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Performance Audit

# **The Management of Compliance in the Small to Medium Enterprises Market**

**Australian Taxation Office**

Australian National Audit Office

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of Australia 2010

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Canberra ACT  
8 December 2011

Dear Mr President  
Dear Mr Speaker

The Australian National Audit Office has undertaken an independent performance audit in the Australian Taxation Office in accordance with the authority contained in the Auditor-General Act 1997. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit, and the accompanying brochure, to the Parliament. The report is titled *The Management of Compliance in the Small to Medium Enterprises Market*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name and title.

Ian McPhee  
Auditor-General

The Honourable the President of the Senate  
The Honourable the Speaker of the House of Representatives  
Parliament House  
Canberra ACT

## AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office (ANAO). The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act* 1997 to undertake performance audits, financial statement audits and assurance reviews of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Australian Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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# Abbreviations

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ACCI	Australian Chamber of Commerce and Industry
ANAO	Australian National Audit Office
ANZSIC	Australian and New Zealand Standard Industrial Classification
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
ATPF	ATO Tax Practitioner Forum
AUSTRAC	Australian Transaction Reports and Analysis Centre
BAS	Business Activity Statement
CEM	Compliance Effectiveness Methodology
CGT	Capital Gains Tax
CWC	Client Contact – Work Management – Case Management
DPP	Commonwealth Director Of Public Prosecutions
FBT	Fringe Benefits Tax
GFC	Global Financial Crisis
GST	Goods and Services Tax
HOTSA	Health of the System Assessment
ICAA	Institute of Chartered Accountants in Australia
IQF	Integrated Quality Framework
ITR	Income Tax Return



KPI	Key Performance Indicator
LB&I	Large Business and International
ME&I	Micro Enterprises and Individuals
MoU	Memorandum of Understanding
OECD	Organisation for Economic Co-operation and Development
PAYG Withholding	Pay as you go withholding tax
PBS	Portfolio Budget Statement
PSCM	Practice Statement Corporate Management
PSLA	Practice Statement Law Administration
QAR	Quality Assurance Review
RAPT	Risk Assessment and Profiling Tool
RDF	Risk Differentiation Framework
RMC	Risk Management Committee
SME	Small to Medium Enterprises
S&ME Business Line	Small and Medium Enterprises Business Line
SNC	Serious Non-Compliance Business Line
TERC	Tax Evasion Referral Centre

# Glossary

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Entity	An independent organisation or person with legal responsibilities.
Highly Wealthy Individuals	Australian residents who, together with associates, effectively control net wealth of \$30 million or more.
Net Income Tax	A taxpayer's total income tax payable after rebates and credits.
Phoenix arrangements	Evasion of tax and/or superannuation guarantee liabilities through the deliberate liquidation of corporate trading entities.
Risk Engine	A computer program that assesses a taxpayer population against risk indicators to give each taxpayer a probability score of potential non-compliance.
Risk Differentiation Framework	A compliance modelling tool that uses a likelihood and consequence assessment to give a relative risk profile of a specified population of taxpayers.
Small to medium enterprise (SME)	Those taxpayers with an annual turnover of between \$2 million and \$250 million.
S1 market sub-segment	A SME market taxpayer with an annual turnover of between \$2 million to \$10 million.
S2 market sub-segment	A SME market taxpayer with an annual turnover of between \$10 million to \$50 million.
S3 market sub-segment	A SME market taxpayer with an annual turnover of between \$50 million to \$100 million.
S4 market sub-segment	A SME market taxpayer with an annual turnover of between \$100 million to \$250 million.

Taxpayer	An individual, partnership, company, superannuation fund or trust that is liable to pay tax.
Turnover	Total annual income, as disclosed in a taxpayer's tax return. When an income tax return has not been lodged, turnover can be estimated using Business Activity Statement and / or Australian Business Number registration data.
Wealthy Australian	Australian residents controlling a net wealth of between \$5 million to \$30 million.



## **Summary and Recommendations**



# Summary

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## Introduction

1. Australia's self-assessment taxation system places responsibility on taxpayers to declare all assessable income and claim only the deductions and offsets to which they are entitled. The self-assessment taxation system allows the Australian Taxation Office (ATO) to apply a risk managed approach to revenue administration, and focus on the risks of taxpayers failing to comply with registration, lodgement, reporting and payment obligations. As the agency responsible for administering the federal taxation system, the ATO seeks to manage these risks and optimise the level of voluntary compliance by taxpayers through its Compliance Model strategies.

2. The ATO's Compliance Model links compliance activities to taxpayers' attitudes to compliance. Taxpayers who deliberately and persistently do not meet their tax obligations may be subject to legal action, whereas education and supportive communication is preferred for taxpayers who are willing to comply with their obligations. The Compliance Model approach is implemented through the ATO's Compliance Program, which is published annually. The Compliance Program identifies compliance trends and issues in each market, and outlines the focus of compliance activities. These activities include taxpayer education, telephone calls, letters, campaigns, reviews and audits.

3. The ATO differentiates its approach to compliance across the following market segments:

- individuals;
- micro enterprises—those with an annual turnover below \$2 million;
- small to medium enterprises (SME)—those with an annual turnover between \$2 million to \$250 million;
- large businesses—corporate groups with an annual turnover above \$250 million; and
- non-profit organisations.<sup>1</sup>

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<sup>1</sup> ATO, *Compliance Program 2010–11*, p. 3.

4. In undertaking its compliance activities, the ATO further breaks down the SME market into the following four sub-segments based on annual turnover:

- S1—\$2 million to \$10 million;
- S2—\$10 million to \$50 million;
- S3—\$50 million to \$100 million; and
- S4—\$100 million to \$250 million.

## Small to medium enterprises

5. There are around 175 000 SMEs in Australia, with 97 per cent being in the S1 and S2 market sub-segments. The SME market segment is an important contributor of taxation revenue. Of the \$273 billion in net cash collections for 2010-11, some 27.4 per cent (\$74.7 billion) was from the SME market segment. Compliance activities related to these taxpayers during the same period resulted in collections of approximately \$1.266 billion in taxes, penalties and interest.<sup>2</sup>

6. SME taxpayers are notable for the diversity of their structures, business size, activities and the industries in which they operate.<sup>3</sup> They can be individuals engaged in business ventures, or partnerships, superannuation funds, trusts, and public or private companies. At their simplest, SMEs can be sole traders who pay tax at the personal rate of income tax; or single companies with employees and a company director. In addition, taxpayers can be linked to one or more trusts, companies and/or partnerships, and these taxpayers may fall across a number of ATO market segments.

7. SMEs operate in a broad range of industries, including the construction, finance, insurance, wholesale and retail trade industries, and employ 28 per cent of Australia's workforce.<sup>4</sup> They contribute significantly to economic

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<sup>2</sup> Information provided by the ATO.

<sup>3</sup> ATO, *Compliance Program 2011–12*, June 2011, p. 17.

<sup>4</sup> *ibid.*, p. 18.



growth, national development, innovation and employment.<sup>5</sup> SMEs are also liable to pay a wide variety of taxes, depending on their circumstances.<sup>6</sup>

## ATO organisational arrangements for the SME market

8. Within the ATO, responsibility for the administration of income tax compliance of the SME market is centred in the Small and Medium Enterprise Business Line (S&ME Business Line). In addition, this business line is responsible for promoting income tax compliance for the following business and individual taxpayers:

- ‘Highly Wealthy Individuals’, those Australian residents who, together with associates, effectively control net wealth of \$30 million or more;
- ‘Wealthy Australians’, Australian residents controlling a net wealth of between \$5 million to \$30 million; and
- non-profit and government organisations.<sup>7</sup>

9. The business line, which has over 1400 staff located in 21 centres across all states and the Australian Capital Territory, is also responsible for managing Fringe Benefits Tax (FBT) across all market segments. Similarly, other business lines are responsible for managing SME compliance with specific taxes and payment obligations such as the Goods and Services Tax (GST), superannuation and excise.

## Managing compliance in the SME market

10. The key tax compliance obligations are to register for tax purposes, file tax returns on time, correctly report liabilities, and pay taxes on time.<sup>8</sup> The ATO seeks to optimise the level of voluntary compliance with these obligations. It has a risk management framework that provides a structured approach for identifying and prioritising the compliance risks associated with each market. Although the SME market is defined on the basis of annual

<sup>5</sup> CPA Australia/CGA-Canada, *Forum on SME Issues—a Background Paper*, May 2010, p. 6.

<sup>6</sup> These taxes can include Income Tax, Capital Gains Tax, Fringe Benefits Tax, Goods and Services Tax and Excise. As well as taxes, SMEs with employees are required to make related payments such as superannuation contributions and Pay As You Go Withholding Tax.

<sup>7</sup> ATO, *Compliance Program 2011–12*, June 2011, pp. 14–15.

<sup>8</sup> OECD, Forum on Tax Administration: Compliance Sub-group, *Final report, Monitoring Taxpayers’ Compliance: A Practical Guide Based on Revenue Body Experience*, 22 June 2008, p. 9. <[http://www.oecd.org/document/31/0,3746,en\\_2649\\_33749\\_46282143\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/31/0,3746,en_2649_33749_46282143_1_1_1_1,00.html)> [accessed 1 September 2011].

financial turnover, there is considerable diversity in the business structures, size and market segment positioning of SME taxpayers.<sup>9</sup> From a compliance perspective, this means that the compliance risks within this group are also diverse and not necessarily correlated with a taxpayer's turnover. For this reason, the ATO seeks to influence taxpayer compliance by addressing specific risks in the SME market.

11. Compliance activities are developed to mitigate and manage risks, and are outlined in the ATO's annual Compliance Program. In accordance with the ATO's Compliance Model, these compliance strategies differentiate between the various perceived behaviours of taxpayers. Strategies range from educational information aimed at making compliance easier, through to prosecution for serious non-compliance.

### *Measuring compliance effectiveness*

12. Revenue administrations commonly face the challenge of measuring their effectiveness in promoting voluntary compliance and addressing non-compliance. One approach generally taken is to measure the size of the tax gap, that is the total amount of unpaid tax, and changes to it. Another is to measure the impact compliance activities have on promoting taxpayer voluntary compliance. Within these general parameters revenue administrations develop approaches tailored to their own national circumstances. Some, such as the United Kingdom and the United States of America, emphasise measurement of the tax gap as an integral part of their monitoring approaches.<sup>10</sup> Others, like Australia, place more emphasis on monitoring the specific contribution their own activities make to government revenue targets and to changes in taxpayer behaviour.<sup>11</sup>

13. The ATO assesses the effectiveness of its compliance activities using the Compliance Effectiveness Methodology (CEM), which it introduced in 2008. The methodology, adopted by the Organisation for Economic Co-operation and Development (OECD), is based on two key elements: the identification of

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<sup>9</sup> ATO, *Compliance Program 2011–12*, June 2011, p. 17.

<sup>10</sup> OECD, Forum on Tax Administration: Compliance Sub-group, *Final Report, Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience*, 22 June 2008, pp. 65–70.

<sup>11</sup> ATO, *Measuring Compliance Effectiveness—Our Methodology*, August 2008. <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00157833.htm>> [accessed 2 August 2010].

measurable compliance objectives; and the articulation and treatment of risks to achieving them.<sup>12</sup> The ATO implements these elements in four phases that:

- describe the risk and align it with the ATO's business intent of optimising voluntary compliance;
- define a successful outcome and develop compliance strategies to achieve this outcome;
- identify and test indicators of success; and
- use these indicators to measure the extent of the effectiveness of the compliance strategies.

## Audit objective and scope

### Objective

14. The objective of the audit was to assess the effectiveness of the ATO's compliance management approach in the SME market.

### Scope

15. The focus of the audit was on the SME market. At the time of the audit, the Inspector General of Taxation was reviewing the ATO's audit and risk review policies, procedures and practices in the \$100 million to \$250 million sub-segment of the SME market and Highly Wealthy Individuals.<sup>13</sup> For this reason, these topics were excluded from the ANAO's audit scope.

16. The audit examined, taking into account the desired outcomes of compliance activity, whether: the ATO's governance arrangements were appropriate; systems and processes to identify and assess compliance risks were adequate; and strategies to promote compliance and address non-compliance were appropriate and implemented effectively.

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<sup>12</sup> OECD, Forum on Tax Administration: Compliance Sub-group, *Final report, Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience*, 22 June 2008, p. 22.

<sup>13</sup> Titled: *Review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices*. The focus of the Inspector General of Taxation's review was: staff resourcing and technical skill levels; information-gathering powers; accuracy of technical decision-making; dispute resolution; and management and conduct of compliance activities. The ANAO did not focus on these issues in this audit.

## Overall conclusion

17. SMEs play a vital role in Australia's economy and contribute significantly to economic growth, national development, innovation and employment.<sup>14</sup> They have diverse structures and operate across a range of industries. They also pay a variety of taxes, contributing around \$74.7 billion to taxation revenue in 2010–11. The ATO defines the SME market on the basis of an annual financial turnover of between \$2 million and \$250 million. As with all markets, the ATO seeks to improve the voluntary compliance by SMEs in meeting their taxation obligations. To achieve this, it identifies and prioritises compliance risks and employs a range of compliance activities to manage these risks.

18. The ATO's Compliance Model approach is structured around four compliance strategies that are designed to address the underlying cause of taxpayer non-compliance: make it easy; help to comply; deter by detection; and use the full force of the law. Assistance is provided to those taxpayers willing to comply, and taxpayers who deliberately avoid their taxation obligations may be subject to prosecution. The ATO uses its CEM to measure the effectiveness of these activities in improving compliance in its priority risk areas.

19. In 2010–11, the ATO's compliance activities in the SME market resulted in the recovery of \$1.266 billion in taxes, penalties and interest.<sup>15</sup> In addressing significant areas of non-compliance, in 2010–11 the S&ME Business Line identified eight priority risk areas directly associated with the SME market.<sup>16</sup> Risk assessment is also conducted at the population level (a defined sub-set of the SME market). Risk managers and population strategists within this business line use a range of data sources and risk profiling tools to determine the extent of these risks, the affected population and the information and data that can be used to quantify the risks. The key automated profiling tools are

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<sup>14</sup> CPA Australia/CGA-Canada, *Forum on SME Issues—a Background Paper*, May 2010, p. 6.

<sup>15</sup> Information provided by the ATO.

<sup>16</sup> A priority risk is assessed as having considerable impact on the SME market, and dedicated risk managers are appointed. The priority risks are: Phoenix; Division 7A; Lodgement; International; Exit Strategies; Capital Gains Tax; FBT; and Trusts.

the SME Risk Engine and the Risk Differentiation Framework.<sup>17</sup> These are used, ultimately, to assist with determining appropriate risk treatments, as well as contributing to a pool of potential cases for compliance activity.

**20.** The ATO's compliance management approach in the SME market is generally effective. The corporate governance framework of planning, performance measures and reporting supports the S&ME Business Line and compliance activities in the SME market. The ATO's Risk Management Framework provides a structured approach for identifying and managing compliance risks, and particularly the specific priority risks associated with this market. The CEM has been applied to seven out of the eight priority risk areas. Four CEMs have been completed to date and three priority risks are now in their annual review phase.<sup>18</sup> Results from the CEM are providing the ATO with useful directions for improving the effectiveness of its compliance strategies. Compliance activities also cover the full range of strategies outlined in the ATO's Compliance Model. Voluntary compliance is promoted through marketing and communication strategies and interpretative assistance<sup>19</sup> and campaigns, reviews, audits and investigations address the continuum of non-compliance. However, enhancements could be made to the SME Risk Engine used to assist in identifying potentially non-compliant taxpayers. There is also an opportunity for the ATO to use the risk engine more effectively.

**21.** The SME Risk Engine is a computer program that profiles taxpayers against risk rules (indicators of a taxpayer's non-compliance with an obligation) and gives a probability score of potential non-compliance.<sup>20</sup> The results of the risk engine contribute to a pool of potential cases for compliance activity. The ANAO's analysis has shown that, of the 100 SME taxpayers with the highest probability score, only 55 were subject to compliance action. Of these, the ATO found no evidence of non-compliance for 42 taxpayers (76.4 per cent). This low success rate would suggest that the methodology used

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<sup>17</sup> The Risk Differentiation Framework is a compliance modelling tool that gives a relative risk profile of a specified population, as opposed to results of the risk engine, which give a relative probability of non-compliance at a taxpayer level.

<sup>18</sup> CEMS have been completed for the Lodgement, Phoenix, Division 7A and FBT priority risks. CEMs are at various phases for Capital Gains Tax, Trusts and International risks. Exit Strategies is a newly initiated priority risk, so a CEM has not yet been started.

<sup>19</sup> Interpretative assistance involves the provision of general advice, rulings and interpretation of legislation in response to requests by taxpayers.

<sup>20</sup> Version nine of the risk engine was assessed during this audit.

to calculate risk scores could be improved. The methodology would be enhanced by running the risk engine more regularly, updating risk engine rules to incorporate additional data sets, and documenting the process and criteria used for a manual process of weighting results.

**22.** The outcome of the risk assessment process is a pool of potential compliance cases. At the time of the audit compliance cases were selected from: the risk engine by individual regional compliance teams; the risk engine and data matching analysis by risk managers and population strategists; and from referrals by the Case Management Unit. In the absence of documented procedures and lack of national coordination of case selection, regional compliance teams did not necessarily consider the compliance cases with the highest risk priority. As a result, the business line had no assurance that the cases with the highest risk priority had been considered for action. The ATO's new 'Front End Operations' approach, introduced in January 2011, has the potential to improve national consistency and oversight of case selection. Importantly too, compliance cases validate the rules in the risk engine by providing feedback about their accuracy. Not all risk rules are currently tested in this way, as cases were not selected for this reason. There is an opportunity for the ATO to establish a process to validate all risk rules to better inform potential case selection, and to support strategic level consideration of compliance risks. The benefits to the ATO would include more robust output from the risk engine, and useful intelligence to support the identification of emerging risks.

**23.** The ATO's CEM methodology for measuring its compliance effectiveness is relatively new. To date, the CEMs have shown that compliance activities are having a positive impact on the voluntary compliance of SMEs in some priority risk areas. These include the lodgement of tax returns, reporting FBT liabilities and the interest income disclosed in relation to shareholder loans.<sup>21</sup> Where compliance activities have not had a positive impact, the ATO has redirected its compliance activities.

**24.** The ANAO has made two recommendations aimed at improving the effectiveness of the SME Risk Engine, and making more effective use of its results.

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<sup>21</sup> Shareholder loans relate to Division 7A of Part III of the Income Tax Assessment Act 1936.

## Key findings

### Governance arrangements supporting compliance in the SME market (Chapter 2)

25. The ATO reports to government on its performance against one outcome, which is delivered through five program components.<sup>22</sup> The S&ME Business Line is primarily focused on delivering Program Component 1.3.<sup>23</sup> This component is further divided into four deliverables, and the focus of this audit was on deliverables 1.3.4: Active Compliance; and 1.3.5: Compliance Intelligence and Risk Management.

26. The corporate governance framework of planning, performance measures and reporting supports the S&ME Business Line and compliance activities in the SME market. Reflecting its responsibility for the SME market, the business line has established coordination and consultative forums with other areas of the ATO that have intersecting responsibilities in the SME market.

27. Planning, performance measures and reporting are linked through a suite of corporate documents, which include the ATO Plan, various supporting business line plans and the Annual Report. There are clear linkages for deliverables under the ATO Plan to the S&ME Business Line Plan, although lower level business plans within the business line could be better aligned with the S&ME Business Line Plan through capabilities, deliverables and KPIs.

28. The internal performance monitoring reports provided to the S&ME Business Line and ATO Executive adequately account for the performance of the active compliance capability. Reporting against the compliance intelligence and risk management capability could be improved by developing more meaningful and measurable KPIs. External reporting on the SME market is limited in extent and coverage, but results achieved by the business line are incorporated into results reported for Program Component 1.3 as a whole.

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<sup>22</sup> The program outcome is: confidence in the administration of aspects of Australia's taxation and superannuation systems through helping people understand their rights and obligations, improving ease of compliance and access to benefits, and managing non-compliance with the law.

<sup>23</sup> This component is: implement compliance strategies to support those willing to participate, those who may need assistance, and deal firmly with those not willing to comply.

## Assessing compliance risks (Chapter 3)

29. The ATO's Risk Management Framework is applied to both the SME market and the business line's broader FBT responsibilities in order to identify the highest risk areas. In 2010–11, this resulted in the business line contributing to the mitigation of nine strategic risks<sup>24</sup> and being the corporate risk owner for three: Phoenix; Non-Resident Withholding Tax<sup>25</sup>; and Trusts. There were eight risk areas, directly associated with the business line, rated as 'priority risks'.<sup>26</sup> A further 10 risks were monitored by the business line.

30. Risks are assessed by 'risk managers' or 'population strategists', at either the priority risk level, or a sub-set (or 'population') of the SME market. The S&ME Business Line's Risk Management Committee (RMC) is responsible for decisions relating to the prioritisation of risks and consistency of treatments. The ATO has identified that risk managers and population strategists had not consistently shared knowledge and information or fully integrated their risk approaches. In response to this shortcoming, the S&ME Business Line conducted workshops and formalised interaction between risk and population approaches in the RMC's forward planning framework.

31. An important factor in effective risk assessment is the use of appropriate information. The ATO has systems and processes in place to collect data and intelligence from a wide range of sources, enabling it to assess compliance risks. It also has processes for analysing and disseminating this data and intelligence across the ATO.

### *Risk assessment methodologies*

32. The size and complexity of the SME market necessitates the use of automated profiling tools to assist risk assessment processes, determine appropriate risk treatments and contribute to a pool of potential cases for compliance activity. Risk managers and population strategists use two automated profiling tools: the SME Risk Engine; and the Risk Differentiation Framework (RDF).

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<sup>24</sup> A strategic risk affects a broad range of ATO responsibilities, or is a risk rated as high or severe when assessed on a corporate scale.

<sup>25</sup> During the course of the year, ownership for Non-Resident Withholding Tax transferred to the Large Business and International Business Line.

<sup>26</sup> A priority risk is assessed as having considerable impact on the SME market and involves the appointment of a risk manager. The eight priority risks were: Phoenix; Division 7A; Lodgement; International; Exit Strategies; Capital Gains Tax; FBT; and Trusts.



33. The SME Risk Engine includes an automated algorithm, specifically developed to support compliance activities relating to the SME market, and produces a probability score of potential non-compliance against each taxpayer.<sup>27</sup> The scores are moderated by an ATO officer, who may change the weighting of results against rules where multiple indicators overlap. However, this process is not documented, rather relying on the experience and judgement of the ATO officer. The resulting pool of taxpayers is one of the sources of compliance cases used by risk managers, population strategists, specialist compliance teams and general compliance teams. Cases are selected either directly from the risk engine results, or after further data matching analysis.<sup>28</sup>

34. Limitations associated with the SME Risk Engine (version nine) include:

- only 44 of the 128 risk rules differentiated between the SME market sub-sectors (S1, S2, S3 and S4);
- small business benchmarks for detecting undeclared cash income were not incorporated;
- ANZSIC codes can be subject to error and this error rate had not been assessed in terms of SME risk engine outputs<sup>29</sup>; and
- only 19 of the 128 risk rules assessed data sets other than internal ATO data, resulting in more manual processes being needed for taxpayer profiling.

35. The risk engine had not been run between November 2009 and the end of fieldwork for this audit (a period of more than 18 months). In this period there were no updates on each taxpayer's risk score against all risk rules in the risk engine. It is also important to document the process and criteria currently used to manually moderate results.

