Audit Procedures for Grocery Stores

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Chapter 1

Introduction

State Sales and Use Tax Rule 3.328, Optional Reporting Methods for Grocers and Other Vendors, defines retail grocers as: "Persons who sell food at retail to be consumed off the premises where such food is sold, and who sell household supplies and nondurable household goods, but whose receipts from the sale of any other tangible personal property do not exceed 5.0 percent of their total receipts."

Through the years, the "neighborhood grocer" who sold only food has given way to the supermarket and the convenience store which sell a variety of products besides food, such as clothing, toys, food for immediate consumption, etc. Consequently, few grocers today qualify under the strict statutory definition of a retail grocer.

As the makeup of the grocery store has changed, so have the various record-keeping systems of the businesses. Many systems in use today provide a more reliable method for auditing for sales and use taxes than the three methods outlined in the statute. However, the Comptroller's office allows usage of one of the three optional statutory methods unless the retailer adopts a more reliable record-keeping method.

This procedure manual has been written for the auditor. It is to be used as a training tool and reference guide. When forms are used as exhibits, they are shown with information correctly completed. References to AM Memos, AP Memos, rulings and statutes are given when needed. Any schedules included in the manual are for illustrative purposes only and are not to be construed as the accepted format. Audit schedules will need to be tailored to the audit situations encountered and to the auditors' needs.

Users of this manual are responsible for any changes that occur after the printing or posting of the manual. References to taxability of individual items, administrative policies or tax law and rules are provided for the guidance of field auditors and are subject to change due to administrative hearings and actions of courts or the legislature.

Before relying on this information, all users should verify the current status of any information by contacting the Comptroller of Public Accounts. Call toll free at 800-252-5555. The local number in Austin is 512-463-4600.

Chapter 2

What is Taxable at Grocery Stores?

Overview

- Examples of Taxable Items
- Food Sold for Immediate Consumption
- Photo Processing
- Rentals of Tangible Personal Property
- Cigarettes and Tobacco Products
- Newspapers
- Phone Cards
- Over-the-Counter Drugs and Medicines

A good place to begin is to list some examples of items which would be subject to the limited sales and use tax. Keep in mind that this only lists examples of items; it is not all-inclusive. Some items will be footnoted and explained further. In addition, some items will not be listed but will be addressed separately.

Examples of Taxable Items

adhesive tape
ale
ammunition
automotive transmission fluid
baby care products (oil, lotion etc.)**
batteries
beer
breath mints
brushes
candy*
charcoal
Christmas trees
cigarette lighters
coffee pots
cosmetics
dental floss
deodorants
diapers
disinfectants
fabric softeners
fishing tackle
floor wax
frozen drinks*
garden supplies
aluminum foil
ammonia
automotive oil
automotive antifreeze
bags (all types)
beauty supplies
bleach
brooms
candles
cards
charcoal lighter fluid
cigarettes
clothing
cologne
cough drops**
detergents
deodorizers
diluted fruit juices*
electrical supplies
fertilizer
firearms
freezer paper and tape
garbage bags
gift wrap

gum
hair shampoo**
hair coloring
houseware items
ice chests
ice cream sundries***
keys (including duplication)
liquor
matches
mops
mothballs
nuts (candy coated)*
perfume
popsicles
razors and blades
sandwich bags
scouring pads
shoelaces
sponges
stationery and cards
thread
toothbrushes
toothpicks
tobacco products
water softener salt
wine (except cooking wine)

hair conditioner
hair spray
hardware items
ice
ice cream salt
insecticides
light bulbs
lotions**
magazines
mop replacement heads/handles
nails
pencils and pens
pet food
powdered drinks*
sandwiches (except frozen)
school supplies
shaving cream/after shave
soft drinks*
starch
tape
toilet tissue
toothpaste
toys
towels
wax removers
water (flavored)

* Exempt if purchased with food stamps or the Lone Star Card
** Exempt if medicated
*** Exempt if sold in packages of six or more

NOTE: As of October 1, 2003, fruit drinks containing more than 50 percent juice are exempt as food products.

As of October 1, 2003, retailers who mix two or more food ingredients for sale by weight or volume (e.g., salad) as a single item must collect sales tax, unless the mixture has raw animal foods (eggs, fish, meat or poultry) that require cooking by the consumer per U.S. Food and Drug Administration (FDA) recommendations. The provision does not include bakery items and food that is only cut, repackaged or pasteurized.

As of June 18, 2012, sunscreen is once again exempt from Texas sales and use tax. Legislation that became effective Sept. 1, 2007 amended the definition of over-the-counter (OTC) drugs in Texas Tax Code Section 151.313 (a)(3) to provide that an OTC item is exempt from sales tax only if the OTC drug or medicine is REQUIRED by the FDA to be labeled with a drug facts panel. As a result of that statutory change, sunscreen became taxable because it was not required to be labeled with a drug facts panel. Because sunscreen is now REQUIRED by the FDA to be labeled with a drug facts panel, it also now qualifies for the exemption set out in Tax Code Sec. 151.313 (a)(3). Therefore, as of June 18, 2012, sunscreen is once again exempt from Texas sales and use tax. <u>So, from Sept. 1, 2007 through June 17, 2012 sunscreen is taxable but non-taxable thereafter.</u>

As of Sept. 1, 2013, snack items are now defined under Sec. 151.314(b) as a "food product." Snack items include:

- breakfast bars, granola bars, nutrition bars, sports bars, protein bars and yogurt bars, unless labeled and marketed as candy;
- snack mix or trail mix;
- nuts, unless candy-coated;
- popcorn; and
- chips, crackers or hard pretzels.

Snack items sold through a vending machine or in individual portions are taxable. An individual-size portion is a portion that is labeled as having not more than one serving or, if the package does not specify the number of servings, that contains less than 2.5 ounces.

Food Sold for Immediate Consumption

A grocer must collect sales tax on:

- all food kept and sold hot, such as barbecued beef, chicken, chili, soups, barbacoa, tamales, tacos etc.; and
- all individual-sized portions of food sold with utensils; i.e., plates, knives, forks, spoons;
- If there is a bakery, coffee shop or delicatessen with a place to sit and eat, then tax must be collected on items sold "through the restaurant" that are listed above, as well as on all food items sold in individual-size containers that are ready to eat, such as chips, cookies, crackers, peanuts etc.

Prior to Oct. 1, 2003, all individual-size bakery products such as doughnuts and cookies, when sold in quantities of five or less by a retailer that provided eating facilities, were considered to be for immediate consumption and, thus, subject to sales tax.

Photo Processing

The grocer must collect sales tax on all film processing, negatives, prints, reprints, pictures-on-disk, slides etc.

Rentals of Tangible Personal Property

A grocer must collect sales tax on the rental of videotapes, digital video discs , videocassette recorders , floor-cleaning equipment and any other rentals of tangible personal property (TPP).

Cigarettes and Tobacco Products

Even though cigarettes and tobacco products are taxed under different statutes, they are also subject to the limited sales and use tax.

Newspapers

Newspapers are not taxable. The state sales and use tax statute, Tax Code Sec. 151.319 (f), defines a newspaper as a publication:

- printed on newsprint;
- distributed at intervals of four weeks or less;
- sold for an average price per copy of $1.50 or less over a 30-day period through Aug. 31, 2013*; and
- whose purpose is the dissemination of news of a general character and of general interest, including advertising.

*As of Sept. 1, 2013, the average price increased to $3.00 or less over a 30-day period.

NOTE: Publications distributed free of charge that meet the above criteria would also qualify as newspapers.

