Sampling Strategies in Sales Tax Audits
Selecting a Sampling Methodology and Negotiating With Auditors

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Today’s faculty features:
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Sampling Strategies In Sales Tax Audits Webinar

Nov. 4, 2010

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Harold Jennings, Multistate Tax Commission

RESEARCHING EACH STATE’S RULES AND POLICIES
Sample Preparation And Negotiations

• Know what to expect
  – Computer-assisted audit (use of electronic records), or
  – Traditional audit
  – Statistical sample
  – Non-statistical sample
    • Random or stratified random
    • Some form of block sampling
    • Other forms
Sample Preparation And Negotiations (Cont.)

• Research
  – State’s rules, policies and guidelines on sampling and computer-assisted audits
  – Online and/or request from the auditor
  – Request a copy of any sampling manuals
  – Network with professionals from other corporations
Sample Preparation And Negotiations (Cont.)

- Educate yourself
  - In statistical sampling, you don’t need to be a statistician.
  - Training
  - Workshops and seminars
  - Wealth of information online
  - Networking with other professionals
  - Consultants
• Sampling plans
  – Prepare your own preliminary sampling plan before the audit ever starts
  – Request a sampling plan from the auditor
  – Discuss and communicate with auditor and try to come to an agreement on the sampling plan
  – Have auditor discuss any deviations from the sampling plan
J.R. Sherman, Wyoming Audit Department

ITEMS DRAWING SPECIAL STATE FOCUS
What Types Of Sales Does Your Company Make?

• A state’s focus depends on what industry the taxpayer is in.

• A wholesaler may not be examined in the same way as a retailer.

• A service provider may not be examined in the same way as a rental company.

• Thoroughly knowing your company’s industry, and related taxability, will give you insight into what a state may focus on.
  • *See example in Appendix A*
Example

Here is an industry specific statute relating to oil and gas well work in the state of Wyoming:

“(K) The sales price paid for all services rendered to real or tangible personal property within an oil or gas well site beginning with and including the setting and cementing of production casing, or if production casing is not set as in the case of an open hole completion, after the completion of the underreaming or the attainment of total depth of the oil or gas well and continuing with all activities sequentially required for the production of any oil or gas well regardless of the chronological occurrence of the activity. All services required during the entire productive life of the well, including recompletion, all the way through abandonment shall be subject to this subparagraph.”
Taxed Sales

• A state may want to separate and reconcile taxed sales.

• A probe sample, rather than a full statistical sample, may be used to identify possible errors.
  – Example: A taxpayer has 25,000 taxed transactions. An auditor may randomly select 20-50 transactions and look for errors. Tax overcharged or undercharged is considered an error. An expansion of the sample may occur if as little as one error is discovered.

• Research a state’s laws and policies regarding tax overcharged to your customers.
Non-Taxed Sales

• What type of sales are not being taxed?
  – Is it a product exemption or a customer exemption?

• Be sure to have exemption certificates available

• Non-taxed sales are usually a state’s primary focus.
Flow Chart Of Audit Focus (Sales)

- Industry
  - Taxed Sales (Secondary Focus)
    - Reconcile
    - Probe Sample
  - Non Taxed Sales (Primary Focus)
    - Sample
Inventory Purchases

- Have a list of types of inventory products available at the time of audit.
- States may look to identify inventory that is consumed by the taxpayer.
- It may be beneficial to separate inventory purchases from expense purchases.
Expense Purchases

- Expenses usually comprise the largest portion of the audit population.

- The audit focus is on finding non-taxed purchases consumed by the taxpayer.
  - Taxes paid on purchases should also be reviewed, and may be separated in the population.
  - Research state laws and policies regarding tax overpayments to vendors

- It is important to have detailed information about any use tax accruals available at the time of audit.
Asset Purchases

- Usually separated and examined in detail

- It may be beneficial to separate assets from expenses, as they may be of higher dollar values that you normally do not want to project.

- Be sure to have all back-up detail documentation available for any use tax accrued on asset purchases.