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<sup>27</sup> An algorithm is a procedure for solving a particular mathematical problem in a finite number of steps.

<sup>28</sup> Data matching is the comparison of data held by the ATO and data obtained from other sources. This enables detection of potential non-compliance such as undisclosed income or non-lodgement of tax returns, and therefore forms an important step in the risk assessment process.

<sup>29</sup> ANZSIC codes can be subject to error when taxpayers have complex corporate linkages and this could mean that a taxpayer's risk score may not be based on thresholds for the industry in which it operates.

36. To assess the effectiveness of the risk engine methodology, the ANAO reviewed the compliance outcomes of the 100 taxpayers rated by the risk engine with the highest potential risk of non-compliance. As at 30 June 2011, only 55 had been subject to compliance action. Of these, only 13 (23.6 per cent) were found to have an outcome from the compliance action. The low success rate in finding evidence of non-compliance suggests that the methodology used to calculate risk scores could be improved. This improvement would also benefit the RDF, which uses the risk engine score.

## **SME market compliance strategies (Chapter 4)**

37. The ATO's strategies for increasing compliance and targeting non-compliance are: marketing and communications; interpretative assistance; active compliance; and prosecutions.

### *Marketing and communications*

38. The ATO's marketing and communications activities are designed to raise awareness and educate taxpayers about their obligations. The ATO engages with SME taxpayers, tax practitioners and financial services industry representatives through formal ATO forums, including a specific online SME Tax Forum. Out of approximately 175 000 total taxpayers in the SME market only around 500 SMEs participate in the online forum. There is little specific SME market educational information, as the broad range of taxation topics applicable to this market are covered in general ATO publications.

### *Active compliance*

39. Active compliance activities predominantly involve intervention with taxpayers to assess and verify non-compliance. This interaction is generally undertaken in a manner consistent with the materiality of the risk.<sup>30</sup> Taxpayers with cases of lower materiality may be contacted by letter or telephone. Higher materiality issues may be subject to reviews and audits.

40. In July 2009, the S&ME Business Line implemented an ongoing 'Campaign Team' to undertake a program of tailored telephone and letter verification activities, as directed by risk managers and population strategists. In 2010–11, \$16.7 million in liabilities was raised as a result of campaigns.

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<sup>30</sup> Materiality is defined as the seriousness of the risk, and can be judged on factors such as the potential revenue loss, impact on third parties, and the risk to the ATO's reputation if the risk is not addressed.

**41.** The campaign approach has been successful. For example, between August and September 2010 the Campaign Team contacted 430 taxpayers by telephone to address the outstanding lodgements of FBT schedules. As a result, 56 per cent of these taxpayers agreed to lodge, which justifies the team's focus on assisting taxpayers to understand their obligations and promoting self-correction. In addition, 23 per cent of taxpayers were found to have already lodged their returns, but due to a systems error their schedule was not visible in the ATO's systems. This interaction identified the systems error, which was subsequently addressed.

#### Selection and management of review and audit cases

**42.** Review and audit cases were selected by:

- regional compliance teams, from the pool of potential compliance cases produced by the SME Risk Engine;
- risk managers and population strategists, from both the risk engine and data matching analysis; and
- the Case Management Unit, from internal ATO referrals.

**43.** At any one time, the risk engine, data matching and referrals provide a large number of potential cases.<sup>31</sup> There were limitations associated with the methods for selecting cases for reviews and audits. In particular, the absence of documented procedures for case selection and of national coordination meant that regional compliance teams were not necessarily considering cases with the highest risk priority. As a result, the business line has no assurance that the cases with the highest risk priority had been considered for action. Validated risk rules would better inform potential case selection, and support strategic level consideration of compliance risks. There is an opportunity for the ATO to establish such a process.

**44.** The ANAO analysis of the highest 100 risk-scored cases showed that, of the 45 cases not subject to compliance action, 14 had been identified by the previous three versions of the risk engine, and three cases had been identified in all nine versions of the risk engine.<sup>32</sup> While there are circumstances that may

<sup>31</sup> SME Risk Engine nine identified approximately 9000 taxpayers.

<sup>32</sup> These nine versions of the risk engine were run between 2004 and 2009. Cases identified as having been in the risk engine pool in previous years may not have had a high risk score in those previous years.

have led to these cases not being selected for compliance action, the reasons for not considering these cases were not documented by the ATO. Compliance cases also validate the rules in the risk engine, and if these cases are not selected this feedback loop is incomplete. Every six months a report on the effectiveness of risk engine rules compares the number of 'hits' against outcomes from closed compliance cases. However, the effectiveness of these rules cannot be validated if compliance cases are not conducted on that particular indicator. The risk engine would be further improved if all risk rules coded within its program could be validated and refined.

45. In January 2011 the ATO introduced a new 'Front End Operations' approach that has the potential to improve national consistency and oversight in case selection and create efficiencies in the way candidate case pools are created. It will be important to document the assessment criteria used for selecting cases and reasons for non-selection, and to follow up on reasons for high-risk cases remaining in the pool of potential cases.

46. The ATO uses the Client Contact—Work Management—Case Management (CWC) system to manage compliance cases. The ANAO analysed a sample of 100 reviews and 100 audits selected randomly from completed cases for 2007–08 to 2010–11. These were assessed against six key ATO administrative guidelines for case conduct, which included documentation of key points in the case, and management sign-off.<sup>33</sup> The majority of cases (163 out of the 200 cases) passed the six guidelines. This result comprised 91 per cent of sampled reviews but only 72 per cent of sampled audits. Of the cases failing checks, there were 23 instances of insufficient documentation to support the case, such as a lack of evidence to support decisions. Potentially this could lead to the ATO not being able to support the decisions relating to a case outcome.

### *Quality assurance*

47. There are two separate quality assurance processes undertaken by the S&ME Business Line on review and audit cases completed in CWC:

- the S&ME Business Line internal Quality Assurance Review (QAR);  
and

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<sup>33</sup> The guidelines involved documentation of the: taxpayer's profile, potential risks, approach to the case (case plan), outcomes of investigations, reasons for decisions and appropriate management signoff.

- the ATO-wide Integrated Quality Framework (IQF). The IQF sampling of closed cases is set corporately, but sampling of open cases is discretionary.

48. Key differences between the two systems are that QAR assesses administrative procedures within the CWC, while the IQF assesses the decision-making process for the case. There are, however, elements of duplication, and the same case can be assessed by both processes. There would be merit in the ATO reviewing the QAR to reduce any potential duplication, further align the two systems and optimise the impact of quality assurance activities.

49. Since June 2009 the most consistent error identified by the QAR was case finalisation reports not being completed appropriately (these document the decisions and outcomes from the case). For the period 1 April 2010 to 30 March 2011, the IQF identified a number of inconsistent practices relating to information not being entered or attached to the CWC.

50. An important part of both the QAR and the IQF is continuous improvement, facilitated through 'workshopping' deficiencies with active compliance staff. The ATO advised that delays in completing activities designed to improve case management were caused by a lack of resources assigned to these tasks. From 1 July 2011 the business line had increased staffing in this area to implement these continuous improvement recommendations.

## **Measuring compliance effectiveness (Chapter 5)**

51. The ATO's method for assessing the effectiveness of its compliance activities is set out in its 2008 Compliance Effectiveness Methodology (CEM). At the core of the methodology are two key elements: the identification of measurable compliance objectives, and the articulation and treatment of risks to achieving them. The CEM is undertaken in four phases, with an ongoing annual review conducted after completion.

52. The S&ME Business Line has implemented the CEM for seven of its eight priority risks.<sup>34</sup> As at June 2011, there were four finalised CEM

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<sup>34</sup> These risks and their nature are listed in Chapter 3, Table 3.1. A CEM has not been initiated for Exit Strategies.

assessments.<sup>35</sup> As the CEMs are focused on a priority risk rather than a market view of compliance risk, they do not provide a comprehensive compliance profile for the SME market as a whole. The S&ME Business Line attempted to apply the CEM to the SME market, but was unable to do so because of the number of variables present in such a large and diverse population.

53. The use of the CEM is maturing within the business line, but results already indicate that this methodology has the potential to provide evidence of the impact of compliance strategies on improving voluntary compliance. Results have also provided useful directions for the ATO to pursue to improve the effectiveness of its compliance strategies. Compliance strategies have improved the on-time lodgement rate and there has been an increase of 3.7 per cent in the number of FBT lodgements, and 17 per cent in the value of FBT payable. Compliance strategies have also been effective in increasing the interest income disclosed in relation to shareholder loans. The CEM for the International risk was inconclusive, and is now being undertaken at the sub-risk level. The CEM for the Phoenix risk identified the need for a revised approach, as it showed compliance activities were not effective. As a result, the ATO redirected its approach and jointly developed a submission (with the Australian Securities and Investments Corporation) for the Treasury.

#### *Market research as a measure of effectiveness*

54. The ATO surveys its taxpayer base and SME market taxpayers to assess its marketing and communication activities. The results of these surveys indicate that the ATO is generally effective in providing information to taxpayers, and therefore in improving voluntary compliance. Independent feedback received by the ANAO generally supports the ATO's survey findings that information assisting taxpayers to comply with their obligations is available. However, there was also feedback that the ATO website search engine could be improved, as information was difficult to find using this function, and that consultative forums could be better promoted. The ATO may also benefit from including tax agents who service SME clients in their future SME surveys.

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<sup>35</sup> The four completed CEM assessments are for the Phoenix, Division 7A, Lodgement and FBT priority risks.

## Summary of agency response

55. The ATO welcomes this review and considers the report supportive of our overall approach to managing the income tax compliance of the Small-to-Medium Enterprise (SME) market segment. The review recognises a number of recent innovations having potential to further enhance our compliance approach. In finding the ATO's compliance approach toward the SME market segment to be generally effective, the review identified a number of opportunities for improvement in our risk assessment processes. The ATO agrees with the two recommendations contained in the report.

56. The full response is at Appendix 1.

# Recommendations

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**Recommendation No. 1** To enhance the results of the Small to Medium Enterprises Risk Engine, the ANAO recommends that the ATO:

**Para 3.57**

- (a) improve the frequency of running the risk engine;
- (b) increase the profiling of all market sub-segments and use of data sets other than taxpayer return information; and
- (c) document the process and criteria used to manually weight the results against each risk rule before the final risk score is determined.

**ATO response:** Agreed

**Recommendation No. 2** To support the identification of emerging priority risks, the ANAO recommends that the ATO periodically

**Para 4.41**

confirm the validity of all risk rules within the Small to Medium Enterprises Risk Engine.

**ATO response:** Agreed



## **Audit Findings**



# 1. Introduction

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*This chapter provides the context for the audit, including an overview of the small to medium enterprise market in Australia. The audit objective and scope are also outlined.*

## Background

**1.1** The Australian Taxation Office (ATO) is the Australian Government's principal revenue collection agency, with responsibility for the effective administration of Australia's tax and superannuation systems. In 2010–11, the ATO collected \$273 billion in net cash from taxpayers and incurred operating expenditure of \$3.1 billion.<sup>36</sup>

**1.2** Australia's self-assessment taxation system places responsibility on taxpayers to declare all assessable income and claim only the deductions and offsets to which they are entitled. The self-assessment taxation system allows the ATO to apply a risk managed approach to revenue administration, and focus on the risks of taxpayers failing to comply with registration, lodgement, reporting and payment obligations. The ATO seeks to manage these risks and optimise the level of voluntary compliance by taxpayers through its Compliance Model strategies.

### ATO's compliance approach

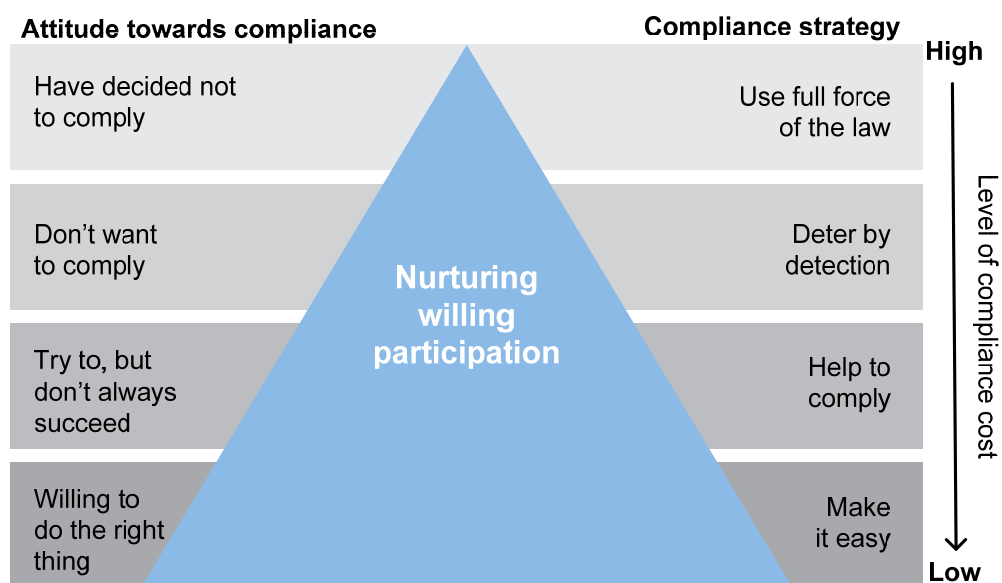
**1.3** The ATO's approach to compliance is based on a model of taxpayer behaviour, which aims to better understand what motivates people to comply or not comply with their taxation obligations. The model assists the ATO to plan interventions that are proportionate and appropriate to the underlying cause of non-compliance. The ATO's Compliance Model is illustrated in Figure 1.1.

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<sup>36</sup> ATO, 2010–11 Commissioner of Taxation Annual Report, p. 9.

**Figure 1.1**

**The ATO's Compliance Model**



Source: ATO, *Compliance Program 2010–11*, July 2010, p. 3.

**1.4** The ATO differentiates its approach to compliance across the following five major market segments:

- individuals;
- micro enterprises—those with an annual turnover below \$2 million;
- small to medium enterprises (SME)—those with an annual turnover between \$2 million to \$250 million;
- large businesses—corporate groups with an annual turnover above \$250 million; and
- non-profit organisations.<sup>37</sup>

**1.5** In undertaking its compliance activities, the ATO further breaks down the SME market into four sub-segments based on annual turnover:

- S1—\$2 million to \$10 million;

<sup>37</sup> ATO, *Compliance Program 2010–11*, p. 3.

- S2—\$10 million to \$50 million;
- S3—\$50 million to \$100 million; and
- S4—\$100 million to \$250 million.

**1.6** The SME market segment is an important contributor of taxation revenue. Of the \$273 billion in net cash collections for 2010–11, some 27.4 per cent (\$74.7 billion) was from the SME market segment.

## Small to medium enterprises in Australia

**1.7** SME taxpayers are notable for the diversity of their structures, business size, activities and the industries in which they operate.<sup>38</sup> They can be individuals, partnerships, superannuation funds, trusts and public or private companies.<sup>39</sup> At their simplest, SMEs can be sole traders who pay tax at the personal rate of income tax; or a single company with employees and a company director. However, it is not uncommon for several taxpayers to be linked to one or more trusts, companies and/or partnerships and for these taxpayers to fall across a number of ATO market segments.

**1.8** In November 2010, the ATO calculated that the SME market comprised approximately 175 000 businesses.<sup>40</sup> Just over one per cent of these businesses are publicly owned. The majority of SMEs (approximately 143 000) are in the S1 market sub-segment, accounting for 82 per cent of the total SME population. With the addition of the S2 market sub-segment, these two lower sub-segments account for a total of 97 per cent of the taxpayers in the SME market. Many SMEs use the services of a registered tax agent because of their size and the complexity of their taxation arrangements. In November 2010, over 156 000 (or 89 per cent) of SMEs across all market sub-segments used a tax agent.

<sup>38</sup> ATO, *Compliance Program 2011–12*, June 2011, p. 17.

<sup>39</sup> ATO, *Organisational Structure—Small and Medium Enterprises* <<http://www.ato.gov.au/businesses/content.aspx?menuid=39504&doc=/content/24463.htm&page=19&H19>> [Accessed 19 April 2011].

<sup>40</sup> Information provided by the ATO as at 16 August 2011. The number of taxpayers is attributed to active clients, i.e. clients who lodged tax returns, business activity statements or registered their business in 2006 or later.

## SME market industry share

1.9 SMEs operate in a broad range of industries including construction, finance, insurance, wholesale and retail trade industries, and employ 28 per cent of the Australian workforce.<sup>41</sup> The ATO has determined that the top seven industries (outlined in Table 1.1) contributed 82 per cent of the net income tax payable by SMEs as at November 2010.<sup>42</sup>

**Table 1.1**

### Small to medium enterprises market by industry as at November 2010

Industry group	Number of taxpayers in industry group	Per cent of total population
Financial and Insurance	33 235	18.9
Retail Trade	22 305	12.7
Construction	20 807	11.9
Wholesale Trade	15 175	8.7
Special ATO Division <sup>1</sup>	13 571	7.7
Rental, Hiring, Real Estate	13 462	7.7
Manufacturing	12 291	7.0
<b>Sub total</b>	<b>130 846</b>	<b>74.6</b>
All others <sup>2</sup>	44 303	25.4
<b>Total</b>	<b>175 149</b>	<b>100.0</b>

Source: Information provided by the ATO.

Note 1: Special ATO Division codes are used where industry activity codes do not cover their activity.<sup>43</sup>

Note 2: 'All others' mainly consists of: administrative support services; agriculture, forestry and fisheries; accommodation and food services; health care services; information and media; transport, postal and warehousing; and mining.

1.10 The ATO regularly undertakes research into SMEs to provide a snapshot of the market and to inform support, risk identification and compliance activities. Key performance, demographic and statistical indicators are reported, including total business income and revenue losses. Significant

<sup>41</sup> ATO, *Compliance Program 2011–12*, June 2011, p. 18.

<sup>42</sup> Information provided by the ATO.

<sup>43</sup> ATO, *Business Industry Codes 2010*, p. 20  
<<http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00237446.htm>>  
[Accessed 21 March 2011].

changes occurred in this market segment for the period 2007–08 to 2009–10 and these are shown in Table 1.2.

**Table 1.2**

**Changes in the SME market segment for the period 2007–08 to 2009–10**

Key indicator	2007–08 (\$ billion)	2008–09 (\$ billion)	2009–10 (\$ billion)
Total business income	1051.2	1009.6	967.7
Revenue losses	16.8	26.8	22.5
Net Income Tax payable	18.4	15.8	15.8

Source: Information provided by the ATO.

**1.11** The ATO considers that the variations in total business income and net income tax payable can be directly attributed to the Global Financial Crisis (GFC). Net Capital Gains Tax (CGT) was a key contributor to this decrease, dropping by 82 per cent across the SME market in 2008–09. Revenue losses also indicate the impact of the GFC, increasing by 59.5 per cent from the previous financial year.<sup>44</sup>

**1.12** The GFC had a considerable impact on the Australian economy and tax administration. Common problems experienced by businesses included reduced cash flows and a lack of available credit.<sup>45</sup> Businesses required greater assistance to meet their tax obligations and the ATO employed several key strategies during the GFC, including interest-free payment arrangements, and deferral on Business Activity Statement payment dates.<sup>46</sup> As part of the flow-on effect, the ATO also noted increases in the number of SMEs with tax debts, and in the average value of these debts.<sup>47</sup> As a consequence, in March 2011, the ATO reported that SMEs were recording increased revenue losses following the GFC, and notified taxpayers that selected cases would be followed up.<sup>48</sup>

<sup>44</sup> Information provided by the ATO.

<sup>45</sup> D'Ascenzo, Michael, *Firm Foundations*, Commissioner's key note address to the 9<sup>th</sup> International Tax Administration Conference, 8 April 2010.

<sup>46</sup> *ibid.*

<sup>47</sup> ATO, *Compliance Program 2009–10*, August 2009, p. 19.

<sup>48</sup> ATO, *Increased focus on small-to-medium enterprises with revenue losses*, webpage <<http://www.ato.gov.au/content/00273563.htm>> [Accessed 20 April 2011].

## Peak bodies representing the SME market

**1.13** There is no single representative organisation for the SME market. Rather, a number of peak bodies and professional associations represent particular interests within the SME market segment. Industry and business-focused bodies include the Australian Chamber of Commerce and Industry (ACCI) and the Australian Industry Group (AIG). Tax agents and accounting organisations include The Institute of Chartered Accountants in Australia (ICAA), CPA Australia and the National Tax and Accountants' Association (NTAA). More generally, there are associations such as Taxpayers Australia. All of these associations aim, broadly speaking, to educate their members, to assist business growth and to provide commentary and lobbying on political policies.

## Small to medium enterprises internationally

**1.14** It is difficult to make comparisons between international and domestic SME markets. Contrasting definitions are used by the ATO, other Commonwealth departments<sup>49</sup>, as well as international organisations. Some organisations define SMEs by annual turnover, others by number of employees, while some include both annual turnover and number of employees. The differences in definitions for SMEs are outlined in Appendix 2.

**1.15** According to a recent Organisation for Economic Co-operation and Development (OECD) report, SMEs play a major role in the economic growth of OECD member countries with over 95 per cent of enterprises being SMEs. This accounts for 60 to 70 per cent of employment in those countries.<sup>50</sup> CPA Australia and the Certified General Accountants Association of Canada jointly state that SMEs play a vital role in the economy and contribute significantly to economic growth, national development, innovation and employment.<sup>51</sup>

**1.16** As the definition of SMEs differs internationally, it was not possible to compare how other taxation jurisdictions approached compliance in the SME

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<sup>49</sup> As of 1 January 2011, the *Fair Work Act 2009* definition of 'small business' changed to businesses that employ fewer than 15 employees. However, on an annual turnover basis, many of these businesses would be classified by the ATO as Small and Medium Enterprises.

<sup>50</sup> OECD Policy Brief, *Small and Medium-sized Enterprises: Local Strength, Global Reach*. <<http://www.oecd.org/dataoecd/3/30/1918307.pdf>> [Accessed 15 March 2011].

<sup>51</sup> CPA Australia/CGA-Canada, *Forum on SME Issues – a Background Paper*, May 2010, p. 6.



market. The tax jurisdictions of Canada, the United Kingdom and the United States of America annually publish their compliance risks and approach to non-compliance, but do not refer specifically to risks or compliance approaches in the SME market. Although New Zealand's Inland Revenue Department annually publishes its key compliance risks and approach to non-compliance, it defines the SME market as entities with employees or active financial transactions in GST and an annual turnover of up to \$100 million.

## ATO organisational arrangements for the administration of the SME market

**1.17** Within the ATO, responsibility for the administration of income tax compliance of the SME market is centred in the Small and Medium Enterprise Business Line (S&ME Business Line). In addition, this business line is responsible for promoting income tax compliance for the following business and individual taxpayers:

- 'Highly Wealthy Individuals', those Australian residents who, together with associates, effectively control net wealth of \$30 million or more;
- 'Wealthy Australians', Australian residents controlling a net wealth of between \$5 million to \$30 million; and
- non-profit and government organisations.<sup>52</sup>

The business line is also responsible for managing Fringe Benefits Tax (FBT) across all markets.<sup>53</sup>

**1.18** Highly Wealthy Individuals and Wealthy Australians are included in the SME market if they fall within the \$2 million to \$250 million annual turnover range. These two populations can also cross over into the Micro Enterprises and Individuals (ME&I) and Large Business and Internationals (LB&I) markets, depending on their business structures and net wealth. The S&ME Business Line coordinates income tax compliance for these cross-over populations. While there are commonalities between many of these responsibilities, this audit looked specifically at the part of the business line that administers the SME market.

