VIA INTERNET

January 16, 2015

Dear Interested Party:

The Audit Manual (AM) is a guide for the Board of Equalization (BOE) staff in administering tax and fee programs. It is available to the public and can be accessed from the BOE web page at http://www.boe.ca.gov/sutax/staxmanuals.htm.

The Sales and Use Tax Department (SUTD) is proposing to revise AM Chapter 4, General Audit Procedures. Section 0405.33, Use of Prior Audit Percentages of Error in Current Audits, is being revised to advise staff that the use of a prior audit percentage of error (PAPE) may be extended to two subsequent audits. The revision material is provided on the following pages for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your association/members.

If you have any comments or suggestions related to the proposed AM revisions, you may contact the BOE at AM.RevisionSuggestions@boe.ca.gov. Your comments or suggestions must be received by BOE no later than March 18, 2015, in order to be considered by staff. Thank you for your consideration.

Sincerely,

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department
The prior audit percentages of error (PAPE) program involves, under certain circumstances, the use of a percentage of error developed in a prior audit for the sales or accounts payable portion of two subsequent audits. Staff must obtain approval from the Chief of Field Operations (COF) to apply a PAPE to the second subsequent audit. The PAPE can be a valuable tool in streamlining the audit process. It is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers.

When planning the audit, supervisors and auditors should evaluate whether the taxpayer is eligible for the use of a PAPE. This evaluation should be conducted whether or not the taxpayer has already requested the use of a PAPE. If the taxpayer is eligible for the use of a PAPE, the auditor should discuss the PAPE with the taxpayer as soon as possible rather than wait for the taxpayer to request using a PAPE. The date of the discussion and the taxpayer’s response should be documented on Form BOE-414-Z, Audit Assignment Activity History. A decision that the taxpayer is not eligible should also be explained and documented on Form BOE-414-Z.

To qualify for the PAPE, the taxpayer must have at least one prior audit and must meet the conditions discussed in this section. The most recent prior audit and the current subsequent two audits must indicate consistent operations, volume, and potential type of errors. Limited testing of the taxpayer’s records and internal controls will be necessary in order to determine whether there have been any changes to the taxpayer’s operations since the last audit. Such testing should include an examination of source documents, such as invoices and paid bills, for changes in processing procedures since the last audit. Other changes to look for include:

1. Nature of their business
2. Accounting procedures
3. Key personnel or turnover of staff
4. New or revised laws or regulations affecting their business
5. Significant increases in the population being sampled

If limited testing discloses some change(s) to the taxpayer’s operations, the auditor should take into consideration the materiality of the change(s) and whether or not a PAPE can still be used for a portion of the audit period or the area being tested. If the change(s) in the taxpayer’s operation is minor, the risk of underestimating the audit results by applying a PAPE may be small. It is important to remember, as noted above, that the use of a PAPE is limited to the current audit period as a PAPE cannot be used in two subsequent audits and therefore will not create a basis for RTC section 6596 relief in a third subsequent audit.

The techniques used in the prior audit to calculate the PAPE will not preclude its use in the subsequent two audits; however, other factors, as noted above, must be taken into consideration before approving the use of the PAPE in the current subsequent two audits.
To be representative, if stratified dollar limitations were used in the last audit, generally the same dollar stratification should be used in the current subsequent two audits. If there is an indication during the limited testing that a different stratification level may be appropriate in the current subsequent two audits, the percentage of error to apply to the current subsequent two audits will be calculated by combining multiple strata from the prior audit. To compute the single percentage of error or a specific area tested in the prior audit, divide the total measure of errors by the population.

For example, if claimed exempt sales were sampled using stratified dollar limitations in the prior audit, the single percentage of error (recomputed PAPE) is the ratio of the total measure of disallowed exempt sales to the total claimed exempt sales, in the prior audit. The total measure of errors (numerator) can be obtained from the audit work papers’ lead schedule, the front of Form BOE-414-A, Report of Field Audit, or IRIS. The total population of claimed exempt sales (denominator) can be obtained from Form BOE-414, Transcript of Return Filed-Sales and Use Tax or in the prior audit work papers. The recomputed PAPE in this example is then applied to the quarterly claimed exempt sales for the current subsequent two audit periods, which are generally available on Form BOE-414.