Phone Cards

Tax must be collected on the sale of all prepaid phone cards. Prepaid calling cards became taxable as TPP effective Sept. 1, 1997 based on Tax Code Sec. 151.01032 for the definition of "calling card" and on Sec. 151.009 for its inclusion as taxable TPP.

For more information on items on which a grocer must collect sales tax, consult *Publication #96-280 — Grocery and Convenience Stores: Taxable and Nontaxable Sales*

Over-the-Counter Drugs and Medicines

As of April 1, 2000, over-the-counter (OTC) drugs and medicines are exempt from sales tax. To qualify for the exemption, a product must be applied to, ingested by or inhaled by humans.

In addition, the drug or medicine must be intended or marketed for use in the diagnosis, cure, mitigation, treatment or prevention of disease, illness, injury or pain. The OTC drug or medicine must have been issued a National Drug Code (NDC) number. However, the number does not have to appear on the product label in order for the drug or medicine to be exempt.

Items for animals are not exempt unless purchased with a veterinarian's prescription.

In order to give the auditor an idea as to which products qualify for the exemption, the following is a short list of qualifying products. Again, the list below merely serves as a guideline.

acne treatment products
analgesics
anti-asthmatic products
anti-fungal products
antibiotics
anti-rheumatic products
cough suppressants
dietary supplements/vitamins
expectorants
hemorrhoid products
pain relievers (aspirin, ibuprofen etc.)
stimulants
sunburn treatment products
allergy treatment products
antacids
anti-diarrhea products
anti-nausea products
antiperspirants
cold remedies
dandruff shampoos
ear care products
eye care/contact lens products*
laxatives
sedatives/sleep aids
sunburn prevention products
wound care dressings

*Must be applied to the eye; exemption does not apply if product merely used to clean contact lenses.

There could be a fine line between a qualifying product and a non-qualifying product. For example, deodorants are subject to sales tax; however, antiperspirants are exempt. For more information on OTC drugs and medicines, consult *Publication # TX 94-155 — Sales Tax Exemptions for Over-the-Counter Drugs and Medicines*.

Chapter 3

Methods of Tax Determination

Overview

- Cash Register Keys
- Computer-generated Sales Registers
- Gross Profit Method (shelf test)

Retailers now use various record-keeping systems. Several methods of determining taxes due are also used including:

- separate keys on cash registers to indicate taxable or nontaxable sales;
- computer-generated sales registers;
- gross profit method;
- estimated taxable percentage; and
- special reporting methods allowed by statute.

Cash Register Keys

Retailers, particularly smaller ones, have a relatively simple method of indicating taxable or nontaxable sales through the use of separate keys on cash registers. The retailer usually has a separate key identifying tax collected. Reported taxable sales will consist of the monthly or quarterly collected amount divided by the applicable tax rate. When this procedure is used:

- determine the taxpayer's knowledge as to which items are taxable and which are exempt from tax;
- determine what guidelines or information have been given to the cashiers to determine taxability;
- determine the taxpayer's exact sales tax reporting procedures;
- trace the postings of taxable sales and tax collected from cash register tapes to summary records and to the tax returns; and
- verify the reliability of this procedure by comparing it to the results of the application of the purchase ratio method, at least on a preliminary sample basis.

Computer-generated Sales Registers

A rapidly expanding method of recording sales transactions for grocery stores is through the use of "product code" recognition for checkout stations. This system uses the standardized manufacturer's product identification code on the wrapper of the merchandise. Various scanners read the coding, and a central computer system matches the product code with the selling price of the item and records this amount on the checkout stand register tape. The taxability of the product is also determined by the central computer system that obtains the total tax due on each transaction.

An audit of a taxpayer using the "product code" system may be limited to:

- verification of the correct internal coding for taxable and nontaxable items;
- verification of summary records generated by the system; or
- the inclusion of all receipts for report periods.

NOTE: Internal codings should be obtained for the entire audit period. A taxpayer's determination of the taxability of an item may have changed during the audit period. In addition, the taxability of products may have changed during the audit period.

Gross Profit Method

Basically, the mark-up method involves applying a gross profit mark-up percentage to the adjusted cost of goods sold in order to estimate sales. This procedure may be used when the expense and cost-of-goods-sold records are adequate, but the sales records are inadequate. This method also may be used to substantiate the reliability of sales records. The gross profit method is most effectively used on businesses in which the unit sales price is small, the volume of transactions is large and gross profit mark-up does not fluctuate greatly.

Using the gross profit method, sales may be estimated with a fair degree of accuracy. This is done by calculating a weighted mark-up through a shelf test of the merchandise purchased.

A standard shelf test includes:

- An actual physical examination of products, quantities, price tags, price stickers, signs or any other devices used to inform the customer of the sales price. Standard catalogs and price lists may also be used when other sources are unavailable.
- The computation of a mark-up percentage after testing items purchased.

The last step is to determine audited gross sales:

```
calculated mark-up percentage + 100%
X cost of goods sold
--------------------
audited gross sales
```

Since the mark-up is based on the cost of purchases, the percentage used in calculating sales will be the mark-up percentage plus 100 percent, with 100 percent representing the original cost of the purchase.

EXAMPLE

Adjusted cost of goods sold for a period = $7,200
Mark-up percentage = 30%
$7,200 X $1.30 = $9,360 (gross sales)

Invoice Date	Invoice Number	Product	1 Total Purchase Price	2 Sales Price Per Item	3 Items Per Unit	4 Number of Units Purchased	5 Total Retail Sale
			from invoice	per shelf test		from invoice	(2)*,(3)*, (4)*
01/03/2014	10708	beer (quart)	50.75	1.99	10	3	59.70
01/10/2014	stmt	milk (gallon)	66.86	1.99	12	4	95.52
02/02/2014	80692	breakfast cereal	25.44	2.12	12	2	50.88
02/07/2014	10912	beer, cans (6-pack)	98.07	2.99	4	10	119.60
03/03/2014	2001	cola, cans (6-pack)	49.80	2.49	4	10	99.60
03/13/2014	stmt	bread, loaf	22.49	0.99	8	4	31.68
04/04/2014	1999	cola, plastic (liter)	87.56	1.99	8	10	159.20
04/11/2014	53399	canned corn	13.71	0.84	12	2	20.16
04/17/2014	11723	cigarettes, regular	503.10	4.30	10	15	645.00
05/02/2014	21606	candy	42.00	0.35	30	2	21.00
05/22/2014	4156	motor oil	44.06	4.59	12	2	110.16
06/01/2014	54396	ketchup	49.92	1.04	24	4	99.84
06/01/2014	16540	paper towels	64.30	0.94	30	6	169.20
06/28/2014	1130	grape drink	20.03	0.89	10	5	44.50
07/13/2014	6611	canned spaghetti	23.33	1.62	12	2	38.88
08/01/2014	9950	garbage bags (10-pack)	49.75	1.99	10	5	99.50
08/19/2014	1050	pet food (cans)	17.64	0.49	24	3	35.28
09/17/2014	8608	detergent (64-ounce)	107.73	3.99	12	5	239.40
09/20/2014	35995	tomato sauce (8-ounce)	26.68	0.38	36	3	41.04
10/03/2014	7404	chicken noodle soup	19.15	0.57	24	2	27.36
10/03/2014	34424	bath soap, bars	18.41	0.59	24	2	28.32
			$1,400.78				**$2,235.82**

Gross profits = total retail sales - total purchase price = $2,235.82 - $1,400.78 = $835.04
Mark-up = gross profit ÷ total purchase price = $835.04/$1,400.78 = 59.6125%
Total purchases (adjusted cost of goods sold) will be multiplied by 1.5961.25 in order to calculate gross sales.

