

# Memorandum

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

Date: April 9, 2015

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



Subject : **Board Meeting April 28 - 29, 2015**  
**Item N: Administrative Agenda**  
**Proposed Revision to Audit Manual, Chapter 4,**  
**General Audit Procedures**

I am requesting approval to forward the attached revision to Audit Manual (AM) Chapter 4, *General Audit Procedures*, to the Board Proceedings Division to be placed as a consent item on the Administrative Agenda at the April 2015 meeting.

The proposed revision to AM section 0405.33, *Use of Prior Audit Percentages of Error in Subsequent Audits*, advises staff that the use of a prior audit percentage of error (PAPE) may be extended to two subsequent audits. In addition, Exhibit 5, *Examples of Prior Audit Percentage Memos*, has been revised to note that the prior audit percentage of error may be used in two subsequent audits.

The revision has been reviewed and approved by SUTD management, provided to Board Members, and posted on the Board's website at <http://www.boe.ca.gov/sutax/pmr.htm> to solicit comments from interested parties. No comments were received from Board Members or other interested parties.

If you have any questions, please let me know or contact Ms. Susanne Buehler at 324-1825.

JLM:ljm

Attachment

Approved:

## STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the April 29, 2015 Board Meeting  
Joann Richmond

Joann Richmond, Chief  
Board Proceedings Division

  
Ms. Cynthia Bridges  
Executive Director

cc: (all with attachment)  
Mr. David Gau (MIC 101)  
Mr. Wayne Mashihara (MIC 46)  
Ms. Susanne Buehler (MIC 92)  
Ms. Lynn Bartolo (MIC 57)  
Mr. Richard Parrott (MIC 88)  
Mr. Kevin Hanks (MIC 49)  
Mr. John Thiella (MIC 73)  
Mr. Marc Alviso (MIC 101)  
Mr. Chris Lee (MIC 101)  
Mr. Gary Lambert (MIC 43)

## USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN ~~CURRENT~~ SUBSEQUENT AUDITS

0405.33

The prior audit percentages of error (PAPE) program involves, ~~the use,~~ under certain circumstances, the use of a percentage of error developed in a prior audit for the sales or accounts payable portion ~~of in two a current~~ subsequent audits. Staff must obtain approval from the Chief of Field Operations (COF) to apply a PAPE to the second subsequent audit. ~~It~~ 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~~ [in](#) 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-M, *Transcript of Returns—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~~ [in](#) the ~~current~~ [subsequent two](#) audit periods, which are generally available on Form BOE-414-M.

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

AUDIT MANUAL

EXAMPLES OF PRIOR AUDIT PERCENTAGE MEMOS

EXHIBIT 5

State of California

Board of Equalization  
Sales and Use Tax Department

Memorandum

Distributed Electronically

To : District Principal Auditor\* Date: December 1, 20XX

From : Audit Supervisor

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~~ may 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.