- Asset purchases are a high priority in most audits.
Flow Chart Of Audit Focus (Purchases)
Data Requirements

• A state’s audit focus may be adjusted by the type of data that it receives from the taxpayer.

• Different states have their own preferred formats and requests.

• Data requirements/request should be discussed during the initial sampling plan.
Roger Pfaffenberger, Ryan
Harold Jennings, Multistate Tax Commission

PREPARING A PRELIMINARY SAMPLING PLAN FOR THE AUDITOR
Determine Sampling Methods Based On Types Of Transactions Under Audit

• Determine types of transactions for detailing, block sampling or random sampling
  – Detailing: Small sets of high-value purchase transactions (e.g., assets)
  – Block sampling: Sales audits for large retailers (e.g., selection of store/days as sampling unit)
  – Random sampling: Large sets of purchase transactions (e.g., expenses)
• Consider isolating transactions with expected liability
  – Example: Procurement card transactions with significant missing documentation
Determine Accounts Of Interest For The Audit

- State selection of accounts of interest
  - Jurisdictions will emphasize selection of non-taxed purchases and sales
- Taxpayer selection of accounts of interest
  - Taxpayer should insure that taxed purchases are selected
- Final determination of accounts of interest
  - Negotiate with auditor/state
  - Exclude accounts containing transactions with no taxability consequences
  - Goal: Select accounts that provide the basis for determining/estimating correct amount of tax due (i.e., potential overpayments and potential underpayments)
Preparation For Audits Based On Statistical Samples

- Know your data well in preparation for initial meeting with auditor
  - Prepare brief descriptions of systems that produce audit data
  - Prepare brief descriptions of how systems treat various types of transactions
  - Research changes in accounting system or in chart of accounts during the audit period
  - Examine prior audits and refund claims
    - What problems arose?
    - Is there potential for overlap?
Preparation For Audits Based On Statistical Samples (Cont.)

- Know your data well in preparation for initial meeting with auditor (Cont.)
  - Determine what is necessary to get from a record in the data file to a physical invoice
  - Describe any patterns of high or low error rates among types of transactions
  - Goal is to minimize chance that auditor will discover “surprises” in the audit data file
Preparation For Audits Based On Statistical Samples (Cont.)

- Research potential problem areas
  - Frequency and nature of transactions in holding or suspense accounts (e.g., GR/IR in SAP)
  - Extent of electronic transactions (e.g., evaluated receipts settlements)
  - Procurement card exposure due to missing documentation
  - Existence and treatment of duplicate payments to vendors
  - Extent of out-of-state transactions
  - Availability of resale exemption certificates and direct pay permits
Preparation For Audits Based On Statistical Samples (Cont.)

• Preparation of electronic files for sample audit
  – Discuss process of downloading data for the audit
  – Discuss reconciliation of download to the general ledger (G/L) and to the tax returns
  – Determine sampling unit (line item, invoice, other)
  – Determine fields to include in data files
  – Reconciliation is essential ("GIGO")
Process Of Developing Audit Sampling Population From Taxpayer Files

- Typical development of audit population data file
  - Tax director requests download from IT department
  - IT department produces download/data extraction
  - Tax director reconciles download to G/L and tax returns
  - Tax director analyzes data to gain knowledge and understanding of data (e.g., data summaries by accounts, vendors, year/month, tax codes, jurisdictions, etc.)
  - Tax director and auditor agree on “carve-down” of downloaded data file to the audit and sampling population
Process Of Developing Audit Sampling Population From Taxpayer Files (Cont.)
Process Of Developing Audit Sampling Population From Taxpayer Files (Cont.)

