Cash Intensive Businesses Audit Techniques Guide - Chapter 4 - Minimum Income Probes

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Conducting the Required Minimum Income Probes

The minimum income probes are analytical tests intended to determine whether the taxpayer accurately reported income. The use of the minimum income probes can establish whether there is unreported income.

If the taxpayer is underreporting income, the probes should result in the identification of at least some of the understatement. The examiner should try to maximize what can be discovered during the minimum income probes. If an indirect method will be needed it would be best to make the decision as quickly into the examination as possible.

The purpose of the Minimum Income Probe Lead Sheet is to assist the examiner in conducting their initial income probe and to determine if further, more detailed investigation is warranted. The examiner must document what auditing steps are used and the results. This can be done by inserting your comments and analysis on the RGS Leadsheets or by using subsidiary workpapers.

Certain minimum probes will be made regardless of the type of return filed by the taxpayer. The minimum income probes for individual business returns are:

Financial Status Analysis (Cash-T) IRM 4.10.4.3.3.1

First, is the development of a preliminary Cash-T analysis based on the tax return and case file information for individual business filers (Schedule C or F). This preliminary Cash-T is not a financial status audit technique (FSAT); it is simply a method of presenting the information and facilitating the analysis. For corporations and other business entities, examiners should prepare a comparative analysis of the balance sheet and income statements using the year under audit and the prior/subsequent year data.

If the preliminary analysis indicates that there is no material imbalance, then the depth of the examination can be limited to the Minimum Income Probes.

However, if the analysis indicates a significant imbalance in cash flows, tell the taxpayer (or representative) that there is an issue and give them a chance to explain or resolve the material imbalance. Show the taxpayer (or representative) how the analysis was completed and give them copies of relevant work papers for their review. To the extent possible, the taxpayer’s exact response to the Cash-T imbalance should be recorded.

During the course of the audit, the preliminary analysis will be updated for new information gathered during the examination process. There is no magic list, but areas to keep in mind are the taxpayer's spending patterns, accumulation of wealth, financial history, and potential for nontaxable sources of funds.

Accept credible oral testimony and reasonable estimates. Estimated personal living expenses should be updated for actual amounts reflected on the tax return and as determined during the examination, but taxpayers should not be asked to complete Form 4822, Statement of Annual

Estimated Personal and Living Expenses. The form is intended to be a tool to help examiners create an audit trail.

Generally, inspecting the interior of a taxpayer's home should only be done to resolve a specific issue such as an office in the home expense – financial status information can usually be obtained from public records or an unobserved drive through the neighborhood. However, if the taxpayer has an office in the home, that portion of the residence is a business location and the examiner is encouraged to conduct the examination at that location.

Interview the Taxpayer IRM 4.10.4.3.3.2

Examiners should use the interview to gain an understanding of the business process and judge the credibility of the taxpayer.

In cash intensive business there may be very few tangible records, so it is important to perform a detailed and meticulous interview. The oral testimony of the taxpayer at this point may turn out to be the only evidence provided, so it must be exhaustive enough to be properly evaluated. The smallest detail gathered may be useful later. The examiner should not abbreviate the interview. A proper interview for a cash intensive business may take two or more hours, so be sure to offer the taxpayer a short break.

Have the taxpayer explain every step from the time cash and other income is received until it is deposited to a bank or spent. Only by taking the time to write down every step in the cash process and noting the name of every person who handles cash, can an examiner find weaknesses in the system if they exist.

Don't hesitate to ask candid questions:

- Taxpayers usually withdraw goods from their stores but rarely adjust cost of goods sold for personal use- ask the taxpayer if they keep track of personal withdraws, if not, ask them to estimate weekly amounts. Follow up by asking them to explain the situations when goods are withdrawn, for example, when their children come to the store, once a week for dinner ingredients, once a month for toiletries, etc. Keep in mind it is unlikely a person will go to the store to purchase items at retail when they can take it home from work at wholesale (or free).
- Owners usually fail to report the value of merchandise, trips or prizes earned from suppliers for volume purchases- ask what awards were earned and who used them. If the response is negative, remind taxpayers that we occasionally follow up unusual situations with third party contacts.
- Ask when financial tasks are usually performed. The shorter the delay in inputting data into the accounting records, the lower the risk of untracked changes. As input time delays increase, the potential risk related to alterations, manipulations and/or deletions increases. This means there is a greater chance of skimming or undisclosed items.
- Ask how employee usage is handled. Do employees get discounts-how? Do employees receive free meals-how?

- Entrepreneurs with cash businesses are usually interested in other types of businesses that will generate cash- ask about sideline or secondary operations. The undisclosed business may be completely unrelated, for example, a convenience store owner who also sells used cars for cash. Ask the taxpayer how they spend leisure time.
- Always ask about bartering. Small businesses will barter with like minded business friends to turn older inventory and avoid spending cash.
- Always ask about a cash hoard. In a cash business this is critical. Find out if one existed and where the money came from. If it was skimmed from the business in prior years, it is taxable. If it came from other sources it can be traced and the examiner must follow up.

Tour the Business IRM 4.10.4.3.3.3.

