

# Audit Procedures for Convenience Stores

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# Chapter I

# Introduction

## Introduction

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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, fiche, rulings and statutes are given when needed. Any schedules included in the manual are for illustration 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 its printing or posting. 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 1-800-252-5555. The local number in Austin is 512-463-4600.

## Chapter II

# What is Taxable at Convenience Stores?

- Examples of Taxable Items
- Food Sold for Immediate Consumption
- 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 that would be subject to the limited sales and use tax. Keep in mind that this only lists examples of items, and is not all-inclusive. Some items will be foot-noted and explained further. In addition, some items not listed will be addressed separately.

### Examples of Taxable Items

Adhesive tape	Aluminum foil
Ale	Ammonia
Ammunition	Automotive oil
Automotive transmission fluid	Automotive antifreeze
**Baby care products (oil, lotion, etc.)	Bags (all types)
Batteries	Beauty supplies
Beer	Bleach
Breath mints	Brooms
Brushes	Candles
*Candy	Cards
Charcoal	Charcoal lighter fluid
Christmas trees	Cigarettes
Cigarette lighters	Clothing
Coffee pots	Cologne
Cosmetics	**Cough drops
Dental floss	Detergents
Deodorants	Deodorizers
Diapers	*Diluted fruit juices
Disinfectants	Electrical supplies
Fabric softeners	Fertilizer
Fishing tackle	Firearms

Floor wax	Freezer paper and tape
*Frozen drinks	Garbage bags
Garden supplies	Gift wrap
Gum	Hair conditioner
**Hair shampoo	Hair spray
Hair coloring	Hardware items
Houseware items	Ice
Ice chests	Ice cream salt
***Ice cream sundries	Insecticides
Keys (including duplication)	Light bulbs
Liquor	**Lotions
Matches	Magazines
Mops	Mop replacement heads/handles
Mothballs	Nails
*Nuts (candy-coated)	Pencils and pens
Perfume	Pet food
Popsicles	*Powdered drinks
Razors and blades	Sandwiches (except frozen)
Sandwich bags	School supplies
Scouring pads	Shaving cream/after shave
Shoelaces	*Soft drinks
Sponges	Starch
Stationery and cards	Tape
Thread	Toilet tissue
Toothbrushes	Toothpaste
Toothpicks	Toys
Tobacco products	Towels
Water softener salt	Wax removers
Wine (except cooking wine)	Water – when 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:** Effective October 1, 2003, fruit drinks containing more than 50 percent juice are exempt as food products.

Effective 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 FDA recommendations. The provision does not include bakery items and food that is only cut, repackaged or pasteurized.

Effective June 18, 2012, sunscreen is once again exempt from Texas sales and use tax. Legislation that became effective on Sept. 1, 2007 amended the definition of OTC drugs in Texas Tax Code Section 151.313 (a)(3) to provide that an over-the-counter 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 Section 151.313 (a)(3). Therefore, as of June 18, 2012, sunscreen is once again exempt from Texas sales and use tax. **So, from September 1, 2007 through June 17, 2012 sunscreen is taxable, but non-taxable thereafter.**

Effective September 1, 2013: Snack items are now defined under 151.314(b) as a “food product.” Snack items include:

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

Snack items sold through a vending machine or in individual portions are taxable. An individual-sized portion is a portion that:

1. is labeled as having not more than one serving; or
2. contains less than 2.5 ounces, if the package does not specify the number of servings.

## Food Sold for Immediate Consumption

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Tax must be collected on:

- all food kept and sold hot, such as barbecued beef, chicken, chili, soups, barbacoa, tamales, tacos, etc.;
- all individual-sized portions of food sold with utensils, such as plates, knives, forks, spoons; and
- if there is a bakery, coffee shop or deli with a place to sit and eat, tax must be collected on items sold “through the restaurant” including the items listed above and all food items, when sold in individual-sized containers, which are ready to eat, such as chips, cookies, crackers, peanuts, etc.

Prior to October 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.

## Cigarettes and Tobacco Products

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

## Newspapers

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Newspapers are not taxable. The State Sales and Use Tax Statute Sec. 151.319 (f) defines a newspaper as publications:

- printed on newsprint;
- distributed at intervals of four weeks or less;
- sold for an average price-per-copy of \$1.50 cents or less over a 30-day period through August 31, 2013. **Effective September 1, 2013**, the average price increased to \$3.00 or less over a 30-day period; and

- for the dissemination of news of a general character and of general interest, including advertising.

**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 pre-paid phone cards. Prepaid calling cards became taxable as tangible personal property effective September 1, 1997, per 151.01032 of the Sales and Use Tax Law for the definition of “calling card” and per 151.009 for its inclusion as taxable tangible personal property.

For more information on items on which the grocer must collect sales tax, consult [Publication # TX 96-280 — What is Taxable at Grocery and Convenience Stores](#).

## Over-the-Counter Drugs and Medicines

Effective April 1, 2000, over-the-counter 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 the use in the diagnosis, cure, mitigation, treatment, or prevention of disease, illness, injury or pain. The over-the-counter drug or medicine must have a NDC (National Drug Code) number, but the number does not have to appear on the product label in order to be exempt.

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

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 products listed below merely serve as a guideline.

Acne treatment products	Allergy treatment products
Analgesics	Antacids
Anti-asthmatic products	Anti-diarrhea products
Anti-fungal products	Anti-nausea products
Antibiotics	Antiperspirants
Anti-rheumatic products	Cold remedies
Cough suppressants	Dandruff shampoos
Dietary supplements/vitamins	Ear care products
Expectorants	*Eye care/contact lens products
Hemorrhoid products	Laxatives
Pain relievers (aspirin, ibuprofen, etc.)	Sedatives/sleep aids
Stimulants	Sunburn prevention products
Sunburn treatment products	Wound care dressings

\* Must be applied to the eye — exemption does not apply if product is merely used to clean the contact lens.

There could be a fine line between a qualifying product and a non-qualifying product. For example, deodorants are subject to sales tax but antiperspirants are exempt. For more information on over-the-counter drugs and medicines, consult [Publication # TX 94-155 — Sales Tax Exemption for Over-the-Counter Drugs and Medicines](#).

## Chapter III

# Methods of Tax Determination

- Cash Register Keys
  - Computer-Generated Sales Registers
  - Retail Inventory Method
  - Gross Profit Method (Shelf Test)
- 

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

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

### Cash Register Keys

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Retailers, particularly the smaller ones, have a relatively simple method of indicating taxable or nontaxable sales through the use of separate keys on the cash registers. The retailer will usually have a separate key identifying tax collected. Reported taxable sales will consist of the monthly or quarterly tax 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

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A rapidly expanding method of recording sales transactions is 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; and
- 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.

## Retail Inventory Method

Some large convenience store chains use the retail inventory method as a method of sales and inventory control, i.e., for loss and theft, etc. Generally, records do not reflect a “tax collected” amount.

Convenience stores have a high rate of employee turnover. Sometimes, the employees are instructed to collect tax whenever in doubt. This usually leads to an over-collection of tax. These amounts are due to the state unless the overages can be refunded back to the original customer.

Under the retail inventory method, all purchases are priced at retail at the time of receipt. Inventories are generally taken on a weekly or bi-monthly basis. The taxpayer determines book sales using the following procedure:

```

Beginning inventory at retail (actual)
+ Purchases marked up to retail
-----
Merchandise available for sale at retail
- Ending inventory at retail (actual)
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Book sales at retail

```

The taxpayer then compares the book sales amount to the actual sales to determine an overage <loss> adjustment to inventory:

```

Actual sales at retail
- Book sales at retail
-----
Overage <loss> adjustment

```

The taxpayer should report sales tax based on the taxable portion of book sales.

For a sales tax audit to be conducted on a taxpayer using the retail inventory method, inventory and purchases must be identifiable by product and the actual physical inventories must have been made. Verify the taxpayer’s calculations of sales tax using the purchase ratio method (except that purchases are recorded at retail prices). The general concepts of the Purchase Ratio Method are covered later in Chapter IV, Section I.

**NOTES:**

- The overage/loss adjustment may not be applied to purchases unless taxable and/or nontaxable substantiated losses can be established.
- See substantiated losses section.

**Gross Profit Method**

Basically, the markup method is to be used only when all purchases are available for the entire audit period, but the sales records are not. It involves applying a gross profit markup percentage to the adjusted cost of goods sold 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. Or, this method 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 markup 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 markup 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 markup percentage after testing items purchased.

The last step is to determine audited gross sales:

$$\begin{array}{r}
 \text{Calculated Markup Percentage} + 100\% \\
 \times \text{Cost of Goods Sold} \\
 \hline
 \text{Audited Gross Sales}
 \end{array}$$

Since the markup is based on the cost of purchases, the percentage used in calculating sales will be the markup 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

Markup Percentage = 30%

\$7,200 X 1.30 = \$9,360 (Gross Sales)

INVOICE DATE	INVOICE NUMBER	PRODUCT	TOTAL PURCHASE PRICE	SALES PRICE PER ITEM	ITEMS PER UNIT	# OF UNITS PURCHASED	TOTAL RETAIL SALE
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)
01/03/2014	10708	Beer-Qts	\$ 50.75	\$ 1.99	10	3	\$ 59.70
01/10/2014	Stmt	Milk-Gal	66.86	1.99	12	4	95.52
02/02/2014	80692	Bkfst Cereal	25.44	2.12	12	2	50.88
02/07/2014	10912	Beer-6-pack (Cans)	98.07	2.99	4	10	119.60
03/03/2014	2001	Cola-6-pack (Cans)	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	10-pack Garbage Bags	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 Oz	107.73	3.99	12	5	239.40
09/20/2014	35995	Tomato Sauce-8 Oz	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 Soup-Bars	18.41	0.59	24	2	28.32
			\$ 1,400.78				\$ 2,235.82
Gross Profit= 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 1.596125 in order to calculate Gross Sales							

## Chapter IV

# Miscellaneous Taxpayer Store Topics

- 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

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### 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 markup or estimation method.