- The AP or sales data file is a subset of the general ledger.
- The population file contains the transactions within the scope of the audit.
- The sample file is a subset of the population file and contains the transactions to be audited.
- The tax accrual data file typically overlaps G/L, AP, population and sample files.
- Key elements in defining the audit population
  - Selection of accounts of interest
  - Stratification of transactions into groups with similar error rates (e.g., assets, expenses, P-cards, utilities, pre- and post-law change periods)
Understand The Audit Data Life Cycle

- Get Data
- Reconcile Data
- Define Population
- Sample Design
- Results
- Post Analysis
Issues To Negotiate Before Audit

- Division of population into strata based on qualitative and quantitative variables
  - Qualitative stratification (i.e., categories representing types of transactions, time periods, outlets, plants)
    - Required by law (e.g., legal entity)
    - To manage risk (e.g., group for items likely to have missing documentation such as P-card transactions)
    - To partition error rates (e.g., assets vs. expenses)
Issues To Negotiate Before Audit (Cont.)

- Division of population into strata based on qualitative and quantitative variables (Cont.)
  - Quantitative stratification (i.e., numerical dollar ranges within groups)
    - Lower exclusion threshold (don’t audit items with absolute values less than exclusion threshold, e.g. $25)
    - Upper detail threshold (take a complete census, or “detail” all items with absolute values greater than detail threshold, e.g., $100,000)
  - Sample strata: At least two, but no more than seven, mutually exclusive and exhaustive dollar ranges, from exclusion threshold to detail threshold
Issues To Negotiate Before Audit (Cont.)

• Determination of controlling date field (invoice date, posting date, etc.)
• Treatment of negatively valued transactions
• Treatment of missing records in audit
• Sampling method selected for the audit
• Statistical issues
  – Block sample or stratified random sample
  – Method of determining numerical strata breaks for stratified samples
  – Sample sizes
  – Detail thresholds
  – Exclusion thresholds
Issues To Negotiate Before Audit (Cont.)

• Statistical issues (Cont.)
  – Evaluation method
  – Lower limit or point estimate
  – Precision level
  – What if precision goal is not met?

• Tentative timetable for audit
Professional Relationship With Auditor

• Communications with and treatment of auditor
  – Do not allow auditor direct access to internal computer systems or internal accounting databases
  – Provide the auditor with a quiet and isolated place to work
  – Jointly work with auditor on auditor’s information request and on the development of the sampling plan
  – Develop a professional, if not cordial, working relationship with the auditor
    • A relationship based on trust is in everyone’s best interest
Review Proposed Sampling Plan, Sampling Procedures

- Ensure that the sampling plan used to draw the sample is the plan that was agreed to originally
- Confirm agreements on the treatment of negatively valued transactions and on transactions with missing documentation
- Confirm the definitions, descriptions and specifications of the population and the sample
- When auditing work is completed, check the accuracy of the estimation/projection methods and results
- Once the sample is pulled, check that the sample appears to be random and representative of the population
Information Sources

- Federation of Tax Administrators *Sampling for Sales and Use Tax Compliance* white paper (December 2002); *Summary of State Sampling Practices* - Update on states’ audit sampling policies and procedures (January 2004). Internet: [www.taxadmin.org](http://www.taxadmin.org)
Brent Fryar, Wal-Mart Stores Inc.

BEST PRACTICES FOR PROTESTING A SAMPLE
Did This Really Happen? Really?!?

Assess the situation

What Happened? When did this become a “National Lampoons: Family Vacation Audit”?

Assessment of the audit
What was audited?
How was it audited?
Areas of agreement, or at least agree to disagree
Did This Really Happen? Really?!?! (Cont.)

Assess the situation (Cont.)

Sample issues vs. taxability issues

Did we sign away our right to protest?

Unavailable records as opposed to the definition of food (or candy)

Projection process is what?

Scientific vs. “This looks about right”
Did This Really Happen? Really?!?! (Cont.)

Assess the situation (Cont.)

Is it worth the time and trouble to protest?
   Is the assessment more than the cost to appeal?
Understand the protest/appeal process

Know the facts of the audit
   Document
   Organize
   Analyze the data
   Did I mention document and organize?
Did This Really Happen? Really?!?! (Cont.)

What can we do now?

