



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.10.3

MAY 3, 2023

EFFECTIVE DATE

(05-03-2023)

PURPOSE

- (1) This transmits revised IRM 4.10.3, Examination of Returns, Examination Techniques.

MATERIAL CHANGES

- (1) Minor editorial changes have been made throughout this IRM. In addition, website addresses, legal references, and IRM references were reviewed and updated, and subsections were renumbered as necessary.
- (2) Significant changes to this IRM are reflected in the table below.

Prior Reference	New Reference	Description of Change
N/A	4.10.3.1 through 4.10.3.1.5	Added internal control framework as required by IRM 1.11.2.2.5, Address Management and Internal Controls, to provide background information, legal authorities that govern the actions covered in this IRM, responsibilities, acronyms, and related resources.
4.10.3.1, Overview	4.10.3.2, Overview	Renumbered section. Moved (1) to 4.10.3.1.1, Background. Made editorial changes.
4.10.3.2, Risk Analysis	4.10.3.3, Risk Analysis	Added reference to IRM 4.46.3.3, Risk Analysis Process for LB&I examiners.
4.10.3.2.2, Mid-Audit Decision Point (50% Rule)	4.10.3.3.2, Mid-Audit Decision Point (50% Rule)	Added reminder to (1) for LB&I examiners that the mid-cycle risk analysis is optional for certain cases.
4.10.3.3, Interviews: Authority and Purpose	4.10.3.4, Interviews: Authority and Purpose	Renumbered section. Made editorial changes. Added statement regarding an interview's impact on scope and depth of an audit. Moved (6) & (7) to 4.10.3.4.1.1, Initial Interviews. Removed (8) as it does not relate to interviews. Moved 4.10.3.3.7(1) in part to 4.10.3.4(4).

Prior Reference	New Reference	Description of Change
4.10.3.3.3, Preparation and Planning for Interviewing	4.10.3.4.2, Preparation and Planning for Interviewing	Moved and renumbered section.
4.10.3.3.4, Types of Interviews	4.10.3.4.1, Types of Interviews	Moved and renumbered section. Created subsections for each interview type.
4.10.3.3.4(1), Types of Interviews	4.10.3.4.1.1, Initial Interviews	Moved and updated guidance. Added reference to field employee's HSPD-12 (SmartID) card. Removed 4.10.3.3.4(3) as third-party interviews are covered in 4.10.3.4.3.4, Third-Party Interviews. Moved (2)d as a reminder for (2)a.
4.10.3.3.4(2), Types of Interviews	4.10.3.4.1.2, Subsequent Interviews	Moved 4.10.3.3.4(2) intact.
4.10.3.3.1.4, Third Party Interviews	4.10.3.4.1.3, Third-Party Interviews	Moved intact.
4.10.3.3.4(4), Types of Interviews	4.10.3.4.1.4, Closing Interviews (Conferences)	Moved 4.10.3.3.4(3) intact.
4.10.3.3.1, Who to Interview	4.10.3.4.3, Who to Interview	Renumbered section.
4.10.3.3.1.1, Powers of Attorney	4.10.3.4.3.1, Taxpayer's Representative	Renumbered and renamed section. Removed (1), (2) and (3) as guidance is covered in 4.10.3.17.4, Power of Attorney and Tax Information Authorization. Renumbered (4) to (3). Added (1) and (2) to provide guidance on interviewing a taxpayer's representative.
4.10.3.3.1.2, Corporate and Partnership Examinations	4.10.3.4.3.2, Corporate and Partnership Examinations	Added (2) who to interview in a BBA examination and (3) who to interview in an ILSC examination. Removed note regarding TEFRA provisions not applying to S corporations to avoid confusion.
4.10.3.3.1.3, Specialist	4.10.3.4.3.3, Specialist	Added statement on timing of mandatory referrals in (2). Clarified timing of international referrals.
4.10.3.3.2, Where to Conduct Interviews	4.10.3.4.4, Where to Conduct Interviews	Added timing of initial interview based on 4.10.3.3.2(3).
4.10.3.3.7, Interview Techniques	4.10.3.4.5, Interview Techniques	Renumbered and moved (1) to 4.10.3.4.1, Types of Interviews.

Prior Reference	New Reference	Description of Change
4.10.3.3.7.1, Conducting the Interview	4.10.3.4.5.1, Conducting the Interview	Moved intact.
4.10.3.3.7.2, Request for Representation - Suspension of Interview	4.10.3.4.5.2, Request for Representation - Suspension of Interview	Moved intact.
4.10.3.3.7.3, Question Construction	4.10.3.4.5.3, Question Construction	Moved intact.
4.10.3.3.7.4, Listening Skills	4.10.3.4.5.4, Listening Skills	Moved intact.
4.10.3.4.6, Documenting Interviews	4.10.3.4.6, Documenting Interviews	Expanded guidance for taxpayers and tax return preparers.
4.10.3.3.6, Request to Audio Record Interviews	4.10.3.4.7, Request to Audio Record Interviews	Moved (2) and (3) to 4.10.3.4.7.1, Taxpayer Requests. Moved (4) and (5) to 4.10.3.4.7.2, IRS Initiated Recordings. Moved (6) to 4.10.3.4.7.2.1, Recording Retention Procedures
N/A	4.10.3.4.7.1, Taxpayer Request for IRS Recording or Transcript	Added guidance on taxpayer's request for copy of audio recording and/or transcript.
N/A	4.10.3.4.7.2, IRS Initiated Audio Recordings	Added guidance on IRS initiated interview recordings.
NA	4.10.3.4.7.2.1, Recording Retention Procedures	Moved (6) and added ECFI guidance for interview recording record retention.
N/A	4.10.3.4.7.4, Taxpayer Request for IRS Recording or Transcript	Added new guidance on the addressing taxpayer request for interview records.
N/A	4.10.3.4.7.3.1, Payment Processing	Added guidance on where to send payments for reproduction fees.
4.10.3.3.9(2), Group Manager Concurrence Meeting (SB/SE Revenue Agents Only)	4.10.3.4.9, Group Manager Concurrence Meeting (SB/SE Revenue Agents Only)	Incorporated IGM SBSE-01-1019-0042, Group Manager Concurrence Meeting (GMCM). Updated (6) to follow flow of LS 100-4.
4.10.3.6, Examination of the Taxpayer's Books and Records	4.10.3.7, Examination of the Taxpayer's Books and Records	Added reminder to use Form 2725-A when original records are taken from a taxpayer.

Prior Reference	New Reference	Description of Change
4.10.3.6.3(7), Step 3: Determination of Accounting Period	4.10.3.7.3(7), Step 3: Determination of Accounting Period	Added Rev. Proc. 2007-64.
4.10.3.6.4, Step 4: Determination of the Taxpayer's Method of Accounting	4.10.3.7.4, Step 4: Determination of the Taxpayer's Method of Accounting	Updated statement regarding Commissioner's authority to select a method of accounting.
4.10.3.6.6, Step 6: Reconciling the Taxpayer's Books and Records to the Tax Return	4.10.3.7.6, Step 6: Reconciling the Taxpayer's Books and Records to the Tax Return	Added reference IRM to (g). Added (h) to address when it is appropriate to request audit or tax accrual workpapers.
4.10.3.7, Schedules M-1, M-2 and M-3	4.10.3.8, Analyzing Schedules M-1, M-2 and M-3	Changed title and updated link in (4).
4.10.3.7.1.1, Schedule M-1: Audit Techniques for C Corporations	4.10.3.8.1.1, Schedule M-1: Audit Techniques for C Corporations	Removed Example: Schedule M-1 Audit Technique to reduce confusion. Change format of example in (5) letter (c) to 508 compliant format.
4.10.3.7.2, Schedule M-2	4.10.3.8.2, Schedule M-2	Changed order of (2) and added (2), letter (c), Accumulated Earnings and Profit.
4.10.3.7.2.1(8), Schedule M-2: Audit Techniques for C Corporations	4.10.3.8.2.1(8), Schedule M-2: Audit Techniques for C Corporations	Updated reference from Exhibit 4.10.3-2 to a linked example.
4.10.3.7.3, Schedule M-3	4.10.3.8.3, Schedule M-3	Added statement on differences in information required depending on form type. Added reference to IRM 4.46.3.3.5.3, Analyzing Schedules M-2 and M-3.
4.10.3.8.4(5), Step 4: Reconciliation of Bank Deposits to Gross Receipts	4.10.3.9.4(5), Step 4: Reconciliation of Bank Deposits to Gross Receipts	Updated reference from Exhibit 4.10.3-3 to a linked example.
4.10.3.8.5, Step 5: Check Analysis	4.10.3.9.5, Step 5: Check and Electronic Funds Transfer Analysis	Updated title and guidance to include EFTs.
4.10.3.9, Balance Sheet Analysis: Introduction	4.10.3.10, Balance Sheet Analysis: Introduction	Added reminder - balance sheet analysis is part of minimum income probes.
4.10.3.9.4.2, Notes and Accounts Receivable	4.10.3.10.4.2, Notes and Accounts Receivable	Added information regarding need to verify if loan or receivable is subject to Original Issue Discount (OID) provisions.
4.10.3.9.4.3, Inventories	4.10.3.10.4.3, Inventories	Added guidance to clarify when IRC 263A applies to taxpayers.

Prior Reference	New Reference	Description of Change
4.10.3.9.4.5, Loans to Stockholders	4.10.3.10.4.5, Loans to Stockholders	Added information regarding need to verify if loan or receivable is subject to Original Issue Discount (OID) provisions.
4.10.3.9.4.10, Prepaid Expenses & Deferred Charges	4.10.3.10.4.10, Prepaid Expenses & Deferred Charges	Removed reference to coordinated issue for Accounting for Payment Liabilities due to no longer being a coordinated issue.
4.10.3.9.4.21, Additional Paid-In Capital	4.10.3.10.4.21, Additional Paid-In Capital (APIC)	Clarified sources of additional paid-in capital.
4.10.3.9.4.23, Retained Earnings for S Corporations	4.10.3.10.4.23, Retained Earnings for S Corporations	Removed non-Section 508 compliant example and replaced with PDF example.
4.10.3.13.2, Statistical Sampling	4.10.3.14.2, Statistical Sampling	Added reference to Rev Proc 2011-42. Clarified when to use statistical sampling.
4.10.3.16, IRS Enforcement Operations in High Assault Risk Areas.	N/A	Removed as HARA no longer in use.
4.10.3.17.4, Power of Attorney	4.10.3.17.4, Power of Attorney and Tax Information Authorization	Updated title. Moved 4.10.3.3.1.1(1) to (2) Moved 4.10.3.3.1.1(4) to (5).
4.10.3.17.8, Penalty Consideration	4.10.3.17.8, Penalty Consideration	Incorporated IGM 04-0920-0054, Timing of Supervisory Approval of Penalties Subject to IRC 6751(b).
N/A	4.10.3.18, Verification of Field Employee Identification	Added guidance on procedures for taxpayers to verify field employees'HSPD-12 (SmartID) card.
N/A	4.10.3.19, Inadequate Records Notices: Overview through 4.10.3.20.6 Inadequate Records Notices: Follow-Up Examinations	Moved and consolidated IRM 4.10.8.15 into IRM 4.10.3.20.
Exhibit 4.10.3-2, Reconciliation of Income and Analysis of Unappropriated Retained Earnings Exhibit 4.10.3-3, Format for Reconciling Bank Deposits to Gross Receipts	N/A	Removed content and created examples to replace the exhibits.
Exhibit 4.10.3-5, Balance Sheet Examination Techniques	Exhibit 4.10.3-3, Balance Sheet Examination Techniques	Updated law for amortizing organization expenses.

EFFECT ON OTHER DOCUMENTS

This IRM supersedes IRM 4.10.3, dated February 26, 2016. This IRM incorporates Interim Guidance Memorandum SBSE-04-0921-0049, Reissue Interim Guidance Memorandum Group Manager Concurrence Meeting (GMCM), dated September 9, 2021 and Interim Guidance Memorandum SBSE 04-0922-0075, Reissue Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b), dated September 28, 2022.

AUDIENCE

Small Business/Self-Employed (SB/SE) and Large Business & International (LB&I) examiners.

Heather J. Yocum
Acting Director, Examination Field and Campus Policy
Small Business/Self-Employed Division
SE:S:DCE:E:HQ:EFCP

4.10.3

Examination Techniques

Table of Contents

- 4.10.3.1 Program Scope and Objectives
 - 4.10.3.1.1 Background
 - 4.10.3.1.2 Authority
 - 4.10.3.1.3 Responsibilities
 - 4.10.3.1.4 Acronyms
 - 4.10.3.1.5 Related Resources
- 4.10.3.2 Overview
- 4.10.3.3 Risk Analysis
 - 4.10.3.3.1 The 80/20 Concept
 - 4.10.3.3.2 Mid-Audit Decision Point (50 Percent Rule)
- 4.10.3.4 Interviews: Authority and Purpose
 - 4.10.3.4.1 Types of Interviews
 - 4.10.3.4.1.1 Initial Interviews
 - 4.10.3.4.1.2 Subsequent Interviews
 - 4.10.3.4.1.3 Third-Party Interviews
 - 4.10.3.4.1.4 Closing Interviews (Conferences)
 - 4.10.3.4.2 Preparation and Planning for Interviewing
 - 4.10.3.4.3 Who To Interview
 - 4.10.3.4.3.1 Taxpayer's Representative
 - 4.10.3.4.3.2 Corporate and Partnership Examinations
 - 4.10.3.4.3.3 Specialists
 - 4.10.3.4.4 Where to Conduct Interviews
 - 4.10.3.4.5 Interview Techniques
 - 4.10.3.4.5.1 Conducting the Interview
 - 4.10.3.4.5.2 Request for Representation - Suspension of Interview
 - 4.10.3.4.5.3 Question Construction
 - 4.10.3.4.5.4 Listening Skills
 - 4.10.3.4.6 Documenting Interviews
 - 4.10.3.4.7 Requests to Audio Record Interviews
 - 4.10.3.4.7.1 Taxpayer Requests for Audio Recording
 - 4.10.3.4.7.2 IRS Initiated Audio Recordings
 - 4.10.3.4.7.3 Recording Retention Procedures
 - 4.10.3.4.7.4 Taxpayer Request for IRS Recording or Transcript
 - 4.10.3.4.7.5 Payment Processing
 - 4.10.3.4.8 Mutual Commitment Date (SB/SE Revenue Agents Only)

-
- 4.10.3.4.9 Group Manager Concurrence Meeting (SB/SE Revenue Agents Only)
 - 4.10.3.5 Tours of Business Sites and Inspection of Residences
 - 4.10.3.5.1 Authority to Conduct Tours of Business Sites
 - 4.10.3.5.2 Conducting Tours of Business Sites
 - 4.10.3.5.3 Audit Techniques for Tours of Business Sites
 - 4.10.3.5.4 Examples for Tours of Business Sites
 - 4.10.3.5.5 Inspection of a Taxpayer's Residence
 - 4.10.3.5.5.1 Inspection of a Business in the Home
 - 4.10.3.5.5.2 Other Inspections of the Taxpayer's Residence
 - 4.10.3.5.6 Case File Documentation
 - 4.10.3.6 Evaluating the Taxpayer's Internal Controls
 - 4.10.3.6.1 Purpose of Evaluating Internal Controls
 - 4.10.3.6.1.1 Evaluation of Internal Controls in a Small Business Environment
 - 4.10.3.6.2 Internal Controls Defined
 - 4.10.3.6.3 Key Steps for Evaluating Internal Controls
 - 4.10.3.6.3.1 Control Environment
 - 4.10.3.6.3.2 Accounting System
 - 4.10.3.6.3.3 Control Procedures
 - 4.10.3.6.4 Industry Examples
 - 4.10.3.6.4.1 Franchises
 - 4.10.3.6.4.2 Cash Businesses
 - 4.10.3.6.4.3 Vertically Integrated Industries
 - 4.10.3.6.5 Summary of Internal Control Evaluations
 - 4.10.3.6.5.1 Evaluation Methods and Tests
 - 4.10.3.6.5.2 Interview Techniques
 - 4.10.3.6.5.3 Compliance Testing
 - 4.10.3.6.6 Re-evaluating Scope and Depth of the Examination
 - 4.10.3.6.6.1 Reliable Books and Records
 - 4.10.3.6.6.2 Unreliable Books and Records
 - 4.10.3.7 Examination of the Taxpayer's Books and Records
 - 4.10.3.7.1 Step 1: Determination of Available Books and Records
 - 4.10.3.7.2 Step 2: Taxpayer Explanation of Books and Records
 - 4.10.3.7.3 Step 3: Determination of Accounting Period
 - 4.10.3.7.4 Step 4: Determination of the Taxpayer's Method of Accounting
 - 4.10.3.7.5 Step 5: Determination of Depth of Examination of Taxpayer's Books and Records
 - 4.10.3.7.6 Step 6: Reconciling the Taxpayer's Books and Records to the Tax Return
 - 4.10.3.8 Analyzing Schedules M-1, M-2 and M-3
 - 4.10.3.8.1 Schedule M-1
 - 4.10.3.8.1.1 Schedule M-1: Audit Techniques for C Corporations

-
- 4.10.3.8.1.2 Schedule M–1: Audit Techniques for S Corporations
 - 4.10.3.8.1.3 Schedule M–1: Audit Techniques for Partnerships
 - 4.10.3.8.2 Schedule M–2
 - 4.10.3.8.2.1 Schedule M–2: Audit Techniques for C Corporations
 - 4.10.3.8.2.2 Schedule M–2: Audit Techniques for S Corporations
 - 4.10.3.8.2.3 Schedule M–2: Audit Techniques for Partnerships
 - 4.10.3.8.3 Schedule M–3
 - 4.10.3.9 Bank Record Reconciliations
 - 4.10.3.9.1 Step 1: Review of Taxpayer’s Bank Account Reconciliation
 - 4.10.3.9.2 Step 2: Review of Monthly Bank Statements
 - 4.10.3.9.3 Step 3: Bank Deposit Analysis
 - 4.10.3.9.4 Step 4: Reconciliation of Bank Deposits to Gross Receipts
 - 4.10.3.9.5 Step 5: Check and Electronic Funds Transfer Analysis
 - 4.10.3.10 Balance Sheet Analysis: Introduction
 - 4.10.3.10.1 Balance Sheet Definitions
 - 4.10.3.10.2 Step 1: Determine Balance Sheet Basis
 - 4.10.3.10.3 Step 2: Identify Accounts for In-Depth Analysis
 - 4.10.3.10.4 Step 3: In-Depth Analysis
 - 4.10.3.10.4.1 Cash on Hand in Bank
 - 4.10.3.10.4.2 Notes and Accounts Receivable
 - 4.10.3.10.4.3 Inventories
 - 4.10.3.10.4.4 Investments
 - 4.10.3.10.4.5 Loans to Stockholders
 - 4.10.3.10.4.6 Depreciable Assets
 - 4.10.3.10.4.7 Depletable Assets
 - 4.10.3.10.4.8 Valuation Reserves
 - 4.10.3.10.4.9 Intangible Assets
 - 4.10.3.10.4.10 Prepaid Expenses & Deferred Charges
 - 4.10.3.10.4.11 Other Assets
 - 4.10.3.10.4.12 Deferred Tax Assets
 - 4.10.3.10.4.13 Liabilities: Accounts Payable
 - 4.10.3.10.4.14 Mortgages, Notes, Bonds Payable in Less Than One Year
 - 4.10.3.10.4.15 Other Current Liabilities
 - 4.10.3.10.4.16 Income Taxes
 - 4.10.3.10.4.17 Loans From Shareholders
 - 4.10.3.10.4.18 Long Term Obligations
 - 4.10.3.10.4.19 Stockholders Equity/Capital Stock
 - 4.10.3.10.4.20 Treasury Stock
 - 4.10.3.10.4.21 Additional Paid-In Capital (APIC)

-
- 4.10.3.10.4.22 Negative Goodwill
 - 4.10.3.10.4.23 Retained Earnings for S Corporations
 - 4.10.3.11 Testing Gross Receipts or Sales
 - 4.10.3.11.1 Gross Profit Ratio Test
 - 4.10.3.12 Testing Expenses: Cost of Goods Sold
 - 4.10.3.13 Testing Expenses: Operating Costs
 - 4.10.3.14 Sampling Techniques
 - 4.10.3.14.1 Judgment Sampling
 - 4.10.3.14.2 Statistical Sampling
 - 4.10.3.15 Recordkeeping Systems
 - 4.10.3.15.1 Double-Entry System
 - 4.10.3.15.2 Single-Entry System
 - 4.10.3.15.3 Voucher System
 - 4.10.3.15.4 Cost Accounting System
 - 4.10.3.15.5 Computerized Accounting Systems
 - 4.10.3.15.6 Manual Accounting Systems
 - 4.10.3.16 Ledgers and Journals
 - 4.10.3.16.1 General Journal
 - 4.10.3.16.2 Special Journals
 - 4.10.3.16.3 Sales Journal
 - 4.10.3.16.4 Purchases Journal
 - 4.10.3.16.5 Cash Receipts Journals
 - 4.10.3.16.6 Cash Disbursements Journal
 - 4.10.3.16.7 Payroll Register
 - 4.10.3.16.8 General Ledger
 - 4.10.3.16.9 Subsidiary Ledgers
 - 4.10.3.17 Correspondence Examination Procedures
 - 4.10.3.17.1 Correspondence Examinations Conducted by Tax Examiners and Audit Accounting Aides
 - 4.10.3.17.2 Classification and Screening of Correspondence Examination Returns
 - 4.10.3.17.3 Correspondence Examination Letters
 - 4.10.3.17.4 Power of Attorney and Tax Information Authorization
 - 4.10.3.17.5 Special Handling Notice Form 3198
 - 4.10.3.17.6 Workpapers
 - 4.10.3.17.7 Report Writing
 - 4.10.3.17.8 Penalty Consideration
 - 4.10.3.17.9 Interview Consideration
 - 4.10.3.17.10 Closing Cases
 - 4.10.3.18 Verification of Field Employee Identification
 - 4.10.3.19 Inadequate Records Notices: Overview

-
- 4.10.3.19.1 Inadequate Records Notices: Determination of Taxpayer Compliance
 - 4.10.3.19.2 Inadequate Records Notices: Examination Procedures
 - 4.10.3.19.3 Inadequate Records Notices: Required Forms and Exceptions
 - 4.10.3.19.4 Inadequate Records Notices: Delivery of Inadequate Records Notices
 - 4.10.3.19.4.1 Inadequate Records Notices: Notices for Joint Returns
 - 4.10.3.19.4.2 Inadequate Records Notices: Notices for Corporate Returns
 - 4.10.3.19.4.3 Inadequate Records Notices: Notices for Partnerships
 - 4.10.3.19.4.4 Inadequate Records Notices: Examiner Responsibilities
 - 4.10.3.19.4.5 Inadequate Records Notices: Joint Investigations
 - 4.10.3.19.5 Inadequate Records Notices: Taxpayer Agreement and Appeal Rights
 - 4.10.3.19.6 Inadequate Records Notices: Follow-Up Examinations

Exhibits

- 4.10.3-1 Analysis of Taxpayer's Internal Controls
- 4.10.3-2 Double Entry Accounting Recording Procedures
- 4.10.3-3 Balance Sheet Examination Techniques
- 4.10.3-4 Markup Table
- 4.10.3-5 Flow of Accounting Transactions

4.10.3.1
(05-03-2023)
Program Scope and Objectives

- (1) **Purpose.** This IRM section provides guidance for examination procedures and techniques used in conducting effective audits.
- (2) **Audience.** These procedures apply to examiners in SB/SE and LB&I.
- (3) **Policy Owner.** The Director, Examination Field and Campus Policy, who reports to the Director, Examination Headquarters.
- (4) **Program Owner.** Field Examination General Processes (FEGP), which is under the Director, Examination Field and Campus Policy.
- (5) **Contact Information.** To recommend changes or make any other suggestions related to this IRM section, see IRM 1.11.6.5, Providing Feedback About an IRM Section - Outside of Clearance, for further discussion.

4.10.3.1.1
(05-03-2023)
Background

- (1) This IRM provides an overview of the examination techniques examiners should understand and apply in the performance of their duties.

4.10.3.1.2
(05-03-2023)
Authority

- (1) By law, the IRS has the authority to conduct examinations under Title 26, Internal Revenue Code, Subtitle F – Procedure and Administration, Chapter 78, Discovery of Liability and Enforcement of Title, Subchapter A, Examination and Inspection, which includes, but is not limited to, the following Internal Revenue Code (IRC) sections:

- IRC 7521, Procedures involving taxpayer interviews
- IRC 7602, Examination of books and records
- IRC 7605, Time and place of examination

Note: Additional information related to conducting examinations is contained in the 26 CFR 601.105, Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

4.10.3.1.3
(05-03-2023)
Responsibilities

- (1) The Director, Examination Headquarters, is the executive responsible for providing policy and guidance for SB/SE Examination employees and ensuring consistent application of policy, procedures and tax law to effect tax administration while protecting taxpayers' rights. See IRM 1.1.16.5.5, Examination Headquarters, for additional information.

Note: LB&I employees should refer to IRM 1.11.24.2.1.1, Strategy, Policy and Governance, for information on the executive responsible for providing policy and guidance for LB&I.

- (2) The Director, Examination Field and Campus Policy, reports to the Director, Examination Headquarters, and is responsible for the delivery of policy and guidance that impacts the field examination process. See IRM 1.1.16.5.5.1, Examination Field and Campus Policy, for additional information.
- (3) Field Examination General Processes (FEGP), which is under the Director, Examination Field and Campus Policy, is the group responsible for providing policy and procedural guidance on standard examination processes to field employees. See IRM 1.1.16.5.5.1.1, Field Examination General Processes, for additional information.

- (4) All examiners must perform their professional responsibilities in a way that supports the *IRS Mission*. This requires examiners to provide top quality service and to apply the law with integrity and fairness to all.
- (5) Income tax examiners and their managers should thoroughly acquaint themselves with the examination procedures and information contained in this IRM, as well as other resources, such as those listed in, IRM 4.10.3.1.5, Related Resources, below.

4.10.3.1.4
(05-03-2023)

Acronyms

- (1) The following table lists acronyms and their definitions used throughout this IRM:

Acronym	Definition
AAA	Accumulated Adjustments Account
ADP	Automatic Data Processing
ATE	Appeals Technical Employee
ATG	Audit Technique Guide
BBA	Bi-Partisan Budget Act
CAF	Centralized Authorization File
CAM	Change in Accounting Method
CAS	Computer Audit Specialist
CCP	Centralized Case Processing
CDE	Compliance Data Environment
CFD	Case File Documents
CFOL	Corporate Files On-Line
COGS	Cost of Goods Sold
DIF	Discriminant Index Function
ECD	Estimated Completion Date
EFT	Electronic Funds Transfer
EOAD	Examination Operational Automation Database
ERCS	Examination Returns Control System
FICA	Federal Insurance Contributions Act
FinCEN	Financial Crimes Enforcement Network
FMV	Fair Market Value
FUTA	Federal Unemployment Tax Act
GMCM	Group Manager Concurrence Meeting
HSPD-12	Homeland Security Presidential Directive-12

Acronym	Definition
IDR	Information Document Request
ILSC	Investor Level Statute Control
IMS	Issue Management System
IRC	Internal Revenue Code
IRP	Information Returns Processing
LB&I	Large Business and International
LIFO	Last-In, First-Out
LLC	Limited Liability Company
LUQ	Large Unusual Questionable
MCD	Mutual Commitment Date
MeF	Modernized e-File
MOI	Memorandum of Interview
OAA	Other Adjustment Account
OID	Original Issue Discount
PII	Personally Identifiable Information
PSP	Planning and Special Programs
PTI	Shareholder's Undistributed Taxable Income Previously Taxed
RA	Revenue Agent
RGS	Report Generation Software
SBU	Sensitive But Unclassified
SME	Subject Matter Expert
SRS	Specialist Referral System
SUTA	State Unemployment Insurance Tax Act
TCO	Tax Compliance Officer
TEFRA	Tax Equity and Fiscal Responsibility Act
TIN	Taxpayer Identification Number
TMP	Tax Matters Partner

4.10.3.1.5
(05-03-2023)

Related Resources

- (1) Examiners will use various IRMs for additional guidance and information examiners including, but not limited to:

- IRM 4.10.2, Pre-Contact Responsibilities
- IRM 4.10.4, Examination of Income
- IRM 4.10.7, Issue Resolution

- IRM 4.10.8, Report Writing
- IRM 4.10.9, Workpaper System and Case File Assembly
- IRM 4.10.20, Requesting Audit, Tax Accrual or Tax Reconciliation Workpapers
- IRM 4.11.6, Changes in Accounting Methods
- IRM 4.11.57, Third-Party Contacts
- IRM 4.46, LB&I Examination Process (LB&I only)

(2) The examples linked below contain additional information:

- *Example - Reconciliation of Current Year Retained Earnings*
- *Example - Reconciliation of Income and Analysis of Unappropriated Retained Earnings*
- *Example - Reconciling Taxable Bank Deposits*

4.10.3.2 (02-26-2016) Overview

- (1) Auditing includes the accumulation of evidence for evaluating the accuracy of the taxpayer's tax return(s). Evidence takes many forms, including the taxpayer's testimony, the taxpayer's books and records, the examiner's own observations and documents from third parties.
- (2) It is important to obtain sufficient competent evidence to determine the accuracy of the taxpayer's return. Every examiner must determine the appropriate amount of evidence to accumulate and establish the proper depth of the examination. This decision is a matter of judgment and is important because of the prohibitive cost of examining and evaluating all available evidence. See IRM 4.10.3.3 (6) for additional guidance on determining the depth of the examination.
- (3) Methods for accumulating evidence include:
 - a. **Analytical Tests** — such as analysis of balance sheet items to identify large, unusual, or questionable accounts. Analytical tests use comparisons and relationships to isolate accounts and transactions that should be further examined or determine that further inquiry is not needed.
 - b. **Documentation** — such as examining the taxpayer's books and records to determine the content and accuracy of items claimed on the tax return.
 - c. **Inquiry** — such as interviewing the taxpayer or third parties. Information from independent third parties can confirm or verify the accuracy of information presented by the taxpayer.
 - d. **Inspection** — such as physically examining the taxpayer's assets, e.g., inventory or securities.
 - e. **Observation** — such as conducting a tour of the taxpayer's business to observe the taxpayer's daily business operations.
 - f. **Testing** — such as tracing transactions to determine if they are correctly recorded and summarized in the taxpayer's books and records.
- (4) Factors to consider when choosing an examination technique are:
 - a. Will the examination technique provide the needed evidence?
 - b. Will the benefits derived from using a particular technique justify the associated costs to both the examiner and the taxpayer?
 - c. Are there less expensive alternatives that will provide the same evidence?
- (5) The following examination techniques used to gather evidence are discussed in this section:

IRM Reference	Examination Technique
IRM 4.10.3.4	Interviews: Authority and Purpose
IRM 4.10.3.5	Tours of Business Sites and Inspection of Residences
IRM 4.10.3.6	Evaluating the Taxpayer's Internal Controls
IRM 4.10.3.7	Examination of the Taxpayer's Books and Records
IRM 4.10.3.8	Analyzing Schedules M-1, M-2 and M-3
IRM 4.10.3.9	Bank Record Reconciliations
IRM 4.10.3.10	Balance Sheet Analyses
IRM 4.10.3.11	Testing Gross Receipts or Sales
IRM 4.10.3.12	Testing Expenses: Cost of Goods Sold
IRM 4.10.3.13	Testing Expenses: Operating Costs
IRM 4.10.3.14	Sampling Techniques

- (6) Accounting systems and the organization of books and records are discussed in IRM 4.10.3.15, and IRM 4.10.3.16, respectively.

