State of New Mexico
Taxation & Revenue Department
Audit & Compliance Division

GENERAL

AUDIT

MANUAL

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INTRODUCTION TO THE AUDIT MANUAL

This Audit Manual is a compilation of current audit policies, procedures, and guidelines of the Audit & Compliance Division of the New Mexico Taxation and Revenue Department. The manual is organized in four parts: the General Audit Manual (GAM), the Combined Reporting System (CRS) Tax Program Supplement, the Corporate Income Tax (CIT) Tax Program Supplement, and the Audit Sampling Supplement. These volumes are issued under the authority of the Audit & Compliance Division of the New Mexico Taxation and Revenue Department.

AUDIT MANUAL OBJECTIVES

The Audit Manual is designed to meet the following objectives:
1. To serve as the primary reference source for the audit process for Department auditors.
2. To assist new auditors in their professional development.
3. To provide auditors with guidelines for applying audit techniques.

NATURE OF THE MANUAL

APPLICABILITY
This manual, and supplements, replaces and supersedes previous manuals and supplements.

EFFECT
No estoppel of the Department, pursuant to the provisions of the Tax Administration Act, can be effected on the basis of this Audit Manual. As stated in Subsection B(4) of Section 9-11-6.2 NMSA 1978, the Audit Manual is instructional and procedural. It does not deal with the merits of any tax, but is an aid in the accomplishment of the duties of the Director.

The Audit Manual is not a legal document and no regulations or rulings are issued by publication of this manual.

REVISIONS
The procedure for updating or otherwise revising the Audit Manual is as follows:

General Audit Manual
This section will be revised and updated by the Audit & Compliance Division as necessary.

CRS, CIT, Audit & Sampling Tax Program Supplements
Each of the Tax Program Supplements will be revised and updated by a committee made up primarily of representatives from the audit section affected. These committees will meet periodically to review and recommend changes. Proposed changes will be submitted for

circulation to Division management, audit management and others as appropriate. Amended pages or sections will be distributed to auditors and managers. In addition, amendments will be published for use by the general public by the Audit and Compliance Division.

Appendices
The Audit Manual Appendices will be revised and updated by the Audit & Compliance Division as necessary.

Auditors are encouraged to submit suggestions for improving or expanding the Audit Manual to their Supervisor or Bureau Chief.

OVERVIEW OF TAX AUDITS

The General Audit Manual (GAM) provides an overview of the purpose of tax audits and defines important audit concepts. This section also describes the organization of the Audit & Compliance Division with respect to the audit function.

PRIMARY AUDIT OBJECTIVES

Audits performed by the Audit & Compliance Division (ACD) have basic objectives:

1. To administer and enforce the tax programs in an equitable manner.
2. To determine proper reporting of the taxpayers audited.
3. To promote accuracy in self-assessments of taxes by educating taxpayers in the application of tax statutes and regulations.
4. To promote voluntary compliance of taxpayers through "visibility" of audit presence.

ROLES AND RESPONSIBILITIES IN AUDITING

In order to achieve these objectives, several persons and/or groups interact and affect the audit process. The following pages list those persons and groups and give a brief summary of their role.

TAXPAYERS –
The entire audit procedure is based upon taxpayers' books and records. The taxpayers' verbal and written statements may also provide crucial information on tax liability. The taxpayers' knowledge of the law is necessary for future compliance.

AUDITORS –
The auditor may be the only one who has the opportunity to look at taxpayer records, interview the taxpayer face to face, observe the reporting of taxes, and educate the taxpayer. Therefore, the auditor has primary responsibility for achieving the general audit objectives discussed above. Auditors are considered to be professionals and must conform to the Auditing Standards as set forth in this manual. The auditor needs to convey his needs to the supervisor and/or bureau chief, and most importantly, to the taxpayer.

Auditors must gather the facts.

- What does the business do?
- How does the business do it?
- How does it relate to taxation?
- Document findings.
- Keep the taxpayer informed.

SUPERVISORS –
The audit supervisors are responsible for training, overseeing, and directing the efforts of the auditors, to assure the audit resources available are applied in a way to achieve the primary objectives. Supervisors assist auditors by making available the necessary tools, training, and guidance. Supervisors are responsible for monitoring workloads, evaluating individual auditor performance, and reviewing each part of the audit to the extent necessary to assure that the final package meets division quality standards. Supervisors are also responsible for the productivity of their sections.

BUREAU CHIEFS –
The Audit Bureau Chiefs direct the activities of the bureaus. Audit Bureau Chiefs are responsible for bureau/district level goal setting in order to meet the Division's objectives. Bureau Chiefs are responsible for directing the unit supervisors in meeting team goals with the most efficient and cost beneficial use of department resources. Bureau Chiefs are also responsible for the development of audit tools to enable the audit section to perform optimally including training, manual updates, and determination and dissemination of technical and policy information, through participation in CORE. Bureau Chiefs address technical issues

CORE –
CORE is comprised of the Deputy Director-Audit, audit bureau chiefs, and audit managers whose purpose is to determine audit policy and procedures, and resolve audit issues in order to ensure audits are conducted and completed equitably throughout the division. CORE considers the other factors, such as pending legislation or court cases relating to tax issues. CORE is also responsible for the development of audit policy.

AUDIT TECHNICAL SUPPORT SERVICES (ATSS) –
ATSS reports to the Deputy Director-Audit. ATSS's main functions are audit review and assessment, quality control, technical advice, statistical reports, and the provision of feedback to management on individual, section, and division training issues.

PROTEST OFFICE –
The Protest Office handles taxpayer protests of audit assessments as well as protests of other enforcement activities and reports to the Legal Services Bureau. Protest personnel can review, rework, verify taxability, and look at legal issues involved.

LEGAL SERVICES BUREAU –
The Legal Services Bureau is a legal resource for Audit. Legal Services assists the Audit & Compliance Division by providing legal advice regarding audit policy and resolving questions related to the interpretation and application of tax law. This office also supports the actions of the Department in hearings.