**THE 5 PERCENT ALLOWANCE IS FOR AUDIT 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 field work after performing a sample examination of the taxpayer's purchase invoices. As an example, a taxpayer 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 taxpayer's reported percentage of taxable sales to gross sales increases.

Example:

Gross Sales	\$ 45,000	\$ 45,000
Percent of Taxable Sales	X .30	X .45
Gross Taxable Sales	\$ 13,500	\$ 20,250
5% Allowance	X .05	X .05
Amount of Allowance	<u>\$675.00</u>	<u>\$1,012.50</u>
Relationship to 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	Taxable Purchases
	\$150,000.00	\$ 75,000.00
*Loss	<u>&lt; 5,500.00 &gt;</u>	<u>&lt; 1,500.00 &gt;</u>
Adjusted Purchases	<u>\$148,500.00</u>	<u>\$ 73,500.00</u>

\*The grocer can substantiate a loss of \$1,500 that consisted of cigarettes.

**NOTE:** If the Markup audit, rather than the Purchase Ratio Method, is performed, the purchase amounts still have to be taken into account. Again, the taxpayer must be able to substantiate a loss and what items were lost (spoiled, stolen, etc.). The purchases of taxable items would be reduced by the substantiated losses before applying the markup percentage.

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

Taxpayers may establish losses for:

- Taxable purchases
- Nontaxable purchases
- 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

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A taxpayer utilizing one of the optional special reporting methods for taxpayers must pay penalties and/or interest if a tax report is not filed on or before the due date or the correct amount of tax due is not remitted with the report. The only exception to penalty and interest is:

- 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

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A taxpayer is entitled to take a deduction for 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 have been or will be written off for federal income tax purposes.

A taxpayer's bad debts generally consist of insufficient fund checks and unpaid charge accounts for which the taxpayer 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.

The following factors must be considered 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 (5 percent Allowance, tax included in gross sales and substantiated losses).

## Consignment and Commission Sales

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Consignment means that goods are in the physical possession of the consignee (taxpayer) 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.

Another method utilized by taxpayers regarding consignment and commission sales is whereby the taxpayer only records the commissions received in income and does not record the sale or purchases 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

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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); and
- Those for which there is no reimbursement to the taxpayer (in-store coupons).

Both of the above coupons are handled in the same manner. The coupons represent a reduction of the item purchased by the customer. Tax is to be collected by the taxpayer on the net price (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 would also qualify as reductions of the sales price and the tax would be 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 the gross sales price of the item before reducing the price for coupons, this constitutes tax collected in error, and the total amount of this tax 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 and there is no additional charge for the premium, 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 on the Taxable Purchases section of the sales and use tax report.
- If the premium is given and there is an additional charge for the premium, the purchase of the premium is for resale. Tax is due on either the retailer's cost or the amount charged the customer, whichever is greater.

## Vending Machine Sales

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Some examples of vending machines located in convenience stores are soft drink machines, postage stamp machines, gumball machines, candy machines and newspapers sold through a rack. All 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 convenience 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 items sold through vending machines. If the Purchase Ratio Method of auditing is performed, adjustments to purchases are necessary for the merchandise sold through the vending machines. If a markup 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 markup audit, include the purchases of items sold through vending machines and apply the applicable markup percentage.

## Items Purchased by Customers with Food Stamps/Lone Star Card

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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 a 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 consists 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 taxpayer would not report any taxable sales on the transaction. However, if the customer only has \$3 in food stamps, the taxpayer should apply the \$3 in food stamps to the first \$3 of the charge for soft drinks and candy and collect tax on the remaining \$2.

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

**NOTE:** In Texas, qualifying individuals utilize the Lone Star Card for making the qualifying purchases.

When we make audit adjustments using an audit method where we are unable to distinguish between taxable products that can be purchased with food stamps and taxable products that are not eligible to be purchased with food stamps, we 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 in the audit period by total audited gross sales in 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 on how to calculate this “allowable percentage” is below:

Total Food Stamps Processed In the Audit Period	=	Food Stamp Allowance Percentage
<hr style="width: 50%; margin: 0 auto;"/> Total Gross Sales In the Audit Period		
Food Stamp Allowance Percentage	X	Taxable Sales = Allowable Offset for Nontaxable

**Example:**

During the audit period, a taxpayer 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 <hr style="width: 50%; margin: 0 auto;"/> \$100,000	=	50%
Allowable Offset for Food Stamp Sales	=	50% X	\$60,000	= \$30,000

When we make audit assessments utilizing specific product scanner codes, we currently do not allow any offset 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 determined that \$20,000 of the Taxable Sales amount consisted of beer (not qualified 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 we make audit adjustments using the purchase ratio method, we will allow food stamps to offset taxable sales, not to exceed the amount of sales associated with qualifying food stamp purchases, if known.

**Example:**

During the audit period the taxpayer's total purchases was \$100,000. Of that amount, \$50,000 was purchases of taxable items. In addition, the taxpayer had accepted \$40,000 in food stamps during the audit period. The auditor determined that of the \$50,000, \$20,000 consisted of non-qualifying items (beer, cigarettes, etc.). The Allowable Offset for Food Stamp Sales would be \$30,000 and not \$40,000 (\$50,000 - \$20,000).

**Combination Grocery and Snack Bar or Delicatessen**

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

- Audit of sales
  - » 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 convenience store's sales.
  - » If separate sales records are not maintained, a reasonable estimate of sales should be made utilizing test periods and any available records.
- Audit of purchases
  - » Separate those purchases made directly for the snack bar/delicatessen so that they will not be included in the Purchase Ratio percentage or markup percentage computation.
  - » A reasonable estimate will have to be made for any portion of grocery items such as bread, meat, etc. that are withdrawn from the taxpayer's inventory for use in the snack bar/delicatessen.

**Items Withdrawn from Inventory for Use**

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A taxpayer's liability for Taxable Purchases is generally limited to:

- Merchandise withdrawn from inventory for business use –
  - » consists of such taxable items as cleaning supplies, brooms, paper products, etc. – these items should be scheduled separately as Adjustments to Taxable Purchase.
- Merchandise withdrawn from inventory for personal use –
  - » many taxpayers, especially small proprietors, will withdraw both taxable and exempt merchandise for home use. Unless the taxpayer maintains records that list the items withdrawn for home use, the same percentage factor utilized in the Purchase Ratio Method audit of the convenience 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**

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A taxpayer must pay tax on all boxes, paper sacks and plastic bags used to package or repackage items for sale. A taxpayer can claim an exemption for any wrapping and packaging materials used in processing items resold (items for the meat department, deli department and bakery department). 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 V

# Auditing Procedures

- Purchase Ratio Method
- Exhibit – Transaction Entry
- Markup Methods
- Lack of Records
- Exhibit – Letter to Vendor
- Exhibit – Vendor’s Records
- Exhibit – Notification of Estimation
- Beer, Wine & Tobacco Vendor Data
- Alternative Markup Factors

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This chapter will deal with auditing procedures, with emphasis on the Purchase Ratio and Markup Procedures. Various auditing issues encountered throughout the years will also be discussed.

### **Purchase Ratio Method**

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

#### **Gross Sales**

Since the percentage ratio will be applied to the taxpayer’s gross sales, less any adjustments, it is extremely important for the auditor to verify gross sales. If gross sales were 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, need to be made to Audited Gross Sales. The taxable percentage ratio obtained must be applied only to sales that are attributable to the taxpayer’s operation. Such items, previously discussed, as delivery charges, commissions, deli/restaurant operation, lotto sales, hunting/fishing licenses, phone cards etc. must be deducted from Audited Gross Sales/Total Receipts before applying the taxable percentage.

Below is an example of a schedule that was performed with some examples of adjustments made to Audited Gross Sales. This schedule is for illustration 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
	(1)	(2)	(3)	(4)
REPORT PERIOD	AUDITED GROSS SALES	LESS: GASOLINE SALES	LESS: LOTTO SALES	NET AUDITED GROSS SALES
	*	*	*	COL. 1 - (COLS. 2 + 3)
1201	\$ 233,132.00	\$ 134,627.00	\$ 895.00	\$ 97,610.00
1202	233,967.00	135,347.00	920.00	97,700.00
1203	217,500.00	118,075.00	1,010.00	98,415.00
1204	226,377.00	126,482.00	1,040.00	98,855.00
1205	242,931.00	141,946.00	1,150.00	99,835.00
1206	208,208.00	106,493.00	1,210.00	100,505.00
1207	247,739.00	144,269.00	1,250.00	102,220.00
1208	216,377.00	113,817.00	1,205.00	101,355.00
1209	200,743.00	99,033.00	1,165.00	100,545.00
1210	215,044.00	115,939.00	1,105.00	98,000.00
1211	210,584.00	112,724.00	1,055.00	96,805.00
1212	207,350.00	106,210.00	1,095.00	100,045.00
TOTALS	\$ 2,659,952.00	\$ 1,454,962.00	\$ 13,100.00	\$ 1,191,890.00
* FROM TAXPAYER'S SALES JOURNAL				

**NOTE:** The taxable ratio percentage will be applied to the amounts in Col. 4 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. Utilizing Comptroller sampling standards, a sample period is obtained. 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 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 law change; such as sunscreen becoming exempt from sales tax effective June 18, 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.

Below is a sample schedule that could be prepared to compute the taxable percentage to be applied to sales. The auditor must prepare an Excel spreadsheet in order to schedule the merchandise purchases for the sample period. This schedule is for illustration purposes only as the auditor may need to tailor the schedule to fit his/her audit’s needs.