4.10.3.3
(05-03-2023)
Risk Analysis

- (1) Risk analysis is the process of comparing the potential benefits to be derived from examining a return or issue to the resources required to perform the examination. Risk analysis is an integral part of the examination process to ensure the efficient and effective use of resources and should be based on experience, judgment, and objective analysis. Risk analysis techniques include the 80/20 concept and mid-audit decision point (50 percent rule). Factors to consider include:
- a. Fraud potential;
 - b. Materiality (see IRM 4.10.7.4.4, Significant Items);
 - c. Corollary effect of adjustment (e.g., whipsaw, NOL, related returns);
 - d. Compliance impact (e.g., strategic or emerging issue);
 - e. Type of adjustment (e.g., permanent or timing);
 - f. Accuracy of books and records; and
 - g. Hours required to audit.
- (2) Risk based decision making should be used throughout the course of the examination, but at a minimum, **must** be considered:
- a. During the pre-audit phase of the examination;
 - b. At the midpoint of the examination (50 percent rule); and
 - c. When a significant event occurs.
- (3) Risk analysis provides the following benefits:
- a. Increased productivity;
 - b. Improved audit planning process;
 - c. Reduced cycle time;
 - d. Increased audit coverage; and
 - e. Reduced taxpayer burden.

- (4) Risk analysis techniques help the examiner determine the “scope” and “depth” of the examination.
- (5) **Scope of Examination** – relates to the selection of “issues” that warrant examination.
 - a. During the pre-contact phase, examiners determine the scope of the examination. See IRM 4.10.2.3, In-Depth Pre-Contact Analysis.
 - b. At the mid-point of the examination, the examiner will re-evaluate and adjust the scope of the examination, if necessary. See IRM 4.10.3.3.2, Mid-Audit Decision Point (50 percent rule).
- (6) **Depth of Examination** – relates to the degree in which examination techniques will be utilized to verify the accuracy of an issue. Factors to consider when establishing the depth of the examination include:
 - a. The risk that the taxpayer has made errors that are individually or collectively material. The factors involved are addressed during the evaluation of the taxpayer’s internal controls.
 - b. The risk that the audit tests will fail to uncover material errors. The factors involved are the examination techniques used, the nature of the errors (intentional or unintentional), and the reliability of available evidence.
- (7) LB&I examiners should reference IRM 4.46.3.3, Risk Analysis Process, for additional guidance.

4.10.3.3.1
(02-26-2016)
The 80/20 Concept

- (1) The goal of an examination is to determine the “**substantially correct**” tax liability. The 80/20 concept is “value-added” decision making that weighs the impact of our decisions (potential results) with the investment of additional case time (cost) and is applicable throughout the audit to evaluate and determine the scope of the examination. See IRM 4.10.2.7.1.1, Risk Analysis, for further discussion of the 80/20 concept.
- (2) The examiner must consider the facts and circumstances, evaluation of internal controls (in business examinations) and use professional judgment to determine whether the scope should be expanded or contracted.
- (3) Examiners must document the reasons for expanding and contracting the examination on Lead Sheet 100-2 or a supporting workpaper indexed to Lead Sheet 100-2, or Form 9984.

4.10.3.3.2
(05-03-2023)
**Mid-Audit Decision Point
(50 Percent Rule)**

- (1) The mid-audit decision point or mid-cycle risk analysis (LB&I only) or 50 percent rule refers to performing a risk-based analysis of the examination at its mid-point.

Reminder: For LB&I examiners, the mid-cycle risk analysis is optional for LB&I IC cases with ECD’s of less than 12 months. See IRM 4.46.3.3.6(3), Documenting the Risk Analysis.

- (2) The mid-point of the examination can be determined based on the number of issues classified/identified or the number of hours expended.
- (3) At the mid-point of the examination, the examiner should determine whether the remaining classified/identified issues should be examined. This decision

should be based on the facts and circumstances, evaluation of internal controls (in business examinations) and the examiner's judgment. For example, the resulting additional tax is not expected to be material, or the time to develop additional issues is not justified, based on the potential for additional tax.

- (4) Examiners are expected to use their professional judgment to determine if it is in the government's best interest to continue the examination. If it is **not** in the government's best interest to continue the examination, the examiner must document this determination. See IRM 4.10.3.3.1 for additional guidance. LB&I examiners should reference IRM 4.46.3.3.6, Documenting the Risk Analysis, for additional guidance.

4.10.3.4
(05-03-2023)
**Interviews: Authority
and Purpose**

- (1) An interview is a meeting between two or more individuals (e.g., in person, by phone, by video conference) for the purpose of gathering information to investigate and/or resolve issues. Examiners conduct interviews to obtain information needed to make informed judgments about the scope and depth of the examination.
- (2) IRC 7602, Examination of books and witnesses, authorizes the Secretary or a delegate to examine books and records and to take testimony under oath.
- (3) Interviews are used to develop information and establish evidence. The testimony of witnesses and statements made by taxpayers or their representatives are major factors in resolving tax cases.
- (4) Interviews provide information about the taxpayer's financial history, business operations, use of internal controls and books and records. This information helps the examiner make informed judgments about the scope and depth of the examination.
- (5) Oral testimony is a significant factor in resolving tax cases. See IRM 4.10.7.3.2, Oral Testimony, for additional guidance. Oral testimony can:
 - a. Provide information not otherwise available from physical documentation;
 - b. Corroborate return information;
 - c. Provide relevant information not reflected on the return; and
 - d. Establish the taxpayer's intent.

4.10.3.4.1
(05-03-2023)
Types of Interviews

- (1) Examiners may conduct interviews during any phase of the examination including pre-contact, initial appointment, review of books and records, fact finding, issue resolution, report writing, and closing. The initial interview is typically the most in-depth interview, however subsequent interviews, and interviews of third parties can be equally important. Further, conducting a thorough interview during the closing phase of the examination (i.e., at the closing conference) will often help the examiner resolve the case more efficiently. See the following for additional guidance:
 - IRM 4.10.3.4.1.1, Initial Interviews
 - IRM 4.10.3.4.1.2, Subsequent Interviews
 - IRM 4.10.3.4.1.3, Third-Party Interviews
 - IRM 4.10.3.4.1.4, Closing Interviews (Conferences)

4.10.3.4.1.1
(05-03-2023)
Initial Interviews

- (1) **Initial Interviews** — Initial interviews are the foundation of an effective examination. The examiner is afforded the opportunity to gain an understanding of the taxpayer's overall financial picture, the business history and operations, and an overview of the taxpayer's recordkeeping practices. Prior to conducting the interview, the examiner should review all taxpayer information available to develop interview questions that are tailored to the taxpayer, their business, and the examination issues present. See IRM 4.10.3.4.2, Preparation and Planning for Interviewing; IRM 4.46.3.6, Opening Conference/Meeting: (LB&I only); and Exhibit 4.46.3-3, Sample Agenda for Opening Conference/Meeting (LB&I only), for additional guidance. Initial interviews may be the only time the examiner can speak directly with the taxpayer, so it's important to obtain as much relevant information as possible.

Note: SB/SE examiners should refer to IRM 4.10.2.9, Scheduling the Appointment: Overview, for specific time frames to hold an interview after the first action on the case.

- (2) Initial interviews should be conducted face to face whenever possible. If an interview is conducted using online meeting tools, IRS procedures must be followed. See IRM 10.5.1.6.18.2, Online Meeting Tools, for additional guidance.
- (3) If not already addressed during the pre-contact phase of the examination, the examiner **must** take the following actions during the initial interview:
- a. Verify the taxpayer's receipt of Pub 1, Your Rights as a Taxpayer, and Notice 609, Privacy Act Notice.

Reminder: Document the confirmation of receipt of Pub 1, Your Rights as a Taxpayer, and Notice 609, Privacy Act Notice, and the discussion held with the taxpayer and/or representative.

- b. Briefly describe the rights discussed in Pub 1 and Notice 609 and respond to any questions.
- c. Briefly describe the examination process and inform the taxpayer and/or representative of the resolution options available for unagreed cases (e.g., managerial conference, Fast Track Settlement, formal appeal, right to petition the United States Tax Court).

Note: For SB/SE Revenue Agents only (GS-12 and below), a mutual commitment date must be established with the taxpayer or representative at the end of the initial appointment. See IRM 4.10.3.4.8, Mutual Commitment Date (SB/SE Revenue Agents Only), for additional guidance.

- (4) The examiner should also inform the taxpayer that Appeals will only accept income, gift and fiduciary tax cases with 365 days and estate tax cases with 270 days remaining on the statute of limitations. (See IRM 8.2.1.4, Receipt of New Assignment by an Appeals Technical Employee (ATE).) In addition, Appeals will generally return the case to Examination if:
- a. The taxpayer submits new information or evidence that in the judgement of Appeals warrants additional analysis or investigation by Examination, or
 - b. The taxpayer raises a new issue. (See IRM 8.2.1.5(2), Returning a Case to Examination - ATE.)

- (5) LB&I examiners should provide the taxpayer with Pub 5125, LB&I Examination Process, and discuss the major sections outlined in Exhibit 4.46.3-3, Sample Agenda for Opening Conference/Meeting.
- (6) If the examiner's identity is questioned by the taxpayer or representative during the initial interview or at any point during the examination, the examiner must provide the IRS Verification for Taxpayers and Representatives phone number. See IRM 4.10.3.18, Verification of Field Employee Identification.

4.10.3.4.1.2
(05-03-2023)
Subsequent Interviews

- (1) Subsequent interviews with the taxpayer should be held if:
 - a. The taxpayer does not provide all the information requested;
 - b. More detailed explanations are needed; or
 - c. A review of the examination's progress is needed. The review should address information provided to date as well as outstanding information needed to complete the audit.

4.10.3.4.1.3
(02-26-2016)
Third-Party Interviews

- (1) IRC 7602, Examination of books and witnesses, allows examiners to obtain testimony from third parties who can provide information that may be relevant to determining a taxpayer's liability or ascertaining the correctness of a return.

Reminder: Examiners must follow the third-party contact provisions discussed in IRM 4.11.57, Third-Party Contacts, and IRM 25.27.1, Third-Party Contact Program, **prior to** making a third-party contact. Also see 26 CFR 301.7602-2, Third party contacts, for definitions, duties and procedures for third-party contacts.

- (2) The taxpayer's right to privacy will be protected when contacting third parties for information.
 - a. Information will be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates.
 - b. No information will be collected or used with respect to the taxpayer that is not necessary and relevant for tax administration or other legally mandated or authorized purposes.
 - c. Information about taxpayers collected from third parties will be verified to the extent practicable with the taxpayer before action is taken.

- (3) Caution should be taken to not disclose any tax information of a confidential nature when contacts are made with third parties.

Exception: IRC 6103(k)(6), Disclosure by certain officers and employees for investigative purposes, provides that IRS employees may make investigative disclosures to the extent necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected. See IRM 11.3.21.8, Requirements for Investigative Disclosures, for additional guidance.

- (4) Tax Compliance Officers/Tax Auditors, under prescribed conditions, may contact taxpayers outside the IRS office while completing their examinations.

4.10.3.4.1.4
(05-03-2023)

**Closing Interviews
(Conferences)**

- (1) Closing interviews should be held to solicit agreement to proposed adjustments. See IRM 4.10.7.5, Proposing Adjustments to the Taxpayer and/or Representative, for additional guidance.

4.10.3.4.2
(03-01-2003)

**Preparation and
Planning for
Interviewing**

- (1) **Timing** — Proper timing of the interview is essential in obtaining information that is material in resolving a case.
- (2) **Review Available Information** — Prior to any interview, the examiner should review all available information relating to the case. Such information may then be divided into three general categories:
 - a. Information that can be documented, and need not be discussed;
 - b. Information that may be documented, but needs to be discussed (i.e., requires further clarification or collaboration); and
 - c. Information that must be developed by testimony.
- (3) **Prepare Outline** — Before the interview, the examiner should determine the goal of or purpose for questioning the taxpayer or witness. The topics that will enable the examiner to accomplish this goal should be outlined in detail, depending on the examiner's experience and the complexity of the case. The outline should contain only information that is relevant and material, including hearsay (see IRM 4.10.7.3.5, Hearsay). Extraneous matters should be excluded because they may be confusing and adversely affect the development of relevant topics. Important topics should be set off or underscored and related topics listed in their proper sequence. Specific questions tend to reduce the flexibility of the examiner and should be kept to a minimum. The outline should include the following:
 - a. Identification of the taxpayer or witness;
 - b. Purpose of the interview;
 - c. Identification of topics to be addressed; and
 - d. Reference to pertinent documents or exhibits that will be shared during the interview.
- (4) A separate interview file may be utilized for purposes of conducting an interview. This file should contain only data or information arranged in the order it is to be discussed or covered in the interview.

4.10.3.4.3
(02-26-2016)

Who To Interview

- (1) Interviews should always be held with the person(s) having the most knowledge concerning the total financial picture and history of the person or entity being examined. Generally, that person(s) is the taxpayer for individual/Form 1040 examinations.
- (2) IRC 7521(c) states that an examiner cannot require a taxpayer who has obtained representation to accompany the representative to an examination interview (absent an administrative summons). However, the taxpayer's voluntary presence at the interview can be requested through the representative as a means to expedite the examination process.

Note: If the representative indicates the taxpayer will not be present for the initial interview, the examiner should confirm with the representative that they have first-hand knowledge of the taxpayer's business, business practices, book-keeping methods, accounting practices, and daily operations. Questions about the location of financial accounts held, the types of books and records maintained, whether the taxpayer engaged a bookkeeper, and other

questions about the taxpayer's business operations will help reveal the level of knowledge that the representative possesses and identify any potential need to interview the taxpayer directly. This information may also assist the examiner and/or group manager in securing the representative's consent to the taxpayer's appearance **without** the need for an administrative summons.

4.10.3.4.3.1
(05-03-2023)
**Taxpayer's
Representative**

- (1) The examiner may interview the taxpayer's representative without the taxpayer present if the representative has first-hand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices, and daily operations.
- (2) The examiner should ask questions about the location of financial accounts held, the types of books and records maintained, whether the taxpayer engaged a bookkeeper, and other questions about the taxpayer's business operations will help reveal the level of knowledge that the representative possesses and identify any potential need to interview the taxpayer directly. This information may also assist the examiner and/or group manager in securing the representative's consent to the taxpayer's appearance.
- (3) If the taxpayer's representative **impedes or delays the examination** by failing to promptly submit the taxpayer's records or information requested by the examiner, failing to keep scheduled appointments, or failing to return telephone calls and written correspondence, the examiner may initiate procedures to bypass the representative and deal directly with the taxpayer, as outlined in IRM 4.11.55.4, By-Pass of a Representative.

4.10.3.4.3.2
(05-03-2023)
**Corporate and
Partnership
Examinations**

- (1) In corporate examinations (e.g., C corporations, S corporations and limited liability companies (LLCs) that file corporate returns), a current officer or managing member with the most knowledge of the business operations should be identified and interviewed.
- (2) In Bi-Partisan Budget Act (BBA) partnership examinations (including LLCs that file partnership returns), the partnership representative (PR) must be identified. The PR has sole authority to act on behalf of the partnership. The examiner should ask the PR to identify company personnel who are most knowledgeable of the business to be present at interviews. See IRM 4.31.9.7.6, Partnership Representative (PR), for additional guidance.

Note: All partners are bound by the decisions made by the partnership representative. See IRC 6223, Partners bound by actions of partnership.

- (3) In Investor Level Statute Control (ILSC) examinations, the general partner(s), managing member(s), or shareholder(s) with the most knowledge of the business operations should be interviewed.
- (4) In Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership examinations (including LLCs that file partnership returns), the Tax Matters Partner (TMP) must be identified. The TMP should be asked to designate the company personnel or representative(s) who are most knowledgeable to be present at any interviews. See IRM 4.31.2, TEFRA Examinations - Field Office Procedures, for additional guidance.

- (5) In non-TEFRA partnership examinations (partnerships with a tax year ending before January 1, 2018), the general partner or managing member with the most knowledge of the business operations should be interviewed.

4.10.3.4.3.3
(05-03-2023)
Specialists

- (1) Examiners should identify, in advance, all the persons the taxpayer will have present at an interview and ensure appropriate IRS personnel will be in attendance. For example, if technical issues outside the examiner's area of expertise will be discussed at the interview, the IRS' specialists should be at the meeting.
- (2) Examiners should also determine if any specialist referrals will be made as early in the examination as possible.
- (3) Mandatory referrals, including international, should be made as soon as possible (i.e., during the pre-contact phase of the examination), but not later than 30 days after the initial appointment or the Group Manager Concurrence Meeting (GMCM) (if applicable), whichever occurs first. For additional guidance, see IRM 4.10.2.7.5, Specialist Referrals and IRM 4.46.3.2.6.1, Specialist Referrals (LB&I examiners only).
- (4) If complex international issues are discovered during the examination, the case should be referred at that time. See IRM 4.46.3.2.6.2, International Referrals - Supporting Documentation and Informal Assistance, for guidance.

4.10.3.4.4
(05-03-2023)
Where to Conduct Interviews

- (1) The time and place of interviews will be set by the Secretary if they are reasonably scheduled. This authority is provided in IRC 7605(a), Time and place, and the related regulations at 26 CFR 301.7605-1, Time and place of examination. In general, the IRS will determine if an office or field examination is to be performed.
- (2) Generally, the initial interview should be held as soon as possible after opening a case with every effort made to hold the initial appointment within 20-35 calendar days. See IRM 4.10.2.9, Scheduling the Appointment: Overview.
- (3) Office examinations will be conducted at the IRS office closest to the location of the taxpayer. See IRM 4.10.2.9.2, Place and Time of Examination for additional information.

Exception: If the office closest to the location of the taxpayer does not have an examination group or appropriate personnel to conduct the examination, it generally is reasonable for the IRS to require the taxpayer to attend an examination at the closest IRS office within the assigned area that has an examination group or the appropriate personnel. See 26 CFR 301.7605-1(d)(2)(ii), Exception.

- (4) Field examinations should be conducted at the taxpayer's residence, place of business, or where the taxpayer's original books and records are maintained. In the case of a sole proprietorship or business entity, this will usually be the taxpayer's principal place of business. See IRM 4.10.2.9.2, Place and Time of Examination, for additional guidance.
- (5) An exception to the rule for field examinations would be for some frivolous filers/nonfilers. Group managers should consider the potential hazards to the personal safety of examiners examining these returns. Meetings between the examiner and the non-compliant taxpayer should be held, where practical, in a

government facility. The group manager may make other arrangements to facilitate the examination when it would not compromise the safety of the examiner.

4.10.3.4.5
(05-03-2023)
Interview Techniques

- (1) It is important to create an environment where the taxpayer feels comfortable. Examiners should maintain a friendly and professional demeanor. Suggestions for establishing rapport include:
 - a. Examiners should introduce themselves.
 - b. Examiners should explain what will happen during the examination.
 - c. Examiners should be prepared to explain return selection procedures, rights to representation, and appeal rights. See Pub 3498, The Examination Process.
 - d. Examiners should recognize that an IRS audit is often a once-in-a-lifetime experience for the taxpayer, and therefore the taxpayer may be tense or nervous.
 - e. Examiners should exhibit openness, honesty and integrity and be calm and objective.
 - f. Examiners should listen carefully to all details, be receptive to all information volunteered, regardless of its nature, and be patient and persistent in extracting the facts necessary to achieve the goals of the interview.

4.10.3.4.5.1
(02-26-2016)
Conducting the Interview

- (1) **Be Adaptable and Flexible** — The examiner should keep an open mind and be receptive to all information provided, regardless of its nature, and be prepared to develop facts as appropriate. The examiner should be flexible, pay close attention to the testimony provided, and adjust the line of questioning as appropriate. Examiners should avoid strictly following a line of questioning when the taxpayer's testimony has already answered one or more intended questions. The questionnaire or interview outline should serve as an aid to ensure that all pertinent matters are addressed, but the examiner should also be prepared to ask original and spontaneous questions as new facts become known. A carefully planned outline will provide enough leeway to allow the examiner to better cope with any situation that may occur and permit the examiner to develop leads that may arise.
- (2) **Follow Through** — Incomplete and unresponsive answers have little or no probative value. Any reply, relative to a pertinent matter, that is not complete and to the point should be followed up by questioning the taxpayer about all knowledge they have concerning every facet of the topic. The examiner should follow through on every pertinent lead or incomplete answer and continue asking questions until all information, which can reasonably be expected, has been secured.
- (3) The following suggestions will help the examiner obtain answers that are complete and accurate:
 - a. Use short questions confined to one topic that can be clearly and easily understood.
 - b. Ask questions that require narrative answers, avoiding "yes" and "no" answers, whenever possible.
 - c. Whenever possible, avoid questions that suggest part of the answer (i.e., leading questions).

- d. Ask how the taxpayer learned what they state to be fact. The taxpayer should also be required to provide a factual basis for any conclusions stated.
 - e. Be alert to instances where the taxpayer starts wandering or going off topic, and redirect the taxpayer's attention to the current talking point. Where possible, ask questions that require a direct response.
 - f. Concentrate on the answers of the witness, not the next question.
 - g. To ensure the accurate collection of facts, the examiner should clearly understand each reply provided and ensure that any lack of clarity is eliminated before continuing.
 - h. When all important points have been resolved, terminate the interview. If possible, leave the door open for further meetings with the subject.
- (4) Maintain control of the interview and establish its pace and direction. Continually assess whether the taxpayer is providing pertinent information or rambling.

4.10.3.4.5.2
(02-26-2016)

**Request for
Representation -
Suspension of Interview**

- (1) Taxpayers have the right to representation at any time during the examination.
- (2) IRC 7521(b)(2), Right of consultation, provides if a taxpayer clearly states, during any interview, that they wish to consult with an attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the IRS, the interview **must** be suspended regardless of whether the taxpayer may have answered one or more questions.

Exception: An interview will not be suspended if required by a court order or initiated by an administrative summons issued under IRC 7602, Examination of books and witnesses. If the interview is initiated by an administrative summons and the summoned individual is uncooperative or invokes their Fifth Amendment right against self-incrimination, refer to IRM 25.5.5.4.7, Noncompliance by the Witness or a Representative, for additional guidance.

- (3) Once a taxpayer states they wish to consult with an authorized representative, the examiner will suspend the interview and allow the taxpayer a minimum of 10 business days to permit such consultation and secure representation (extensions of time may be granted on a case-by-case basis). The taxpayer should be informed of the consequences if the examiner is not contacted within 10 business days, and if necessary, a Form 4564, Information Document Request (IDR), should be provided to the taxpayer via hand delivery or mail. If mailed, the examiner should advise the taxpayer that an IDR will be sent and document this on Form 9984, Examining Officer's Activity Record.
- (4) While an interview may be suspended, there are situations where examination activities involving correspondence with the taxpayer (e.g., issuance of a 30-day letter, third-party contacts) should not be delayed, such as cases with statutes expiring in 270 days or less, or cases requiring the collection of third-party evidence scheduled for destruction or deletion.

Note: Examination activities that can be performed at the examiner's work location and are transparent to the taxpayer (e.g., audit work on information previously secured, case write-up, case file documentation, etc.) do not need to be suspended because of suspension of an interview per IRC 7521(b)(2).

- (5) An administrative summons should be issued if the taxpayer abuses this process through repeated delays or suspensions of interviews.
- (6) Examiners must document the taxpayer's request to consult with an authorized representative and all actions taken related to that request on Form 9984.

4.10.3.4.5.3
(03-01-2003)
Question Construction

- (1) The areas to be addressed during the interview should be based on analyses completed prior to conducting the interview. Questions are the principal tools of interviewing.
- (2) There are four types of questions: open-ended, closed-ended, probing, and leading. Each is described below:

Type	Description
Open-Ended Questions	Open-ended questions are framed to require a narrative answer. They are designed to obtain a history, a sequence of events, or a description. Ask open-ended questions about the taxpayer's business, employment, education, and sources of income which may not be reflected on the return. The advantage of this type of question is that it provides a general overview of some aspect of the taxpayer's history. The disadvantage is that this type of question can lead to rambling.
Closed-Ended Questions	Closed-ended questions are more appropriate for identifying definitive information such as dates, names, and amounts. These questions are specific and direct. Ask closed-ended questions for personal background information such as the number of dependents or current address. Closed-ended questions are useful when the taxpayer has difficulty giving a precise answer. They are also useful to clarify a response to an open-ended question. The disadvantage to closed-ended questions is that the response is limited to exactly what is asked and can make the taxpayer uncomfortable.
Probing Questions	Probing questions combine the elements of open and closed ended questions. They are used to pursue an issue more deeply. For example, when questioning a taxpayer's travel expense, ask "How many miles is it from your residence to your practice and where do you first travel to in the morning?" The advantage of this type of question is that the taxpayer's response is directed, but not restricted.
Leading Questions	Leading questions suggest that the interviewer has already drawn a conclusion or indicate what the interviewer wants to hear. Limit the use of leading questions. Use them when looking for confirmation, since the answer is stated in the form of a question. For example: "So you did not keep a log or other written record of your auto expenses?"

- (3) Use the interview questionnaire or outline as a guide, but it should be flexible. Respond to new information as it is received and ask follow-up questions when clarification is needed.
- (4) Vary the types of questions and pause between questions. This technique can help establish a more conversational atmosphere.
- (5) Obtain as much information as possible during an interview. There may not be an opportunity to conduct another interview.

4.10.3.4.5.4
(03-01-2003)
Listening Skills

- (1) The question, no matter how important, becomes irrelevant if the response is not accurately understood. Ways to enhance listening include:
 - a. Making sure that non-verbal communication contributes to a comfortable atmosphere. If the examiner appears overly relaxed and is not looking at the taxpayer, the taxpayer may believe the examiner is not interested and will respond accordingly.
 - b. Listening for the meaning of words. If the taxpayer's response is unclear, try paraphrasing or repeating what was said.
 - c. Not interrupting the taxpayer and allowing a brief pause at the end of the response. Use the time to analyze the response and, if appropriate, formulate a follow-up question.
 - d. Maintaining eye contact with the taxpayer. This demonstrates interest and non-verbal responses can be observed.

4.10.3.4.6
(05-03-2023)
Documenting Interviews

- (1) Interviews provide information not available from other sources. A properly planned and executed interview will provide an understanding of the taxpayer's financial history, business operations, and accounting records.
- (2) The case file should reflect in-depth planned interviews throughout the examination. Sufficient questions should be asked to gain a clear understanding of the taxpayer, as well as the operations of the taxpayer.
- (3) The elements of an adequately documented interview include, but are not limited to:
 - a. Items specific to the taxpayer such as the type of return and relevant facts and circumstances.
 - b. Sufficient depth to give a clear understanding of the nature of the taxpayer's financial history, business history, and day-to-day operations.
 - c. Explanations of large, unusual or questionable (LUQ) items and whether such explanations resolve the potential issues.
 - d. Description of books and records maintained and their availability.
 - e. Description of financial status or overall assessment of return validity, when appropriate.
 - f. Complete explanation of the taxpayer's accounting system and accounting methods, including any changes when appropriate. This may also include an explanation of the accounting method used for tax, if different from book accounting, and any adjustments that were made.
 - g. Explanation of the taxpayer's internal controls as discussed in IRM 4.10.3.6 below, Evaluating the Taxpayer's Internal Controls.
 - h. Additional items addressed (as warranted).
- (4) Examiners should inquire about the return preparer including, but not limited to:
 - a. Was the return prepared for compensation?
 - b. What information or documents did the T/P provide to the preparer?
 - c. Did the preparer sign the return and include the appropriate identification number(s)?
 - d. Did taxpayer receive a copy of the return?
 - e. Did preparer negotiate the refund?
- (5) Case files may be reviewed by many individuals after closing from the examiner, especially if the examination is unagreed. This includes the

examiner, who may need to provide testimony during litigation. The interview(s) should be documented in sufficient detail that no unanswered questions remain.

- (6) It is important for the examiner to ask appropriate follow-up questions and properly document the interview without hindering the flow of information. Examiners should:
 - a. Take brief notes during the interview for significant responses to questions and note those areas that need additional development. It is not advisable to take extensive notes during the interview as it can be distracting and hinder the flow of the interview.
 - b. Prepare a memorandum of interview (MOI) immediately following the meeting or shortly thereafter, fully documenting the statements and replies made by the taxpayer. The MOI and the handwritten interview notes will serve to document statements made by the taxpayer, refute subsequent contradictory statements, and support examination positions taken.
- (7) As an alternative, questionnaires may be used to record taxpayer responses instead of a memorandum. If an interview questionnaire is used, the examiner should ask follow-up questions as needed. The original questions and responses should be included in the case file.
- (8) **Use of Lead Sheets in RGS** — RGS contains various lead sheets for use by SB/SE Examination.
 - a. **Tax Compliance Officers** — SB/SE tax compliance officers (TCO) are **required** to use the following lead sheets.

Title of Lead Sheet	When Used:
Lead Sheet 100-3, TCO Initial Discussion	Pre-contact or Interview
Lead Sheet 400, Initial Interview Questions and Notes	Interview
Lead Sheet 400, Initial Interview Questions and Notes - Business Supplement	Interview

- b. **Revenue Agents** — SB/SE revenue agents use Lead Sheet 400, Initial Interview Questions and Notes.

4.10.3.4.7
(05-03-2023)
**Requests to Audio
Record Interviews**

- (1) IRC 7521(a) provides that taxpayers and IRS employees may **audio** record an “in-person” interview, provided that advance notice is given to the other party.

Caution: The taxpayer or representative does not have the right to record a **telephone interview**, with or without the IRS’ knowledge. If a taxpayer begins to record a conversation during a telephone call, and the examiner becomes aware of it, the examiner should advise the taxpayer or representative that the recording must be stopped. If the recording is not stopped, the examiner should terminate the call and document the incident on Form 9984, Examining Officers Activity Record. See IRM 5.1.12.3(3), Taxpayer Recording of Interviews, for additional guidance.

Caution: Cameras, videotaping equipment and electronic image recording devices are never permitted. At no time, however, should employees try to physi-

cally confiscate this equipment. See IRM 25.5.5.4.4, Right to Make an Audio Recording of the Proceeding, for additional guidance.