DEPUTY DIRECTOR-AUDIT –
The Deputy Director-Audit is ultimately responsible for program level performance standards for the CRS, CIT, PIT, Oil & Gas, Miscellaneous, and Fuel taxes. The Deputy Director is knowledgeable about the tax programs and aware of audit activities. The Deputy Director – Audit supervises the Audit Bureau Chiefs and leads CORE.

DIRECTOR'S OFFICE –
The Audit & Compliance Division Director's Office is responsible for setting the overall goals for Division activity. The Director and Deputy Director-Audit are also concerned with the effectiveness of the audit sections in meeting the basic audit objectives. The Director functions as liaison with the Cabinet Secretary's Office, and along with the Deputy Director-Audit ensures that the work of the Audit Section is worthwhile and effective.

SECRETARY'S OFFICE –
The Secretary's Office is responsible for interaction with the Legislature in the creation of tax statutes, promulgating necessary regulations, and writing rulings.

ADMINISTRATIVE SERVICES DIVISION –
This division affects audits through overseeing the audit budget and through development of the systems which capture audit data.

RETURNS PROCESSING DIVISION –
This division affects audits by processing self-assessments and payments.

COMMUNICATION

Audit personnel are expected to comply with the following guidelines for communication of audit information.

AUDITORS –
When an auditor has audit related information or questions that need consideration or answers, the auditor should first discuss with their supervisor. The supervisor may address the issue or may instruct the auditor to contact another employee or supervisor. If the supervisor is not available, the auditor should talk with the Bureau Chief or the Deputy Director-Audit.

SUPERVISORS –
If an audit supervisor has information or questions related to auditing, they should refer them to the Bureau Chief, unless otherwise instructed. The Bureau Chief or Deputy

Director-Audit may address the issue or may direct the supervisor to contact other offices.

BUREAU CHIEFS –
Bureau Chiefs may instruct supervisors to refer certain information and questions to ATSS, CORE, or the Deputy Director-Audit. If Protest or Legal interaction is necessary, it will be coordinated through the Bureau Chief or Deputy Director-Audit.

CORE –
CORE will meet a minimum of once each month and will discuss audit and tax related questions. CORE members will provide technical advice to develop a consistent and Division approved policy, which will be followed by all audit sections.

ATSS –
If a member of the ATSS team has information or questions related to audits, he or she should refer them to the appropriate supervisor and Bureau Chief that is responsible for the audit. Also, ATSS will communicate any proposed procedural or policy changes that may arise to CORE, and recommend any policy and training needs to CORE.

PROTEST OFFICE –
The Protest Office should not be contacted directly by auditors or Supervisors. Questions and information for the Protest Office should be routed through their Bureau Chief or Deputy Director-Audit, unless otherwise instructed.

Certain critical information on audits should be communicated to the audit supervisor, the Bureau Chief, and the Deputy Director-Audit as soon as the auditor has obtained that information. This includes:

- ❑ Refusal of a taxpayer to provide records.
- ❑ Refusal of a taxpayer to sign a waiver.
- ❑ Statements by the taxpayer that they intend to contact the Secretary, Governor or other state official.
- ❑ Threats made by a taxpayer.
- ❑ Possible fraud.
- ❑ Possible bankruptcy.
- ❑ Taxpayer doing business with the Department
- ❑ Any event that might critically jeopardize the state's interest.

MEASUREMENT CRITERIA

To determine whether the basic audit objectives are being met, certain measurement criteria are applied to the audit results. Those measurement criteria can be categorized as follows:

QUANTITY –
The quantity of the audits produced is important primarily because a minimum amount of "audit coverage" is necessary to obtain effective enforcement of the tax laws. Audit coverage is the percentage of the total taxpayer population subject to audit in a given year. By tracking the number of audits completed each year, the Division can determine whether it is meeting its audit coverage goals.

DOLLARS –
The amount of dollars assessed is important because it helps to target the taxpayers who have underpaid or misallocated the largest amount of taxes. Since audit coverage for any tax agency is generally less than 5%, it is crucial the taxpayers selected for audit are the ones responsible for the largest amounts of under-reporting. By measuring the dollars generated by audits over a period of time, we can determine whether we are meeting our audit revenue goals.

QUALITY –
Generally, quality can be determined from the number and type of review comments generated by supervisors and ATSS, the number and type of protests received, and the percentage of collection recovery on audit assessments. By promoting high quality standards, we assure that resources are used productively, provide taxpayer education, and maintain a high collectibility rate.

COMPLIANCE –
This is the most difficult criterion to apply. It has to do with the affect of the audit effort on the entire taxpayer population. It is presumed that the more audit coverage achieved, the greater the incentive for taxpayers to correctly self-assess. Also, it is presumed that targeting specific industries with reporting issues will assure greater compliance within those industries.

THE AUDIT PROCESS

Tax audits generally have four stages: pre-audit research, investigation/fieldwork, workpaper documentation (write-up), and review.

PRE-AUDIT RESEARCH –
The purpose of pre-audit research and audit planning is to decide if the audit assignment meets the initial criteria for selection and to make a preliminary determination of the best audit approach. Pre-audit research will vary according to tax program, but will include a review of Department records, initial contact with the taxpayer, and discussion with the audit supervisor. The auditor should use the results of such research to develop the audit approach and to budget time for the audit. Thorough research in the office

should reduce fieldwork time and should assist the auditor by disclosing any irregularities which need to be investigated.

INVESTIGATION / FIELDWORK –
Investigation often commences with an initial interview at the taxpayer's place of business, includes fieldwork, and ends with an exit interview. However, investigation may also be done by the auditor in the office. The initial interview should be viewed as an opportunity to gain knowledge useful in making the audit more effective and efficient. The auditor should discuss the audit procedures with the taxpayer to assure that the information obtained is accurate. However, the auditor should use discretion if the taxpayer is evasive. Auditors may ask taxpayers to provide specific records containing the information necessary, but should also work with the taxpayer in obtaining the records and information requested. The auditor should use the exit interview to explain the results of the audit, provide draft workpapers, inform the taxpayer of any additional documentation needed, explain available remedies, and educate the taxpayer to correctly self-assess.

