
Features:

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Managed audits: Gain control, save time, avoid lengthy protests-but at a cost

Managed audits give taxpayers the ability to see around the corner—a much-wished-for advantage in a state audit. Companies that agree to conduct their own audits under the supervision of a state tax official or other certified professional will be informed well in advance what is expected. The benefits may be lower assessments, abated interest and avoiding the hassle of fighting a higher assessment produced by a traditional audit. But the taxpayer must absorb the cost of the audit by supplying the qualified staff to conduct the procedure. How much will be gained must be weighed against that cost.

For the taxpayer, the benefit of a managed audit comes in the absence of problems associated with a traditional audit, notes **J. Whitney Compton**, director of Compton & Associates in Atlanta.

"The biggest advantage is what it avoids," says Compton. "It avoids the 500- or 1,000-page listings of unrelated transactions, typically small amounts" generated by auditors in traditional audits.

Compton recalls a managed audit conducted for a taxpayer in Ohio, a chemical plant. The managed audit produced a \$100,000 assessment that resulted in a \$10,000 refund in a process that took two weeks. A similarly situated client, also a chemical plant, yielded to a traditional audit. That taxpayer had a state auditor on site for six months, who assessed a liability of \$2 million.

"For what it's worth, the second plant got about the same result," says Compton, "but only after three years and litigation.

"It's a matter of controlling the audit and controlling the auditor, or not controlling the audit and not controlling the auditor," Compton adds.

Getting ready

To prepare for a managed audit, first check to see that a particular state offers a managed audit program, says **Diane Yetter**, of Yetter Consulting Services Inc. in Chicago. (See the Bonus Insert in this issue for a comprehensive list of states that offer managed audit programs.) Then check the rules. Find out who must conduct the audit. For instance, Florida demands that the person who conducts the managed audit be certified by the state.

Next, make sure you have the resources and the qualified personnel to dedicate to a managed audit before you commit. Some smaller companies may not be able to conduct a managed audit. However, a managed audit program such as the one revived in California will soon allow managed audits that cover certain aspects of business activity; other factors may be audited by the state. (See the related article below, "California Revives, Expands Managed Audit Program.")

Be familiar with the techniques of that state's tax agency, advises **Karri Rozario**, a senior manager with Deloitte & Touche's Multistate Tax Services Group in Sacramento. Do they want block samples or statistical samples? Block samples generally require more recent and readily available documents; statistical samples may require older samples. Do an inventory of the necessary

documents to make sure you have them ready.

Practice run

Also, taxpayers should do a preliminary examination, "a sort of dry run on their own to see if there are big areas where they are making big mistakes, overpaying or underpaying, *before* they do the official managed audit process," Compton states. "They need to know their strengths and weaknesses before they start."

Rozario agrees. "I would recommend doing some high-level spot testing," Rozario adds, "to make sure what you expect to see in terms of documentation and support is what you're going to see."

Randomly check a handful of customer sales invoices or whatever files you will be sampling for the audit to make sure they are complete and contain the proper documentation.

Talk to others

Also, talk with department heads. Find out if there has been personnel turnover in the sales or purchasing departments as well as the accounts payable staff. "Sometimes if you have a purchasing manager that is the go-to person, and that person leaves...things can change," Rozario notes.

Have any alterations occurred in the policy manual? A different policy or procedure concerning sales and use tax might affect the outcome of the audit. These could be manual changes or automated changes, such as installing a new software system, perhaps. Know your business activity over the audit period. Have there been major changes there that will affect sampling?

"Anticipate the questions and answer them before they are asked," Rozario advises. "It's like the old devil's advocate theory."

Drawbacks

Despite the advantages of managed audits, they may not be the best alternative for every taxpayer.

Of course, there is the cost associated with the managed audit that the taxpayer will assume. "If you're doing a managed audit program, you're picking up the state's payroll," notes Yetter. "If the liability is small, do you want to incur those additional costs versus just having the state come in and do it?"

Better consider just how big the savings are. Be alert, Yetter warns. Calculate the actual dollar savings of a managed audit for your company. It may not be worth the effort. For instance, if under a managed audit program you are allowed to waive half the interest, are those savings greater than the cost of conducting a managed audit? Perhaps you only have a small assessment, and half the interest on it is a minimal figure.

"Are you going to pay someone \$50,000 to save \$200?" Yetter asks.

Taxpayers have been slow to participate in managed audit programs-for a good reason, she adds. "One of the reasons managed audits haven't taken off is the taxpayer has to pay someone to do it, and the break isn't big enough."

Also, although states allow taxpayers to negotiate some of the parameters of a managed audit, still, the state auditor retains the final say in what the audit will cover. The tendency of the taxpayer is to

test less, and to run smaller tests, notes Rozario. But if the results are not representative, the auditor may make the taxpayer do it again. Soon.

"You will be held to a timeline," she adds. "Make sure you have adequate resources before you begin."

The taxpayer and the state may differ in opinion as to what needs to be included in the audit, agrees Yetter. Depending upon how the audit is set up, if you have a lot of gray transactions that you believe are not taxable, you are not going to put them on the list. That's a plus for taxpayers.

Still, states may zero in on controversial issues in an industry. For manufacturers, that may be what is considered manufacturing equipment, or research and development property versus testing equipment. Other industries may be affected by whether certain software meets the definition of custom software. These industry issues could result in a lot of investigations about the details of transactions, Yetter notes.

Other reasons

There may be other reasons to choose a managed audit. They generally involve a desire to keep state auditors off the premises.

Yetter recalls a client who chose a managed audit because of a nexus determination by a state. "They didn't think they had nexus and didn't want the state rummaging through their records," she says.

Sometimes taxpayers just don't want the state in their facility. Maybe they lack space or auditors from other jurisdictions are already auditing on site.

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MANAGED AUDIT CHECKLIST

Experts offer these tips to sales tax managers as a checklist for smoothly conducting a successful managed audit:

- Make sure the state you are approaching offers a managed audit program. (Consult the Bonus Insert included in this issue for a complete list of states that allow managed audits.)
- Find out who must conduct the audit-some states require professionals certified to conduct managed audits.
- Determine whether you have the resources and the personnel to dedicate to a managed audit before you commit.
- Familiarize yourself with a state's techniques. Does the state want block samples or statistical samples?
- Do an inventory of the necessary documents to ensure you have all of them.
- Conduct a practice audit before beginning the official managed audit. Know what your strengths and weaknesses are and what to expect.
- Talk with the heads of the sales, purchasing and accounts payable staff. Has there been turnover in personnel? Perhaps the go-to person has left, and procedures have changed. Any alterations in the procedures manual? Has a new automated system been introduced? Did business activity vary during the period

under audit? Any of these factors could affect sampling.

- Decide whether a managed audit is cost-effective for your business. Perhaps only a small assessment would result, the only savings being half the interest on that amount. Yet keeping snoopy, nexus-imaginative auditors from camping in your office for a months-long traditional audit may be worth the extra costs of conducting a managed audit.

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