- Assess the state’s position on the matter
- Meet with the auditor and audit supervisor to discuss
  - Offer solutions before you protest
  - You may not always get the complete victory
- Understand and document their position
  - Build a protest file
  - Offer to pre-pay parts of the assessment, when possible
Did This Really Happen? Really?!?! (Cont.)

What can we do now? (Cont.)

Only protest items where both parties disagree
   If you can’t reach resolution by meeting with the supervisor
   Try to avoid the “throw-the-kitchen-sink” defense

Make sure your counsel, in-house or external, agrees

Run it by another expert in the state
Roger Pfaffenberger, Ryan

**SIGNIFICANT MULTI-STATE SAMPLING TRENDS**
Trends In Sales And Use Tax Auditing

• Use of lower exclusion threshold in stratified random samples
  – Example
    • Lower exclusion threshold = $25; no items with amounts (or absolute amounts) less than $25 will be audited
  – Michigan application
    • Up to 5% of population base dollars in audit population may be placed in lowest exclusion stratum (e.g., $0 to $25)
    • Error rate in next lowest range stratum applied to exclusion stratum
• Extended and extensive reviews of refund claims based on sample audits
  – State of Texas illustration
    • Requirement for audit sample refund claims to include all reports required by state auditors for state-initiated audit samples
Trends In Sales And Use Tax Auditing (Cont.)

- Use of random sampling methods for audits of purchases
  - Exception: New York audit field offices continuing to push for the use of block samples for audits of assets and expenses
- Use of a minimum stratum sample size of 100
  - Exception: Tennessee continues to use minimum stratum sample size of 70
- Use of block sampling for sales audits of large retailers
  - Example: Randomly selected store/day sales or store/day/hour sales
  - Assumption: Cluster sampling; all stores/days in population have approximately same error rates
RECENT SAMPLING DEVELOPMENTS
Unclaimed Property Sample Audits

- State of Delaware audits
  - Unclaimed property audits are third-highest source of revenue.
  - Use of contract auditors
  - Projection of gross unclaimed property liability back to 1981
  - SB 272 (introduced 5/13/10; signed into law 7/23/10)
    - Provides for an administrative review process that includes independent review
    - Creates limited exemption from definition of unclaimed property covered by Uniform Commercial Code (no liability for goods received but not invoiced)
    - Provides general basis for using samples to estimate holders’ liability
- Use of contract auditors (e.g., Kelmar Associates)
  - Most contract audits conducted on contingency fee basis
  - Encourages contract auditors to be overly aggressive in identifying liability
Unclaimed Property Sample Audits (Cont.)

- Commonly used liability estimation methods
  - Identify recent years for a sample audit ("base years")
  - Sampling population defined as transactions in various property classes for which unclaimed property liability exists during base years
  - Typical property classes: Payroll, AR, AP, workers’ comp, consumer relations, rebates, inventory not invoiced
  - Projection of gross liability in base years to years not sampled ("non-base years")

- Efforts to reform state unclaimed property laws
  - Current law: 1995 Uniform Unclaimed Property Act
Sampling For Tax Determination
Software Performance

- Objectives of audit sampling for tax determination software evaluation
  - Primary objective
    - Assess tax system to analyze the treatment of transactions processed in system
    - Typically tracks transaction through multiple steps from inception to final accounting determination
    - System includes people and computer software decisions
    - Attribute sampling to estimate proportion of transactions treated correctly at each stage in system
  - Secondary objective
    - Estimate dollar amount of tax errors encountered
    - Variables sampling to estimate dollar amount of the tax error
Sampling For Tax Determination

Software Performance (Cont.)

• Audit sampling design considerations
  – Sample size determination
    • Goal: Estimation of correct treatment proportions only
      – Use sample size determination formulas for proportions
    • Goal: Joint estimation of proportions and dollar amount of tax error
      – Use larger of sample size determined for proportions and sample size determined for total tax error amount
  – Selection of types of transactions selected for study
    • Typically transactions subject to tax determination decisions
    • May include broader sets of transactions (e.g., wages, tax payments)