WORTH CORPORATION FORT WORTH, TEXAS SCHEDULE OF GROCERY PURCHASES					EXAM 1C TP#12345678903 PAGE 6 OF 6	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
VENDOR	DATE	INVOICE #	DESCRIPTION	TAXABLE AMT.	TAX CHANGE AMT.	TOTAL AMT.
JOE'S WHOSLE GR	05/02/2012	362230	HBC, Sunscreen, Food items	\$ 2,638.35	\$ -	\$ 4,529.00
M N M 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, Lunch meat	-	-	-
PAUL'S MEDICAL	05/08/2012	400192	Aspirin, cold med	-	-	-
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 BOTTL	05/12/2012	483820	Water, Energy Drinks	3,285.00	-	4,784.00
TOMMY'S MEATS	05/12/2012	195834	Meat, Lunch meat	-	-	-
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	-	-	-
M N M 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 WHOSLE GR	06/18/2012	172082	HBC, Sunscreen, Food items	529.00	2,102.20	3,023.00
M N M 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, Lunch meat	-	-	-
PAUL'S MEDICAL	06/07/2012	527731	Aspirin, cold med	-	-	-
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 BOTTL	06/11/2012	496997	Water, Energy Drinks	3,168.00	-	5,101.00
<b>TOTALS</b>				<b>\$ 39,659.35</b>	<b>\$ 2,102.20</b>	<b>\$ 48,490.00</b>
TAXABLE PERCENTAGE:		PERIODS PRIOR TO TAXABILITY CHANGE		(COL. 5 + COL. 6)/COL. 7		86.1240%
TAXABLE PERCENTAGE:		PERIODS AFTER TAXABILITY CHANGE		(COL. 5/COL. 7)		81.7887%
* NOTE: SUNSCREEN WAS TAXABLE FROM 9/01/07 THROUGH 6/17/12						

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

**NOTE:** For 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.

Example of Application of 5 percent Allowance – utilizing the previous examples of Worth Corporation

WORTH CORPORATION FORT WORTH, TEXAS ADDITIONAL TAXABLE SALES							EXAM 1A TP#12345678903 PAGE 1 OF 1
REPORT PERIOD	(1) NET AUDITED GROSS SALES	(2) TAXABLE PERCENTAGE	(3) AUDITED TAXABLE SALES	(4) 5% ALLOWANCE FOR SPOILAGE, THEFT	(5) ADJUSTED AUDITED TAXABLE SALES	(6) REPORTED TAXABLE SALES	(7) ADDITIONAL TAXABLE SALES
		FROM EXAM 1C	COL. 1 * COL. 2		COL. 3 * COL. 4	TP HISTORY	COL. 5 - COL. 6
1201	\$ 97,610.00	86.1240%	\$ 84,065.68	95%	\$ 79,862.40	\$ 19,701.00	\$ 60,161.40
1202	\$ 97,700.00	86.1240%	84,143.19	95%	79,936.03	19,724.00	60,212.03
1203	\$ 98,415.00	86.1240%	84,758.98	95%	80,521.03	19,885.00	60,636.03
1204	\$ 98,855.00	86.1240%	85,137.93	95%	80,881.03	19,979.00	60,902.03
1205	\$ 99,835.00	86.1240%	85,981.94	95%	81,682.84	20,197.00	61,485.84
1206	\$ 100,505.00	81.7887%	82,201.75	95%	78,091.66	20,343.00	57,748.66
1207	\$ 102,220.00	81.7887%	83,604.43	95%	79,424.21	20,694.00	58,730.21
1208	\$ 101,355.00	81.7887%	82,896.96	95%	78,752.11	20,512.00	58,240.11
1209	\$ 100,545.00	81.7887%	82,234.47	95%	78,122.74	20,342.00	57,780.74
1210	\$ 98,000.00	81.7887%	80,152.94	95%	76,145.30	19,821.00	56,324.30
1211	\$ 96,805.00	81.7887%	79,175.57	95%	75,216.79	19,572.00	55,644.79
1212	\$ 100,045.00	81.7887%	81,825.52	95%	77,734.25	20,228.00	57,506.25
TOTALS	\$ 1,191,890.00		\$ 996,179.37		\$ 946,370.40	\$ 240,998.00	\$ 705,372.40

**Credit for Food Stamps**

In the example above, food stamps (Lone Star Card) were not an issue. If the taxpayer is qualified to accept and if customers have made purchases with food stamps, credit needs to be given for these sales. In the example above, credit would be given after Adjusted Audited Taxable Sales. Please refer to Chapter V for the allowable amount of credit for food stamp sales.

WORTH CORPORATION FORT WORTH, TEXAS ADDITIONAL TAXABLE SALES							EXAM 1A TP#12345678903 PAGE 1 OF 1	
REPORT PERIOD	(1) NET AUDITED GROSS SALES	(2) TAXABLE PERCENTAGE	(3) AUDITED TAXABLE SALES	(4) 5% ALLOWANCE FOR SPOILAGE, THEFT	(5) ADJUSTED AUDITED TAXABLE SALES	(6) Food Stamp Sales	(7) REPORTED TAXABLE SALES	(8) ADDITIONAL TAXABLE SALES
		FROM EXAM 1C	COL. 1 * COL. 2		COL. 3 * COL. 4	BANK STMTS	TP HISTORY	COL. 5 - COL. 6 - COL. 7
1201	\$ 97,610.00	86.1240%	\$ 84,065.68	95%	\$ 79,862.40	\$ 1,137.40	\$ 19,701.00	\$ 59,024.00
1202	\$ 97,700.00	86.1240%	84,143.19	95%	79,936.03	948.74	19,724.00	59,263.29
1203	\$ 98,415.00	86.1240%	84,758.98	95%	80,521.03	985.63	19,885.00	59,650.40
1204	\$ 98,855.00	86.1240%	85,137.93	95%	80,881.03	1,001.60	19,979.00	59,900.43
1205	\$ 99,835.00	86.1240%	85,981.94	95%	81,682.84	918.66	20,197.00	60,567.18
1206	\$ 100,505.00	81.7887%	82,201.75	95%	78,091.66	811.25	20,343.00	56,937.41
1207	\$ 102,220.00	81.7887%	83,604.43	95%	79,424.21	649.41	20,694.00	58,080.80
1208	\$ 101,355.00	81.7887%	82,896.96	95%	78,752.11	592.07	20,512.00	57,648.04
1209	\$ 100,545.00	81.7887%	82,234.47	95%	78,122.74	647.22	20,342.00	57,133.52
1210	\$ 98,000.00	81.7887%	80,152.94	95%	76,145.30	440.20	19,821.00	55,884.10
1211	\$ 96,805.00	81.7887%	79,175.57	95%	75,216.79	459.32	19,572.00	55,185.47
1212	\$ 100,045.00	81.7887%	81,825.52	95%	77,734.25	550.39	20,228.00	56,955.86
TOTALS	\$ 1,191,890.00		\$ 996,179.37		\$ 946,370.40	\$ 9,141.89	\$ 240,998.00	\$ 696,230.51

To assess the tax on the above 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, onto the CATS Exam. The Comptroller’s automated audit system would then assess the additional tax, penalty and interest due.

## Exhibit – Transaction Entry

Footnote List	Local Jurisdictions	Direct Pay
<b>Add New Sales Transaction</b>		
Exam:	1 - TAXABLE SALES	DETAIL
Customer:	ADDITIONAL TAXABLE SALES - FORT WORTH, TARRA	
Shipped to Location - City:	FORT WORTH	<input checked="" type="radio"/> ICL <input type="radio"/> OCL
Shipped to Location - County:	TARRANT	
Date:	01/01/2000	
Reference:	EXAM 1A	
Taxable Amt.:	42214.68	Calculator
Description:		
Comment:		
Footnote:		
<b>Local Tax Allocation:</b>		
Vendor POS Location: City:	FORT WORTH	<input checked="" type="radio"/> ICL <input type="radio"/> OCL
County:	TARRANT	
Delivery Method:	PICKED UP	<input type="checkbox"/> Shipped from OOS
<input checked="" type="checkbox"/> State Tax	<input type="checkbox"/> Override Recommendations	<input type="checkbox"/> Show Recommendations
Jurisdictions:		Recommendations:
City:	<input type="text"/> Add City >	FORTWO - FORT WORTH
County:	<input type="text"/> Add County >	MTAFOR - FORT WORTH MTA
Transit:	<input type="text"/> Add Transit >	SCCFOR - FORT WORTH CRIME COM
SPD:	<input type="text"/> Add SPD >	
Combined:	<input type="text"/> Add Cmbind >	
		Tax Rate: 0.08250

## Markup Methods

The Purchase Ratio Method cannot be used when the auditor determines that sales and purchases cannot be verified using traditional auditing methods. The auditor must estimate taxable sales from whatever information is available. **A markup method is the preferred method of auditing convenience stores when the records are unavailable, inadequate or unreliable.** The *ABC Dictionary for Accountants (Fifth Edition)* defines “markon” as “the amount added to cost, in setting selling prices, to cover operating expenses and profit; also, the ratio of the added amount to cost or selling price.” What the dictionary refers to as markon, this manual will refer to as “markup.” This ratio of the added amount to cost is expressed as a percentage. This markup percentage is the factor by which cost of sales is multiplied to determine, for our purposes, taxable sales. The markup percentage obtained is applied to the taxpayer’s purchases; those merchandise items, when resold through the convenience store, would be subject to sales tax. Some of the most common markup methods will be discussed in this section.

