

Auditing Strategies for Strengthening Tax Administration on Small and Medium Enterprises (SME)

--Overview of Auditing Strategies of China Tax Authorities on SME

Preface	3
I. Challenges against tax administration in SME	7
(I) The quantity of SME increases rapidly, while the tax collection and administration resources are relatively insufficient.	7
(II) As the tax evasion tactics in SME spread quickly among industries, the tax auditing mode is confronted with changes.	8
(III) The tax revenue source administration in SME lacks planning and coordination as a whole and tax authorities are in an urgent need to improve organizational operation modes.	9
(IV) The tax administration on SME lacks feasible and effective methods so that the administrative approaches must be innovated as soon as possible.	10
II. Integrated auditing strategies for strengthening tax administration on SME	10
(I) Identify the suspicious tax evasion groups in SME in accordance with the “plane-line-point” hierarchical data analysis method so as to improve auditing efficiency.	15
(II) Follow the audit administration way of “point-line-plane”, conclude the industry rules and establish the tax administrative approaches for different industries so as to improve the auditing effect.	22
(III) Implement the integrated linkage and ensure the smooth “plane-line-point to point-line-plane” work flow in organizational operation.	29
1. Administrative organization in integrated linkage	30
2. Operating mechanism in integrated linkage	32
(IV) Rely on information technology to explore and apply scientific management methods and support the realization of the “plane-line-point to point-line-plane” work flow and the integrated linkage mechanism.	34
1. Information Technology	35
2. Scientific management method	38
III. Integrated tax auditing practice with application of risk management techniques	38

(I) Using a number of analytical methods to identify and estimate the tax risk of SME with industrial classification	40
1. Event tree analysis.....	40
2. Analysis on industry chain.....	42
(II) Implementing industry-classified tax assessment and taxation inspection according to risk estimation level.....	44
1. Tax assessment is marked by “industry-classified assessment”	45
2. Tax inspection mainly focuses on ‘industry rectification’ and ‘promoting administration by inspection’	46
(III) Combine the project evaluation with the long-term administrative mechanism to industries, and carry out the integrated administration in tax audit over SME	48
1. Project evaluation is the foundation of evaluation of risk treatment effect	49
2. Realizing long-term effective tax administration of industries is the goal of risk treatment effect evaluation	50
IV. Expectation.....	53
(I) Combination of risk forecast with long-term effective management.....	53
(II) Information support and new technology application	54
(III) Construction, application and development of the modes in industry tax analysis, tax assessment and the typical cases database in tax inspection	54

Preface

SME has been developed so rapidly in China that its annual growth rate has come up to 10%. The number of these enterprises in 2006 has exceeded 10 million, accounting for more than 99% of the total. The tax payment features and tax risks of SME result in higher and higher requirements on administration capability of tax authorities. Through the analysis of tax administration environment in SME, China tax authorities have found out the challenges against tax administration in SME and then established corresponding strategies. And by applying risk management techniques and innovating upon the organizational operation modes, China tax authorities have implemented the integrated auditing strategies effectively, explored beneficially into making effective use of auditing resources and reinforcing tax administration of SME, and gained satisfactory achievements.

I. Find out the challenges against tax administration in SME via environment analysis:

- The quantity of SME increases rapidly, while the tax collection and administration resources are relatively insufficient.
- As the tax evasion tactics in SME spread quickly among industries, the tax auditing mode is confronted with changes.
- The tax revenue source administration lacks planning and coordination as a whole and tax authorities are in an urgent

need to improve organizational operation modes.

- The tax administration on SME lacks feasible and effective methods so that the administrative approaches must be innovated as soon as possible.

II. The integrated auditing strategies against the challenges confronted by tax administration in SME

- Identify the suspicious tax evasion groups in SME in accordance with the hierarchical “plane-line-point” data analysis method, and implement effective tax assessment and tax audit to deal with challenges against the relative lack of tax collection and administration resources.
- Summarize characteristics of individual cases and conclude industry rules in accordance with the comprehensive administrative approaches carried out in “point-line-plane” sequence, formulate specialized tax administration measures or methods according to different industries to improve the auditing effect and deal with the challenges from more and more tax evasion behaviors in SME.
- Improve the organizational operating mechanism, implement the integrated linkage of “taxation analysis, tax assessment, tax inspection and comprehensive administration”, and ensure the smooth operation of closed-loop work flow of “plane-line-point to point-line-plane” integrated auditing strategies and deal with the challenge that tax revenue source administration lacks

planning and coordination as a whole.

- Explore into such methods as application of risk management techniques, process rebuilding of tax evasion cases, and analysis of industry chains, group supply chain and related pricing on an informationization basis, and thus support the realization of “plane-line-point to point-line-plane” work flow and integrated linkage mechanism to deal with the challenge that the administrative approaches must be innovated as soon as possible.

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

- Identify and estimate the tax risks of different industries among SME by utilizing many analysis methods including event tree, industry chain and group supply chain.
- Implement the tax assessment and tax inspection of different industries according to the risk estimation.
- Combine the project evaluation with long-term effective management of industry and carry out the integrated administration of tax audit in SME.

Through analyzing the tax administration environment, formulating tax auditing strategies and integrated tax auditing practice with application of risk management techniques, China tax authorities

are stepping soundly towards the tax administration objectives of SME: “Promote tax compliance through analysis and renovation on each industry”.

I. Challenges against tax administration in SME

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

The quantity of SME in China increases rapidly at the speed of over 10% per annum, and it has exceeded 10 million ones as of 2006. While the newly-established enterprises are increasing rapidly, the suspension, cancellation and share transaction of SME also increase rapidly. If taking Qingdao State Administration of Taxation (SAT Qingdao) as an example, about 20,000 newly-established taxpayers are available per annum accounting for 20% of the total; the number of canceled taxpayers is approximately 10,000 per annum accounting for about 10% of the total.

In a distinct contrast with the rapid increase of enterprises, the quantity of tax administrators keeps almost steady. The average number of SME under the control of tax administrators has been increased continuously, and in many regions, each tax administrator may administrate more than two hundred enterprises. This has affected tax services provided by tax administrators for many SME, especially made these administrators unable to give

enough education and instructions about tax laws to newly-established enterprises, resulted in the enterprises' poor obedience with tax laws, and brought enormous tax collection and administration risks.

As of now, the tax administration on SME is confronted with the difficulties in that the increase of tax collection and administration resources lags behind the increase and change of tax collection and administration objectives. As a result, the tax evasion risks in SME are continuously enlarged, so the administration efficiency of tax authorities should be increased as soon as possible.

(II) As the tax evasion tactics in SME spread quickly among industries, the tax auditing mode is confronted with changes.

On the one hand, under the circumstance of low tax compliance, since the SME have close economic relationships and exchange information frequently with other enterprises in the same industry or between the upstream and downstream, homogeneous tax evasion modes spread widely in enterprise clusters and such tax gap can not be verified without adequate information of the third party.

On the other hand, the traditional tax auditing deters the whole through suppressing individuals with a view to the taxation inspected. In the cluster of SME, because the insufficient tax

collection and administration resources bring about the reduction of auditing proportion, and such unfavorable factors as ubiquitous refusal to preserve records, high proportion of non-declaration and a large quantity of cash transactions, the deterrent of tax audit is greatly weakened.

Therefore, it is hard for traditional suppressing and deterring type audit to prevent the homogeneous tax evasion methods from spreading in large quantities of SME. So tax authorities have to change the auditing modes.

(III) The tax revenue source administration in SME lacks planning and coordination as a whole and tax authorities are in an urgent need to improve organizational operation modes.

Central, provincial and municipal tax authorities set up internal administration departments in accordance with the administrating modes on different taxes, but grass-root tax authorities establish tax sources administration departments and keep taxpayers under uniform control according to territorial principle or other sorting means. Because of different establishment principles, the superior and subordinate tax authorities are relatively independent in tax collection, administration and inspection, and are easy to have confliction in work. That can be resembled as “One needle to

thousands of threads”.

Considering the aforesaid problems, the superior and subordinate tax authorities must change their organizational operating mode and allocate reasonably tax collection and administration resources so as to improve the quality and efficiency.