4.10.3.4.7.1
(05-03-2023)
**Taxpayer Requests for
Audio Recording**

- (1) In accordance with IRS Notice 89–51, Procedures Involving Taxpayer Interviews, requests by taxpayers or their authorized representatives to make audio recordings of examination proceedings will be allowed by the IRS official or employee conducting the interview under the following conditions:
 - a. The taxpayer or authorized representative supplies the recording equipment;
 - b. The IRS may produce its own recording of the proceedings (using the IRS' equipment);
 - c. The recording takes place in a suitable location, ordinarily in an IRS office where equipment is available to produce the IRS' recording; and
 - d. All participants in the proceeding other than IRS personnel must consent to the making of the audio recording and all participants must identify themselves and their roles in the proceeding.
- (2) Requests by taxpayers or authorized representatives to make audio recordings of examination proceedings must be addressed to the officer or employee of the IRS who is conducting the interview and must be received by the IRS no later than 10 calendar days prior to the interview that is to be recorded. If 10 calendar days' advance notice is not given, the IRS may, in its discretion, conduct the interview as scheduled (permitting the recording) or set a new date.
- (3) When a proper written request to record an interview is received, the employee conducting the interview must secure management approval prior to agreeing to the request. Ensure that the interview is scheduled for an IRS location and that working recording equipment will be available for the IRS to use to record the interview.
- (4) When recording equipment and/or a suitable location are not available, postpone and reschedule the meeting until the necessary equipment and a suitable location are available.
- (5) The taxpayer or representative does not have the right to record a **telephone interview**, with or without the IRS' knowledge. If a taxpayer begins to record a conversation during a telephone call, and you are aware of it, advise the taxpayer or representative that the recording must be stopped. If the recording is not stopped, politely terminate the call, and document your case history accordingly.
- (6) The taxpayer or representative does not have the right to videotape or film an interview, with or without the IRS' knowledge.

4.10.3.4.7.2
(05-03-2023)
**IRS Initiated Audio
Recordings**

- (1) The IRS can initiate an audio recording provided it notifies the taxpayer 10 calendar days in advance of the interview using Letter 2156, Recording Interviews. The Field Territory Manager must approve all IRS initiated recordings.
- (2) At the outset of the recording, the examiner conducting the interview will identify themselves, the date, the time, the place, and the purpose of the interview. The audio recording will also contain the following:
 - a. Name of the taxpayer or witness;

- b. Personal identification of all participants along with a statement of each participant's role in the examination;
 - c. Identification of participants when they arrive or when they leave throughout the meeting;
 - d. Description of any written documentation presented or discussed during the proceeding in sufficient detail to make the audio recording a meaningful record when matched with the other documentation contained in the case file;
 - e. The time the proceeding completed, the total recording time for the interview (i.e., time audio recording was running), and that the recording is ended.
- (3) Transcribe all or part of the recording when necessary to make the verbatim recording a meaningful record which can be matched with the documentation contained in the case file.

4.10.3.4.7.3
(05-03-2023)
**Recording Retention
Procedures**

- (1) In RGS, create a subfolder in Case File Documents (CFD) titled "Interview Recording" and save a copy of the voice recording and if applicable, a copy of the transcript, in the folder.

Note: If the interview recording causes the casefile to exceed 400MB, case closing procedures for large cases must be followed. See *Closing Large Cases (Larger than 400 MB)*.

Reminder: Subfolders created in RGS are not accessible in CEAS. The files within the subfolders will appear as single files in CEAS; therefore, use of proper naming conventions is essential to ensure sensitive information is properly safeguarded. All voice recording files stored in the interview recording folder must use **INTERVIEW** as the file's category name (e.g., INTERVIEW – Initial Interview Audio 01012023; INTERVIEW – 2nd Interview Audio 02042023; or INTERVIEW – Closing Conference Audio 03212023)

Note: See *RGS File Naming Conventions Job Aid*, for additional guidance..

- (2) The interview recording folder should contain an electronic copy of all documents discussed or received, and in the event a document was marked during the interview, an electronic version of both the clean copy and marked copy. The documents must use **INTERVIEW** as the file's category name (e.g., INTERVIEW – Gross Receipts Computation, etc.)
- (3) For cases exempt from paperless electronic closure (see *Cases Currently Excluded from Paperless Electronic Closure*), the physical copy of the interview recording (e.g., DVD, thumb drive) and if applicable, a copy of the transcript, will be labeled with the taxpayer's name, SSN, year(s) examined, date of interview, total time of the recording and sealed in a manila envelope that should be stapled into the body of the workpapers. See IRM 4.33.1.8.2, Referencing Electronic Files Stored on Portable Storage Devices (PSDs) and IRM 4.33.1.8.3, Documenting Contents of Portable Storage Devices (PSDs), for additional guidance.

4.10.3.4.7.4
(05-03-2023)

**Taxpayer Request for
IRS Recording or
Transcript**

- (1) If a taxpayer requests a copy of an audio recording or transcript of the interview, the taxpayer must first remit payment. See IRM 4.10.3.4.7.5, Payment Processing. Additional procedures are outlined in the table below:

If	And	Then
An audio recording was created by the IRS	The taxpayer requests a copy of the recording	Provide the taxpayer with a copy on taxpayer provided media (e.g., DVD, thumb drive). A fee should not be charged. See IRM 4.33.1.4, Accessing Electronic Records, for guidance on accessing stored records.
A transcript was created by a third party (e.g., stenographer)	The taxpayer requests a copy of the transcript	Provide the taxpayer with the third party's contact information so the taxpayer can secure the transcript directly from the third party.
A transcript was created by the IRS	The taxpayer requests a copy of the transcript	Provide the taxpayer with a copy of the transcript.

4.10.3.4.7.5
(05-03-2023)

Payment Processing

- (1) Payments collected to cover the cost of reproduction must be remitted to Beckley Finance Center by following the procedures outlined below.
- (2) Prepare Form 3210, Document Transmittal, listing: total payment received, the preparer's name, payment amount, the check or money order number and date, and the following account number:

GL	Fund	Internal Order	Functional Area
5200.urec	AAXX5432.5	AUREC	FA

- (3) Send Form 3210 and the payment to Beckley Finance Center via USPS at the following address:

Internal Revenue Service
PO Box 9002,
Beckley, WV 25802-9002

4.10.3.4.8
(02-26-2016)

**Mutual Commitment
Date (SB/SE Revenue
Agents Only)**

- (1) The mutual commitment date (MCD) is a tool used by SB/SE revenue agents to promote cooperation and the timely submission and review of records, resulting in a more efficient examination.
- (2) The MCD is the date the parties agree the SB/SE revenue agent will issue the audit report (generally the closing conference date) and should be established with the input of the taxpayer and/or representative at the end of the first ap-

pointment. If the initial appointment is scheduled for multiple days, then the MCD should be established at the end of the last day.

- (3) The MCD process establishes mutual responsibilities such as:
 - a. Identifying and discussing potential areas of examination (including issues raised by the taxpayer);
 - b. Requesting, providing and reviewing pertinent information necessary to determine the deductibility of an expense or inclusion of an income item;
 - c. Applying relevant tax law, including the Internal Revenue Code, the Treasury Regulations, court cases, etc., required to make a correct determination;
 - d. Keeping all parties advised of unavoidable delays;
 - e. Addressing all parties' questions and concerns raised during the audit; and
 - f. Keeping all parties fully informed about the adjustments being proposed, and the progress of the audit.
- (4) The MCD should be reasonable and attainable. The following factors should be considered when determining the MCD:
 - a. Number of anticipated additional visits;
 - b. Days needed between visits to get information properly prepared; and
 - c. Availability of records.
- (5) SB/SE revenue agents must:
 - a. Document the MCD on Lead Sheet 100-2, Revenue Agent Audit Plan;
 - b. Discuss the MCD with the group manager during the GMCM and ensure the discussion is documented on Lead Sheet 100-4, Group Manager Concurrence Meeting; and
 - c. Promptly notify the group manager if a taxpayer and/or representative declines to establish a MCD or fails to cooperate. If this occurs, the group manager should contact the taxpayer and/or representative to discuss expectations and responsibilities of the IRS and taxpayer or representative during the course of the examination. Based on the results of the discussion, the group manager and examiner will establish and document an estimated completion date (ECD).
- (6) Both the MCD and ECD may be extended if:
 - a. The examination is expanded to new issues;
 - b. The examination is expanded to pick up prior, subsequent, or related returns;
 - c. New information is discovered;
 - d. The taxpayer and/or representative become uncooperative; or
 - e. Unforeseen circumstances arise.
- (7) An extension of the MCD must be communicated to the taxpayer/representative. If the MCD is extended more than 30 calendar days, the revenue agent must also notify the group manager and discuss the reasons for the extension. The revenue agent must document the discussions with the taxpayer/representative and group manager on Lead Sheet 100-2, a workpaper, or Form 9984.
- (8) Whether or not the taxpayer or representative agrees to establish a MCD, in the event a taxpayer and/or representative fails to work with the IRS in a col-

laborative manner, the revenue agent will be expected to use the full extent of the authority allowed by the Internal Revenue Code to obtain the information necessary for an effective examination, make an appropriate determination, and conclude the examination in a timely manner.

- (9) Pertinent case actions and related discussions concerning the MCD/ECD should be documented on Lead Sheet 100-2, a workpaper, or Form 9984.

4.10.3.4.9
(05-03-2023)
**Group Manager
Concurrence Meeting
(SB/SE Revenue Agents
Only)**

- (1) The GMCM is an opportunity for the group manager and SB/SE revenue agent to discuss the scope and depth of the examination, as well as the MCD. Group manager involvement in the early stages of an examination results in fewer delays, increased efficiency and higher quality cases.
- (2) The GMCM should occur no later than 30 business days after completion of the initial appointment **or** 60 business days after the case is updated to Status 12, Started, in the Examination Returns Control System (ERCS), **whichever is first**.
- (3) The revenue agent should schedule the GMCM meeting as soon as the date of the initial appointment is scheduled.
- (4) GS-12 revenue agents and below are required to use the GMCM.
- (5) GS-13 revenue agents are encouraged to utilize a GMCM to provide updates on cases and obtain guidance from managers.
- (6) At a minimum, the revenue agent should be prepared to discuss audit issues, accomplishments, concerns and barriers including:
 - a. Case overview;
 - b. Initial appointment and MCD;
 - c. Books and records;
 - d. Minimum income probes;
 - e. Required filing checks;
 - f. Risk analysis, scope and depth;
 - g. Planned actions; and
 - h. Managerial involvement.
- (7) The GMCM is documented on Lead Sheet 100-4, Group Manager Concurrence Meeting and Managerial Involvement.

4.10.3.5
(03-01-2003)
**Tours of Business Sites
and Inspection of
Residences**

- (1) The physical observation of the taxpayer's operation, or tour of business site, is an integral part of the examination process. Viewing the taxpayer's facilities and observing business activities is an opportunity to:
 - a. Acquire an overview of the business operation;
 - b. Establish that the books and records accurately reflect actual business operations;
 - c. Observe and test internal controls;
 - d. Clarify information obtained through interviews; and
 - e. Identify potential audit issues.
- (2) See IRM 4.10.3.5.5, Inspection of a Taxpayer's Residence, for guidance related to inspection of a taxpayer's residence.

4.10.3.5.1
(03-01-2003)
**Authority to Conduct
Tours of Business Sites**

- (1) 26 CFR 301.7605–1(d)(3)(iii) states: “Regardless of where an examination takes place, the IRS may visit the taxpayer’s place of business or residence to establish facts that can only be ascertained by direct visit, such as inventory or asset verification. The IRS generally will visit for these purposes on a normal workday of the IRS during the IRS’ normal duty hours.”

4.10.3.5.2
(03-01-2003)
**Conducting Tours of
Business Sites**

- (1) Tours of business sites should be conducted during examinations of all business entities. Generally, the principal location, and any locations acquired during the period under examination, should be visited. However, consideration should be given to the cost effectiveness and practicality of conducting the tour. When appropriate, alternatives should be considered.

Example: A fish processing company owns more than a dozen vessels and several onshore processing plants in three states. Rather than conducting tours of the different business sites, the examiner reviewed video tapes the company had prepared for insurance purposes. The tapes helped the examiner understand the taxpayer’s operation and how various pieces of heavy machinery were used.

- (2) Tours should be conducted after the initial interview and early in the examination process. This clarifies what was said during the interview and provides a frame of reference when interpreting information in the books and records. This assists examiners to correctly determine the scope and depth of the examination and avoid unnecessary audit steps.
- (3) Tours should be conducted with knowledgeable individuals. Taxpayers, or their representatives, can often explain business practices that appear unusual to the examiner.
- (4) Tours should be planned to address large, unusual, or questionable items identified during the pre-contact analysis or interviews.
- (5) Design the tour to fit the type of business. The Audit Technique Guides (ATGs) include descriptions of business operations which can help determine what examiners should expect to see. The ATGs are available at: <https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Audit-Techniques-Guides-ATGs>.
- (6) Tours should not disrupt business operations or interfere with the taxpayer’s interactions with customers.

4.10.3.5.3
(03-01-2003)
**Audit Techniques for
Tours of Business Sites**

- (1) Observe and be alert to the physical surroundings. Confirm that assets identified on the tax return (and identified as having audit potential during the pre-contact analysis) are physically present and identify assets that are physically present but are not represented on the return.
- (2) Ask questions to confirm understanding of what is observed and avoid confusion.
- (3) Trace common business transactions through the system. Look for discrepancies between what the transactions “should” look like and what actually happens. Look for weaknesses in the internal controls such as a lack of separation of duties. This will help determine what degree of reliance can be placed on the books and records and what audit steps will be needed.

4.10.3.5.4
(03-01-2003)

**Examples for Tours of
Business Sites**

- (1) The following examples emphasize how tours of business sites can assist examiners to determine the correct scope and depth of examinations, identify significant issues, and avoid unnecessary and time consuming procedures.
 - a. **Example 1** – An examination of an auto dealership was conducted at the representative's office due to limited space at the business site. During the tour of the business, the examiner asked what was on the second floor above the work area and the POA stated that some obsolete parts were kept there. The examiner asked to look and found a well-stocked inventory of parts used for repairs. The inventory, as represented on the return, included only the vehicles held for sale and not the parts used to complete repairs.
 - b. **Example 2** – During the tour of a pharmacy, the examiner noticed that a large billboard was mounted on the roof of the building. It was determined that the income from the rental of the billboard was omitted from the tax return.
 - c. **Example 3** – Touring a new building included questions about a demolition loss claimed on the return. The examiner determined that the expense was for the demolition of the old building on the site of the new facility and was not properly accounted for on the tax return.
 - d. **Example 4** – During the tour of an auto repair shop, an examiner observed a new computerized alignment rack, an air conditioning evacuation and charging station, two brake lathes, and an elaborate engine analyzer. The depth of the examination into depreciation was minimized because the examiner was able to inspect and observe many of the assets listed on the depreciation schedule.

4.10.3.5.5
(03-01-2003)

**Inspection of a
Taxpayer's Residence**

- (1) An examiner may consider inspecting the taxpayer's residence. Due to privacy issues and the intrusiveness of such inspections, their use should be limited. The purpose of inspecting the taxpayer's residence includes (but is not limited to):
 - a. Determining the validity of deductions for an office or business located in the residence.
 - b. Determining the taxpayer's financial status.

4.10.3.5.5.1
(03-01-2003)

**Inspection of a Business
in the Home**

- (1) When determining the validity of office in the home deductions, the office or business should be toured as any other business site. For any portion of a personal residence to qualify, it must be used **exclusively** for business purposes. This can only be determined by inspecting the business portion of the residence.

4.10.3.5.5.2
(03-01-2003)

**Other Inspections of the
Taxpayer's Residence**

- (1) When determining the taxpayer's financial status, an inspection of the interior of the home is not required. The following techniques are suitable alternatives:
 - a. Ownership, sales price and mortgage information can be obtained from public records.
 - b. The examiner can drive through the taxpayer's neighborhood to estimate the taxpayer's standard of living.
- (2) These activities should be completed early in the examination process. Coordination with the taxpayer is not necessary.

4.10.3.5.6
(03-01-2003)
**Case File
Documentation**

- (1) Examiners should document that a tour or inspection was completed and describe the results, including observations and resolution of any questions. The tour of the business site or inspection of the taxpayer's residence should also be noted on the activity record.
- (2) If a tour of the taxpayer's business facilities is not conducted, the reason(s) should be documented in the workpapers.

4.10.3.6
(03-01-2003)
**Evaluating the
Taxpayer's Internal
Controls**

- (1) This section discusses examiner responsibility for evaluating internal control.
- (2) Examiners are required to evaluate the existence and effectiveness of internal control for all types of business returns as described in IRM 4.10.4, Examination of Income.
- (3) Many of the businesses will be sole proprietorships or small, closely-held corporations. In this environment, the owner-managers usually control the entire operation through direct supervision of the business activities. It is not uncommon for one person or a small group of people to have the ability to override vital elements of a system of internal controls. Even in this environment, however, it is essential to evaluate internal controls to determine the appropriate audit techniques to be used during the examination.
- (4) The evaluation of internal controls will assist examiners in determining the accuracy and reliability of the taxpayer's books and records. Additionally, the evaluation of internal controls should be part of the decision making process used to select the appropriate method for the examination of income and expenses. Examiners should consider the type of business, the type of records maintained and the taxpayer's financial status and not just the income and expenses reflected on the tax return.

4.10.3.6.1
(03-01-2003)
**Purpose of Evaluating
Internal Controls**

- (1) An evaluation of a taxpayer's internal controls is necessary to determine the reliability of the books and records.
- (2) It is essential to evaluate internal controls to determine the appropriate audit techniques to be used during the examination.
- (3) The evaluation of internal controls gives examiners the opportunity to identify high risk accounts and eliminate verification of accounts that have little or no tax consequence.
- (4) An evaluation of internal controls is used to determine the scope of an audit and the extent of audit procedures to be used.
- (5) An evaluation of internal controls is used to assess the level of control risk and establish the depth of the examination. "Control risk" is defined as the risk that a material misstatement could occur, and it will not be prevented or detected on a timely basis by the business's internal control structure, policies or procedures.

4.10.3.6.1.1
(03-01-2003)
**Evaluation of Internal
Controls in a Small
Business Environment**

- (1) Internal controls are often limited to the consideration of controls for segregation of duties and safeguarding assets. With this limited perspective, the evaluation of internal controls in small businesses are often viewed as unimportant because control procedures in such environments are often weak or non-existent. This may be due to cost factors, lack of staffing, or a lack of concern with this aspect of the business.

- (2) The fact that internal controls may be weak in a small business environment does not preclude the necessity of determining the reliability of the books and records. Every taxpayer has a method of conducting business and safeguarding business operations.

4.10.3.6.2
(03-01-2003)
**Internal Controls
Defined**

- (1) Internal Controls are defined as the “taxpayer’s policies and procedures to identify, measure and safeguard business operations and avoid material misstatements of financial information.”
- (2) Examiners should obtain an understanding of three key elements of the taxpayer’s business:
- a. The control environment;
 - b. The accounting system; and
 - c. The control procedures.

4.10.3.6.3
(03-01-2003)
**Key Steps for Evaluating
Internal Controls**

- (1) The evaluation of internal controls can be described as an analysis completed by the examiner to understand and document the entire business operation. The key steps of the evaluation process are:
- a. Understanding the control environment;
 - b. Understanding the accounting system; and
 - c. Understanding the control procedures.
- (2) Each of these steps is discussed in the following subsections. To add clarity, a flowchart of the process of evaluating internal controls is included as Exhibit 4.10.3-1, Analysis of Taxpayer’s Internal Controls. The flowchart identifies the minimum steps to be taken by the examiner to understand and document the entire business operation.
- (3) While the flowchart appears to be a linear process, the evaluative process is not linear and the steps illustrated need not be followed in the order shown in the exhibit.

4.10.3.6.3.1
(03-01-2003)
Control Environment

- (1) The first area examiners must understand is the control environment of the business. The control environment is made up of many factors that affect the policies and procedures of the business, including:
- Management philosophy;
 - Management operating style;
 - Organizational structure;
 - Personnel policies; and
 - External influences that affect the business.
- (2) To assess the control environment, examiners must understand, in detail, how the business operates. Therefore, the first step on the flowchart is to draw an overview of business operations. Interviewing the taxpayer and/or representative and touring the business are integral steps for completing the flowchart.

4.10.3.6.3.2
(03-01-2003)
Accounting System

- (1) The second key area of internal control that examiners must understand is the taxpayer’s accounting system. Gaining knowledge of the accounting system provides information about many of the taxpayer’s transactions.

- (2) The examiner should become familiar with the normal flow of each type of transaction, including:
 - a. The accounting records which are involved in the processing, and
 - b. Reporting of transactions.
- (3) Generally, there are two significant elements to a transaction:
 - a. The recordation of the transaction from its initiation to its inclusion in the financial statement, and
 - b. The flow of funds into or out of the business.
- (4) Examiners must acquire knowledge of how the business operates on a day-to-day basis with respect to customers, suppliers, management, sales, work performed, pricing, location, employees, assets used, production and record-keeping.

4.10.3.6.3.3
(03-01-2003)
Control Procedures

- (1) Control procedures are the policies and procedures established by management to achieve the objectives of the business. The control procedures are the methods established to assure that the business operates as intended. Separation of duties is the primary control procedure that concerns the examiner. If properly executed, separation of duties will reduce the opportunity for any person to both perpetrate and conceal errors or irregularities in the normal course of their duties. Other specific procedures include:
 - a. Documentation of procedures and transactions;
 - b. Supervision of work and periodic review by independent third parties; and
 - c. Timely recording of all transactions.
- (2) Many small businesses have one owner and no employees. Although no separation of duties can exist in this situation, other control procedures might be in place to assure accurate reporting of income and expenses. The greater the number of employees, and the more complex the structure of the business, the more likely some formal control procedures will exist.

4.10.3.6.4
(03-01-2003)
Industry Examples

- (1) Not all businesses are susceptible to the same level of control risk. In some businesses, internal controls are required by third parties (such as when a franchise is involved). Moreover, internal controls for businesses within the same industry may vary significantly.

4.10.3.6.4.1
(03-01-2003)
Franchises

- (1) Internal controls are usually very good in franchise companies due to independent audits and verifications performed by the franchisor. Typically, the franchise fee is based on the gross revenue of the business. The franchisee usually must buy products from the franchisor to keep the franchise. The franchisor also requires that minimum records be kept. Regular audits, some announced and some unannounced, are performed by the franchisor. Franchise businesses may be operated in either corporate or non-corporate form.

4.10.3.6.4.2
(03-01-2003)
Cash Businesses

- (1) Many small businesses that deal almost exclusively in cash are likely to have few internal controls. Practically all income is received in cash. No independent third parties review the operation. Many expenses are paid in cash and documentation for transactions is often lacking.

4.10.3.6.4.3
(03-01-2003)

Vertically Integrated Industries

- (1) Generally, accounting methods and procedures are rigid in vertically integrated industries. Periodic checks are made to ensure compliance with the system. The majority of income is not generated by cash transactions. Most expenses are paid by check and are well documented. The new car market segment is a good example of an integrated industry.
- (2) By contrast, few used car dealers are integrated or incorporated and most do not maintain double-entry books and records. Until recently, no third parties, other than law enforcement personnel looking for stolen cars, would review these operations. Since many buyers arrange their own financing, dealers often receive cash payments. It may also be difficult to trace the origin of the inventory.

4.10.3.6.5
(03-01-2003)

Summary of Internal Control Evaluations

- (1) An examination of a taxpayer cannot be undertaken without an overview of the entire operation. An in-depth review of taxpayers' financial status can only be accomplished through an evaluation and **documentation** of internal controls, including the control environment, the accounting system and the control procedures.

4.10.3.6.5.1
(05-03-2023)

Evaluation Methods and Tests

- (1) The examiner's role in evaluating internal controls must encompass a complete review of existing procedures. Adequate tests to validate the taxpayer's records and testimony should be carried out as applicable.
- (2) Information regarding internal controls may be obtained by interviewing the taxpayer and/or representative, inspecting the documents and records, and observing the taxpayer's activities and operations.
- (3) To complete a comprehensive evaluation of internal controls, the examiner should document the business operation and document the accounting system.
- (4) **Document the Business Operation** — Draw-up an overview of the business operations. At a minimum, the information obtained should depict by whom, with what, how many, where, when and how business is transacted.
- (5) **Document the Accounting System** — Identify what books and records are maintained. At a minimum examiners should determine:
 - a. What the books of original entry are, whether they are automated, what types of subsidiary records (invoices, etc.) are maintained, what kinds of reports are prepared, how often they are prepared, and by whom.
 - b. How income is received, how expenses are paid, and who is responsible for receiving and recording income and expenses.
 - c. Who opens mail, deposits funds, writes checks, approves expenditures (both regular and extraordinary), signs checks, makes book entries, prepares invoices, matches invoices, has access to cash registers, and receives and reconciles bank statements.
- (6) **Document Assets** — Identify the taxpayer's business and personal assets, including capital acquisitions, investment and bank accounts, digital assets and cash. At a minimum, the taxpayer and/or representative should be questioned regarding capital asset transactions, cash in financial institutions, cash on hand, bartering, number and location of financial and bank accounts, non-taxable sources of funds, and total assets held.

- (7) **Document the Flow of Transactions** — Outline the flow of receipts and expenditures through the books and records. Are there changes in the books? Is there a system of accounting for non-taxable receipts? Do the books and records have a system of accounting for cash receipts and expenditures? Does the taxpayer rely on information generated by third parties? Is the taxpayer's mark-up identifiable? Does the taxpayer use the books and records for purposes other than tax? Do the books and records reflect regulatory or licensing requirements?
- (8) **Document Procedures Established to Safeguard Business Operations** — Review procedures designed to safeguard the taxpayer's business. Assets should be insured and employees who handle cash may be bonded.

4.10.3.6.5.2
(03-01-2003)
Interview Techniques

- (1) Most of the knowledge needed to evaluate the control structure of the business is acquired through interviews of individuals having first hand knowledge of the business or through observations of the business operations. An in-depth interview of the owner of the business who is usually involved with every facet of the business is an excellent way to gain insight into the control structure.
- (2) While interviewing the business owner is ideal, examiners cannot require a taxpayer to accompany an authorized representative to an examination interview in the absence of an administrative summons. Examiners should, however, request the taxpayer's voluntary presence through the representative.
- (3) When dealing with an individual who may be attempting to distort or conceal information, any information obtained through the interview process should be verified through tests of controls, such as the inspection of documents and reports or observations of the business operation.

4.10.3.6.5.3
(03-01-2003)
Compliance Testing

- (1) The internal control system should be tested for compliance with the taxpayer's (or representative's) description. Observe or "walk through" sample transactions through the entire accounting process.
 - a. Select different types of transactions.
 - b. Look for consistency in recording similar or repetitive transactions.
 - c. Identify points where existing internal controls could be compromised.

4.10.3.6.6
(03-01-2003)
Re-evaluating Scope and Depth of the Examination

- (1) Once these steps are completed, the examiner can decide if the books and records adequately reflect business operations. Examiners should utilize the 80/20 concept to determine whether the scope of the examination should be revised and select the appropriate depth and method of examining income and other issues based on the evaluation of internal control. See IRM 4.10.3.3.1, The 80/20 Concept, for additional guidance.

4.10.3.6.6.1
(03-01-2003)
Reliable Books and Records

- (1) If it is determined that the taxpayer's books are reliable, the examination of income may include direct testing of the taxpayer's books and records. Some examples of audit procedures using books and records are:
 - a. Tracing specific items to receipts;
 - b. Testing sample receipts to books and records;
 - c. Applying taxpayer's mark-up to expenditures per records;
 - d. Testing sample client accounts to receipts; and

- e. Analyzing adjusting journal entries and differences between books and the tax return.

- (2) See IRM 4.10.4, Examination of Income, for additional guidance.

4.10.3.6.6.2
(03-01-2003)
Unreliable Books and Records

- (1) If it is determined that the taxpayer's books are not reliable, the examination of income should include indirect analyses. See IRM 4.10.4.6, Formal Indirect Methods of Determining Income, for audit techniques for determining income using Indirect Methods.

4.10.3.7
(05-03-2023)
Examination of the Taxpayer's Books and Records

- (1) The examination of the taxpayer's books and records serves two basic purposes:
 - a. To analyze the likelihood that there are no material errors; and
 - b. To determine that individual transactions are valid (allowable), have not been omitted, are recorded at the correct dollar value, are properly classified, and are recorded in the correct time period.

- (2) This section includes basics steps for analyzing and testing the taxpayer's books and records.

Note: If original records are taken from the taxpayer, preparer, promoter or third party, Form 2725-A, Document Receipt/History and Custody of Documents, must be completed, signed and issued when the records are received. When the records are returned, both the person returning the documents and the person receiving the returned documents must sign Form 2725-A.

4.10.3.7.1
(02-26-2016)
Step 1: Determination of Available Books and Records

- (1) The first step is to determine what books and records are available for examination.
- (2) If applicable, read the audited and certified financial statements, including the notes, for unusual comments and potential audit issues.
- (3) Taxpayers may present receipts and cancelled checks as verification for items on the return. A business may use a single-entry system with daily, weekly, or monthly entries and total, or a double-entry system. The routine bookkeeping may be accomplished through computerized or manual means.
- (4) If the taxpayer is under a record retention agreement with the IRS, they must maintain magnetic tapes, disks, or other machine sensible data or media used for recording, consolidating, and summarizing accounting transactions and records within the taxpayer's processing system. See Rev. Proc. 98-25, 1998-1 C.B. 689, for further information on Record Retention Agreements.

4.10.3.7.2
(03-01-2003)
Step 2: Taxpayer Explanation of Books and Records

- (1) The second step is to have the taxpayer explain the books and records. The accounting and recordkeeping system should be explained by the person most knowledgeable of the system. The appropriate person may be the taxpayer, an employee of the taxpayer, or the taxpayer's representative. The key is that the person must have knowledge of the taxpayer's accounting system.
- (2) The taxpayer's explanation of the books and records should include:
 - a. Explaining the flow of transactions or entries from the initial transaction, through all book entries and reconciliations to the tax return.

- b. Tracing specific income, expense, and, if applicable, balance sheet items through the accounting system (an accounting system includes all books of entry and all reconciliations).
- c. If applicable, tracing the flow of purchases and inventory through to Cost of Goods Sold.

Note: These steps will also be used to evaluate the taxpayer's internal controls as described above.

4.10.3.7.3

(05-03-2023)

Step 3: Determination of Accounting Period

- (1) The third step is to determine the taxpayer's accounting period. "Annual Accounting Period" means the annual period regularly used by the taxpayer to compute income and maintain books and records. (See IRC 441(c)), Annual accounting period.
- (2) The term "taxable year" means:
 - a. The taxpayer's annual accounting period, if it is a calendar year or a fiscal year; or
 - b. The period for which the return is made, if a return is made for a period of less than 12 months.
 - c. See IRC 441(b), Taxable year, for other taxable years.
- (3) A tax year is adopted when a tax return for the taxpayer is filed by the due date of the taxpayer's first taxable year. Examples:
 - a. A new corporate taxpayer, with a fiscal year ending August 30, has until November 15 of that same year to file its first tax return, to adopt this taxable year.
 - b. A new individual taxpayer, with a calendar year, has until April 15 of the subsequent year to file his/her first tax return, to adopt this taxable year.
 - c. A new corporate taxpayer, with a calendar year, has until March 15 of the subsequent year to file its first tax return, to adopt this taxable year.
- (4) Allowable annual accounting periods include:
 - a. Calendar year, ending December 31 — A calendar year is required if the taxpayer does not keep books, does not have an annual accounting period, or has an annual accounting period that does not qualify as a fiscal year.
 - b. Fiscal year, ending on the last day of a month other than December.