### **Shelf Test**

A shelf test is a general term for procedures used to determine the unit price of merchandise sold. The auditor arrives at the convenience store on a predetermined date and performs an actual physical examination on the products being sold through the convenience store. Procedures are used to determine the unit sales price of the merchandise on the shelves of the convenience store. The auditor would physically view the sales price that is being charged for an item. Purchase invoices are examined for a **current** period to determine wholesale cost of the items purchased by the taxpayer. If the auditor finds that the taxpayer's purchase records are incomplete, unavailable or unreliable, some or all of the purchases should be obtained from suppliers. Because some items have a higher sales volume than others the auditor **should take a weighted average** when computing our markup percentages.

If the store is still in business, any markup percentage utilized **must be based on a shelf test performed** utilizing purchase information obtained from the taxpayer and/or vendors.

**If the store is not open, markup percentages should be based on the best information available. The auditor should document what information was used to determine markup percentages and why they utilized that method.**

### **Markup Based on Purchase Segregation**

Briefly, individual markups will be computed for each class/category of merchandise. The percentages of markup computed will be applied to their respective purchase category over the entire audit period. Before using this method, the auditor must determine that an accurate segregation of purchases can be made over the entire audit period. This method is better suited to convenience stores whose merchandise categories are few in number and with a wide variance in markup. **In fact, this is the preferred markup method to be utilized when auditing convenience stores.** As in the shelf test example above, many, if not all, of the purchases amounts may have to be obtained from the various vendors.

Utilizing the same information as in the previous example, an example of such a shelf test follows. Again, this is only a **brief** example. The auditor must utilize an adequate product mixture for each product category.

INVOICE DATE	INVOICE NUMBER	PRODUCT	(1) TOTAL PURCHASE PRICE	(2) SALES PRICE PER ITEM	(3) ITEMS PER UNIT	(4) # OF UNITS PURCHASED	(5) TOTAL RETAIL SALE	(6) MARKUP %
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)	(5) / (1)
08/03/2014	415328	Coca Cola 12oz 6pk can	167.52	3.49	4	20	279.20	
08/03/2014	415328	Pepsi 12oz 6pk can	142.13	3.29	4	18	236.88	
08/03/2014	415328	Coca Cola 12oz 12pk can	95.22	5.29	2	15	158.70	
08/03/2014	415328	Pepsi 12oz 12pk can	91.62	5.09	2	15	152.70	
08/03/2014	415328	Coca Cola 20oz single bottle	313.92	1.09	24	20	523.20	
08/03/2014	415328	Pepsi 20oz single bottle	235.44	1.09	24	15	392.40	
08/03/2014	415328	Dr. Pepper 12oz 6pk can	184.27	3.49	4	22	307.12	
08/03/2014	415328	Dr. Pepper 12oz 12pk can	88.87	5.29	2	14	148.12	
08/03/2014	415328	Dr. Pepper 20oz single bottle	313.92	1.09	24	20	523.20	
08/03/2014	415328	Sunny D 8oz single bottle	192.24	0.89	24	15	320.40	
		<b>Product Type - Soft Drinks</b>	1,825.15	30.10		174	3,041.92	166.67%
	Notes:	Actual items per unit are being taken from the invoice.						
INVOICE DATE	INVOICE NUMBER	PRODUCT	(1) TOTAL PURCHASE PRICE	(2) SALES PRICE PER ITEM	(3) ITEMS PER UNIT	(4) # OF UNITS PURCHASED	(5) TOTAL RETAIL SALE	(6) MARKUP %
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)	(5) / (1)
08/01/2014	8124	Bubble Yum	4.93	0.79	12	1	9.48	
08/01/2014	8124	Mars bar	12.36	0.99	24	1	23.76	
08/01/2014	8124	Hershey's bar	12.36	0.99	24	1	23.76	
08/01/2014	8124	Big league chew	15.50	1.49	20	1	29.80	
08/01/2014	8124	Twizzler's	12.42	1.99	12	1	23.88	
08/01/2014	8124	3 Musketeer's bar	12.36	0.99	24	1	23.76	
08/01/2014	8124	Chocolate mints	3.82	0.49	15	1	7.35	
08/01/2014	8124	Bag of peppermints	18.64	2.39	15	1	35.85	
08/01/2014	8124	Lolly pops	18.53	0.99	36	1	35.64	
08/01/2014	8124	Bag of Gumballs	20.70	1.99	20	1	39.80	
		<b>Product Type - Candy</b>	131.60	13.10		10	253.08	192.31%
	Notes:	Actual items per unit are being taken from the invoice.						
INVOICE DATE	INVOICE NUMBER	PRODUCT	(1) TOTAL PURCHASE PRICE	(2) SALES PRICE PER ITEM	(3) ITEMS PER UNIT	(4) # OF UNITS PURCHASED	(5) TOTAL RETAIL SALE	(6) MARKUP %
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)	(5) / (1)
08/03/2014	94257	Doritos "big grab" bag	37.42	0.99	20	3	59.40	
08/03/2014	94257	Lay's "big grab" bag	37.42	0.99	20	3	59.40	
08/03/2014	94257	Cheetos "big grab" bag	37.42	0.99	20	3	59.40	
08/03/2014	94257	Doritos single serving bag	18.52	0.49	20	3	29.40	
08/03/2014	94257	Lay's single serving bag	18.52	0.49	20	3	29.40	
08/03/2014	94257	Cheetos single serving bag	18.52	0.49	20	3	29.40	
08/03/2014	94257	Peanuts-single serving bag	70.09	0.89	25	5	111.25	
08/03/2014	94257	Sunflower seeds-single serving bag	76.07	0.69	25	7	120.75	
08/03/2014	94257	Pork Rinds-single serving bag	62.37	0.99	20	5	99.00	
08/03/2014	94257	Beef Jerky-single serving	105.18	1.59	35	3	166.95	
		<b>Product Type - Chips/Snacks</b>	481.54	8.60		38	764.35	158.73%
	Notes:	Actual items per unit are being taken from the invoice.						

INVOICE DATE	INVOICE NUMBER	PRODUCT	(1) TOTAL PURCHASE PRICE	(2) SALES PRICE PER ITEM	(3) ITEMS PER UNIT	(4) # OF UNITS PURCHASED	(5) TOTAL RETAIL SALE	(6) MARKUP %
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)	(5) / (1)
08/05/2014	04018267	Bud, Budlight - 12 pk. Cans	381.25	9.39	2	25	469.50	
08/05/2014	04018267	Bud, Budlight - 12 pk. Bottles	381.25	9.39	2	25	469.50	
08/05/2014	04018267	Bud, Budlight - 18 pk.	157.50	13.29	1	15	199.35	
08/05/2014	04018267	Bud, Budlight - 6 pk. Cans	93.00	4.89	4	6	117.36	
08/05/2014	04018267	Bud, Budlight - Quart	220.00	2.89	10	10	289.00	
08/05/2014	04018267	Bud, Budlight - 24 oz.	180.00	2.39	10	10	239.00	
08/05/2014	0480587	Coors, Coors Lt. - 12 pk. Cans	310.00	9.39	2	20	375.60	
08/05/2014	0480587	Coors, Coors Lt. - 12 pk. Bottles	310.00	9.39	2	20	375.60	
08/05/2014	0480587	Coors, Coors Lt. - 18 pk.	107.50	13.29	1	10	132.90	
08/05/2014	04631154	Milwaukee Best - 6 pk. 16 oz. Can	135.00	3.89	4	10	155.60	
08/05/2014	04631154	Milwaukee Best - 12 pk.	90.00	5.29	2	10	105.80	
08/05/2014	04631154	Miller, Miller Lite - 12 pk. Cans	315.00	9.29	2	20	371.60	
08/05/2014	04631154	Miller, Miller Lite - 12 pk. Bottles	315.00	9.29	2	20	371.60	
08/05/2014	04631154	Miller, Miller Lite - 18 pk.	115.00	13.29	1	10	132.90	
08/05/2014	0438561	Corona, Corona Lt. - 6 pk.	300.00	6.49	4	15	389.40	
08/05/2014	0438561	Corona, Corona Lt. - 24 oz.	345.00	2.99	10	15	448.50	
08/05/2014	0455672	Smirnoff Ice - 6 pk.	318.75	6.79	4	15	407.40	
08/05/2014	0444368	Zima - 6 pk.	212.50	6.79	4	10	271.60	
08/05/2014	0451238	Heineken - 6 pk.	212.50	6.79	4	10	271.60	
08/05/2014	04856447	Mogan David 20/20	227.50	2.99	10	10	299.00	
08/05/2014	04856447	Boone's Farm	227.50	2.99	10	10	299.00	
		<b>Product Type - Beer &amp; Wine</b>	<b>\$4,954.25</b>	<b>\$151.19</b>		<b>296</b>	<b>\$6,191.81</b>	<b>124.98%</b>
	Notes:	* A "unit" of beer is typically a case. A case of beer normally contains 24 cans/bottles of beer. Actual items per unit are being taken from the invoice.						
INVOICE DATE	INVOICE NUMBER	PRODUCT	(1) TOTAL PURCHASE PRICE	(2) SALES PRICE PER ITEM	(3) ITEMS PER UNIT	(4) # OF UNITS PURCHASED	(5) TOTAL RETAIL SALE	(6) MARKUP %
			from invoice	per shelf test	*	from invoice	(2) * (3) * (4)	(5) / (1)
08/06/2014	0406240059	Cigarettes - Basic pack	430.00	2.49	10	20	498.00	
08/06/2014	0406240059	Benson & Hedges pack	600.00	3.69	10	20	738.00	
08/06/2014	0406240059	Camel pack	150.00	2.89	10	6	173.40	
08/06/2014	0406240059	Doral pack	395.00	2.29	10	20	458.00	
08/06/2014	0406240059	Newport pack	640.00	3.69	10	20	738.00	
08/06/2014	0406240059	Marlboro pack	147.00	2.99	10	6	179.40	
08/06/2014	0406240059	Salem pack	147.00	2.89	10	6	173.40	
08/06/2014	0406240059	Winston pack	147.00	2.89	10	6	173.40	
08/06/2014	0406240059	Kool	600.00	3.69	10	20	738.00	
08/06/2014	0406240059	Parliament	150.00	2.89	10	6	173.40	
		<b>Product Type - Cigarettes</b>	<b>\$3,406.00</b>	<b>\$30.40</b>		<b>130</b>	<b>\$4,043.00</b>	<b>118.70%</b>
	Notes:	* A "unit" of cigarettes is typically a carton. A carton of cigarettes normally contains 10 packs of cigarettes. Actual items per unit are being taken from the invoice.						