AUDIT DOCUMENTATION (WRITE UP) –
Documenting the audit goes on throughout the entire process. Throughout the interviews and investigative procedures auditors record (or document) their findings and conclusions in order to accurately determine audit exceptions. The write up stage includes organizing and editing the draft workpapers and narratives into a final report. This process creates the permanent workpaper file which becomes the documentation that supports an assessment.

It is neither prudent nor possible to document every aspect of the audit procedures performed. The auditor must use his or her judgment to determine what information is necessary to support exceptions noted and what is not. Audit policy may require certain minimum information. Supervisors may expand on that requirement.

REVIEW –
The review process assures that the audits meet the Division's quality standards and that audit procedures are consistent throughout the Districts. There are three main reviews all audits must go through, self/peer review, supervisor review to the extent necessary to determine that quality standards are met, and ATSS review. The auditor/peer review ensures that the auditor/peer has reviewed the work thoroughly as documented on the Quality Assurance Evaluation Form (QAEF). The supervisor reviews the audit throughout all phases to the extent necessary to determine that correct procedures are applied, workpapers are properly documented, correct statutes are used, and narratives are well documented. ATSS review focuses on adherence to tax law and audit policy. This review also confirms that the audit contains all information necessary to defend the audit in case of protest. Finally, the ATSS review serves to determine if the auditor, peer, and supervisor's review procedures are sufficient.

TYPES OF AUDITS

There are certain classifications of audits for every tax program audited by the Department. An audit can have more than one classification. Below are the common classifications:

URGENT –
Urgent audits are assigned by the Director's Office to be completed within a specific time period. Estimate the amount of time needed for completion and keep parties informed of progress. If the time frame cannot be met, notify the Director's Office.

ROUTINE (FIELD)-
Routine audits are audits selected within the District offices as a result of research or because of auditor request.

MANAGED (DESK) –
These audits are requested by the taxpayer. Two types of managed audits are available to taxpayers. Type A – taxpayer self-assesses and leaves audit periods open for possible field audit. Type B – taxpayer works with auditor and closes audit periods from further audit.

IN-STATE –
These audits are generally assigned to the district in which the taxpayer is located.

OUT-OF-STATE –
These audits are generally assigned to facilitate two or three week "audit trips" for auditors to an out-of-state location. Each district chooses audit prospects for various locations and business types.

STANDARD PERIOD –
These audits are for the current audit period which is normally three years plus the current year up to the last reporting period before the starting date of an audit.

EXTENDED PERIOD –
These audits are for the current period plus some previous years as allowed by the Statute of Limitations (Section 7-1-18 NMSA 1978).

RE-AUDIT –
These are taxpayers previously audited but re-assigned to a district for a revision of that audit and generally include specific instructions and deadlines. The district supervisor should immediately notify the person requesting the re-audit if completion deadlines cannot be met.

AUDITING STANDARDS

The remainder of this manual is devoted to further defining the systematic process of tax auditing. This section defines the characteristics of a tax auditor and discusses the standards that the Taxation and Revenue Department and its auditors must meet in order for the Department to achieve its objectives.

Auditors should keep in mind that as public servants they are subject to public scrutiny and criticism. They should at all times strive to act in a manner that would reflect well on the Department. By acting according to professional standards, auditors add credibility to the audit process and to the tax law as well.

PROFESSIONAL STANDARDS

Professional standards constitute a minimum acceptable level of performance by an auditor. The profession has generally accepted standards for financial auditing and uses them for determining accountability. These standards apply to tax auditors as well. However, Taxation and Revenue Department auditors are subject to higher standards of conduct in some areas. The standards that serve as guidelines for appropriate professional conduct of a tax auditor are described on the following pages.

INDEPENDENCE

In order for the results of a tax auditor's investigation to be relied upon by taxpayers and third parties, the auditor must be independent. Independence is generally discussed in two parts: "independence in appearance" and "independence in fact." Both are necessary to defend against the criticism that the audit process might be biased.

1. "Independence in appearance" means an auditor is free from financial interests in the taxpayer being audited; is not employed by the taxpayer; does not have close personal ties with the taxpayer; nor has any relationship with the taxpayer that a third party would consider an impairment of the auditor's judgment.
2. "Independence in fact" is a personal characteristic. It relates to the auditor's objectivity and integrity. The auditor must evaluate audit evidence in a manner that treats all taxpayers equitably. To determine independence in fact, the auditor must evaluate his or her ability to make judgments with respect to the taxpayer, regardless of appearance.

If the auditor believes that independence in appearance or fact could be compromised, the auditor and audit supervisor should re-evaluate the assignment immediately. The audit supervisor can evaluate the problem and either confirm the assignment or re-assign the audit to another auditor. This evaluation process gives credibility to the auditor and the Department.

Taxation and Revenue Department auditors must also comply with the State Conflict of Interest Statute and the Department's Code of Conduct. The penalty for failing to comply with the statute or the code may be disciplinary action including dismissal. You will note that the statute and code apply to interactions with all taxpayers, not just those that are being audited.

Some of the activities prohibited by the Conflict of Interest Statute and the Code of Conduct include:

- Preparing tax returns other than for immediate family or as part of the regular services offered by the Department,
- Using information about taxpayers gained as the result of being employed by the Department for personal benefit,
- Performing bookkeeping or accounting services, whether for payment or not,
- Asking for or accepting favors or bribes from taxpayers, and
- Misuse of equipment or supplies.

Auditors should be familiar with the statute and the code to assure that they are in compliance with the rules set out.