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<sup>52</sup> ATO, *Compliance Program 2011–12*, July 2010, pp. 14–15.

<sup>53</sup> The audit did not include the specific FBT administration undertaken by the business line.

**1.19** Depending on their circumstances, the taxes SMEs are liable for generally include: Income Tax; Capital Gains Tax (CGT); Fringe Benefits Tax (FBT); Goods and Services Tax (GST) and excise. SMEs with employees are also required to make related payments such as superannuation contributions and Pay As You Go Withholding Tax (PAYG Withholding). A breakdown of the revenue collections for the period 2008–09 to 2010–11 is shown in Table 1.3.

**Table 1.3**

**SME market revenue collections for the period 2008–09 to 2010–11**

Revenue Type	2008–09 (\$ billion)	2009–10 (\$ billion)	2010–11 (\$ billion)
Income Tax—companies	16.1	13.6	15.6
Income Tax—superannuation funds	1.5	0.9	1.1
Fringe Benefits Tax	0.9	0.9	0.9
Goods and Services Tax	18.3	19.7	21.1
Pay as You Go Withholding	31.6	30.9	34.6
Excise	0.2	0.3	0.4
Other	0.8	0.9	1.0
<b>Total SME Market Collections</b>	<b>69.4</b>	<b>67.2</b>	<b>74.7</b>
<b>Total ATO Collections</b>	<b>264.5</b>	<b>253.2</b>	<b>273.0</b>
<b>SME market collections as a percentage of ATO collections</b>	<b>26.2 %</b>	<b>26.5 %</b>	<b>27.4%</b>

Source: Information provided by the ATO.

Note: SME Market Collections figure excludes collections made by the Australian Customs and Border Protection Service as they are not allocated to market segments.

**1.20** As part of overall revenue collections in 2008–09, the ATO recovered over \$1.2 billion (32 per cent of the total for the ATO) in additional taxes, penalties and interest from the SME market as a result of active compliance activities completed during that financial year.<sup>54</sup> In 2009–10, this figure was

<sup>54</sup> ATO, *Commissioner of Taxation Annual Report 2008–09*, October 2009, p. 77.

\$991 million (27 per cent of the total for the ATO).<sup>55</sup> In 2010–11, \$1.266 billion (26.5 per cent of the total for the ATO) was recovered from the SME market as a result of these activities.<sup>56</sup>

## Managing compliance in the SME market

**1.21** Key compliance obligations are to: register for tax purposes; file tax returns on time; correctly report liabilities; and pay taxes on time.<sup>57</sup> The ATO seeks to optimise the level of voluntary compliance. Compliance management in the ATO is a significant activity, with an annual budget of over \$1.1 billion and a workforce of nearly 11 000 staff committed to it. In implementing its compliance approach, and in measuring the success of its compliance strategies, the ATO groups taxpayers into different market segments (as outlined in paragraph 1.4).<sup>58</sup> It has a risk management framework that provides a structured approach for identifying and prioritising the compliance risks associated with each market.

**1.22** Although the SME market is defined on the basis of annual financial turnover, there is considerable diversity in the business structures, size and market segment positioning of SME taxpayers.<sup>59</sup> From a compliance perspective, this means that the compliance risks within this group are also diverse and not necessarily correlated with a taxpayer's turnover. For this reason, the ATO seeks to influence taxpayers' compliance by addressing specific risks in the SME market.

**1.23** Compliance activities are developed to mitigate and manage these risks, and are outlined in the ATO's annual Compliance Program. In accordance with the Compliance Model, these compliance strategies differentiate between the various types of taxpayer behaviour. Strategies range from educational information aimed at making compliance easier, through to prosecution for serious non-compliance.

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<sup>55</sup> ATO, *Commissioner of Taxation Annual Report 2010–11*, October 2011, p. 229.

<sup>56</sup> Information provided by the ATO.

<sup>57</sup> OECD, Forum on Tax Administration: Compliance Sub-group, *Final report, Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience*, 22 June 2008, p. 9.

<sup>58</sup> The ATO's business lines are also structured around these markets.

<sup>59</sup> ATO, *Compliance Program 2011–12*, June 2011, p. 17.

## *Measuring compliance effectiveness*

**1.24** Revenue administrations commonly face the challenge of measuring their effectiveness in promoting voluntary compliance and addressing non-compliance. One approach generally taken is to measure the size of the tax gap, that is the total amount of unpaid tax, and changes to it. Another is to measure the impact compliance activities have on promoting taxpayer voluntary compliance. Within these general parameters revenue administrations develop approaches tailored to their own national circumstances. Some, such as the United Kingdom and the United States of America, emphasise measurement of the tax gap as an integral part of their monitoring approaches.<sup>60</sup> Others, like Australia, place more emphasis on monitoring the specific contribution their own activities make to government revenue targets and to changes in taxpayer behaviour.<sup>61</sup>

**1.25** The ATO assesses the effectiveness of its compliance activities using the Compliance Effectiveness Methodology (CEM), which it introduced in 2008. This methodology, adopted by the Organisation for Economic Co-operation and Development (OECD), is based on two key elements: the identification of measurable compliance objectives; and the articulation and treatment of risks to achieving them. The ATO implements these elements in four phases that:

- articulate the risk and align it with the ATO's business intent of optimising voluntary compliance;
- define a successful outcome and develop compliance strategies to achieve this outcome;
- identify and test indicators of success; and
- use these indicators to measure the extent of the effectiveness of the compliance strategies.

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<sup>60</sup> OECD, Forum on Tax Administration: Compliance Sub-group, *Final Report, Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience*, 22 June 2008, pp. 65–70.

<sup>61</sup> ATO, *Measuring Compliance Effectiveness—Our Methodology*, August 2008. <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00157833.htm>> [accessed 2 August 2010].

## Audit objective and scope

### Objective

**1.26** The objective of the audit was to assess the effectiveness of the ATO's compliance management approach in the SME market.

### Scope

**57.** The focus of the audit was on the SME market. At the time of the audit, the Inspector General of Taxation was reviewing the ATO's audit and risk review policies, procedures and practices in the \$100 million to \$250 million sub-segment of the SME market and Highly Wealthy Individuals.<sup>62</sup> For this reason, these topics were excluded from the ANAO's audit scope.

## Audit criteria

**58.** The audit examined, taking into account the desired outcomes of compliance activity, whether the ATO's:

- governance arrangements were appropriate;
- systems and processes to identify and assess compliance risks were adequate; and
- strategies to promote compliance and address non-compliance were appropriate and implemented effectively.

## Audit methodology

**1.27** The ANAO examined ATO documentation and interviewed staff across the S&ME and other business lines in Canberra, Melbourne, Perth, Brisbane and Sydney. A range of stakeholders were also consulted, including: ACCI; ICAA; Taxpayers Australia; the Australian Securities and Investments Commission (ASIC) and the Australian Transaction Reports and Analysis Centre (AUSTRAC). A sample of 200 compliance reviews and audits was also analysed.

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<sup>62</sup> Titled: *Review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices*. The focus of the Inspector General of Taxation's review was: staff resourcing and technical skill levels; information gathering powers; accuracy of technical decision-making; dispute resolution; and management and conduct of compliance activities. The ANAO did not focus on these issues in this audit.

## **Acknowledgements**

**1.28** The ANAO appreciates the contribution of ATO staff, industry contributors, and other Australian Government organisations that assisted in the conduct of the audit.

## **Structure of report**

**1.29** This report is structured into five chapters, reflecting the high-level audit criteria. Following on from this introductory chapter, the subsequent four chapters examine whether the ATO had effective arrangements in place for the SME market for:

- governance (Chapter 2);
- assessing compliance risks (Chapter 3);
- promoting voluntary compliance and addressing non-compliance (Chapter 4); and
- measuring the effectiveness of compliance activities in promoting voluntary compliance (Chapter 5).

## 2. Governance Arrangements

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*This chapter examines the governance arrangements for the S&ME Business Line's compliance management approach in the SME market.*

### Introduction

**2.1** Governance refers to the processes by which organisations are directed, controlled and held to account.<sup>63</sup> The ATO has in place a governance framework that defines its organisational structure, roles and responsibilities.

**2.2** At the highest level, the ATO reports on its performance against one Portfolio Budget Statement outcome:

Confidence in the administration of aspects of Australia's taxation and superannuation systems through helping people understand their rights and obligations, improving ease of compliance and access to benefits, and managing non-compliance with the law.<sup>64</sup>

**2.3** Delivery of this outcome is achieved through five Program Components:

- 1.1—design and build administrative services to support government, the community and other agencies;
- 1.2—provide strategies to make it easy and as cheap as possible for people to meet their obligations;
- 1.3—implement compliance strategies to support those willing to participate, who may need assistance, and deal firmly with those not willing to comply;
- 1.4—Australian Business Register; and
- 1.5—Australian Valuation Office.<sup>65</sup>

**2.4** The S&ME Business Line is primarily focused on delivering Program Component 1.3. As at February 2011, almost 87 per cent of its staff were allocated to activities attributed to this program component. Delivery of this

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<sup>63</sup> ANAO Better Practice Guide, *Public Sector Governance*, July 2003, Canberra ACT, volume 1, p. 6.

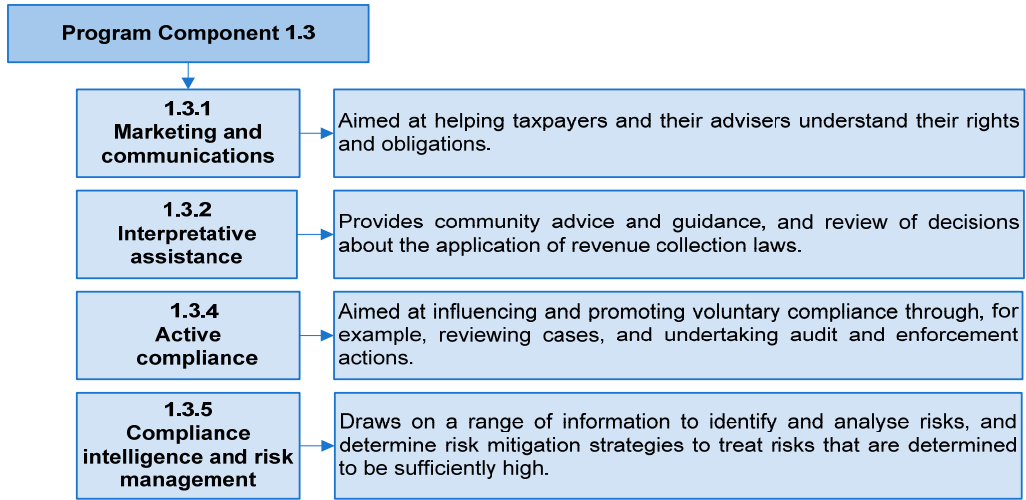
<sup>64</sup> ATO, *ATO Program Framework 2010–11*, July 2010, p. 7.

<sup>65</sup> Australian Government (2010), *Portfolio Budget Statements 2010–11: Treasury Portfolio*, pp. 199–200.

Program Component is further divided into four deliverables (outlined in Figure 2.1), each of which has its own key performance indicators (KPIs). The primary focus of this audit was on deliverables 1.3.4: Active Compliance; and 1.3.5: Compliance Intelligence and Risk Management. These are discussed in Chapters 3 and 4.

**Figure 2.1**

**The four deliverables in Program Component 1.3**



Source: ANAO analysis of *ATO Program Framework*, July 2010, p. 7.

Note: Number 1.3.3 was not utilised.

**2.5** To assess the effectiveness of the ATO’s governance arrangements supporting the management of compliance in the SME market, the ANAO examined the:

- organisational arrangements for administering the SME market;
- business planning processes for the S&ME Business Line; and
- performance monitoring and reporting against the KPIs for capabilities 3.4 and 3.5.

The ATO’s Risk Management Framework and systems and processes for assessing and managing compliance risks are covered in Chapter 3.



## Organisational arrangements for administering the SME market

**2.6** The ATO has adopted a matrix approach in developing its corporate governance framework. Organisational functions are divided across four functional areas, called sub-plans: Compliance; Corporate Services and Law; Enterprise Solutions and Technology; and Operations. The S&ME Business Line falls within the Compliance Sub-plan.

**2.7** High-level management is provided by a senior leadership group and through the ATO's senior executive reporting structure. Collectively, they have responsibility for managing a number of business and service lines designed to deliver the ATO's outcome and program commitments to government.<sup>66</sup> Planning, performance measures and reporting are linked through a suite of corporate documents, which include the ATO Plan<sup>67</sup>, various supporting business line plans and the Annual Report.<sup>68</sup>

### The S&ME Business Line

**2.8** The S&ME Business Line was established in 2006–07 following an organisational restructure, which separated the former Small Business (SB) Business Line into the S&ME Business Line, administering the \$2 million to \$100 million market sub-segment, and the Micro Enterprises and Individuals (ME&I) Business Line, administering enterprises with an annual turnover of less than \$2 million. Further organisational changes in 2007–08 saw the increase in the upper limit of the SME market to \$250 million with the transfer of this market sub-segment from the Large Business and International (LB&I) Business Line.<sup>69</sup> Figure 2.2 sets out the S&ME Business Line Structure as at February 2011.

<sup>66</sup> ATO, *2009–10 Commissioner of Taxation Annual Report*, p. 119.

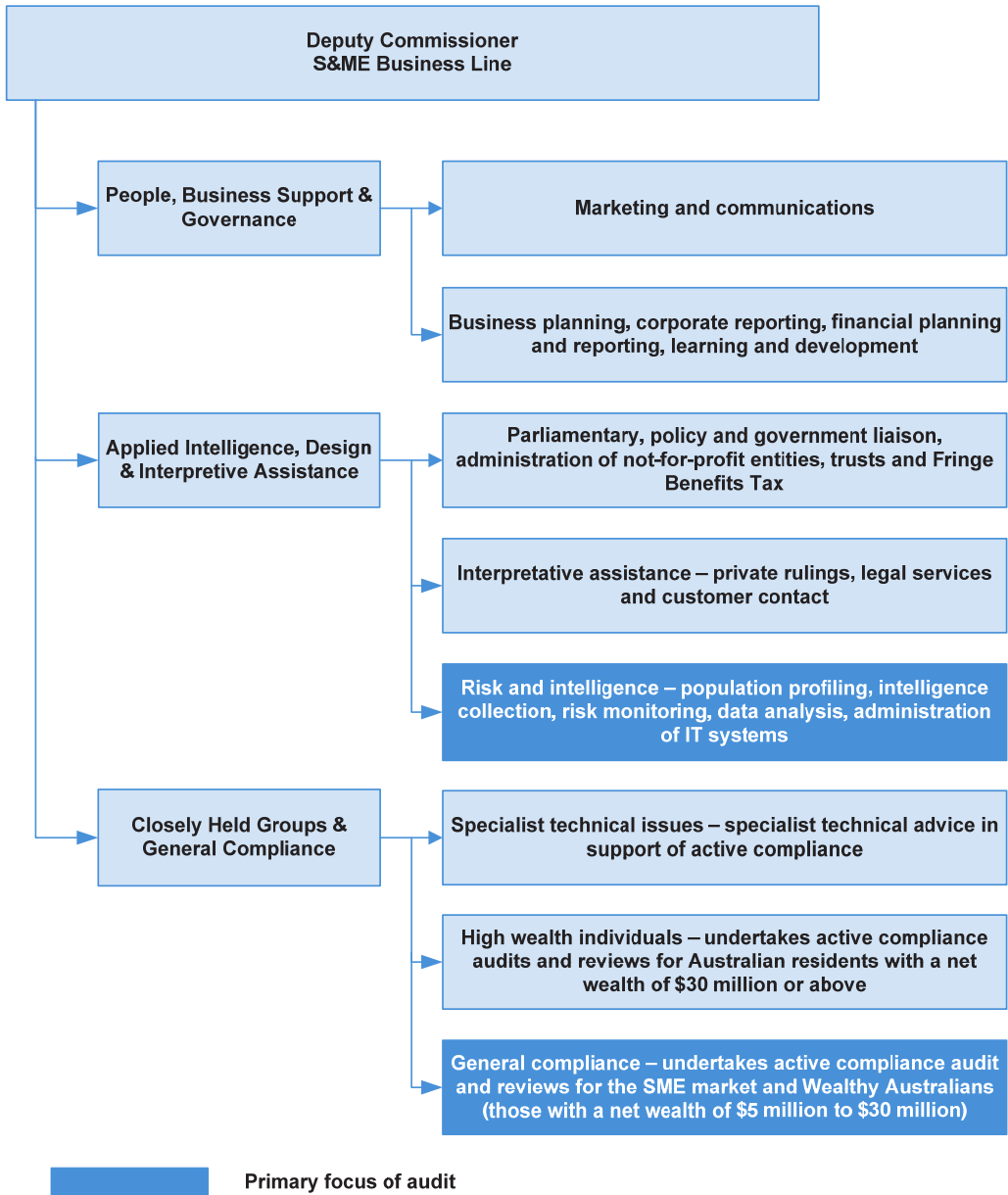
<sup>67</sup> The ATO Plan 2010–11 provides a high-level outline of all the work the ATO intends to undertake in the financial year, and includes performance measures against deliverables. The strategies outlined in the plan cascade down into the sub-plans and ultimately to tasks at the individual ATO staff level.

<sup>68</sup> ATO *Management Arrangements*, April 2011, available from <<http://www.ato.gov.au/content/downloads/cor24463orgstruct.pdf>> [accessed 23 February 2011]

<sup>69</sup> ATO, *Commissioner of Taxation Annual Report 2007–08*, October 2008, p. 52.

**Figure 2.2**

**Structure of the S&ME Business Line as at February 2011**



Source: ATO, *S&ME Line Organisation Chart*, current February 2011.

Note: The following have been excluded from the above structure: S&ME Case Leadership, which provides highly specialised support for active compliance; and the Assistant Deputy Commissioner, Projects and SME Population Strategy, as the organisational responsibilities and structure were under development at the time of this audit.

**2.9** As at February 2011, the Business Line had over 1400 full-time equivalent staff, located in 21 centres across all states and the Australian Capital Territory. Teams are not necessarily co-located. The size and geographic spread of the business line requires considerable coordination and accountability, which is principally undertaken through a range of committees and associated reporting. Appendix 3 outlines the key internal committees, their membership and the frequency of meetings.

**2.10** Similarly, the complexity of the taxation affairs of this market segment requires coordination and cooperation with other areas of the ATO. The S&ME Business Line has representation on 27 cross-business line committees and forums, and administrative responsibility for four of these: the SME Market Committee; and the Wealthy Australians, Phoenix and Trusts Steering Committees.

**2.11** Key coordination committees in relation to the management of compliance in SMEs include:

- Compliance Executive Meeting—senior executives from the Compliance Sub-plan;
- Active Compliance Steering Committee—responsible for national consistency across the Active Compliance capability; and
- Income Tax Steering Committee—responsible for activities relating to income tax across all markets.

**2.12** In addition to the committees on which the S&ME Business Line is directly represented, there are nine committees where the S&ME Business Line does not have formal representation, although they may be invited to attend as necessary. These include the GST, Superannuation, Excise and the Cash Economy committees.

## **SME business planning and reporting**

**2.13** The ATO's high-level planning documents, particularly the Strategic Statement<sup>70</sup> and ATO Plan<sup>71</sup>, set the overall direction for the organisation.

<sup>70</sup> The Strategic Statement provides direction and a framework for the ATO's activities over a five-year period from 2010–15.

<sup>71</sup> The ATO Plan provides a consolidated view of all the sub-plans' annual work to support corporate priorities.

Planning cascades from these high-level planning documents through business line, branch and project plans and finally to team plans and individual performance and development agreements.

**2.14** The S&ME Business Line Plan 2010–11 (S&ME Line Plan) provides the overall framework for the work of the business line, and is directly integrated into the ATO Plan, aligning with the four deliverables (as outlined in Figure 2.1). The plan assigns responsibility for tactics<sup>72</sup> to individuals or to teams to enable the business line to deliver against the KPIs, for each of the four capabilities outlined in Program Component 1.3.

**2.15** Within the S&ME Business Line, over 30 individual branch and team plans contribute to the overarching business line plan. The ANAO examined the relationship between the S&ME Line Plan 2010–11 and eight representative lower level plans from branches and teams.<sup>73</sup> These plans covered the three capabilities that are particularly relevant to the scope of this audit: marketing and communications; active compliance; and compliance intelligence and risk management.

**2.16** The eight lower level plans examined were inconsistent in format and alignment with the S&ME Line Plan:

- three of the plans covered all responsibilities and could be easily aligned with the S&ME Line plan;
- two plans contained responsibilities that had not been identified in higher level plans;
- one plan did not include responsibilities that had been identified in higher level plans; and
- two plans had no clear alignment with higher level plans, capabilities or tactics.

**2.17** There was also variation in the KPIs included in the plans. While some KPIs could be traced back to capability performance indicators, others lacked a clear line of sight to higher level plans and KPIs were not included in one plan.

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<sup>72</sup> A tactic contributes to delivering a strategy, as set out in the ATO Plan.

<sup>73</sup> The plans examined were the: Marketing, Education and Alliances Team; Active Compliance; Risk, Intelligence, Strategy and Coordination Branch; Population Risk Profiling Team; Intelligence and Risk Monitoring Team; Analytics, Information Management and Systems Branch; Data Analysis and Systems Design Team; and Information Collection and Data Matching Team.

**2.18** For the next planning cycle, there would be merit in the ATO reviewing internal business planning processes to achieve more consistency across the business line's plans, with a focus on better alignment of capabilities, tactics and KPIs from lower level business plans to the S&ME Line Plan.

## **Performance monitoring and reporting**

**2.19** Ongoing monitoring and reporting of performance assists agencies to manage programs, inform management decision-making and meet external reporting obligations. Reporting against the SME market is generally not segregated from other deliverables of the business line, so the ANAO examined internal and external reporting of the S&ME Business Line where relevant to SME market administration.

### *Internal performance monitoring and reporting*

**2.20** Within the S&ME Business Line, compliance and other issues are reported and monitored at several levels. The key governance reports relevant to the scope of this audit are:

- a monthly snapshot report which monitors key deliverables for the business line, and a monthly executive summary report, both for the S&ME Executive. These reports monitor progress against key deliverables, as well as staffing statistics, emerging risks and issues and exceptions reporting;
- a quarterly governance report, the last of which forms the end of year report for the business line. This report gives comprehensive results against service standards, the four capability KPIs, specific projects and financial indicators; and
- monthly, and twice-yearly internal governance reports from the three Business Management Committees and Business Management Group to the S&ME Executive. These specifically cover the four capabilities, and contain ongoing monitoring and reporting of performance for key elements such as active compliance activities, and the interpretative assistance provided by the business line. There are also regularly scheduled reports to the Risk Management Committee (RMC) on issues such as demographics analysis, revenue raised, forward revenue indicators and evaluation of the quality and effectiveness of active compliance activities.

**2.21** Within the context of the scope of this audit, the S&ME Business Line also reports on a regular basis on performance against the S&ME Line Plan through:

- monthly capability performance reports and exception reports;
- annual reports to the Compliance Sub-plan Governance Forum; and
- bi-annual reports to the Corporate Plenary Governance Forum.