In the above example, the auditor performed the Shelf Test in August 2014. The shelf price was then compared with current purchase invoices which the taxpayer had on hand. The above markup factors are then forwarded to another exam which computes Additional Taxable Sales.

Based on the shelf test utilizing purchase segregation, an example of an exam computing Audited Taxable Grocery Sales follows.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
PERIOD	BEER PURCHASES	MARKUP	AUDITED BEER SALES	TOBACCO PRODUCTS PURCHASES	MARKUP	AUDITED TOBACCO PRODUCTS SALES	SOFT DRINK PURCHASES	MARKUP
	Exam 1B	Exam 1D	Col. 2 x Col. 3	Exam 1C	Exam 1D	Col. 5 x Col. 6	Exam 1E	Exam 1D
1309	32,982.00	124.98%	41,220.83	32,535.00	118.70%	38,619.79	15,307.00	166.67%
1310	39,988.00	124.98%	49,976.91	33,048.00	118.70%	39,228.73	14,992.00	166.67%
1311	30,677.00	124.98%	38,340.04	40,981.00	118.70%	48,645.39	14,694.00	166.67%
1312	33,942.00	124.98%	42,420.63	37,440.00	118.70%	44,442.14	14,802.00	166.67%
1401	30,715.00	124.98%	38,387.53	38,342.00	118.70%	45,512.83	14,714.00	166.67%
1402	30,455.00	124.98%	38,062.59	31,974.00	118.70%	37,953.87	15,183.00	166.67%
1403	36,802.00	124.98%	45,995.05	33,371.00	118.70%	39,612.14	14,903.00	166.67%
1404	40,583.00	124.98%	50,720.54	38,268.00	118.70%	45,424.99	14,365.00	166.67%
1405	32,417.00	124.98%	40,514.69	33,111.00	118.70%	39,303.52	15,177.00	166.67%
1406	35,889.00	124.98%	44,853.99	35,552.00	118.70%	42,201.04	15,482.00	166.67%
1407	40,702.00	124.98%	50,869.26	35,214.00	118.70%	41,799.82	15,353.00	166.67%
1408	38,605.00	124.98%	48,248.44	30,646.00	118.70%	36,377.50	13,714.00	166.67%
TOTALS:	423,757.00		529,610.50	420,482.00		499,121.76	178,686.00	

(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
AUDITED SOFT DRINK SALES	CANDY PURCHASES	MARKUP	AUDITED CANDY SALES	CHIPS/SNACKS PURCHASES	MARKUP	AUDITED CHIPS/SNACKS SALES	AUDITED GROCERY TAXABLE SALES
Col. 8 x Col. 9	Exam 1F	Exam 1D	Col. 11 x Col. 17	Exam 1G	Exam 1D	Col. 14 x Col. 15	
25,512.18	6,172.00	192.31%	11,869.37	7,262.00	158.73%	11,526.97	167,368.93
24,987.17	6,175.00	192.31%	11,875.14	7,844.00	158.73%	12,450.78	177,747.46
24,490.49	7,432.00	192.31%	14,292.48	7,479.00	158.73%	11,871.42	186,285.20
24,670.49	7,373.00	192.31%	14,179.02	7,308.00	158.73%	11,599.99	181,754.40
24,523.82	6,794.00	192.31%	13,065.54	7,093.00	158.73%	11,258.72	178,261.28
25,305.51	6,044.00	192.31%	11,623.22	7,803.00	158.73%	12,385.70	163,284.75
24,838.83	7,479.00	192.31%	14,382.86	7,488.00	158.73%	11,885.70	176,326.73
23,942.15	7,424.00	192.31%	14,277.09	7,795.00	158.73%	12,373.00	192,162.77
25,295.51	6,306.00	192.31%	12,127.07	7,171.00	158.73%	11,382.53	167,926.82
25,803.85	6,059.00	192.31%	11,652.06	7,941.00	158.73%	12,604.75	179,316.73
25,588.85	7,152.00	192.31%	13,754.01	7,168.00	158.73%	11,377.77	185,189.54
22,857.12	7,402.00	192.31%	14,234.79	7,125.00	158.73%	11,309.51	169,404.87
297,815.96	81,812.00		157,332.66	89,477.00		142,026.84	2,125,029.48

The subsequent exams would follow the same format as in the prior shelf test example.

### Shelf Test Basics

This section pertains to both the shelf test markup and the markup based on purchase segregation.

- If vendors must be contacted in order to estimate an audit liability, all suppliers within a particular purchase category, if available, must be contacted. For example, all soft drink suppliers must be contacted to estimate soft drink sales.
- There will be price fluctuations within any given category of purchases. The auditor needs to get a good mix of product sizes and high- and low-dollar value items. This good mixture of products should overcome any of these price fluctuations.
- Convenience stores generally change their prices as their costs change. Audit experience of the industry has shown that convenience stores, at least the smaller entities, do not maintain a pricing history. Out of necessity, we use current sales prices versus current costs at the time the shelf test is performed.
- A shelf test must be conducted on each active outlet. It should have a **minimum** of 10 different high/medium volume items for each category. These 10 items should be a mix of the different variety of sizes and brands available for sale (for example, 12 pack, 6 pack, 18 pack, 20 oz, one-liter bottles, quart

bottles, smokeless tobacco, cigar products, domestic beer, imported beer, Coors, Budweiser, etc.) as these are often sold with different markups. If the taxpayer does not offer a variety of sizes and brands, **it must be documented** to explain why at least 10 items were not used.

- When performing a shelf test, there are a few things that we need to keep in mind:
  - » Look around the store and take note of what products are being sold, including the brands. This is helpful for verifying the completeness of purchase records when you are trying to compute a product mix (which we will talk about later).
  - » Take note of the amount of shelf space each product category is taking up. Again, this is useful for verifying purchases for a product mix. For instance, it wouldn't make any sense to see five out of 10 coolers stocked with soft drinks (the other half being beer) when purchase records reflect that soft drinks are less than 10 percent of beer purchases (by volume, not dollars). This would be an indication that the taxpayer's soft drink purchase records are incomplete.
  - » Take note of the number of registers are present as well as how many employees are working. If the store has two registers and sales records are provided, you should see register tapes from both registers. Also take a look at the register to see how the keys are labeled.
  - » Look for anything that can change the taxability of items, such as an eating area or a microwave for customer use.
  - » If the store has a separate deli area that sells prepared food, check to see if it has a separate register used for purchases made from that area. If the deli has a separate register, the taxability of snack food (greater than one serving or more than 2.5 ounces) would be taxable if sold through the deli, but not taxable if sold through the front register. However, keep in mind that unless the store has an advanced POS system, or the sales records to support where the sales were "rung up," we can't distinguish which sales should be taxable and which sales should not (of course, this is only an issue with snack food; all prepared food or food sold ready for immediate consumption is taxable regardless of which register it was sold at-see Sales and Use Tax Bulletin for August 2007: Ready-To-Eat-Food).

### **Tobacco Products Rebates**

A taxpayer may receive a rebate from the cigarette manufacturer(s) which reduces the purchase price of tobacco products. This rebate information should be requested from the taxpayer. If provided, these amounts must be deducted from the purchase price of the tobacco products by month. **Rebate amounts should always be considered when calculating the markup, when applicable.** If the taxpayer or their representative is unable or unwilling to provide rebate information, the computed markup for tobacco will be small or possibly a negative number. If this happens, **and** the taxpayer does not provide any rebate information, the auditor should utilize the best information available per API 34 to markup the tobacco products.

An example of how to handle rebate information with regards to calculating a markup is below:

The markup of a particular brand of tobacco products appears to be less than cost. After asking for rebate information, the taxpayer provides documentation that shows the taxpayer was receiving 38¢ per pack back via the rebate. In order to calculate the markup correctly, the auditor must take this rebate into consideration.

BEFORE:			(1)	(2)	(3)	(2)	(3)	(4)	(5)	(6)	
INVOICE DATE	INVOICE NUMBER	PRODUCT	TOTAL PURCHASE PRICE	# OF UNITS PURCHASED	COST/UNIT	SALES PRICE PER ITEM	ITEMS PER UNIT	# OF UNITS PURCHASED	TOTAL RETAIL SALE	MARKUP %	
			from invoice	from invoice	(1)/(2)	per shelf test	*	from invoice	(2) * (3) * (4)	(5)/(1)	
08/06/2014	0406240059	Cigarettes - Basic pack	500.00	20	21.50	2.49	10	20	498.00	99.60%	99.60% *This means that the taxpayer is selling at 99% of his cost, which is selling at a loss.
<p>\$0.38 per pack = \$3.80 per carton (0.38 * 10 = 3.80)                      \$3.80 multiplied by the number of cartons purchased (20) equals \$76                      We will make our adjustment from the purchase price; \$500 minus \$76 equals \$424</p>											
AFTER:			(1)	(2)	(3)	(2)	(3)	(4)	(5)	(6)	
INVOICE DATE	INVOICE NUMBER	PRODUCT	TOTAL PURCHASE PRICE	# OF UNITS PURCHASED	COST/UNIT	SALES PRICE PER ITEM	ITEMS PER UNIT	# OF UNITS PURCHASED	TOTAL RETAIL SALE	MARKUP %	
			from invoice	from invoice	(1)/(2)	per shelf test	*	from invoice	(2) * (3) * (4)	(5)/(1)	
08/06/2014	0406240059	Cigarettes - Basic pack	424.00	20	21.50	2.49	10	20	498.00	117.45%	117.45% *After our adjustment for the rebates we see that the true mark-up is actually 17% above cost.