In addition, each year the Department asks employees to submit disclosures of all relationships which might give rise to a conflict of interest. Such relationships include owning or being part owner in any business, partnership, corporation, or other organization for profit or for the conduct of business. Most of these relationships are permissible; however, failure to disclose them is a violation of the Conflict of Interest Statute. Before becoming involved in any business activity auditors should get approval in writing from the Secretary. The Secretary makes the final determination whether participation in an outside business is permissible.

During the audit, the auditor is encouraged to develop a cooperative working relationship with the taxpayer and/or taxpayer's representative. However, the auditor must not develop any relationship beyond this which would endanger the auditor's independence.

DUE PROFESSIONAL CARE

During the audit, the auditor must perform the procedures and prepare the report in accordance with accepted and appropriate methods. The auditor should use due professional care in applying audit procedures to obtain accurate and fairly stated results. "Due professional care" is the concept that encompasses the auditor's responsibility for being adequately trained, prepared, and able to do the job assigned. This includes adequate knowledge of the taxpayer's industry.

Due professional care is usually defined as the care that a reasonable person in the same profession and the same situation would exercise to achieve the desired results. Again, tax auditors are subject to public scrutiny and it is the public that defines due professional care. In addition, the auditor owes a duty of care to the Department to protect the state's interest.

The responsibility for exercising due professional care is one which management must also address. To assist auditors in using accepted and appropriate methods, the division management provides auditors with tools and training. One of the primary tools provided is the Audit Manual. Therefore, a large portion of the auditor's responsibility for due professional care is to comply with the audit guidelines as set forth in this manual and other official sources and to participate in training and self-development. In addition, when performing audits, the auditor's conclusions must be based on the verified facts as determined by the auditor.

CONFIDENTIALITY

The auditor must always protect the confidentiality of the taxpayer. Confidentiality is a requirement of the Tax Administration Act, per Section 7-1-8 NMSA 1978.

Auditors must take all reasonable measures to assure that the audit is a confidential matter between the Department and the taxpayer. The auditor should not discuss the audit with anyone at the taxpayer's business, other than the employees designated by the taxpayer to handle the audit. The auditor should also take care when discussing the audit with other Taxation and Revenue Department employees. Only employees who have a valid cause to discuss the audit should do so and then, only to the extent necessary.

Furthermore, auditors should try to avoid any action that might indirectly cause a breach of confidentiality. For instance, if an auditor gives the phone number where he will be auditing to a friend or relative, this may result in that person finding out the name of the taxpayer being audited. While this may seem overly strict, it is important that auditors keep in mind that the public they serve depends on them to maintain the confidentiality of information entrusted to the Department. Furthermore, many people see an audit as an indication that the taxpayer has done something wrong. Therefore, auditors should take every precaution to protect audit scheduling information.

Another aspect of confidentiality applies to the use of information. Auditors and other Department employees are constrained from using any information obtained as the result of their employment for any purpose other than in the performance of their duties.

The auditor should use discretion in disclosing to the taxpayer the reason for the audit. If the audit is the result of a referral by a third party, the auditor should avoid disclosing any information to the taxpayer that would allow the taxpayer to identify the third party source.

STANDARDS OF FIELD WORK

Planning of the audit must be precise and well-founded. Reasons for the audit must be understood by both supervisor and auditor(s).

- Supervision
    - The Audit Section is committed to adequate supervision, in workpapers and in the field.
- Internal Control Study and Evaluation

- The auditor must have sufficient knowledge of the taxpayer's accounting system to determine the level of internal control present, in order to ascertain the testing procedures necessary.
- Evidence
  - The auditor is the gatherer of facts and must explain what, how, and why procedures were performed and conclusions reached.
  - The auditor must be able to effectively communicate why the taxpayer activities are taxable or not taxable; and how the taxable or non-taxable activities relate to New Mexico statutes and regulations.
- Standard of Reporting
  - The report must contain a clear statement of the scope of the audit and must also clearly state and describe the results of the auditor's examination.
  - The report should also adhere to the following reporting standards when applicable:
    - GAAP
    - GAAS
    - Consistency
    - Disclosure
    - Opinion

PROFESSIONALISM

Auditors are professionals. A professional is distinguished by four characteristics:

1. Having a specialized body of technical knowledge,
2. Meeting standards of admission to the profession (education, experience, testing, etc.),
3. Self-regulation (both the individual and the profession as a whole), and
4. Acceptance by the public.

If the profession or the individual professional fails to meet these characteristics, the results can be very damaging, especially with respect to self-regulation. For instance, if an auditor is not independent in approaching audits or does not exercise due care, it is impossible for the profession to continue to allow that auditor to represent the profession. Self-regulation means the auditor must be able to justify his or her actions to management. Management in turn must justify the actions of the Department to the public.

Like independence, professionalism has two components, the visible component, or the appearance of professionalism, and the factual component. It is not sufficient to be a professional in fact alone. Auditors must also strive for a professional appearance. This can be achieved by always acting in accordance with professional standards, being well prepared for the job, and treating the public with respect and courtesy.

If auditors strive for professional appearance, then public acceptance is increased, which in turn contributes to the Department being better able to meet its objectives.

Auditors must never use the power of their office to intimidate taxpayers. There are legal methods for dealing with uncooperative taxpayers. Those methods are sufficient without using aggressive tactics or misusing authority.

It is critical that the auditor and the taxpayer understand each other's position. Many times the parties will disagree on the application of the tax law. The auditor should not argue with the taxpayer regarding any matter. If the taxpayer refuses to discuss his or her position without arguing, the auditor should close the discussion and inform the taxpayer of the available remedies.

Professionalism applies to all the activities of an auditor. Whether through written correspondence, phone conversations, or face-to-face interactions, the auditor has a responsibility to make sure his or her actions reflect favorably on the Department. Consideration and courtesy should also be practiced among audit team members.

