

M e m o r a n d u m

To : Ms. Cynthia Bridges
Executive Director (MIC 73)

Date: August 23, 2012

From : Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department (MIC 43)



Subject : Board Meeting September 12-14, 2012
Item N: Administrative Agenda
Proposed Revisions to Audit Manual Chapter 4, General Audit Procedures

In accordance with the established procedures for audit and compliance manual revisions, I am submitting the proposed revisions to Audit Manual (AM) sections 0405.33, *Use of Prior Audit Percentages* and 0435.20, *Audit Procedure* and Exhibit 6, *Examples of Prior Audit Percentage Memos*.

The proposed revisions, which incorporate current policies and procedures, have been reviewed and approved by SUTD management, provided to Board Members, and posted at <http://www.boe.ca.gov/sutax/pmr.htm> to solicit comments from interested parties. No comments were received from interested parties with regard to these revisions.

The revised sections and exhibit are attached for your reference. We request your approval to forward them to the Board Proceedings Division for placement on the next Administrative Agenda as a consent item. If you have any questions, please let me know or contact Ms. Susanne Buehler at 324-1825.

SB:llw
Attachment

Approved:



Ms. Cynthia Bridges
Executive Director

USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN CURRENT AUDITS 0405.33

The prior audit percentages of error (PAPE) program involves the use, under certain circumstances, of a percentage of error developed in a prior audit for the sales or accounts payable portion of a current audit. ~~The techniques used in the prior audit to calculate the percentages of error will not preclude the use of the prior audit percentage; however, other factors, as noted below, must be taken into consideration before approving the use of the prior audit percentage in a current audit.~~ It 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.

~~Each district office will identify taxpayers currently under audit or selected for audit with at least one prior audit.~~

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 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 audit must indicate consistent operations, volume, and potential type of errors. ~~Once these taxpayers have been identified, limited~~ 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 ~~of such~~ since the last audit. Other changes to look for include:

~~Other changes to look for include:~~

- ~~The n~~Nature of their business
- ~~Their a~~Accounting procedures
- Key personnel or turnover of staff
- New or revised Laws or regulations affecting their business
- 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 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 subsequent audit.

The techniques used in the prior audit to calculate the PAPE will not preclude its use in the audit; however, other factors, as noted above, must be taken into consideration before approving the use of the PAPE in the current audit.

To be representative, if stratified dollar limitations were used in the last ~~audit~~ audit, generally the same dollar stratification should be used in the current audit. ~~However, if~~ **If** there is an indication during the limited testing that a different stratification level may be appropriate in the current audit, the ~~new stratification level should be used.~~ If so, the prior percentages of error will have to be adjusted to reflect the new stratification level. percentage of error to apply to the current audit will be calculated by combining multiple strata from the prior audit. To compute the single percentage of error for a specific area tested in the prior audit, divide the total measure of errors by the population.

~~For example, a decrease or increase in the stratification level will affect the sample base (by deleting or including sample items), the population base (by deleting or including population items) and the percentage of error (by deleting or including error items) in the prior audits. These recalculations must be made so that the proposed percentage of error to be used in the current audit is an accurate representation of the prior audit percentages of error at the new stratification level.~~

~~This information should then be used by the District Principal Auditor and audit supervisor to evaluate such taxpayers for inclusion in this program.~~

~~Those taxpayers meeting the criteria described above should then be contacted and informed of the program by an auditor and audit supervisor. The taxpayer must also be informed that this procedure will not be used in consecutive audits.~~

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 audit period, which are generally available on Form BOE-414.

After discussing the ~~discussion~~use of a PAPE with an eligible ~~taxpayers,~~ taxpayer(s), a detailed outline memo from the Audit Supervisor to the District Principal Auditor (DPA) (Exhibit 6, page 1) should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program (Exhibit 6). Each outline should include:

- (a) Name and, account number, case Id and NAICS code of the eligible taxpayer
- (b) Nature of taxpayer's business
- (c) Current audit period

- (d)- Portion(s) of audit where a prior percentage of error is to be used
- (e)- Prior audit periods and corresponding percentages of error for those portion(s)
- (f)- Population(s) to which the prior percentage(s) of error was applied
- (g)- Proposed percentage of error to be used for the portion(s) in the current audit
- (h)- Population(s) to which the proposed percentage(s) of error will be applied in the current audit
- (i)- Any other pertinent information

The memo outline should be approved by the ~~District Principal Auditor DPA~~ and maintained in the audit as a memo schedule. ~~Upon completion of the audit, the district will prepare an evaluation memo (Exhibit 6, page 2) to the Chief, Tax Policy Division with a copy to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out of State District, or the Chief, Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section.~~

~~The evaluation memo must include the tax change of the portion(s) of the audit utilizing the prior percentage of error along with an estimate of the number of audit hours saved. A copy of the outline memo should be attached to the evaluation memo.~~

Upon the DPA'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

AUDIT PROCEDURE

0435.20

The MAP 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 MAP. This evaluation should be conducted whether or not the taxpayer has already requested the use of a MAP.

It is primarily the responsibility of the auditor to determine whether a taxpayer should be considered for the MAP. However, it is the ~~The~~ auditor's immediate supervisor who is responsible for approval of the auditor's recommendation. If the taxpayer is eligible for use of a MAP, the auditor should discuss the MAP with the taxpayer as soon as possible rather than wait for the taxpayer to request using a MAP. The date of the discussion with the taxpayer and the taxpayer's response should be documented on Form BOE-414-Z. A decision that the taxpayer is not eligible should also be explained and documented on Form BOE-414-Z.

~~This information must be documented by the auditor on Form BOE 414-Z, Assignment Contact History.~~

EXAMPLES OF PRIOR AUDIT PERCENTAGE MEMOS

EXHIBIT 6
-Page 1 of 2-

State of California

Board of Equalization

Memorandum**To** : District Principal Auditor**Date:** December 1, 20XX**From** : Audit Supervisor**Subject** : Request to Use a Prior Audit Percentage ABC Company SR KH 12-345678

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 KN 12-345678
- (b) The taxpayer is a manufacturer and distributor of consumer electronics.
- (c) The audit period is 1/1/00 - 12/31/02
- (d) The prior audit percentage would be used in the paid bills portion of the audit.
- (e) For the prior audit period, 1/1/97 - 12/31/99, the percentage of error was 2.01 percent.
- (f) For the prior audit period, 1/1/97 - 12/31/99, 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 be used in consecutive 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

DELETED

AUDIT MANUAL

This memo is no longer required

(CONT.) EXHIBIT 6

Page 2 of 2

State of California

Board of Equalization

Memorandum

To : Chief, Tax Policy Division, (MIC: 92)

Date: December 1, 20XX

From : District Principal Auditor

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, 2000 through December 31, 2002. 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