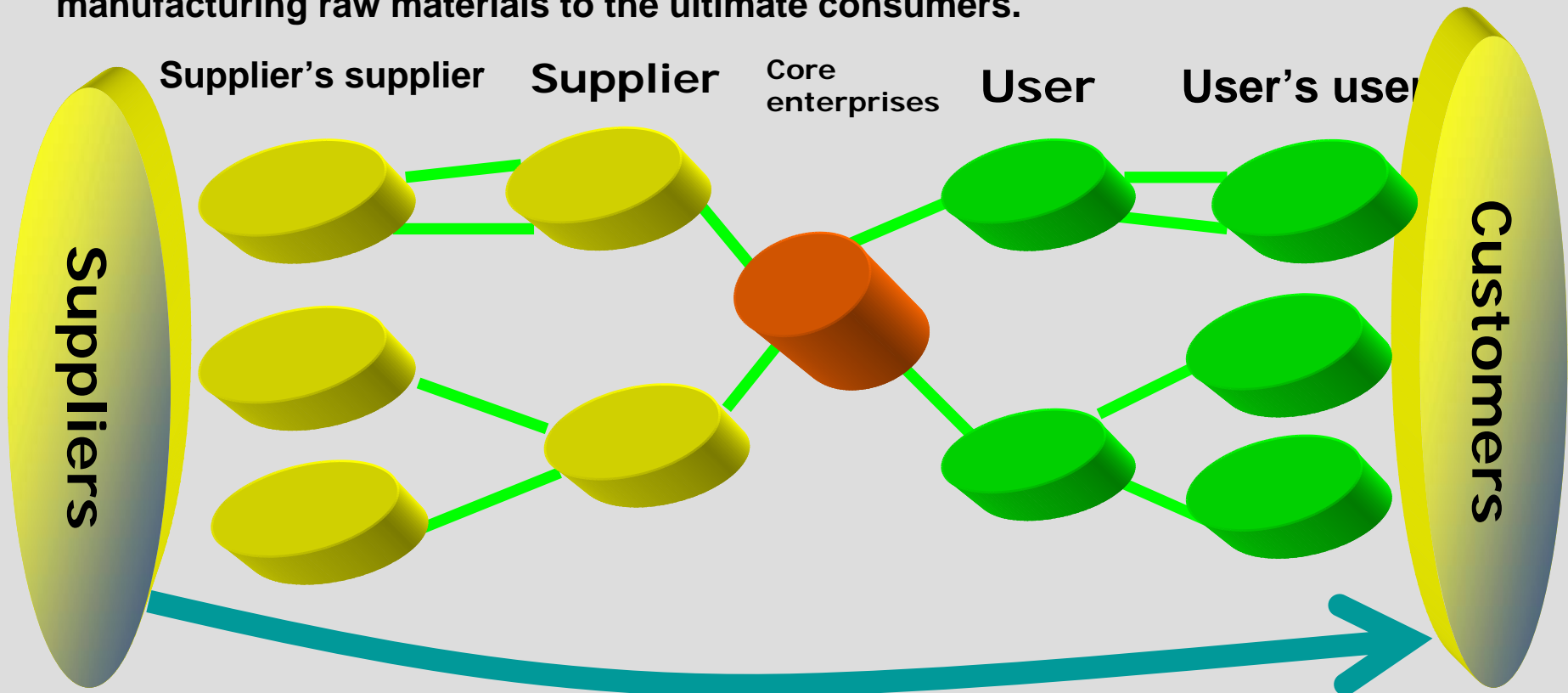
## 1. Event tree analysis



## 2. Analysis on industry supply chain

### Definition of industry supply chain

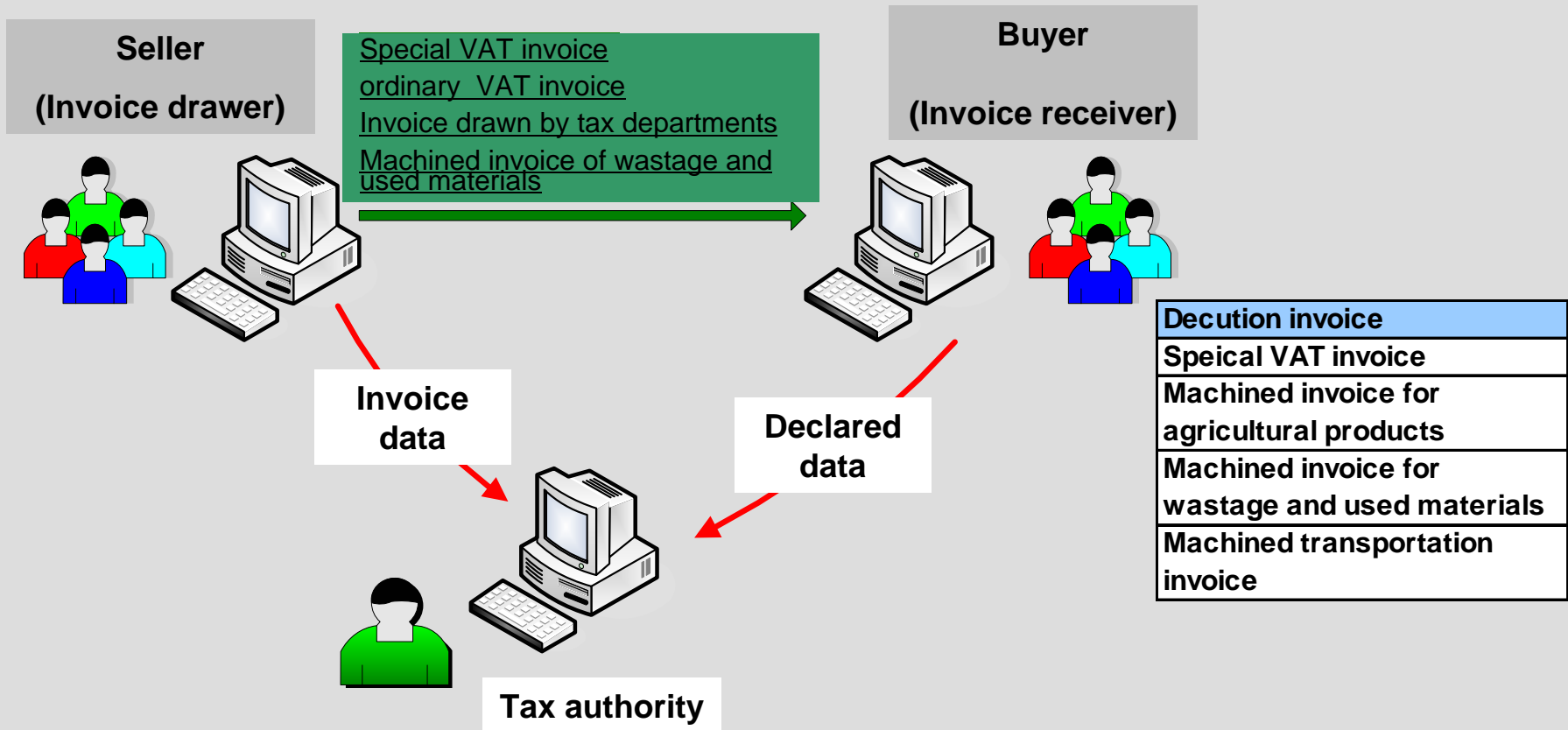
Centering on core enterprises and through controlling logistics, information flow and capital flow, the industry supply chain is a functional network composed of manufacturers, suppliers and retailers supplying raw materials, components and parts, products and services mutually. It covers all the business-related activities from manufacturing raw materials to the ultimate consumers.



# 3. Cross checking analysis

Basic principle:

The seller will deliver the invoicing information to tax authority, while the buyer will submit the sales information to tax authority. The tax authority can compare the purchases and sales of the downstream buyers, and thus control the false declaration such as concealment of income.