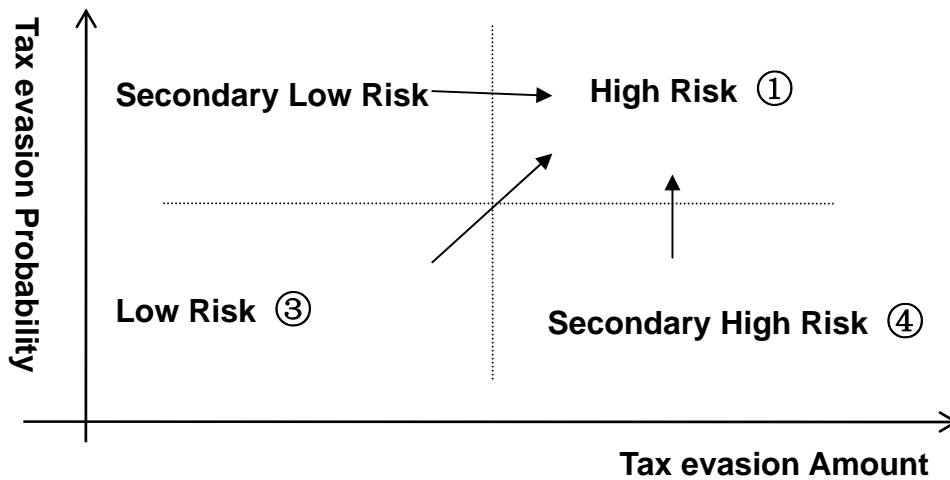
(IV) The tax administration on SME lacks feasible and effective methods so that the administrative approaches must be innovated as soon as possible.

In face of these problems, it is difficult for tax authorities just relying on traditional administration to play its role and adapt to the demand for administrating SME effectively in modern market economy. So, strategic management conception must be introduced. Tax authorities have to consider comprehensively the environment analysis, resource capability support and strategy selection, rely on information technology and effective modern administrative approaches, and try to realize the scientific and refined tax collection and administration on SME.

II. Integrated auditing strategies for strengthening tax administration on SME

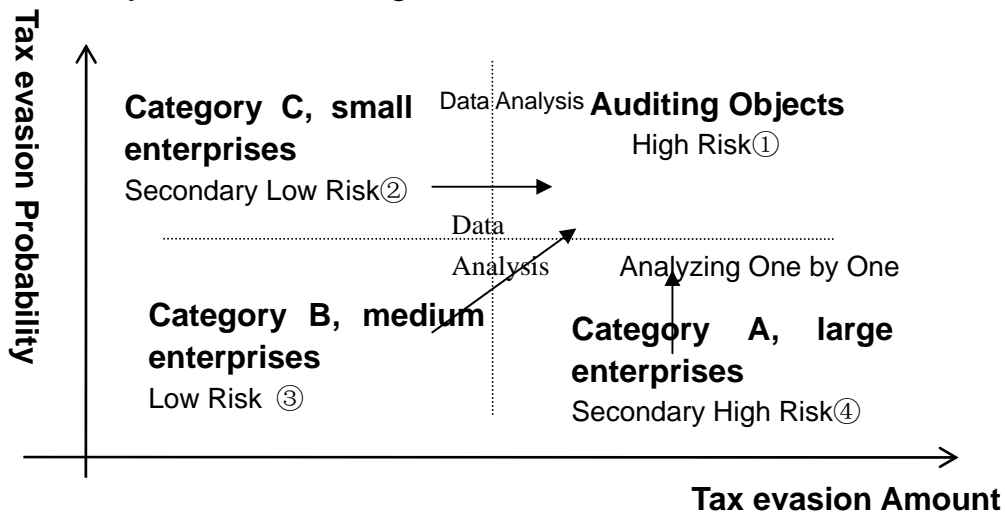
The segmentation to objects is an effective method to boost up the

administration efficiency. China tax authorities generally apply the taxpayer categories management methods. SAT Qingdao employs the ABC taxonomy to distinguish SME from the taxpayer collectivity adhering to the basic principle of risk analysis matrix. This method lays the groundwork for the integrated tax auditing strategies of SME and has typically representative significance.



The risk analysis matrix above divides taxpayers into four groups from the two aspects of tax evasion probability and tax evasion amount: ① represents those taxpayers with high tax evasion probability and high tax evasion amount, which is the auditing object of tax authorities, and its specific quantity depends on the auditing capability of tax authorities; ② represents large quantities of newly-established small enterprises with high tax evasion probability but low tax evasion amount; ③ represents taxpayers with low tax evasion probability and low tax evasion amount. Many medium enterprises which have developed for a long time but are not big in size are parts of this group; ④ represents taxpayers with low tax evasion probability but very high tax evasion amount. A few of large enterprises belong to this group. From the view of the requirements on tax auditing, we'll select the high-risk taxpayers from Group ①, ②, and ④, i.e., to find out specific taxpayers in Group

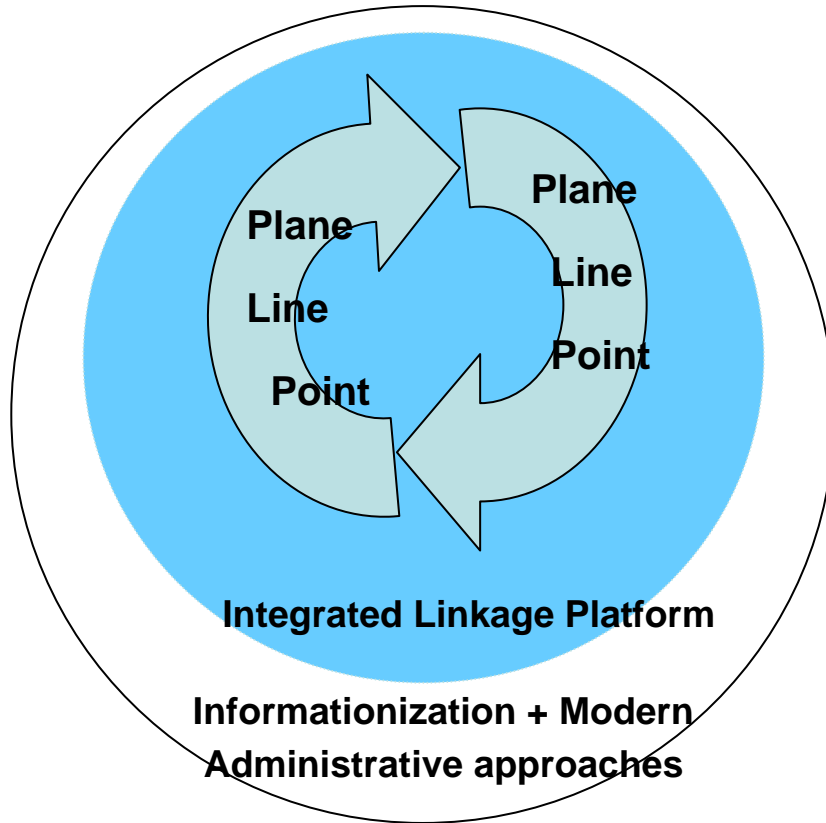
and carry out tax auditing.