Chapter 4

Special Reporting Methods

Overview

- Method B – Purchase Ratio Method
- Method C – 15 Percent of Gross Sales
- Audit Procedure – 15-Percent Method
- Method E – Commingled Receipts

Three special reporting methods are available to retail grocers as outlined in the sales tax statute (TEX. TAX CODE ANN. 151.412, 151.413 and 151.416) and State Sales and Use Tax Rule 3.328 (Optional Reporting Methods for Grocers and Other Vendors).

The special reporting methods are commonly referred to as follows:

- purchase ratio method (Method B)
  - » A percentage ratio of taxable items purchased to total items purchased is applied to gross sales to determine taxable sales.
- 15-percent method (Method C) [Note: not available to convenience stores]
  - » A retail grocer whose gross receipts do not exceed $100,000 per calendar year may report and pay tax based on 15 percent of gross receipts.
- commingled receipts method (Method E)
  - » Tax collected is commingled with the receipts from the sales of both taxable and nontaxable items.

If a taxpayer is reporting by using one of these methods and qualifies for use of the method, the audit procedure is to verify returns and computations based on the method being used.

Purchase invoices must be maintained for at least four years to verify sales tax returns, regardless of the method chosen for reporting purposes.

The use of an optional special reporting method does not relieve the seller from the obligation and duty of collecting tax in the specific manner as prescribed in the statute and in accordance with the bracket system (TEX. TAX CODE ANN. 151.415).

Method B – Purchase Ratio Method

This method may be used for reporting purposes only, and eligibility is restricted to:

- any retail grocer;
- any vendor who maintains a separate grocery department with separate records that may be audited by the Comptroller, as applies to the grocery department only; or
- any vendor whose taxable receipts from the sale of taxable items are less than 10 percent of total receipts.

NOTE: Under the current definition of a retail grocer, most convenience stores and many grocers do not qualify; however, the Comptroller still allows them to use this method. The following steps are used under this arrangement:

- Determine the total sum of merchandise purchased for resale during the preceding calendar or fiscal years.
- Determine the total sum of taxable merchandise purchased during the preceding calendar or fiscal years.
- Divide the total amount of taxable merchandise purchased by the total merchandise purchased for resale to obtain a percentage relationship.
- Multiply the percentage obtained by the total sales for the reporting period to obtain the taxable sales.
- Items which are purchased tax free and used by the taxpayer (and subject to sales/use tax) must be included on the return as taxable purchases.

An audit of a taxpayer who uses the purchase ratio method to compute taxable sales will generally be limited to verification of reported amounts based on summary records and computation procedures. The verification procedures should include the following:

- An examination of the taxpayer's worksheets that were prepared to compute total purchases and segregate taxable and nontaxable item purchases. Worksheet amounts for total purchases should be traced to summary records (purchases journal, cost of goods sold section of the federal income tax return etc.).
- Tracing purchase invoices for sample periods to verify proper inclusion and segregation. Sample periods should include entire purchase cycles (weeks, months etc.).
- Comparing the purchasing patterns with the purchase invoices for the sample period. Vendors may need to be contacted to verify purchases.
- Verifying any adjustments to taxable and gross purchases, which would include:
    - » operating supplies;
    - » wrapping and packaging items;
    - » trading stamps;
    - » finance, insurance and other charges;
    - » inventory variances;
        - ° method of inventory – actual physical inventory, gross profit method
        - ° valuation of inventory – retail value, cost
        - ° segregation by product line or department
    - » base stock inventories for new stores or departments;
    - » inter-store transfers;
    - » personal purchase/use items (employee gifts etc.);
    - » unusual losses due to theft, spoilage, fire or other reasons that can be supported by police/fire reports, insurance claims, inventory studies etc.;
    - » significant purchase discounts and allowances including cash discounts, volume rebates, quantity discounts, promotional allowances etc.;

      Because these discounts can apply to taxable/nontaxable grocery items as well as non-grocery items, a segregation test of the discounts may have to be performed.
        - ° cash discount (reduction from invoice price allowed for prompt payment); and
        - ° volume rebate or quantity discount – an allowance or reduction of the price for volume purchases based on the number of units sold or purchased during a promotional period.
        - ° The allowance is directly related to units sold or purchased, although some additional promotional expense may be incurred. The retail price of the product may or may not be lowered during the promotional period. This term does not include display or other merchandising plan allowances or payments that are based on agreements unrelated to volume of purchases or cooperative advertising allowances that are based on national line rate advertising and are also not related to volume or purchases and sales. Cooperative advertising allowances are intended to be a reimbursement of a portion of advertising costs for a particular product or products.

NOTE: Some of the discounts listed above may not be reflected on the purchase invoice but rather may be listed as a separate credit memo. Verification of gross receipts may have to include adjustments for the following:

- Sales tax included in reported gross sales
  - » EXAMPLE: Gross sales including tax = $104,950
    - ° Tax collected is unknown because taxpayer's cash register only accounts for total sales amount, which may include any tax collected.
    - ° The percentage relationship of taxable purchases to total purchases is determined by the auditor to be 60 percent.

      = .60 taxable percentage multiplied by
      x .0825 applicable tax rate
      = 0.0495 percentage relationship
      + 1.00
      = 1.0495 taxable percentage relationship ratio

      = $104,950 gross sales including sales tax
      / 1.0495 divided by taxable percentage relationship ratio
      = $100,000 gross sales excluding sales tax
      x .60 multiplied by taxable percentage
      = $60,000 audited taxable sales
    - ° Audited taxable sales of $60,000 X .0825 = $4,800 sales tax collected.
      - * delivery charges
      - * vending machine sales
      - * sales of food for immediate consumption
      - * meat processing revenue
      - * Commission receipts which may result from:
        - - money orders;
        - - gasoline sales;
        - - leased departments;
        - - amusement machines;
        - - vending machines; or
        - - movie rentals on a commission basis.
      - * any departments where records are separately maintained
      - * video rentals
      - * rentals of equipment such as steam-cleaning machines
      - * deposits on returnable items
      - * coupon handling fees
      - * verification of any deductions for bad debts
      - * any adjustments for other items noted

NOTE: The receipts for the above-listed items must be deducted from gross sales/total receipts before applying the applicable taxable percentage.

If the preliminary tests indicate that the taxpayer's worksheet amounts (total purchases and nontaxable purchases) are correct, only the proper application and mathematical accuracy of reported amounts needs to be verified.

If the preliminary tests indicate that the taxpayer's worksheet amounts are not correct, then the tests should be expanded to determine if the potential audit adjustment warrants the additional time to perform the fieldwork.

NOTE: For audit purposes only, the Comptroller permits a 5 percent theft and spoilage allowance on gross taxable sales. This should be taken into consideration when determining a potential audit adjustment. The application of the 5 percent allowance will be discussed later.

Exams and schedules prepared by auditors utilizing the purchase ratio method of auditing grocery stores will be discussed later in this manual.

Method C – 15 Percent of Gross Sales

Under this method, a grocer may report and pay tax based on taxable sales equaling 15 percent of gross sales. However, eligibility for the use of this method is restricted to:

- Retail grocers, as previously defined, whose gross receipts do not exceed $100,000 per calendar year; or
- A retail grocer with one or more outlets, if all the outlets under the same ownership qualify and if the combined gross sales of all the outlets do not exceed $100,000 per calendar year.

NOTE: If more than 5 percent of the receipts consist of sales of tangible personal property (beer, wine, cigarettes, gasoline etc.), the grocer is not eligible for Method C.