SUPERVISION

All auditors must be properly supervised. The level of supervision will be dependent upon the auditor's experience and expertise. Therefore, supervision will vary based on the auditor and the circumstances of the audit.

It is the supervisor's responsibility to be sufficiently involved with the audit to make sure that the auditor follows all Audit Manual guidelines, Technical and Policy Memorandums, Rulings, and Statutes. Supervisors may also require lead auditors to give feedback on assisting auditors concerning their performance during team audits.

Furthermore, each audit supervisor is responsible for the performance of his or her unit. The supervisor should provide timely guidance to auditors, to assure that professional standards are met and that the unit performs efficiently.

It is the responsibility of each auditor to perform the duties assigned to them by their supervisor in accordance with professional standards. Therefore, each auditor should use his or her supervisor as a resource to obtain training and development, to answer technical questions, to get feedback on performance, and for assistance in planning audit activity.

The supervisor should provide opportunities for career and professional development for the auditors in their unit. Each supervisor must balance audit production against the training and development needs of individual auditors.

TRAINING

It is the responsibility of Division management to ensure sufficient training is provided to auditors. Training provided may come in the form of classroom instruction, on-the-job training, cross training, and/or feedback on audits completed.

It is the responsibility of each auditor to complete all required training. Professional standards further require auditors to determine what additional training is needed to continue their professional development. The Department has a long-standing commitment to training and tuition assistance to help employees stay current in their fields.

QUALITY CUSTOMER SERVICE

Although the concept of service is not always associated with auditing (since those being audited do not often see themselves as being served), quality customer service is a standard auditors must apply to their audits and to themselves.

Each audit should result in taxpayer education on the reporting requirements applicable to their business activity. If the taxpayer is not able to use the results of the audit to correctly self-assess, then the auditor has not met the standard of quality customer service. One method the auditor can use to educate and assist the taxpayer in correctly self-assessing is the exit interview. Another way is through clear, concise audit workpapers.

The goal of quality customer service also applies to interactions with other Department employees. Auditors should cooperate with other employees and contribute their expertise toward accomplishing Department goals.

COLLECTIBILITY

The primary objectives of tax auditing cannot be accomplished by the auditors alone. Auditors, collectors, and taxpayer assistance personnel act in a partnership to achieve enforcement. Whenever the auditor becomes aware of factors in an audit that might affect the collection of an assessment, the auditor should take whatever steps are necessary to protect the state's interest.

Factors that might impair the collectibility of an assessment are:

- Sales of assets,
- Poor financial condition or possible bankruptcy,
- Moving of assets out-of-state,
- Taxpayer refusal to pay other assessments, and
- Taxpayer behavior which might be fraudulent.

Whenever an auditor observes any of the above factors, he or she should inform the audit supervisor and discuss the need to expedite the audit or recommend a jeopardy assessment.

AUDIT RISK

Auditing, in general, is based on the assumption that there is a need to verify what someone else has done. Tax auditing is based on the assumption that there is a need to verify the taxes paid by individuals and companies.

There are various factors that cause this need for audit. Some of them are:

1. Paying taxes involves giving up financial assets. Taxpayers have a financial interest, therefore, in paying the smallest amount of tax possible and may tend to under-report.
2. The tax law is subject to interpretation. Taxpayers and the Department often disagree about what a statute or regulation means.
3. The changing economic environment often affects the ways in which business is conducted and there may be no laws that specifically address these changes.
4. The complexities of reporting taxes to multiple jurisdictions or reporting for multiple tax programs often cause errors in reporting.
5. There are questions of nexus that may cause taxpayers not to report.
6. A general lack of knowledge on the part of certain taxpayers may cause reporting errors.
7. Inadequate or incorrect records or controls may cause mistakes in reporting.

The combination and degree to which these factors affect any taxpayer will vary. For instance, if a business is having financial difficulties, the incentive to underreport tax may be greater than if the business is having no problems meeting expenses.

THE RISK OF INCORRECT REPORTING

This section discusses the risk of incorrect reporting and the procedures that can be used to control that risk.

Every tax audit, no matter which tax program or taxpayer is being audited, involves the risk of incorrect reporting. This risk can be viewed as the sum of the reasons that make tax-auditing necessary. This risk can be broken down into two separate categories of risk:

RISK OF INACCURATE RECORDS	RISK OF MISAPPLICATION OF TAX LAW
The risk that the taxpayer's records do not accurately reflect the facts.	The risk that the taxpayer did not apply the tax law correctly.

The risk of inaccurate records has to do with whether the activities of the taxpayer are properly stated in the records used to compute taxes. In other words, it is the risk that the records contain mistakes or omissions that effect the computation of tax.

The auditor must determine if the summary records are complete and accurate and if he/she can rely on the summary records. For example, if taxable sales were left out or understated, the tax reported based on the records would be incorrect. This risk is addressed through a test of summary records.

The risk of misapplication of the tax law deals with the taxpayer's understanding of the tax law and the application of the law to their activities. The risk here is that the taxpayer incorrectly interpreted or failed to correctly apply the tax law, and therefore, misstated the taxes owed. The auditor should thoroughly discuss with the taxpayer the procedures used in determining the tax base for the program being audited to evaluate this risk.

In addition, both the risk of inaccurate records and the risk of misapplication of the tax law can be broken down into two fundamental kinds of risk; inherent risk and audit risk, as follows:

RISK OF INCORRECT REPORTING			
RISK OF INACCURATE RECORDS		**RISK OF MISAPPLICATION OF THE TAX LAW**	
INHERENT RISK	**AUDIT RISK**	**INHERENT RISK**	**AUDIT RISK**
The risk that the taxpayer made mistakes in the records.	The risk that the audit will not reveal the mistakes made in the records.	The risk that the taxpayer made mistakes in applying the tax law.	The risk that the audit will not reveal the misapplication of tax law.
This risk can only be assessed, not controlled.	***This risk can be controlled to a reasonable level by the auditor.***	***This risk can only be assessed, not controlled.***	***This risk can be directly controlled by the auditor.***

As shown in the RISK OF INCORRECT REPORTING diagram, audit risk is the only risk that can be directly controlled by the auditor. Audit risk is controlled by determining the proper **procedures** and **sampling methods** to apply and applying them correctly. Therefore, audit risk can be broken down into **procedures risk** and **sampling risk**. In other words, there are two reasons the audit may not disclose mistakes in reporting. Procedure risk is the risk that the audit procedures applied are not appropriate or useful. Sampling risk is the risk that the sample used does not represent the entire population.