What if the taxpayer is no longer in business, and a shelf test cannot be performed? See section regarding Alternative Markup Factors.

### Lack of Records

Taxpayers may claim that they do not possess the records necessary for an audit of their business activity. Before performing an estimated audit, vendors need to be contacted. In situations with incomplete records, the audit should follow the most current audit policy. Currently, that policy is contained in AP134 dated August 1, 2014 (also see section regarding Alternative Markup Factors).

Below is an example of a letter sent by a Comptroller auditor to a vendor in order to obtain purchases made by a convenience store.

#### Exhibit – Letter to Vendor

Austin Audit Office  
 1711 San Jacinto, Suite 410  
 Central Services Bldg.  
 Austin, Texas 78711-3003  
 512-305-9800  
 Fax 512-305-9875

August 10, 2014

Mr. Sam Smith  
 Beer Distributor of Austin  
 111 Pony Dr.  
 Austin, Texas 78701

RE: Request for purchase information for ABC, Inc.  
 5809 Longhorn Ave.  
 Austin, Texas 78709

Dear Mr. Smith:

I am requesting monthly totals of purchases for the above account for the period of August 1, 2010 through July 31, 2014. Please fax the information to the number listed above.

If you have any questions, please call me.

Ralph Norton  
Auditor

The above letter must be sent out on the Comptroller's letterhead. At times it may be necessary to follow this letter with a telephone call or a personal visit to the vendor's location.

Vendors should have the necessary records for a four-year audit period. At the least, enough records should be available to allow a representative sample audit of the taxpayer.

Below is an example of a beer vendor's response to a Comptroller auditor's request for records.

### Exhibit – Vendor's Records

#### JOE'S COCA-COLA

Trend ME 08-09 – 07-13

PATH: Cla: CUSTOMER By: Brands Focus: Coke Zero

Acc: 0123456 ABC's Convenience

5809 LONGHORN

Date	Sales (Cases)	Net Price/Case
Aug-10	122	14.05
Sep-10	117	13.35
Oct-10	98	12.95
Nov-10	90	14.43
Dec-10	100	14.58
Jan-11	120	14.29
Feb-11	102	14.36
Mar-11	101	14.26
Apr-11	143	14.70
May-11	106	14.49
Jun-11	91	14.70
Jul-11	95	14.70
Aug-11	113	14.70
Sep-11	80	14.70
Oct-11	80	14.44
Nov-11	98	14.70
Dec-11	94	14.90
Jan-12	82	14.07
Feb-12	108	14.81
Mar-12	81	14.75
Apr-12	92	15.15
May-12	90	14.99
Jun-12	91	15.15
Jul-12	92	15.15

Aug-12	87	15.15
Sep-12	99	14.79
Oct-12	89	14.86
Nov-12	112	14.47
Dec-12	104	14.46
Jan-13	70	14.86
Feb-13	64	14.90
Mar-13	57	14.94
Apr-13	78	15.37
May-13	55	14.87
Jun-13	78	15.60
Jul-13	72	15.60
Aug-13	70	15.47
Sep-13	93	15.31
Oct-13	55	15.21
Nov-13	72	15.27
Dec-13	46	15.43
Jan-14	58	15.49
Feb-14	46	15.60
Mar-14	70	15.31
Apr-14	51	15.60
May-14	87	14.74
Jun-14	97	14.44
Jul-14	115	14.70
Average	88	14.81
Total	4211	

**NOTE: HB 11, as passed by the 80th Texas Legislative Session, requires wholesalers of alcoholic products and cigarette/tobacco products to file reports with the Comptroller that summarize a convenience store's purchases. Beginning with January 2008, the Comptroller has data of a taxpayer's purchases of alcoholic and tobacco products. Contact of the applicable vendors will no longer be necessary.**

If records necessary for the audit cannot be obtained from vendors, an estimated audit may have to be performed. Before estimating an audit, the detailed instructions per AP70, dated March 26, 2002, must be followed. Briefly, the following steps must be followed:

- Letter 1 – first request for records must be issued to the taxpayer or to the taxpayer's authorized representative.
- Letter 2 – second request for records must be issued to the taxpayer or to the taxpayer's authorized representative (this second letter may not be necessary if the auditor gets a signed statement from the taxpayer stating that all records available have been provided).
- Auditor fills out a Request for Subpoena of Records form, listing
  - » type of subpoena: first party or third party
  - » name and address of the person or entity to whom subpoena will be served

- » name and address of person or entity for whose records subpoena will be served
- » detailed description of records for which subpoena will be served
- » time period of records
- » name of person who will serve the subpoena
- » title of person and the Comptroller field office

Please refer to AP70 for more detailed instructions and copies of the necessary letters and form.

If, after following the above steps, records have not been obtained, an estimated audit should be performed. However, estimated amounts must be based on some reasonable basis (see AP134).

Below is an example of a Notification of Estimation issued to a taxpayer.

#### Exhibit – Notification of Estimation

COMPTROLLER OF PUBLIC ACCOUNTS STATE OF TEXAS	
<b>NOTIFICATION OF ESTIMATION PROCEDURES FOR STATE TAX AUDIT</b>	
Taxpayer Name	: CORY, INC
Taxpayer Number	: 17554983266
Type of Tax	: LIMITED SALES, EXCISE, AND USE TAX
Audit Period	: August 1, 2010 through July 31, 2014
Reporting Category: Sales	Subcategory: Additional Taxable Sales

1. Reason for estimation (including a description of records which the taxpayer failed to provide after notification from the auditor by letter or subpoena):

Estimation is necessary due to incomplete records. Although some records were provided, there were several missing months as well as missing vendors.

2. The records to be examined in performing the estimation will include (but not limited to):

Vendor records will be used in conjunction with HB11 data to obtain a more accurate representation of the beer, wine, candy, soda and tobacco purchases.

3. List periods (they may or may not be the entire audit period) being estimated:

August 10, 2010 through July 31, 2014

The periods listed in number 3, under audit are being estimated based on the best information available due to your failure to maintain/provide adequate records for a sample in compliance with Comptroller policy. Since adequate records were not maintained/provided, no credit projections will be allowed based on the estimation procedures used by the Comptroller.

4. Describe procedures taken to perform estimate:

An average estimated taxable sales amount will be computed for the entire audit period. Actual beer and tobacco purchases were obtained from your vendors and HB 11 data to insure accuracy. Taxable items

being sold include beer, general merchandise, soft drinks, candy, other miscellaneous taxable items and tobacco. An average markup or profit margin for beer, general merchandise, soft drinks, for candy, for other miscellaneous taxable items and for tobacco was calculated during a shelf test. Estimated beer sales will be calculated by multiplying beer purchases by the average markup for beer calculated during the shelf test. Estimated tobacco sales will be calculated by multiplying tobacco purchases by the average markup for tobacco calculated during the shelf test. A product mix percentage was calculated by examining three complete months of purchase records for August, September and October 2013. The product mix for beer and tobacco was calculated by dividing the total estimated beer and tobacco sales for the periods of August, September and October 2013 by the estimated taxable sales made in that same period (which was calculated by multiplying beer, general merchandise, soft drink, candy, other miscellaneous taxable items and tobacco purchases by their corresponding markup percentages previously calculated during the shelf test). Estimated total taxable sales for the entire estimation period will be estimated by dividing estimated beer and tobacco sales by the product mix percentage for beer and tobacco. Estimated total taxable sales will then be reduced by 5 percent for theft/spoilage per Comptroller guidelines to arrive at net estimated additional taxable sales for the audit period. Per Comptroller guidelines, the percentage of net estimated additional taxable sales that can be purchased with food stamps (for the audit period) will be reduced by an allowance for food stamps percentage. This food stamp percentage was calculated by dividing the total food stamps processed during the entire audit period by the estimated total sales for the same period. Reported taxable sales will then be subtracted from net estimated taxable sales (after the food stamp allowance) to arrive at estimated additional taxable sales. Additional tax due will then be calculated by multiplying the applicable state and local tax rates to estimated additional taxable sales for each period within the audit.

This notification was hand delivered on	Date:
TO: Keith Smith	Title: President
SIGN HERE >	

Comptroller's Representative

## Beer, Wine & Tobacco Vendor Data

HB 11, as passed by the 80th Legislative Session, amended Tax Code Chapter 151 (Limited Sales, Excise, and Use Tax), Chapter 154 (Cigarette Tax) and Chapter 155 (Cigars and Tobacco Products Tax) by requiring wholesalers and distributors of beer, wine, and malt liquor, cigarettes, cigars and tobacco products to file monthly reports with the Comptroller. The wholesaler or distributor shall file the report on or before the 25th day of each month. The report must contain the following information for the preceding calendar month's sales made to each retailer:

the name of the retailer and the address of the retailer's outlet where delivery was made, including the city and zip code, the sales tax permit number assigned by the Comptroller to the retailer, the retailer's permit or license number assigned by the Texas Alcoholic Beverage Commission, the cigarette permit number or the tobacco permit number, whichever applicable, the monthly net sales made to the retailer by outlet, including the quantity and units sold to the retailer. The wholesalers/distributors began filing these reports with the Comptroller beginning with sales made for January 2008. Thus, the first report was due from the wholesalers/distributors by February 25, 2008. A link was added on the Audit Division internal website.