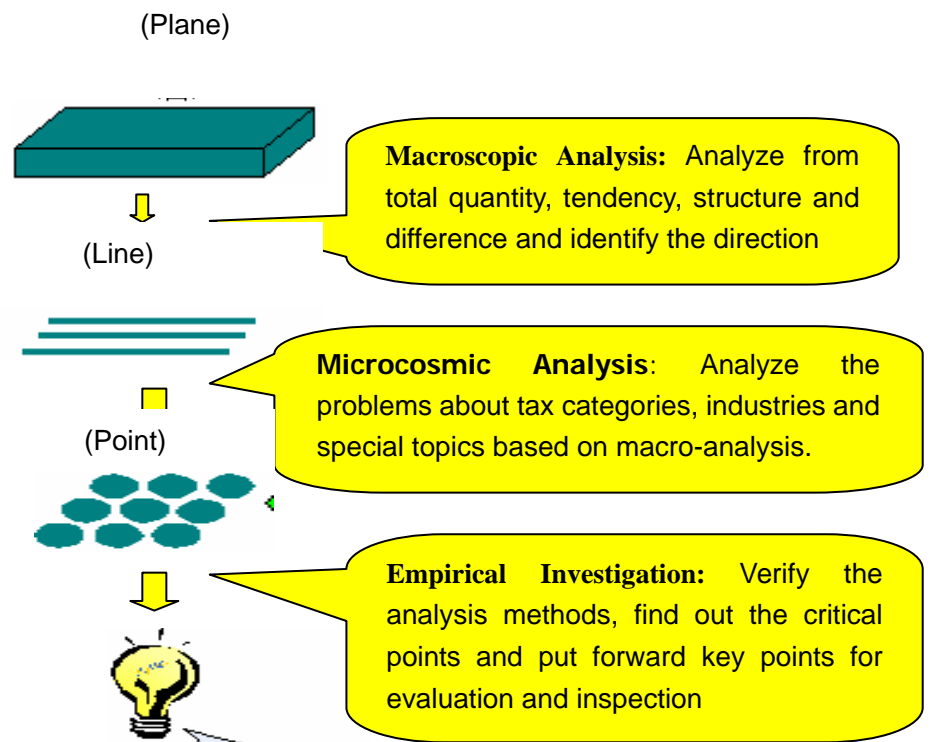
SAT Qingdao classifies taxpayers into Category A, B and C based on the basic analysis above: Taxpayers in Group belong to Category A enterprises, which is small in quantity but high in taxation, so the tax authorities carry out supervision and control one by one and report any suspicious tax evasion enterprises to the tax auditing departments; Taxpayers in Group and in large quantities belong to Category B and C enterprises respectively, i.e., SME. Tax authorities shall analyze and manage data about these enterprises through macroscopic and microcosmic data analysis as well as empirical investigation, and report the suspicious tax evasion enterprises if any to the tax auditing departments. According to such indicators as specific years of existence, sales income and tax payment credit level, SAT Qingdao classifies all of 94, 200 enterprises into 6,200 ones of Category A, 41, 000 ones of Category B and 47, 000 ones of Category C.

SAT Qingdao carries out the integrated auditing strategies on SME on the basis of classified administration. **Namely, according to the hierarchical “plane-line-point” data analysis mode, the Administration can identify the suspicious tax evasion groups among SME and improve the auditing efficiency. It also concludes rules of different industries and formulates the tax administration method thereof according to the hierarchical “point-line-plane” auditing administration modes and thus upgrades the auditing effect; the Administration also employs the integrated linkage mechanism and ensures the smoothness of “plane-line-point to point-line-plane” work flow in organizational operation, relies on informationization, explores into the application of scientific administrative approaches and supports the “plane-line-point to point-line-plane” work flow and the realization of integrated linkage mechanism.**

Integrated Auditing Strategy



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



Demonstration analysis and problem check

The “plane-line-point” hierarchical data analysis method means to adhere to “confirming the direction through macroscopic analysis and finding out the problems through microcosmic analysis”. Data processing analysis is carried on in multiple levels and different aspects to tone up the pertinence and validity of tax sources administration.

Firstly, confirm the administrative direction from the so-called “plane”. The macroscopic taxation data analysis is carried on from multiple levels and different aspects to boost up the administration on tax sources. It’s recommended to find out the weak link existing in tax category administration among certain regions, divide the

SME in large quantities into different risk groups as per specified industries or other similar characteristics, and seek after the so-called “line” (industries or homogeneous groups) under key supervision and control.

Secondly, find out the common rules from the so-called “line”.

Centralize the problems from the above analysis results, subdivide the industries and confirm the doubtful problems about tax category administration generally existing in industries through contrastive data analysis between different systems, departments and links.

Thirdly, anatomize the problems about rules from the so-called

“point”. Carry out thoroughly the typical anatomization by means of man-machine combination, checking real evidence and evaluating analysis of cases, choose the suspicious taxpayers with large tax risks in key risk groups and verify the doubtful points found in data analysis and practical situation about taxpayers, summarize and conclude the commonness of taxpayers.

From the “plane” to “line” and from “line” to “point”, reduce the supervision and control range of tax risks in SME gradually by means of hierarchical data analysis, pertinently input limited auditing resources, and thus greatly enhance the auditing efficiency of SME. Please refer to the case about “Taxation Analysis of Pharmaceutical Retail Industry” for details.

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

I. Macro-analysis (from “plane” to “line”)

In point of macroscopic economy, the GDP of Qingdao reached RMB269.5 billion Yuan with a growth of 16.9% in 2005, of which the sales of pharmaceutical retail industry reached RMB722.18 million Yuan with a growth of 18%. In point of tax revenues, the declared taxable annual sales amount of pharmaceutical retail industry was RMB475.23 million Yuan in 2005, but the VAT paid was only RMB11.06 million Yuan. Compared with macroeconomic data, revenue growth of pharmaceutical retail industry was too slow, and there was a large gap between the declared sales amount and GDP data.

In addition, according to the result of Internet survey, the pharmaceutical retail amount through punching medical insurance cards in Qingdao reached RMB360 million Yuan in 2005. Considering the large number of cash transactions, we believe the declared taxable sales income of the industry was significantly smaller.

Through a wide range of data comparative analysis, we make the initial judgment that there is a high risk of loss of tax revenue in the industry.

II. Micro-analysis (from “line” to “point”)

(I) Analyze the registered drugstores of the industry

The registered drugstores of Qingdao pharmaceutical retail industry are as follows: a total of 1,576 drugstores, including 719 independent accounting ones and 857 non-independent accounting ones; in independent accounting drugstores, there are 45 general taxpayers, 331 small-scale enterprises and 343 individually-owned ones with regular and fixed amount of tax.

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

Table: Comparison between medical insurance card income and VAT declared income Unit: ten thousand Yuan

Primary 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
			260		
Total	120	7903	3	5300	27660

Through other government departments, SAT Qingdao obtained the medical insurance card settlement information of the whole city in 2005 (②). After compared with the income declared to tax authorities (③), it was found that there were 120 drugstores (①) whose incomes declared to tax authorities were significantly less than the settlement data of medical insurance cards, with the difference totaling RMB53 million Yuan (④). According to an actual survey, in gross sales income of a drugstore, the income in form of cash and check is usually 2.5 times as much as medical insurance card income. Therefore, the estimated actual sales income of the whole city' drugstores was RMB276.6 million Yuan (⑤). Meanwhile, we also discovered that 44 drugstores did not handle tax registration and declaration in SAT.

Thus, we believe that there has been very high tax risk in the industry.

III. Empirical investigation (confirming problems and summarizing the tax evasion rules)

To test the accuracy of analysis result and find out the reasons and solutions, through carrying out empirical investigation to people involving in tax, SAT Qingdao found the main problems in tax administration in the industry were as follows: economic nature, tax burden rate, changing rate of sales amount, investment scale, gross profit margin of sales and geographic analysis. Some representative taxpayers are selected.

1. Most of pharmaceutical retail enterprises are privately-run and individually-owned, which commonly have the problems of low level of accounting, incomplete evidence for keeping account and without subsidiary ledger for inventory, and some of them even set up “two sets of accounts” to deceive tax authorities, as a result it is hard to get accurate sales amount and relevant cost on account book. Several individual pharmaceutical retailers actually have not handled tax registration for the purpose of tax avoidance.

2. Because of competition within the industry and increase of rent, water & electricity fees and wages, some pharmaceutical retail enterprises often make a reckless move to make profits directly by less declaration of income.

3. In terms of using ordinary invoices, there is the phenomenon of changing names of articles at will and drawing up invoices that amounts in the invoice form and in the stub form are different.

