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TO: Government Operations and Audit Committee  
FROM: Secretary Andy Gerlach, Department of Revenue  
DATE: August 25, 2017  
RE: August 18, 2017 Audit Division Procedures

This memo is in response to the committee request for information on various audit procedures. Your members asked that I follow up on several questions regarding five topics. I appreciate the opportunity to provide you additional information regarding the Department of Revenue.

## **Audit Selection**

### **1. What policies and procedures do you have in place for selecting businesses for a sales tax audit?**

- a. Businesses are audited on a periodic basis to ensure compliance with state tax reporting, and to make sure tax is paid correctly. During the audit process, businesses can also expect to be educated on any questions they have or any issues that arise during the audit.
- b. Common audit selection methods: business type or industry, previous high risk audits, tax filing history, 1099-K leads, inconsistent reporting, geographic area, and non-compliance.
  - i. Business type or industry: Certain industries have identifiable trends. When a business within an industry falls outside what is expected, they may be selected for audit.
  - ii. Previous high risk audits: Businesses are evaluated for a follow-up audit of the tax periods immediately succeeding the first audit. This practice helps ensure compliance and provides follow-up education.
  - iii. 1099-K leads: The IRS shares credit card information for in-state businesses. This method of selection is very straight forward, as we simply compare gross credit card receipts to what was actually reported.
  - iv. Geographic area: The Division receives quarterly reports from neighboring states of audits with assessments greater than \$25,000. If a common business with a large assessment is thought to have a similar issue within our state, that license will be assigned to an auditor for audit.

### **2. Who is responsible for approving the businesses scheduled to be audited?**

- a. Audit supervisors are responsible for monitoring and approving audit selection for Auditor I's, and in some cases assigning audits.

### **3. Does the audit division have goals or targets for the expected outcomes of scheduled audits?**

- a. No.



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- 4. Do more senior auditors get to select the businesses they want to audit?**
  - a. Experienced auditors have more discretion in audit selection, but their audit selection is still monitored by audit supervisors.
  
- 5. How are the newer auditors assigned businesses to audit?**
  - a. Audit supervisors are responsible for monitoring audit selection for all their staff and approve selections for their Auditor I's.

### **Audit Division Personnel**

- 6. Are audit division auditors in the Bureau of Human Resources career band for compensation?**
  - a. Yes.
  
- 7. If the auditors are career banded, what are some of the performance indicators or qualities rewarded to obtain the maximum increase in salary?**
  - a. Metrics used for evaluation:
    - i. Leads – Information found through invoices in other audits, the news, building permits, and construction contracts.
    - ii. Days - This is the average days it takes to complete an audit.
    - iii. Hours - Average hours to complete an audit based on completed audits issued as lead.
    - iv. Audits Completed - The number of audit cases an auditor closes as the lead auditor in a calendar year.
    - v. Quality Distinct Audits - All metrics listed above were within acceptable ranges.
  
- 8. Is the amount of taxes recovered as the result of an audit a metric in evaluating an auditor's performance?**
  - a. No. Audit assessments are not used in evaluating performance, determining salary adjustments or financial benefits of any kind.
  - b. This is prohibited by [SDCL 10-59-29](#)
  
- 9. Is there any salary or bonus financial benefit to auditors associated with the amount recovered as the result of their audits?**
  - a. No.
  - b. This is prohibited by [SDCL 10-59-29](#)
  - c. This would be a violation of the [Taxpayer Bill of Rights](#)



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**10. What training is done with revenue auditors about policy and procedures for conducting an audit?**

- a. All new auditors attend two weeks of classroom training on Sales, Use, and Excise tax laws.
- b. All DOR auditors attend classroom audit procedures training which is taught by a senior auditor with over 23 years of experience.
- c. During the first six months, auditors receive on the job training by assisting other auditors, and they do not lead their own audits.
- d. All auditors receive valuable on the job training by continuously assisting on other audits with more experienced staff or asking other staff to assist them on their own audits.
- e. The audit division holds annual training for all staff in a range of auditing topics including statistical sampling, Excel pivot tables, and QuickBooks.

**11. What are the expectations for the conduct of the auditors?**

- a. Auditors are expected to follow Generally Accepted Auditing Standards (GAAS) as required by [SDCL 10-59-35](#)
- b. [AU-C 200](#)
  - i. Among other things, this standard states, "It is the responsibility of each auditor to have appropriate competence and capabilities to perform the audit, compliance with ethical requirements, maintenance of professional skepticism, and exercising professional judgment throughout the audit."

**Audit Process and Communication**

**12. What is the standard operating procedure for communicating with a business regarding an audit or a review?**

- a. A business will be called by an auditor to set up an audit appointment that works for both the business and the auditor. A Notice of Intent to Audit will follow in the mail. An opening conference will be held on the commencement date of the audit. Businesses have at least 60 days to furnish any additional documentation to the auditor.
- b. A business that is having a review of its records with the DOR will be contacted by letter and by phone prior to the meeting. The agent will call the business to set up an appointment time that works for both the agent and the business. The agent will advise the business prior to the visit what records to have available for the review in order to not be intrusive to the business.

**13. Are businesses informed of their right to have a lawyer and/or CPA present during the audit or review?**

- a. No. Businesses are welcome to have lawyers or CPA's present during an audit or review. We follow what the business requests.