Note: If the taxpayer intends to choose a fiscal year, adequate books of account **must** be established before the end of the first annual accounting period.
 - c. 52–53 week period.
- (5) A short tax year is one of less than 12 months. The following two situations can result in a short tax year:
 - a. When a taxable entity is not in existence for an entire tax year. Income, expenses, and tax are computed solely for the period of time the entity is in existence.
 - b. When an existing taxable entity changes or is required to change its annual accounting period. In this case, income, expenses, and tax must be annualized.

Example: A corporation files a tax return because of a change in accounting period for the 6-month short tax period ending June 30. The corporation has taxable income of \$40,000 during the short tax year. Its annualized income is \$80,000 ($\$40,000 \times \frac{12}{6}$). Its total tax (as annualized) is \$15,450. The tax for the short year is \$7,725 ($\$15,450 \times \frac{6}{12}$).

- (6) Generally, partnerships, S corporations, and personal service corporations must use a calendar year unless:
 - a. A business purpose is established for another tax year, or
 - b. An IRC 444 election is made.
- (7) In general, the taxpayer must obtain the consent of the Commissioner to change the annual accounting period. (See 26 CFR 1.442-1(a)). The guidelines for obtaining this consent are contained in Rev. Proc. 2002-39, Rev. Proc. 2003-62, Rev. Proc. 2006-45, Rev. Proc. 2006-46, Rev. Proc. 2007-64 and Rev. Proc. 2018-17. Please note that each of these Revenue Procedures have been clarified and/or modified on numerous occasions and an electronic research request (e.g., Westlaw) should be made to identify current guidance.
- (8) 26 CFR 1.442-1(c), Special rule for change of annual accounting period by subsidiary corporation, provides a special rule for qualifying subsidiary corporations to change their annual accounting period without the prior approval of the Commissioner.

4.10.3.7.4 (05-03-2023)

Step 4: Determination of the Taxpayer's Method of Accounting

- (1) The fourth step is determining the taxpayer's method of accounting. An accounting method is a system for stating income, expenses, assets, liabilities, and financial position. Taxable income must be computed not only based on a fixed accounting period, but also in accordance with a method of accounting regularly employed in keeping the taxpayer's books.
- (2) An accounting method is selected when the first tax return is filed.
- (3) IRC 446(c), Permissible methods, states a taxpayer may compute taxable income under any of the following methods of accounting:
 - a. The cash receipts and disbursements method;
 - b. An accrual method;
 - c. Any other method permitted by this section, or any combination of the foregoing methods permitted under regulations prescribed by the Secretary (hybrid methods).
- (4) There are specific methods of accounting for income and expense items, which include, but are not limited to:
 - a. Depreciation (IRC 167, Depreciation, and IRC 168, Accelerated cost recovery system).
 - b. Amortization (IRC 169, Amortization of pollution control facilities, IRC 178, Amortization of cost of acquiring a lease, IRC 194, Treatment of reforestation expenditures, and IRC 197, Amortization of goodwill and certain other intangibles).
 - c. Depletion (IRC 611, Allowance of deduction for depletion, IRC 612, Basis for cost depletion, IRC 613, Percentage depletion, and IRC 613A, Limitations on percentage depletion in case of oil and gas wells).

- d. Deduction for Bad Debts (IRC 166, Bad debts, and IRC 582, Bad debts, losses, and gains with respect to securities held by financial institutions).
 - e. Installment Sales (IRC 453, Installment method, and IRC 453B, Gain or loss on disposition of installment obligations).
 - f. Long Term Contracts (IRC 460, Special rules for long-term contracts).
- (5) A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.
- (6) A reasonable (hybrid) method may be used, subject to the following restrictions:
- a. If inventories are present, the accrual method must be used for purchases and sales.
 - b. If the cash method is used to compute income, the cash method must be used to compute expenses.
 - c. If the accrual method is used for reporting expenses, the entire accounting method must be accrual.
- (7) If the taxpayer selects an erroneous accounting method when the first return is filed, it can be corrected by filing an amended return before the filing of the next year's return. All other accounting method changes can only be done with the permission of the Commissioner. See paragraph (9) below.
- (8) The IRS can prescribe a method of accounting that will “**clearly reflect income**” if, in the IRS’ opinion, the taxpayer’s method does not clearly reflect income. See IRM 4.11.6.2(2) through (4), General Principles for Changes in Accounting Methods. The Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer once the Commissioner has determined that the taxpayer’s method of accounting does not clearly reflect income. See Rev. Proc. 2002-18
- (9) Taxpayers may obtain the consent of the Commissioner to voluntarily change their method of accounting. In addition, an examiner may require a taxpayer to change from an improper method of accounting to a proper one. The IRS has issued a series of revenue procedures to provide guidance and procedures for changes in method of accounting, whether voluntary or involuntary. Examiners must ensure that they are familiar with the applicable guidance in effect for the tax year under examination. See *Methods of Accounting and Timing Practice Network* for additional guidance.
- (10) For additional details concerning change in accounting method, please refer to IRM 4.10.13.7, Change in Accounting Method. Additionally, examiners are encouraged to consult with the *Change in Accounting Method (CAM) Technical Advisor* for additional assistance. For additional information regarding changes in accounting methods refer to IRM 4.11.6, Examining Officers Guide (EOG), Changes in Accounting Methods, and *Corporate/Business Issues & Credits Knowledge Base*.

4.10.3.7.5
(03-01-2003)

**Step 5: Determination of
Depth of Examination of
Taxpayer's Books and
Records**

- (1) The fifth step is determining the depth of the examination of the taxpayer's books and records.
- (2) Factors that should be considered when determining the depth include:
 - a. **Type of Records** — taxpayers use a variety of bookkeeping methods and maintain different types of records.
 - b. **Volume of Records** — voluminous records may be encountered when auditing larger taxpayers or when the taxpayer's records are unorganized.

Note: When a taxpayer submits unorganized records, the burden is on the taxpayer to organize them and prepare summaries and reconciliations. This can be done with or without the examiner's presence.
- (3) The depth of the examination of the taxpayer's books and records should be established after:
 - a. Interviewing the taxpayer;
 - b. Touring the business site (if applicable); and
 - c. Evaluating the taxpayer's internal controls.
- (4) The depth may be expanded or contracted as the examination progresses, if warranted.
- (5) The depth of the examination of the taxpayer's books and records can be limited to the verification of specific items. This is appropriate for Office Audit examinations of wage earners and small Schedule C's (where gross receipts have not been classified as an audit issue).
- (6) The depth of the examination of the taxpayer's books and records should include sampling techniques when there are voluminous records. This is an effective use of time in situations when it is impossible to review all records.
- (7) Mechanical verification of particular accounts or journals should be kept to a minimum. If the degree of error is substantial, the taxpayer should be asked to make suitable verification and correction before the examination proceeds. Mechanical verification of the taxpayer's books and records should be more extensive when indications of fraud are present.
- (8) Taxpayers are required by law to maintain accounting records in sufficient detail to enable the preparation of an accurate tax return (See IRC 6001). The appearance of the records is not important if the accuracy and orderliness are not affected.
- (9) If the taxpayer's records are lost, destroyed, or are not available due to circumstances beyond the taxpayer's control, examiners may allow the taxpayer to present reconstructed records. The reconstructed records should be reviewed to determine the amounts are ordinary and necessary to the business activity.
- (10) When records are incomplete, nonexistent, or suspect, the examiner should document Form 9984, Examining Officer's Activity Record, with all attempts to obtain the taxpayer's records and the group manager should be informed so delays can be kept to a minimum.

4.10.3.7.6

(05-03-2023)

Step 6: Reconciling the Taxpayer's Books and Records to the Tax Return

- (1) The sixth step is reconciling the taxpayer's books and records to the tax return. The reconciliation traces the process the taxpayer used to prepare the return from the books and records.
- (2) The records used for this reconciliation are:
 - a. Taxpayer and/or accountant summaries, reconciliations, and account grouping papers — These will show the grouping of book accounts to the respective line items on the tax return.
 - b. Profit and loss statement — The profit and loss statement is a financial report of an entity's revenues and expenses for the accounting period. The report summarizes the net income or net loss for the period. The report is sometimes referred to as a "P&L", income statement, or statement of operations.
 - c. Compilations, audited and certified financial statements.
 - d. Trial balance sheets — The trial balance is the listing of all accounts in the general ledger and their balances. A trial balance may be prepared at any time.
 - e. Adjusted trial balance — A trial balance taken immediately after all year-end adjusting entries have been posted is called an adjusted trial balance. The adjusted trial balance is used to prepare financial statements. The balance taken immediately after closing entries have been posted is called a post-closing trial balance. Schedule M adjustments are calculated next, and then the tax return is prepared.
 - f. Adjusting journal entries — Normally a taxpayer will need to correct, adjust or reclassify some original book entries by making adjusting journal entries. The adjusting journal entries are often recommended by persons conducting the year-end audit for financial reporting purposes.
 - g. Tax reconciliation workpapers — The trial balances and adjusting (and consolidating, if applicable) entries are usually included in what the taxpayer may call the "tax reconciliation workpapers" or "grouping papers". The tax reconciliation workpapers are requested at the beginning of an examination. These workpapers include the final balance which ties the tax return to the general ledger and other analyses necessary to complete the return. See IRM 4.10.20.2, Service Policy for Requesting Tax Reconciliation Workpapers, for additional information.
 - h. Audit or tax accrual workpapers — In unusual circumstances, the IRS may request audit or tax accrual workpapers but only when such factual data cannot be obtained from the taxpayer's records or from available third parties. See IRM 4.10.20.3.1, Unusual Circumstances Standard, and IRM 4.10.20.3.2, Requests for Tax Accrual Workpapers Involving Listed Transactions, and IRM 4.10.20.4, Procedure for Requesting Audit and/or Tax Accrual Workpapers, for additional information.
- (3) The following audit techniques should be used to reconcile the taxpayer's books and records to the tax return:
 - a. Reconcile the profit or loss shown on the return to the taxpayer's books.
 - b. Compare prior and subsequent years P&L statements. Identify significant changes and adjust the scope/depth of the examination as needed.
 - c. Review the adjusted trial balance, including the adjusting entries and explanations.
 - d. Compare the current year's trial balance to the prior and subsequent year's balance. Note significant variations for further inquiry.

- e. Review the adjusting journal entries. Analyze the adjusting journal entries to verify the corrections or reclassifications are proper. Confirm the taxpayer's explanations depict the true effect of the adjustments.

4.10.3.8
(02-26-2016)
**Analyzing Schedules
M-1, M-2 and M-3**

- (1) The following section outlines procedures for analyzing Schedule M-1, Schedule M-2, and Schedule M-3.
- (2) Effective for tax years ending on or after December 31, 2004, the IRS replaced Schedule M-1 with Schedule M-3 for corporations (or LLCs filing as a corporation) with assets of \$10 million or more. Corporations with assets of less than \$10 million continue to use Schedule M-1.
- (3) Beginning with tax year 2006 returns, partnerships (or LLCs filing as a partnership) with assets of \$10 million or more must generally file Schedule M-3 in lieu of Schedule M-1. See IRM 21.7.4.4.2.13, Schedule M-3 (Form 1065), Net Income (Loss) Reconciliation for Certain Partnerships, for additional guidance.
- (4) Effective for tax years ending December 31, 2014 and later, corporations and partnerships with at least \$10 million but less than \$50 million in total assets at tax year end will be permitted to file Schedule M-1 in place of Schedule M-3, parts II and III. Schedule M-3, part I will continue to be required of all corporations and partnerships with total assets of \$10 million or more. See *Schedule M-3 for Large Business & International (LB&I)* for additional guidance.

4.10.3.8.1
(02-26-2016)
Schedule M-1

- (1) Schedule M-1 is a critical schedule for identifying potential tax issues resulting from both temporary and permanent differences between financial and tax accounting.
- (2) For a C corporation, Schedule M-1 is the reconciliation between net income per the books and taxable income before the net operating loss deduction, dividends received, and the special deductions per Schedule C.
- (3) For S corporations and partnerships, Schedule M-1 is the reconciliation of net income per the books to the net income per Schedule K after taking into consideration all the separately stated income and expense items.
- (4) Since the Schedule M-1 for C corporations is slightly different than the Schedules M-1 for S corporations and partnerships, the audit techniques vary slightly as addressed in the following subsections.

4.10.3.8.1.1
(05-03-2023)
**Schedule M-1: Audit
Techniques for C
Corporations**

- (1) Verify that net income per the books agrees with net income per Schedule M-1, line 1. If not, obtain the taxpayer's reconciliation of net income per the books, to net income per Schedule M-1, line 1.
- (2) Obtain the workpapers showing how all Schedule M-1 adjustments were calculated. Verify that large Schedule M-1 adjustments going in opposite directions (i.e., one increasing taxable income and the other decreasing taxable income), were not netted to arrive at what appears to be an immaterial amount not worthy of further review.
- (3) Reconcile the federal income tax on line 2 of the Schedule M-1 to the amount reported on the books (including both current year and deferred amounts), and investigate any differences.
- (4) Review legal authority supporting book versus tax difference.

- (5) Compare current year M–1 adjustments to prior and subsequent years' Schedule M–1 adjustments:
- If a prior year's Schedule M–1 adjustment is not made in the current year, determine the reason why.
 - If a new Schedule M–1 adjustment is made in a subsequent year, determine if a similar Schedule M–1 adjustment should have been made in the year under examination.
 - For book versus tax temporary timing differences, verify that the applicable Schedule M–1 adjustments were made on the prior and subsequent year returns.

Example: During 2019, the taxpayer received \$30,000 for a three year agreement to buy a specific amount of raw materials from a supplier. For book purposes this \$30,000 will be amortized into income at \$10,000 per year over the three year term of the agreement. For tax purposes, the \$30,000 will be recognized as income when received in 2019. The 2020 tax return is under audit. Review the 2019 return and verify the Schedule M–1 adjustment (income on return and not books of \$20,000) was made. The following Schedule M–1 adjustments should have been made:

M-1 Adjustment	Amount
2019 M–1: Income subject to tax not recorded on books this year	\$30,000 — \$10,000 = \$20,000
2020 M–1: Income recorded on books this year not included on this return	(\$10,000)
2021 M–1: Income recorded on books this year not included on this return	(\$10,000)

- (6) Generally, for most reserves, a schedule should be prepared showing the beginning and ending balances. If the reserve increases during the year, a Schedule M–1 adjustment should have been made to increase taxable income. If the reserve decreases, taxable income would be decreased through a Schedule M–1 adjustment.

4.10.3.8.1.2
(02-26-2016)
**Schedule M–1: Audit
Techniques for S
Corporations**

- (1) Complete all steps identified in IRM 4.10.3.8.1.1, Schedule M–1: Audit Techniques for C Corporations, except the reconciliation of federal income tax shown in paragraph (3).

4.10.3.8.1.3
(02-26-2016)
**Schedule M–1: Audit
Techniques for
Partnerships**

- (1) Complete all steps identified in IRM 4.10.3.8.1.1, Schedule M–1: Audit Techniques for C Corporations, except the reconciliation of federal income tax shown in paragraph (3).
- (2) Reconcile guaranteed payments listed on Schedule M–1 to the amount of guaranteed payments reported on Schedule K and to the sum of the amounts reported on the partners' Schedules K–1.

4.10.3.8.2
(05-03-2023)
Schedule M–2

- (1) Form 1120, Schedule M–2, Analysis of Unappropriated Retained Earnings per Books, reflects changes in the retained earnings account per books during the year.
- (2) Form 1120S, Schedule M–2, Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account, reflects the following:
 - a. **Accumulated Adjustments Account** – Reflects the accumulated undistributed net income of the corporation for the corporation's post-1982 S corporation years. S corporations with accumulated earnings and profits must maintain the AAA to determine the tax effect of distributions made in each year.
 - b. **Shareholders' Undistributed Taxable Income Previously Taxed** – Reflects pre-1983 income that has been taxed on the shareholder's return, but has not been distributed to the shareholder. The PTI is decreased by the S corporation losses accumulated prior to 1983.
 - c. **Accumulated Earnings and Profit** – Reflects the earning and profits from when the entity was a C corporation or the earnings and profits from an acquired C corporation.
 - d. **Other Adjustments Account** – Reflects S corporation tax exempt income and/or expenses related to tax exempt income.
- (3) Form 1065, Schedule M–2, Analysis of Partners' Capital Accounts, reflects changes to the partners' capital accounts during the year.

4.10.3.8.2.1
(05-03-2023)
**Schedule M–2: Audit
Techniques for C
Corporations**

- (1) Analyze all changes in the retained earnings account per books during a given accounting period.
- (2) Reconcile income per books with income per return. (Schedule M–2, line 2 equals Schedule M–1, line 1 or Schedule M–3, line 11.)
- (3) Reconcile opening balance with prior year's ending balance.
- (4) Determine that income items recorded as credits have been properly included in income.
- (5) Verify that no deduction has been claimed for expenses related to stock dividends. (Schedule M–2, line 5b and line 6.)
- (6) Consider imposition of IRC 531 tax.
- (7) Reconcile ending balance to book balance.
- (8) See *Example - Reconciliation of Income and Analysis of Unappropriated Retained Earnings* for an example.

4.10.3.8.2.2
(02-26-2016)
**Schedule M–2: Audit
Techniques for S
Corporations**

- (1) The Schedule M–2 on a C corporation return is the reconciliation of the retained earnings account while the Schedule M–2 on an S corporation return is the analysis of the Accumulated Adjustments Account (AAA), Other Adjustments Account (OAA) and Shareholder's Undistributed Taxable Income Previously Taxed (PTI). The OAA will only be used if the S corporation has tax exempt income and/or expenses related to tax exempt income. The PTI account will only be used if the S corporation was in existence prior to 1983

and has income that has been taxed on the shareholder's return, but has not been distributed to the shareholder or S corporation losses accumulated prior to 1983.

- (2) The purpose of the Schedule M-2 is to track the income, losses and separately stated items that should have been reported on the shareholder's tax returns.
- (3) The examiner should remember that the retained earnings account on the S corporation balance sheet is a book number and more than likely will not tie to the amounts in the AAA, OAA and PTI, which are tax numbers. The main difference will be timing differences between book and tax. For example, if the book depreciation is less than the tax depreciation, the retained earnings account on the balance sheet will be larger than the AAA balance. See IRM 4.10.3.10.4.23, Retained Earnings for S Corporations, for the reconciliation of S corporation retained earnings.

4.10.3.8.2.3
(02-26-2016)
**Schedule M-2: Audit
Techniques for
Partnerships**

- (1) Schedule M-2, Analysis of Partner's Capital Accounts, identifies the causes of any changes in the partner's capital accounts during the tax year. The amounts shown should agree with the partnership's books and records.
- (2) Reconcile income per books with income per return. (Income per books should equal Schedule M-1, line 1 and Schedule M-2, line 3.)
- (3) Reconcile opening balance with prior year's ending balance.
- (4) Reconcile capital contributed and distributions to the partners' Schedules K-1 and/or Schedule K.
- (5) Reconcile "other increases" and "other decreases" to the books and records.
- (6) Reconcile ending balance to book balance.

4.10.3.8.3
(05-03-2023)
Schedule M-3

- (1) The purpose of the Schedule M-3 is to provide increased transparency and disclosure of the differences between financial statement income and tax return income. The information required on Schedule M-3 will vary, based on the return type (e.g., Form 1120, Form 1120-S, Form 1065). The information required on Schedule M-3 provides examiners with data needed to perform more efficient risk analysis and improved audit selection capability. See IRM 4.46.3.3.5.3, Analyzing Schedules M-2 and M-3, for additional guidance.

4.10.3.9
(03-01-2003)
**Bank Record
Reconciliations**

- (1) Bank records are third-party source documents which support the taxpayer's records. They provide an audit trail for transactions not disclosed in the taxpayer's books and records.
- (2) An examination of the bank records is necessary to determine:
 - a. Whether bank account transactions are being properly recorded;
 - b. Whether amounts deposited from all taxable sources have been reported; and
 - c. Whether any improper entries were recorded in the books and records during the year.
- (3) The depth of the bank account analysis depends on the circumstances of each examination. The analysis is more important in an examination where the

records are inadequate, nonexistent or possibly falsified. See IRM 4.10.4, Examination of Income, for additional guidance.

4.10.3.9.1
(03-01-2003)

**Step 1: Review of
Taxpayer's Bank
Account Reconciliation**

- (1) Review the year-end bank account reconciliations prepared by the taxpayer to determine how much audit work is required.
- (2) If the bank accounts reconcile back to the books, then all transactions are probably recorded somewhere in the records. The transactions should be tested for proper recordation.
- (3) If reconciliations do not exist or the bank accounts do not reconcile to the books, additional audit procedures are necessary.
- (4) Reviewing the bank reconciliations involves the following steps:
 - a. Trace the ending balance to the general ledger.
 - b. Review any outstanding checks and investigate their status.
 - c. Review outstanding deposits and determine if all are included in the reconciliation.
 - d. Trace total deposits and disbursements per the reconciliation to the general ledger account entries.

4.10.3.9.2
(03-01-2003)

**Step 2: Review of
Monthly Bank
Statements**

- (1) Review the monthly bank statements to:
 - a. Gain an understanding of the frequency and typical amounts of deposits.
 - b. Determine the average amount and volume of checks written.
 - c. Establish the interaction between accounts.
 - d. Compare the total deposits to the gross income of the taxpayer by considering non-taxable deposit sources such as loans, checks to cash, transfers between accounts, gifts and inheritances, and insurance proceeds and by identifying large, unusual, questionable (LUQ) deposits and withdrawals which warrant further audit action. Keep in mind that this is not a bank deposit indirect method of determining income, which is only appropriate for cash method taxpayers or taxpayers who have inadequate books and records.
 - e. Trace these LUQ items through the ledger to determine their source and book treatment.
 - f. Interview the appropriate person to determine the treatment of LUQ items.

4.10.3.9.3
(03-01-2003)

**Step 3: Bank Deposit
Analysis**

- (1) The purpose of the bank deposit analysis is to determine the source of the deposits. An analysis is time consuming, and in many instances, inappropriate, as in the case of a large corporation with a double entry accounting system. Therefore, the examiner must use judgment as to the extent and degree of this analysis.
- (2) For testing the reporting of income, trace specific items of income from the source document through to the general ledger to determine whether all income transactions are reported properly and to detect unreported or improperly recorded items. A review of two or three months' transactions postings should be sufficient.
- (3) LUQ deposits deserve attention. Information from the initial interview should help determine what is LUQ.

- (4) Some examples of LUQ deposits include:
 - a. A large deposit when the normal is small;
 - b. Even dollar amounts when most are not even;
 - c. Cash deposit(s) by a non-cash business;
 - d. Regular monthly deposits from unidentified source(s) (possible sources include unreported rental or installment sale income, and repayment of loans without reporting appropriate interest income); and
 - e. Any other deviations from a regular deposit pattern.

4.10.3.9.4
(05-03-2023)

Step 4: Reconciliation of Bank Deposits to Gross Receipts

- (1) A useful audit procedure for small to medium-size taxpayers who deposit the majority of their gross receipts into a bank account is the reconciliation of bank deposits to gross receipts reported on the tax return.
- (2) Non-taxable sources of income are critical to this computation and should be identified first.
- (3) If the deposit analysis shows no material discrepancy between deposits and gross receipts, then a testing of income transactions may be all that is needed to determine whether all receipts were deposited.
- (4) If the deposit analysis shows a discrepancy between deposits and gross receipts, the audit steps are expanded to determine the cause of the discrepancy. See IRM 4.10.4.4.1, Material Understatements and Managerial Involvement, and IRM 4.10.4.5, In-Depth Examinations of Income, for additional guidance.
- (5) See *Example - Reconciling Taxable Bank Deposits* for an example.

4.10.3.9.5
(05-03-2023)

Step 5: Check and Electronic Funds Transfer Analysis

- (1) A check and EFT analysis is conducted as a:
 - a. Means of verifying the expenses and deductions claimed on the return.
 - b. Source of information to determine the total disbursements, including nondeductible expenditures.
- (2) A detailed analysis is time consuming and only necessary when there are inadequate records or when a potential for unreported income is present.
- (3) If a review of disbursements is necessary, a quick scan of the cash disbursements journal can be made. Look for LUQ items and follow up as necessary.
- (4) Checks and EFTs should be analyzed to identify:
 - a. Possible undisclosed income;
 - b. Possible investments;
 - c. Possible expenditures; and
 - d. Check endorsements.
- (5) When there are inadequate records or when the possibility of unreported income is present, an indirect method of determining income is indicated. IRM 4.10.4.6, Formal Indirect Methods of Determining Income, contains guidelines and computational instructions for indirect methods.

4.10.3.10
(05-03-2023)

**Balance Sheet Analysis:
Introduction**

- (1) The preliminary analysis of corporation and partnership returns should also include consideration of the balance sheet.
- (2) The balance sheet analysis is a useful technique to review the taxpayer's financial position and identify adjustments to the profit and loss accounts.

Reminder: Balance sheet analysis is part of the minimum income probes. See IRM 4.10.4.3.4.1, Balance Sheet Analysis (Corporations and Other Business Returns), for additional guidance.

4.10.3.10.1
(03-01-2003)

**Balance Sheet
Definitions**

- (1) A balance sheet, or statement of financial position, presents the financial position of a business entity on a specific date. The balance sheet provides a summary of the following elements:
 - a. **Assets** — the financial resources the entity owns, future benefits obtained or controlled by the entity as result of past transactions or events.
 - b. **Liabilities** — the debts the entity owes, the sacrifice of economic benefit, obligations to transfer assets or provide services to other entities.
 - c. **Equity** — the remaining interest in the assets of the entity after deducting its liabilities. The equity represents the ownership interest.
- (2) A balance sheet is a detailed expression of the equation:
Assets = Liabilities + Equity
- (3) Exhibit 4.10.3-2, Double Entry Accounting Recording Procedures, demonstrates how transactions are posted to balance sheet and income statement accounts.

4.10.3.10.2
(02-26-2016)

**Step 1: Determine
Balance Sheet Basis**

- (1) The first step when analyzing a balance sheet is to determine whether the taxpayer's balance sheet is tax or book based.

Note: It is common for partnerships to book assets at fair market value (FMV) to coincide with the partnership allocation rules. In these situations, the examiner should solicit a tax basis balance sheet from the taxpayer, if available.
- (2) If the balance sheet is tax based, account balances are calculated based on the tax treatment of various income and expense items, as opposed to the book treatment of these items.
- (3) In most instances where the balance sheet is tax based, the net income per the books will not agree to Schedule M-1, line 1 or M-3, line 11, per the tax return. This means that all Schedule M-1 or M-3 adjustments have not been disclosed. For example, balances on the tax return balance sheet do not agree to balances per books. Small differences may be the result of different account groupings for book and tax purposes.
- (4) Use the following audit steps if the balance sheet is tax based:
 - a. Verify net income per books agrees to net income per Schedule M-1, line 1, or M-3, line 11. If it does not reconcile, obtain a schedule from the taxpayer reconciling the net income per the books to net income per Schedule M-1, line 1, or M-3, line 11.

- b. Verify total assets and retained earnings per tax return balance sheet agrees to total assets and retained earnings per books. Any differences should be analyzed.
- c. Determine if the taxpayer's accounting method clearly reflects income pursuant to IRC 446(c), Permissible methods.

4.10.3.10.3
(03-01-2003)
**Step 2: Identify
Accounts for In-Depth
Analysis**

- (1) The second step when analyzing a balance sheet is to identify accounts for in-depth analysis. See IRM 4.10.2.3.1, Large Unusual or Questionable (LUQ) Items Defined.
- (2) The analysis will include review of the books and records and consideration of:
 - a. Accounts with unusual titles;
 - b. Unusual entries within accounts;
 - c. Accounts with large numbers of adjusting journal entries; and
 - d. Accounts with large dollar amount entries in one month versus other months.

4.10.3.10.4
(03-01-2003)
**Step 3: In-Depth
Analysis**

- (1) The third step of a balance sheet analysis is the in-depth analysis of the balance sheet accounts selected in Step 2.
- (2) The following subsections present specific techniques for analyzing individual balance sheet items. See Exhibit 4.10.3-3, Balance Sheet Examination Techniques, for additional information.

4.10.3.10.4.1
(03-01-2003)
Cash on Hand in Bank

- (1) Verify the book year-end balance reconciles to the bank statement year-end balances. Review reconciling items for propriety and test transactions as appropriate.
- (2) Review cash disbursements journal for a representative period. Note any missing check numbers, checks drawn to the order of cash, bearer, etc.; large or unusual items; and determine propriety thereof, through a comparison with vouchers, journal entries, etc.
 - a. In the case of a cash basis taxpayer, ascertain if checks were written and recorded which were issued after the close of the year under examination.
 - b. Consider checks issued for cashier's checks, checks payable to cash, etc., where the payee and nature are not clearly shown.
- (3) Obtain bank statements and cancelled checks for each bank account for one or more months, including the last month of the period under examination.
 - a. Compare deposits shown by the bank statement against entries in the cash book.
 - b. Note year-end bank overdrafts in the case of a cash basis taxpayer. This may indicate expenses which are unallowable since funds were not available for payment.
 - c. Determine if any checks have remained outstanding for an unreasonable time. This may indicate improper or duplication of disbursements. Old outstanding checks possibly could be restored to income.
 - d. Determine whether voided checks have been properly handled.
 - e. For a period, test sample check endorsements to see if they are the same as payee, noting any endorsements by owner, or questionable endorsements.

- (4) Review cash receipts journal for items not associated with ordinary business sales, such as sales of assets, prepaid income, income received under claim of right, etc.
- (5) Investigate entries in the general ledger cash account. Look for unusual items which do not originate from the cash receipts or disbursements journals. These entries may indicate unauthorized withdrawals or expenditures, sales of capital assets, omitted sales, undisclosed bank accounts, etc.
- (6) Test check some cash sales with the cash receipts journal to ascertain if they have been correctly recorded. Also, check cash sales made at the beginning and end of the period under examination to determine if year-end sales have been recorded in the proper accounting period.
- (7) Test check disbursements from petty cash to determine if there are any unallowable items included.
- (8) Scrutinize cash overages and shortages, being alert to irregularities which may have cleared through accounts.
- (9) Review the cash on hand account to determine if there are any credit balances during the period under examination. This may indicate unrecorded receipts.