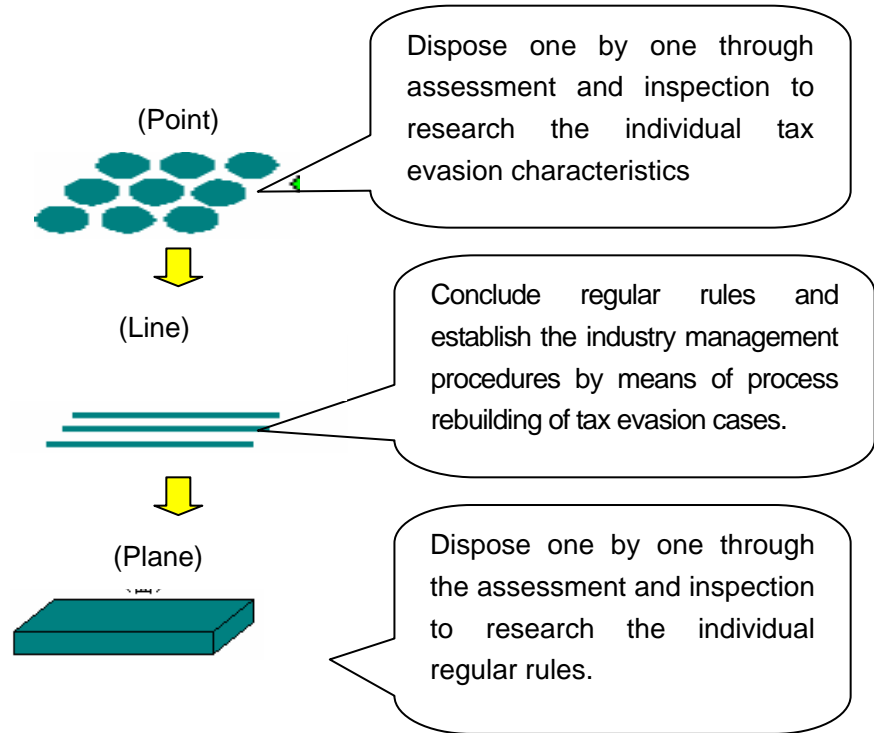
IV. Pharmaceutical retail industry audit based on the above analysis had positive effect that the taxation inspected in one month accounted for 91% of the annual tax returns.

In May 2006, tax audit work of Qingdao pharmaceutical retail industry was carried out comprehensively. Remarkable effect was achieved within a month:

Firstly, 44 tax evaders were identified, tax registration administration was strengthened and the fair market competition environment was improved.

Secondly, through taxpayers' self-inspection, tax assessment and tax inspection, SAT Qingdao retrieved a revenue loss of RMB10.052 million Yuan, which accounted for 91% of the total annual initiatively declared taxation of the industry in 2005.

(II) Follow the audit administration way of “point-line-plane”, conclude the industry rules and establish the tax administrative approaches for different industries so as to improve 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”.

Firstly, “find solutions on the point”. After data analysis on the “plane-line-point”, the tax authority will direct the SME suspected of tax evasion to conduct self-inspection. If tax authorities find some questions about the self-inspection results, it will make a separated appointment with the taxpayer to know about some information. Then the tax authority will decide if the tax assessment will be further done on the site. During the process of tax analysis, instructions to taxpayers, interview and tax assessment & inspection, the case will be

handed over to the tax inspection authority for key inspection once any significant evidence of tax evasion is discovered. Investigate the problems on the “point” deeply and thoroughly by various means.

Secondly, “research measures on the line”. According to the problems on each “point”, make use of the process rebuilding of tax evasion cases, dissect each link of the enterprise’s tax evasion and analyze the characteristics of tax evasion. Based upon the analysis results of many cases, draw a conclusion to the characteristics of frequent tax evading behaviors and find the tax administration rules on the “line”. Then formulate corresponding industry taxation administrative measures or procedures according to the tax evasion regular rules of enterprises within certain industry and control the extension of the same tax evading behaviors within that industry.

Thirdly, “establish administrative regulations on the plane”. According to the standard of National Bureau of Statistics of China, the taxpayers are divided into 913 small industries. Since 2006, SAT Qingdao has carried out the project-based audit and inspection to about 8 key industries every year, constantly summarized the homogeneous groups in SME, solved the problems existing in tax administration of each industry, so as to

establish the overall tax source administration system.

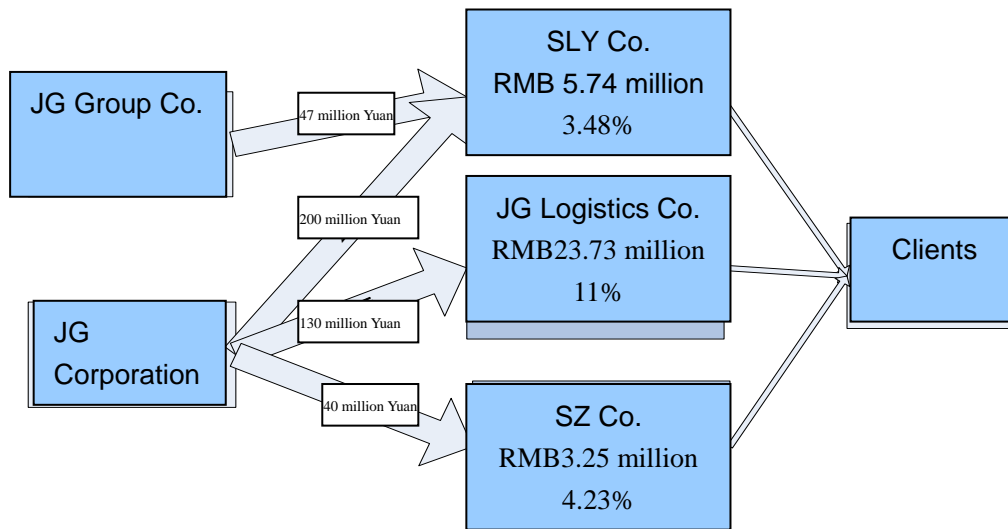
Case: Tax risk administration on income tax reduction and exemption for newly-established enterprises

I. Policy background of income tax reduction and exemption for newly-established enterprises

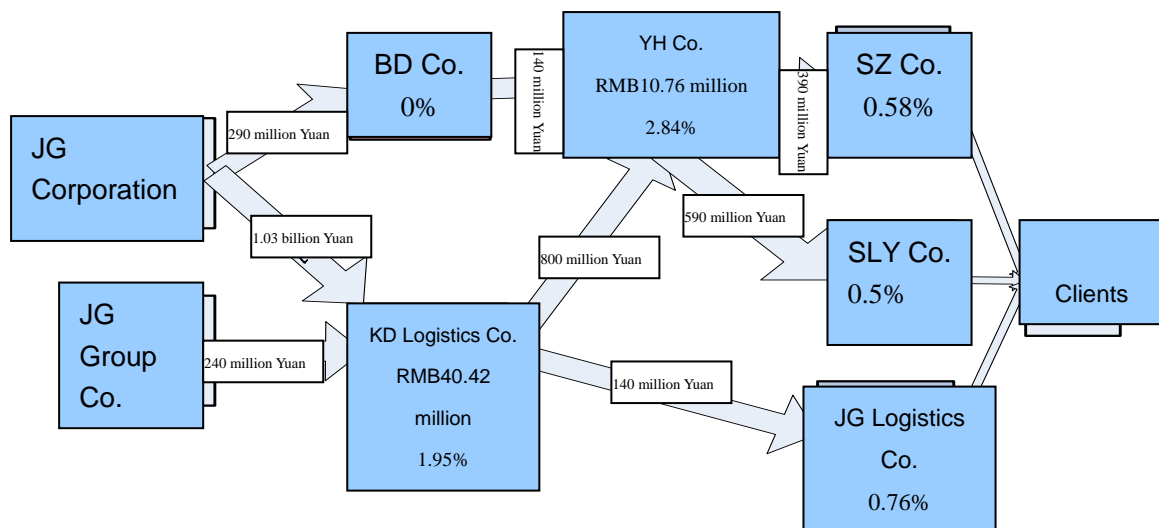
The current policy of income tax reduction and exemption for newly-established enterprises began in 1994, which is a preferential policy for supporting and encouraging the development of tertiary industry, namely newly-established enterprises of service sector are exempted from income tax in the first year and halved in the second year.