The grocer's eligibility will be determined on a calendar-year-by-calendar year basis.

Tax Code Sec. 151.413 (the state sales and use tax statute) and Sales and Use Tax Rule 3.328 delineate the procedures and requirements to be followed by a taxpayer who elects to use this method:

- Gross sales per report period are multiplied by 15 percent to obtain the taxable sales.
- A grocer who elects to report under this method must continue to do so for three years unless gross sales for a calendar year exceed $100,000.
- When the receipts of a grocer who elects to use this method exceed $100,000 for a calendar year, the grocer is ineligible to continue reporting under this method on the first day of the calendar month after the month in which the limitation is exceeded.
    - » EXAMPLE: Grocers using this method will be quarterly filers. If a grocer exceeds the $100,000 limit in October, the fourth quarter report is not eligible for the 15-percent method. In addition, the grocer is liable for assessment of all back taxes, penalties and interest under actual percentage for the other quarterly period of the calendar year.

If a retail grocer is eligible for filing under this method and actually files using the 15-percent method, any audits performed will be limited to verification through this same method. Additional taxes will not be assessed, nor will any refunds/credits be allowed, because the amount differs from the amount that would have been paid under any other reporting method. This holds true if comparing taxes collected to taxes reported, as in the example below. However, adjustments may be made for computational, transpositional and carry-forward errors such as using an incorrect or incomplete sales figure or multiplying by the wrong percentage.

> EXAMPLE: Taxpayer's gross sales for a reporting period equals $20,000. Utilizing the 15-percent method, the taxpayer reported $3,000 as taxable sales and paid tax of $247.50 (@ 8.25%). Taxpayer's sales journal states that $200 in sales tax was collected. The taxpayer is not due a refund.

This method is prospective and may not be substituted for another method previously elected.

Audit Procedure – 15-Percent Method

An audit of a retail grocer electing to report taxable receipts using this method will be limited to determining whether or not the grocer is eligible to use this method and the accuracy of the tax reports.

The following criteria must be considered for audit purposes:

- The taxpayer must meet the definition of a “retail grocer” as covered above in the manual’s introduction.
    - » Sales of items other than food (not for immediate consumption), household supplies and nondurable household goods must not exceed 5 percent of gross sales. Such items include:
        - ° beer and wine
        - ° gasoline (not on commission)
        - ° hardware
        - ° automotive parts
        - ° fishing/hunting supplies
        - ° souvenirs/curios
        - ° cigarettes, cigars, tobacco products
- Gross sales must not exceed $100,000 per calendar year, even though the taxpayer may not have been in business for the entire year.
- The method must be continuously used for three years unless the taxpayer becomes ineligible.

Audit assessments will be based on the actual percentage of taxable sales for any calendar year(s) in which the taxpayer is not eligible. If an audit of a taxpayer who has not elected to use the 15-percent method discloses that the taxpayer could have used the method for any or all years in the audit period, the taxpayer will not be allowed to amend prior reports, nor will the audit be performed using the method for any years in the audit period.

Method E – Commingled Receipts

A third method is provided by the sales tax statute and Rule 3.328 for grocers who establish an accounting system in which sales tax collected is commingled with the receipts from sales of taxable items. Method E establishes a method of backing out the tax from the gross sales.

The formula to be used to determine taxable sales using this method is:

```
gross sales including tax
<nontaxable/exempt sales>
----------------------------
taxable sales including tax
```

the taxable sales amount including tax is then divided by 1.00 plus the applicable tax rate decimal factor to derive taxable sales excluding tax.

```
taxable sales
-------------   =   taxable sales excluding tax
1 + tax rate
```

An examination of the records of a taxpayer using this method will include:

- verification of gross sales;
- verification that tax is included in gross sales;
- confirmation that the taxable or nontaxable sales are accurate through use of one of the other special reporting methods; and
- confirmation of the mathematical accuracy of computations.

Chapter 5

Miscellaneous Grocery Store Topics

Overview

- 5-Percent Audit Allowance
- Actual Substantiated Losses
- Penalty and Interest Application
- Allowance for Bad Debts
- Consignment and Commission Sales
- Coupons and Premiums
- Vending Machine Sales
- Items Purchased by Customers with Food Stamps/Lone Star Card
- Combination Grocery and Snack Bar or Delicatessen
- Items Withdrawn from Inventory for Use
- Wrapping and Packaging Supplies

5-Percent Audit Allowance

An allowance of 5 percent of audited **gross taxable sales** must be allowed as a deduction for pilferage, shrinkage, spoilage and any possible errors inherent in projection techniques for audits completed using the purchase ratio method (Method B) and any audits using a mark-up or estimation method.

THE 5-PERCENT ALLOWANCE IS FOR AUDITING PURPOSES ONLY AND CANNOT BE USED FOR REPORTING PURPOSES BY A TAXPAYER UNDER ANY CIRCUMSTANCES.

As previously mentioned, it is important to take this 5-percent factor into consideration when determining whether to continue with the audit fieldwork after performing a sample examination of the taxpayer's purchase invoices. As an example, a store has taxable sales that are 30 percent of audited gross sales. A 5-percent allowance of taxable sales amounts to 1.5 percent of gross sales (.30 X .05). This percentage increases as the amount of the store's reported taxable sales increases.

Example

Description	Situation #1	Situation #2
Gross sales	$45,000.00	$45,000.00
Share of taxable sales	30%	45%
Gross taxable sales (gross sales X percent of taxable sales)	$13,500.00	$20,250.00
5% allowance	5%	5%
Amount of allowance (gross taxable sales X 5%)	$675.00	$1,012.50
Relationship to gross sales (amount of allowance ÷ gross sales)	1.5%	2.25%

Actual Substantiated Losses

If the taxpayer can substantiate actual inventory losses above the 5 percent allowance previously described, the purchases percentage computation is adjusted for the substantiated loss. However, the taxpayer must be able to substantiate what items were lost. For example, in cases of theft, the taxpayer must be able to provide a police report listing the items stolen.

Example

Total purchases of $150,000 less total losses of $5,500 equals $148,500 in adjusted purchases. Taxable purchases of $75,000 less a substantiated loss of $1,500 for cigarettes equals $73,500 in adjusted purchases.

NOTE: If a mark-up audit is performed, rather than the purchase ratio method, the purchase amounts still must be taken into account. Again, the taxpayer must be able to substantiate a loss and which items were lost (spoiled, stolen etc.). The purchases of taxable items would be reduced by the substantiated losses before applying the mark-up percentage.

Losses must be substantiated with proper documentation: police reports, fire reports, insurance claims, inventory studies etc. The taxpayer may further substantiate a loss by performing a physical inventory.

Taxpayers may establish losses for:

- taxable purchases,
- nontaxable purchases and
- an overall loss on purchases.

NOTE: Besides adjustments to purchases for substantiated losses, the taxpayer would also be entitled to the 5 percent allowance previously discussed.

Penalty and Interest Application

A taxpayer utilizing one of the optional special reporting methods must pay penalties and/or interest if a tax report is not filed on or before the due date, or if the correct amount of tax due is not remitted with the report. The only exception to these requirements is that penalty and interest will not be assessed on additional taxes found to be due by audit when the taxpayer uses Method B (purchase ratio method) for reporting purposes. This penalty and interest exemption will be lost if the taxpayer has not recomputed the taxable percentage each year.

Allowance for Bad Debts

A taxpayer is entitled to deduct bad debts if the taxable transaction was previously reported or if the transaction occurred in the current reporting period. The bad debt must also be recorded and written off for federal income tax purposes.