## **(II) Implement industry-classified tax assessment and tax inspection according to risk estimation level**

**According to risk estimation level, two kinds of risk treatment as follows:**

- One is for the common infringement, implement tax assessment (Which refers to a kind of administrative behavior to make a qualitative and quantitative judgment toward the authenticity and accuracy of taxpayers' declaration information through paperwork analysis and to take further tax collection and administration measures. )**
- the other is for the typical infringement with proof-positive, implement taxation inspection.**

## **(II) Implement industry-classified tax assessment and tax inspection according to risk estimation level**

- Main procedures of tax assessment include tax appointment, investigation and verification, problem correction, administrative proposals, delivery to tax inspection departments, etc.
- Tax assessment in SMEs is highlighted with “industry-classified” assessment, i.e., to find out the typical “suspicious industry” by “plane-line-point” taxation analysis, make out industry assessment panel, then scan all taxpayers of this industry as per this panel, and give a comprehensive tax assessment to the suspicious taxpayer.
- At present, China tax authorities has established special tax assessment software on the basis of lots of operable application system.

## **(II) Implement industry-classified tax assessment and tax inspection according to risk estimation level**

### **2. Tax inspection mainly focuses on ‘industry rectification’ and ‘promoting administration by inspection’**

- (1) According to the results of ‘plane-line-point’ analysis, the special inspection shall be done to the taxpayers suspected of serious tax evasion, and the whole industry shall be completely rectified through centralizing the audit resources.

**The significant difference between the traditional tax audit and the integrated audit with regard to the tax inspection link is that, the former usually focused on specified taxpayers, and its results generally reflect the amount of tax payment exerted from tax inspection, while the latter usually focuses on a typical industry subject to serious suspicion of tax evasion, and concentrating labor force on the overall industry, so as to renovate it thoroughly.**

## **(II) Implement industry-classified tax assessment and tax inspection according to risk estimation level**

**2. Tax inspection mainly focuses on ‘industry rectification’ and ‘promoting administration by inspection’**

**(2) Based on the ‘point-line-plane’ management ways, summarize the regular pattern of different industries, and put forward the proposals for promoting management**

**Another major difference between the traditional tax audit and the integrated audit is that, the former aims to get more taxation through inspection, while the latter aims to summarize the regular pattern of different industries in tax evasion, and put forward the relevant proposals for promoting tax management, rather than tax payment itself.**

## **(III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SMEs**

**1. Project evaluation is the foundation for evaluating risk treatment effect.**

**Quality evaluation shall be carried out on every integrated linkage project. Project evaluation shall include the project organization and management, project implementation, fulfillment of project objectives, combination of project result and long-term management, etc.**

**With concrete standards, project evaluation can effectively promote the implementation of the integrated auditing strategies centering on projects, and lay the foundation for form into long-term administrative approaches and measures.**