II. Rebuild the process of tax evasion case: JG Group evaded income tax through newly-established subsidiaries

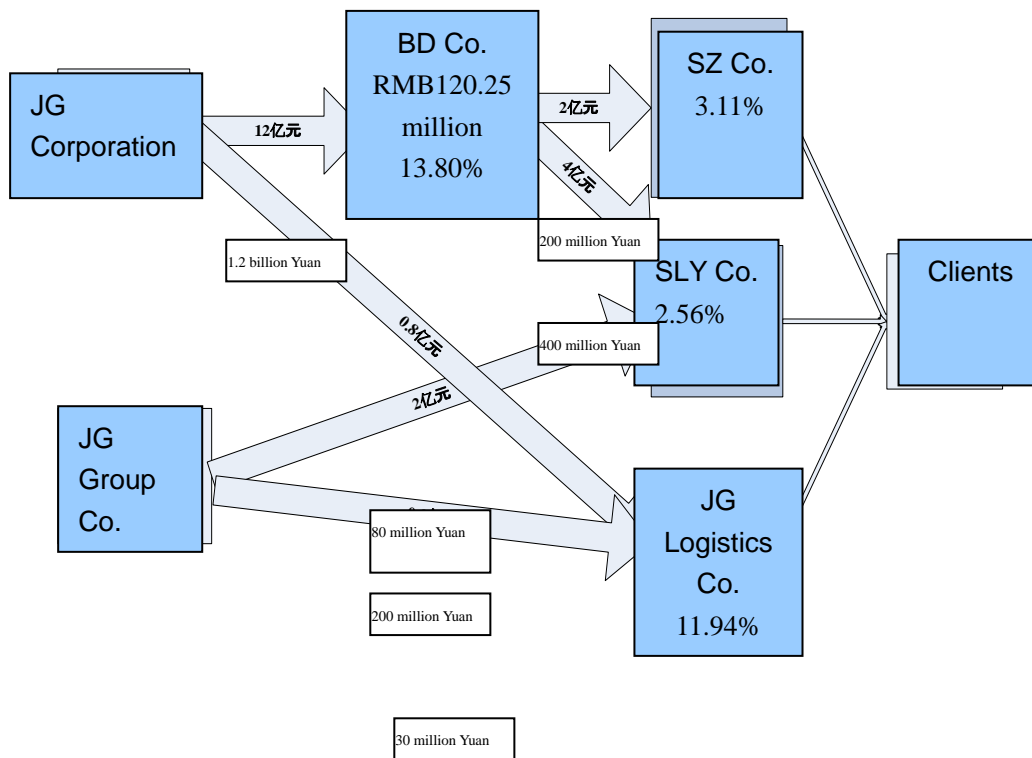
1. Flow of special invoices of JG Group and affiliated enterprises in Qingdao in 2003



2. Flow of special invoices of JG Group and affiliated enterprises in Qingdao in 2004



3. Flow of special invoices of JG Group and affiliated enterprises in Qingdao in 2005



4. Taxation condition of JG Group from 2003 to 2005

Enterprise name	2003		2004		2005	
	Tax burden rate	Deducted and exempted amount (ten thousand Yuan)	Tax burden rate	Deducted and exempted amount (ten thousand Yuan)	Tax burden rate	Deducted and exempted amount (ten thousand Yuan)
SLY Co.	0.6%	574	0.41%	0	0.08%	0
JG Logistics Co.	1.8%	2373	2%	0	0.23%	0
SZ Co.	0.6%	325	0.26%	0	0.10%	0
BD Co.	--	--	2.11%	12025	0%	0
KD Logistics Co.	--	--	--	--	0.38%	4042
YH Co.	--	--	--	--	0.55%	1076
Total	0.8%	3272	1.5%	12025	0.28%	5118

Total amount of tax reduction and exemption is RMB204.15 million Yuan

III. Summarize the features of tax evasion of newly-established enterprises swindling income tax reduction

1. The affiliated enterprises take advantage of affiliated transactions to transfer profits and decrease tax payment.
2. Tax-exempted enterprises adjust costs between tax holiday and levy period to decrease tax payment.
3. After tax holiday, enterprises increase expenses in all kinds of ways to decrease tax payment.
4. The income of enterprises during tax holiday is not true.

III. Work out long-term and effective methods for administrating tax reduction and exemption of newly-established enterprises based on the tax evasion features

According to the above tax evasion features, SAT Qingdao puts forward the following measures for strengthening the administration on tax reduction and exemption for newly-established enterprises:

Firstly, it has stipulated clearly that those enterprises with the businesses mainly transferred from affiliated enterprises that have already enjoyed the income tax reduction and exemption for newly-established enterprises of tertiary industry can not enjoy the tax preferential policies for newly-established enterprises again.

Secondly, it has further clearly intensified the year-end audit and settlement on tax reduction and exemption.

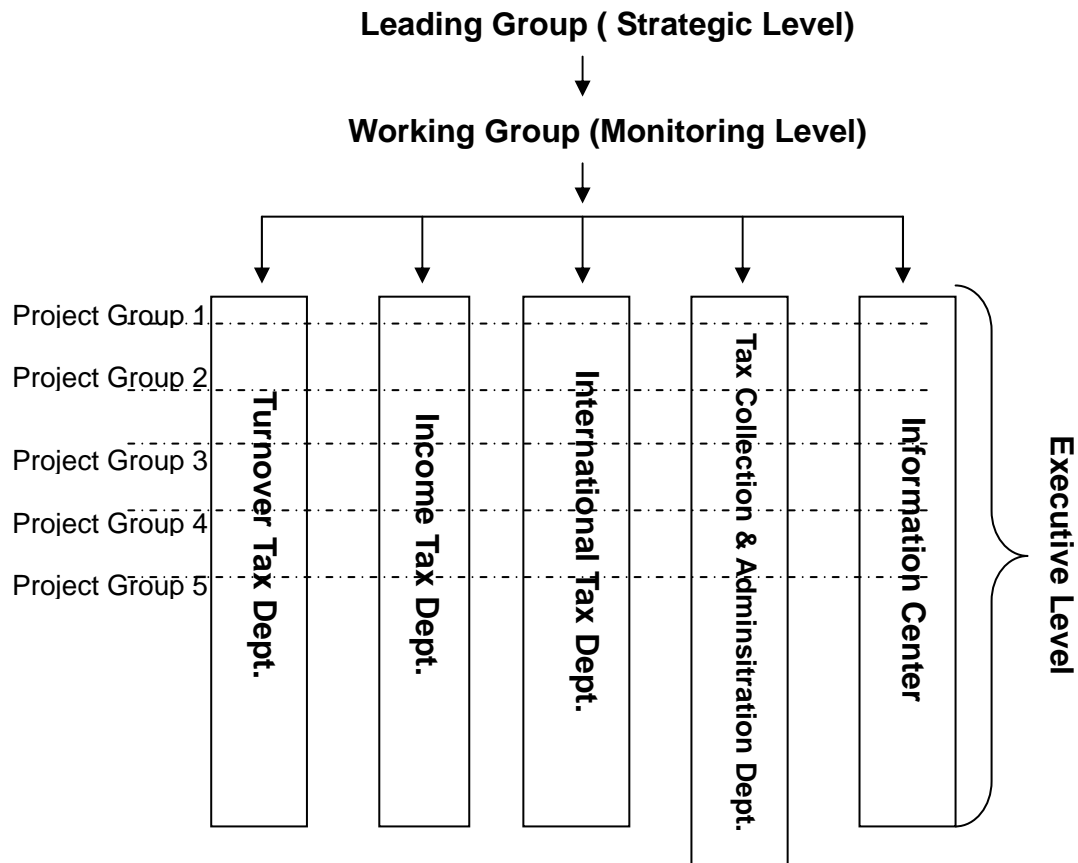
Thirdly, it has intensified the administration on enterprises whose tax reduction and exemption have been cancelled.

SAT China has recognized the administrative measures of SAT Qingdao and promptly issued *Notice on the Executive Standards for Identification of Newly-established Enterprises Paying Enterprise Income Tax*, and popularized the main ways for strengthening administration on tax reduction and exemption for newly-established enterprises nationally.

(III) Implement the integrated linkage and ensure the smooth “plane-line-point to point-line-plane” work flow in organizational operation.

The closed loop “plane-line-point to point-line-plane” work flow breaks the department duties administrated as per tax categories and China tax authorities begin to implement the 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 and four links, of which the former refer to the administrative organization and the latter refer to the operating mechanism. The integrated linkage of

related departments and working links breaks up the administration situation of simple fragmentation and enables the closed loop “plane-line-point to point-line-plane” work flow to run smoothly.



1. Administrative organization in integrated linkage

The integrated auditing administrative organization consists of the leading group, the working group and the project groups, among which the leading group is for the strategic level, the working group the monitoring group and the project groups for the executive level.

(1) The leading group consists of the leaders of SAT Qingdao and

department chiefs, in charge of the overall auditing and the confirmation of instructions of tax audit and major projects etc. The quarterly comment meeting is the main form by which the leading group advances the integrated auditing.

(2) The working group is with a deputy director of SAT Qingdao as the group leader and department chiefs and excellent tax administrators as members, in charge of organizing and fulfilling the work tasks determined by the leading group, coordinating the tax collection supervision resources of the entire system to carry out the tax audit, instructing and supervising the work of project groups in multiple aspects from problem analysis, empirical investigation, project proposal, tax assessment and tax audit to formulation of industry administration measures or methods and taking charge of the effect assessment on projects. The working group holds the regular project meeting monthly and the basic-level work dispatching meeting quarterly to advance the tax audit administration.