**2.22** The S&ME Business Line is also required to report against the KPIs for the active compliance and compliance intelligence and risk management capabilities. In the S&ME Business Line end of financial year reports for 2008-09, 2009-10 and 2010-11:

- active compliance capability KPIs<sup>74</sup> were consistently reported against;
- compliance intelligence and risk management capability KPIs<sup>75</sup> were not reported against, although the business line did include status updates for the tactics that this capability was responsible for delivering.

**2.23** The non-reporting of compliance intelligence and risk management KPIs reinforces the need to better align KPIs with tactics and capabilities. In 2009-10 only two of these KPIs related to the tactics to be delivered, out of a total of 15 tactics assigned for this capability. In 2010-11, three KPIs related to tactics, out of a total of 11 tactics assigned. The ATO advised that some of the metric-based KPIs identified in the line plan were not considered useful for lower level plans, and this was particularly the case for the compliance risk and intelligence capability. Consequently, in 2010-11 the business line began developing different success measures for use in the 2011-12 financial year.

### *External reporting of performance*

**2.24** External reporting of results against the specific performance measures set out in an agency's Portfolio Budget Statements is generally via an agency's annual reports. The SME market is not specifically included in the ATO's Portfolio Budget Statements.

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<sup>74</sup> Number of cases conducted against cases planned; dollar value of tax, penalties and interest liabilities raised against the value planned to be raised; performance against case cycle times and client service standards; and some qualitative measures.

<sup>75</sup> Number of risk reviews conducted, number of new risks entered into the risk register and level of acceptance of risk escalations.

**2.25** Recent Commissioner of Taxation annual reports, however, have included some data about compliance activities undertaken by the ATO in the SME market segment. For example, the Commissioner of Taxation Annual Report 2009–10 included reporting against settlement numbers<sup>76</sup>, service standard results for completion of private ruling cases<sup>77</sup>, and specified the value of extra tax collected as a result of active compliance activities. The ATO's annually published Compliance Programs have also included snapshots of activity in the SME market during the preceding year, detailing numbers of audits and reviews undertaken, and telephone and letter-based verification activities for specific topics such as superannuation, GST and income tax.

## Conclusion

**2.26** There is a sound governance framework supporting the S&ME Business Line and compliance activities in the SME market. Reflecting its responsibility for the SME market segment, the business line has established coordination and consultative forums with other areas of the ATO that have intersecting responsibilities in the SME market.

**2.27** Planning, performance measures and reporting are linked through a suite of corporate documents, which include the ATO Plan, various supporting business line plans and the Annual Report. There are clear linkages for deliverables under the ATO Plan to the S&ME Line Plan, although lower level business plans within the business line could be better aligned with the S&ME Line Plan through capabilities, tactics and KPIs. The internal performance monitoring reports provided to the S&ME Business Line and ATO Executive adequately account for the performance of the active compliance capability. Reporting against the compliance intelligence and risk management capability could be improved by reviewing the alignment of capabilities, tactics and KPIs. External reporting on the SME market is limited in extent and coverage, but results achieved by the business line are incorporated into results reported for Program Component 1.3 as a whole.

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<sup>76</sup> The ATO describes settlements as an alternative form of dispute resolution.

<sup>77</sup> The service standard is to finalise 80 per cent of private rulings within 28 days of receiving all information, or by a negotiated date.

### 3. Assessing Compliance Risks

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*This chapter examines the ATO's approach to identifying, analysing and evaluating the risk of taxpayers not complying with taxation obligations in the SME market.*

**3.1** The ATO assesses the risks associated with taxpayers not complying with their taxation obligations through its risk management framework.<sup>78</sup> The framework examines risk through a number of lenses, enabling the ATO to assess the extent of the risks across the economy and to develop a range of remedial responses that are proportionate and appropriate to address the underlying areas of concern.<sup>79</sup> Within this framework, the S&ME Business Line has responsibility for the analysis and treatment of compliance risks in the SME market.

**3.2** The ANAO reviewed the ATO's approach to assessing compliance risks in the SME market by examining whether:

- the administrative arrangements for managing risks were effective;
- appropriate information sources were used to assess compliance risks; and
- the risk assessment methodologies employed were appropriate and effective.

#### Administrative arrangements for managing risks

**3.3** The ATO's Risk Management Framework is outlined in Practice Statement PS CM 2003/02, including its policy, corporate requirements and roles and responsibilities.<sup>80</sup> Accordingly, the S&ME Business Line Deputy Commissioner has responsibility for ensuring that appropriate risk management is applied in the operation of the business line.

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<sup>78</sup> The ATO's Risk Management Framework is an integrated risk management strategy linking tactical, operational and enterprise risk. The current version meets ISO 31000:2009 standards. The framework consists of: a corporate risk register; an issues management database that records information on new and emerging risks, as well as the status of treatment strategies for existing risks; risk matrices which define how each level of risk is to be managed; and instructions for staff.

<sup>79</sup> Commissioner of Taxation, *Risk: The framework, the vision, the values*. Presentation to the CPA Public Sector Finance and Management Conference, 12 August 2010.

<sup>80</sup> ATO, *Corporate Management Practice Statement*, Risk and Issues Management PS CM 2003/02.



**3.4** The S&ME Business Line's organisational arrangements for assessing compliance risks are largely divided into three components:

- the S&ME Business Line Risk Management Committee (RMC);
- staff in the Applied Intelligence and Design area; and
- risk managers and population strategists, who deal with specific risks and populations.

### **The S&ME Business Line Risk Management Committee**

**3.5** The RMC is the key strategic risk management committee for the business line. It meets monthly and S&ME Business Line senior executive staff are members of this committee. They may also be 'owners' of specific risks and populations. The RMC makes decisions on a range of functions associated with the management of compliance risks, including:

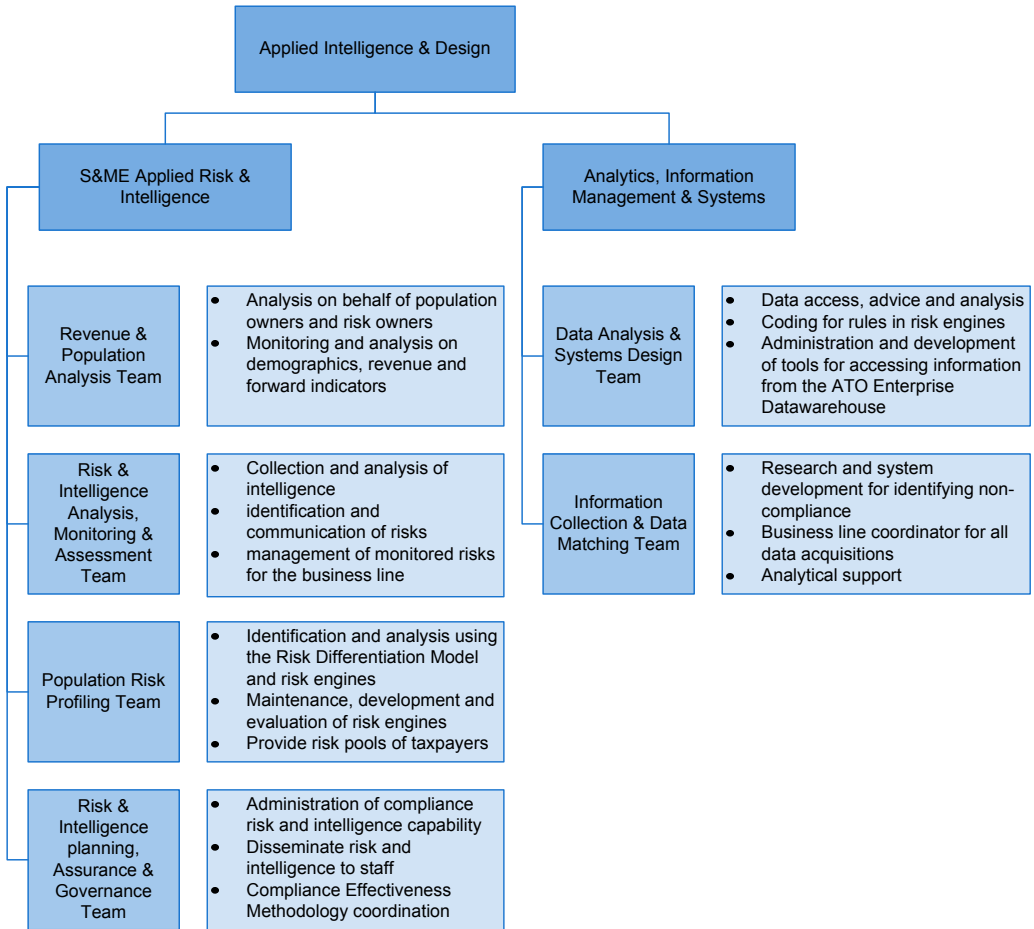
- setting the strategic direction for compliance risk management;
- overseeing the identification, assessment and prioritisation of compliance risks;
- monitoring emerging compliance risks;
- integrating risk management strategies across the whole SME market;
- monitoring the effectiveness of treatment strategies to manage individual compliance risks; and
- ongoing evaluation of risk management processes.

### **Applied Intelligence and Design**

**3.6** The Applied Intelligence and Design area (Figure 2.2) provides technical expertise such as data collection and analysis, systems design, economic forecasting and revenue monitoring. Teams from this area support the work done by risk managers, population strategists and the RMC. Figure 3.1 outlines their structure and broad functions.

Figure 3.1

Structure and functions of the Applied Intelligence and Design area as at August 2011



Source: ANAO analysis of ATO organisational charts for the S&ME Business Line and information from business plans for the teams depicted.

Note: There are additional teams not represented in this diagram as they support specific projects that were not within the scope of this audit.

Risk managers and population strategists

3.7 The S&ME Business Line assesses compliance risks at both the risk level and the population level. The risk level assessment is based on a

particular tax or event (such as FBT, or lodgement of returns).<sup>81</sup> The 'population' level assessment is based on a grouping of taxpayers (such as the S4 population). Risk managers and population strategists are responsible for assessing the compliance risks.

**3.8** The 'population approach' was instigated in response to specific drivers, such as the expansion of the SME market in 2007–08 to encompass the S4 market sub-segment. The business line decided that all taxpayers in the S4 market sub-segment would be risk assessed, as the information known about this group was limited.<sup>82</sup> Population approaches are used for the S4 market sub-segment, and also the Wealthy Australian and Highly Wealthy Individuals populations. There are no specific assessments covering the S2 or S3 populations and, during the course of this audit, the program of work for the S1 population was incorporated into business as usual.

**3.9** Senior executive staff are appointed as risk owners and population owners to supervise and direct the work of risk managers and population strategists respectively. These roles are not positioned in any particular area of the business line, rather, they are allocated having regard to the experience of staff. While the ultimate responsibility for managing a particular risk or population lies with the owner, decisions relating to the prioritisation of risks and consistency of treatments remain with the RMC. The S&ME Executive is responsible for the allocation of resources.

## **The ATO's Risk Management Framework in the S&ME Business Line**

**3.10** The ATO's Risk Management Framework is applied to both the SME market and the business line's broader responsibilities in order to identify risk areas. In 2010–11, this resulted in the business line contributing to mitigating nine strategic risks<sup>83</sup> and being the corporate risk owner for three of them:

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<sup>81</sup> Analysis and treatment of priority risks is the responsibility of the business line. These are explained in more detail in Table 3.1.

<sup>82</sup> As previously noted in Chapter 1, this project is not within the scope of this audit.

<sup>83</sup> A strategic risk cuts across the ATO, or is a risk rated as high or severe when assessed on a corporate scale. The nine strategic risks contributed to by the S&ME Business Line are: Phoenix; Aggressive Tax Planning; Non-Lodgement of FBT and Income Tax Returns by large clients; Consolidation; International; Capital Gains Tax (CGT); Losses; Trusts; and Non Resident Withholding Taxes.

Phoenix; Non-Resident Withholding Tax<sup>84</sup>; and Trusts.<sup>85</sup> There were eight risks, directly associated with the business line, rated as priority risks<sup>86</sup> (and outlined in Table 3.1 on the following page). A further 10 risks were monitored by the business line, and were either the responsibility of a specific team, or subject to other business arrangements.<sup>87</sup>

**3.11** The business line develops or provides input into a variety of reports to identify, analyse and manage its compliance risks. The key risk management reports relevant to the scope of this audit are: the annual Health of the System Assessments on Income Tax and other key revenue topics; monthly Compliance Exceptions Reports; and the two risk registers for the SME market and the S&ME Business Line.

**3.12** The business line is also responsible for contributing to corporate risk reporting. This is done through the two risk registers that the business line administers:

- the *S&ME Risk Landscape – Detail*; and
- the *SME Market Segment Report*.<sup>88</sup>

**3.13** The registers include all risks identified for the business line or the SME market, respectively, and the business line reviews these twice a year. The registers contain a risk description, status of current risk treatment strategies and risk ratings.

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<sup>84</sup> During the course of the year, ownership for Non-Resident Withholding Tax transferred to the Large Business and International Business Line.

<sup>85</sup> A corporate risk owner has specific responsibilities according to the ATO's corporate management practice statement on risk and issues management (PS CM 2003/02). These include a coordination role with risk analysis and mitigation strategies between other business lines and additional monitoring and reporting responsibilities.

<sup>86</sup> A priority risk is assessed as having considerable impact on the SME market and usually involves the appointment of a dedicated resource such as a risk manager.

<sup>87</sup> The 10 monitored risks are: Not for Profit; Professional Firms Compliance; Losses; Private Equity Funds; Capital Management-Share Buy Backs; Demergers; Research and Development Concessions; Property Building and Construction; Consolidation; and Taxation of Financial Arrangements.

<sup>88</sup> The SME Market Risk Register, named the *SME Market Segment Report*, contains risks relating to the SME market, and therefore incorporates risks owned by other business lines within the ATO. The S&ME risk register (*S&ME Risk Landscape – Detail*) combines all risks for the business line's area of responsibility, i.e. the SME market, Highly Wealthy Individuals and Wealthy Australians.

**Table 3.1****S&ME Business Line priority risks for 2010–11**

Priority Risk	Nature of Risk
Phoenix	The evasion of tax and/or superannuation guarantee liabilities through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities.
Division 7A	Tax-free distributions to shareholders or shareholders' associates in the form of payments, loans or debts forgiven made by private companies.
Lodgement	Failure to voluntarily lodge activity statements, income tax or other returns, schedules or forms.
International	Non-compliance with tax obligations arising from international dealings, based on six risk themes: <ul style="list-style-type: none"> <li>• foreign residents;</li> <li>• foreign source income;</li> <li>• non-resident withholding tax;</li> <li>• tax havens;</li> <li>• thin capitalisation<sup>89</sup>; and</li> <li>• transfer pricing.<sup>90</sup></li> </ul>
Exit Strategies	The failure of business owners to comply with their tax obligations upon winding up of their business, leading to adverse tax outcomes.
Capital Gains Tax	Taxpayers incorrectly reporting capital gains and/or losses, undermining voluntary compliance (incorrectly reporting includes avoiding, classifying, calculating and omitting).
Fringe Benefits Tax	The failure of employers and employees to voluntarily comply with tax obligations arising from the provision of fringe benefits.
Trusts	Tax outcomes for trust beneficiaries that do not match the amounts they are entitled to under trust law, providing opportunities for tax evasion.

Source: ANAO analysis of S&ME Business Line risk registers.

<sup>89</sup> Failure to comply with rules for debt deductions. A taxpayer can claim against Australian assessable income when the debt used by the taxpayer to fund its Australian assets exceeds certain limits.

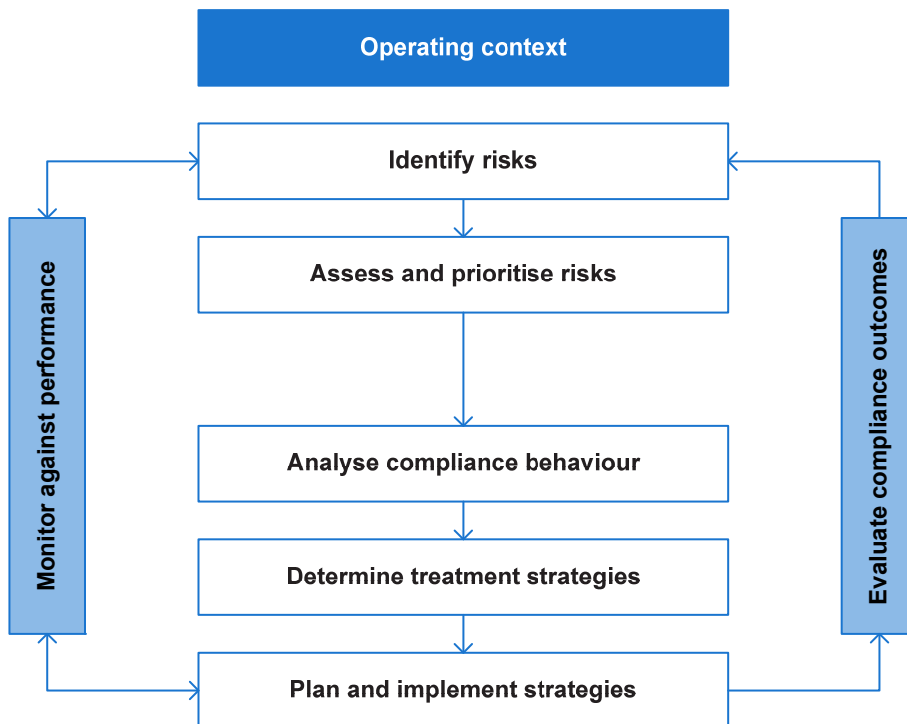
<sup>90</sup> The underpayment of Australian tax by businesses with related-party international dealings due to undervaluing Australian goods, services or intangibles.

## Analysis of compliance risks

**3.14** As the S&ME Business Line cannot individually risk-assess the approximately 175 000 taxpayers in the SME market at any one time, it uses risk management strategies to verify compliance and reinforce voluntary compliance. Triggers are used to identify higher risk cases; and can be transactional (for example, overseas transfers, and major commercial sales) or economic (such as ratios of revenue against losses). Figure 3.2 outlines the business line's risk management process, which is aligned to the ATO's Risk Management Framework.

**Figure 3.2**

### S&ME Business Line risk management process



Source: ATO, *Developing Effective Compliance Strategies, Guide for Compliance Officers*, November 2009, p. 4.

**3.15** This process is used by both risk managers and population strategists, and consists of the following steps:

- operating context—determine if the ATO already has an established position, what previous activity has been undertaken, how many

taxpayers and how much tax is at risk, and whether there are any proposed changes, such as to legislation, that may affect the risk;

- identify risks—determine what is currently known about the risk, the affected population, the information and data that can be used to quantify and learn about the risk, and how the risk fits within the broader ATO view;
- assess and prioritise risks—methodology includes use of various information and data sources, and automated profiling tools to quantify the likelihood and consequence of the risk. As previously noted, the RMC is responsible for decisions on overall prioritisation of risks and populations;
- analyse compliance behaviour—determine underlying drivers for taxpayer behaviour and whether sub-populations of non-compliance are present (for example, a particular industry group);
- determine treatment strategies—evaluate compliance activities suitable for targeting different causes of the risk. Activities may include production of educational material, or active compliance engagement such as reviews and audits. Recommendations for treatment are put to the RMC for decision;
- plan and implement strategies—activities are planned in conjunction with marketing and education, risk and intelligence, interpretative assistance and active compliance staff;
- monitor against performance—the outcomes of compliance activities are monitored by staff in the active compliance and Applied Intelligence and Design areas, risk managers and population strategists. Results are fed back into future analysis and used to improve analytical methodology; and
- evaluate compliance outcomes—known as Compliance Effectiveness Methodology (CEM). Analysis and results are documented and reported, both to the RMC and corporately through risk management reports.<sup>91</sup>

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<sup>91</sup> The Compliance Effectiveness Methodology is discussed in Chapter 5.

**3.16** As previously noted, the SME market is large and complex, and the S&ME Business Line is wholly or partly responsible for managing a large number of risks (discussed in paragraph 3.10) as well as the S4 sub-segment project, and the Wealthy Australians and Highly Wealthy Individuals populations. The integration of risk assessments across risks and populations is important in terms of efficiency, client service and the ATO's reputation. It provides a means of ensuring more efficient use of staff resources, and that taxpayers are approached on suspected non-compliance through a single contact, rather than through multiple contacts.<sup>92</sup>

**3.17** The ATO advised that risk managers and population strategists had not always shared information or fully integrated their risk approaches. To address this shortcoming, the business line held workshops in May and November 2010 to discuss population strategy development, with a view to developing population strategies that are informed by risk managers. In addition, in December 2010 the business line formalised interaction between risk and population strategies in the RMC's forward planning framework. This involves scheduling risk presentations before population work, to allow the risk strategies to be incorporated into population strategies.

## **Conclusion**

**3.18** The ATO's Risk Management Framework provides a sound basis for managing compliance risks in the SME market. The business line applies this framework to both risks and populations, and has a strategic risk management committee to oversee this process. The business line has also initiated processes to better integrate the work of risk managers and population strategists.

## **Sources of information**

**3.19** An important factor in effective risk assessment is the utilisation of appropriate information. Taxpayers provide the ATO with data, and it is also acquired through legislative arrangements, memoranda of understanding, or

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<sup>92</sup> Potential duplicate compliance cases are discussed further in Chapter 4.



by purchasing it when needed.<sup>93</sup> Information is also collected by the ATO and received from other sources, such as members of the public and tax agents.

**3.20** The two key internal ATO data sets used in the risk assessment of the SME market are Income Tax Returns (ITR) and Business Activity Statements (BAS). These have associated schedules and forms such as the Capital Gains Tax (CGT) schedule that are applicable depending on the taxpayer's circumstances. In addition, the ATO regularly receives data from third parties (external data) for a variety of different purposes such as detection of undisclosed income, the non-lodgement of income tax returns and activity statements, and enterprises outside the tax system, for example, unregistered businesses that deal in cash payments.<sup>94</sup> These data sets are available to risk managers and population strategists via the ATO's Enterprise Data Warehouse.<sup>95</sup>

**3.21** The acquisition of data for the ATO is coordinated through the cross-business line Data Matching Steering Committee. The committee meets quarterly, and is responsible for providing a corporate approach to identifying data that meets ATO business needs; the storage and usage of this data; and adherence to privacy guidelines.<sup>96</sup> The S&ME Business Line is represented on this committee, and has input into the corporate priorities for data acquisition.

## Arrangements with external data providers

**3.22** The ATO has ongoing arrangements in place with a number of external data providers including other Australian government agencies, State and Territory Revenue Offices, national share registries and financial institutions. Two key external government agencies important for the data they provide are the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Australian Securities and Investments Commission (ASIC).

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<sup>93</sup> ANAO, Performance Audit Report No. 30 2007–08, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration*, pp. 114–121.

<sup>94</sup> ANAO, Performance Audit Report No. 30 2007–08, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration*, p 37.

<sup>95</sup> The Enterprise Data Warehouse encompasses the ATO's entire data holdings.

<sup>96</sup> In accordance with the Corporate Management Practice Statement PS CM 2004/17, *Data Matching—special purpose acquisition data*.

