

# Cash Intensive Businesses Audit Techniques Guide - Chapter 7 - Digital Cash and Electronic Money

**NOTE:** This document is not an official pronouncement of the law or the position of the Service and can not be used, cited, or relied upon as such. This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

**Contents**

Definition of Digital Cash..... 2  
Funding and Using Digital Cash..... 2  
Detecting the Use of Digital Cash ..... 3  
Audit Techniques ..... 3

## Definition of Digital Cash

Digital cash (also known as e-money, electronic cash, or digital currency) is just like real cash, except it's not tangible. It's money, or a money substitute, such as script, that is exchanged only electronically. Electronic Funds Transfer (EFT), direct deposit, PayPal and WebMoney are all examples of electronic money. These digital currencies offer irrevocable online payments, easy online access, and most importantly: identity protection.

Cash plays an essential role in every community, and the reality is that the nature of cash, because it is easy to use anonymously, means there will always be an opportunity for tax evasion by people dealing in cash. The risk is greatest in businesses with large volumes of cash turnover and weak or nonexistent internal controls. Fortunately, the use of cash and cash-like items is not as undetectable as its users believe.

## Funding and Using Digital Cash

Digital cash vehicles can be easily funded with wire transfers, anonymous money orders, certified checks, or stolen credit cards. Many are becoming widely accepted, stable, and secure.

Some banks have partnered with cell phone companies to offer banking services. An account is opened at a bank and a deposit is made. An ATM card is issued. The user can now transfer the funds on deposit to any cell phone user. For example, a business can transfer funds to a partnered supplier, who receives the funds electronically into their cell phone account and ships the merchandise. Or, the business can transfer funds to a family member in another country. The family member can then use the funds in their cell phone, by making purchases with others, or by redeeming the funds via their own ATM card.

**PayPal** lets you fund an account by transferring money from a bank or credit card. Money can then be sent to anyone with an email address in 103 countries and regions.

Some barter companies and "alternative currency markets" available can allow their members to transfer funds to anyone who has an email address or cell phone number.

Money can flow between countries without being traced; circumventing banks. This procedure is simple and convenient and eliminates paper transactions.

In order to purchase goods and supplies over the internet, most companies have developed a safe technology for payment that involves pre-registering a credit card number over a secure network. The pre-registration converts the credit card number to a coded number, that, when used, will authorize the credit card payment. In this example, the digital transaction is funded by the credit card and used to pay for whatever goods are purchased over the internet. If the company offering the transaction is the same company selling the goods, the transactions can be discovered in the seller's sales records. If the company offering the transactions is a middle-man who accepts the credit card information and guarantees it to the seller, the transaction is harder to discover.

**E-gold** lets anyone fund an account with cash or a cashier's check. The funds can be moved around, or used for payment without revealing the payor's identity by simply having an untraceable check issued to a payee in any currency. E-gold funds can also be transferred to a debit card so cash can be withdrawn anonymously at any ATM.

One example of a digital cash vehicle is issued by an **Internet site** called Cash Cards International, who will provide a stored value ATM debit card that can be used at over 800,000 ATM's worldwide in any local currency. The ATM card can be funded with a credit card or wire transfer, from funds skimmed from a cash intensive business or from stolen funds or from an individual's own bank account or credit card.

The most important point to remember is that none of these procedures uses a **bank** to store or transfer funds. It's possible that the Bank Deposit Analysis that we have relied on for the past 70 years is becoming a dinosaur facing extinction, and we will have to find new ways to locate hidden income.

## Detecting the Use of Digital Cash

An analysis of all bank accounts, part of the minimum income probes, is the first step. When analyzing bank statements, especially for personal accounts, see what is debited besides the checks written. Most sole proprietors have life insurance premiums deducted, and this is easily found on the bank statement. Look for other debits and ask about anything that is not familiar.

Digital cash, like any other cash, must be funded from a source and the examiner must locate that source in order to account for all purchases and personal living expenses. A review of the bank statements will show if amounts are transferred from the bank accounts to unusual sources. A review of the credit cards will show payments to unusual payees. Ask the taxpayer to explain any questionable transaction. If they cannot, or if the explanation is not credible, the examiner is advised to follow the money by contacting the bank or credit card company for detail on the transaction.

## Audit Techniques

- Treat all credit cards like another bank account. What went in (large payments or minimum amount due payments?) and what went out (vacation spending or gambling)?
- Determine if anything is missing. Are the expenditures that are visible (checks written or debits shown on the bank statements) reasonable based on what is known? For example, is a lower income taxpayer getting haircuts at a discount shop or at a high end salon; are car payments being paid for a Lexus or a Honda?
- Income can be used in two main ways, it can be consumed (spent for personal expenses) or it can be used to acquire assets (bank savings and CD accounts, real estate, etc.). The examiner will want to analyze the taxpayer's overall net worth, such as investments and real property holdings, in relation to the reported income.

- Normal audit procedures, such as tracing gross receipts and analyzing bank accounts should always be done. That said it is important to remember that cash spent for any reason can be difficult to verify.

Consider other ordinary audit techniques that may produce results. In many instances the discovery of an unusual transaction or entry can lead the examiner to trace the transaction and locate the vehicle used to convert the funds to personal use.

- Review the cash disbursements journal for a selected period. Determine if there are any missing check numbers by scanning the bank statements. If many checks are missing, be alert for the possibility that checks are written for expense items, the expenses are deducted, and the check is never actually issued (no goods are received, but a fake expense payment is recorded.)
- Note any large check amounts or unusual payees. Determine the propriety of these items by comparing the checks with an invoice or other records.
- Review the cash receipts journal for any that might indicate the sale of an asset, pre-paid income or a potential source for unreported income. These are all opportunities for hiding the income by investing in digital cash.
- Similarly, review entries in the general ledger cash accounts for unusual items that may indicate questionable withdraws or expenditures, sales of capital assets or omitted income.