An example of inappropriate procedures is examining bank statements to determine the receipts of a taxpayer that does not always deposit all cash received. This procedure will not reveal the amount of the receipts not deposited.

An example of a sampling error is the selection by the auditor of a large item that is non-recurring in the population and inclusion of the item in determining the results to be applied to the population.

ADDRESSING RISKS IN AUDITING

Some of the risks making up the overall risk of incorrect reporting can be controlled and reduced through knowing how and when to apply certain audit procedures. Other risks cannot be controlled directly, but can only be assessed. Assessing risks and applying the right procedures go hand-in-hand.

RISK OF INACCURATE RECORDS - INHERENT RISK

This risk must be assessed by the auditor before an effective audit approach can be designed. Some of the factors that might indicate a high inherent risk of inaccurate records are:

- ❑ Absence of controls over recording transactions
- ❑ Inexperienced personnel recording transactions
- ❑ Changes in the accounting system
- ❑ Management inattention to information accuracy
- ❑ Decentralized record-keeping
- ❑ Commingling business and professional records (i.e. some proprietorships)
- ❑ Businesses dealing strictly in cash or bartering
- ❑ Manual accounting systems or large transaction volume
- ❑ Computerized systems that do not address tax reporting needs

RISK OF MISAPPLICATION OF THE TAX LAW - INHERENT RISK

As with the inherent risk of inaccurate records, the risk of misapplication of the tax law must be assessed by the auditor before an effective audit approach can be designed. Some of the factors that might indicate a high inherent risk of misapplication of the tax law are:

- ❑ Multi-state businesses where New Mexico laws are not understood
- ❑ Aggressive interpretation of the law to avoid taxes
- ❑ Small businesses without separate accounting or tax departments
- ❑ Industries which historically have problems in applying the tax law
- ❑ New industries with gray area tax issues
- ❑ Unique New Mexico tax laws
- ❑ Industries for which the tax law is complex

RISK OF INCORRECT RECORDS AND MISAPPLICATION OF THE TAX LAW - AUDIT RISK

The auditor can control this risk by applying the appropriate audit procedures, using correct sampling methods and by properly evaluating the sample results. Specific sampling and audit procedures are addressed in the Tax Program Supplements.

The procedures used to address the risk of inaccurate records are different from those used to address the risk of misapplication of the tax law. Furthermore, each taxpayer will have different levels of these risks. For instance, all things being equal, a retailer will have less risk of improper application of tax law than a research and development contractor, due to the greater complexity of the tax law covering research and development services (R&D).

REDUCTION OF RISK

When an audit is complete, the risk of inaccurate records and the risk of misapplication of the tax law should have been addressed and the result will be either an adjustment of the taxes due or a no-change. A key question in any audit is when to stop auditing.

Whether the audit result is an adjustment or a no-change, the auditor must be convinced that the overall risk of incorrect reporting has been reduced to an acceptable level. **It is neither possible nor practical to attempt to reduce the risk of incorrect reporting to zero**. The cost, in terms of auditor time and Department resources, would be too great to justify the benefit. More importantly, the auditor would not know whether some risk still exists.

Therefore, auditors must use their professional judgment to determine when the risk of incorrect reporting has been sufficiently addressed. The supplements to this manual set forth certain minimum procedures for all audits. The supplements describe audit procedures and give guidelines for when and how to apply those procedures. The supplements also discuss the minimum requirements for documentation of the audit procedures performed. However, final determination of the audit approach will be made by the auditor after discussion with the audit supervisor.

FRAUD

A separate risk, not included above, is the risk of the taxpayer actively trying to defraud the state by hiding taxable transactions or ignoring the tax law. The key to distinguishing this risk from the other risks is taxpayer intent.

Certain taxpayers may desire to minimize their tax liability and may interpret certain laws in a way to reduce it. This does not necessarily constitute fraud. Tax fraud is an active disregard of the tax law or active omission of transactions with the intent of evading taxes.

Other taxpayers may keep inadequate records and/or ignore certain tax laws. Often the distinction between mere negligence and tax fraud is not clear. Therefore, certain kinds of negligence may be referred to as "civil fraud."

This manual does not address auditing for fraud. The procedures in this manual may or may not detect fraud. Generally, fraud audit procedures are not concerned with the records of the taxpayer since those records are probably incorrect. The manual and the Tax Program Supplements include certain procedures helpful in identifying mere negligence.

In any case, when the auditor suspects fraud, he or she should immediately contact the audit supervisor. The auditor and the auditor supervisor should discuss how to proceed.