## AUSTRAC

**3.23** AUSTRAC is Australia's financial intelligence regulator for monitoring anti-money laundering and the financial services industry for flows of funds that enter and leave Australia. AUSTRAC collects information relating to international financial transfers that occur between companies, financial institutions and individuals. Section 125 of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* gives the ATO the right to access AUSTRAC data, which is used extensively by the ATO to data match against tax returns to identify undeclared international financial transfers.<sup>97</sup>

**3.24** There is a Memorandum of Understanding (MoU) between the two agencies governing cooperation, formal meeting arrangements, access and use of AUSTRAC information.<sup>98</sup> The ATO and AUSTRAC have recently agreed to increase the frequency of the data download to quarterly, and this will improve data currency for data matching and running risk engines.

## ASIC

**3.25** ASIC is Australia's regulator for Australian companies, financial markets, financial services organisations and professionals that deal and advise in investments, superannuation, insurance, deposit taking and credit. ASIC holds data on Australian company registrations, de-registrations and liquidations; and license and regulation data on consumer credit agencies (such as banks), financial markets (such as the futures market) and financial services industries (such as superannuation funds).

**3.26** The ATO routinely uses ASIC data, for example, to check if companies that are de-registering have fulfilled all of their taxation obligations. This data is available through public databases on the ASIC website. The ATO and ASIC also have an MoU<sup>99</sup> that provides the formal framework for meeting arrangements, exchanging confidential information and other aspects of

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<sup>97</sup> The legislative and policy frameworks that regulate ATO access to data and related activities was not included in the scope of this audit. ANAO Audit Report No. 30 2007–08, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration* provides these details.

<sup>98</sup> AUSTRAC/ATO, *Memorandum of Understanding between the Chief Executive Officer of the Australian Transaction Reports and Analysis Centre and the Commissioner of Taxation regarding cooperation and the access to and use of AUSTRAC information or documents containing AUSTRAC information*, 5 August 2009.

<sup>99</sup> ASIC/ATO, *Memorandum of Understanding between the Australian Securities and Investments Commission and the Australia Taxation Office*, 9 May 2007.

cooperation. An attachment to the MoU details how data will be exchanged and the frequency of these exchanges.

## Gathering and disseminating intelligence

**3.27** Intelligence is also received from members of the public and tax agents. The ATO's Tax Evasion Referral Centre (TERC) manages the collection and internal referral of this intelligence for the ATO.<sup>100</sup> The S&ME Business Line uses a number of mechanisms to gather and disseminate intelligence. Responsibility for intelligence collection, analysis and dissemination primarily belongs to the S&ME Applied Risk and Intelligence Branch (see Figure 3.1). In particular:

- the Risk and Intelligence Planning, Governance and Communication Team manages the processes to collect intelligence. This includes workshops with active compliance staff and reporting on selected risk topics; a monthly telephone forum between risk managers and key compliance intelligence and risk monitoring staff; the monthly *S&ME Risk and Intelligence News*; managing a yearly internal *S&ME Risk and Intelligence Survey*; and producing a quarterly report on results from completed compliance cases;
- the Risk and Intelligence Analysis, Monitoring and Assessment Team provides analytical services for intelligence collected; and
- the Revenue and Population Analysis Team provides analysis on revenue collections and forecasting, and demographics analysis on the whole SME market and specific populations.

**3.28** The S&ME Business Line also receives intelligence from media alerts, stakeholder forums (discussed further in Chapter 4) and maintains links to other business areas so that intelligence can be shared. Intelligence from the S&ME Intelligence Linkers Forum is uploaded onto ATO *intelligence*, an ATO-wide intelligence intranet site. The Forum's membership includes staff from other business lines, and the S&ME Business Line has members on similar forums, such as those for the Large Business and International and

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<sup>100</sup> For more information on these processes refer to ANAO, Performance Audit Report No. 48 2009–10, *Community Intelligence—Collecting and Processing Tip-offs*, pp. 27–30.

Indirect Taxes Business Lines. Qualitative intelligence is captured on the ATOi database<sup>101</sup>, accessed through ATOintelligence.

## Conclusion

**3.29** The ATO has systems and processes in place to collect data and intelligence from a wide range of internal and external sources, enabling it to properly assess compliance risks. It also has processes for analysing and disseminating this data and intelligence across the ATO.

## Risk assessment methodologies

**3.30** The size and complexity of the SME market necessitates the use of automated profiling tools to assess compliance risks.<sup>102</sup> The automated tools used by risk managers and population strategists are the SME Risk Engine and the Risk Differentiation Framework (RDF). These tools are used, ultimately, to assist with determining appropriate risk treatments as well as contributing to a pool of potential cases for compliance activity.

### SME Risk Engine

**3.31** In the ATO context, a risk engine is a computer program that assesses data on individual taxpayers to determine a relative risk of non-compliance. At the time of conducting this audit, the S&ME Business Line had three risk engines, for the SME market, Wealthy Australians, and Highly Wealthy Individuals. The ANAO examined the ninth version of the risk engine applied to the SME market. The tenth version of the SME Risk Engine was run in June 2011, and was not examined as part of this audit.

#### *Content of the SME Risk Engine*

**3.32** The SME Risk Engine includes an automated algorithm, specifically developed to support compliance activities relating to the SME market.<sup>103</sup> The algorithm assesses data in the ATO's Enterprise Data Warehouse, which is drawn from both taxpayer returns and external sources. The results are moderated by an ATO officer, who may change the weighting of results

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<sup>101</sup> ATOi is the main database used to store and analyse intelligence information obtained from a range of internal and external sources.

<sup>102</sup> A profile is a description of the key characteristics of an entity or a group of taxpayers.

<sup>103</sup> An algorithm is a procedure for solving a particular mathematical problem in a finite number of steps.

against rules where multiple indicators overlap. The risk engine then produces a probability score of non-compliance for each taxpayer. The resulting pool of taxpayers is used as a basis for determining compliance activity by risk managers, population strategists, specialist compliance teams and general compliance teams. Cases can be selected either directly from the risk engine pool, or after further data matching analysis has been undertaken by risk managers and population strategists.<sup>104</sup>

**3.33** The rules applied to SME taxpayers' data are known as 'risk flags' and 'risk signposts', which are grouped into risk themes. These risk themes largely correspond to most S&ME Business Line priority risks (outlined in Table 3.1). A number of the business line's monitored risks also have flags and/or signposts in the risk engine.

#### Risk flags

**3.34** Risk flags provide a potential indicator of a taxpayer's non-compliance with an obligation. Most flags are primarily ratios or percentages based on a taxpayer's return, for example tax to profit ratios. The risk engine assigns each taxpayer a score against each flag for which the taxpayer has a characteristic outside an expected range of the industry's average (known as the risk threshold).

**3.35** Other flags relate to the taxpayer's tax and economic performance. Examples of these include failure to lodge a tax return for one or more years, and recording a tax loss for a number of years. The overall risk score for the taxpayer is determined by a formula based on a factor related to the likelihood of non-compliance (based on the outcome of the risk engine) and a factor related to the consequence of non-compliance (derived from the taxpayer's taxable income). The ninth version of the SME Risk Engine had 74 risk flags.

#### Risk signposts

**3.36** Risk signposts relate to tax and economic performance and highlight a particular aspect of a taxpayer's return, for example, that the amount of their carried forward losses is in the top 20 per cent of the sub-segment they are in. Signposts differ from flags in that they do not contribute to the risk score. Rather, they provide additional contextual information about the taxpayer that

<sup>104</sup> Data matching is the comparison of data held by the ATO and data obtained from other sources. This enables detection of potential non-compliance such as undisclosed income or non-lodgement of tax returns, and therefore forms an important step in the risk assessment process.

can be used by compliance officers in the event that a case is referred to them for action. The ninth version of the SME Risk Engine had 54 risk signposts.

### *Manual process*

**3.37** Risk engine results are manually weighted to take account of the:

- importance of the flag in indicating a risk of non-compliance; and
- presence of multiple hits against flags within each particular risk theme to ensure that the overall score is not skewed by a particular risk theme.

These weights are assigned manually by an experienced officer, in consultation with risk managers where multiple flags overlap. The process and criteria for these decisions are not documented. This manual process also introduces a discretionary component to the decision-making process about potential cases for compliance action, and a business continuity risk for the business line.

### *Risk engine effectiveness reports*

**3.38** There is no reporting on the overall effectiveness of each risk engine. However, the Population Risk Profiling Team is responsible for the maintenance, development and analysis of risk engines and their subsequent results. Every six months this team produces *Risk Flag Effectiveness Reports*, covering the effectiveness of each risk theme, by comparing the number of flag and signpost 'hits' against outcomes from closed compliance cases. The effectiveness of flags and signposts cannot be validated if compliance cases are not conducted on that particular indicator. Consequently, some flag effectiveness reports recommended that risk managers actively encourage compliance staff to select cases related to their specific risk. However, follow-up of outcomes and recommendations from these reports are the responsibility of the risk manager, or in the case of monitored risks, the Risk and Intelligence Analysis, Monitoring and Assessment Team. The ANAO reviewed the eleven flag effectiveness reports for risk themes in the ninth version of the Risk Engine but was unable to determine if recommendations had been implemented, as these are generally incorporated in the next version of the risk engine. The ATO advised that all recommendations were carried out prior to Risk Engine 10 being implemented.

### *Improvements to the SME Risk Engine*

**3.39** There has been a risk engine for the SME market since 2004 and the S&ME Business Line is currently running its tenth version.<sup>105</sup> Since initial development, the risk engine and associated processes have undergone considerable change. This includes:

- updates to the information technology that runs the risk engine;
- an increase in risk rules from 27 to 128 in the ninth version;
- updates to the methodologies for calculating risk scores; and
- cross-testing of risk rules against populations between the LB&I and the ME&I Business Lines.

**3.40** Changes to the risk engine are ongoing and, at the time of the audit, the S&ME Business Line was transferring the risk engine into a new application known as the Risk Assessment and Profiling Tool (RAPT). Existing and updated rules and associated methodology were being translated into RAPT. The ATO has advised that RAPT is better able to respond to emerging circumstances as rules can be changed more quickly, and it contains dedicated functions for rules configuration, case selection<sup>106</sup> and risk profiling. RAPT also provides a platform for coordinating and automating existing and future risk assessment tools. This includes the three risk engines run by the S&ME Business Line, and the RDF. Immediate benefits include the ability to run risk rules or risk themes independently, hence improving the ability to test results.

### *Limitations of the ninth risk engine*

**3.41** The transition to RAPT has provided the S&ME Business Line with the opportunity to evaluate the SME Risk Engine methodology more broadly, and to avoid transferring the limitations of version nine to the new platform. These limitations involve the:

- market segmentation of risk scores;
- small business benchmarks;

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<sup>105</sup> Before the S&ME Business Line was established, the earlier versions of the risk engine were run and maintained by the LB&I Business Line.

<sup>106</sup> Case selection is discussed further in Chapter 4.

- Australian and New Zealand Standard Industrial Classification (ANZSIC) codes; and
- incorporation of external data sets.

#### Market segmentation of risk scores

**3.42** Currently only two of the 128 risk rules have thresholds that reflect the four SME market sub-segments. Also, there are only 42 rules that contain a dollar and percentage threshold, which makes the rules applicable to all market sub-segments. This may limit the ability of the risk engine to adequately profile all SME market sub-segments.

#### Small business benchmarks

**3.43** In November 2010, the ATO publicly released small business benchmarks as a method of detecting undeclared cash income by businesses with an annual turnover of up to \$15 million. The benchmarks are a series of key business activity ratios, developed by the Tax Practitioner and Lodgement Strategy Business Line of the ATO, and are directly applicable to the S1 sub-segment, and the lower end of the S2 sub-segment of the SME market (which contain the majority of taxpayers). The risk engine does not use these benchmarks in any indicators, despite containing numerous risk rules which relate to the economic and tax performance of taxpayers.

#### ANZSIC codes

**3.44** The risk engine determines how well a taxpayer is performing economically, within broad industry averages. The ATO uses the industry code (ANZSIC) to categorise taxpayers and calculate average levels of performance. There are quality assurance processes around the accuracy of ANZSIC codes recorded against taxpayers, both initially and on an on-going basis.<sup>107</sup> However, the ANZSIC codes can be subject to error when taxpayers have complex corporate linkages and this could mean that a taxpayer's risk score may not be based on thresholds for the industry in which it operates. Currently, the ATO does not assess the extent or impact of these errors on SME risk engine outputs.

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<sup>107</sup> Errors can arise due to a number of factors including: incorrect recording at the time an entity applied for an ABN or TFN; recording of a tax group as a single ANZSIC, irrespective of whether all the taxpayers within that group operate within the same industry; and changes over time to the industry in which the entity operates.



Incorporation of external data sets

**3.45** The risk engine had only 19 flags or signposts (out of 128) that assessed external data. Outside the risk engine process, all risk managers are conducting, at times, a considerable amount of data matching of ITR and BAS information (the predominant data that the risk engine draws upon) against externally sourced datasets. Examples of other data that could be more consistently incorporated into risk rules are Australian Stock Exchange and ASIC data, which are available on a regular basis. This ‘automation’ has the potential to increase the efficiency of risk assessment processes. It would also potentially improve the consistency of risk engine results and compliance case selection, as the risk score would be based on a wider data set than just ITR.

**ANAO analysis of risk score outcomes**

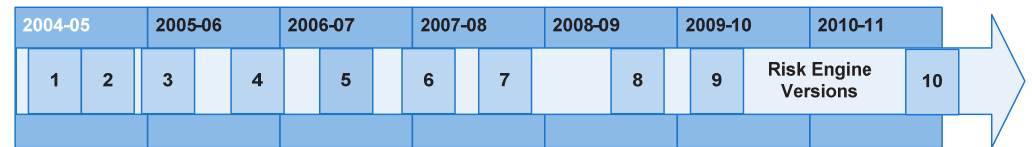
**3.46** The ANAO examined the frequency of running the SME Risk Engine and the compliance outcomes of those cases with the top 100 risk scores.

*Frequency of running the risk engine*

**3.47** The decision to run the SME Risk Engine takes into account the completeness of the necessary internal and external data sets and operational capacity. The outputs of each run are used to contribute to a pool of potential compliance cases. It is possible to run all of the rules, or some of the rules in the risk engine, although the process for individual rules is time consuming. For the period 2004–05 to 2010–11, the entire risk engine (that is all rules) had been run 10 times. Figure 3.3 shows each risk engine version, and when it was run, over that period.

**Figure 3.3**

**Timeline of running the SME market risk engine**



Source: ANAO analysis of ATO data.

**3.48** The ATO advised that the decision not to run the entire risk engine over the 18 months between November 2009 and June 2011 was based on consideration of data completeness, as well as the allocation of resources for the development of the RAPT. Even though the entire risk engine had not been run, particular risk rules were reviewed and updated as necessary and sections

of the risk engine were run using these updates. As a consequence, from November 2009 to June 2011, there was no current information as to whether a taxpayer had a high risk profile against the whole range of risk themes. This may have indicated that the taxpayer should be reviewed comprehensively, rather than on a specific risk. In addition, the datasets accessed by the risk engine are continually updated as taxpayers lodge returns, therefore data relating to them becomes more complete over time. There would be benefits in running the risk engine more regularly, to overcome any bias within a particular run from incomplete datasets.

#### Cases with the top 100 risk scores

**3.49** To assess the effectiveness of the methodology in the risk engine, the ANAO examined the compliance outcome rate for the top 100 risk scores (that is, the highest risk taxpayers as rated by the risk engine from the November 2009 run). Of the 100 SME taxpayers with the highest risk scores, as at 30 June 2011, 55 taxpayers had been selected for compliance action. Of these 55 taxpayers, only 13 (23.6 per cent) were found to have an outcome from the compliance action, meaning that for 42 of these taxpayers there was no evidence of non-compliance. This low success rate would suggest that the methodology used to calculate risk scores has limited effectiveness in identifying taxpayers at risk of non-compliance. The ATO advised that other reasons for the low success rate could include the capability of the active compliance officer to uncover the risk; business decisions to cease activities on a category of cases; and low materiality of the case or the risk itself. While these reasons may have applied to these cases, the ATO was unable to advise whether these circumstances were specific to any of these cases.

**3.50** As previously mentioned, results from flags and signposts cannot be validated if compliance cases are not conducted on that particular indicator. The remaining 45 top risk-scored taxpayers (within the top 100) did not have the accuracy of their score tested, as these potential cases were not subject to compliance action. There would be benefits in the ATO reviewing the risk engine methodology as part of moving to RAPT. Case selection, and the particular issues associated with the 45 high-scoring taxpayers who were not selected for compliance action, is discussed in Chapter 4.

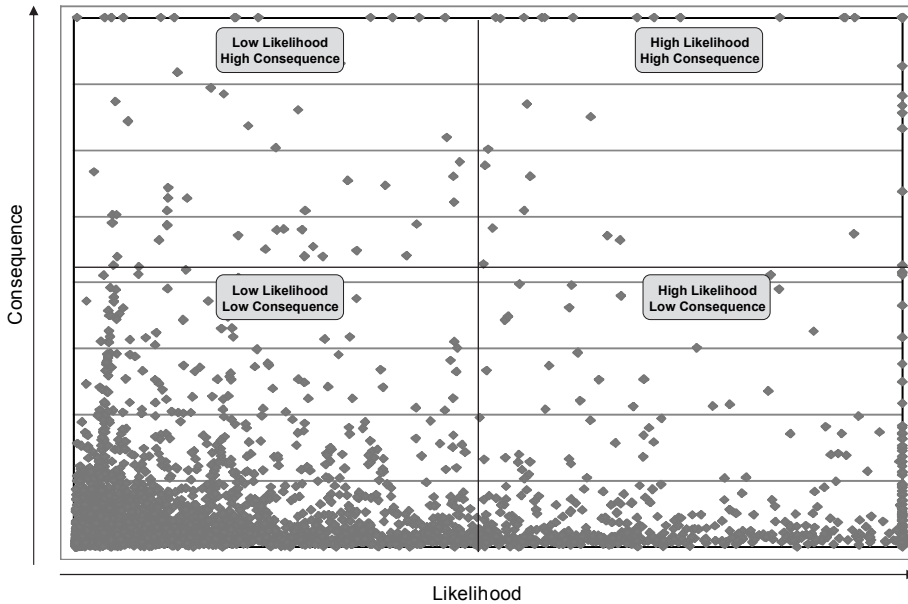
## Risk Differentiation Framework

**3.51** The RDF is a compliance modelling tool. The results give a relative risk profile of a specified population, as opposed to the SME Risk Engine, which

gives an indication of the probability of a compliance risk at the case level. This analysis can be applied to all taxpayers in a selected population, and results are used to assist compliance strategy selection and taxpayer and treatment differentiation. Figure 3.4 gives an example of the output.

**Figure 3.4**

### Output of the Risk Differentiation Framework



Source: Information provided by the ATO.

**3.52** The RDF is implemented as a spreadsheet that maps taxpayers against scores for the consequence and likelihood of risk factors. The RDF risk rates taxpayers across their own sub-segments, and uses a combination of factors that include the taxpayer's risk engine score and ANZSIC code. For example, if the taxpayer's annual turnover range puts them in the S1 sub-segment, then that taxpayer is risk rated against the S1 sub-segment and the ANZSIC code compares taxpayers in the same industry. This analysis has been used to identify clusters of non-compliance within a particular industry type. However, even though the input data is the same as for the SME Risk Engine, some cases identified by the RDF in the high likelihood/high consequence quadrant do not get picked up by the risk engine. The ATO has advised that this provides a useful comparison to judge whether particular rules in the risk engine are performing as they were intended, although this comparison is not

made in the risk engine flag effectiveness reports discussed earlier in this chapter.

**3.53** As the RDF uses essentially the same data as the risk engine, the comments made earlier in this chapter about limitations associated with accuracy of ANZSIC scores also apply to the RDF. In addition, the RDF uses the risk score output of the SME Risk Engine.

## **Conclusion**

**3.54** The two automated risk profiling tools used for the SME market provide a useful means of drawing together a range of factors to identify risks and potential high-risk cases for compliance activities. The move to the new RAPT profiling tool provides the opportunity to review the methodology used for both the SME Risk Engine and the RDF (which uses the risk engine score). It would also mitigate the potential risk of transferring to RAPT the limitations of version nine, such as:

- only 44 of the 128 risk rules differentiate between the SME market sub-sectors (S1, S2, S3 and S4);
- small business benchmarks have not been incorporated;
- ANZSIC codes can be subject to error; and
- the limited incorporation of external data sets results in more manual processes being needed.

**3.55** The risk engine had not been run between November 2009 and the end of fieldwork for this audit (a period of more than 18 months). In this period there were no updates on each taxpayer's risk profile against all risk rules in the risk engine. Running the risk engine on a more regular basis would overcome any bias associated with incomplete data sets. It is also important that the process and criteria currently used to manually weight flag hits before calculating the risk score are documented.

**3.56** The ANAO analysis of the compliance case outcomes for the top 100 risk-scored cases showed a low success rate in identifying non-compliance. Of the 55 taxpayers subject to compliance action, only 13 (23.6 per cent) were found to have an outcome from the compliance action. This suggests that improvements could be made to the effectiveness of the risk engine for predicting potential compliance cases.

## Recommendation No.1

**3.57** To enhance the results of the Small to Medium Enterprises Risk Engine, the ANAO recommends that the ATO:

- (a) improve the frequency of running the risk engine;
- (b) increase the profiling of all market sub-segments and use of data sets other than taxpayer return information; and
- (c) document the process and criteria used to manually weight the results against each risk rule before the final risk score is determined.

### ATO response

Agreed. At the time of the audit, the SME Risk Engine was being converted to a new corporate application, the Risk Assessment and Profiling Tool (RAPT). With RAPT implemented, we can now build further enhancements into our risk assessment process. Specifically:

- the flexibility to run our risk engine as frequently as business requirements dictate; and
- the ability to risk assess and profile any population (turnover-based or other).

We are also developing a governance process around the weighting assigned to particular risk rules, risk themes and overall risk scoring methodologies.

## 4. SME Market Compliance Strategies

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*This chapter outlines the ATO's compliance activities directed towards achieving voluntary compliance in the SME market.*

### Introduction

**4.1** The ATO's Compliance Model (Figure 1.1), is structured around the following four strategies designed to address the underlying cause of taxpayer non-compliance:

- make it easy: the marketing and communications capability provides educational information and services, and stakeholder engagement;
- help to comply: the interpretative assistance capability provides assistance to taxpayers by interpreting taxation laws in the form of public and private guidance, and responding to objections;
- deter by detection: the active compliance capability undertakes campaigns through telephone and letter interactions with taxpayers, reviews and audits; and
- use the full force of the law: the prosecution of significant fraud or serious tax evasion activity.

**4.2** The compliance activities for the SME market are determined following the assessment of compliance risks (as outlined in Chapter 3). Planning for the forward Compliance Program, against the four Compliance Model strategies, is undertaken between February and June each year. This planning process incorporates the:

- RMC's priorities for the new compliance activities to be delivered against risks and populations, and corporate priorities; and
- calculation of liabilities, and cash targets for revenue collections based on prior year performance, incorporating work currently in progress.<sup>108</sup>

**4.3** The forward work program gives targets for the number and types of compliance activities to be delivered by different work areas. It also outlines the number of reviews and audits to be undertaken against priority risks,

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<sup>108</sup> Some compliance products have time spans of more than one financial year, and cases already in progress need to be factored into the forward year planning.

projects and other business line priorities. Planning and reporting is not necessarily delineated for the SME market, but rather is conducted for the business line as a whole.