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- 14. Is it common practice to select a business for a full audit before determining audit risk? Is audit risk a factor in determining the scope of an audit?**
- Yes. A business is selected based on one or more of our audit selection methods. Audit risk cannot be fully assessed until the opening conference.
  - Yes. Audit risk is a factor in determining the scope of an audit.
- 15. If audit risk is a factor in determining audit scope, is there a preliminary meeting with the businesses selected for audit or review to help determine audit risk?**
- Yes. The opening conference serves as the time to evaluate audit risk.
  - If it is determined that audit risk is low, an auditor may close the audit before completing fieldwork.
- 16. If the business appears to have a good understanding of sales tax laws that govern the type of business they operate, are the businesses still subjected to a full audit?**
- Not always. After all components of risk are assessed, an auditor may recommend closing the audit.
- 17. Is cost vs. benefit analysis performed to focus audit resources on troubled businesses?**
- Please see question 1 for audit selection.
- 18. What are the objectives of an audit or review? Is the primary objective education or finding errors and collecting more money for the state?**
- Our division's mission is to detect and resolve reporting errors and omissions made by taxpayers and correct reporting habits for future returns.
  - Our primary objective is ensuring compliance.
- 19. What is the standard operating procedure for scheduling a site visit to perform the audit?**
- The business will be called by an auditor to set up an audit appointment that works for both the business and the auditor. Businesses receive a minimum 30 days of notice. A Notice of Intent to Audit will follow in the mail.
- 20. What is the standard operating procedure for conducting an audit at the business location?**
- An opening conference will be held on the commencement date of the audit. The auditor will discuss audit procedures, gather an understanding the business practices, review the data provided, and may request additional documentation. Statutorily and in accordance with Streamlined, the business will have a minimum of 60 days to furnish any additional documentation to the auditor.



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**21. If there is a manual for conducting an audit, can it be shared with businesses?**

- a. Yes, we have an audit manual. We do not share it with businesses; however we do have an [Audit Tax Fact](#) for information on audit conduct.

**22. Is there a way for a business to report complaints about an audit or abuse by an auditor? What is the process a business uses to report such a matter and what is the process used internally for resolution of such matters?**

- a. Contact information for the auditor's supervisor is in the initial information the business receives. There is also a survey sent to businesses after an audit is conducted.

**Audit Assessments and Penalties**

**23. Are businesses specifically allowed to operate for one or more years before being considered for audit selection? If so, why and why is a three year look back period used for determining assessment amounts?**

- a. All businesses operating in South Dakota are eligible for an audit or a review.
- b. The three year lookback is established by [SDCL 10-59-16](#)

**24. If businesses are not eligible for audit selection for one or more years, why are disputed amounts and related penalties and interest computed from day one?**

- a. All businesses operating in South Dakota are eligible for an audit or a review at any time.
- b. Interest begins to accrue when the tax becomes delinquent.

**25. How is the interest rate on audit assessments established and revised?**

- a. The interest rate is established by [SDCL 10-59-6](#) and [SDCL 10-59-6.1](#)
- b. In 2015, [SB182](#) was passed unanimously by the House and Senate and was supported by the Governor's Office and the Department of Revenue. This bill reduced the monthly interest rate by 0.25%.

**26. Is it audit division practice to inform taxpayers that there can be no settlement without all of the tax, interest and penalty being paid? Even if the assessment amount or application of law are disputed?**

- a. No.

**27. How does a business dispute an audit assessment and how are disputes handled?**

- a. The businesses have 60 days from the end of the audit to request a hearing per [SDCL 10-59-8](#)
- b. [SDCL 10-59-9](#) outlines the hearing process.



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## **Business Tax and Audit Division Interaction**

- 28. If a business calls the business tax division to ask questions on sales tax or if the business calls multiple times, is that information communicated to the audit division in any form or fashion? Does such an inquiry flag a business for potential audit or result in an inquiry report?**
- Asking questions shows due diligence on the business' part in understanding tax laws. When a business contacts the Business Tax Division to ask questions, a note or comment is attached to the business license. These comments are made for the protection of the business. The DOR will stand by advice provided to a business if the advice is documented.
  - These comments are not shared directly with audit staff. However, auditors have access to the same tax collection system as Business Tax agents. If it is determined that the business may not be reporting correctly during a contact with a Business Tax agent, the agent will work with the business to resolve reporting errors without going through the audit process.
  - Multiple questions asked by a business do not flag the business for a potential audit.
- 29. Do questions commonly asked of the business tax division lead to focused effort by the audit division related to those subjects? If so, how are subject audit efforts developed and conducted?**
- No. If the Business Tax Division receives multiple calls from businesses in a particular industry, it may trigger an effort to more thoroughly educate businesses in that particular industry of their tax obligations through seminars, written correspondence, and newsletter articles.
- 30. What assurances do businesses have if they call and ask business tax related questions to ensure they are operating with the correct tax law that they will not be turned over for an audit?**
- All businesses operating in South Dakota are eligible for an audit or a review. During FY17 the Business Tax phone agents answered 31,116 calls. This does not include calls answered by field agents. If it is determined that a business is not reporting properly during a conversation with an agent, the agent will take steps to assist the business in correcting previous filing errors and ensure they file properly moving forward. The same is true no matter if the business has overpaid or underpaid taxes.
- 31. What interaction occurs between the business tax division and the audit division before, during or after an individual audit?**
- The audit division does have access to the same tax collection system as the Business Tax Division. If a business under audit calls the Business Tax Division with a question, the business is referred to the auditor or audit manager.