4.10.3.10.4.2

(05-03-2023)

**Notes and Accounts
Receivable**

- (1) Check entries in the general ledger control accounts. Look for unusual items, especially those which do not originate from the sales or cash receipts journals.
- (2) Obtain a detailed schedule of the notes and accounts receivable at year-end showing the customer's name, invoices outstanding, and the balance due. Determine if the documentation agrees with the ending balance per books. Investigate any identified differences.
 - a. Review detailed schedules of receivables for credit balances. This may indicate deposits, advance payments or overpayments which could be additional income or unrecorded sales.
 - b. Review detailed schedules for related party loans. Verify whether stated interest on the loan is adequate per IRC 7872, Treatment of loans with below-market interest rates, and if not, whether the related parties are accounting for the imputed interest correctly. Determine if the loan is subject to the original issue discount (OID) provisions of IRC 1273, Determination of amount of original issue discount, and if so, whether the lender is including the OID in income as it accrues pursuant to IRC 1272, Current inclusion in income of original issue discount, even if the lender uses the cash method.
- (3) Trace selected credit sales from the original invoices and postings through posting in the sales and accounts receivable journals.
- (4) Determine whether accrued income on interest bearing notes or accounts has been included in income. Determine if the note or receivable is subject to the OID provisions of IRC 1273, and if so, whether the taxpayer is including the OID in income as it accrues pursuant to IRC 1272 (even if the taxpayer uses the cash method).
- (5) Where the taxpayer reflects an accrual method by subtracting beginning receivables and adding ending receivables to cash collected, consider checking

the detailed listing of receivables at the beginning of the period to the cash receipts journal. This may disclose diverting of funds, etc. Determine if beginning receivables used in the computation are the same as the ending receivables of the preceding year.

4.10.3.10.4.3
(05-03-2023)
Inventories

- (1) Obtain year-end physical inventory sheets and review for the following:
 - a. Verify, on a test basis, that all quantities and costs have been accurately extended.
 - b. Reconcile total inventory per physical inventory sheets to amounts per books. Investigate any differences.
 - c. Review for items on hand with a cost of \$0.
 - d. On a test basis, compare costs per physical inventory sheets to cost per purchase invoice, job cost reports, etc.
- (2) Compare inventory balances on the return under examination, with the balances on the prior and subsequent years' returns, and verify these with the taxpayer's records.
- (3) Check the gross profit percentages for variations and investigate any significant differences.
- (4) Determine that all direct, indirect and overhead burdens are properly accounted for. Analyze unusual entries to cost of sales for labor, materials and burden costs, not directly related to sales or transfers of finished goods.
- (5) Review the taxpayer's method of inventory valuation for consistency and compliance with the applicable code and regulation sections; such as IRC 471, General rule for inventories, and IRC 472, Last-in, first-out inventories. See also 26 CFR 1.471-11, Inventories of manufacturers, for taxpayers engaged in manufacturing and production activities.
- (6) Review the general ledger for inventory write downs, reserves for obsolescence or other decreases to inventory and test for propriety. See Rev. Rul. 80-60, Accounting Methods; Change; Inventory Write-Down, and IRM 4.11.6, Changes in Accounting Methods, for additional guidance.
- (7) Verify year end purchases were included in the ending inventory.
- (8) Verify direct costs have been allocated to ending inventory (i.e., freight in, duty taxes, packaging materials, etc.).
- (9) Determine if taxpayer is subject to IRC 263A, Capitalization and inclusion in inventory costs of certain expenses. Generally, IRC 263A applies to real or tangible personal property produced by the taxpayer and real or tangible personal property which is acquired by the taxpayer for resale. Generally, taxpayers that have average annual gross receipts for the previous 3-taxable year period that do not exceed \$25 million (indexed for inflation) are not subject to IRC 263A for taxable years beginning after December 31, 2017. For a list of other exceptions, see 26 CFR 1.263A-1(b). If applicable, determine whether all applicable indirect costs have been properly allocated to all items of ending inventory (i.e., raw materials, work-in-process, and finished goods).
- (10) Determine the significance of any qualifying statements on financial reports prepared by independent accounting firms.
- (11) For taxpayers using the LIFO method of inventory valuation:

- a. Verify that the taxpayer made a proper LIFO election (Form 970, Application to Use LIFO Inventory Method) and that it has been consistently applied. Also verify there have been no unauthorized changes from the LIFO election.
- b. Verify LIFO index calculations are based on actual costs and that any writedowns to market value have been restored pursuant to 26 CFR 1.472-2(c), Requirements incident to adoption and use of LIFO inventory method.
- c. Verify LIFO inventory valuation method is used on all financial reports issued to shareholders, partners, creditors, etc.
- d. Verify reasonableness of the taxpayer's cumulative index by comparing the price increases per table 6 of the Producer Price Index published by the US Bureau of Labor Statistics. Investigate any material differences.
- e. Verify that the taxpayer has established an appropriate number of LIFO pools and that only substantially similar items are included in a particular pool.
- f. If the taxpayer is using sampling techniques to calculate a current year index, verify that no segment of the inventory has been excluded from the sample population and that the index sample is based on valid statistical sampling principles.
- g. Review ending inventory for "new items". Verify base year cost is the current year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the taxpayer establishes a cost different from the current year cost, review calculations and supporting documentation for propriety.

4.10.3.10.4.4
(03-01-2003)
Investments

- (1) Obtain a schedule of investments on hand at the beginning and end of the year. For investments acquired during the year, verify that the cost (including commissions and sales charges) has been accurately recorded in the general ledger.
- (2) Review debit entries. Consider such items as:
 - a. Nontaxable securities acquired with borrowed funds.
 - b. Other acquisitions (transactions with related taxpayers, noncash acquisitions, creation, organization or reorganization of a foreign corporation, etc.)
- (3) Analyze sales and other credit entries with regard to the following:
 - a. Gains or losses (basis, wash sales, interest included in sales price, etc.).
 - b. Other exchanges, write downs, write-offs, transactions with related taxpayers or controlled foreign entities, etc.
- (4) Analyze the nature of investments using any records maintained by the taxpayer. Determine that related income such as dividends and interest has been properly reported.
- (5) If stock is held in a foreign corporation, determine whether it is a foreign personal holding company.
- (6) If the taxpayer is a dealer in securities, verify that all securities have been marked to market pursuant to IRC 475, Mark to market accounting method for dealers in securities, (i.e., treated as sold for the FMV on the last day of the tax year and gain/loss recognized) . If the securities are either identified as "held for investment" or "not held for sale", they are not subject to the mark to

market rules. Generally, the identification must be made before the close of the day on which the securities were acquired, originated or entered into.

4.10.3.10.4.5
(05-03-2023)
Loans to Stockholders

- (1) Verify that the interest rate equals at least the minimum Applicable Federal Rate pursuant to IRC 7872, Treatment of loans with below-market interest rates. Determine if the loan is subject to the OID provisions of IRC 1273, and if so, whether the taxpayer is including the OID in income as it accrues pursuant to IRC 1272, even if the taxpayer uses the cash method.
- (2) Determine whether the amounts advanced to the stockholder are bona fide loans or distributions of earnings and profits, which are taxable as dividends. This determination is based on the actions and intent of the parties at the time of the withdrawal and no single test or set formula can give a definite answer. Some of the factors to be considered include the following:
 - a. Whether the amounts of the withdrawals are carried on the books as a loan receivable.
 - b. Whether the withdrawals were secured by collateral or accompanied by other indications of a bona fide loan, such as interest-bearing notes and the observance of other ordinary loan formalities.
 - c. Whether both the stockholder and the corporation treat the withdrawals as indebtedness.
 - d. Whether interest is paid by the stockholder or charged by the corporation.
 - e. Whether the corporation had sufficient surplus to cover the withdrawals when they were made.
 - f. Whether the stockholder had the ability and intended to make repayment with interest at the time of the withdrawal.
 - g. The presence or absence of a maturity date.
 - h. The corporation, though prosperous, has not distributed dividends.
- (3) If the amounts advanced to the stockholder are determined to be loans, a dividend can arise pursuant to IRC 7872 if the stockholder is not obligated to pay interest or pays a below-market interest rate on the loan.

4.10.3.10.4.6
(03-01-2003)
Depreciable Assets

- (1) Determine whether assets shown on the depreciation schedule, which have a prior year acquisition date, are the same as shown on the tax return for the immediately preceding period. If not, this would indicate depreciation being claimed for assets which have previously been expensed or fully depreciated.
- (2) Review purchases of assets made during the tax year under audit. Review the transactions and associated documentation, considering the following:
 - a. Note items which appear to have originated from unusual sources such as appraisal increases, transfers, exchanges, etc. and determine propriety thereof. Ascertain if prior earnings were adequate to cover acquisitions.
 - b. Determine if costs relating to the acquisition and installation of assets, leasehold improvements, etc. have been capitalized with the appropriate useful life.
 - c. Ascertain if assets include items of a personal nature.
 - d. Where construction or any other work of a capital nature is performed with the taxpayer's own equipment, labor, etc., for its own use, be certain that the basis of such assets includes the proper elements of material, labor and overhead, including depreciation.

- e. Regarding the basis of assets, consider such items as trade-ins, acquisitions from related taxpayers, allocations of costs between land and building, etc.
- (3) For any construction in-progress, determine if IRC 263A(f), Special rules for allocation of interest to property produced by the taxpayer, capitalization of construction period interest is applicable. If so, verify that the proper amount of both direct and indirect interest on outstanding indebtedness during the construction period was capitalized.
- (4) Decreases in the asset accounts during the year should be noted. The resulting gains or losses should be verified. Ascertain if the taxpayer has transferred assets to a related party for less than FMV.
- (5) Examiners should be alert for situations where accelerated deductions are being claimed in the following situations:
 - a. Tangible property used predominately outside the U.S.;
 - b. Property leased to tax exempt entities; and
 - c. Property financed with tax exempt bonds.

(Note: IRC 168(g), Alternative depreciation system for certain property, requires straight line depreciation over an extended recovery period.)

4.10.3.10.4.7
(03-01-2003)

Depletable Assets

- (1) Depletion allows the owner of a natural resource (such as minerals) to recover their basis in the minerals just as depreciation allows a manufacturer to recover the cost of equipment and buildings.
- (2) IRC 611, Allowance of deduction for depletion, establishes the depletion allowance. IRC 612, Basis for cost depletion, defines basis in the property. IRC 613, Percentage depletion, defines the percentage depletion rates, gross income and taxable income from mining. IRC 614, Definition of property, defines property and related rules. Associated regulation sections provide additional direction.
- (3) Audit techniques are the same as those used for depreciation. See IRM 4.10.3.10.4.6, Depreciable assets, above.

4.10.3.10.4.8
(03-01-2003)

Valuation Reserves

- (1) Review nature and sources of all accounts and ascertain whether they are being used as a means of diverting or understating income, or claiming unallowable deductions.
- (2) For unallowable reserves which were created in a prior year and now closed by the statute of limitations, the beginning balance of the reserve for the year under audit should be brought into income through a "Change in Method of Accounting" adjustment pursuant to the provisions of IRC 446, General rule for methods of accounting, and IRC 481(a), Adjustments required by changes in method of accounting.
- (3) Determine whether the depreciation, amortization, and depletion reserves are contingent reserves. Check for reasonableness of any addition.

4.10.3.10.4.9
(03-01-2003)

Intangible Assets

- (1) Verify correctness of deductions claimed, such as amortization, write downs, write-offs, royalties, etc.

- (2) Determine if there have been any transactions with related taxpayers, or controlled foreign entities. Consider arms-length transactions attributes.
- (3) Determine if revenue derived from intangibles has been included in income. Be aware that it is not necessary for an intangible to have a basis or to appear on the records (e.g. subleases, overriding royalties, franchises, etc.).
- (4) Analyze any transaction involving a transfer of foreign rights to any foreign entity for an equity interest or for nominal consideration.
- (5) IRC 197 Assets — acquisitions after (8/10/93). For asset or stock sales, verify per a review of the buyer's return that the purchase price agrees to the sales price on the seller's return. Be aware of "off" balance sheet contingent liabilities assumed by the buyer and included in the purchase price on the buyer's return but not in the sales price per the seller's return.

(6) Contingent liabilities, basis allocation issues:

- a. Analyze the adjusted grossed-up basis calculations to determine whether the buyer has, or should have, included contingent liabilities in arriving at the basis of acquired assets, including intangibles.

Note: The premature inclusion of contingent liabilities in arriving at asset basis may result in an incorrect amortization deduction. Conversely, exclusion of contingent liabilities assumed as part of the consideration paid may create the potential for bargain purchase treatment even though, economically, a premium may have been paid by the purchaser.

- b. Determine whether contingent liabilities were assumed by the buyer or arose after the acquisition.

Note: While financial statement accruals are an indicator of the existence of a liability, the liabilities recorded on the seller's financial statements should be distinguished from those entered on the buyer's records. While it might appear that such items should be considered in the computation of asset basis, as they relate to conditions existing at the time of acquisition, this treatment would be incorrect since the decision to incur such expenditures is usually at the purchaser's discretion.

- c. Be alert to economic performance issues. A contingent liability becomes "fixed and determinable" when it meets the "all events test" under IRC 461(h), General rule. The purchase price should not include any contingent liabilities.

- (7) Test check current additions to determine if the basis includes the proper elements of cost such as legal fees, appraisal fees, officers' salaries, etc.
- (8) Review allocation of purchase price between inventories, fixed assets with three to seven year depreciable lives, and intangible assets with a 15 year life.
- (9) Determine if "consulting" agreements, employment contracts, etc., entered into as a result of an asset acquisition are in substance, covenants not-to-compete (the cost should be amortized over 15 years).
- (10) Verify no loss has been claimed on the disposition of an IRC 197, Amortization of goodwill and certain other intangibles, asset if any other IRC 197 intangible asset acquired in the same transaction has been retained.

- 4.10.3.10.4.10
(05-03-2023)
Prepaid Expenses & Deferred Charges
- (1) Review supporting schedules showing the specific prepaid expense capitalized at year end (e.g., insurance, real estate taxes, service contracts, etc.).
 - (2) Review documents such as invoices or policies on a test basis to verify the year-end prepaid expense balance is not understated.
 - (3) For accrual basis taxpayers, verify the prepaid expenses have not been expensed for tax purposes, via M-1 (or M-3) adjustments.
- 4.10.3.10.4.11
(03-01-2003)
Other Assets
- (1) The nature and classification of other asset accounts should be considered to determine if they have a bearing on tax liability.
- 4.10.3.10.4.12
(03-01-2003)
Deferred Tax Assets
- (1) Review workpapers to determine the composition of the deferred tax asset. That is, income recognized for tax before book and expenses recognized for book prior to tax.
 - (2) The absence of a deferred tax asset may indicate the above noted timing differences have been treated the same for book and tax and thus taxable income has been understated.
- 4.10.3.10.4.13
(03-01-2003)
Liabilities: Accounts Payable
- (1) Review any debit balances in the general ledger or subsidiary accounts. This may indicate diversion of funds, potential unreported income and/or understatement of sales.
 - (2) Review computation of year-end accruals for purchases. Purchases should be included in ending inventory. Determine if the taxpayer is accelerating subsequent year expense into the current year.
 - (3) Review any accounts which have long overdue balances. This may indicate contested liabilities or liabilities which no longer exist such as unclaimed wages. These items should be picked up as income or be disallowed as current expenses.
 - (4) Tie in trial balance amounts to general ledger. Check for adjusting entries or reclassifications and netting of related accounts receivable. This may indicate understatement of sales.
 - (5) Review for accruals to "related" cash basis taxpayers. Per IRC 267(a)(2), Matching of deduction and payee income item in the case of expenses and interest, no deduction is allowable until the amount is includible in the gross income of the related payee.
- 4.10.3.10.4.14
(03-01-2003)
Mortgages, Notes, Bonds Payable in Less Than One Year
- (1) Test interest expense and year-end accruals to reconcile interest expense. Test the mathematical accuracy of the analysis and trace to the general ledger.
 - (2) Obtain copies of debt agreements on a sample basis and review terms and conditions.
 - (3) Obtain loan amortization schedules, year-end statements, etc. to verify the accuracy of the year-end balance per the books.
- 4.10.3.10.4.15
(03-01-2003)
Other Current Liabilities
- (1) Tie in trial balance amounts to the general ledger. Check for adjusting entries or reclassifications and netting of related accounts receivable. This may indicate an understatement of sales.

- (2) Review computation of year-end accruals. Ensure actual expenses were incurred and that benefit has been received as of the balance sheet date.
- (3) Review accrual amount to payments made after the balance sheet date to ensure compliance with applicable code sections. (IRC 267, Losses, expenses, and interest with respect to transactions between related taxpayers, IRC 404, Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan, and IRC 461, General rule for taxable year of deduction).
- (4) Review accruals for compensated absences (e.g. vacation pay, sick leave) to ensure only amounts paid within $2\frac{1}{2}$ months of year end are deducted.
- (5) Review a copy of the employee benefit plan. Determine that the current period contribution has been timely paid by examining a copy of the cancelled check.
- (6) Review year-end accruals to ascertain any amounts which must be paid prior to year end to be deductible under the economic performance rules (e.g., tort liabilities, retrospective workmen's compensation, etc.).

4.10.3.10.4.16
(03-01-2003)
Income Taxes

- (1) Review and analyze current and deferred income tax workpapers. Review detail of all temporary and permanent differences between income per books and the taxable income, including the following:
 - a. Balances at the beginning of the period;
 - b. Current period provisions for income taxes; and
 - c. Balances at the end of the period.
- (2) Temporary differences are differences between income tax and financial reporting that have future tax consequences. Temporary differences arise as a result of the following:
 - a. Revenues or gains that are taxable after they have been recognized for financial income (e.g., an installment sale).
 - b. Expense or losses that are deductible after they have been recognized in financial income.
 - c. Revenues or gains that are taxable before they have been recognized in financial income.
 - d. Expenses or losses that are deductible before they have been recognized in financial income.
 - e. A reduction in the tax basis of depreciation on assets because of tax credits.
 - f. A business combination accounted for by the purchase method.
- (3) Examples of temporary differences include:
 - a. **Marketable Securities** — Unrealized gains and losses on securities held for investment that are reported as an adjustment to income or retained earnings in the financial statements based on the market value of the securities at the balance sheet but are not reported in the tax return until the securities are sold.
 - b. **Receivables** — bad debts that are recognized using the allowance method for financial reporting and the direct charge-off method for tax.
 - c. **Gross profit on sales** — gross profit that is recognized in different periods for financial and tax reporting such as gross profit recognized in the year of sale for financial reporting and on the installment method for

- tax reporting and gross profit recognized on the cost recovery method for financial reporting and the installment method for tax reporting.
- d. **Sales returns and allowances** — returns and allowances that are accrued for financial reporting but are not reported on the tax return until the goods are actually returned.
 - e. **Imputed interest** — the imputed interest amount for financial reporting that differs from the amounts for tax reporting.
 - f. **Long-Term Construction Contracts** — revenues on long-term construction contracts that are accounted for differently for financial and tax reporting. Examples include percentage-of-completion for financial reporting and completed contract for tax reporting and percentage of completion method for financial reporting and cash or accrual method for tax reporting.
 - g. **Inventories** — inventories that are recorded at the lower of cost or market for financial reporting and at cost for tax reporting; reserves for obsolete inventory that are expensed for financial reporting and are not deductible for tax reporting, unless the inventory is scrapped or offered for sale at a reduced value; and related costs for retailers, wholesalers and manufacturers that are expensed for financial reporting and capitalized for tax reporting.
 - h. **Investments** — investments accounted for by the equity method for financial reporting and the cost method for tax reporting and the excess of cash surrender value of life insurance over the cumulative premiums paid, which is taxable if the insurance is terminated for reasons other than death.
 - i. **Property and Equipment** — depreciation for financial reporting using estimated useful lives or methods that differ from tax reporting; interest income that offsets capitalized interest income for financial reporting and is recognized as income for tax reporting; assets recorded at fair-market-value (FMV) for financial reporting and at a different basis for tax reporting; gains and losses on depreciable assets that are recognized for financial reporting and deferred for tax reporting because the assets are traded in on similar assets; gains on the appreciation of assets distributed as a part of a liquidation, that are recognized when liquidation is imminent for financial reporting and on distribution for tax reporting; leases that are capitalized for financial reporting and reported as operating leases for tax, amortizing capitalized leases over different periods for financial and tax reporting, and depletion based on historical cost of the asset (cost depletion) for financial reporting and on percentage rates (percentage depletion) for tax.
 - j. **Intangible Assets** — intangible drilling costs that are capitalized for financial reporting and expensed for tax, amortization of intangible assets using periods or methods for book purposes which differ from tax, and organizational costs expensed for book and capitalized for tax. **Liabilities** — debt issue costs that are amortized using the interest method for financial reporting and straight-line for tax, expenses that are accrued for financial reporting but deductible for tax reporting only when paid (e.g., vacation pay, retrospective portion of workmen's compensation, losses on discontinued operations), and imputed interest for financial reporting that differs from amounts for tax reporting.
 - k. **Deferred Revenue** — revenues received in advance, deferred for book, but recognized as income for tax.

4.10.3.10.4.17
(03-01-2003)
**Loans From
Shareholders**

- (1) Review loan agreements to determine if there is a true debtor-creditor relationship. Large liabilities in relation to capital stock may indicate a “thin capitalization” situation.
- (2) Determine the source of funds advanced by shareholders to ensure no outright diversion of corporate receipts.
- (3) Review the rates of interest and the scheduled dates of repayment to ensure transactions are at arms-length. If “loans” are “equity capital” then:
 - a. Disallow interest expense; treat as dividends.
 - b. Disallow bad debt deductions claimed by the shareholder.
 - c. Treat the entire repayment as a dividend.

4.10.3.10.4.18
(03-01-2003)
Long Term Obligations

- (1) Fixed Liabilities are usually found in the form of long-term bonds, notes, mortgages and debentures.
- (2) Determine the source of funds advanced by reviewing registration statements, prospectus, and/or related documents in connection with any financing arrangement. Ensure all related costs (e.g. legal, professional, bond issuance) have been properly deferred and are being written-off over the life of the obligation.
- (3) Review the transactions with related taxpayers and controlled foreign entities to ensure there is no mismatching of income and expenses and that the transactions are at arm’s-length.
- (4) Review the tax-exempt securities on the books. The interest expense to carry tax-exempt securities is not deductible.
- (5) Review the zero coupon bonds to ensure the correct allocation of the original issue discount.
- (6) Test the interest and year-end accruals to reconcile interest expense.
- (7) Determine whether any transactions are involved with no purpose, other than to create a tax deduction. Obtain copies of debt agreements on a sample basis and review terms and conditions. Obtain loan amortization schedules, year-end statements, etc. to verify the property of the year-end balance per the books.

4.10.3.10.4.19
(03-01-2003)
**Stockholders
Equity/Capital Stock**

- (1) Review all capital stock accounts and consider the following:
- (2) If there were no changes during the period, consider:
 - a. Subchapter S corporations — review valid election, number and changes in stockholders’ loss limitations.
 - b. Dealing in stock between shareholders — check gains or losses to individuals which involve the corporation and consider the possibility of distributions being equivalent to a taxable dividend.
 - c. Closely-held corporations should be carefully reviewed for arms-length features, disguised dividends, etc.
- (3) If there were new issues and additions during the period, consider:
 - a. Review the corporate minute book with items recorded on the books to determine if proper entries have been made.

- b. Verify all credit entries. Consider the tax implications of stock issued for services or properties, stock dividends, employee stock options, stock issued at less than FMV.
- c. Determine if expenses relating to the issuance of stock have been properly handled, (e.g., legal fees, registration fees, etc.)
- d. Determine (in closely-held corporations) that if a recapitalization of stock occurs, then the FMV of the stock received is equal to the FMV of the stock surrendered. Significant differences indicate possible gift tax consequences.

(4) If there were reductions and cancellations during the period, consider:

- a. Compare the corporate minute book with the items recorded on the books to determine if proper entries have been made.
- b. Verify all debit entries. Consider the tax implications of partial or complete liquidations, partial or complete redemptions, and distributions essentially equivalent to dividends.

4.10.3.10.4.20
(03-01-2003)
Treasury Stock

- (1) Review any changes in the account. The acquisitions may be essentially equivalent to a dividend if an increase in treasury stock (redemption) or a decrease in treasury stock (bargain sale).

4.10.3.10.4.21
(05-03-2023)
Additional Paid-In Capital (APIC)

- (1) Review any changes to this account for the current period. APIC results from either a shareholder making additional contributions (e.g., cash, property, etc.) or paying more than the par value of the shares.
- (2) Reserves created by charges to income may no longer be needed. If a credit to Paid in Capital is made, it could escape taxation.

4.10.3.10.4.22
(03-01-2003)
Negative Goodwill

- (1) For tax purposes, verify that the "bargain" element (difference between the FMV of assets and purchase price) has been allocated to all such assets on a pro-rata basis pursuant to IRC 1060.
- (2) For GAAP purposes, the bargain element is allocated to fixed assets first, then any remainder creates negative goodwill.
- (3) For the bargain element allocated to current assets, verify income (i.e., bargain element) is recognized as the asset is consumed, sold, or collected.

4.10.3.10.4.23
(02-26-2016)
Retained Earnings for S Corporations

- (1) Since there is no reconciliation of the book retained earnings account shown on an S corporation return, as there is on a C corporation return, a reconciliation of current year retained earnings should be made. See *Example - Reconciliation of Current Year Retained Earnings* for additional information.
- (2) Sometimes the distribution section of the Schedule K and AAA are not completed or are completed incorrectly. Using the above analysis will detect the potentially incorrect entries on the Schedule K and AAA. If it is assumed that no entries were made directly to the retained earnings other than actual distributions, the amount of the distribution can be determined using the above analysis. The preparer should always be asked to reconcile any differences brought out with the use of the above analysis.

4.10.3.11

(03-01-2003)

**Testing Gross Receipts
or Sales**

- (1) The following techniques are used when testing gross receipts.
 - a. Test the methods of handling cash to see if all receipts are included at end of year.
 - b. Test the reported gross receipts by using the gross profit ratio method. See IRM 4.10.3.11.1, Gross Profit Ratio Test, for additional guidance.
 - c. Note items that are unusual in origin, nature, or amount.
 - d. Test the books of original entry by tracing the entries back to the original sales slips, original cash register tapes, original contracts, job record book, or bank deposits.
 - e. Check selected entries made at different times of the year, including some at the beginning of the year.
 - f. Test check footings and postings to the general ledger.
 - g. Review bank statements and deposit slips as described in IRM 4.10.3.9, Bank Record Reconciliations, above.
 - h. Scan the sales account in the ledger for unusual entries.
 - i. Test entries from the general and sales journals.
 - j. Be alert for taxable income which may not appear on the books (high percentage of cash receipts which are not regularly deposited or properly accounted for, dealer reserve income, constructive receipt, foreign source income).
 - k. Determine the extent the receipts were used to pay operating expenses. Question any unusual discounts or sales allowances.
 - l. Determine the method and adequacy of the accounting for merchandise withdrawn for personal use.
 - m. Determine if all receivables are included in income for accrual base taxpayers.
 - n. Scan sales agreements, contracts, and related correspondence for leads to unrecorded bonuses, awards, kickbacks, etc.
 - o. Review workpapers prepared for tax purposes and confirm that adjustments are appropriate.
 - p. Be alert to indications of capital gains treatment of items which are ordinary income, sales made or services rendered in exchange for other goods and services, and unreported commissions or rentals from activities operated on the taxpayer's business premises such as arrangements for operating concessions, such as cafes, bars, candy counters, vending machines, video games, etc.
- (2) Each examination is unique. The above items are a suggested list, neither all inclusive or required in every situation. The examiner must use techniques which are effective in the conduct of their specific audit.

4.10.3.11.1

(03-01-2003)

Gross Profit Ratio Test

- (1) When inventories are a material income producing factor, the gross profit test serves as an indicator of the reasonableness of gross receipts, inventories, purchases, and business net profit represented on the tax return.
- (2) The term, "gross profit ratio" refers to the ratio: Gross Profit Realized on Sales divided by Gross Receipts from the Sales.
- (3) It is the difference, or "margin", between the cost of sales and gross receipts expressed as a percentage of sales.
- (4) The margin is always computed based on the selling price.

Example: An article is purchased for \$1.20 and sold for \$1.60.

- a. The gross profit would be 40 cents; ($\$1.60 - \1.20).
- b. The gross profit ratio or “margin” would be 25 percent; ($\$1.60 - \$1.20 / \$1.60$).

- (5) A related computation, “markup”, can be computed as either a percentage of cost or of selling price. Although many consider markup as a percentage of the selling price, computing the markup on the cost price is easier and less confusing to be used to compute the markup on the cost of goods and determine the correct sales.

Note: The percentages of margin and markup on cost are not the same. Margin and markup in dollars are identical, however, the percentages are different. Both represent the differences between the cost of merchandise and the selling price.

- (6) Exhibit 4.10.3-4, Markup Table, shows what the markup on cost must be to give the desired margin for common cases. To use this table, find the margin or gross profit percentage in the left column. Multiply the cost of the article by the corresponding percentage in the right or markup column. The result, added to the cost, gives the correct selling price.
- (7) When the markup is computed based on the selling price, a different markup percentage must be used than when computing the markup on the cost price.

Example: An article is purchased for \$1.20 by a seller who then marks it up 25 percent.

- a. The markup of 25 percent of the cost (\$1.20) equals 30 cents. Add 30 cents to the cost, and the selling price is \$1.50 with a margin of 30 cents, or 20 percent gross profit margin.
 - b. If a 25 percent margin is needed, then the percentage that will yield the desired margin when applied to the cost price must first be determined.
 - c. From Exhibit 4.10.3-4, Markup Table, it can be determined that a 25 percent margin is equivalent to a 33.3 percent markup on cost.
 - d. Multiplying 33.3 percent times the cost (\$1.20) equals 40 cents. Adding 40 cents to the cost price gives a selling price of \$1.60, and a margin of 40 cents, or 25 percent .
 - e. A markup on cost of 25 percent gives a selling price of \$1.50. If it were necessary to have a margin of 25 percent to cover the costs of operations and net profit, the taxpayer would be losing money by pricing merchandise on the basis of a 25 percent markup **on cost**. To realize a 25 percent margin, the taxpayer would need to use a 33.3 percent markup on the cost price.
- (8) The following example illustrates the application of the gross profit ratio as a percentage of sales:

Description	Amount
Gross Sales	\$50,000
Cost of Sales	(\$40,000)
Gross Profit (Margin)	\$10,000

- a. The gross profit margin ratio is 20 percent. That is, 20 percent of \$50,000 sales gives the margin of \$10,000.
 - b. From the markup table it is determined that a 20 percent gross profit ratio (margin) requires a 25 percent markup based on cost. The cost of sales in the amount of \$40,000 must be increased by 25 percent or \$10,000, to give the \$50,000 gross sales.
- (9) A change in the gross sales, in the example above, results in a change in the gross profit ratio and the markup:

Description	Amount
Gross Sales.....	\$60,000
Cost of Sales.....	(\$40,000)
Gross Profit (Margin).....	\$20,000

- a. There has been an increase in gross sales of \$10,000 (\$50,000 to \$60,000) or a 20 percent increase in gross sales. This results in a gross profit ratio of 33.3 percent. The markup (on cost) formerly is now 50 percent.
- (10) After the ratio for the business under examination has been determined:
- a. Compare it with the prior years' ratios for the same taxpayer, and
 - b. Compare it with the ratios of similar businesses. In making the comparison, remember that the ratio will vary according to the size, sales volume and location.
- (11) If the comparison indicates that there is a probable error in the reported gross profit amount, consider the reasons listed in items (12), (13), and (14) below, as possible reasons for the error.
- (12) Possible errors in reporting "**Gross Receipts**":
- a. Inclusion of costs not subject to the gross profit ratio, i.e., rents, interest, dividends, etc.;
 - b. All accounts receivable were not reported when accrual basis accounting was used;
 - c. All collected accounts receivable were not reported when the cash basis of accounting was used;
 - d. Income constructively received was not reported;
 - e. Installment sales were incorrectly reported;
 - f. Sale of ending inventory was not included in gross receipts when the business was sold;
 - g. Theft of inventory; or
 - h. Unreported gross receipts from bartering.
- (13) Possible errors in reporting "**Inventory**":
- a. Inventory improperly valued or incorrect amount carried over from the prior year;
 - b. Figures are estimates;
 - c. Inventories are not used, even though inventory is a material income producing factor; or
 - d. Ending inventory is understated.