The link can be found under the heading of "Taxes & Research." The auditor enters the retailer's sales tax permit number or the retailer's physical address and the beginning and ending periods, by month, needed.

The auditor will be able to obtain all of the beer and other alcoholic beverages and cigarettes and tobacco products purchased by the retailer for the period requested. These data can then be exported into an Excel spreadsheet. If vendor data are not available for an entire audit period, vendors will continue to have to be contacted for retailer sales amounts.

## **Alternative Markup Factors (when all records are not available)**

The following are guidelines. Each audit is different, and any extraordinary situations will be handled on a case-by-case basis.

Two methods are to be used to perform audits in cases when records are unavailable, inadequate or unreliable.

- **Markup Method – All Purchase Records Available**

Purchase information for the entire audit period is obtained from the taxpayer and/or third-party vendors. The auditor performs a shelf test and computes a markup percentage. The markup percentage is applied to the purchase amounts obtained from the taxpayer and/or the third-party vendors. Please refer to the section dealing with the shelf test and the section dealing with markup based on purchase segregation above.

- **Markup Method (Average Taxable Sales Method) – All Records Not Available**

This method is to be used only when purchase invoices are not available for any or all product categories. For example, beer and tobacco product invoices can be obtained from the vendors and/or from HB 11 data at Audit Division's website, but purchases cannot be obtained from other suppliers. Taxable sales would be estimated using the best information available to make an estimate (statute 111.0042(d) and 111.008(a)).

**Documentation should be made to justify the estimated procedures utilized.** Professional auditor judgment is crucial to this process as well as a review of existing information that is generally available to the public. Examples of source material are:

- Texas Food & Fuel Association (TFFA) <http://txfoodandfuel.org>
- National Association of Convenience Stores (NACS) <http://www.nacsonline.com>

When audits are estimated using alternative sources per AP134, the auditor must state in the Notification of Estimation where the percentages were obtained from.

### **Product Mix Percentage**

When the only known purchase amounts for the entire audit period are beer/tobacco purchases (via HB11 and/or vendor records) a product mix percentage must be calculated in order to estimate taxable sales for the audit period. The product mix percentage is calculated by examining a few months' worth of complete purchase records and establishing a ratio for each taxable product category. Since the only known purchases for the entire audit period are beer/tobacco purchases, the product mix percentage for beer/tobacco purchases is divided by the total estimated beer/tobacco sales to calculate estimated taxable sales. A brief example of a product mix calculation is below:

TAXABLE PRODUCT	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	COST JANUARY 2014	COST FEBRUARY 2014	COST MARCH 2014	TOTAL COST	MARKUP %	EST TAXABLE SALES	PRODUCT MIX %
				col. (1) + (2) + (3)	PER SHELF TEST	col. (4) * (5)	col. (6) SALES/TOTAL
BEER & WINE	\$17,151.99	\$14,877.87	\$13,370.40	\$45,400.26	124.98%	56,741.14	21.11%
CIGARETTES & TOBACCO	27,545.67	26,322.84	25,456.00	79,324.51	118.70%	94,160.01	35.02%
GENERAL MERCHANDISE/HBC	4,163.42	4,119.47	3,707.22	11,990.11	181.82%	21,800.20	8.11%
SOFT DRINKS	11,483.87	10,427.66	10,427.66	32,339.19	166.67%	53,898.65	20.05%
CANDY	2,639.57	2,446.94	2,595.30	7,681.82	192.31%	14,772.72	5.49%
CHIPS & SNACKS	4,401.89	6,690.76	6,216.95	17,309.60	158.73%	27,475.56	10.22%
OTHER TAXABLE FOOD/DRINKS	0.00	0.00	0.00	0.00		0.00	0.00%
<b>TOTALS</b>	<b>\$ 67,386.41</b>	<b>\$ 64,885.54</b>	<b>\$ 61,773.53</b>	<b>\$ 194,045.49</b>		<b>268,848.28</b>	<b>100.00%</b>
<b>TOTAL OF BEER &amp; WINE AND CIGARETTES &amp; TOBACCO PRODUCT MIX %</b>							<b>56.13%</b>
							<b>FWD. TO EXAM 100A COL. (9)</b>

**EXAMPLES:**

Example #1 – Purchases Available for Beer and Tobacco Products/ Out of Business

- The taxpayer is out of business when the audit is generated
- The taxpayer's purchase invoices are incomplete or not made available to the auditor
- taxpayer's beer and cigarette vendors are known

The auditor contacts the taxpayer's beer and tobacco products vendors and the HB 11 information on Audit Division's website in order to obtain the necessary purchase information for the audit period. A shelf test cannot be performed since the taxpayer is out of business. The auditor would obtain the markup percentages using the best information available for the appropriate product category. The auditor would obtain the product mix for beer and tobacco using the best information available. Remember to include only taxable items in your product mix.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
PERIOD	BEER PURCHASES	MARKUP	ESTIMATED BEER SALES	TOBACCO PRODUCTS PURCHASES	MARKUP	ESTIMATED TOBACCO PRODUCTS SALES	ESTIMATED BEER AND TOBACCO SALES
	Exam 1B	Exam 1D	Col. 2 x Col. 3	Exam 1C	Exam 1D	Col. 5 x Col. 6	Col. 4 + Col. 7
1309	32,982.00	124.98%	41,220.83	32,535.00	118.70%	38,619.79	79,840.62
1310	39,988.00	124.98%	49,976.91	33,048.00	118.70%	39,228.73	89,205.64
1311	30,677.00	124.98%	38,340.04	40,981.00	118.70%	48,645.39	86,985.43
1312	33,942.00	124.98%	42,420.63	37,440.00	118.70%	44,442.14	86,862.77
1401	30,715.00	124.98%	38,387.53	38,342.00	118.70%	45,512.83	83,900.37
1402	30,455.00	124.98%	38,062.59	31,974.00	118.70%	37,953.87	76,016.46
1403	36,802.00	124.98%	45,995.05	33,371.00	118.70%	39,612.14	85,607.19
1404	40,583.00	124.98%	50,720.54	38,268.00	118.70%	45,424.99	96,145.53
1405	32,417.00	124.98%	40,514.69	33,111.00	118.70%	39,303.52	79,818.21
1406	35,889.00	124.98%	44,853.99	35,552.00	118.70%	42,201.04	87,055.03
1407	40,702.00	124.98%	50,869.26	35,214.00	118.70%	41,799.82	92,669.09
1408	38,605.00	124.98%	48,248.44	30,646.00	118.70%	36,377.50	84,625.94
<b>TOTALS:</b>	<b>423,757.00</b>		<b>529,610.50</b>	<b>420,482.00</b>		<b>499,121.76</b>	<b>1,028,732.27</b>

(1)	(9)	(10)	(11)	(12)	(13)	(14)
PERIOD	AVERAGE PRODUCT MIX TO TAXABLE SALES **	ESTIMATED TAXABLE SALES Col. 8 / Col. 9	LESS 5% ALLOWANCE ***	NET ESTIMATED TAXABLE SALES Col. 10 * Col. 11	LESS: TAXABLE SALES REPORTED Tax History	ADDITIONAL TAXABLE SALES Col. 12 - Col. 13
1309	62.50%	127,744.99	95%	121,357.74	40,142.00	81,215.74
1310	62.50%	142,729.03	95%	135,592.57	30,756.00	104,836.57
1311	62.50%	139,176.68	95%	132,217.85	35,234.00	96,983.85
1312	62.50%	138,980.43	95%	132,031.41	33,805.00	98,226.41
1401	62.50%	134,240.59	95%	127,528.56	33,769.00	93,759.56
1402	62.50%	121,626.33	95%	115,545.02	31,905.00	83,640.02
1403	62.50%	136,971.51	95%	130,122.94	38,918.00	91,204.94
1404	62.50%	153,832.85	95%	146,141.21	39,059.00	107,082.21
1405	62.50%	127,709.13	95%	121,323.67	41,503.00	79,820.67
1406	62.50%	139,288.04	95%	132,323.64	39,636.00	92,687.64
1407	62.50%	148,270.54	95%	140,857.01	42,935.00	97,922.01
1408	62.50%	135,401.51	95%	128,631.43	44,506.00	84,125.43
TOTALS:		1,645,971.62		1,563,673.04	452,168.00	1,111,505.04

*	Markup for beer and tobacco was estimated using (THIS IS WHERE YOU DOCUMENT HOW YOU CAME UP WITH THE MARKUP FOR BEER AND TOBACCO)
**	The product mix for beer and tobacco was estimated using (THIS IS WHERE YOU DOCUMENT HOW YOU CAME UP WITH THE PRODUCT MIX FOR BEER AND TOBACCO)
***	To allow 5% for spoilage, pilferage, theft, etc.