**4.4** The ANAO examined how the ATO:

- promotes voluntary compliance in the SME market through the marketing and communication capability; and
- treats non-compliance in the SME market through campaigns, reviews and audits undertaken by the active compliance capability.

**4.5** The interpretative assistance capability, and activities undertaken for serious non-compliance were not a focus of this audit. However, the ANAO examined the activities undertaken to give an indication of the coverage of all four compliance strategies for the SME market.

## Marketing and communications capability

**4.6** Educational information and services are aimed at helping taxpayers and their advisors to understand their rights and obligations. This information, which may form part of a broader ATO publication, includes internet-based tools and services, booklets, newsletters, online forums, seminars, speeches by senior ATO staff and consultative forums.

**4.7** The S&ME Business Line has a dedicated marketing and communications section that works with:

- risk managers and population strategists to design and deliver communications strategies and educational information for SME taxpayers<sup>109</sup>; and
- SME taxpayers and industry groups to better understand reasons for non-compliance and tailor information to make it easier for taxpayers to comply.

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<sup>109</sup> Communications strategies can be tailored to specific sub-populations of taxpayers, such as the building and construction industry or tax agents. Educational information can include brochures or online information on how to calculate specific taxes or instructions to assist with the submission of tax returns.

## Educational information and services

4.8 There is little educational information specific to the SME market. Information on particular taxes and business requirements overlap with other market segments, such as micro and large businesses. The S&ME Business Line marketing and communications area contribute to ATO-wide publications, and the ATO advised that there were a total of 992 educational publications applicable to SME taxpayers. The ATO website has a generic ‘businesses’ page<sup>110</sup> that covers topics rather than markets, and three links from this page specifically mention the SME market:

- Compliance Issues: gives the Compliance Program breakdown for the SME market;
- Community Consultation: lists forums relevant to the SME market; and
- News and Seminars: gives a link to the *SME Communicator*, a monthly SME market-specific online newsletter.

4.9 The ATO website also has a ‘business portal’ that businesses register to use, and for tax agents and accountants there is a ‘tax agent portal’ and ‘BAS agent portal’. These sites allow users to view activity statements and lodge returns electronically. In addition, the ATO hosts a business tax enquiries line that provides advice to businesses for all market segments.<sup>111</sup>

## Stakeholder engagement

4.10 The ATO engages with taxpayers, industry groups and tax practitioners, including holding forums tailored to the SME market. The terms of reference for and the minutes from these forums are publicly available on the ATO website.<sup>112</sup> ATO forums for tax practitioners and the financial services industry representatives of relevance to the SME market are the ATO Tax Practitioner Forum (ATPF), SME Working Group of ATPF, Regional Tax Practitioner Working Groups of the ATPF and the Financial Services Industry Partnership. In addition, there is the online SME Tax Forum (SME Tax Forum) that engages with SME taxpayers online, via social media tools. Out of

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<sup>110</sup> [www.ato.gov.au/businesses/](http://www.ato.gov.au/businesses/)

<sup>111</sup> Business tax telephone enquiries line—13 28 66.

<sup>112</sup> ATO website, [www.ato.gov.au/community\\_consultation/about\\_consultation/overview](http://www.ato.gov.au/community_consultation/about_consultation/overview), updated 2 February 2010.



approximately 175 000 total SME taxpayers, only around 500 SME participate in the online forum.<sup>113</sup> Information is also published in a monthly online newsletter called the *SME Communicator*, which can be accessed on the ATO website<sup>114</sup>, or by subscription. The SME Tax Forum hosts online live chats with senior ATO staff on topical taxation issues, question and answer discussion boards and live ‘webinars’—online seminars—on topics suggested by members. The ATO also conducts regular surveys and market research of taxpayers and tax agents (discussed in Chapter 5).

## Conclusion

**4.11** The ATO’s marketing and communication activities are designed to raise awareness and educate taxpayers about their taxation obligations. It uses a range of methods to educate and communicate with SME taxpayers, but most of these methods fall across markets, rather than being specific to the SME market. As the majority of SME taxpayers are businesses who use tax agents, the ATO also has activities that engage with this demographic.

## Active compliance

**4.12** To assess whether active compliance strategies were appropriate in targeting non-compliance in the SME market, the ANAO reviewed the ATO’s:

- use of a campaign team for taxpayer engagement activities;
- selection and management of reviews and audits; and
- quality assurance processes for reviews and audits.

## Campaign team

**4.13** In July 2009, the S&ME Business Line implemented an ongoing ‘Campaign Team’, to undertake a program of tailored telephone and letter verification activities, as directed by risk managers and population strategists. A major premise of campaigns is to let taxpayers know that the ATO is aware of discrepancies or changes in their tax returns and is taking an interest in their

<sup>113</sup> This low take-up rate could be attributable to the fact that most (approximately 90 per cent) SME taxpayers use tax agents.

<sup>114</sup> [www.ato.gov.au/smecommunicator](http://www.ato.gov.au/smecommunicator).

tax affairs. This interaction, while brief, may lead taxpayers to be more compliant with their tax affairs in the future. As such, campaigns involve:

- specific compliance education, intelligence gathering or early intervention; and
- targeting a specific topic to verify a likely discrepancy or follow-up on non-compliance identified during other campaigns.

**4.14** The team’s forward year work plan is developed during the business line’s February to June planning cycle, in collaboration with risk managers and population strategists. The RMC decides the priority afforded to campaigns, and the resources that will be directed towards them. Table 4.1 summarises the results for the campaign team for the period 2009–10 and 2010–11. These figures are for the S&ME Business Line as a whole (inclusive of the SME market).

**Table 4.1**

**Campaign team performance 2009–10 and 2010–11**

	Planned campaigns	Actual Campaigns	Planned interactions	Actual Interactions	Liabilities raised (\$m)
2009–10	36	23	6894	12 224	5.1
2010–11	43	26	12 100	15 627	16.7

Source: Information provided by the ATO.

**4.15** Planning for 2009–10 underestimated the number of interactions able to be delivered, as the campaign approach was new, and the team more than doubled the number of interactions undertaken. In terms of the scope of this audit, in 2010–11, the team delivered targeted interactions for all priority risks as well as the S1 population.

**4.16** The campaign approach has been successful. For example, between August and September 2010 the Campaign Team contacted 430 taxpayers by telephone to address the outstanding lodgements of FBT schedules. As a result, 56 per cent of these taxpayers agreed to lodge, which justifies the team’s focus on assisting taxpayers to understand their obligations and promoting self-correction. In addition, 23 per cent of taxpayers were found to have already lodged their returns, but due to a systems error their schedule was not visible in the ATO’s systems. This interaction identified the systems error, which was subsequently addressed.

## Reviews and audits

**4.17** Compliance reviews and audits are typically undertaken to target specific risks or non-compliance by taxpayers. Reviews provide the ATO with an opportunity to assess the risk concerning individual taxpayers, and may or may not involve contact with the taxpayer. Issues detected through a review may be escalated to an audit. Audits are more intrusive and resource-intensive examinations of the affairs of a taxpayer. Audits can be ‘desktop’, where the ATO contacts the taxpayer via correspondence or telephone to clarify aspects of transactions and to request further documentation. Field audits may also be conducted, where evidence is collected from the premises of the taxpayer.

**4.18** The ANAO assessed the ATO’s systems and processes for selecting and managing reviews and audits.

### *Case selection methodology*

**4.19** At the time of the audit, review and audit cases were selected by:

- regional compliance teams from the pool of potential compliance cases produced by the SME Risk Engine;
- risk managers and population strategists, from both the risk engine, data matching analysis, and referrals; and
- the Case Management Unit from internal ATO referrals.

### *Regional compliance teams*

**4.20** As discussed in Chapter 3, an outcome of running the SME Risk Engine is a ‘pool’ of taxpayers selected for potential non-compliance who have been allocated a risk score. Review and audit cases can be selected directly from this risk engine pool. These cases are recorded as ‘risk pool’ cases in the Client Contact—Work Management—Case Management (CWC) system (discussed later in this chapter). At any one time, the risk engine pool provides a large number of potential cases (approximately 9 000 for SME Risk Engine nine). Cases were selected by a compliance officer, generally a team leader, for the individual team or region that needed a new compliance case.

**4.21** A purpose built database called *iPAT* allowed users to view risk engine pool cases, segregated by ATO regions. Officers then searched on basic information, such as risk score, market sub-segment, type of industry and the identified risk. Team leaders could request further information on the case to assist with their selection. The ATO advised that cases were chosen for a variety of reasons, which may have included:

- the skill level of a particular compliance officer, with less complex cases chosen for inexperienced staff members;
- staff expertise in particular topics; and
- intelligence known about a particular taxpayer.

**4.22** There were a number of limitations with this process. For example:

- while the *iPAT* provided an interface for case selection, there was no directive given to staff that cases with higher risk priorities were to be considered; and
- as case selection was undertaken on a regional basis, there was no administrative check by the business line at the national level to ensure that priority cases were being considered for selection.

**4.23** Conducting reviews and audits on risk engine cases is important for the ongoing development of the risk engine. It provides confirmation that the risks identified by the engine resulted in actual non-compliance (or not), and this information is fed back through the risk flag effectiveness reports (as discussed in Chapter 3). As mentioned previously, some risk flag effectiveness reports recommended that risk managers actively encourage compliance staff to take risk engine pool cases related to their specific risk area, to allow the validity of the risk rules to be checked. These cases may or may not be a high-priority risk.<sup>115</sup>

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<sup>115</sup> As mentioned in Chapter 3, the onus is on the risk manager to follow up on the recommendations given in the risk flag effectiveness reports.

## Selections from risk managers and population strategists

**4.24** The case selection methodology adopted by risk managers and population strategists can vary depending on the risk or population, current status of their analysis and whether the SME Risk Engine, the RDF and/or data matching provide useful indicators of non-compliance. There is one fundamental difference between cases selected by risk managers and population strategists—the extent to which they use risk rules:

- the business line's priority risks generally have risk rules<sup>116</sup> in the risk engine. Most risk managers use the risk engine to some degree for case selection; and
- populations have no rules in the risk engine, as all priority risks apply to that population. Population strategists primarily use the RDF<sup>117</sup> to support case selection.

**4.25** The approach to case selection by risk managers varies according to the risk, and is also influenced by the availability of skilled staff to conduct the reviews or audits. There were four different methods of case selection identified during the audit:

- cases selected either by the risk manager, or by a specialist compliance team associated with a particular risk, from the risk engine pool and/or data matching analysis.<sup>118</sup> Data matching is used to filter the initial risk engine pool down to a smaller case pool, and cases are then allocated to compliance officers for action. These cases are not recorded as 'risk pool' cases. They are tracked under their separate risk project labels, for example 'FBT', or 'Trusts';
- using the RDF to identify sub-groups of taxpayers that may be exhibiting the same characteristics. Risk managers and population strategists both use these groupings to support the targeting of

<sup>116</sup> A risk rule provides an indicator of non-compliance with a risk.

<sup>117</sup> The RDF provides a relative risk profile of a specified population, as opposed to the results from the SME Risk Engine, which give an indication of the probability of a compliance risk at a case level.

<sup>118</sup> For example, the International risk has specialist compliance teams because it deals with complex legislation and issues such as foreign residents, tax havens, transfer pricing and thin capitalisation.

compliance cases for particular issues, for example, businesses that had not lodged CGT returns after the sale of commercial property;

- data matching analysis of information available in the ATO's Enterprise Data Warehouse, such as comparing Income Tax Returns with ASIC and AUSTRAC data; and
- referrals. At least one risk, the Phoenix risk, is difficult to detect from standard available data sources. The Phoenix risk manager selects most compliance cases from referrals received from other business lines or from members of the public.

#### Referrals

**4.26** Key sources of referrals received by the S&ME Business Line are:

- the ATO's Tax Evasion Referral Centre (TERC), that manages referrals received from members of the public;
- the Referral Database, located on an ATO-wide intelligence intranet site (*ATOintelligence*). This database is used by staff from other business lines, who make a referral by completing an online form;
- direct from other business lines;
- as part of information exchanges with overseas tax authorities; and
- a dedicated referrals in-box—for example, for the Phoenix risk.

**4.27** Referrals are not a common method of case selection for active compliance. In 2010–11 they comprised only four per cent of cases. However, the selection of these cases lacked transparency. Most referrals were received by the Case Management Unit, and this unit assessed the referrals for allocation and monitored their progress. There were no specific guidelines or criteria for assessing referrals and they were not assessed against the priorities for risk and populations decided by the RMC.

#### *ANAO analysis of high-risk cases*

**4.28** As previously noted in Chapter 3, the ANAO analysed the compliance actions for the highest 100 risk score cases from the risk engine (version nine). This risk engine pool has been available for selection since November 2009. Of these cases, as of 30 June 2011, 55 had been subject to compliance action, but for the remaining 45 there was no compliance action. Of the 45 cases, 14 had also been identified by the previous three versions of the risk engine (SME Risk Engines 6, 7 and 8 run in July 2007, July 2008 and February 2009 respectively).

Three cases had been identified in all nine versions of the SME Risk Engine (from 2004 to 2009).<sup>119</sup>

**4.29** These results indicate that the S&ME Business Line is not selecting those cases with the highest risk scores. The ATO advised that the risk score is only an indicator of risk and is not intended as a priority list for individual case selection. The ATO also advised that there could be a number of reasons why these 45 cases were not selected, including prioritisation of other topics, and lack of suitably experienced officers to undertake the case. While these circumstances may have applied to these cases, the reasons for not considering these cases for action were not documented by the ATO.

**4.30** The business line invests considerable resources in maintaining, analysing and running the risk engine to identify potential compliance cases but there is no overall analysis of the effectiveness of the risk engine. The risk engine is only one of the methods used to identify potential compliance cases, and testing of the rules within the risk engine is reliant on the outcomes from completed compliance cases. The six-monthly *Risk Flag Effectiveness Reports* provide a feedback loop. However, this feedback loop is incomplete if compliance cases have not been conducted. This is illustrated by the remaining 45 top risk-scored taxpayers (within the top 100), because the accuracy of their score could not be tested as those potential cases were not subject to compliance action.

**4.31** The lack of a national case selection process could also lead to taxpayers being subject to multiple compliance actions. For the period 1 July 2007 to 30 June 2010, the ANAO found 29 examples out of 6783 cases that appeared to be duplicate cases being conducted on the same taxpayer within an overlapping period.<sup>120</sup> The ATO advised that:

- thirteen were escalations to another active compliance case type, and that there was a time delay between closing the first case and working on the next case due to staff not being available;
- one was a duplication detected before the taxpayer was contacted; and

<sup>119</sup> Cases identified as having been in the risk engine pool in previous years may not have had a high risk score in those previous years.

<sup>120</sup> The period ranges from two days to 11 months.

- fifteen involved unrelated risks, and there is the potential that some of these taxpayers were contacted more than once about different issues within an 11 month period. The number of these instances is not statistically significant —0.2 per cent of the total review and audit cases conducted during the three financial years from 2007–08 to 2009–10.

#### *Planned and completed review and audit cases*

**4.32** The active compliance forward work plan specifies the number of cases that must be actioned annually, against the risk engine pool, priority risks, populations and other projects. Table 4.2 outlines the number of cases planned to be selected from the risk engine pool, the number of actual selected cases, and the number of completed cases for the period 2008–09 to 2010–11. The ATO advised that the reason for the decline in numbers in 2010–11 is because of the decision to reduce the number of risk pool cases and redirect compliance resources to the S4 sub-segment and Wealthy Australians projects, as part of the shift to a private wealth approach by the business line.

**Table 4.2**

#### **Planned versus selected ‘risk pool’ cases for the period 2008–09 to 2010–11**

	2008-09	2009-10	2010-11
Cases planned to be selected from the risk pool	760	804	170
Actual cases selected from risk pool	633	559	229
Completed risk pool cases	566	526	204

Source: Information provided by the ATO.

Note: Figures for numbers selected and numbers completed do not align as cases can take more than 12 months to complete. The completed figures include cases selected before that financial year.



**4.33** Table 4.3 summarises the number of reviews and audits planned and completed for each priority risk for the period 2008–09 to 2010–11.

**Table 4.3**

**Planned versus completed compliance cases for priority risks for the period 2008–09 to 2010–11**

Priority risk	Number of review and audit cases					
	2008–09		2009–10		2010–11	
	Planned	Actual	Planned	Actual	Planned	Actual
Phoenix	90	124	161	139	137	133
Division 7A	n/a	n/a	n/a	n/a	35	55
Lodgement	100	76	n/a	29	n/a	8
International	565	509	354	206	381	334
Exit Strategies	n/a	n/a	560	411	176	82
Capital Gains Tax	242	271	238	122	157	172
Fringe Benefits Tax	50	162	60	156	70	56
Trusts	12	16	193	181	79	91

Source: ATO active compliance forward work plans for 2008–09 to 2010–11, and closed case reporting. Actual figures for the Lodgement project risk in 2009–10 and 2010–11 are referrals.

Note: The figures for completed cases varies from the planned figures due to reallocation of resources to target emerging priorities, or due to cases taking more or less time than anticipated. The completed case figures also include cases which were started in years prior to the financial year in which they were reported.

**4.34** For total audits and reviews (inclusive of ‘risk pool’ cases), Table 4.4 outlines the number completed for the SME market for the period 2008–09 to 2010–11 and the taxation liabilities, losses adjusted, notional tax and actual tax raised from these.

**Table 4.4****Liabilities, losses adjusted and notional tax from reviews and audits in the SME market for the period 2008–09 to 2010–11**

Year	Reviews	Audits	Liabilities raised (\$m)	Losses adjusted (\$m)	Notional tax (\$m)	Actual tax collected
2008—09	2627	200	253.8	524.0	174.6	<b>130.4</b>
2009—10	1705	215	298.0	322.8	107.6	<b>102.4</b>
2010—11	1183	127	299.2	375.6	119.7	<b>80.8</b>

Source: Information provided by the ATO.

**4.35** The business line completes reviews and audits against its forward work plans, and tracks and reports against the number of planned and finalised cases, and the resulting revenue.

*Ongoing review of case selection*

**4.36** In January 2011, the S&ME Business Line introduced a new approach to case selection and case profiling, known as ‘Front End Operations’. The approach was being transitioned during 2011 to coincide with the new Risk Assessment and Profiling Tool (RAPT), discussed in Chapter 3, being used to run the SME Risk Engine in June 2011. This audit has not assessed the effectiveness of this new approach.

**4.37** The role of Front End Operations is to coordinate a national case selection process for the S&ME Business Line. This process incorporates:

- identifying potential cases from all sources (RAPT, risk managers, population strategists and referrals), compiling information about risk scores from RAPT, RDF results and intelligence sources, and mapping cross-overs between risks and population strategies;
- National Case Selection Panels consisting of senior expert staff who make national case selection and treatment decisions based on considerations such as risk and business line priorities;
- the Information Collection Team, responsible for generating profiles of taxpayers, and standardising the information required for an audit or review before a case formally begins; and

- the Case Management Unit, using RAPT's candidate selection functionality to upload cases into CWC for compliance action, or recording the reasons for a case not being selected.<sup>121</sup>

## Conclusion

**4.38** The S&ME Business Line's active compliance activities are directed towards those taxpayers unwilling to comply, by using the 'deter by detection' strategy. The Campaign Team is a new operational method of taxpayer engagement, providing letter and telephone interactions with taxpayers. The targeting of these interactions is directed by risk managers and population strategists, and topics covered directly align to the business line's priority risks and populations. More intensive investigation of potential non-compliance is undertaken, through reviews and audits.

**4.39** There were limitations associated with the methods for selecting reviews and audits at the time of this audit. As a consequence, the business line had no assurance that it was targeting its highest priority cases. In particular, the lack of documented procedures for case selection and no national oversight meant that regional offices were not necessarily considering cases with the highest risk priority. The ATO's new Front End Operations approach has the potential to address the issues identified in the previous methods of case selection, including: a lack of guidance for selecting cases; no national oversight of case selection; not documenting the reasons why cases were not selected; and no follow-up of high risk cases not being considered for action.

**4.40** Compliance cases also contribute to the validation of rules in the risk engine, and if these cases are not selected this feedback loop is incomplete. The ATO can use rules validated in this way to inform potential case selection. There is an opportunity for the ATO to establish a process to validate the risk rules which are not tested through compliance action. This would increase the use of the risk engine's results, by providing greater confidence about individual risk rules, and subsequently providing useful intelligence to support identification of emerging risks.

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<sup>121</sup> RAPT's candidate selection functionality replaced the iPAT database on 30 June 2011.

## Recommendation No.2

**4.41** To support the identification of emerging priority risks, the ANAO recommends that the ATO periodically confirm the validity of all risk rules within the Small to Medium Enterprises Risk Engine.

### ATO response

Agreed. We agree that all viable methods of validating risk rules should be utilised to support the accurate identification, monitoring and prioritisation of risks.

### Case management of reviews and audits

**4.42** The S&ME Business Line uses the CWC system to record active compliance activities and to manage client relationships and taxpayer work items.<sup>122</sup> The CWC is an ATO enterprise system, and as such there are whole-of-ATO business processes and procedures for the management of active compliance cases, as well as reporting functionality for the management of the active compliance capability.<sup>123</sup> Active compliance officers have access to, and are provided with, a broad range of training and support material. These include training and guidance material for each step in the active compliance case<sup>124</sup>; broad support on the methodology for undertaking active compliance cases; as well as online training modules.<sup>125</sup> Active compliance officers also have access to support from specialist technical officers, team leaders and supervisors, as well as the interpretative assistance capability for further specialist input on complex technical issues.

**4.43** For the SME market, the business line delineates reviews and audits into four active compliance case types: internal risk reviews; preliminary risk reviews; comprehensive risk reviews; and audits. Appendix 4 describes these in more detail and the expected completion time (known as the cycle time). There are documented procedures to support each of these case types.

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<sup>122</sup> Taxpayer work items include change of address details and client enquiries.

<sup>123</sup> These include procedures for active compliance case products with hyperlinks to instructions for staff, guidance, policy and legislation references.

<sup>124</sup> Active compliance officers have access to help and support material contained on the ATO intranet that is linked to each product activity.

<sup>125</sup> ATO *i-learn* modules on active compliance case management.

Following the completion of the review or audit, case officers record decisions in CWC, select the relevant case outcome and, in all but the Internal Risk Review, present the findings to the taxpayer. There are three outcomes available to case officers in the CWC (outlined in Table 4.5).

**Table 4.5**

**Active compliance case outcomes and their application**

Possible outcomes	Examples of outcome application
Early Exit	Used if the case did not commence for a valid and approved reason. For example, the risk was not substantiated during preliminary case profiling (before the taxpayer was contacted), or a different case was allocated to the compliance officer due to a change in priority.
Nil Outcome	Where the case was either escalated for further action on the taxpayer, or if no further action is proposed on the taxpayer.
Outcome	Where the case officer has determined there will be a financial result, voluntary disclosure or a lodgement as a result of the case.

Source: Information provided by the ATO.

**4.44** There is an ATO client service standard applicable to audits and reviews where there is also contact with the taxpayer, called the case finalisation service standard. The ATO aims to notify taxpayers of the outcome of the case within seven days of making the decision.<sup>126</sup> The ATO's benchmark for performance against this standard is 99 per cent.