A grocer's bad debts generally consist of insufficient fund checks and unpaid charge accounts for which the grocer does not have itemized listings of taxable and nontaxable sales. The taxpayer may apply the same percentage computed under the purchase ratio method to bad debts to determine the amount of deduction. If the 15-percent method is being properly used, 15 percent of allowable bad debts may be deducted.

Two procedures must be followed before allowing bad debts:

- Examine original or copies of all insufficient fund checks.
- Determine whether the insufficient fund checks represent sales of merchandise or whether they represent check cashing. Losses for insufficient checks will not be allowed if the loss was for cashing a check.

NOTE: Allowances for bad debts are made in addition to any other allowances previously mentioned (e.g., 5-percent allowance, tax included in gross sales, substantiated losses).

Consignment and Commission Sales

Consignment means that goods are in the physical possession of the consignee (grocer), but title remains with the consignor (vendor). Title passes to the customer through the consignee at the point of sale. The taxpayer only receives either a fixed amount or a percentage of the sales. The consignee may record in gross sales the amount of the full retail price to the customer and may record in purchases the amount of the wholesale price. If the taxpayer handles consignment sales in this manner, include the consignment purchase transaction in the total purchases and the taxable or nontaxable purchases (depending on the item) amounts for the purchase ratio method.

Using another method regarding consignment and commission sales, the taxpayer only records the commissions received as income and does not record the sale or purchase amounts in the accounting books. Consequently, the commission transaction would not be included in the purchase ratio method computations. An adjustment to gross sales may be necessary if commission receipts are included in reported gross sales.

Coupons and Premiums

Coupons redeemed by the taxpayer fall into two categories:

- those for which the taxpayer is reimbursed for the face value of the coupon plus a handling fee (manufacturer's coupons).
- those for which there is no reimbursement to the taxpayer (in-store coupons).

Both types of coupons are handled in the same manner. Coupons represent a reduction of the price of the item purchased by the customer. Tax is to be collected by the taxpayer on the net price; i.e., the price after allowing for reduction of the face value of the coupon.

Periodically, a taxpayer may, as an inducement to attract customers, offer to double or triple the face value of manufacturers' coupons. These promotions also qualify as reductions of the sales price and the tax due on the reduced sales price.

Verification must be made that the taxpayer is handling the tax implications of coupons correctly. If the taxpayer is collecting tax on an item's gross sales price, before reducing it by the value of the coupons, the tax is being collected in error. The total tax amount is due and is to be allocated to the state.

A premium is an item offered by retailers to attract customers.

- If the premium is given at no additional charge, the purchase of the premium by the taxpayer is not for resale. The taxpayer should pay tax to the vendor of the premium or report and pay the tax in the taxable purchases section of the sales and use tax report.
- If there is an additional charge for the premium, the purchase of the premium is for resale. Tax is due on the greater of either the retailer's cost or the amount charged the customer.

Vending Machine Sales

Some examples of vending machines are those that sell soft drinks, postage stamps, gumballs and candy, as well as racks from which newspapers are sold. Sales of postage stamps and newspapers are not taxable. In addition, sales of food, gum and candy sold through bulk vending machines for $.50 or less are exempt.

Items sold through vending machines in grocery stores must be addressed separately. Separate records should be maintained by the taxpayer in order to substantiate vending machine sales. The taxpayer should be able to itemize not only the sales amounts but also what items are sold through vending machines. If the purchase ratio method of auditing is used, adjustments to purchases are necessary for the merchandise sold through the vending machines. If a mark-up percentage method is utilized, purchases of merchandise sold through the vending machines must be excluded before applying the percentage.

If the taxpayer does not maintain records to substantiate vending machine sales, then include vending machine receipts in gross sales and apply the taxable percentage appropriately if performing a purchase ratio method audit. If performing some type of mark-up audit, include the purchases of items sold through vending machines and apply the applicable mark-up percentage.

Items Purchased by Customers with Food Stamps/Lone Star Card

Food stamps may be used by customers to purchase both items exempt from sales tax (food items) and items, if qualifying, which are subject to sales tax (soft drinks, candy, ice cream novelties etc.). When a customer uses both food stamps and cash to pay for the purchase of both taxable and non-taxable items, the food stamps should first be applied to taxable items.

Example

A customer purchases multiple items totaling $10, $5 of which consist of soft drinks and candy. Both items are subject to sales tax, but they may be legally purchased with food stamps. If the customer pays for the entire purchase with food stamps, the grocer does not report any taxable sales on the transaction. However, if the customer only has $3 in food stamps, the grocer should apply it to the first $3 of the charge for soft drinks and candy and collect tax on the remaining $2.

In order to qualify to accept food stamps for payment of sales, the grocer must maintain records supporting food stamp sales. The grocer must also maintain adequate records to support reported taxable and non-taxable sales.

NOTE: In Texas, qualifying individuals utilize the Lone Star Card to make qualifying purchases.

When audit adjustments are made using an audit method where taxable products that may be purchased with food stamps are indistinguishable from taxable products that are not eligible to be purchased with food stamps, the Comptroller will allow a food stamp reduction to audited taxable sales based on a pro rata percentage. The pro rata percentage will be determined by dividing total food stamps processed during the audit period by total audited gross sales during the audit period. The resulting percentage will be applied to audited taxable sales to determine the allowable offset to taxable sales due to food stamp purchases. An example of how to calculate this “allowable percentage” follows:

- Total food stamps processed in the audit period divided by total gross sales in the audit period equals food stamp allowance percentage
- Food stamp allowance percentage multiplied by taxable sales equals allowance offset for nontaxable food stamp sales.

Example

During the audit period, a grocer had $100,000 in gross sales and $60,000 in taxable sales and processed $50,000 worth of food stamps. The auditor could not determine what items were included in the taxable sales amount.

- Food stamp allowance percentage = $50,000 ÷ $100,000 = 50%
- Allowable offset for food stamp sales = 50% X $60,000 = $30,000

When audit assessments are made utilizing specific product scanner codes, currently no offset is allowed for food stamps on products (e.g., beer, cigarettes, cosmetics etc.) that are not eligible for purchase with food stamps under federal law.

Therefore, any verified amounts of non-qualifying items in taxable sales should be subtracted before applying the percentage. Utilizing the above example, if the auditor determines that $20,000 of the taxable sales amount consisted of beer (not allowed for food stamp purchase), the amount would be subtracted from the $60,000, and the allowable offset for food stamp sales would be $20,000 ($60,000 - $20,000 X .50 = $20,000).

When audit adjustments are made using the purchase ratio method, food stamps may offset taxable sales in an amount not to exceed the amount of sales associated with qualifying food stamp purchases, if known.

Example

During the audit period, the grocer's purchases totaled $100,000; of that amount, $50,000 was for purchases of taxable items. In addition, the grocer accepted $40,000 in food stamps during the audit period. The auditor determined that $20,000 of the $50,000 consisted of non-qualifying items (beer, cigarettes etc.). The allowable offset for food stamp sales would be $30,000, not the $40,000 ($50,000 - $20,000).

Combination Grocery and Snack Bar or Delicatessen

If a grocery store has a separately identifiable snack bar or delicatessen selling food for immediate consumption, all sales and purchases of each item must be segregated and audited independently.

- Sales audit
  - » If separate sales records for the snack bar/delicatessen are maintained either through a separate cash register or tax key, segregate these sales from the grocery sales.
  - » If separate sales records are not maintained, a reasonable estimate of sales should be made utilizing test periods and any available records.
- Purchase audit
  - » Separate those purchases made directly for the snack bar/delicatessen so that they will not be included in the purchase ratio percentage or mark-up percentage computation.
  - » A reasonable estimate must be made for any portion of grocery items such as bread, meat etc. that are withdrawn from grocery inventory for use in the snack bar/delicatessen.