(14) Possible errors in reporting “**Purchases**”:

- a. Included costs are not properly a part of the cost of sales;
- b. Personal withdrawals are not properly accounted for;
- c. Purchases are not reduced for returned merchandise; or
- d. Purchase discounts are not properly reflected.

4.10.3.12
(03-01-2003)

**Testing Expenses: Cost
of Goods Sold**

(1) Testing the Cost of Goods Sold (COGS) may include the following techniques.

- a. Review inventory as provided in IRM 4.10.3.10.4.3, Inventories, above.
- b. If the taxpayer is a manufacturer, confirm they are in compliance with the full absorption rules in 26 CFR 1.471-11, Inventories of manufacturers, and IRC 471.
- c. If the taxpayer is a producer or re-seller, as defined in IRC 263A, confirm they are in compliance with the code and regulations of IRC 263A.
- d. Review the cost of sales and examine the accounts that are material.
- e. Review the cost system and variance accounts.
- f. Compare the current year beginning inventory balance with the prior year ending inventory balance and resolve any discrepancies.

4.10.3.13
(03-01-2003)

**Testing Expenses:
Operating Costs**

(1) The following techniques can be used to test operating expenses:

- a. Scan the expenses per the return and examine those which are large, unusual, or questionable.
- b. Trace the selected expenses back through the books to the original source documents.
- c. Verify the timing of the expense.
- d. Verify the amount of the expense.

(2) Be aware of the following possible technical issues:

- a. Excess officers compensation;
- b. Expense versus capitalization in the areas of “interest” (see IRC 263A(f)), Special rules for allocation of interest to property produced by the taxpayer, “accounting and legal fees”, “organization costs” (see IRC 195), Start-up expenditures, “franchise costs”, “asset acquisition costs”, and “capital expenditures” (see IRC 263, Capital expenditures);
- c. Bad Debt Treatment;
- d. Fair Rental Value when dealing with rent expense to related parties or entities;
- e. Lease-Purchase arrangements;
- f. Passive loss limitations;
- g. At risk limitations;
- h. Proper year end accruals of accrual basis taxpayers;
- i. Personal use of business assets;
- j. Net Operating Loss computations;
- k. Imputed interest expense;
- l. Franchise expense and amortization; and
- m. Expense vs. Credit vs. Capitalization.

4.10.3.14
(03-01-2003)

Sampling Techniques

(1) The process of examining the taxpayer’s books and records can be substantially enhanced and improved through the appropriate use of sampling techniques.

- (2) There are two basic types of sampling, judgment sampling and statistical sampling, as discussed in the following subsections.

4.10.3.14.1
(03-01-2003)

Judgment Sampling

- (1) Judgment sampling requires examiners to use professional judgment in performing the sampling procedure and in evaluating the results of the sample.
- (2) One type of judgment sampling is **block sampling**.
 - a. Block sampling may use groups of continuous items selected from an account balance or class of transactions.
Example: An examiner selects one month of travel expense to reach a conclusion about travel expense for the entire year.
 - b. Block sampling may include selecting all items in a selected numerical or alphabetical sequence.
Example: Gross Receipts is sampled by selecting customers with names beginning with certain letters such A, B, or C or by selecting the months of January, September and December.
- (3) Another type of judgment sampling is **dollar limitation sampling** (cut-off sampling).
 - a. Dollar limitation sampling is a method which selects a minimum dollar amount and creates a sample by selecting all items exceeding that dollar amount.
 - b. This type of sampling prevents the examiner from wasting time examining small, insignificant amounts.
 - c. This method is often combined with block sampling.

4.10.3.14.2
(03-01-2003)

Statistical Sampling

- (1) Statistical sampling is a procedure used to choose a portion of the whole to make a statement about the entire population.
- (2) Other terms applied to statistical sampling include probability sampling and random sampling. See Rev. Proc. 2011-42 and IRM 4.47.3, Statistical Sampling Auditing Techniques for more information.
- (3) Using statistical sampling, there is no way for the person who is sampling to impose their judgement on the selection process.
- (4) Examiners will discuss the facts and circumstances of the case with their manager and determine if a request for a computer audit specialist (CAS) is necessary. If a statistical sample is warranted, CAS assistance must be requested. Refer to IRM 4.10.2.7.5, Specialist Referrals, for instructions to request CAS assistance. Also refer to IRM 4.47.1, Computer Audit Specialist Program (CAS).

4.10.3.15
(03-01-2003)

Recordkeeping Systems

- (1) Taxpayers are required to maintain accounting records in sufficient detail to enable them to make a proper return of income (IRC 6001). No particular form is required for keeping the records. They must, however, be accurate. (See 26 CFR 31.6001-1, Records in general.)
- (2) This section provides descriptions of the common recordkeeping systems used by taxpayers.

4.10.3.15.1
(03-01-2003)

Double-Entry System

- (1) Double-entry recordkeeping is a system which is based on the "accounting equation":
$$\text{Assets} = \text{Liabilities} + \text{Capital}$$
- (2) Every net increase or decrease in assets is accompanied by a corresponding increase or decrease in either liabilities or capital.
- (3) Each transaction is recorded as a debit entry in one account and a credit entry in another. Therefore, a properly maintained set of double-entry books is always in balance.
- (4) The double-entry system is comprised of journals and ledgers.
- (5) See Exhibit 4.10.3-5, Flow of Accounting Transactions, for a flowchart of accounting transactions in double entry accounting systems.

4.10.3.15.2
(03-01-2003)

Single-Entry System

- (1) The single-entry system of recordkeeping does not include equal debits and credits to the balance sheet and income statement accounts. A single-entry accounting system is not self-balancing. Mathematical errors in the account totals are thus common. Reconciliation of the books and records to the return is an important audit step.
- (2) A single-entry system may consist only of transactions posted in a notebook, daybook, or journal. However, it may include a complete set of journals and a ledger providing accounts for all important items.
- (3) A single-entry system for a small business might include a business checkbook, check disbursements journal or register, daily/monthly summaries of cash receipts, a depreciation schedule, employee wages records, and ledgers showing debtor and creditor balances.
- (4) See Exhibit 4.10.3-5, Flow of Accounting Transactions, for a flowchart of accounting transactions in single entry accounting systems.

4.10.3.15.3
(03-01-2003)

Voucher System

- (1) The voucher system is a recordkeeping system which uses a voucher register for recording expenditures that are to be paid for by check. The voucher register is similar to and replaces the purchases journal. The following steps are performed when this system is used:
 - a. Each invoice (or group of invoices) which is paid by one check is entered in the voucher register on a single line.
 - b. An identifying number is placed on both the voucher and the register.
 - c. The voucher is placed in an unpaid voucher file until it is paid.
 - d. When paid, the check number is placed in an appropriate box on the same line as the original entry in the voucher register.
 - e. Postings are made periodically to appropriate cost or expense accounts (debits) and accounts payable (credits).
- (2) Accounts Payable is the total of the items in the voucher register not having check numbers and invoices not posted in the register.

4.10.3.15.4
(03-01-2003)

Cost Accounting System

- (1) A cost accounting system is a double entry system designed to show the cost of:
 - a. Each completed job;
 - b. Each completed process;
 - c. Each completed product,; and
 - d. Work in process.
- (2) Cost systems are used primarily by manufacturers and fabricators. They are also used by some smaller businesses, such as automobile dealers.
- (3) There are three types of cost accounting systems in general use:
 - a. **Job cost** — used when goods are manufactured on specific orders only. Costs are accumulated on a departmental basis for each order or job.
 - b. **Process cost** — used when goods are manufactured continuously or in bulk and it is not desirable to distinguish between orders. Costs and quantities processed are determined by department and the average costs per unit are determined. The accumulated costs are transferred from department to department and inventories of work-in-process are valued on the basis of the accumulated costs.
 - c. **Standard cost** — sometimes used in conjunction with either job or process cost systems. Standard costs are the costs that are expected to be achieved in a particular production process under normal conditions. These costs are based on estimates and are used by management to determine how much a product should cost (standard), how much a product does cost (actual), and the causes of any difference (variance) between the two.
- (4) Cost accounting systems include the following ledgers with related general ledger control accounts. Each of these accounts is debited for all additions and is credited for all deductions.
 - a. **Work-in-process** — journal entries are made, charging (debiting) work-in-process for material put in process, labor expended, and overhead applied to production.
 - b. **Materials** — journal entries are made, charging work-in-process for materials put in process. If materials are allocated between direct and indirect costs, the indirect portion is charged to Factory Overhead.
 - c. **Payroll** — journal entries are made, charging work-in-process for labor expended in manufacturing. If labor is allocated between direct and indirect costs, the indirect portion is charged to Factory Overhead.
 - d. **Factory overhead** — overhead expenses incurred are initially recorded as debits to the Factory Overhead account. Journal entries are then made, charging work-in-process for overhead applied to production. The overhead applied is an estimate based on experience. At year-end, the variance between the overhead applied and the actual overhead is closed to the income summary account.
 - e. **Finished goods** — cost of goods or jobs completed during the month is removed from the work-in-process account and recorded in Finished Goods.

Note: Some cost systems do not use a finished goods account. In that situation, the cost of goods or jobs completed is recorded in the Cost of Goods Sold account.

- f. **Cost of goods sold** — At year-end, the cost of finished products or jobs sold is removed from Finished Goods and charged to Cost of Goods Sold.

- (5) Taxpayers using standard cost systems sometimes maintain a separate variance account. The variance is the difference between actual and standard costs. At year-end, the variance accounts are usually closed to the income summary account. If any of the products manufactured are still on hand, the variances should be allocated between the work-in-process, Finished Goods, and Cost of Goods Sold accounts. This year-end allocation is necessary to convert these account balances from standard cost to actual cost.

4.10.3.15.5
(03-01-2003)
**Computerized
Accounting Systems**

- (1) Rev. Proc. 98-25 , 1998-1 C.B. 689, provides requirements for taxpayers maintaining accounting records within Automatic Data Processing (ADP) systems. Per this revenue procedure, ADP systems include all accounting systems that process information “by other than manual methods.”
- (2) Taxpayers who use computerized systems for recordkeeping must:
 - a. Be able to produce legible records from the systems to provide the information needed to determine their correct tax liability.
 - b. Keep all machine-sensible records and a complete description of the computerized portion of their accounting systems.
- (3) The computer systems used by small businesses are usually less complex, consisting of microcomputers and purchased software packages which may be designed for their industry. In these situations, the examiner does not need specialized computer skills or knowledge to conduct the examination. The examiner should learn how the taxpayer’s computer is used, while obtaining an understanding of the accounting system.
- (4) For examinations involving computerized accounting systems, the examiner should consider requesting the assistance of a computer audit specialist (CAS). See IRM 4.10.2.7.5.1, Specialist Referral System (SRS) - Online Referrals.
- (5) Examiners must request the assistance of a CAS:
 - a. When Form 5546, Examination Return Charge-Out Sheet, states “Record Retention Agreement on File.”
 - b. For all examinations of corporations with an activity code of 219 or above where the taxpayer has a computerized accounting system.

4.10.3.15.6
(03-01-2003)
**Manual Accounting
Systems**

- (1) There are many different types of manually prepared recordkeeping systems. Some are simple single-entry systems and others are sophisticated multi-journal, double-entry systems.

4.10.3.16
(03-01-2003)
Ledgers and Journals

- (1) “Books of Entry” are classified as either “original” or “final” entry. The books of original entry are the journals because entries are made in chronological order from the primary records. The books of final entry are the ledgers because transactions are finally entered therein through posting from the books of original entry.

- (2) The individual items on a tax return are usually groupings of similar items on the books. The taxpayer will have summaries and reconciliation records which give the detail of the combined items. These summaries and reconciliations must be obtained to reconcile the books to the return.
- (3) When examining a consolidated group, each subsidiary and the parent will keep separate ledgers and journals. There are no consolidated ledgers or journals. Examiners should tie the separate general ledgers to the consolidating workpapers to compare these totals to the tax return.
- (4) When a large corporation (assets in excess of \$50,000,000) is under examination, the examiner should not ask for all of the records at one time because the records are voluminous and the audit is time consuming.
- (5) There are unique features in some businesses which require the use of slightly different terminology, adaptation of journals, etc.; some examples of books and records maintained by the taxpayer may include:
 - a. **Primary Records —**
Invoices
Bills
Vouchers
Cancelled checks
Brokers' statements
 - b. **Books of Original Entry —**
General Journal
Voucher Register
Special Journals
Sales Journal
Purchases Journal
Checkbook
Cash Receipts Journal
Cash Disbursements Journal
Payroll Register
 - c. **Books of Final Entry —**
General Ledger
Subsidiary Ledgers
Private Ledger
Accounts Receivable Ledger
Accounts Payable Ledger General Journal

4.10.3.16.1
(03-01-2003)
General Journal

- (1) The general journal is used to record all transactions for which special journals have not been provided.
- (2) Usually, the general journal has only a single pair of columns for the recording of debit and credit entries, but many variations of this basic design can be found. A third column may be included for entries to subsidiary ledgers, or various multi-column forms may be used.
- (3) Entries can include:
 - a. Routine monthly accruals;
 - b. Standard journal entries (computations made the same way each month, on standardized journal entry forms);

- c. Reversals; and
- d. Correcting Entries.

Note: Not all entries necessarily flow through to the tax return.

- (4) Some companies maintain a system of journal vouchers. These are serially numbered documents, each containing a single, general journal entry, with full supporting details. In many cases the transaction numbering system used will indicate the source and type of each entry.
- (5) Vouchers may be used in lieu of a general journal or a general journal, in traditional form, may be prepared from the journal vouchers.
- (6) Companies having electronic data processing equipment generally enter journal vouchers to serve as one of the transaction sources for printouts of the ledger and the trial balance.
- (7) Audit techniques for verifying journal entries include determining:
 - a. That entries in the general journal were posted from authentic sources.
 - b. That entries in the journal are properly supported by tracing a sample of journal entries back into the source documents. Sampling techniques may reveal transactions that are not supported, and possibly, not valid.
 - c. Unusual entries by scanning.
 - d. Material differences from prior and subsequent years.

4.10.3.16.2
(03-01-2003)
Special Journals

- (1) A special journal is used to group similar types of transactions, such as all sales of merchandise on account, or all cash receipts. The types of special journals used depends largely on the types of transactions that occur frequently in its business.
- (2) In each special journal, all transactions result in debits and credits to the same accounts.
- (3) If the transaction cannot be recorded in a special journal, it is recorded in the general journal.

4.10.3.16.3
(03-01-2003)
Sales Journal

- (1) The sales journal is a special journal designed to record only credit sales.
 - a. Each sale is debited to Accounts Receivable and credited to Sales.
 - b. Sales invoices are prepared for each sale.
 - c. A copy of the sales invoice is used to make an entry in the sales journal.
 - d. The sales journal entry usually includes the date, the customer's name, an invoice number, the amount of the sales, and possibly the credit terms.
- (2) Cash sales are entered in the cash receipts journal.
- (3) The nature of a taxpayer's business will determine whether other entries are included in the sales journal. An example is a retailer required to collect sales tax from its customers. In this case, an additional column in the sales journal is needed to record the necessary credit to Sales Tax Payable.
- (4) Sales returns and allowances are frequently accounted for in the back of the sales journal. The daily activity is posted to the individual customers' accounts in the Accounts Receivable subsidiary ledger. The returns and allowances are

totaled periodically (usually monthly) and are posted to the sales returns and allowances (debit) and control accounts receivable (credit) accounts in the general ledger.

4.10.3.16.4
(03-01-2003)
Purchases Journal

- (1) The purchases journal is a special journal designed to record all purchases on credit, including merchandise for resale or materials/supplies for incorporation into a finished product.
 - a. Each purchase is debited to purchases and credited to accounts payable.
 - b. Purchase invoices are prepared for each purchase.
 - c. A copy of the purchase invoice is used to make an entry in the purchases journal.
 - d. The purchases journal entry usually includes the date, the supplier's name, the invoice number, the amount of the purchase, and possibly the credit terms.
- (2) Cash purchases are recorded in the cash disbursements journal.
- (3) The nature of a taxpayer's business will determine whether other entries are included in the purchases journal. An example of this would be other expenses often bought on credit (e.g., Freight In, Supplies, etc.). In this case, an additional column in the purchases journal is needed to record the necessary debit to the appropriate expense account.
- (4) Purchase returns and allowances are frequently accounted for in the same purchases journal. The daily activity is posted to the individual suppliers' accounts in the Accounts Payable (subsidiary) ledger. The returns and allowances are totaled periodically (usually monthly) and are posted to the control accounts payable (debit) and the purchase returns and allowances (credit) accounts in the general ledger.

4.10.3.16.5
(03-01-2003)
Cash Receipts Journals

- (1) The cash receipts journal is a special journal designed to handle all transactions involving receipts of cash.
- (2) Unlike other special journals in which all transactions result in debits and credits to the same accounts, all transactions in the cash receipts journal result in debits to Cash, but require a variety of credit entries.
- (3) Examples of transactions recorded in the cash receipts journal include cash sales, cash received from credit customers in payment of their accounts, or cash from other sources (such as a loan).
- (4) The journal entry usually includes the date, the amount received, the payor, and the account credited with the cash receipt.
- (5) In practice, almost all companies that sell to customers on credit keep an individual accounts receivable record for each customer in an Accounts Receivable (subsidiary) Ledger. The individual customer's accounts are credited daily as receipts of cash occur.
- (6) The cash receipts journal is totaled periodically and posted to the cash (debit) control accounts receivable (credit), cash sales (credit), and other (credit) accounts in the general ledger.
- (7) The nature of a taxpayer's business will determine the type and complexity of its cash receipts journal. It could be integrated with the cash disbursements in

a checkbook or combined cash journal. Many taxpayers simply use bank records as a cash receipts journal. The bank statements or deposit slips are totaled and used for sales or gross receipts on the return. In this situation, failing to include non-deposited cash in gross receipts is a potential for an adjustment.

4.10.3.16.6
(03-01-2003)

**Cash Disbursements
Journal**

- (1) The cash disbursements journal is a special journal designed to handle all transactions involving payments of cash.
- (2) Unlike other special journals in which all transactions result in debits and credits to the same accounts, all transactions in the cash disbursements journal result in credits to Cash, but require a variety of debit entries.
- (3) Examples of transactions recorded in the cash disbursements journal include cash purchases, payments of obligations, resulting from earlier purchases on credit, or other cash payments.
- (4) The journal entry usually includes the date, the amount paid, the payee, and the account charged with the disbursement for each check.
- (5) In practice, almost all companies that purchase from suppliers on credit keep a separate accounts payable record for each supplier in an Accounts Payable (subsidiary) Ledger. The individual supplier's accounts are debited daily as payments of cash occur.
- (6) The cash disbursements journal is totaled periodically and is posted to the control accounts payable (debit), cash purchases (debit), other (debit) accounts, and cash (credit) in the general ledger.
- (7) The nature of a taxpayer's business will determine the type and complexity of its cash disbursements journal. It could be integrated with the cash receipts in a checkbook or combined cash journal. Many taxpayers simply use bank records, check stubs, or a check register as a cash disbursements journal. The bank statements or checks are totaled and used for various expense accounts.

4.10.3.16.7
(03-01-2003)

Payroll Register

- (1) The payroll register is a special journal which includes a detailed listing of the company's total payroll for each payday.
- (2) The payroll register generally includes the name of the employee, hours worked, earnings, deductions, and net pay.
- (3) The payroll register is totaled each payday to record the payroll journal entry, usually in the general journal.
- (4) The journal entry results in a debit to the Salary Expense accounts, credits to Federal Insurance Contributions Act (FICA) Tax Payable, Federal Income Tax Payable, and Other Payables (e.g., medical insurance, union dues, etc.) deducted from the employees' earnings, and a credit to Salaries Payable for the net amounts due the employees.
- (5) The nature and size of the taxpayer's business will determine how the net amounts due the employee will be paid. Many companies use a separate payroll bank account against which payroll checks are drawn. Under this system, a check must first be drawn from a regular checking account for the net earnings due to employees and deposited into the payroll account.

- (6) Besides the FICA Tax and Federal Income Tax deducted from the employees' earnings discussed above, the employer must also pay FICA Tax equal to the amount paid by the employee, Federal Unemployment Insurance Tax (FUTA), and State Unemployment Insurance Tax Act (SUTA). These three taxes on salaries paid by the employer are considered operating expenses. The journal entry results in a debit to Payroll Tax Expense and credits to FICA Tax Payable, FUTA Payable, and SUTA Payable.
- (7) The FICA Taxes (both employees' and employer's shares) and the Federal Income Tax Withheld from the employees' earnings are reported on the Form 941, Employer's Quarterly Federal Tax Return, and must be paid at least quarterly. Depending on the liability, payments may be required monthly or more frequently. The FUTA Taxes are reported on the Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and must be paid at least yearly. Depending on the liability, payments may be required quarterly. The SUTA Taxes are reported on various state forms and payment dates among the states vary. Other payroll deductions (e.g., medical insurance, union dues, etc.) must be paid according to the contracts or agreements involved.

4.10.3.16.8
(03-01-2003)
General Ledger

- (1) The general ledger is used to accumulate and classify the transaction data posted from the journals.
- (2) The general ledger is self-balancing and has an account for every balance sheet and profit and loss statement item.
- (3) Periodic postings are made to these accounts. At the end of each accounting period:
 - a. Proper adjustments are made to the accounts through the general journal.
 - b. A balance sheet and profit and loss statement are prepared from the open accounts.
 - c. Income and expense accounts are then closed.
 - d. The net balances are transferred to the capital account.
- (4) Some businesses include details of all entries in the general ledger, in effect combining the ledger and journal into one document. Others show only net debits and credits for each month, with the specifics recorded elsewhere.
- (5) The mathematical accuracy of the account balances is tested by verifying the footings of some or all of the ledger accounts. Audit techniques include:
 - a. The general ledger is scanned for entries that are unusual in amount, source, or nature. All significant entries are analyzed.
 - b. Compare some or all of the account balances and entries recorded for the year under examination with the previous and/or subsequent year. This is an important task and can determine the depth and scope of your audit.
 - c. Verify that entries in the general ledger were posted from authentic sources because the return is drawn from the general ledger balances. These balances can be falsified through the recording of unsupported debits or credits in the general ledger. Trace a sample of ledger entries back to the journals. Sampling techniques can reveal unsupported entries.

- d. Trace a sample of entries from the journal into the general ledger. An omitted transaction can be detected only by tracing from the source documents or the journals to the ledgers.
- e. Some errors, such as transposition errors in entering transactions and postings to the wrong account, may be discovered by tracing in either direction.

4.10.3.16.9
(03-01-2003)

Subsidiary Ledgers

- (1) A subsidiary ledger contains the detail of a large general ledger account (i.e., accounts receivable detail). A taxpayer will maintain a controlling account in the general ledger that summarizes the totals in the subsidiary ledger.
- (2) Subsidiary ledgers are not self-balancing.
- (3) Subsidiary ledgers may be established for accounts such as:
 - a. Accounts Receivable
 - b. Accounts Payable
 - c. Inventory
 - d. Selling Expenses
 - e. Property, Plant, and Equipment
 - f. Investments
 - g. General Expenses
- (4) The general ledger control account balance must equal the composite balance of the individual accounts in the subsidiary ledger.
- (5) The Accounts Receivable Ledger is a subsidiary ledger containing a chronological record of customer transactions. The customers' accounts are usually filed in alphabetical order in the Accounts Receivable Ledger.
 - a. Most taxpayers that sell to customers on credit keep an individual accounts receivable record for each customer. Including all of these accounts in the general ledger, with all other accounts, would be cumbersome. Credit sales are recorded as debits to the appropriate customer's account and payments received from customers are recorded as credits to the accounts.
 - b. When a taxpayer puts its individual customers' accounts in an Accounts Receivable Ledger, there is still a need for an Accounts Receivable account in the general ledger to maintain its balance and to control the subsidiary ledger. It is a controlling account in that its balance should equal the total of the individual account balances in the subsidiary ledger. This is true because there must be postings to the individual subsidiary customer accounts every day and to the controlling account, in total, each month.
 - c. The single controlling account in the general ledger takes the place of all the individual accounts in the subsidiary ledger and the trial balance can be prepared using only the general ledger accounts.
- (6) The Accounts Payable Ledger is a subsidiary ledger containing a chronological record of supplier transactions. The suppliers' accounts are usually filed in alphabetical order.
 - a. Most taxpayers that purchase from suppliers on credit keep a separate accounts payable record for each supplier. Including all of these accounts in the general ledger, with all other accounts, would be cumbersome.

- b. Purchases of goods and services on account are recorded as credits to the appropriate supplier's account and payments to the suppliers are recorded as debits to the accounts.
- c. When a taxpayer puts its individual suppliers' accounts in an Accounts Payable Ledger, there is still a need for an Accounts Payable account in the general ledger to maintain its balance and to control the subsidiary ledger. It is a controlling account, in that its balance should equal the total of the individual account balances in the subsidiary ledger. This is true because there must be postings to the individual subsidiary supplier accounts every day and to the controlling account, in total, each month.
- d. The single controlling account in the general ledger takes the place of all the individual accounts in the subsidiary ledger and the trial balance can be prepared using only the general ledger accounts.

4.10.3.17
(03-01-2003)
**Correspondence
Examination Procedures**

- (1) Historically in a field office environment, correspondence examinations were normally conducted only when requested by the taxpayer. Over the years, correspondence examinations have increased significantly to include returns included in Nonfiler Strategies, Preparer Projects, and other local source inventory.
- (2) Every attempt should be made to limit correspondence examinations at field locations. In addition, the use of Tax Compliance Officers, Tax Auditors and Revenue Agents to conduct correspondence examinations should be minimized, since cases commensurate with their grade level should normally require face-to-face interviews. Cases examined using the correspondence technique should only be assigned to Tax Compliance Officers, Tax Auditors or Revenue Agents when there are no qualified tax examiners or audit accounting aides available and a special compliance need exists.
- (3) If there is a need to conduct correspondence examinations in field offices, every effort should be made to assign these examinations to tax examiners or audit accounting aides, but only those who have been adequately trained to conduct examinations.

4.10.3.17.1
(02-26-2016)
**Correspondence
Examinations
Conducted by Tax
Examiners and Audit
Accounting Aides**

- (1) Management will ensure that tax examiners and audit accounting aides conducting correspondence examinations:
 - a. Receive the appropriate training (minimum Revenue Agent/Tax Compliance Officer Unit 1 Technical Training and Revenue Agent/Tax Compliance Officer Unit 2 Technical Training).
 - b. Work only those cases suitable for their grade and experience level.
 - c. Issue the appropriate initial contact letter for correspondence examinations (See IRM 4.10.3.17.3).
- (2) In conducting correspondence examinations, tax examiners and audit accounting aides will follow the same procedures as the tax compliance officers and revenue agents for ensuring that a quality audit is completed and they should always charge complete and accurate time to the cases examined.

4.10.3.17.2
(03-01-2003)
**Classification and
Screening of
Correspondence
Examination Returns**

- (1) Returns that will be examined by correspondence from Discriminant Index Function (DIF) inventory should be screened and classified in accordance with regular screening and classification procedures (including the use of classification check sheets).
- (2) Returns selected using the Compliance Data Environment (CDE) and other local source work identified for correspondence technique will be screened and classified in accordance with Planning and Special Programs (PSP) procedures.
- (3) The examiner assigned to a correspondence case will review the classified issues and prepare the necessary initial contact letter.

4.10.3.17.3
(03-01-2003)
**Correspondence
Examination Letters**

- (1) The following letters should be used to communicate with the taxpayer when conducting an examination via correspondence.

Letter No.	Title	Description
Letter 2202-B	Initial Contact Letter for Correspondence Cases	Letter used to advise taxpayers that their return will be examined via correspondence.
Letter 915	Letter to Transmit Examination Report	Letter used by SB/SE office examination to transmit examination reports.
Letter 1020 (DO)	Correspondence and Interview Examination	Letter advising taxpayer of the status of the examination, or necessary action needed to complete examination.
Letter 1912	Follow-Up Letter Transmitting Examination Reports	Letter used by SB/SE office examiners as a 15-day follow-up to the 30-day letter (Letter 915).

- (2) Only nationally developed letters should be used to correspond with taxpayers, since they have been approved for content and clarity. Modification of national letters is not authorized. Letters should be generated using the Report Generation System (RGS), whenever possible.
- (3) All letters will contain:
 - a. Examiner's name;
 - b. Examiner's identification number; and
 - c. Telephone contact number.

4.10.3.17.4
(05-03-2023)
**Power of Attorney and
Tax Information
Authorization**

- (1) Form 2848, Power of Attorney and Declaration of Representative, is used by a taxpayer to designate representatives to receive and answer notices, letters, and reports regarding their tax matters.

Note: This individual must be eligible to practice before the IRS (i.e., attorney, certified public accountant, enrolled agent, officer, full-time employee, family member, enrolled actuary, unenrolled return preparer).

- (2) When a taxpayer obtains representation, the examiner will ensure that the authorization, Form 2848 or a similar privately designed form, is properly executed. See IRM 4.11.55.2.6, Authorized Forms, and IRM 4.11.55.2.7, Receipt of POA or TIA Form, for additional guidance.
- (3) Form 8821, Tax Information Authorization, is used by a taxpayer to authorize an individual, corporation, firm, organization, or partnership to inspect and/or receive confidential information in any office of the IRS for the type of tax and the years or periods listed on the form.

Caution: This form does not authorize the appointee to advocate the taxpayer's position with respect to the Federal tax laws, to execute waivers, consents or closing agreements or to otherwise represent the taxpayer before the IRS.

- (4) Practice before the IRS is restricted to persons recognized or qualified under provisions of Treasury Department Circular No. 230, Regulations Governing Practice before the Internal Revenue Service. See IRM 4.11.55, Power of Attorney Rights and Responsibilities, for additional guidance.
- (5) If the taxpayer's representative impedes or delays the examination by failing to promptly submit the taxpayer's records or information requested by the examiner, failing to keep scheduled appointments, or failing to return telephone calls and written correspondence, the examiner may initiate procedures to bypass the representative and deal directly with the taxpayer, as outlined in IRM 4.11.55.4, By-Pass of a Representative.