Example # 2 – Purchases Available for Beer & Tobacco Products/ Still in Business

- The taxpayer is still in business when the audit is generated
- The taxpayer’s purchase invoices are incomplete or not made available to the auditor
- Only known vendors are the taxpayer’s beer and cigarette distributors

The auditor obtains the taxpayer’s beer and tobacco products from HB 11 information on Audit Division’s website to obtain the necessary purchase information for the audit period. A shelf test must be performed since the taxpayer is still in business. The auditor would apply the shelf test markup percentages for beer and tobacco products to the beer and tobacco products purchases amounts to arrive at the estimated dollar value of beer sales and for tobacco products for the audit period. The estimated dollar amount of beer sales and of tobacco products sales for the audit period will be divided by the applicable product mix percentage obtained using the best information available. Again, remember to only include taxable items in your product mix percentage.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
PERIOD	BEER PURCHASES Exam 1B	MARKUP Exam 1D	ESTIMATED BEER SALES Col. 2 x Col. 3	TOBACCO PRODUCTS PURCHASES Exam 1C	MARKUP Exam 1D	ESTIMATED TOBACCO PRODUCTS SALES Col. 5 x Col. 6	ESTIMATED BEER AND TOBACCO SALES Col. 4 + Col. 7
1309	32,982.00	129.55%	41,220.83	32,535.00	117.35%	38,619.79	79,840.62
1310	39,988.00	129.55%	49,976.91	33,048.00	117.35%	39,228.73	89,205.64
1311	30,677.00	129.55%	38,340.04	40,981.00	117.35%	48,645.39	86,985.43
1312	33,942.00	129.55%	42,420.63	37,440.00	117.35%	44,442.14	86,862.77
1401	30,715.00	129.55%	38,387.53	38,342.00	117.35%	45,512.83	83,900.37
1402	30,455.00	129.55%	38,062.59	31,974.00	117.35%	37,953.87	76,016.46
1403	36,802.00	129.55%	45,995.05	33,371.00	117.35%	39,612.14	85,607.19
1404	40,583.00	129.55%	50,720.54	38,268.00	117.35%	45,424.99	96,145.53
1405	32,417.00	129.55%	40,514.69	33,111.00	117.35%	39,303.52	79,818.21
1406	35,889.00	129.55%	44,853.99	35,552.00	117.35%	42,201.04	87,055.03
1407	40,702.00	129.55%	50,869.26	35,214.00	117.35%	41,799.82	92,669.09
1408	38,605.00	129.55%	48,248.44	30,646.00	117.35%	36,377.50	84,625.94
TOTALS:	423,757.00		529,610.50	420,482.00		499,121.76	1,028,732.27

(1)	(9)	(10)	(11)	(12)	(13)	(14)
PERIOD	AVERAGE PRODUCT MIX TO TAXABLE SALES **	ESTIMATED TAXABLE SALES Col. 8 / Col. 9	LESS 5% ALLOWANCE ***	NET ESTIMATED TAXABLE SALES Col. 10 * Col. 11	LESS: TAXABLE SALES REPORTED Tax History	ADDITIONAL TAXABLE SALES Col. 12 - Col. 13
1309	64.70%	123,401.26	95%	117,231.20	40,142.00	77,089.20
1310	64.70%	137,875.80	95%	130,982.01	30,756.00	100,226.01
1311	64.70%	134,444.25	95%	127,722.03	35,234.00	92,488.03
1312	64.70%	134,254.67	95%	127,541.93	33,805.00	93,736.93
1401	64.70%	129,675.99	95%	123,192.19	33,769.00	89,423.19
1402	64.70%	117,490.66	95%	111,616.13	31,905.00	79,711.13
1403	64.70%	132,314.06	95%	125,698.35	38,918.00	86,780.35
1404	64.70%	148,602.06	95%	141,171.95	39,059.00	102,112.95
1405	64.70%	123,366.62	95%	117,198.29	41,503.00	75,695.29
1406	64.70%	134,551.82	95%	127,824.23	39,636.00	88,188.23
1407	64.70%	143,228.88	95%	136,067.44	42,935.00	93,132.44
1408	64.70%	130,797.44	95%	124,257.57	44,506.00	79,751.57
TOTALS:		1,590,003.50		1,510,503.33	452,168.00	1,058,335.33

*	Markup for beer and tobacco was calculated per the shelf test findings. See Exam 1D.
**	The product mix for beer and tobacco was estimated using (THIS IS WHERE YOU DOCUMENT HOW YOU CAME UP WITH THE PRODUCT MIX FOR BEER AND TOBACCO)
***	To allow 5% for spoilage, pilferage, theft, etc.

Example # 3 – Purchases Available for a few months/ Still in Business

- The taxpayer is still in business when the audit is generated
- The taxpayer’s purchase invoices are incomplete, but a few months’ worth of complete purchases are available
- Beer and tobacco purchases are the only purchases available for the entire audit period (HB11).

The auditor obtains the taxpayer’s beer and tobacco purchase information via the HB 11 information on Audit Division’s website to obtain the necessary purchase information for the audit period. A shelf test must be performed since the taxpayer is still in business. The auditor would examine the purchase records the taxpayer has on hand for completeness. If the auditor determines that the few months of records are mostly complete, a product mix must be calculated using the records available. To calculate the product mix, the

auditor would apply the shelf test markup percentages for all product categories to their corresponding product purchase amounts to arrive at an estimated dollar value of taxable products for the months made available. A product mix for beer and tobacco will then be calculated based on this information. The estimated dollar amount of beer sales and of tobacco products sales for the audit period will be divided by the product mix percentage calculated. Again, remember to only include taxable items in your product mix percentage.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
PERIOD	BEER PURCHASES	MARKUP	ESTIMATED BEER SALES	TOBACCO PRODUCTS PURCHASES	MARKUP	ESTIMATED TOBACCO PRODUCTS SALES	ESTIMATED BEER AND TOBACCO SALES
	Exam 1B	Exam 1D	Col. 2 x Col. 3	Exam 1C	Exam 1D	Col. 5 x Col. 6	Col. 4 + Col. 7
1309	32,982.00	122.63%	41,220.83	32,535.00	119.17%	38,619.79	79,840.62
1310	39,988.00	122.63%	49,976.91	33,048.00	119.17%	39,228.73	89,205.64
1311	30,677.00	122.63%	38,340.04	40,981.00	119.17%	48,645.39	86,985.43
1312	33,942.00	122.63%	42,420.63	37,440.00	119.17%	44,442.14	86,862.77
1401	30,715.00	122.63%	38,387.53	38,342.00	119.17%	45,512.83	83,900.37
1402	30,455.00	122.63%	38,062.59	31,974.00	119.17%	37,953.87	76,016.46
1403	36,802.00	122.63%	45,995.05	33,371.00	119.17%	39,612.14	85,607.19
1404	40,583.00	122.63%	50,720.54	38,268.00	119.17%	45,424.99	96,145.53
1405	32,417.00	122.63%	40,514.69	33,111.00	119.17%	39,303.52	79,818.21
1406	35,889.00	122.63%	44,853.99	35,552.00	119.17%	42,201.04	87,055.03
1407	40,702.00	122.63%	50,869.26	35,214.00	119.17%	41,799.82	92,669.09
1408	38,605.00	122.63%	48,248.44	30,646.00	119.17%	36,377.50	84,625.94
TOTALS:	423,757.00		529,610.50	420,482.00		499,121.76	1,028,732.27

(1)	(9)	(10)	(11)	(12)	(13)	(14)
PERIOD	AVERAGE PRODUCT MIX TO TAXABLE SALES	ESTIMATED TAXABLE SALES	LESS 5% ALLOWANCE	NET ESTIMATED TAXABLE SALES	LESS: TAXABLE SALES REPORTED	ADDITIONAL TAXABLE SALES
	**	Col. 8 / Col. 9	***	Col. 10 * Col. 11	Tax History	Col. 12 - Col. 13
1309	67.84%	117,689.59	95%	111,805.11	40,142.00	71,663.11
1310	67.84%	131,494.16	95%	124,919.46	30,756.00	94,163.46
1311	67.84%	128,221.44	95%	121,810.37	35,234.00	86,576.37
1312	67.84%	128,040.64	95%	121,638.61	33,805.00	87,833.61
1401	67.84%	123,673.89	95%	117,490.20	33,769.00	83,721.20
1402	67.84%	112,052.56	95%	106,449.93	31,905.00	74,544.93
1403	67.84%	126,189.85	95%	119,880.36	38,918.00	80,962.36
1404	67.84%	141,723.95	95%	134,637.76	39,059.00	95,578.76
1405	67.84%	117,656.55	95%	111,773.73	41,503.00	70,270.73
1406	67.84%	128,324.04	95%	121,907.83	39,636.00	82,271.83
1407	67.84%	136,599.48	95%	129,769.51	42,935.00	86,834.51
1408	67.84%	124,743.43	95%	118,506.26	44,506.00	74,000.26
TOTALS:		1,516,409.59		1,440,589.11	452,168.00	988,421.11

\* Markup for beer and tobacco was calculated per the shelf test findings. See Exam 1D.  
 \*\* The product mix for beer and tobacco was calculated using taxpayer records. See Exam 1E  
 \*\*\* To allow 5% for spoilage, pilferage, theft, etc.

## Chapter VI

# Convenience Store Audit Checklist

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

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

### Gross Sales

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- 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 deli 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 sales, meat, produce)?
  - » If so, can sales and purchases be segregated for the applications 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

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- 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
  - » Other (describe)
- Review list of taxable items with taxpayer.
- 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 and apart from the grocery operation?

## Selection of Test Periods

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- 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 carried for only certain seasons of the year?
  - » Christmas trees and ornaments
  - » Minnows and fishing supplies
  - » 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 the business operation 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

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- 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 periods tested?
- 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 new departments establishing a base stock inventory?
- Have adjustments been made for any unusual losses such as theft, spoilage or fire losses that can be substantiated by police reports, insurance claims, or inventory studies?
- Have the necessary adjustments been made for customer purchases by 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 amounts of the grocery purchases used in the preparation be obtained/reasonably estimated?
- Was the allowance made for theft, spoilage, and 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 utilized?

## Sampling/Estimation Issues

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Although an audit of a grocery/convenience store will rarely utilize true sampling procedures, an estimated audit will more than likely be performed. A Notification of Estimate will need to be issued if one or more of 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 markup percentages and product mix percentages per AP134 guidelines 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 needs to 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 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 of the population base must also be evaluated, and any large variances similarly explained.

For more information on sampling issues and procedures, please refer to Audit Division's sampling manual.