(3) The project groups are established by the working group in time according to the progress of taxation analysis, with the project leading departments and the members of project groups determined. The project group takes charge of fulfilling the business specifically, solving specific problems, summarize basic

rules, formulating the industry administrative measures or methods and following up the execution effects of projects. The project groups hold the brief meetings irregularly as required and complete the work concerning projects via mutual exchange and collaboration. The leading departments of project groups are determined according to the major business that the said project involves and the functions of business departments in SAT Qingdao.

2. Operating mechanism in integrated linkage

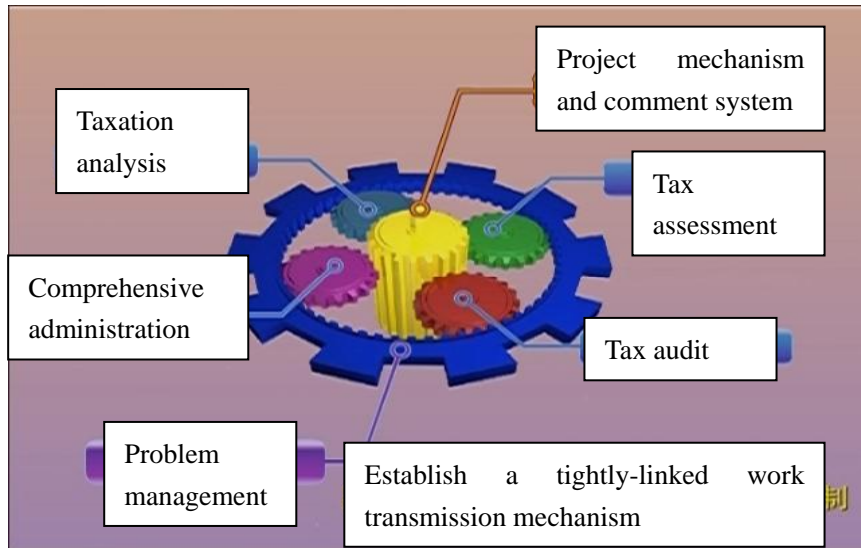
The four links of operating mechanism are taxation analysis, tax assessment, tax audit and comprehensive administration.

(1) Taxation analysis is the link of initiating in integrated linkage and its major tasks are to identify the risk elements of tax administration, appraise the risk level, find out the weak points of tax collection and administration and drive the tax audit and the tax assessment.

(2) Tax assessment and audit are the link of fulfillment in integrated linkage. The basic clew of tax assessment is to assess as per different industries and solve the industry administration problems in the concentrated way. The major task of tax audit is to take controlling and striking measures against tax risk elements that are determined as high level.

(3) Comprehensive administration is the link of integration. Its major tasks are to sort and summarize the specific work fruits of taxation analysis and tax audit, formulate and fulfill the industry tax administrative approaches, determine the panels of data analysis and ensure the actual administration effects and continuous improvement of tax source analysis and management projects.

With projects as the core and via the foregoing administrative organization and operating mechanism in integrated linkage, the “risk management” serves as the main line to connect the four links namely taxation analysis, tax assessment, tax audit and comprehensive administration together in an organic way; when each link is brought into play, it will gain the powerful response from other links in terms of the quarterly comment meeting of leading group, the monthly regular meeting of working group and the brief meeting of project groups. In this way, the trans-department “plane-line-point to point-line-plane” work flow is able to run smoothly and a basic running platform is available for the integrated audit strategies for risk management of SME.



(IV) Rely on information technology to explore and apply scientific management methods and support the realization of the “plane-line-point to point-line-plane” work flow and the integrated linkage mechanism.

If the integrated auditing strategies are regarded as a car, taxation analysis, tax assessment, tax audit and comprehensive administration would be four wheels, while the information technology as the transmission driving shaft and the scientific management methods as the excellent driving skills.

Like the driver should master the driving skills and drive four wheels via the driving shaft to run safely and rapidly, tax administrators should master the scientific management methods, rely on information technology and try to drive the four links of taxation

analysis, tax assessment, tax inspection and comprehensive administration to run consonantly so as to control the tax risks of SME.

1. Information Technology

(1) Application of internal administration information system of tax authorities

“China Taxation Administration Information System (CTAIS)”

has been completely applied in China tax authorities, with the provincial data centralization in most regions. In 2005, SAT Qingdao upgraded CTAIS to Version 2.0 according to the unified deployment of SAT China, further expanded and completed the tax operation functions and supplied the overall and integral data sources for the provincial taxation analysis. The previous auditing was only limited in single case analysis, selection and inspection and the auditing result was only embodied as single case tax inspection and repayment, with no powerful rectification on the entire industry. While the “plane-line-point” data analysis executed on the basis of provincial unified database has the ideal effect of analyzing as per different industries and the data analysis reaches the unprecedented depth and width.

In 2004, SAT China developed and applied the comprehensive data

management system based on CTAIS2.0, conducted the systematic sorting towards taxation data according to certain management targets, covered functions such as centralized inquiry for data of one taxpayer, alarming supervision, taxation quality control, tax assessment management monitoring and matters to be done by tax collectors and realized the basic function of decision-making support.

In 2007, SAT Qingdao designed and developed the linkage process support software integrating four aspects namely taxation analysis, assessment, inspection and comprehensive administration, which brought every aspect and its convergence of the integrated linkage mechanism into automated information system.

(2) The application of external information application in association with tax authorities

Enterprise declaration information is the main part of external data of tax authorities. China tax authorities extensively acquire information of taxpayers based on the integrated audit strategy. Take SAT Qingdao for example, 60% of enterprises have chosen e-file method, delivering tax returns and related financial statements directly to the administration database of SAT Qingdao, which has provided a strong support to integrated audit.

China tax authorities have also launched information networking with enterprise registration administration departments (industrial and commercial administration bureaus). The basic enterprise registration information can be transmitted through the network to the administration database of tax authorities, which has provided an effective data sources.

Third-party data sources also include pharmaceutical retail information of labor insurance agencies, bank POS card punching information, information of automobile maintenance industry administration departments, enterprise power utilization information of power companies, etc.

(3) Support from tax authorities' internal and external information application systems to the integrated linkage

CTAIS is the main administration operating software of tax authorities, the integrated data management system is the main data analysis monitoring software, and the integrated linkage software directly supports the seamless implementation of integrated audit work; enterprise financial data acquisition is an important data source for taxation analysis, assessment and inspection; the third-party data plays a decisive role in carrying out relevant data comparison to find out evidence of tax evasion. The internal and external information application of China tax authorities

has been a strong support for the smooth operation of integrated linkage mechanism.

2. Scientific management method

After many years of exploration, using the concept of process rebuilding of tax evasion case, risk management techniques, event tree analysis, analysis on industry chain, analysis on group supply chain and related pricing, establishing data analysis panels and database of tax assessment cases, database of typical tax inspection cases and other scientific management methods, China tax authorities have preliminarily realized the goals of selecting audit objects efficiently and keeping long-term audit effectiveness, and have achieved better audit effect.