4.10.3.17.5
(03-01-2003)
**Special Handling Notice
Form 3198**

- (1) Cases that require special processing will have a Form 3198, Special Handling Notice for Examination Case Processing, attached to the outside of the file folder. See IRM 4.10.9.9, Case File Assembly for Closing, to determine which forms should be placed on top of Form 3198.
- (2) This form is used for:
 - a. Forwarding cases for mandatory quality review;
 - b. Identifying cases subject to backup withholding;
 - c. Identifying that taxpayer extension to file is invalid (annotate with "Extension is Invalid, reverse TC 460");
 - d. Correcting the taxpayer's address of record; and
 - e. Identifying any other special handling requirement.

4.10.3.17.6
(05-03-2023)
Workpapers

- (1) Every case conducted by correspondence must contain workpapers that document and support the examination process and results. The depth, scope, and quality of the examination should not be compromised because the examination is being conducted by correspondence rather than by interview.
- (2) Workpapers are the written records kept by the examiner which provide the principal support for the examiner's report and document the procedures applied, tests performed, information obtained, and the conclusions reached in the examination. They should include all the information necessary to conduct the examination and support the audit results.
- (3) Supporting workpapers are used to document the audit trail. Types of documents which support the examiner's conclusion include, but are not limited to:

- a. Records documenting a sample of specific expenditures verified and the conclusions reached.
 - b. A list of questions or items raised during the examination and the conclusions reached.
 - c. Photocopies of relevant documents secured from the taxpayer during the examination.
 - d. Documents from computer sources such as IRP or CFOL.
 - e. Pro forma audit aids and case law (i.e., IRC, regulations, court cases, revenue rulings, etc.) supporting positions taken.
 - f. Correspondence from the taxpayer.
- (4) IRM 4.10.9.7, Workpapers, provides guidelines for the development of workpaper content and organization. These guidelines are provided to promote quality and consistency in workpapers and should be used when conducting correspondence examinations. LB&I examiners should refer to IRM 4.46.6, Workpapers and Report Resources, for additional guidance.

4.10.3.17.7
(03-01-2003)
Report Writing

- (1) IRM 4.10.8, Report Writing, includes guidelines for the preparation of audit findings (reports), in terms of content and format and provides instructions for critical case closing requirements.
- (2) When conducting examinations by correspondence, the examiner will observe the appropriate procedures and response times for each letter and report as outlined in IRM 4.10.8, Report Writing. Under no circumstances should these time frames or requirements be modified.
- (3) The examiner will ensure the taxpayer has received and understands the right to appeal, as well as other rights as outlined in IRM 4.10.1.2, Taxpayer Rights.

4.10.3.17.8
(05-03-2023)
Penalty Consideration

- (1) The IRS is involved in an ongoing effort to develop, monitor and revise programs designed to assist taxpayers in complying with legal requirements and avoid penalties. As indicated in IRM 1.2.1.12.1, Policy Statement 20-1 (Formerly P-1-18), "the Service uses penalties to encourage voluntary compliance".
- (2) It is the examiner's responsibility to identify, document, and accurately calculate appropriate penalties. This responsibility remains the same even when examinations are conducted by correspondence. See IRM 4.10.6, Penalty Considerations, for additional guidance. Written supervisory approval is required for certain penalty determinations, see IRM 20.1.1.2.3, Approval Pre-requisite to Penalty Assessments. IRC 6751(b), Approval of assessment, states certain penalties may not be assessed unless the initial determination of the assessment is personally approved, in writing, by the immediate supervisor of the person making the penalty determination. Supervisory approval is not required for:
 - Failure to file or pay penalties under IRC 6651, Failure to file tax return or to pay tax,
 - Estimated tax penalty under IRC 6654, Failure by individual to pay estimated income tax, or IRC 6655, Failure by corporation to pay estimated income tax,
 - Any overstatement of the deduction provided in IRC 170(p) , Special rule for taxpayers who do not elect to itemize deductions, under IRC 6662(b)(9), Portion of underpayment to which section applies,

- Any disallowance of a deduction by reason of IRC 170(h)(7), Limitation on deduction for qualified conservation contributions made by pass-through entities, or
- Any other penalty automatically calculated through electronic means.

Reminder: Written supervisory approval of penalties proposed under IRC 6751(b) must be obtained timely or related penalties cannot be assessed. See IRM 20.1.1.2.3.1, Timing of Supervisory Approval, for additional guidance.

- (3) The taxpayer must be provided the name of the penalty, the IRC section under which the penalty is imposed, and computation of penalty on each notice imposing the penalty. An examination report is considered a notice for imposing a penalty if the penalty is proposed on the report.

4.10.3.17.9
(03-01-2003)

Interview Consideration

- (1) If a taxpayer requests a face-to-face interview, the request should be honored. The case should be referred to the Group Manager for reassignment, if necessary.
- (2) There may be other instances in which a face-to-face interview would be required. Examples of these situations include:
 - a. The issue becomes too complex for correspondence. The examiner should discuss the case with the group manager and arrange for reassignment, if necessary.
 - b. Fraud development is required. The development of fraud requires face-to-face contact. The case should be discussed with the group manager and reassigned, if necessary.

4.10.3.17.10
(03-01-2003)

Closing Cases

- (1) In addition to preparing all necessary reports, lead sheets, workpapers and organizing the contents of the case file, examiners have other critical case closing requirements. These include:
 - a. Completion of Form 5344, Examination Closing Record. (See IRM 4.4.12, Examined Closings, Surveyed Claims and Partial Assessments, for additional guidance on completing Form 5344.)
 - b. Entry of data required for the Examination Operational Automation Database (EOAD).
- (2) The examiner conducting a correspondence examination has the same responsibility for case closing procedures as examiners conducting interview cases. Refer to IRM 4.10.8, Report Writing, for Examiner Case Closing Requirements.

4.10.3.18
(05-03-2023)

Verification of Field Employee Identification

- (1) Increased taxpayer awareness of identity theft, IRS impersonation scams, and cyber security threats have led some taxpayers to question the validity of IRS-initiated contacts. Field employees meeting with taxpayers in person may face additional scrutiny or safety concerns due to this heightened taxpayer suspicion. Taxpayers and/or representatives may challenge IRS-issued credentials presented by field employees, and they may contact local law enforcement.

- (2) When a field employee's identity is challenged, the employee will display the information on their HSPD-12 (SmartID) card, but must not surrender it. The employee is only obligated to allow the information on the SmartID card to be viewed.
- (3) If additional verification is needed, the field employee must follow the guidance below:

If	Then
A field employee's identify is challenged by a taxpayer and/or representative	<p>The field employee will provide the taxpayer and/or representative with the IRS Verification for Taxpayers and Representatives phone number at <i>Field Employees' Credentials Verification</i> to confirm their identity.</p> <p>Caution: This phone number may only be provided in person (i.e., not by telephone, letter, email, text, etc.).</p>
A field employee's identify is challenged by local law enforcement	<p>The field employee will provide the local law enforcement officer with the Bureau of Engraving and Printing Police Operations Center phone number at 202-874-0911 to confirm their identity.</p> <p>Caution: This phone number may only be provided in person and is for law enforcement use only.</p>

4.10.3.19
(05-03-2023)
**Inadequate Records
Notices: Overview**

- (1) Every taxpayer is required by law and regulations to maintain records with sufficient detail to prepare a proper return. This may require the maintenance of such permanent books of account and records sufficient to establish the amounts of gross income, deductions, credit, or other matters to be shown on the taxpayer's return. See 26 CFR 1.6001-1, Records; Rev. Rul. 71-20; Rev. Proc. 98-25; and Rev. Proc. 97-22.
- (2) Taxpayers who maintain automated records can enter into a record retention agreement with the Area Director (SB/SE) or Director, Field Operations (LB&I). This agreement limits retained records to those specifically identified as needed to perform auditing procedures.
- (3) Inadequate Records Notices place taxpayers on notice that their recordkeeping practices are deficient and must be improved to meet the requirements of the law. The issuance of an Inadequate Records Notice may result in a follow-up examination and is a tool to enforce taxpayer compliance with legal requirements to keep adequate records and properly report tax liabilities.

4.10.3.19.1
(05-03-2023)
**Inadequate Records
Notices: Determination
of Taxpayer Compliance**

- (1) The determination that a taxpayer has not maintained adequate books and records, or has not complied with a record retention agreement, is a matter of judgment and should be based on the facts of the individual case. Factors to be considered include, but are not limited to:

- a. An alternative or indirect method was used to establish the amounts of gross income, deductions, credits, or other matters shown on the taxpayer's return because the taxpayer's records were not sufficient,
- b. Prior history and present degree of noncompliance,
- c. Indications of willful intent or evidence of refusal to keep adequate books and records,
- d. Probability that the inadequacies in recordkeeping will result in significant underreporting of tax liabilities, or
- e. Other evidence of harm to the Government.

4.10.3.19.2
(05-03-2023)
**Inadequate Records
Notices: Examination
Procedures**

- (1) When an examiner determines the taxpayer has not maintained adequate books and records or has not complied with a record retention agreement the examiner will:
 - a. Charge all time for development of inadequate records issues to the case.
 - b. Fully develop the facts to explain how the taxpayer's books and records are inadequate and what steps need to be taken to bring them into compliance with applicable statutes.
 - c. Document the nature of the inadequacies of the taxpayer's records, group manager discussions, and basis for the conclusion reached.
 - d. Discuss the inadequacies with the group manager to determine if an inadequate records notice should be issued.
 - e. Contact a computer audit specialist if the case includes a record retention agreement.

4.10.3.19.3
(05-03-2023)
**Inadequate Records
Notices: Required Forms
and Exceptions**

- (1) Generally, Letter 979, Inadequate Record Notice, requesting a follow-up statement of corrective action from the taxpayer within 6 months, will be used to notify the taxpayer.
Exception: If the taxpayer is within the racketeer classification, engaged in illegal activities, or is willfully disregarding the law, the examiner will prepare Form 2807, Agreement to Maintain Adequate Books of Account and Records, and Letter 978, Notice of Inadequate Records, which includes a description of exact records required and penalties for failure to keep records.
- (2) The designated contact identified on Letter 979 or Letter 978 should be the individual in PSP responsible for monitoring the taxpayer's future compliance.
- (3) The narrative on Letter 979 or Form 2807 must include the following:
 - a. The date the taxpayer was orally notified that the records were inadequate or not in compliance with a record retention agreement,
 - b. The tax year(s) examined,
 - c. A clear and concise statement specifying how the taxpayer's records were inadequate or not in compliance with a record retention agreement.

Note: Form 2807 should specify the books and records which will be maintained.

- (4) Examiners will prepare a detailed Form 5346, Examination Information Report, following the form instructions. The "other" section should state that the package is documentation for an Inadequate Records Notice. The package should include:
 - a. Copies of pertinent workpapers,
 - b. Copy of the audit report,
 - c. Copy of Letter 978 or Letter 979,
 - d. Original Form 2807, if applicable.
- (5) A copy of the completed Form 5346 should be included in the workpapers with other documentation of the issue.
- (6) The original Form 5346 and documentation should be forwarded to PSP for suspense and follow-up action.

4.10.3.19.4
(05-03-2023)

**Inadequate Records
Notices: Delivery of
Inadequate Records
Notices**

- (1) Inadequate Records Notices should be served personally by examiners or sent by certified mail.
- (2) The examiner will complete the record of service on Letter 978 and Letter 979 at the time of delivery or before it is sent certified mail. The record of service should also be completed on all retained copies.
- (3) If sent by certified mail, the return receipt will constitute the record of service and will be attached to the copy of Letter 978 or Letter 979 retained in the case file.

Caution: If Form 2807 is mailed, Letter 978 should be held 15 days to give the taxpayer an opportunity to execute Form 2807.

4.10.3.19.4.1
(05-03-2023)

**Inadequate Records
Notices: Notices for
Joint Returns**

- (1) Section 3201(d), Relief from Joint and Several Liability on Joint Return, of the IRS Restructuring and Reform Act of 1998, P.L. 105-206, 112 Stat. 685, 734, requires that whenever practicable, any notice relating to a joint return be sent separately to everyone filing a joint return. Congress believed that sending separate notices would result in mail being forwarded to a spouse who moved. See IRM 4.10.1.2.2.1, Separate Notice Requirements, for detailed procedures.

4.10.3.19.4.2
(05-03-2023)

**Inadequate Records
Notices: Notices for
Corporate Returns**

- (1) When a notice is addressed to a corporation, it should be delivered to an officer authorized to sign tax returns and preferably to the officer who signed the return under examination.

4.10.3.19.4.3
(05-03-2023)

**Inadequate Records
Notices: Notices for
Partnerships**

- (1) In the case of a ILSC partnership, the notice will be addressed to all the partners and will show the name in which the partnership is doing business. The original notice will be delivered to the partner who signed the return or, if this is not possible, to a partner who takes an active part in the business. A copy of the notice, including the record of personal service or the mailing receipt, will be sent by registered or certified mail to all the other partners. Receipts from these mailings will be associated with the copy of the notice retained in the case file.

4.10.3.19.4.4
(05-03-2023)
**Inadequate Records
Notices: Examiner
Responsibilities**

- (1) Revenue agents should deliver the Letter 979 or Letter 978 and Form 2807, at the closing conference if possible. Otherwise, send by certified mail.
- (2) Tax Compliance Officers/Tax Auditors should give the Letter 979 or Letter 978 and Form 2807 to the taxpayer at a face-to-face appointment if possible. Otherwise, send by certified mail.
- (3) In cases where Form 2807 is required, the taxpayer will be given the opportunity to execute the agreement, specifying the books and records which will be maintained.

4.10.3.19.4.5
(05-03-2023)
**Inadequate Records
Notices: Joint
Investigations**

- (1) In joint investigations, the criminal investigator will determine the appropriate time to inform the taxpayer of the inadequacies of the records and issue the notice letter. The criminal investigator is also responsible for delivering the Inadequate Records Notice.

4.10.3.19.5
(05-03-2023)
**Inadequate Records
Notices: Taxpayer
Agreement and Appeal
Rights**

- (1) Letter 978 and Letter 979 serve as notification to taxpayers that their records are inadequate and execution of Form 2807 is not necessary to close the case. Whether or not the taxpayer signed Form 2807 will be noted on Letter 978.
- (2) If the taxpayer does not execute Form 2807 and the case is unagreed, the taxpayer will be informed of the further opportunity to discuss the matter at an Appeals conference.

Caution: An Appeals conference is not given to taxpayers who agree to proposed adjustments but do not execute Form 2807.

4.10.3.19.6
(05-03-2023)
**Inadequate Records
Notices: Follow-Up
Examinations**

- (1) Follow-up examinations will be conducted when appropriate. These examinations should be started with sufficient time to be completed within established audit cycles.
- (2) The examiner will document consideration of the inadequate recordkeeping issue and state whether the taxpayer has corrected the inadequacies in the recordkeeping practices.
 - a. If the examiner concludes that the taxpayer is substantially complying with requirements to keep adequate records, the inadequate records notice information should be included in the case file when the examination is closed.
 - b. If the examiner concludes that the taxpayer is not substantially complying with requirements to keep adequate records, then consideration of additional enforcement measures, such as the assertion of penalties, is warranted.

This Page Intentionally Left Blank

Exhibit 4.10.3-1 (03-01-2003)