Auditors should be aware of the indications of possible fraud. Some indications are:

- ❑ taxpayer evasiveness
- ❑ reluctance of taxpayer to answer certain questions
- ❑ a taxpayer who reschedules the audit several times
- ❑ missing or destroyed records
- ❑ excessive turnover of accounting personnel
- ❑ records appearing inadequate for any purpose
- ❑ lack of controls over assets and records
- ❑ commingling of owner and company assets
- ❑ multiple bank accounts for the same purpose
- ❑ excessive transferring of money between bank accounts
- ❑ failure to deposit cash "intact" each day
- ❑ cash-only policies in businesses where such a policy is unusual
- ❑ use of cash to buy inventory and supplies
- ❑ use of cash to pay employees
- ❑ habitual late or non-filing of returns
- ❑ evidence of habitual lateness in paying creditors or employees
- ❑ excessively high returns and allowances or cash discounts
- ❑ excessively high bad debt expense
- ❑ third party reports of fraud
- ❑ businesses which appear to be doing better financially than is indicated by the reporting history
- ❑ abuse of nontaxable transaction certificates, either accepting or executing
- ❑ records misstating the nature of transactions
- ❑ records which omit important details
- ❑ records which appear to have been changed
- ❑ any indication of two sets of books
- ❑ employee reports of fraud
- ❑ sole proprietorships or partnerships where the owners appear financially well-off while the business does not
- ❑ erratic reporting inconsistent with business activity
- ❑ taxpayers asking for preferential treatment

- taxpayers not complying with the laws and regulations of other agencies

The presence of one or more of the above items does not prove that fraud has occurred. Absence of these factors does not prove that fraud is not occurring. However, as stated above, when there is possible fraud, the auditor should inform their audit supervisor. If the audit approach needs to be changed, the auditor and supervisor should decide what additional procedures should be performed to effectively protect the state's interest.

In most audits, it is not necessary to actively investigate the possibility of fraud since this would require a substantial expansion of the audit procedures. It is only necessary for the auditor to be observant and keep in mind the indications above.

AUDIT SAMPLING

Sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

Much of the information included in this manual was taken from the Statement on Auditing Standards No. 39 on Audit Sampling which provides guidance on the use of sampling in an audit of financial statements. This information has been adapted to fit the circumstances most often encountered in tax auditing.

HISTORY

The Department has used sampling in its audit procedures for many years. That sampling, for the most part, has been block sampling. That is, taking a period of time and testing 100% of the records during that time. Until 1990, the Department's policy on sampling was to take 100% samples from three test months per year selected for being the high, low, and average months of the year. From 1990 forward, the Department has adopted other systematic or random sampling techniques.

Generally, when sampling procedures have been challenged by a taxpayer, we have allowed the taxpayer to present detailed information to refute the results of the sample. Neither New Mexico statutes nor case law gives us the authority to base audit results on sampling errors when complete records are available. However, sampling is still the rule, rather than the exception, due to its efficiency for both the Department and the taxpayer.

This section of the General Audit Manual can be applied to all tax programs.

PURPOSE OF AUDIT SAMPLING

Sampling is done because it is more efficient than testing 100% of the population. In tax audits, if the taxpayer and the Department can agree on a representative sample, it can save both parties time and money. By definition, any procedure that does not examine 100% of the items in question is a sampling procedure.

WHEN NOT TO SAMPLE

There are many audit procedures that do not involve sampling.

- Inquiry and Observation:
  - Reviewing records for the method of accounting and other information.
  - Observing accounting procedures.
  - Discussing methods of accounting and reporting with taxpayer.
  - Scanning documents for possible issues.

- Analytical Review Procedures:
  - Comparing records, reports, and other information.
  - Recomputing or estimating amounts.
  - Reviewing trends in reporting.
  - Comparing similar businesses.

- One-Hundred Percent Examination:
  - Reviewing all fixed asset purchases, where appropriate.
  - Examining all contracts, where there are a small number.
  - Reconciling each year's gross receipts to the New Mexico CIT -A sales factors or Schedule C receipts.

- Zero Percent Examination:
  - This occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested.

Note: Even though 100% examination may be done where appropriate, it is not mandatory for any particular taxpayer or tax program. Sampling procedures discussed in the Sampling Manual Supplement may be more cost effective.

AUDIT REVIEW

INTRODUCTION

Every audit will go through the review process before the audit findings are accepted. At a minimum, the audit will be reviewed during the audit process by the auditor (self review), peer review at the district level, the Audit Supervisor to the extent deemed necessary, and ATSS after the completion of the audit. However, audits may also be reviewed by Audit Managers, Bureau Chiefs, the Protest Office, Legal, and executive management. The taxpayer also has an opportunity to review the audit prior to assessment during the "10 day period." The Taxation & Revenue Department informs the audited taxpayers of the results of the audit and allows the taxpayers ten (10) working days in which to contact ATSS to discuss any concerns that they may have regarding the audit.

The review process is an integral part of the audit; the same as pre-audit research, investigation, and write up. While auditors should do a thorough self/peer review, it is necessary to have other reviewers who are not directly involved in the audit examine the audit workpapers for accuracy and completeness. This objective review will often discover weaknesses in documentation or other problems that the auditor may have overlooked.

The auditor's own self/peer review is a detail review of the audit. Detail review means checking all computations, all documentation, and all narratives to ensure that the audit is complete, correct and ready for submission to ATSS. The supervisor will review and discuss all phases of the audit with the auditor to the extent the supervisor considers necessary to ensure that the auditor followed all Audit Manual guidelines, Technical and Policy Memorandums, Rulings, Regulations, Statutes, and department procedures.

The ATSS review may be a detail review. ATSS will also review whether auditors are following all Audit Manual guidelines, Technical and Policy Memorandums, Rulings, Regulations, Statutes, and department procedures. Moreover, ATSS will review the audit for viability. This means ATSS reviews from the standpoint of a taxpayer filing a protest and will look for lapses in documentation, discrepancies, contradictions, errors or any other problems that might jeopardize the Department's position. Protest will review audits only when a formal protest is filed, or when critical issues are present and will concentrate on those issues as well as the viability of the audit.

Furthermore, audit review is used to determine if the Department is being equitable in its administration. Sometimes audits point out the need for additional regulations, changes in policy, or auditor training.

GENERAL REVIEW OBJECTIVES

1. To assure proper administration of the tax law through audit activity.
2. To instruct auditors in the specific application and documentation of audit procedures.
3. To capture information useful in managing audit activity.

REVIEW RESPONSIBILITIES

The responsibilities pertaining to review for auditors, supervisors, ATSS and the Protest Office are discussed below.