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

China tax authorities implement the audit strategy integrating “taxation analysis, tax assessment, tax inspection and comprehensive administration” on SME, which is highly related with the “identification - estimation - treatment - assessment” of risk management. Tax risk identification and estimation of SME are

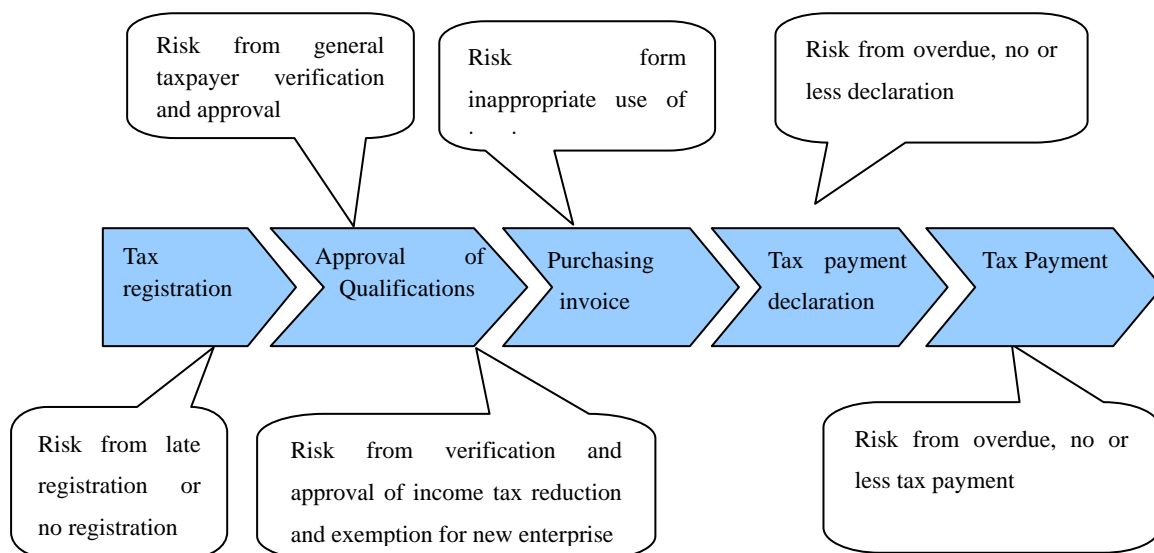
accomplished through tax analysis, and risk treatment is accomplished through tax assessment and taxation inspection. Effect evaluation is closely combined with long-term administration on tax sources intensified by formulating industry tax administrative measures or methods.

The specific application of risk management techniques contains: in the aspect of risk identification and estimation, China tax authorities adopt taxation analysis methods such as event tree analysis, industry chain analysis, group supply chain analysis and related pricing analysis; in the aspect of risk treatment, China tax authorities take the different tax assessment measures of “self-inspection, interview, investigation and treatment” or measures of special control and inspection according to different risk levels; in the aspect of risk control effect evaluation, China tax authorities employ not only ABC three-level effect evaluation method but also the long-term effective management mechanism on tax sources.

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

1. Event tree analysis

Firstly put forward by Bell Laboratories USA in 1962, event tree analysis has been extensively applied to risk management field. event tree is a kind of tree diagram composed of nodes and lines, in which the node represents certain specific link, while the line shows the relationship between these links. As for the tax analysis on single enterprise, China tax authorities actually use the event tree risk management method to simply and vividly make clear the key risk aspects of routine tax administration.



For risks may exist in the aspects above, China tax authorities have established corresponding administration systems:

- Tax registration: Mass media publish an Announcement on consolidation within a specified time per month; be networked with the industrial and commercial bureau that is in charge of the registration and management of the enterprises, and find the tax evaders according to the regular data analysis and verification.
- **Approval of qualifications:** For the major general taxpayers, they are not only examined on the spot for their sales income, but also verified the sales transactions of their suppliers. For the approval of the new firms' income tax reduction and exemption, their essential transactions must be examined if they are transferred from the old ones. For other approval projects, the detailed examining points and operating procedures are obviously described.
- **Invoice control:** The risk of VAT special invoices has been reduced to a lower level, through comparison and verification to invoice information of upstream and downstream enterprises within China. Meanwhile, the risk of ordinary invoices is also being controlled to a lower level by popularizing the Tax Controlling Cashier Machine.
- **Tax declaration control:** The risks of overdue declaration and none declaration are mainly controlled through the routine supervision and administration by tax officers, while the ones of

understatement are generally controlled through the approaches of classification management, integrated audit, etc.

- **Tax payment:** Building the network system among Revenue, Bank and Treasure, it is convenient for taxpayers paying tax on-line. Tax administrators usually call and notify the taxpayers who do not pay their tax on time, and expose the delinquent ones through mass media, or even adopt the tax guarantee and enforcement measures if necessary.

2. Analysis on industry chain

The event tree analysis on tax risks of single enterprise only shows the circumstances of individuals. However, the analysis of upstream and downstream industries chains including a great number of enterprises can expose the problems which can not be found in single ones. For example, the tax evasion through the purchase invoice of wastage and used materials by the enterprises of upstream and downstream, is found via industry chain analysis, and countermeasures are made on this basis.

Case: Vertical analysis on industry chain for controlling the invoice of wastage and used materials

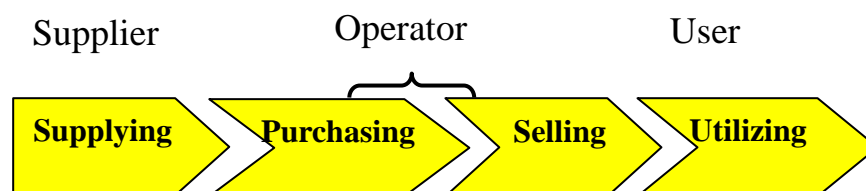
I. Policy background

When enterprises of wastage and used materials purchase goods

from residents, the input VAT can be calculated as per 10%.

II. Industry chain and risk analysis

The related parties of wastage and used materials businesses can be divided into three kinds of 'supplier, operator and user', and the businesses can be divided into four segments of 'supplying, purchasing, selling and utilizing', according to the characteristics of operator chains of upstream and downstream in the industry.



A data analysis shows that the suppliers of wastage and used materials are individuals who evade tax with the ID of resident and providing indirect invoices to buyers who can get more deduction of input VAT. And perhaps the users of downstream likely claim more invoices from operators, who have adequate input invoices, for more input tax reduction, that it gets rise to the risks of tax losses.

III. Relevant measures

For the potential risks in the foresaid segments, tax authorities list out the administration targets and adopt critical measures as follows:

Implement the system of “withholding taxation to the large amount of suppliers”. All the suppliers who provide goods more

than RMB 5,000 Yuan once a time, must have drawn up invoices and pay tax in tax authorities.

Reduce the sums and amount of invoices to operators in the segment of purchase, so as to control input tax through invoice. Implement the system of 'monthly statement of purchase, sales and inventory' in selling segment, so as to control output by input, and prevent from defraud in VAT special invoices.

Prevent from false deduction of input tax, implementing the analysis of input & output.

The effectiveness of the measures mentioned above is very remarkable, for the results of the comparison in 2004 and 2005 shows that the deduction of input tax for users was reduced more than RMB 80 million Yuan, the VAT of credit and exemption for operators was reduced more than RMB16.5 million Yuan, and the withholding VAT for larger suppliers was RMB 4.1804 million Yuan. More than RMB 100 million Yuan totally increased.

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

Take two steps according to risk estimation level: One is for the common infringement, implement tax assessment; the other is for the typical infringement with proof-positive, implement taxation inspection. Tax assessment and taxation inspection are effective ways for dealing with risks. They have two functions as below: one is the traditional deterrent, the other is proposing suggestions on industry management by dodging tax cases in order to accumulate

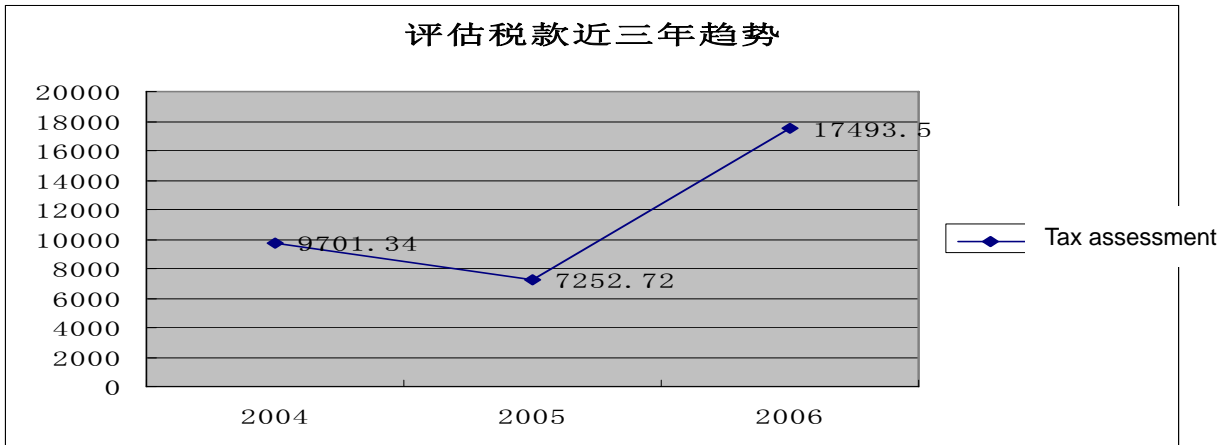
and summarize as the steps or methods of management on industry revenue gradually.