Analysis of Taxpayer's Internal Controls

**Summary of the Steps Taken to Evaluate Internal Controls
Flowchart 1**

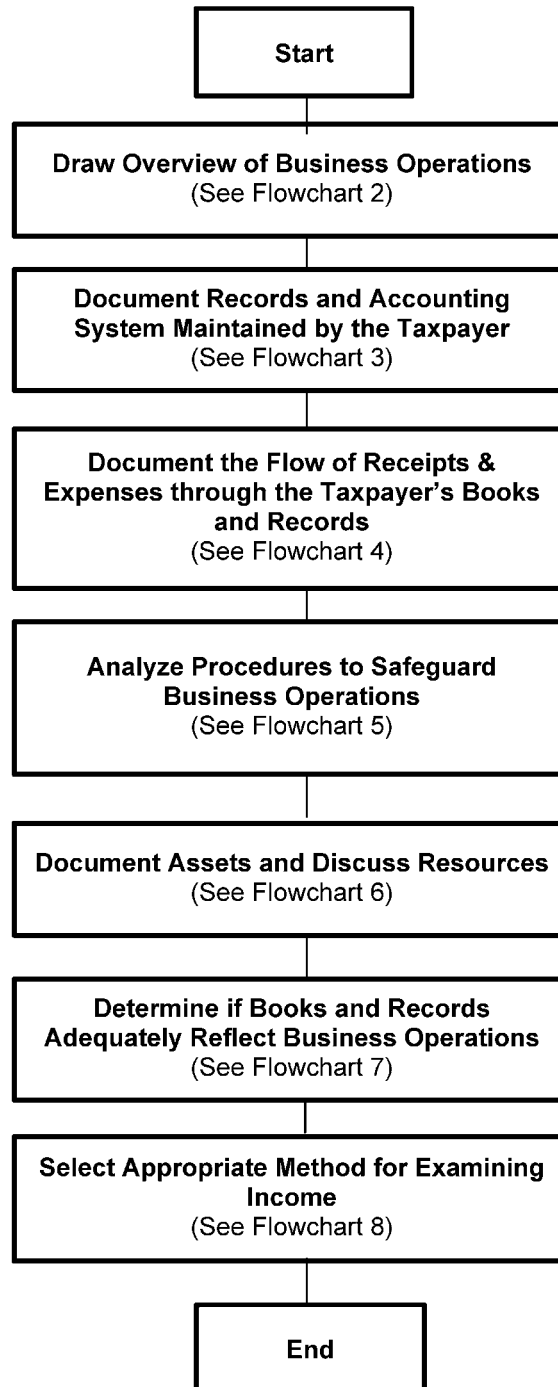


Exhibit 4.10.3-1 (Cont. 1) (03-01-2003)
Analysis of Taxpayer's Internal Controls

**Drawing Overview of Business Operations
Flowchart 2**

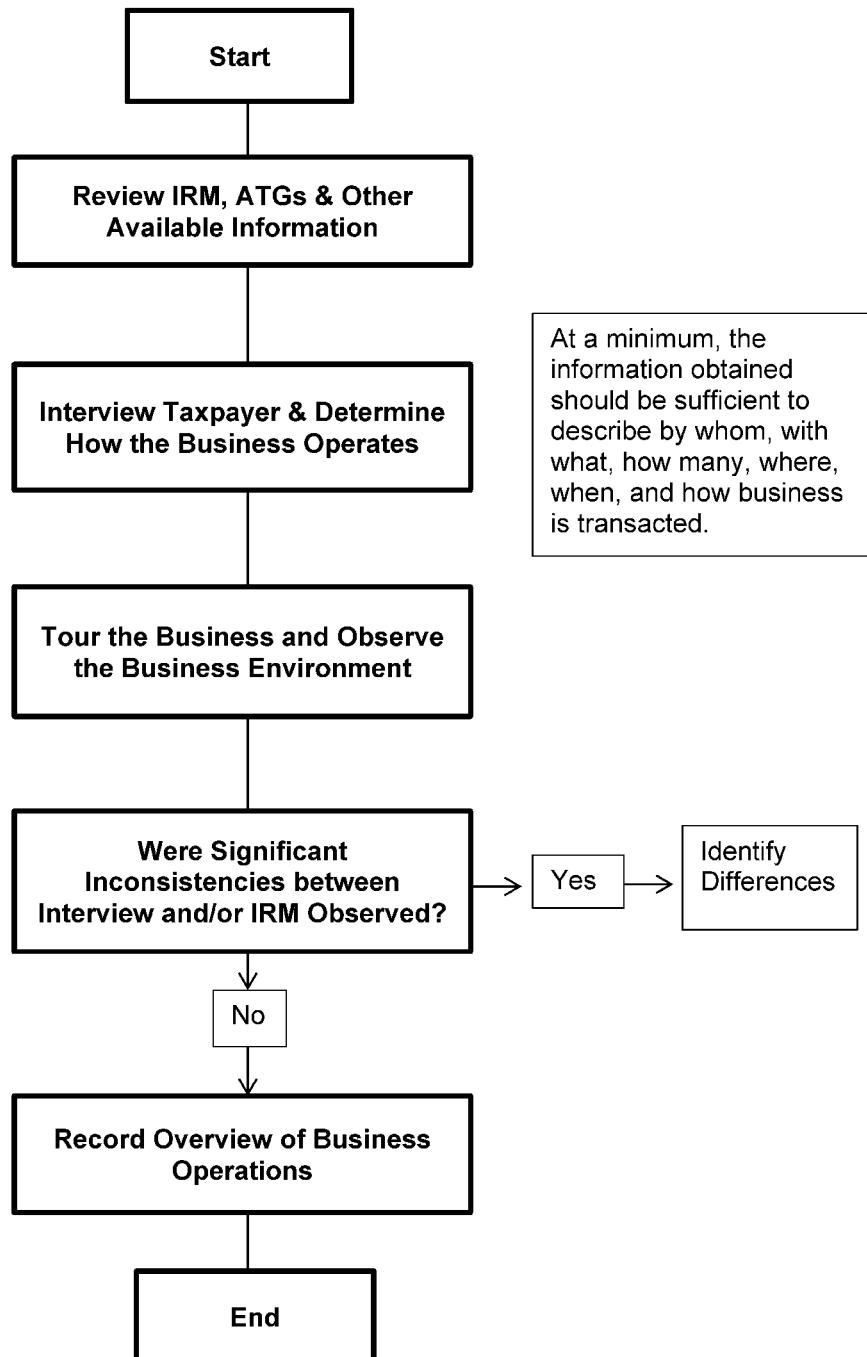


Exhibit 4.10.3-1 (Cont. 2) (03-01-2003)
Analysis of Taxpayer's Internal Controls

**Documenting the Records and Accounting System
Maintained by the Taxpayer
Flowchart 3**

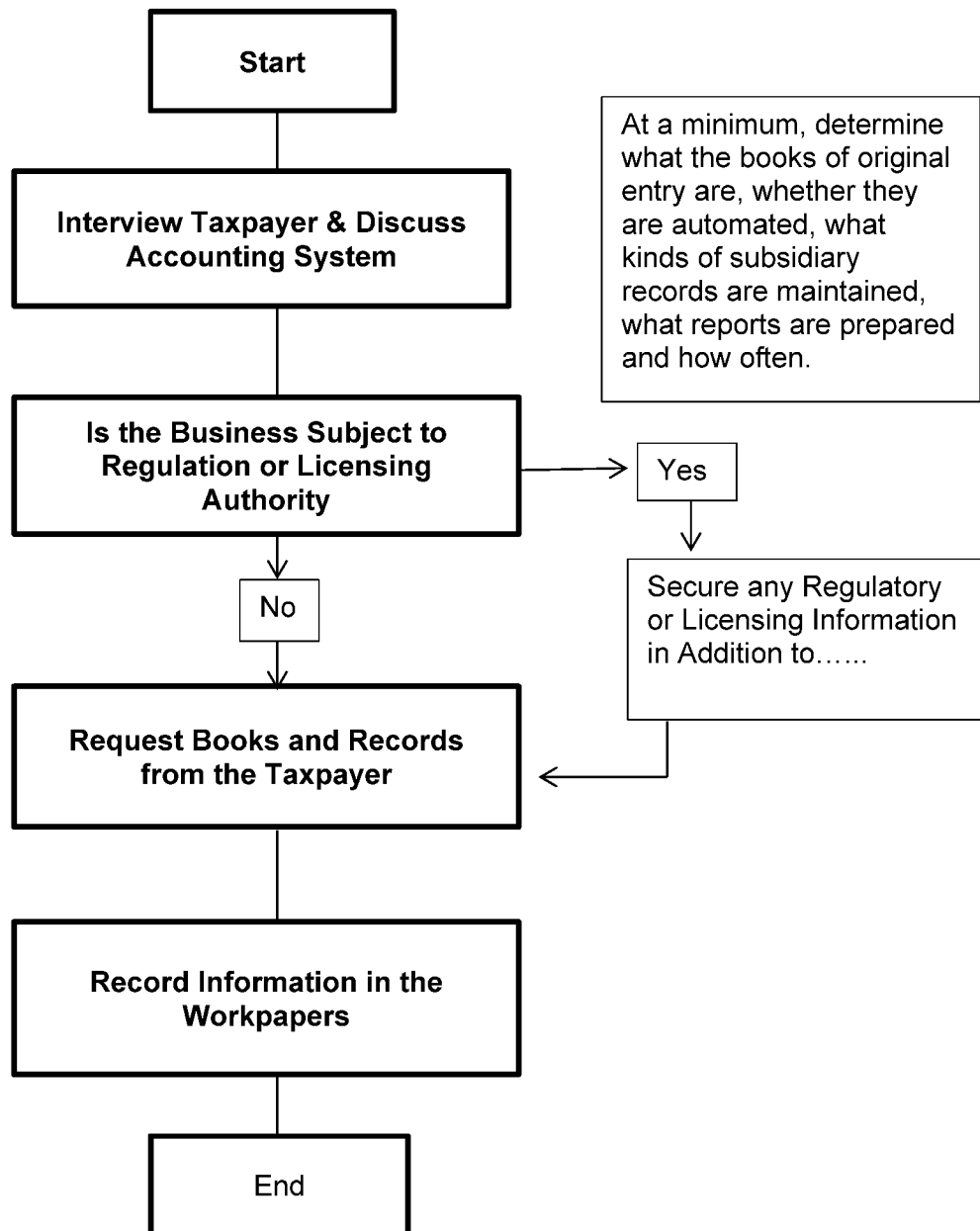


Exhibit 4.10.3-1 (Cont. 3) (03-01-2003)
Analysis of Taxpayer's Internal Controls

**Documenting the Flow of Receipts and Expenses Through the
Taxpayer's Books and Records
Flowchart 4**

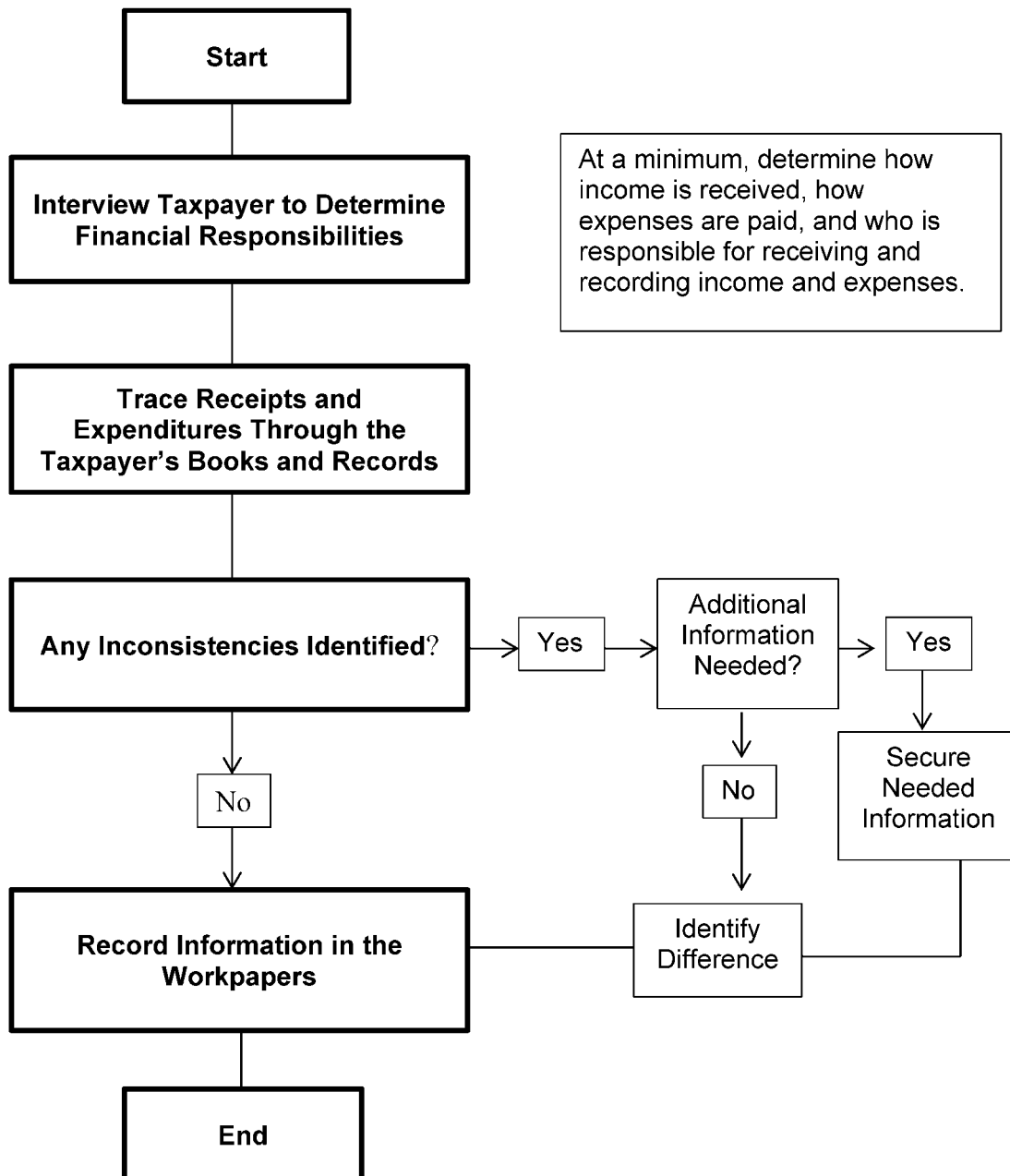


Exhibit 4.10.3-1 (Cont. 4) (03-01-2003)
Analysis of Taxpayer's Internal Controls

Analyzing Procedures to Safeguard Business Operations
Flowchart 5

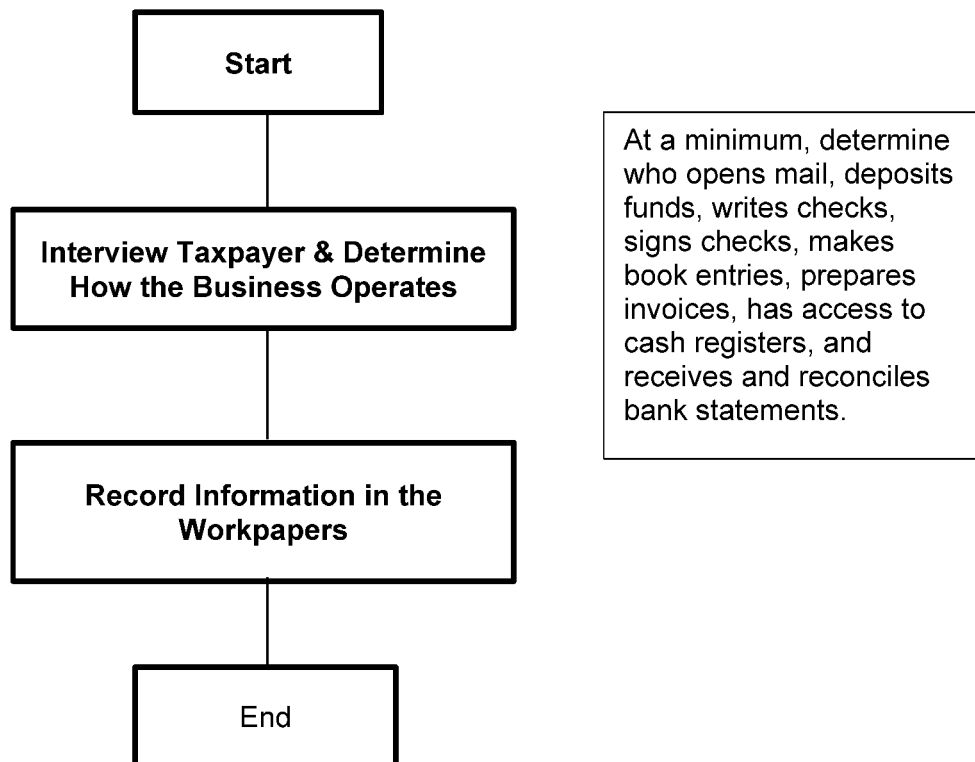


Exhibit 4.10.3-1 (Cont. 5) (03-01-2003)
Analysis of Taxpayer's Internal Controls

Documenting Assets
Flowchart 6

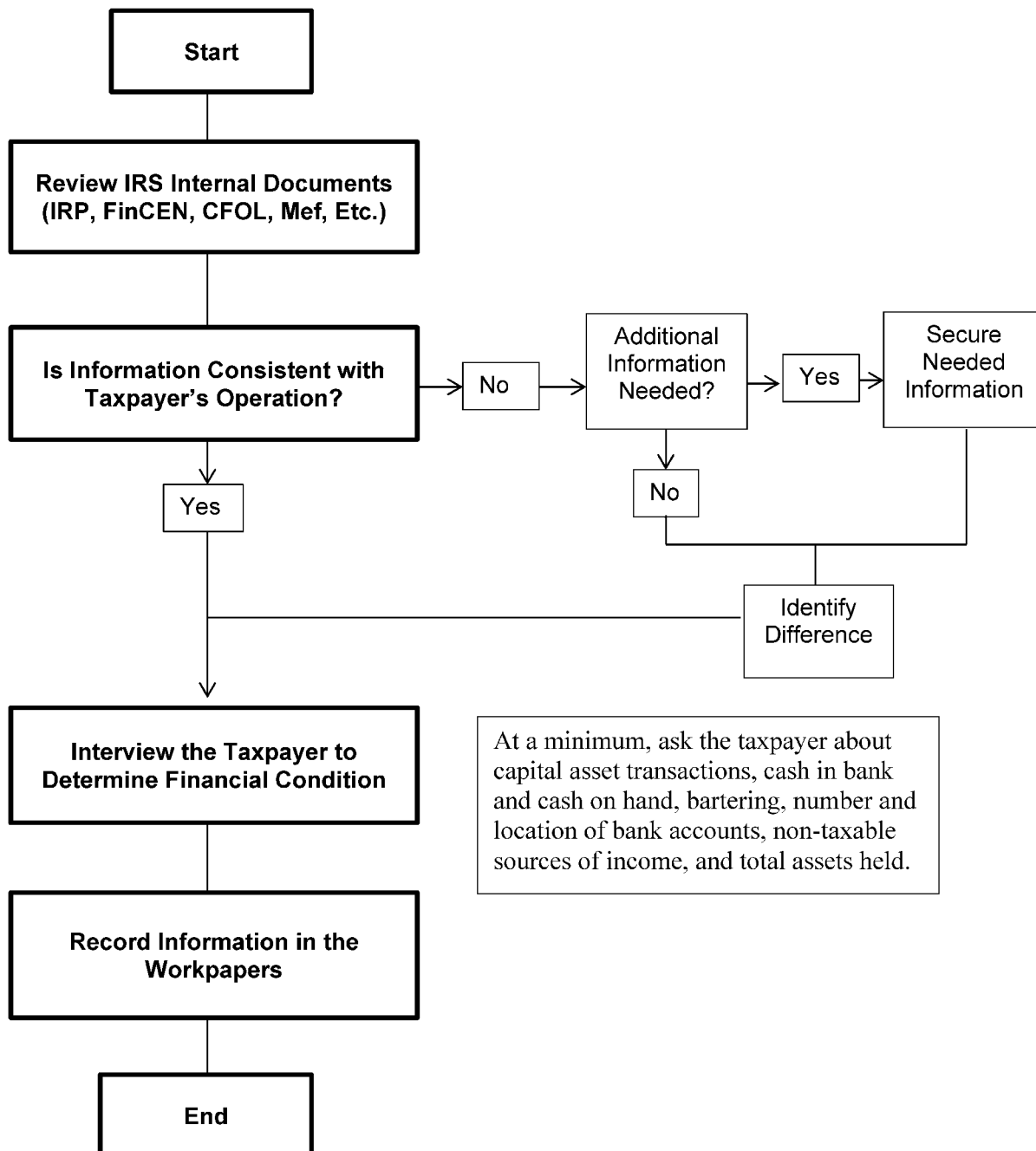
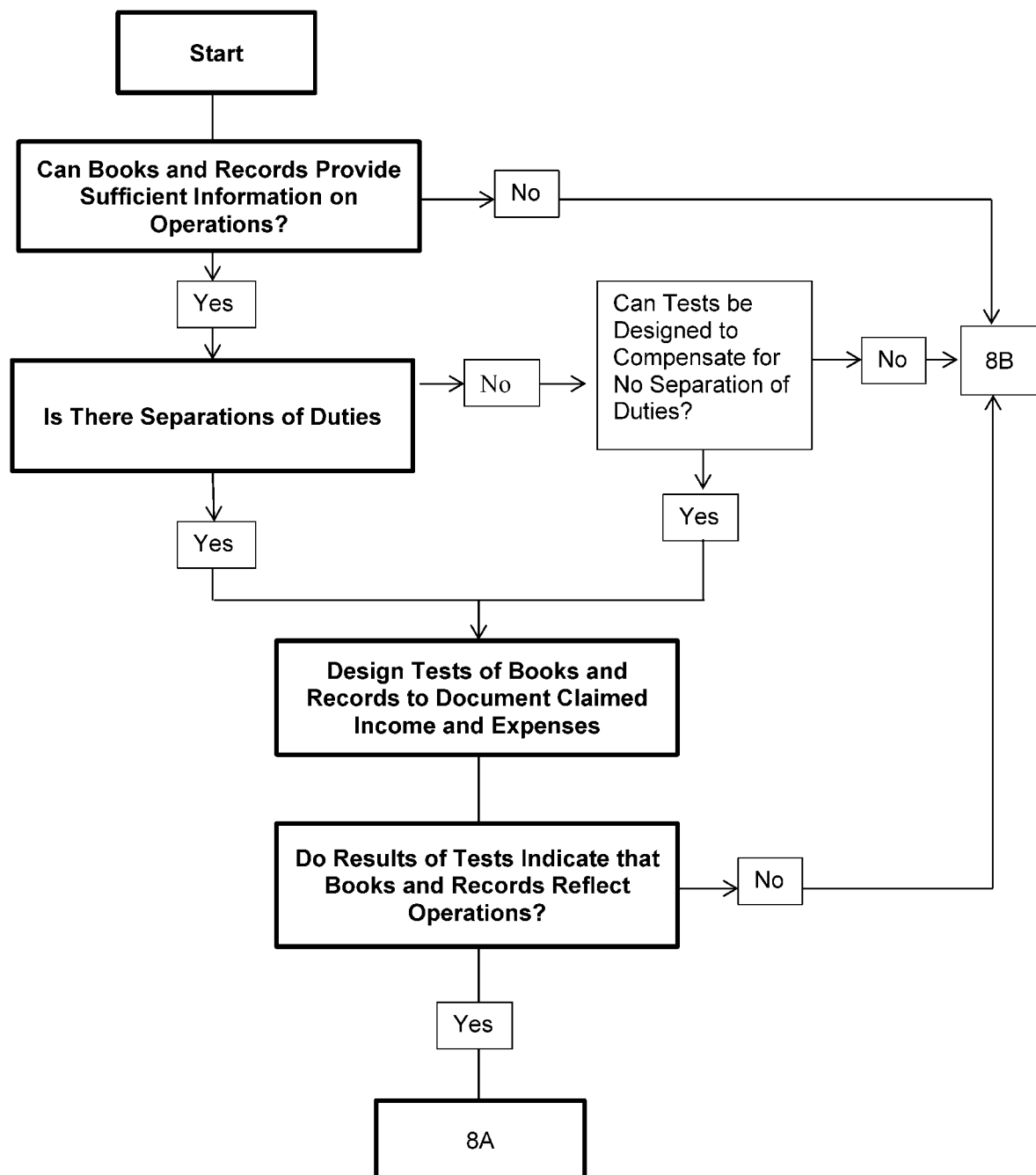


Exhibit 4.10.3-1 (Cont. 6) (03-01-2003)
Analysis of Taxpayer's Internal Controls

**Determining if Books and Records Adequately
Reflect Business Operations
Flowchart 7**



Determining if Books and Records Adequately Reflect Business Operations (Cont.)

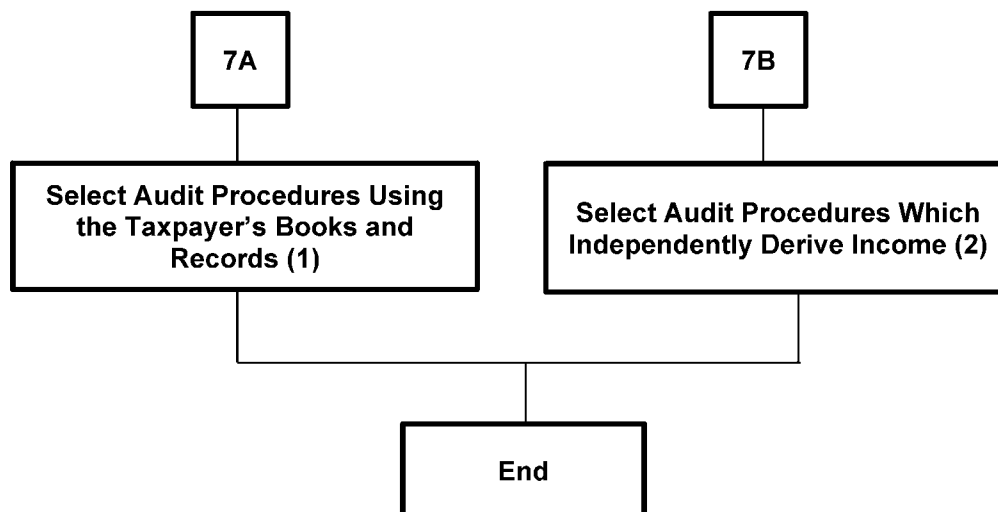
Exhibit 4.10.3-1 (Cont. 7) (03-01-2003)
Analysis of Taxpayer's Internal Controls

At a minimum, determine:

- Is the taxpayer's financial status commensurate with income?
- Are there changes in the books?
- Do the taxpayer's books and records include a system for accounting for nontaxable receipts?
- Do the taxpayer's books and records include a system for accounting for cash expenditure?
- Do the taxpayer's books and records include a system for accounting for cash receipts?
- Does the taxpayer rely on information generated from third parties?
- Has the taxpayer identified their mark-up?
- Does the taxpayer use their books and records for purposes other than tax?
- Do the taxpayer's books and records take regulation and licensing into account?

Exhibit 4.10.3-1 (Cont. 8) (03-01-2003)
Analysis of Taxpayer's Internal Controls

Selecting Appropriate Method for Examining Income
Flowchart 8



(1) Some examples of audit procedures using the taxpayer's books and records are:

- Trace specific items to receipts
- Test sample of receipts to books and records
- Use taxpayer's mark-up to apply to expenditures per books
- Test sample of taxpayer's client accounts to receipts
- Analyze adjusting entries and differences between books and return

(2) Some examples of audit procedures which independently arrive at income are:

- Test taxpayer's sales to industry standards using mark-up statistics of income
- Use formal indirect methods (Source and Application of Funds, Bank Deposits and Cash Expenditures, Markup, Unit and Volume, Net Worth)
- Verify income through third party information; i.e., contact major clients
- Test taxpayer's reported income against information from regulatory and licensing sources.

Exhibit 4.10.3-2 (03-01-2003)

Double Entry Accounting Recording Procedures

Balance Sheet:

Assets		Liabilities	
Dr.	▲ ▼	Dr.	▼ ▲
Normal Bal.			Normal Bal.

Equity	
Dr.	▼ ▲
	Normal Bal.

Income Statement:

Income		Expense	
Dr.	▼ ▲	Dr.	▲ ▼
	Normal Bal.	Normal Bal.	

▲ Indicates an increase in the account balance

▼ Indicates a decrease in the account balance

Normal balance is the type of balance the account is usually expected to have.

Exhibit 4.10.3-3 (05-03-2023)**Balance Sheet Examination Techniques****1. Cash**

Cash may include cash on hand, money in checking and savings accounts, time deposits and other cash investments. The taxpayer may maintain multiple checking accounts. Time deposits may be in the form of savings accounts, money market accounts, certificates of deposit or similar accounts. Many times, transfers of funds occur among these accounts.

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Recently drawn checks that have not been issued. Check the dates the bank made payment.	Overstatement of expenses in the current year. (Cash-basis taxpayer)
Checks with unusual endorsements (officers, partners, shareholder, etc.).	Unauthorized withdrawal, diversion of funds.
Review sequence of numbers for several months and note any missing numbers.	Diversion/withdrawal of income.
Unusual entries in the cash ledger account or cash receipts journal	Sales of assets not recorded on the books or omission of income.
Check interest earned on CDs or brokerage accounts.	Possible omission of income.

2. Accounts Receivable

Examiners should analyze accounts by the following categories: Customer accounts, affiliated companies, shareholders, officers and employees.

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Interest-bearing notes.	Proper recordation of interest.
Credit balances on the trial balance or in the subsidiary receivable ledger.	Deposits or overpayments, additional income or unrecorded sales.
Loans to officer/shareholder, affiliates or other related parties.	Possible disguised dividend or compensation.
Receivables on installment sales.	Interest should be reported as collected.
Credits to receivable accounts, other than collections and bad debts.	The offsetting debit means that an asset was received.
Check subsidiary ledger for unusual items, entries arising from other than the sales or cash journals.	Unreported income.

3. Investments

Taxpayers often hold stocks, bonds, real estate, or other types of investments through their corporations.

Exhibit 4.10.3-3 (Cont. 1) (05-03-2023)**Balance Sheet Examination Techniques**

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Review acquisitions.	Determine source of funds; omission of income.
Write-up or write-down to reflect market values	The taxpayer is taking an unauthorized deduction on the tax return. Proper treatment is an M-1 entry.
Purchases and sales should be recorded at FMV; look to underlying journal entry to determine the sales price.	Correct income or loss should be reported; independent sources may have to be used to verify sales price.
Review investment income account and dividends and interest in conjunction with portfolio; review GL account for investments; increases or decreases.	Ensure sales and purchases are being picked up; ensure interest and dividends are properly recorded.
Test acquisitions to determine if basis was properly recorded.	Over or understatement of income.
Test dispositions to determine if gain or loss was properly recorded.	Over or understatement of income.
Check sales of depreciable property to related parties; sales may be below FMV to shareholders.	Ordinary income to corp. or unallowable losses; sales below FMV are ordinary income (dividend) to the recipient.
Check real estate holdings with rents, or inadequate rents on a yearly basis.	The corporation may be carrying the personal residence of the shareholder; constructive dividends.
Review Investment accounts, for an accrual basis taxpayer; check interest receipt dates.	Failure to set up the accruals from the interest receipt dates to the year end; omission of income.

4. Inventory

Exhibit 4.10.3-3 (Cont. 2) (05-03-2023)
Balance Sheet Examination Techniques

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Inventory valuation method conforms to methods prescribed by IRC 471 and the regulations thereunder (inventory write-downs Rev. Rul. 80-60).	If nonconforming, over or understated inventories and over or understatement of income.
Compare prior and subsequent year inventory balances with current year balances and note any discrepancies.	Possibility of over/under statement of cost of goods sold and under/over statement of net income.
Are year-end purchases included in closing (ending) inventory?	If not, COGS is overstated and net income is understated.
Unauthorized changes inventory valuation method.	The Commissioner may refuse to accept the unauthorized change. In addition, there is a possibility of a distortion of income if no IRC 481(a) adjustment was taken into account.
Removal of inventory for personal use by owners.	Constructive dividend to shareholder and an increase in income to the corporation.
Check for gross profit variations.	Withdrawal of inventory for personal use, understatement of net income.
Notes or qualifying statement on financial statements with respect to inventories.	Change in valuation method (unauthorized), inventory write-downs, under or overstatement of inventory and net income.

5. Other Current Assets

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Review current and prior year balances along with subsequent year balances.	Account for large or unexplained variations, under or overstated income.
Determine the taxpayer's procedure for writeoff's; check cost basis.	Over or understated income.
Prepaid expenses are deductible in the year to which they apply; absence of prepaid expenses.	Understatement of income, improper handling of expenses; expenses may have been prematurely written-off.

6. Loans to Shareholders

Loans to shareholders have potential for audit adjustment to both the corporation and the shareholder. Loans to shareholders may include advances paid in varying amounts over a continuing period, may include the personal expenses of the shareholder paid by the corporation, and there may be no interest charge.

Loan agreements should be reviewed to determine if a bona fide creditor-debtor relationship exists between the corporation and the shareholder.

Items indicative of a true loan include:

- a. Signed note;

Exhibit 4.10.3-3 (Cont. 3) (05-03-2023)**Balance Sheet Examination Techniques**

- b. Security or collateral given;
- c. Definite repayment date;
- d. Periodic repayments or prior withdrawals;
- e. Interest charged and paid; and
- f. Shareholder has available funds to repay the outstanding balance.

Items indicative of a dividend:

- a. No note or open account;
- b. No security given;
- c. No specified repayment date;
- d. No repayments to date;
- e. No interest charged; and
- f. Shareholder cannot repay his or her outstanding balance unless his or her interest in the corporation is liquidated.

Additional considerations:

- a. Closely held corporations;
- b. Poor dividend history;
- c. Corporation's retained earnings account;
- d. Efforts made by corporation to enforce collection;
- e. Ultimate use of the funds borrowed;
- f. Moderate compensation is paid to shareholders;
- g. Withdrawals or advances are proportionate to stock holdings; and
- h. Whether the corporation had sufficient surplus to cover the amount withdrawn.

Beginning and ending balances for shareholder loan accounts should be verified to determine if a pattern of continually increasing balances is occurring. Even when bona fide loan agreements exist, such increases may represent dividends to the shareholder. If a distribution that was originally classified as a loan is found to no longer be a bona fide loan, the amount will be considered to be a distribution of property under CFR 1.301-1(k).

7. Real Estate and Fixed Depreciable Assets

In examining this account, a review of related reserve amounts, depreciation schedules and other pertinent documents will be required. If necessary, consider engineering referrals.

A change to correct a taxpayer's improper depreciation method, recovery period, or convention for computing its depreciation deduction is a change in method of accounting to which the provisions of IRC 446 and IRC 481 generally apply; as is a change to the allocation of basis between assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account.

Exhibit 4.10.3-3 (Cont. 4) (05-03-2023)
Balance Sheet Examination Techniques

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Review acquisitions to ascertain that basis has been properly recorded.	Over or understated income.
For asset acquisitions where other than cash was the consideration, determine how basis was arrived at.	Over or understated income.
Basis should include all expenditures required to place the asset in service.	Understated income.
Review retirement policy of fixed assets; proper recording of receipts from dispositions.	Understated income.
Write-up of assets to appraised value on the books.	Not permissible for tax purposes; overstated depreciation and understated income.
Prior RARs that capitalized items or changed the method.	The taxpayer must follow those changes in subsequent years.
IRC 351 transfers of assets; transferee must use the transferor's basis.	Overstated depreciation and understated income.
Decreases in asset account balances during the year.	Sales have taken place; check for gain or loss; possible sale to shareholder at less than FMV; recapture.
Transfer of assets from shareholder to related corporation.	Under IRC 351, the transferee must use the transferor's basis; be alert to inflated basis and inflated depreciation deductions followed by understated income.

8. Intangible Assets

Old Law:

- a. On April 20, 1993, the Supreme Court held in **Newark Morning Ledger Co. v. United States**, 507 U.S. 546 (1993), that customer-based intangible assets acquired incident to the purchase of an ongoing business are depreciable if the taxpayer can identify the asset and demonstrate that the asset has an ascertainable value and a limited useful life which can be determined with reasonable accuracy. The government had argued that intangible assets that are valued based upon future revenue from continuing at will relationships are non-amortizable goodwill as a matter of law.
- b. The burden of proof remains with the taxpayer to show ascertainable value and a limited useful life which can be determined with reasonable accuracy. Because the government did not contest the life and value issues in **Newark Morning Ledger**, choosing instead to focus on the goodwill argument, the case should not be read as sanctioning any method of valuation or the existence of value or limited life for any asset or type of asset. These issues must be decided based on the facts in each case. The ISP paper on customer based intangibles for all industries, issued February 19, 1996, should also be consulted when examining such intangibles.

New Law:

- a. The Omnibus Budget Reconciliation Act of 1993 was signed into law on August 10, 1993. The Act provides that most acquired intangible assets are to be amortized over a 15 year period. These IRC

Exhibit 4.10.3-3 (Cont. 5) (05-03-2023)**Balance Sheet Examination Techniques**

197, Amortization of goodwill and certain other intangibles, intangibles include goodwill, going concern value, customer lists, core deposits, know-how, information base, workforce in place, and covenants not to compete and similar agreements. The Act generally applies to property acquired after the date of enactment, but provides the taxpayer an election whereby it may apply to all property acquired after July 25, 1991 and before the date of enactment. This election, if made, would include all related parties and apply to any acquisition reported on the electing entity's consolidated return.

Changing a Taxpayer's Method of Accounting:

- a. A change to correct a taxpayer's improper amortization method, recovery period, or convention for computing its amortization deductions is a change in method of accounting to which the provisions of IRC 446 and IRC 481 generally apply; as is a change to the allocation of basis between assets, the result of which simply changes the time or period over which the costs of the assets are recovered or taken into account.

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Basis of asset should include all elements of cost; legal fees, application fees, and proper costs of acquisition.	Under or overstated income.
Goodwill, going concern, workforce in place, information base, know-how, customer-based intangibles, supplier-based intangibles, government licenses and permits, franchises, trademarks and trade names.	IRC 197 intangibles. (see above)
Covenants not to compete; computer software; copyrights and patents, sound recordings, video tapes, film and books.	Treated as IRC 197 intangibles only if acquired in connection with the acquisition of a business. Otherwise, amortizable under IRC 167.
Organizational expenses.	Deductible \$5,000 of costs paid or incurred after October 22, 2004. The \$5,000 deduction is reduced by the amount the organizational costs exceed \$50,000. Any remaining costs must be amortized over 180 months.
Lease acquisition costs. Check for renewal option and over/under stated amortization.	Amortized over lease term.
Lessee Improvements.	Improvements to real property subject to MACRS. Recovery period is generally the same as property to which the improvement was made.
Exchange, clearing, or suspense accounts; question why the accounts were set up and for what purpose.	Possible diversion of income, inflated expenses, loans to shareholders. Over/under statement of income.
R & D expenditures taken as a current year deduction or capitalized; check for proper amortization.	Over/under stated income.
Request engineering services when applicable.	Determination of correct valuation of asset

Exhibit 4.10.3-3 (Cont. 6) (05-03-2023)
Balance Sheet Examination Techniques

9. Liabilities — Current and Accrued

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Large expenses charged to the first month of the tax year under examination.	These expenses may have been accruable for the preceding tax year.
Security Deposits.	If applied to last month's rent, then taxable upon receipt.
Year-end accruals and reversals including purchases. Purchases should be included in ending inventory. Acceleration of subsequent expenses into current year. Review invoices.	Determine propriety of year-end accruals; were actual expenses incurred, and for what amount; were accruals actually charged to expenses in the subsequent period? Net income will be understated; distortion of income.
Read minutes being alert for contingent liabilities.	If an accrual was set up, consider IRC 461 for proper year of deduction; expenses cannot be contingent, must be fixed and the amount reasonably determinable.
Accounts payable— tie in trial balance to general ledger; check for adjusting entries or reclassification and netting of related accounts receivable.	Potential unreported income; understatement of sales.

10. Loans From Shareholders

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Large liabilities in relation to capital stock. (especially with a new company) . Thin capitalization exists.	Thin capitalization. Disallow interest expense and treat payments to the shareholder as dividends.
The loan is not a bona fide debt and the shareholder took a bad debt deduction.	In addition to Item a. above, disallow the bad debt deduction.

11. Deferred Credits

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Credit balance accounts, reserve accounts, contra-balance in receivables.	Deferred credits exist. The taxpayer has the free and unrestricted use of an assets. Income should be recorded. Cash or accrual basis is irrelevant.
Installment method of reporting income. The deferred credit recorded will be the unrecognized gain for tax purposes. Check year-end balances to determine if the amount reconciles with the gross profit to be reported.	Should be a Schedule M-1 entry. Possible under/over statement of income.

12. Capital Stock

Exhibit 4.10.3-3 (Cont. 7) (05-03-2023)**Balance Sheet Examination Techniques**

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
New issues or additions	Was stock issued for services rendered or for property? Check for FMV and gains/losses to shareholder.
Reduction or cancellation of stock, by complete or partial liquidation.	Determine recipient's basis and gain/loss if it is a taxable transaction. Refer to IRC 337, IRC 338, and IRC 1245 — depreciation recapture.

13. Retained Earnings

WHAT TO LOOK FOR:	WHAT TO CONSIDER:
Reconcile income per books with income per tax return (go back to general ledger, not just the balance sheet).	Note any differences and review those that present tax problems.
Reconcile opening balance with year-end balance.	Investigate increases or decreases. Credit items may be income items.
Determine if there is an unreasonable accumulation of funds.	Consider imposition of IRC 531, accumulated earnings tax.

Exhibit 4.10.3-4 (03-01-2003)**Markup Table**

Margin Percent of Selling Price	Blank	Markup Percent of Cost
4.8	5.0
5.0	5.3
6.0	6.4
7.0	7.5
8.0	8.7
9.0	10.0
10.0	11.1
10.7	12.0
11.0	12.4
11.1	12.5
12.0	13.6
12.5	14.3
13.0	15.0
14.0	16.3
15.0	17.7
16.0	19.1
16.7	20.0
17.0	20.5
17.5	21.2
18.0	22.0
18.5	22.7
19.0	23.5
20.0	25.0
21.0	26.6
22.0	28.2
22.5	29.0
23.0	29.9
23.1	30.0
24.0	31.6

Exhibit 4.10.3-4 (Cont. 1) (03-01-2003)**Markup Table**

Margin Percent of Selling Price	Blank	Markup Percent of Cost
25.0	33.3
26.0	35.0
27.0	37.0
27.3	37.5
28.0	39.0
28.5	40.0
29.0	40.9
30.0	42.9
31.0	45.0
32.0	47.1
33.3	50.0
34.0	51.5
35.0	53.9
25.5	55.0
36.0	56.3
37.0	58.8
37.5	60.0
38.0	61.3
39.0	64.0
39.5	65.5
40.0	66.7
41.0	70.0
42.0	72.4
42.8	75.0
44.4	80.0
46.1	85.0
47.5	90.0
48.7	95.0
50.0	100.0

Exhibit 4.10.3-5 (03-01-2003)
Flow of Accounting Transactions

Single-Entry Accounting System

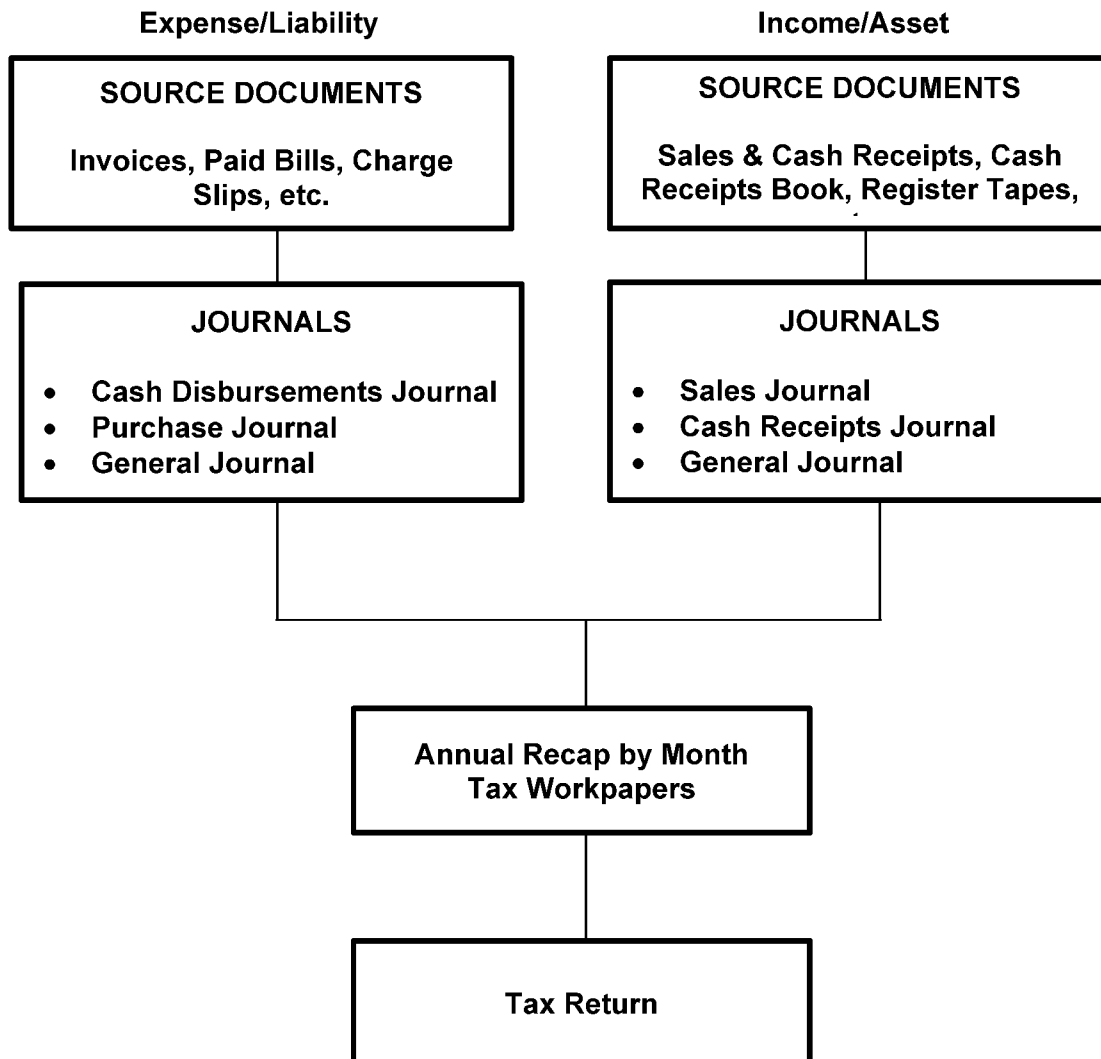


Exhibit 4.10.3-5 (Cont. 1) (03-01-2003)

Flow of Accounting Transactions

Double-Entry Accounting System