Items Withdrawn from Inventory for Use

A taxpayer's liability for taxable purchases is generally limited to merchandise withdrawn from inventory for business or personal use.

- Business use
  - » Taxable items such as cleaning supplies, brooms, paper products etc. These items should be scheduled separately as adjustments to taxable purchases.
- Personal use
  - » Many taxpayers, especially small proprietors, withdraw both taxable and exempt merchandise for home use. Unless the grocer maintains records that list the items withdrawn for home use, the same percentage factor utilized in the purchase ratio method audit of the store can be applied to these withdrawals. These items should also be scheduled separately as adjustments to taxable purchases.

NOTE: Amounts for merchandise withdrawn may be obtained from the cost of goods sold section of the taxpayer's federal income tax return.

Wrapping and Packaging Supplies

A taxpayer must pay tax on all boxes, paper sacks and plastic bags used to package or repackage items for sale. A taxpayer may claim an exemption for any wrapping and packaging materials used in processing items resold (for the meat, deli and bakery departments). The taxpayer must pay tax on all paper and plastic bags used to package products purchased by customers. Make adjustments to taxable purchases for any non-qualifying, tax-free purchases of wrapping/packaging materials purchased by the taxpayer.

Chapter 6

Auditing Procedures

Overview

- Purchase Ratio Method
- Exhibit – Transaction Entry

This chapter will deal with auditing procedures, emphasizing the purchase ratio method and mark-up procedures. Various auditing issues encountered throughout the years will also be discussed.

Purchase Ratio Method

Briefly, under this auditing method an analysis is made of the taxpayer's purchases of inventory items for a representative sample period. A percentage relationship between taxable merchandise (items on which the taxpayer must collect tax from the customer when sold) and total purchases is established. This percentage is then applied to the store's gross sales throughout the audit period.

Gross Sales

Because the percentage ratio will be applied to the store's gross sales, less any adjustments, it is extremely important for the auditor to verify gross sales. If gross sales are not correctly reported, the auditor must establish the correct amounts for gross sales for the entire audit period. At the very least, a close approximation to the taxpayer's gross sales must be obtained utilizing available accounting records and auditing techniques.

Adjustments, where applicable, should be made to audited gross sales. The taxable percentage ratio obtained must be applied only to sales that are attributable to the grocery store operation. As previously discussed, items such as delivery charges, commissions, deli/restaurant operations, lotto sales, hunting/fishing licenses, phone cards etc. must be deducted from audited gross sales/total receipts before applying the taxable percentage.

The following is an illustration of a schedule that was performed including some examples of adjustments made to audited gross sales. This schedule is for instructional purposes only and does not represent all of the potential adjustments to audited gross sales.

Worth Corporation **Exam 1B**
Fort Worth, Texas **TP# 12345678903**
Additional Taxable Sales **Page 1 of 1**

Report Period	(1) Audited Gross Sales*	(2) Less Gasoline Sales*	(3) Less Lotto Sales*	(4) Less Hunting & Fishing Licenses*	(5) Net Audited Gross Sales (Col. 1 - Col. 2 - Col. 3 - Col. 4)
1201	$233,132.00	$134,627.00	$895.00	$228.00	$97,382.00
1202	233,967.00	135,347.00	920.00	494.00	97,472.00
1203	217,500.00	118,075.00	1,010.00	589.00	97,921.00
1204	226,377.00	126,482.00	1,040.00	684.00	98,266.00
1205	242,931.00	141,946.00	1,150.00	1,159.00	99,151.00
1206	208,208.00	106,493.00	1,210.00	1,254.00	99,346.00
1207	247,739.00	144,269.00	1,250.00	1,178.00	100,966.00
1208	216,377.00	113,817.00	1,205.00	1,197.00	100,177.00
1209	200,743.00	99,033.00	1,165.00	1,140.00	99,348.00
1210	215,044.00	115,939.00	1,105.00	2,223.00	96,860.00
1211	210,584.00	112,724.00	1,055.00	2,147.00	94,582.00
1212	207,350.00	106,210.00	1,095.00	1,102.00	97,898.00
Total	**$2,659,952.00**	**$1,454,962.00**	**$13,100.00**	**$13,395.00**	**$1,179,369.00**

*from taxpayer's sales journal

NOTE: The taxable ratio percentage will be applied to the amounts in Column 5 on a period-by-period basis.

Computing the Taxable Percentage

Once the auditor has verified gross sales, or obtained gross sales amounts by other means, the taxable percentage to be applied to the sales amounts must be computed. A sample period is obtained utilizing Comptroller sampling standards. As in any other type of sales and use tax audit, the sample period selected must be representative of the entire audit period. The invoices for purchases of merchandise resold through the grocery operation will be examined for the sample period. A percentage relationship will be established between merchandise items that are taxable when resold and total purchases for the sample period. Items such as phone cards that are taxable (but not a grocery item) should be added back to audited taxable sales after obtaining and applying the taxable percentage to audited gross sales.

Sometimes an item's taxability can change due to a change in law, such as when sunscreen became exempt from sales tax in 2012. In order to take this fact into account, the auditor must schedule these "tax change items" separately and arrive at two taxable percentages: one for the periods before the change and one for those periods after the change.

What follows is a sample schedule that could be prepared to compute the taxable percentage applicable to sales. The auditor must prepare a spreadsheet in order to schedule the merchandise purchases for the sample period. This schedule is for instructional purposes only, as the auditor may need to tailor the schedule to fit specific audit needs.

Worth Corporation **Exam 1C**
Fort Worth, Texas **TP# 12345678903**
Schedule of Grocery Purchases **Page 6 of 6**

(1) Vendor	(2) Date	(3) Invoice Number	(4) Description	(5) Taxable Amount	(6) Tax Change Amount	(7) Total Amount
Joe's Wholesale Groc.	05/02/2012	362230	HBC, sunscreen, food items	$ -	$2,638.35	$4,529.00
MNM Beer Co.	05/02/2012	154499	beer	2,945.00	-	2,945.00
Chris's Chips	05/03/2012	164017	chips	-	-	-
Tommy's Meats	05/02/2012	243240	meat, lunchmeat	-	-	-
Paul's Medical	05/08/2012	400192	aspirin, cold medicines	-	-	-
Mr. Harvey's Br	05/10/2012	558614	bread, buns, snacks	-	-	-
ABC Beer Co.	05/11/2012	621470	beer	4,050.00	-	4,050.00
Coca-Cola Bottling	05/12/2012	483820	water, energy drinks	3,285.00	-	4,784.00
Tommy's Meats	05/12/2012	195834	meat, lunchmeat	-	-	-
Pepsi Bottling	05/13/2012	538564	water, energy drinks	3,235.00	-	4,249.00
USA Yesterday	05/13/2012	379983	newspapers	-	-	-
Sam's Ciggies	05/15/2012	295147	cigarettes	4,590.00	-	4,590.00
Chris's Chips	05/22/2012	192742	chips	-	-	-
MNM Beer Co.	05/23/2012	566668	beer	2,655.00	-	2,655.00
Farm Fresh Milk	05/26/2012	223965	milk	-	-	-
ZYX Beer	05/28/2012	418211	beer	4,145.00	-	4,145.00
Mr. Harvey's Br	05/29/2012	437984	bread, buns, snacks	-	-	-
Joe's Wholesale Groc.	06/18/2012	172082	HBC, sunscreen, food items	2,102.20	-	3,023.00
MNM Beer Co.	06/01/2012	423825	beer	4,255.00	-	4,255.00
Chris's Chips	06/02/2012	140593	chips	-	-	-
Tommy's Meats	06/01/2012	633625	meat, lunchmeat	-	-	-
Paul's Medical	06/07/2012	527731	aspirin, cold medicines	-	-	-
Mr. Harvey's Br	06/09/2012	379806	bread, buns, snacks	-	-	-
ABC Beer Co.	06/10/2012	568389	beer	4,164.00	-	4,164.00
Coca-Cola Bottling	06/11/2012	496997	water, energy drinks	3,168.00	-	5,101.00
				$38,594.20	**$2,638.35**	**$48,490.00**

Taxable Percentage
Periods prior to taxability change: (Col. 5 + Col. 6)/Col 7 = 85.0331%
Periods after taxability change: Col. 5/Col. 7 = 79.5921%

Note: Sunscreen was taxable from 9/1/07 through 6/27/12.