After discussing the use of a PAPE with an eligible taxpayer(s), a detailed outline memo from the Audit Supervisor to the District Principal Auditor (DPA) or in the case of a second subsequent audit, from the Audit Supervisor to the DPA and COF should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program (Exhibit 56, page 1). Each outline should include:

- Name, account number, case ID, and NAICS code of the eligible taxpayer
- Nature of taxpayer’s business
- Current audit period
- Portion(s) of audit where a prior percentage of error is to be used
- Prior audit periods and corresponding percentages of error for those portion(s)
- Population(s) to which the prior percentage(s) of error was applied
- Proposed percentage of error to be used for the portion(s) in the current audit
- Population(s) to which the proposed percentage(s) of error will be applied in the current audit
- Any other pertinent information

The memo outline should be approved by the DPA and in the case of a second subsequent audit the DPA and COF, and maintained in the Memos & Misc. Documents subfolder of the audit case folder as a memo schedule.

Upon the DPA’s and if needed COF’s approval of a PAPE, the DPA (or designee) will enter basic information on the account into the District Reports Data Base (DRD). Basic information includes:

- Account Number
- Case ID
- Taxpayer Name
- Auditor Name
- Industry Type (NAICS)
- Audit Period
- “Area” that PAPE will be applied to
- Approval date by District Principal Auditor

In addition, immediately after the audit has been transmitted to headquarters, the DPA (or designee) will enter the remaining detailed information regarding the outcome of using the PAPE into the District Reports Data Base (DRD). This information will include:
- Tax for “Proposed” PAPE assessment
- Estimated Hours Saved
- Total Audit Hours
- Transmittal date
Memorandum

State of California

Board of Equalization
Sales and Use Tax Department

Distributed Electronically

To: District Principal Auditor*

From: Audit Supervisor

Date: December 1, 20XX

Subject: Request to Use a Prior Audit Percentage

ABC Company
SR KH 1802-345678

We would like to use a prior audit percentage in the current audit of ABC Company. Staff has reviewed their accounting procedures and determined that there has been no change since the last audit. In addition, there have been no changes to the personnel handling their accounts payable and there have been no changes to any laws or regulations affecting their business. The following is an outline of our proposal as specified in Audit Manual Section 0405.33:

(a) ABC Company
   SR KH 180-345678

(b) The taxpayer is a manufacturer and distributor of consumer electronics.

(c) The audit period is 1/1/100 - 12/31/102

(d) The prior audit percentage would be used in the paid bills portion of the audit.

(e) For the prior audit period, 1/1/097 - 12/31/099, the percentage of error was 2.01 percent.

(f) For the prior audit period, 1/1/097 - 12/31/099, the population was $4,100,000.

(g) We propose the use of 2.01 percent in the current audit.

(h) The population to which this percentage of error will be applied is $5,600,000.

We have discussed this approach with the tax manager and she is agreeable to the use of the prior percentage of error. The tax manager was informed that this approach **would not** only be used extended in to two consecutive subsequent audits. We both agree that given the relative consistency in the error rates, populations, accounting procedures, internal controls and personnel, the use of a prior percentage of error would save significant audit time while achieving substantially the same result as a new test.

Thank you for your consideration. Please let me know if you have any questions.

cc: I. M. Auditor

* In the case of a second subsequent audit, the memo is sent to the District Principal Auditor and the Chief of Field Operations for approval by both.
Memorandum

Distributed Electronically

To: Chief, Tax Policy Division, (MIC: 92)  
From: District Principal Auditor  
Date: December 1, 20XX

Subject: Use of a Prior Audit Percentage

ABC Company SR KH 12-345678

We have completed our audit of ABC Company for the period of January 1, 20100 through December 31, 20102. The prior audit error percentage was used in the paid bills portion of this audit. The tax change resulting from the use of the prior audit error percentage is $8,723. We estimate that a total of 40 audit hours were saved by utilizing this method.

Please let me know if you have any questions.

Attachment: December 1, 20XX Memo from Audit Supervisor to District Principal Auditor requesting use of prior audit percentage for ABC Company

cc: Chief, Field Operations Division Equalization Districts 1 and 2 Out-of-State District (MIC 47), or Chief, Field Operations Division Equalization Districts 3 and 4 Centralized Collection Section (MIC 46)

I.M. Auditor

Exhibit to be deleted as this memo is no longer required per 3/1/10 email sent to all Districts from the Supervisor, Audit and Information Section. A database is now in place to capture information and prepare reports.