AUDITORS

The longer the auditor reviews his or her own work to find possible weaknesses, the longer it will be before the audit is submitted to the supervisor. The concept of review presumes that there is some point when it becomes less efficient for auditors to review their own work and more efficient for someone else to perform the review. However, if there are numerous mistakes in the audit workpapers, it becomes more difficult for someone other than the auditor to review the work performed. Auditors of all levels should participate in the review process by reviewing audits from other auditors. Auditors have a responsibility to discuss any issues or questions with their supervisor and to keep the supervisor advised of audit progress.

Auditors should, at a minimum, complete a self-review of audit work. It is anticipated that audits, except for the most simple, will require some additional level of review before submitting the audit to ATSS.

It is anticipated that every audit phase submitted for supervisor review, except for the most simple, will be returned to the auditor for some correction or change, even if the changes are only minor. It is expected that the auditor will have kept the supervisor sufficiently informed throughout the audit process so no major revisions will need to be made in audit procedures.

Auditors must complete a self/peer review of every audit.

A helpful hint in doing self-review is to wait a day or two between completion of the audit write up and performing the self-review. This may lend more objectivity to the review.

When auditors have questions about self/peer review, they should discuss any issues with their audit supervisor.

SUPERVISORS

Supervisors must discuss procedures and methods for conducting and documenting the audit with the auditor as the audit progresses to monitor each auditor's progress. Auditors are required to keep supervisors informed about their audits but both auditors and supervisors are responsible for audits being done correctly and efficiently.

Supervisors should determine the appropriate balance between auditor self-review and supervisor monitoring based on individual auditor needs. The supervisor should also recognize the training potential of the review process and discuss with the auditor what could have been done differently, based on their experience.

The supervisor should treat all employees equitably in the monitoring process so every auditor is given the opportunity to learn from feedback. At the same time, supervisors should expect better audits from auditors who are more experienced or are in a higher classification.

Supervisors should provide sufficient feedback to auditors to help them submit audits of good quality in a timely manner and to give them the opportunity to develop and achieve career objectives.

Feedback from supervisors should be given both in writing and orally. Supervisors should follow up on any changes made by the auditor to ensure that they were made correctly.

AUDIT BUREAU CHIEFS

Bureau Chiefs are responsible for the production of all audits within their section, providing technical support, assessing and addressing training needs, and assisting in the development of consistent audit procedures. Bureau Chiefs provide an overview function for supervisors to ensure all audits meet the division standards for equitable administration of all tax programs and complete and accurate audit documentation.

AUDIT TECHNICAL SUPPORT SERVICES

As with auditors, audit supervisors, and Bureau Chiefs, ATSS also takes responsibility for all audits they accept for processing.

ATSS review may or may not be a detail review. It focuses not only on whether the audit was done correctly according to audit policy, but also on any changes that may need to be made to the audit policy itself. If there is an area for which audit policy is lacking, ATSS will direct the problem to CORE for discussion and final approval.

ATSS provides feedback after reviewing each audit through a QAR. These forms are provided to the Director's office, the Bureau Chief, the Audit Supervisor, and the auditor or auditors as needed. All QAR's will be returned to ATSS with responses addressing the QAR. The responses to QAR's should be discussed with the Supervisor or Bureau Chief, if necessary, before returning to ATSS with copies to the Director's office.

QARs contain comments on exceptional, as well as sub-standard work. QARs make requests for clarification, or suggestions for improving the audit. The QAR references ACD written guidance for all comments on errors or misapplications of audit policy.

ATSS keeps a file of completed QARs and may publish statistical reports, or summaries of the QARs, and trends in audit quality.

APPENDIX A

TAXATION & REVENUE DEPARTMENT ACRONYMS

Acronym	Definition
ACD	Audit & Compliance Division
ATSS	Audit Technical Support Services
BC	Bureau Chief
CFT	Combined Fuel Tax
CIG	Cigarette Tax
CIT	Corporate Income Tax
CON	Coal & Uranium Conservation Tax
CRS	Combined Reporting System
CRS-1	form to use to report GRT and a variety of other taxes
CVA	Commercial Vehicle Audit
DBA	Doing business as
EDA	Employee Development & Appraisal
E911	E911 Services Surcharge
FAST	GenTax Company
FEIN	Federal Employer Identification Number
FID	Fiduciary Income Tax
GR	Gross Receipts
GRT	Gross Receipts Tax
H2O	Water Conservation Fee
IC	Investment Credit
ID#	Identification Number
IFTA	International Fuel Tax Agreement
IRP	International Registration Plan
LFC	Legislative Finance Committee
LIQ	Liquor Excise Tax
LLQ	Local Liquor Excise Tax
LLC	Limited Liability Company
LVGRT	Leased Vehicle Gross Receipts Tax

LVSur	Leased Vehicle Surcharge
MISC	Miscellaneous Tax Programs
NAICSA	North American Industry Classification System
NMAC	New Mexico Administrative Code
NMP	GenTax Production Environment
NMS	GenTax Staging Environment
NMSA	New Mexico Statutes Annotated
OGAS	Oil & Gas Audit Section
OGP	OGP Withholding
P&I	Penalty and Interest
PIT	Personal Income Tax
PRC	Private Railroad Car Company Tax
PL	Public Law
PTE	Pass-Through Entity
QAEF	Quality Assurance Evaluation Form
QAR	Quality Assurance Report
RDO	Regular Day Off
RES	Hard Mineral Resource Tax
SHARE	Statewide Human Resources, Accounting, & Management Reporting System
SPO	State Personnel Office
SEV	Hard Mineral Severance Tax
TP	Taxpayer
TPA	Taxpayer Assistance
TPT	Tobacco Products Tax
TRD	(New Mexico) Taxation and Revenue Department
TRS	Telecommunications Relay Services Surcharge
WCT	Water Conservation Fee
WDT	Weight Distance Tax
WKC	Worker's Compensation Fee
YTD	Year to Date