If an invoice lists both taxable and nontaxable merchandise, place examples of both in the "Description" column.

NOTE: In the above example, a random computer-generated month sample was utilized using CATS.

Application of the 5-Percent Allowance

The 5-percent allowance is applied to audited gross taxable sales for each period in the audit, even if a period results in a credit amount. However, if, after application of the 5-percent allowance, the audit results in an overall credit, the audit becomes a "no-tax-due" audit. Application of the 5-percent allowance will never result in an overall credit audit.

The following table illustrates the application of the 5-percent allowance utilizing the previous examples of Worth Corporation.

Worth Corporation **Exam 1A**
Fort Worth, Texas **TP# 12345678903**
Additional Taxable Sales **Page 1 of 1**

Report Period	(1) Net Audited Gross Sales	(2) Taxable Percentage (from Exam 1C)	(3) Audited Taxable Sales Col. 1 X Col. 2)	(4) 5% Allowance (for theft, spoilage)	(5) Adjusted Audited Taxable Sales (Col. 3 X Col. 4)	(6) Reported Taxable Sales per TP history)	(7) Additional Taxable Sales (Col. 5 - Col.6)
1201	$97,382.00	85.0331%	$82,806.93	95%	$78,666.59	$19,701.00	$58,965.59
1202	97,206.00	85.0331%	82,657.28	95%	78,524.41	19,724.00	58,800.41
1203	97,826.00	85.0331%	83,184.48	95%	79,025.26	19,885.00	59,140.26
1204	98,171.00	85.0331%	83,477.84	95%	79,303.95	19,979.00	59,324.95
1205	98,676.00	85.0331%	83,907.26	95%	79,711.90	20,197.00	59,514.90
1206	99,251.00	79.5921%	78,995.96	95%	75,046.16	20,343.00	54,703.16
1207	101,042.00	79.5921%	80,421.45	95%	76,400.38	20,694.00	55,706.38
1208	100,158.00	79.5921%	79,717.86	95%	75,731.96	20,512.00	55,219.96
1209	99,405.00	79.5921%	79,118.53	95%	75,162.60	20,342.00	54,820.60
1210	95,777.00	79.5921%	76,230.93	95%	72,419.38	19,821.00	52,598.38
1211	94,658.00	79.5921%	75,340.29	95%	71,573.28	19,572.00	52,001.28
1212	98,943.00	79.5921%	78,750.81	95%	74,813.27	20,228.00	54,585.27
Total	**$1,178,495.00**		**$964,609.61**		**$916,379.13**	**$240,998.00**	**$675,381.13**

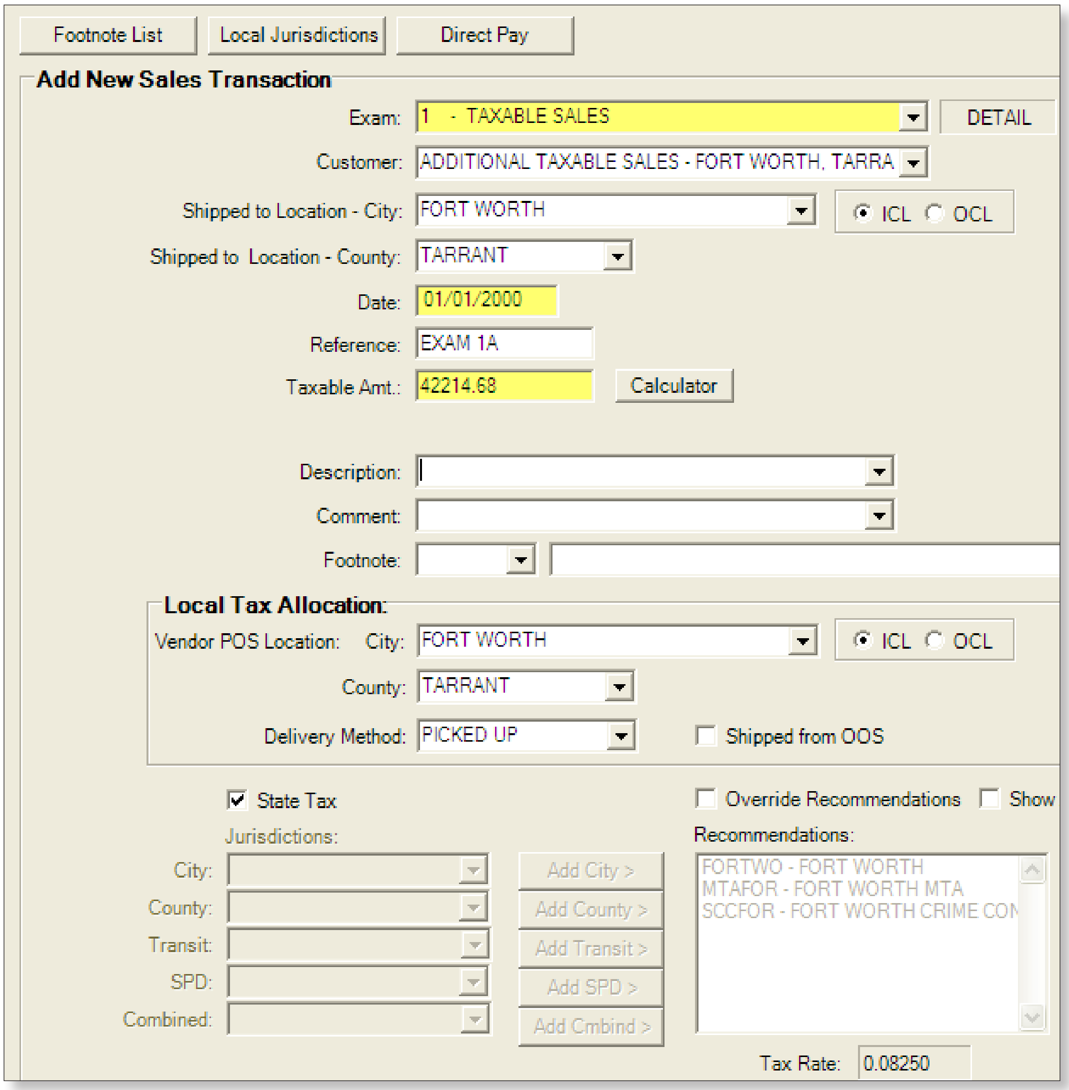
Credit for Food Stamps

In the previous example, food stamps (Lone Star Card) are not an issue. If the taxpayer is qualified to accept food stamps and customers have made purchases with them, credit should be given for these sales. In the example below, credit is given after adjusted audited taxable sales. Please refer to Ch. 5 for the allowable amount of credit for food stamp sales.