## (III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SMEs

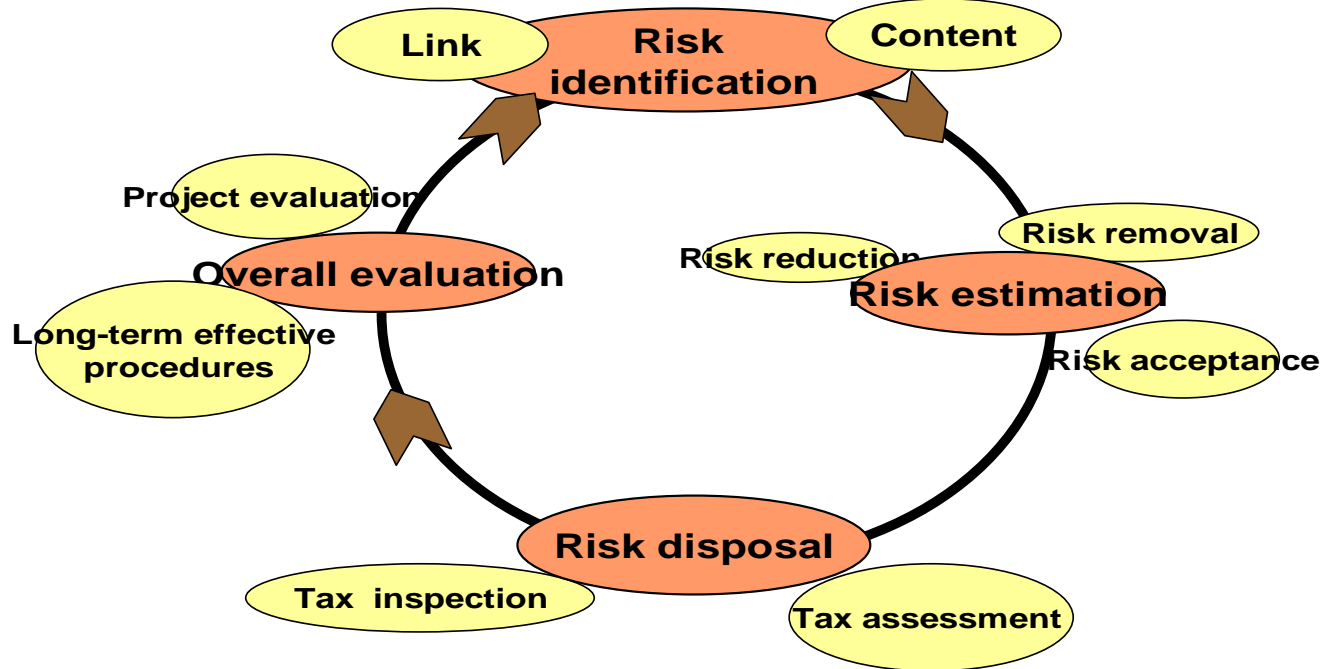
2. Realizing long-term effective tax administration of industries is the goal of effect evaluation on risk treatment

### (1) Formulate long-term tax administration system for specialized industries

	Measures and Approaches	
1	Administrative Approaches for Pharmaceutical Retail Industry ★	★ represents the industry tax administration procedures summarized from the Category A projects
2	Proposals for Strengthening Supervision of Transport Enterprises Invoice Offset	
3	Administrative Approaches of Individual Businesses and Trade Markets	
4	Interim Approaches of VAT Administration of Machine-drawn Invoices With Agricultural Product Purchase★	
5	Notice on Strengthening Tax Collection Management in Foreign Trade Enterprises★	
6	Administrative Approaches of Steel Work Industry★	
7	Proposals on Tax Concession Management in New Commercial and Trade Enterprises★	
8	Notice on Strengthening Tax Administration of Real Estate Industry★	
9	Implementing Proposals on Strengthening Tax Control and Administration of Non-residents	
10	Proposals on Strengthening the Income Tax Administration in the Industries of Catering, Accommodation and Entertainment Funded by Home and Abroad.	

**(III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SMEs**

**2.(2) Form a closed-loop rising work process**



# (III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SMEs

## 2. (3) Set up data analysis panel base

<b>Confirm projects analyzed (set up the panel)</b>	(Name of data analysis panel)
	Descript data analysis project and come up with the question prepared to solve
<b>Apply panels in data analysis</b>	Choose different method of data analysis to analyze first and confirm the aim of analysis, form the result.
<b>Empirical analysis</b>	Select suspected taxpayers to inspect on the spot and conclude unique rules
<b>Outline of appraisal and inspection</b>	Come up with the outline of appraisal and inspection aiming at the problem and characteristics of vocation
<b>Put into effect the feedback</b>	<ol style="list-style-type: none"> <li>1.To inspect the suspected taxpayers</li> <li>2.To evaluate the analysis project or quality condition of target</li> </ol>
<b>Long-term mechanism</b>	Solid panel, transfer to panel base and build up effective measures or policies of management

## **IV. Expectation**

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**(I) Expand the range of cross checking on tax data through network.**

**(II) Support of Information technology**

**(III) Combination of risk forecast with long-term effective management**

**(IV) Construction, application and development of the industry tax analysis and assessment panels and the typical cases database**

**Thank you!**

**Your comments will be appreciated!**

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