1. Tax assessment is marked by “industry-classified assessment”

An outstanding feature of China tax authorities' conducting tax assessment work is industry-classified assessment. Procedures of tax assessment include case analysis, on-site investigation, enterprise interviews and assessment treatment. The following is SAT Qingdao's tax assessment on the graphite production industry.

SAT Qingdao hadn't established the procedures of industry assessment before 2004. Since the end of 2005, with the implementation of integrated audit strategy, the work of tax assessment on industries has made rapid progress. Compared with 2005, the taxation of the tax assessment in 2006 increased by 140%, which promoted the revenue of the city increasing by 23%, the highest level in recent years.

Trend of Tax Assessment in Recent Three Years



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.

Take the mentioned pharmaceutical retail industry as the example, SAT Qingdao mainly worked in one month on more than thousand drugstores in whole city, and got the result of tax payment RMB10.05 million Yuan in the inspection, accounting for 91% of the

total amount of self-declaration in 2005. Therefore, the whole industry was completely rectified since then.

(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.

In 2005 and 2006, the Inspection Department of SAT Qingdao put forward proposals for 13 times, of which five inspection proposals titled *Proposals on Strengthening the Audit of Tax Offset Behavior with Tax Payment Certificate of External Customs*, *Strengthening the Tax Administration of Purchasing and Using Segment in Wastage and Used Materials*, *Strengthening the Administration of Invoices for the Purchase of Agricultural and Sideline Products*, etc. were adopted by the relevant departments, and put into effect as the long-term measures in tax collection and administration.

In the above proposals, SAT Qingdao successively formulated some measures based on the proposals on the administration of

tax payment certificate of customs, such as *The Notice of Strengthening the Audit on Abnormal Tax Payment Certificate of External Customs*, and *The Notice of the 'Three Receipt and One Book' Audit Approach on Withholding Tax of Import Goods Declared by Commercial Enterprises in Other Places* etc. *Nine Methods to Identify the Fake Customs Tax Payment Certificate*, put forward by the Inspection Department, was noticed as the attachment of the above document. More than 200 tax officers at different posts such as tax inspection, tax assessment, and tax administration etc., were trained subject to these documents. This activity had obtained significant results, namely, the monthly amount of tax offset with customs tax certificate reduced more than RMB100 million Yuan, the reduction rate reached over 10%, through strengthening the daily administration.

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

It is very important to evaluate the effect of tax analysis, tax assessment and tax inspection carried out by projects. China tax authorities combine the project evaluation with the approaches establishment in long-term administrative mechanism, forming the

closed-loop rising mode of tax risk management for SME.

1. Project evaluation is the foundation of evaluation of risk treatment effect.

Integrated linkage projects shall be done the quality evaluation one by one. The evaluation shall include the project organization and management, project program implementation, fulfillment of project objective, project result and long-term management etc. The specific evaluation standards are as follows:

Category A standard: after completion of project, the VAT burden rate of the industry shall increase by 15% at least, the loss percentage of domestic and foreign investment enterprises in same industry referred to income tax shall reduce by 5%, the average income taxation per SME shall be higher than that of last year within the bureau, and the paying ratio of taxation inspected shall be over 90%.

Category B standard: the actual industry tax burden rate shall increase by 5% to 15% than that of last year, or the loss percentage of domestic and foreign investment enterprises in same industry referred to income tax shall reduce by 5% less, or the average income taxation per SME shall be lower than that of last year within the bureau, and/or the paying ratio of taxation inspected shall be

80% more and 90% less.

Category C standard: include the enterprises which can not reach the Category A and B standard mentioned above.

The project evaluation system can effectively promote the implementation of the integrated audit strategy focused on the projects in the terms of concrete standards, and lay foundation for the forming the long-term administrative approaches and measures.

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

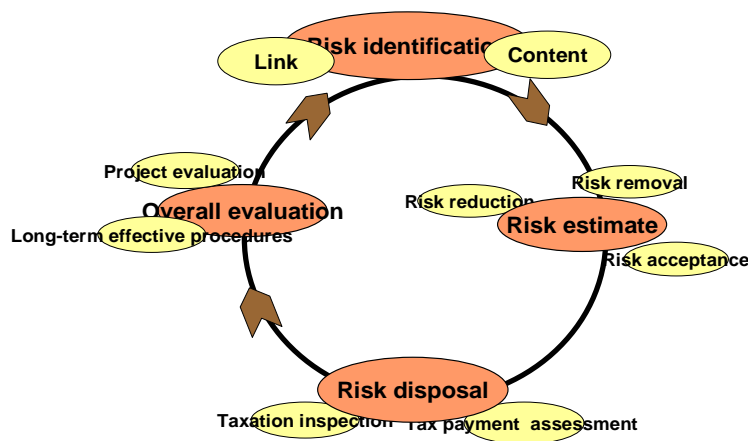
(1) Basing on the project evaluation, find the weakness in the management through typical cases, and establish the long-term effective tax control system upon relevant industry according to the successful experiences in projects. In 2006, SAT Qingdao selected ten major projects under integrated audit, and finally built up the administrative measures and approaches of relevant industries based on the summary and evaluation of the projects quality.

No.	Measures and Approaches	★ represents the industry tax administration procedures summarized
1	Administrative Approaches for Pharmaceutical Retail Industry ★	

2	Proposals for Strengthening Supervision of Transport Enterprises Invoice Offset	from the Category A projects
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.	

After the establishment of the tax administrative approaches on

above industries, according to the actual effects applied in the grass-roots tax offices, organize the previous members of project teams and part of the operators from the front line, who will make re-evaluation with the effectiveness of these approaches and measures every half or one year, and revise relevant administrative regulations according to the practical result, promoting the continuous improvement of such measures and approaches with industries, and forming the closed-loop rising work process.



(2) In addition to the industry tax administration approaches and measures, according to the summary of tax assessment and tax inspection, China tax authorities also establish the data analysis modes, typical case database of tax assessment and inspection over different industries, providing assistance for the subsequent tax analysis, assessment and inspection. Taking SAT Qingdao as the example, the tax analysis modes for over 70 industries, tax

assessment modes for over 20 industries and over 40 typical cases of tax inspection have been established.

In general, China tax authorities set up a closed-loop rising process for risk managements to SME, through three-step procedures, such as “make use of several methods to identify and estimate the tax risks in SME”, “enforce the tax assessment and inspection over different industries according to the results of risk estimation” and “carry out the comprehensive management of tax audit to SME, through combining the project evaluation and industry long-term management”. Therefore, the integrated tax audit objectives of “Promote tax compliance through analysis and renovation on each industry” are realized basically.

IV. Expectation

Although China tax authorities have made some achievements in the tax audit for SME, there is still much puzzlement in the work. Looking forward, a lot of subjects need to be researched further.

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

The integrated audit strategy has made certain achievements in the risk identification, risk estimation, risk treatment and evaluation,

however, it needs to be improved in the aspects of how to forecast risks and adopt relevant administrative measures in advance. In future, in addition to strengthening tax audit, draw inferences from other cases, research and forecast some specific risk factors in tax administration, estimate their levels and make the effective countermeasures.

(II) Information support and new technology application

Although the integrated audit strategy is primarily running smoothly under the support of information technology in China, the aspects in the completeness of taxpayer data collection and the timeliness of data exchange with the external departments concerned, etc. are not perfect. Meanwhile, some new technologies such as data warehouse and data mining etc, are not applied adequately in China tax administration, and need to be explored further. Nevertheless, the development of new technology provides new driving force to the integrated audit strategy.

(III) Construction, application and development of the modes in industry tax analysis, tax assessment and the typical cases database in tax inspection

The integrated tax audit strategy characterized with tax

administration by different industries, which have unique features in production and operation and tax payment. The construction of the panels in tax data analysis, tax assessment, and the typical case database in tax inspection, is beginning in China tax authorities, and a lot of operational details need to be further studied.

Furthermore, due to the unbalanced regional economic development, the effectiveness of the nationwide unified tax administration measures and approaches for industries still needs to be verified. In addition, the tax environment of industries may change with time, and also requires constant improvement in these measures and approaches. The objective of “Promote tax compliance through analysis and renovation on each industry” needs the practical verification regardless of time or space.