Worth Corporation **Exam 1A**
Fort Worth, Texas **TP# 12345678903**
Additional Taxable Sales **Page 1 of 1**

Report Period	(1) Net Audited Gross Sales	(2) Taxable Percentage (From Exam 1C)	(3) Audited Taxable Sales (Col. 1 X Col. 2)	(4) 5% Allowance (for theft, spoilage)	(5) Adjusted Audited Taxable Sales (Col. 3 X Col. 4)	(6) Food Stamp Sales (per bank statements)	(7) Reported Taxable Sales (per TP history)	Additional Taxable Sales (Col. 5 - Col. 6 - Col. 7)
1201	$97,382.00	85.0331%	$82,806.93	95%	$78,666.59	$1,137.40	$19,701.00	$57,828.19
1202	97,206.00	85.0331%	82,657.28	95%	78,524.41	948.74	19,724.00	57,851.67
1203	97,826.00	85.0331%	83,184.48	95%	79,025.26	985.63	19,885.00	58,154.63
1204	98,171.00	85.0331%	83,477.84	95%	79,303.95	1,001.60	19,979.00	58,323.35
1205	98,676.00	85.0331%	83,907.26	95%	79,711.90	918.66	20,197.00	58,596.24
1206	99,251.00	79.5921%	78,995.96	95%	75,046.16	811.25	20,343.00	53,891.91
1207	101,042.00	79.5921%	80,421.45	95%	76,400.38	649.41	20,694.00	55,056.97
1208	100,158.00	79.5921%	79,717.86	95%	75,731.96	592.07	20,512.00	54,627.89
1209	99,405.00	79.5921%	79,118.53	95%	75,162.60	647.22	20,342.00	54,173.38
1210	95,777.00	79.5921%	76,230.93	95%	72,419.38	440.20	19,821.00	52,158.18
1211	94,658.00	79.5921%	75,340.29	95%	71,573.28	459.32	19,572.00	51,541.96
1212	98,943.00	79.5921%	78,750.81	95%	74,813.27	550.39	20,228.00	54,034.88
Total	**$1,178,495.00**		**$964,609.61**		**$916,379.13**	**$9,141.89**	**$240,998.00**	**$666,239.24**

In order to assess the tax on the previous amounts, CATS E&T Exam #1 would consist of the auditor entering the amounts of the additional taxable sales, on a period-by-period basis, into the CATS exam. The Comptroller's automated audit system would then assess the additional tax, penalty and interest due.



Chapter 7
Grocery Store Audit Checklist

Overview

- Gross Sales
- Taxable Sales
- Selection of Test Periods
- Examination of Records
- Sampling/Estimation Issues

The following checklist has been developed as a tool to be used in completing a grocery audit. The items on this checklist are not all-inclusive but are meant to serve as a guideline to the auditor.

Gross Sales

- Do gross sales include any of the following?
    - » Sales tax collected
    - » Money order sales
    - » Gasoline sales
    - » Delivery income
    - » Sales of hunting or fishing licenses
    - » Sales of Lotto tickets
    - » Meat processing revenue
    - » Vending machine income
    - » Sales of amusement admissions
    - » Consignment or commission sales
    - » Snack bar or delicatessen sales
- Have amounts paid by manufacturers to retailers for redeemed coupons been included in gross sales?
- Are separate sales records maintained for different departments (bakery, delicatessen, gasoline, meat, produce)?
    - » If so, can sales and purchases be segregated for the application of the taxable percentage factor?
- Can the method of recording sales through vending machines be determined?
- How many cash registers are present?
- What is the product mix? Is there a higher ratio of taxable items than normal?

Taxable Sales

- Determine method of reporting taxable sales.
    - » separate tax key on cash register
    - » computer generated sales register
    - » retail inventory method
    - » gross profit method

- » purchase ratio method
  - » estimated taxable percentage
  - » 15-percent method
  - » other (describe)
- Review list of taxable items with grocer.
- Has the taxpayer failed to collect tax on any taxable items?
- Has the taxpayer collected tax on any nontaxable items?
- Are separate sales and purchase records maintained for the delicatessen department, lunch counter, meat department, etc.?
  - » If so, can an audit of these departments be performed separately apart from the grocery operation?

Selection of Test Periods

- Have there been any changes in the taxpayer's business operation during the audit period?
  - » Addition of beer and wine sales
  - » Addition of gas pumps
  - » Addition of "food-to-go" counter or delicatessen
  - » Addition of bakery department
  - » Addition of meat department
- Do sales fluctuate or increase at a fairly moderate rate?
- Is the reported percentage of taxable business relatively uniform throughout the audit period?
- Is there any noticeable effect of seasonal fluctuations?
- Are there any products offered only during certain seasons of the year?
  - » Christmas trees and ornaments
  - » bait and fishing tackle
  - » hunting supplies
- Has the taxpayer used the same reporting procedures throughout the audit period?
- Are adequate records available to select test periods representative of all years and seasons of the year?
- Does the taxpayer agree that the test periods selected are the most representative of business operations throughout the audit period?
- If there have been any significant changes in the business operations, have the test periods been selected to reflect these changes?

Examination of Records

- Has a receipt been issued for all records removed from the taxpayer's premises?
- Has a "cut-off" date been established to include all purchases received/paid within the test periods?
- Have all supply items been eliminated from gross purchases (grocery bags, deli supplies etc.)?
- Have adjustments been made for purchase returns within the cut-off period?
- Have adjustments been made for self-consumed merchandise?
- Have adjustments been made for in-store transfers of merchandise?
- Are beginning and ending inventory figures available for the test period?
- Can inventories be identified by product or department?
- How were inventories priced? At retail? At cost?
- Are adjustments necessary for new stores or departments establishing a base stock inventory?
- Have adjustments been made for any unusual losses such as theft, spoilage or fire that can be substantiated by police reports, insurance claims or inventory studies?
- Have necessary adjustments been made for customer purchases with food stamps/Lone Star Card?
- Does the taxpayer have any purchases or inventory on consignment?
- Check the method of handling sales made through vending machines and adjust purchases and/or sales accordingly.

- If the grocer is preparing sandwiches or hot food for immediate consumption, can the amounts of the grocery purchases used in the preparation be obtained or reasonably estimated?
- Was an allowance made for theft, spoilage or any errors inherent in the sampling/estimation technique?
- Were the audit procedures adequately discussed with the taxpayer?
- If an estimated audit is being performed, was the taxpayer adequately notified of the estimation procedures being utilized?

Sampling/Estimation Issues

Although a grocery store audit rarely utilizes true sampling procedures, an estimated audit more than likely will be performed. A Notification of Estimate must be issued if one or more of the following conditions are met:

- The taxpayer refuses to provide all or part of the records requested by the auditor.
- The taxpayer does not have all or part of the records requested by the auditor.
- The auditor uses the purchase ratio method but projects the computed percentage into an estimated population.
- The auditor establishes mark-up percentages and product mix percentages from AP 134 because the taxpayer's records are incomplete or unreliable, and the taxpayer is out of business.
- The auditor obtains third-party information because the taxpayer's records are incomplete or unreliable.

NOTE: Before estimating any audit, the auditor should follow the instructions in AP 70 regarding issuing a subpoena to obtain taxpayer records.

If a time period is utilized, the amounts obtained must be evaluated in the applicable section of the audit plan in order to ensure that the amounts are reasonably similar throughout the audit period. Any large variances must be explained. The averages of the sample base and the population base must also be evaluated, and any large variances similarly must be explained.

For more information on sampling issues and procedures, please refer to the Audit Division's *Sampling Manual*.