HONG KONG

Tax Audit Indicators

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Introduction

Tax audits in Hong Kong are divided into two areas: the Tax Investigation Unit (commonly known as "INV") and the Field Audit Team (commonly known as "FA"). The INV is primarily responsible for the in-depth review of cases where tax evasion is suspected,[1] while the role of the FA is to enhance voluntary compliance under the Inland Revenue Ordinance (IRO).[2]

The total back taxes and penalties recovered by the Inland Revenue Department (IRD) for the year of assessment 1996/97 is expected to be over HK$2billion, compared with HK$1.7 billion for the year of assessment 1995/96.[3] It is important to bear in mind that the *hit* rate (i.e. the discovery of cases with income understatements) is over 90% for the past five years. One of the main reasons for the substantial amount of back tax and penalties assessed was the successful introduction of the FA. For the year of assessment 1990/91,[4] for example, the amount of back tax and penalties collected was only $395million.

The major reason for the high success rate has to do with the file selection method and review procedures used by the FA. An assessing officer can select any file and look for indications of possible understatements in certain areas. Should they be found, a file may be opened for a full review.

Financial statements provide the IRD with the most important information required in ascertaining whether there are any irregularities. The following are some of the areas in financial statements that might indicate the possibility of an understatement of profit.

Ratios

The use of ratios is a very good tool to evaluate whether there are any irregularities. Valuable information can be obtained through analyzing the trend of the business and comparing the ratios with those of businesses in the same industry.