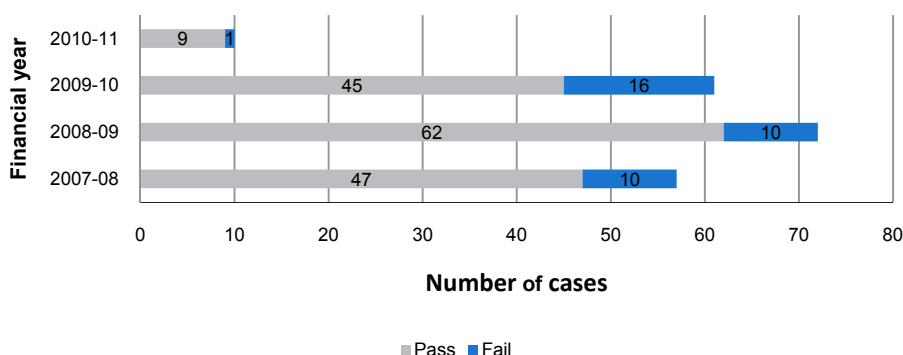
***ANAO analysis of compliance cases***

**4.45** The ANAO examined a sample of 100 reviews and 100 audits of taxpayers in the SME market. These cases covered the period from 1 July 2007 to 30 April 2011 and were selected to represent all four market sub-segments and the three possible case outcomes. The cases were tested against six key ATO administrative guidelines. These are significant in CWC case conduct as they involve documentation of: taxpayer's profile; potential risks; approach to the case (case plan); outcomes of investigations; reasons for decisions; and appropriate management signoff. The results of all 200 cases (reviews and audits) against the six tests are shown in Figure 4.1. The majority of cases (163 out of 200 cases) passed the six tests. This represented 91 per cent of reviews but only 72 per cent of audits.

<sup>126</sup> ATO, *Current Year Service Standards*, <[http://www.ato.gov.au/corporate/content.aspx?menuid=0&doc=/content/25940.htm&page=2#P21\\_949](http://www.ato.gov.au/corporate/content.aspx?menuid=0&doc=/content/25940.htm&page=2#P21_949)> [Accessed 8 July 2011].

**Figure 4.1**

**Number of total cases consistent with all six tests**



Source: ANAO analysis of ATO case data.

**4.46** Of the cases that failed, the following reasons were noted:

- insufficient documentation attached in CWC to support the case. There were 21 cases lacking taxpayer profile documentation, four cases lacking case plans, and six cases lacking decision explanations<sup>127</sup>;
- two cases where documents were attached in CWC but, due to a system malfunction, were unable to be opened;
- two cases where there was no evidence of management signoff of case conduct. In one of these cases, a correspondence review, the 'E24'<sup>128</sup> decision was approved by the officer who conducted the case; and
- 12 cases where essential steps were not completed in CWC because the cases were already in progress when CWC was initiated. The ATO advised that staff were instructed to maintain the hard copy case files and continue new work in CWC.

<sup>127</sup> These documents may have been held in hard copy files, although this was not recorded in CWC. Hard copy files were not assessed by the ANAO as these are stored by the region that conducted the cases.

<sup>128</sup> 'E24' signoff is the final signoff of decisions relating to a case, performed by a team leader. The S&ME Business Line guide to comprehensive audit states that the compliance officer should not proceed until this step has been completed, as the next step in the process is to send a case finalisation letter to the taxpayer. A letter is sent for all review and audit product types, except for internal risk reviews (as the taxpayer is not contacted by the ATO).

## Recording case outcomes

**4.47** Of the 200 cases reviewed by the ANAO there were six instances where the incorrect outcome was recorded against a case (as assessed against information in Table 4.5). This sample size cannot be used to form a view on the statistical significance of this error, but does indicate that the error may be present more widely. It could result in inaccurate reporting and data integrity issues as case outcomes are used by the business line:

- in a number of internal reports;
- to determine escalation rates and success rates for cases; and
- to determine the effectiveness of its risk assessment methodology, such as cases selected from the risk engine.

**4.48** The S&ME Business Line advised that it was aware that case outcomes were not being properly recorded in the CWC and, in May 2010, issued advice to staff reminding them of the correct procedures. Case outcomes are also verified and corrected if necessary by the business line's Active Compliance Planning and Reporting Team. The ATO advised that the number of case outcomes needing correction has reduced from 108 in 2009–10 to 38 in 2010–11.

## Case finalisation service standard

**4.49** The ANAO reviewed results against the case finalisation service standard. Performance against the standard is assessed by comparing two dates of management signoff, the 'E24' (team leader's approval of case decisions) and 'E25' (the final procedural sign-off of the case). The reported S&ME Business Line performance (inclusive of SME market cases) was:

- 96 per cent in 2008–09, but the ATO reported that in most cases the taxpayer was sent a letter within the seven-day period. However, case officers were not updating the action in CWC;
- 99.4 per cent in 2009–10, but the ATO advised that its figures had to be adjusted to account for 32 instances where the CWC steps were not completed within the seven days; and
- 99.5 per cent in 2010–11. Out of the 2969 cases closed only 14 cases failed to achieve the standard.

**4.50** The ATO advised that the procedural failures in completing CWC were being rectified. In May 2010, S&ME Business Line Active Compliance Planning and Reporting Team began daily monitoring of the progress of cases that had

reached the E24 stage, and emails are sent to staff reminding them of the procedures until they are finalised.

### *Complaints against active compliance*

**4.51** The ATO has a complaints management system, and for 1 July 2010 to 30 June 2011 total complaints for the S&ME Business Line active compliance capability were only 0.18 per cent of all complaints received by the ATO. The number of complaints appears comparatively small in comparison with the number of cases completed (outlined in Table 4.6). Complaints ranged from audit conduct, inappropriate conduct of ATO staff, information requests and requests for additional response time.

**Table 4.6**

### **Complaints against active compliance capability in the SME market**

	Number of Reviews and audits	Number of complaints	Percentage
2008–09	2827	25	0.9
2009–10	1920	21	1.1
2010–11	1310	15	1.1

Source: Information provided by the ATO.

### **Quality assurance**

**4.52** There are two separate quality assurance processes undertaken by the S&ME Business Line on review and audit cases completed in CWC:

- the business line's internal Quality Assurance Review (QAR); and
- the ATO-wide Integrated Quality Framework (IQF).

**4.53** The CWC was rolled out to S&ME Business Line active compliance staff in July 2006. In March 2007, in acknowledgment that staff lacked the practical training to enable them to undertake casework using CWC, the business line instigated an internal quality assurance process. The purpose of the QAR is to identify: whether components of a case have been completed; where improvement is required; and what can be done to improve processes.



**4.54** On 1 June 2009, the IQF was applied to active compliance cases undertaken by the S&ME Business Line.<sup>129</sup> IQF assessment on closed cases is mandatory for the business line, and results are reported corporately. Open case assessment is at the discretion of the business line, and is not corporately reported. The focus of IQF is to facilitate the consistency and correctness of administrative decisions made by staff. The IQF also identifies opportunities for improvement.

**4.55** The two quality assurance systems have some key differences, but also similarities in the way they are conducted, and the case management issues that they assess. Key differences are:

- sampling methodology—the QAR is a six-monthly random sample of one case from each compliance team that has finalised a case in the preceding quarter. The IQF uses a corporate sampling methodology;
- sample coverage—the QAR samples from all types of compliance cases conducted by the business line.<sup>130</sup> The IQF only samples from comprehensive and specific reviews, and comprehensive and specific audits.<sup>131</sup>
- sample size—from 1 July 2009 to 30 June 2011, the QAR sample was 3.8 per cent of reviews and 5.5 per cent of audits. For the same period the IQF closed case sampling was 3.2 per cent of reviews and 11.6 per cent of audits. Cases can be sampled by both systems;
- assessment measures—the QAR assesses 94 administrative functions in CWC, but not the decision-making process for the case. The IQF assesses some administrative functions in CWC and the decision-making process for the case. IQF assessment involves nine

<sup>129</sup> The IQF is also applied to interpretative assistance activities, but these were not a focus of this audit.

<sup>130</sup> These include a number of other compliance case types (some of which do not involve taxpayer contact), such as: comprehensive audits; specific audits; preliminary risk reviews; risk assessments; comprehensive reviews; comprehensive risk reviews; internal reviews; specific correspondence reviews; voluntary disclosures; specific enquiries; and preliminary risk assessments.

<sup>131</sup> 'Comprehensive' and 'specific' describe sub-types of cases. For example, a comprehensive audit is a full investigation of the taxpayer's taxation affairs. A specific audit investigates a specific taxation issue.

quality measures, five assessment grades and two risk-based quality ratings<sup>132</sup>;

- benchmarks—the QAR has an 85 per cent benchmark while the IQF has no benchmark, but cases can fail the assessment; and
- trends in results—QAR trends are monitored for the most common case deficiencies. High-level IQF trends, such as fail rating, are monitored by the business line, but common case deficiencies are difficult for the business line to monitor due to the large number of assessment points.

**4.56** The similarities of the two systems extend to the benefits the ATO considers they produce. The ATO advised that the QAR provides benefits in staff training. Compliance officers and team leaders are given direct feedback if one of their cases has been reviewed, and staff rotate through the role of QAR assessor, making them a training resource. The QAR gives the business line the ability to identify training needs and, as each team's work is sampled, the business line is also able to identify localised problems such as training deficiencies. A primary function of the IQF framework is to identify training to enhance the development of technical and organisational capacity in the area of active compliance.

### *QAR results*

**4.57** The business line monitors result trends at six-monthly intervals. Since implementation, average results from QAR (represented in Figure 4.2) showed rapid initial improvement in both the 'whole of case' and 'critical' elements.<sup>133</sup> Results have levelled out since September 2008, but have exceeded the 85 per cent benchmark set by the business line. Since June 2009, the most consistent error was that case finalisation reports were not completed appropriately (these document the decisions and outcomes from the case). This reduced from 54 per cent of cases in June 2009, to 23 per cent in

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<sup>132</sup> The quality measures are: integrity; transparency; consistency; administrative soundness; timeliness; effectiveness; efficiency; correctness; and appropriateness to taxpayers' requirements and circumstances. The assessment grades are: very high; high; meets standards; aligned; and not aligned. The quality ratings are: critical and important.

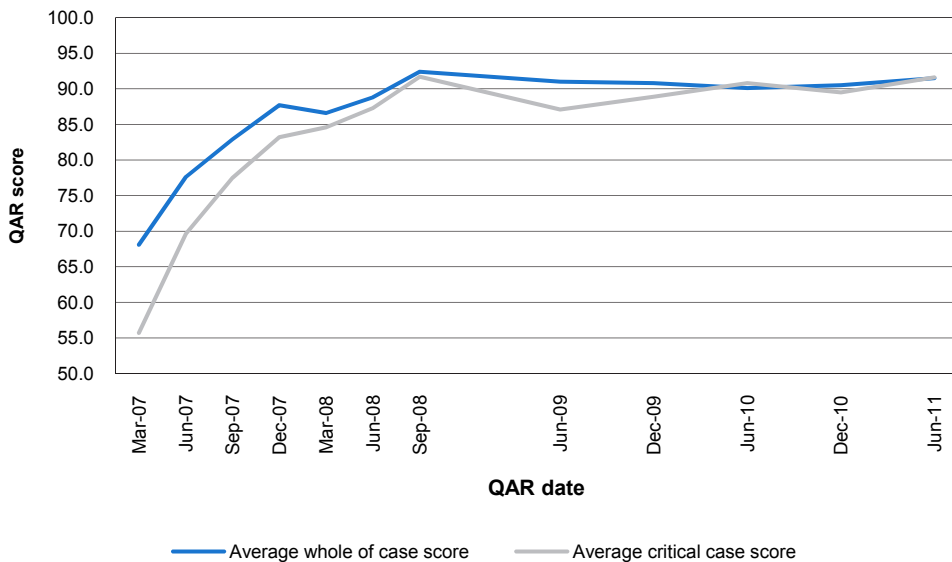
<sup>133</sup> Whole-of-case assessment is conducted against 94 administrative processes in CWC, including completing certain data fields, supplying adequate description and recording the details of hard copy files. Critical assessment points are a sub-set of 40 of the 94 assessment points, and include actions that relate to documenting taxpayer contact, decisions and team leader approvals.

December 2010, to 14 per cent in June 2011. Improvements are attributed to the conduct of staff workshops and staff communications addressing this issue.

**4.58** QAR sampling is not intended to be statistically valid, as it samples a closed case from each team for the preceding three months. However, the ANAO has estimated the number of deficient case finalisation reports for June 2011 at up to 295 individual cases.<sup>134</sup>

**Figure 4.2**

### Results of Quality Assurance Review



Source: ANAO interpretation of ATO data.

Note: Assessment points changed between the June 2010 and December 2010 QAR, so the December results cannot be directly compared to previous results.

### *IQF closed case results*

**4.59** For closed cases from April 2010 to March 2011, IQF reports identified a number of inconsistent practices in documenting cases in CWC across the nine quality measures, although the majority of the cases examined met the required quality standards. For this period, the business line reported that three per cent of audits and eight per cent of reviews failed the required

<sup>134</sup> An estimate of 14 per cent based on a sample of 79 from a population of approximately 1917 gives a 95 per cent confidence interval of '12.6 to 15.4 per cent'.

quality standards.<sup>135</sup> The estimated failure rate for audits is up to 3.5 per cent, and for reviews is up to 9.5 per cent at the 95 per cent confidence level.<sup>136</sup> The inconsistencies particularly related to information not being entered or attached into the CWC. Findings included:

- insufficient records to reflect taxpayer contact;
- documents submitted by a taxpayer and other relevant evidence were not attached in the CWC or the hard copy file; and
- the final version of a taxpayer profile report, an audit work plan, and a case report were not attached.

**4.60** The business line also conducts discretionary open case IQF assessments, which allow correction of errors before a case is closed. Since 1 June 2009, there have been an additional 83 audits and 152 reviews assessed.

**4.61** Both the QAR and the IQF assess some similar administrative points in CWC, and, as both are random samples, one case can be assessed by both systems. Their intent is also similar, although the IQF feeds into a corporate quality assurance process of both administrative case conduct and case decision-making. The combination of QAR and IQF (both open and closed case sampling), introduces the potential for duplication of quality assurance sampling effort. More generally, there is considerable similarity in the purposes, results and benefits of the IQF and QAR systems. Within the S&ME Business Line, there would be benefit in reviewing the internal QAR and the number of IQF discretionary closed case assessments to reduce potential duplication, align the two systems and further target quality assurance activity.

### *Continuous improvement*

**4.62** The QAR and the IQF process identify potential improvements, largely through workshopping deficiencies with active compliance staff. Improvements are entered onto the business line's *Opportunity for Improvement Register*, or are escalated to the corporate register as appropriate. The first

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<sup>135</sup> A case fails if at least one 'not aligned' rating is given to one of the nine quality measures.

<sup>136</sup> An estimate of 3 per cent for audits, based on a sample of 37 from a population of 324 gives a 95 per cent confidence interval of '2.55 to 3.45'. An estimate of 8 per cent for reviews, based on a sample of 28 from a population of 870 gives a 95 per cent confidence interval of '6.42 to 9.48'.

workshop held to identify improvement activities was in September 2009. These continuous improvement activities include:

- assigning a dedicated staff member responsible for maintenance of policy, procedural and template documentation;
- improving guidelines for staff on specific topics and case types; and
- reviewing, updating or developing practical training packages, and improving accessibility of intranet information.

**4.63** It is only since February 2011 that items from these workshops have begun to be implemented. The ATO advised that the delay in completing continuous improvement activities was because of a lack of resources assigned to these tasks. From 1 July 2011 the business line increased staffing in this area.

## Conclusion

**4.64** There were inconsistencies in the management and recording of review and audit cases in CWC for the cases sampled by the ANAO. The ANAO's analysis of 200 cases identified that only 72 per cent of audits, the most resource intensive interaction with taxpayers, passed key administrative tests. Similar issues in case management were identified in the ATO's quality assurance processes.

**4.65** The S&ME Business Line has a range of guidance and training material for compliance officers and two quality assurance frameworks that assess review and audit cases for continuous improvement. The combination of the QAR and the IQF alerts the business line to processing errors. Results for the QAR show that errors in the conduct of compliance cases diminished rapidly, but have effectively levelled off since September 2008. This may be due to the slow completion of activities identified through the quality assurance workshops. The business line has recently allocated further resources to this task.

**4.66** There would be benefits in the ATO reviewing the S&ME Business Line's internal QAR processes, particularly as there is some duplication of effort and assessment points between the QAR and the IQF. In addition, there is the potential that the same case can be sampled three times: by the QAR and by the IQF open and closed case assessments. Streamlining the QAR, reviewing the number of IQF open case assessments conducted, and identifying the complementary issues between them has the potential to strengthen the impact of active compliance activities. In conjunction with

continuous improvement activities, this has the potential to further improve the quality of data entered into CWC, and the integrity of compliance activities and reporting.

## **Interpretative assistance, prosecutions and serious non-compliance**

### **Interpretative assistance**

**4.67** The ATO provides assistance to taxpayers about the application of taxation laws in the form of general advice, public and private rulings, interpretative guidance and responding to objections.<sup>137</sup> The S&ME Business Line has an interpretative assistance area that provides general advice to taxpayers, as well as:

- private rulings—taxpayers who have specific circumstances for which they consider that the general guidance provided by the ATO does not give sufficient clarity may seek a private ruling;
- class rulings—these apply to advice that affects more than one taxpayer, and can be requested by one entity on behalf of others, for example an employer asking on behalf of employees. These are made publicly available; and
- objections—taxpayers can make an objection against some decisions the ATO makes about their tax affairs.

**4.68** While the interpretative assistance capability was not a focus of this audit, Table 4.7 outlines the numbers of private rulings, class rulings and objections for the period 2008–09 to 2010–11.

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<sup>137</sup> Public rulings cover areas of administrative interpretation of taxation law that are likely to apply to a significant group of taxpayers.

**Table 4.7****SME market private rulings, class rulings and objections for the period 2008–09 to 2010–11**

	2008–09	2009–10	2010–11
Private Rulings	283	312	407
Class Rulings	45	30	41
Objections	368	524	338

Source: Information provided by the ATO.

**4.69** Taxpayer objections to audit outcomes can proceed to litigation, and the interpretative assistance capability in the S&ME Business Line also has a dedicated litigation team. This team assists the Legal Services Branch of the Corporate Services and Law sub-plan with litigation cases. These cases can proceed to the Administrative Appeals Tribunal, the Federal Court and the High Court, depending on the circumstances. The ATO has advised that it has been focusing on alternative dispute resolution methods, to reduce the number of unnecessary cases proceeding through to a formal hearing.

## **Prosecutions and Serious Non-Compliance**

**4.70** Taxpayers involved in significant fraud or serious tax evasion activity are the responsibility of the Serious Non-Compliance (SNC) Business Line and investigations can only be undertaken by appropriately qualified or supervised staff. The work undertaken by the SNC Business Line includes: identifying people who seek to operate outside the tax system; detecting illicit activity in relation to excise legislation; investigating schemes that are fraudulent in substance; and gathering intelligence concerning activities involving serious tax evasion.<sup>138</sup>

**4.71** Taxpayers that are the subject of compliance activities, including audit, may be referred to SNC for investigation. These cases may, in turn, be referred to the Commonwealth Director of Public Prosecutions (DPP) for criminal

<sup>138</sup> Adapted from the ATO website, <<http://www.ato.gov.au/corporate/content.asp?doc=/content/24463.htm&page=18&H18>> [Accessed 5 January 2011].

prosecution when there has been fraud or serious tax evasion. While the decision to prosecute ultimately rests with the DPP, prosecution is a powerful deterrent and is the firmest of the compliance strategies available to the ATO. For 2009–10, the S&ME Business Line referred 22 cases to SNC for investigation. SNC referred one case to the DPP and there were three successful prosecutions. For 2010–11, the S&ME Business Line referred 17 cases to SNC for investigation. There were no cases referred to the DPP and there was one successful prosecution.<sup>139</sup>

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<sup>139</sup> Prosecutions are not necessarily completed in the year they were referred due to the lengthy processes involved.



## 5. Measuring Compliance Effectiveness

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*This chapter examines the ATO's methodology for assessing the contribution of its activities towards improving taxpayer compliance, and the ATO's effectiveness at improving voluntary compliance in the SME market.*

### Introduction

**5.1** As previously noted, the ATO's method for assessing the effectiveness of its compliance activities is set out in its 2008 Compliance Effectiveness Methodology (CEM). The methodology, adopted by the OECD, is based on two key elements: the identification of measurable compliance objectives; and the articulation and treatment of the risks to achieving them.

**5.2** The ANAO examined how the ATO measures its contribution to promoting voluntary compliance in the SME market, through reviewing:

- the application of the CEM; and
- for the marketing and communications capability, the results from market research.

### The ATO's Compliance Effectiveness Methodology

**5.3** In 2008, the ATO publicly released its CEM, to assist with the planning of compliance strategies and the evaluation of their effectiveness.<sup>140</sup> The S&ME Business Line sponsored the development of this methodology, with a specialised design and implementation team located within the business line. As such, the S&ME Business Line is a lead proponent of the methodology, and some of the first applications of the CEM were for risks managed within this business line.

**5.4** The CEM is undertaken in four phases (outlined in Table 5.1). An ongoing annual review is conducted after phase four is completed.

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<sup>140</sup> ATO, *Measuring Compliance Effectiveness—our methodology*, August 2008, <<http://www.ato.gov.au/content/00149070.htm>> [Accessed 14 July 2011].

**Table 5.1****Compliance Effectiveness Methodology—phases and description**

Phase	Description of activity
<b>Phase 1</b> Articulate risk and align with ATO business intent.	Understanding and documenting the risk, and aligning the risk to the ATO business intent of optimising voluntary compliance, making payments under the law and building community confidence. Prior to this phase, risks need to be identified, quantified and prioritised based on the ATO's Risk Management Framework.
<b>Phase 2</b> Define successful outcomes and develop compliance strategies.	Desired outcomes and their impact are defined and expressed in terms of what success would look like. Treatments to minimise cases of non-compliance are identified to address both the causes and symptoms of non-compliance. This includes the use of educational information, stakeholder engagement, and compliance activities such as letters, telephone calls, reviews and audits.
<b>Phase 3</b> Design and test success indicators.	Identifying potential indicators of success to be used during the compliance strategies and applying a series of tests to determine if these indicators are viable and useful.
<b>Phase 4</b> Validate indicators and determine extent of effectiveness.	The technical validation of the performance indicators and the evaluation and reporting of effectiveness. The ability for the strategies to affect behaviour in the short, medium and long terms is also evaluated.

Source: ATO, *Measuring Compliance Effectiveness—our methodology*, August 2008, pp. 8–9.

**5.5** CEM phases one and two are conducted together during a two day workshop that includes key internal stakeholders from within the business line, and other areas of the ATO. Phase three is approved through the risk or population owner. Phase four is endorsed by the RMC, and presented for subsequent annual review. The entire process can take a number of years to complete, as many results are dependent on outcomes such as comparing lodgement rates in successive tax return years. The ongoing annual reviews are intended to feed back into the continuous improvement of compliance strategies for the particular risk or population.

**5.6** Selected finalised reports are discussed at Compliance Executive Meetings attended by Deputy Commissioners and the ATO's Second Commissioner for Compliance. Leadership of the CEM across the Compliance Sub-plan is provided through a leadership forum, consisting of senior officers from all Compliance Sub-plan business lines.

