

PRO-ACTIVE FRAUD AUDITING

Technology, Fraud Auditing, and Liquor

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INTRODUCTION

It may surprise you, but technology, fraud auditing, and liquor have something in common. Over the last year, the Compliance Division of the Comptroller of Maryland has been using some of the most recent developments in fraud auditing and technology to uncover liquor sales tax fraud.

In the state of Maryland, revenues collected from sales and use taxes accounted for 28% of the general fund revenues in 2002.¹ With such a large portion of the state's revenue derived from sales and use taxes, William Donald Schaefer, the Comptroller of Maryland, is very concerned about whether these taxes have been properly collected and paid. Sales and use tax audits continue to be the main method to ensure that sales and use taxes have been properly collected and paid.

One of the main problems with sales and use tax audits are the cost. If the audits are not properly planned, a state can expend a significant amount of resources auditing compliant taxpayers. As

¹ *State of Maryland Consolidated Revenue Report 2002* at www.marylandtaxes.com.

corporate America faces the challenge of doing more with limited resources, states are experiencing the same challenge. To address this challenge, the Compliance Division of the Comptroller of Maryland has incorporated the fraud hypothesis testing approach in their liquor establishment audit program. This approach and the use of recent audit technologies has allowed the Compliance Division to crackdown on liquor sales tax fraud using a limited amount of resources.

FRAUD HYPOTHESIS TESTING APPROACH

With recent advances in technology, the fraud hypothesis testing approach has become a formalized fraud detection method.² This approach is unique in that it does not focus on frauds that have been already discovered. Instead, it attempts to pro-actively detect fraud that has not yet been discovered by requiring the formulation and testing of numerous null hypotheses, each

² See "Conducting a Pro-Active Fraud Audit: A Case Study" by Albrecht, C.A., Albrecht, W.S., and Dunn, J.D. in the *Journal of Forensic Accounting*, Vol. II (2000): pages 203-218 for a more thorough discussion of the fraud hypothesis testing approach.

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stating that no fraud of a particular type exists. The fraud hypothesis testing approach requires an auditor to:

- Identify the types of fraud that may exist in a particular situation
- Formulate a null hypothesis stating that each type of fraud does not exist
- Identify the red flags that each type of fraud would create
- Design a set of customized queries to search for those specific red flags or a combination of red flags to test each of the specific fraud hypotheses
- Obtain data from the files of liquor distributors, sorted by customer tax ID number, to determine the total amount of purchases made by each liquor establishment for the most recent two-year period
- Use Monarch and ACL software to read the data files from each distributor and convert the data to an Excel spreadsheet
- Combine the customer data from all of the distributors and sort by the liquor establishment tax ID number using Excel
- Compare the total amount of purchases made by each liquor establishment, as reported by the distributors, to the total amount of sales reported on the sales and use tax returns

In the case of the liquor establishment audit program, the Compliance Division of the Comptroller of Maryland was primarily concerned with one type of fraud, the under-reporting of sales on sales and use tax returns by liquor establishments. The null hypothesis for this fraud was: "liquor establishments do not under-report their sales on their sales and use tax returns". The fraud hypothesis testing approach is especially useful in this situation because of the detailed records maintained by distributors and the limited number of distributors. Distributors are required to record the liquor establishment's tax ID number to document the sales tax exemption for resale.

The main part of the effort expended by the Compliance Division in searching for the under-reporting of sales on sales and use tax returns by liquor establishments was to design a set of customized queries. The following steps were performed:

Once the suspected under-reporters are identified, an audit is assigned and an auditor performs a routine examination of the business records. The auditor normally performs a complete audit of one year of records. If the business records of the liquor establishment are determined to be incomplete or inaccurate, the sales tax due is calculated by marking up the purchased amount provided by the distributors and applying an appropriate sales factor. Additional tax due on other taxable sales such as soda, cigarettes, and food are calculated and projected on available records.

The general statute of limitations for sales and use tax returns in the State of Maryland is four years. However, if fraud exists, there is no statute of limitations. Thus, with the liquor establishment audit program, the Compliance

Division of the Comptroller of Maryland is able to assess additional taxes for an unlimited period of time. In addition, any under-reporting of sales on the sales and use tax returns are referred to the income tax compliance area to determine whether additional income taxes should also be assessed.

The Compliance Division of the Comptroller of Maryland is eager to use the fraud hypothesis testing approach for audits of other industries. The Compliance Division is in the preliminary stages of identifying industries that have similar attributes to the liquor industry. These attributes include distributor files that include customer tax ID numbers with a limited number of distributors in the industry. As the Compliance Division identifies these industries, they will apply the same fraud hypothesis testing approach to these industries.

CONCLUSION

In the article “Conducting a Pro-Active Fraud Audit: A Case Study”, Albrecht, Albrecht, and Dunn (2000) used actual operating data for a large oil refinery to detect fraud that had not yet been discovered. After applying the fraud hypothesis testing approach, the authors were able to identify a number of red flags that appeared to represent fraudulent activities. The liquor establishment audit program of the Compliance Division of the Comptroller of Maryland is another example of the application of the fraud hypothesis testing approach. These two examples present evidence that the fraud hypothesis testing approach can be an efficient and effective approach to detect uncovered fraud. As organizations consider the risk of undetected fraud, the fraud hypothesis testing approach may

be another avenue that could assist in determining whether fraud is going undetected in their organizations and/or the organizations they monitor.