## Application of CEM to the SME market

5.7 From October 2008 the S&ME Business Line has been applying the CEM to its priority risks and populations, and these are at different phases of completion. Not all of these have reached phase four, although some have achieved their annual review status. As at June 2011, there were four finalised CEM assessments for priority risks within the SME market, and Table 5.2 summarises the CEM status of all priority risks and the two populations of relevance to the SME market as at June 2011.

**Table 5.2**

### Compliance Effectiveness Methodology status for the SME market, as at June 2011

SME market priority risks and populations	CEM phase				Annual review
	1	2	3	4	
Phoenix	√	√	√	√	√
Division 7A	√	√	√	√	√
Lodgement	√	√	√	√	
International	√	√	√		
Exit Strategies	Not applicable, as the risk assessment was in its initial stages				
Capital Gains Tax	√	√	√		
Fringe Benefits Tax	√	√	√	√	√
Trusts	√	√	√		
\$2 million to \$10 million (S1)	√	√	√	Discontinued <sup>1</sup>	
\$100 million to \$250 million (S4)	√	√	√	√	

Source: Information provided by the ATO.

Note: Specific work on the S1 market sub-segment became business as usual in 2010–11.

5.8 A CEM for Income Tax compliance for the SME market was also commenced, and reached phase four in December 2009. The ATO advised that

work on this ceased in 2010, as the large number of variables associated with the market and associated economic conditions made applying the methodology problematic at a whole-of-market level.

**5.9** The ATO's CEM is relatively new and, as previously noted, several years of reporting can be needed before compliance trends become evident. Within this context, the initial CEM may be used to set a baseline so that trends can be subsequently measured. The CEM process involves analysing quantitative measures such as lodgement rates and ratios of debt to collections and income reported, as well as comparing historical and current performance data. Qualitative measures include media reports, community and tax practitioners' feedback and the use of the ATO's marketing information.

**5.10** The results to date for the priority risk CEMs included:

- Lodgement—the 'on time' lodgement rate has generally improved, being 66.8 per cent in 2005–2006 increasing to 70.1 per cent in 2008–2009. There has also been success with letter and telephone campaigns involving pools of selected taxpayers, as well as reviews and audits;
- Fringe Benefits Tax—in July 2010 the CEM reported that compliance activities<sup>141</sup> were not effective as growth in the SME market reporting against fringe benefits had not kept pace with the growth in employment, or the consumer price index. The suggestion for continuous improvement was to increase taxpayer contact through letter and telephone campaigns, bulk mail outs, reviews and audits. In September 2011, there was a reported positive influence on taxpayer compliance, as measured by an increase of 3.7 per cent in the number of FBT lodgements; and 17 per cent in the value of FBT payable from the previous reporting period;
- Division 7A—in February 2010 the CEM reported that compliance activities<sup>142</sup> had been effective at increasing the interest income

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<sup>141</sup> FBT compliance activities included: marketing and communications; direct contact with taxpayers through letters, telephone calls, reviews and audits; communicating the ATO's awareness of non-compliance and the high risk of detection; and legislative reform.

<sup>142</sup> Division 7A compliance activities primarily included updated internet products, such as calculators and practice statements, and active engagement with ATO stakeholder forums of relevance. Compliance reviews and audits were also conducted, but to a lesser degree.

disclosed by taxpayers (a 58 per cent increase from 2006–07 as compared to 2007–08), and therefore an increase in repayments. The use of specific Division 7A pages on the ATO website had also increased, from approximately 20 000 hits in 2007–08 to 30 000 hits in 2008–09. The May 2011 report showed spikes in use of particular ATO internet products coinciding with the release of new assistance products and ATO presentations to professional tax agent associations. A comparison between interest income reported by companies with shareholder loans, and companies without shareholder loans, showed a one per cent (\$15 million) increase between 2007–08 and 2008–09 for companies with shareholder loans;

- International—this risk contains six sub-risks<sup>143</sup>, and the first CEM phase four update was completed in May 2011. The RMC determined that it was difficult to measure the impact of compliance activities due to the number of variables, and that this work would be more effective at the sub-risk level. The ATO advised that this will be undertaken in conjunction with international tax specialists from the LB&I Business Line; and
- Phoenix—the S&ME Business Line is the corporate owner of this risk, and leads a cross-ATO steering group to coordinate work across all market segments in the ATO. Compliance activities have not been effective in reducing phoenix behaviour despite some successes with prosecutions and court decisions. The number of phoenix operators and their distribution across market segments has steadily increased. The May 2010 and 2011 CEM reports showed that there was some success using targeted audits and prosecutions in specific industries, however the resource intensiveness of these activities is not conducive to reducing the risk across the entire population. As a result, the ATO changed its approach and jointly (with ASIC) developed an approach to the Treasury. The CEM process contributed towards this change of approach by demonstrating that existing legislation was not effective in deterring fraudulent phoenix behaviour.

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<sup>143</sup> The six sub-risks being: foreign residents income; foreign source income; non-resident withholding tax; tax havens; thin capitalisation; and transfer pricing.

## Conclusion

**5.11** The ATO measures the effectiveness of its compliance strategies through the CEM. This methodology recognises the importance of not only being effective in improving voluntary compliance, but of also being able to measure the ATO's contribution to improving voluntary compliance. The S&ME Business Line has implemented the CEM for all but one of its priority risks in the SME market. The exception was Exit Strategies, as the risk assessment was in its initial stages. As of June 2011 there were four finalised CEM assessments, and three of these are now in their annual review stage. The nature of the CEM methodology means that, potentially, several years of phase four reporting are needed before trends become recognisable. As the CEM is a new process for the ATO, the first iterations are often needed to set a baseline. This was the case in the Lodgements, FBT and Division 7A priority risks.

**5.12** As the CEMs are focused on a priority risk rather than a market view of compliance risk, they do not provide a comprehensive compliance profile for the SME market as a whole. The S&ME Business Line attempted to apply the CEM to the SME market, but was unable to do so because of the number of variables present in such a large and diverse population. However, results from the completed CEMs for priority risks are indicating that the ATO's compliance activities are generally having a positive impact on voluntary compliance in the SME market.

**5.13** The CEM for the International risk was inconclusive, and is now being undertaken at the sub-risk level. The CEM for the Phoenix risk identified the need for a revised approach as it showed compliance activities were not effective. As a result, the ATO is pursuing legislative change through the Treasury (jointly with ASIC).

**5.14** The use of the CEM is maturing within the business line. Results from it are providing the ATO with useful directions for improving the effectiveness of its compliance strategies. There is an opportunity for the ATO to integrate the CEM results from the S&ME Business Line with those from other areas of the ATO. This would benefit the ATO by producing a more comprehensive view of its overall effectiveness in addressing compliance risks and promoting voluntary compliance.

## Market research as a measure of effectiveness

**5.15** The ATO undertakes extensive market research, including surveys of its taxpayer base, and all results are publicly available on the ATO website.<sup>144</sup> Three ‘whole of ATO’ surveys, that include SME taxpayers in their samples, are conducted each year on:

- staff professionalism, by contacting taxpayers who have had interaction with the ATO over the past six months.<sup>145</sup> The May 2010 survey included 95 respondents from the SME market, out of 448 SME taxpayers contacted. Seventy-four per cent of SME market respondents were satisfied or very satisfied that they had a better understanding of the issue following discussions with the ATO. Results for taxpayer understanding were generally comparable with results for the ATO as a whole and exceeded benchmarks<sup>146</sup>;
- business perceptions of the ATO across the micro and SME market segments.<sup>147</sup> The survey contacted a national random sample of 1500 businesses—500 of them from the SME market—and the overall response rate was 49 per cent. Eighty per cent of respondents agreed that the ATO provides them with the information they need to manage their business tax affairs; and
- community perceptions, to capture trends in how the community perceives the ATO’s administration of the taxation system.<sup>148</sup> The 2000 respondents were adults representative of the Australian population in terms of age, gender, and geographical location. Results for the SME market were not delineated, however 86 per cent agreed

<sup>144</sup> ATO website, Corporate, Research.  
<[http://www.ato.gov.au/corporate/pathway.aspx?sid=42&pc=001/001/024&mfp=001/001&mnu=39508#001\\_001\\_024](http://www.ato.gov.au/corporate/pathway.aspx?sid=42&pc=001/001/024&mfp=001/001&mnu=39508#001_001_024)> [Accessed 6 July 2011].

<sup>145</sup> DBM Consultants, *Australian Taxation Office Professionalism Survey*, May 2010, pp. 54–57.

<sup>146</sup> Results are derived from the answers to two survey questions: ‘Overall, how satisfied are you with the professionalism of Tax Office staff you had contact with?’, and ‘Overall, how satisfied are you that you now have a better understanding of the issue you discussed with the Tax Office?’

<sup>147</sup> Ipsos-Eureka Social Research Institute, prepared for the ATO, *Business Perceptions Survey Wave 16, Full Report*, May 2010, p. 36.

<sup>148</sup> DBM Consultants, prepared for the ATO, *Community Perceptions Survey 2009, 08.043—05*, October 2009, p. 3.

that the ATO offers service and assistance to help them understand and meet their taxation obligations.

**5.16** Every two years the S&ME Business Line also commissions a survey of SME taxpayers, *Understanding the Small and Medium Enterprise Market*.<sup>149</sup> The most recent survey in November 2010 consisted of interviews with 1000 SME taxpayers. Regarding education and communication products, the survey showed that attitudes towards the ATO are generally positive with:

- 76 per cent of respondents agreeing that the ATO provides their business with the information required to manage their tax affairs, 19 per cent disagreeing or strongly disagreeing with this statement and five per cent not knowing; and
- 66 per cent endorsing the ATO's effort in educating/informing the business community about taxation matters, 27 per cent disagreeing or strongly disagreeing and seven per cent not knowing.

**5.17** Respondents were asked which products and services provided by the ATO they had used in the last 12 months:

- 79 per cent of respondents used the ATO website;
- the business portal and online calculators were the next most popular, at 47 per cent and 46 per cent respectively; and
- the *SME Communicator* and the SME Tax Forum had only been used by three and two per cent of respondents, respectively.

The most preferred channel for ATO information was the website, nominated by 52 per cent of respondents, followed by the business tax enquiries line at 15 per cent of respondents.

## **Taxpayer feedback**

**5.18** During the course of this audit the ANAO held discussions with three organisations that work with, and represent, taxpayers in the SME market: Taxpayers Australia, The Institute of Chartered Accountants in Australia (ICAA) and the Australian Chamber of Commerce and Industry (ACCI). These organisations provided feedback on their own and their members' awareness

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<sup>149</sup> ATO, *A Research Report on: Understanding the Small and Medium Enterprise Market*, Sweeney Research, 23 November 2010.



of the ATO's SME market educational programs, communication methods and general perceptions of the ATO's dealing with taxpayers.

**5.19** Broadly, the organisations themselves were very satisfied with the ATO's consultation and, in particular, with the higher-level industry forums such as the ATO Tax Practitioner Forum, and the Tax Commissioner's Small Business Consultative Group.

**5.20** In order to provide member feedback, in November 2010, Taxpayers Australia surveyed its members through an online survey. Of the 395 respondents, 89 per cent were tax agents, advisors or practitioners, and nine out of 10 serviced clients in the SME market. The ICAA also asked for comments from members. Feedback received from these organisations provides another perspective on the ATO's survey results. In summary, members from both organisations indicated that taxpayers are aware of the ATO's educational information, but noted some shortcomings, namely:

- specific products are difficult to find on the ATO website as the search engine is cumbersome and does not always provide the most logical search results. Less than half of Taxpayers Australia's respondents found the products easy to access. The ATO survey results did not elicit this response. Given that the preferred method of communication is the ATO website, the ATO could consider improving their website search engine to improve the accessibility of taxpayer educational products;
- the products are too general with not enough detail for tax agents, or the products are too detailed and the language excessively 'official'. These comments may reflect the differences between respondents being either taxpayers, tax agents, or business owners; and
- there was a perception that consultative forums and stakeholder meetings did not represent the entire SME market. This may be an uninformed view, as almost 60 per cent of Taxpayers Australia respondents were unaware of specific SME stakeholder forums conducted by the ATO. There may therefore be merit in the ATO better promoting the SME market-specific consultative forums.

**5.21** The majority of member feedback from these organisations was from tax agents, and approximately 90 per cent of SME taxpayers use a tax agent. While the ATO has formal forums for tax practitioners, and conducts research that targets tax practitioners on a variety of topics, it might be useful for the ATO to consider including this demographic in future SME market surveys.

This would increase the ATO's understanding of how tax agents prefer to service the taxation needs of SME taxpayers.

## **Conclusion**

**5.22** The ATO surveys its taxpayer base, and SME market taxpayers, to assess its marketing and communication activities. The results of these surveys indicate that the ATO is generally effective at providing information to taxpayers, and therefore in improving voluntary compliance. Independent feedback received by the ANAO generally supports the ATO's survey findings that information needed by businesses is available. However, there was also feedback that the ATO website search engine could be improved, as information was difficult to find using this function and that consultative forums could be better promoted. The ATO may also benefit from including tax agents who service SME clients in their future SME surveys.

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Ian McPhee  
Auditor-General

Canberra ACT  
8 December 2011

# Appendices



## Appendix 1: ATO response



Australian Government  
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Mr Mark Harradine  
ANAO Performance Audit Executive Director  
Australian National Audit Office  
GPO Box 707  
CANBERRA ACT 2601

Dear Mr Harradine

**RE: Australian National Audit Office Performance Audit of the  
Australian Taxation Office's Management of Compliance in Small to  
Medium Enterprises**

Thank you for your letter dated 24 October 2011 and for the opportunity to provide comments on the proposed report on the Australian Taxation Office's Management of Compliance in Small to Medium Enterprises.

The ATO accepts the two recommendations as presented in the Section 19 report.

I would like to thank the Australian National Audit Office audit team for the cooperative and professional manner they have adopted in working with us on this matter. I look forward to continuing the good working relationship developed in this performance audit.

Attached is the ATO response to recommendations (Annexure 1) and summary of our comments to be used in the report brochure (Annexure 2).

If you require further information on this matter, please contact Gary Andrews – Assistant Deputy Commissioner - Small & Medium Enterprises.

Yours sincerely

Bruce Quigley  
Second Commissioner of Taxation  
21 November 2011

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## **ATO response to recommendations**

**ANAO Recommendation 1:** To enhance the results of the Small to Medium Enterprises Risk Engine, the ANAO recommends that the ATO:

- a) improve the frequency of running the risk engine;
- b) increase the profiling of all market sub-segments and use of data sets other than taxpayer return information; and
- c) document the process and criteria used to manually weight the results against each risk rule before the final risk score is determined.

**ATO response:** Agreed. At the time of the audit, the SME Risk Engine was being converted to a new corporate application, the Risk Assessment and Profiling Tool (RAPT). With RAPT implemented, we can now build further enhancements into our risk assessment process. Specifically:

- the flexibility to run our risk engine as frequently as business requirements dictate; and
- the ability to risk assess and profile any population (turnover-based or other).

We are also developing a governance process around the weighting assigned to particular risk rules, risk themes and overall risk scoring methodologies.

**ANAO Recommendation 2:** To support the identification of emerging priority risks, the ANAO recommends that the ATO periodically confirm the validity of all risk rules within the Small to Medium Enterprises Risk Engine.

**ATO response:** Agreed. We agree that all viable methods of validating risk rules should be utilised to support the accurate identification, monitoring and prioritisation of risks.

## **Comments to be used in report brochure**

The ATO welcomes this review and considers the report supportive of our overall approach to managing the income tax compliance of the Small-to-Medium Enterprise (SME) market segment. The review recognises a number of recent innovations having potential to further enhance our compliance approach. In finding the ATO's compliance approach toward the SME market segment to be generally effective, the review identified a number of opportunities for improvement in our risk assessment processes. The ATO agrees with the two recommendations contained in the report.

## Appendix 2: Variations in definition of SMEs

Organisation	Terminology used	Definition
Australian Taxation Office	Small-to-Medium Enterprise	Taxpayer with an annual turnover of between \$2 million and \$250 million.
Australian Bureau of Statistics	Small and Medium Enterprise	Small business—business employs less than 20 employees; and Medium business—business employs more than 20 employees, but less than 200. <sup>150</sup>
Australian Government Department of Education, Employment and Workplace Relations	Small business	A business that employs less than 15 people in the case of an unfair dismissal claim. <sup>151</sup>
European Commission	Small and medium-sized enterprises (combines micro, small and medium enterprises)	Enterprises that employ less than 250 persons, with a turnover less than 50 million euro and/or an annual balance sheet total not exceeding 43 million euro. <sup>152</sup>
New Zealand Inland Revenue	Small and Medium Enterprises	Entities with employees or active financial transactions in GST and an annual turnover of up to \$100 million. <sup>153</sup>
Her Majesty's Revenue and Customs, United Kingdom	Small and Medium Enterprises	Less than 500 employees and either: an annual turnover not exceeding 100 million euro, or a balance sheet not exceeding 86 million euro. <sup>154</sup>
Canada Revenue Agency	none	Does not use a single agency-wide definition. <sup>155</sup>

<sup>150</sup> Australian Bureau of Statistics, *Small and Medium Enterprises*, p. 4.  
<<http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8141.01996-97>> [Accessed 11 March 2011].

<sup>151</sup> Department of Education, Employment and Workplace Relations, Minister's Media Centre, <[http://www.deewr.gov.au/Ministers/Gillard/Media/Transcripts/Pages/Article\\_090320\\_103427.aspx](http://www.deewr.gov.au/Ministers/Gillard/Media/Transcripts/Pages/Article_090320_103427.aspx)> [Accessed 20 April 2011].

<sup>152</sup> European Commission, *But what is an SME? The new SME definition—user guide and model declaration*, <[http://ec.europa.eu/small-business/index\\_en.htm](http://ec.europa.eu/small-business/index_en.htm)> [Accessed on 21 March 2011], p. 5.

<sup>153</sup> New Zealand Inland Revenue, *Inland Revenue's Compliance Focus 2010—11*, IR504, July 2010, p. 18.

<sup>154</sup> <<http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1083661692&type=RESOURCES>> [Accessed 21 March 2011].

<sup>155</sup> Canada Revenue Agency, *Measuring the Small Business Compliance Burden – Benchmark report*, 2009, <<http://www.cra-arc.gc.ca/gncy/bnchmrk/2009/menu-eng.html>> [Accessed 17 March 2011].



Organisation	Terminology used	Definition
Statistics Canada	Small to Medium Enterprise	Any business establishment with 0 to 499 employees and less than \$50 million in gross revenues. <sup>156</sup>

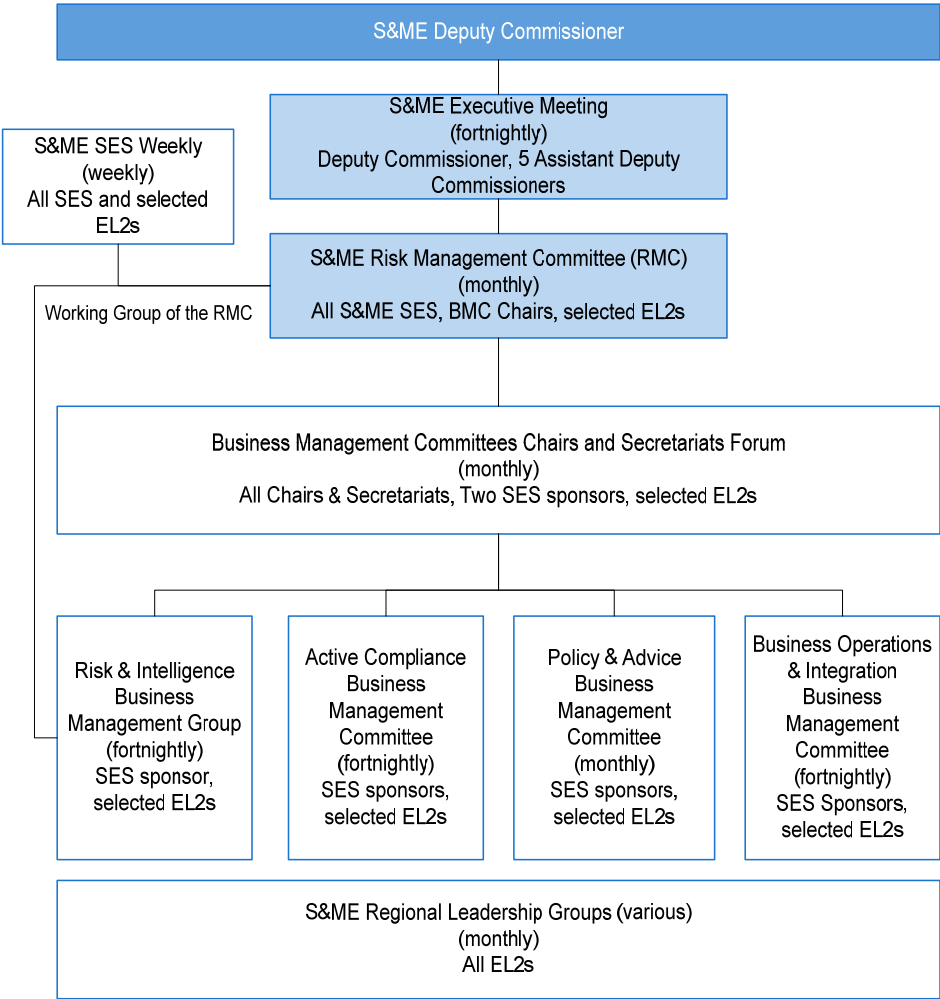
Source: ANAO analysis.

Note: Amount figures are in the currency of the country mentioned.

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<sup>156</sup> Small Business Canada, *About.com Guide to SME*, <<http://sbinfocanada.about.com/od/businessinfo/g/SME.htm>> [Accessed 17 March 2011].

### Appendix 3: S&ME Business Line management committees



Source: ATO, S&ME Business Management Structure, November 2010.

Note: SES are senior executive service staff, EL2s are senior executive level staff. Omitted from this diagram are several sub-committees to the Business Management Committees, and a new SES committee , called the Business Futures Forum, chaired by the Assistant Deputy Commissioner, Projects and SME Population Strategy that was being formed at the time of the audit.

## Appendix 4: Review and audit products for the SME market

Active compliance product	Description of active compliance product	Cycle time
Internal Risk Review (IRR)	<p>Internal risk reviews (IRR) include taxpayer profiling and the establishing and reviewing of any taxpayer risks. The IRR will also provide any recommendations for further action required on the specific risks identified.</p> <p>An internal review does not involve any taxpayer contact.</p>	40 days
Preliminary Risk Review (PRR)	<p>A preliminary risk review (PRR) is more intensive than an IRR. It includes taxpayer contact in the form of a review letter and the receipt of taxpayer information by the ATO.</p> <p>For a PRR the active compliance team are also required to prepare a product plan, prepare a recommendation on further action required, as well as communicate the outcomes to the taxpayer.</p>	60 days
Comprehensive Risk Review (CRR)	<p>A comprehensive risk review (CRR) is a step further than a PRR. The CRR includes a plan, taxpayer contact, an internal workshop on identified risks and may include a field visit.</p> <p>The requirements of a CRR are reflected in the extended cycle time.</p>	120 days
Audit	<p>An audit is the most resource and time intensive active compliance product. The audit is targeted towards a particular risk(s) presented by the taxpayer, and includes a thorough review of these risks.</p> <p>The more intensive nature of this product is reflected in the long cycle time.</p>	540 days

Source: ANAO analysis of ATO information.

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