Have the taxpayer explain how the business operates, including each process. For example, in a convenience store, have the owner explain how grocery sales are made, how checks are cashed, how money orders are sold, how Western Union transfers are made, how coins are collected from vending machines, etc.

For each process, document each step, especially the handling of cash, from its receipt to the time it leaves the business.

To accommodate the owner, consider combining the interview with the business tour. This is especially effective when the examiner will be working with a representative or at another location.

Observe the type of payments that are made and how they are handled. Spend some time watching the procedures at the register and stay long enough to observe several transactions. If the taxpayer has said he rarely receives cash, but in two hours the examiner notes 10 cash purchases, that observation must be recorded and analyzed.

- Compare the cash register tapes from the day the register was observed, to the tapes for the audit period.
- Match the taxpayer's statements, cash register records or reports, against the findings.
- Note the manufacturer and model number of all cash registers and point of sale (POS) systems. If necessary, the manufacturer can be contacted for an owner's manual or information on accessing reports.
- A cash business needs a safe method for storing cash. Note the location and size of the vault and who has access. Ask if the owner maintains another safe in his home or an alternate location and determine the size of that as well.
- Observe income sources, such as vending machines, newspaper stands, fax machines, or phone cards for sale, and ask questions about them. In most businesses, space is at a premium and every inch must produce income.
- Some owners have been known to reduce prices when learning of an IRS, State or Sales Tax examination, in an effort to reduce the eventual adjustment based on a percentage markup calculation. During the tour the examiner should record a sample of prices on key items; later these can be compared to cash register tape entries. If the cash register tapes are missing, the taxpayer cannot verify that prices were either higher or lower.

Evaluate Internal Controls IRM 4.10.4.3.3.4

An evaluation of the taxpayer's internal controls will determine the reliability of the books and records. The fact that the income as reported on the return matches the books and records does not mean that the books and records are reliable or that they reflect the actual business operations. The evaluation of a taxpayer's internal controls, and techniques used to gather information for the evaluation, are not financial status audit techniques.

Internal controls are the taxpayer's policies and procedures to identify, measure, and safeguard business operations to avoid material misstatements of financial information. The purpose in analyzing internal controls is to (1) understand and document the entire business operation and (2) determine if the books and records are reliable and adequately reflect business operations. Every taxpayer has a method for conducting the business and understanding that methodology is important to establishing the depth of the examination of income and determining which analytical tools are most appropriate.

If there is a system in place, a flow chart should be prepared. The flow chart of the internal control system should also describe how the income is derived and flows through the business. Knowledge, review, and testing of the business' internal control system may (1) provide a reasonable level of assurance that all income is accurately accounted for or (2) may uncover transactions that are omitted from the accounts.

Example: The taxpayer delivers cash register tapes to the bookkeeper, who reconciles the cash deposited to the tape amounts and prepares the QuickBooks entries. The taxpayer collects all cash and deposits it to the bank account. The bookkeeper's oversight accounts for a substantial control and reliability in the books, but does not ensure that all income is reported.

Reconcile Income to Books IRM 4.10.4.3.3.5

Reconcile the income reported on the tax return to the taxpayer's books and records. Ask the taxpayer how income was computed and duplicate the taxpayer's steps.

Techniques to consider:

1. Test the information obtained in the initial interview, observed during the tour of the business site, and from the evaluation of the internal controls to determine if transactions were properly recorded. Make sure any information provided by the taxpayer in the interview is reflected in the book and records.
2. Confirm that income from all assets and operations observed during the tour of the business is included in income.
3. Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income.
4. Test the weaknesses to determine whether income actually was diverted.

Test gross receipts IRM 4.10.4.3.3.5(6

After reconciling the income to the books, test the income that is included in the books by tying the original source documents (cash register receipts and/or invoices) to the amount reported.

When the original records that would trace to the books are missing, for whatever reason, further testing must be done. The examiner may try to match an expense item to verify the corresponding income is reported. Or, an indirect method of calculating income must be used.

Example: The taxpayer's books and records are reconciled to the income tax return. No discrepancy is noted when reconciling income to the bank statements and sales journals, or verifying purchases by inspecting cancelled checks and invoices. The examiner also attempted to tie purchases to specific jobs and the income received from those jobs. For a few purchases, there was no corresponding job or income reported. An indirect method will be used to compare with reported income.

Example: *The taxpayer owns and operates a cash-intensive food service business. The taxpayer's books and records tie to the tax return. As part of the audit, the examiner should test gross receipts by tying the original source documents (cash register receipts and/or invoices) to the books. However, the taxpayer does not have the original documents. A percentage markup method will be used to calculate income.*

Analyze Bank Accounts IRM 4.10.4.3.3.6

The examiner must review all accounts, business and personal, including investment accounts, CD accounts, savings account, etc.

Look for unusual deposits (by size or source), the general frequency of deposits, deposits of cash in sufficient quantities, specific deposits that do not follow the taxpayer's normal routine or pattern, nontaxable deposits such as loans and transfers, commingling of personal and business activities, and cash-backs when a deposit is made.

The examiner should be concerned when the total deposits are less than the reported gross receipts. This can mean either business receipts are being spent instead of being deposited (for example, cash pay outs for the business or cash paid to the owner) or, the business receipts as reported are not accurate.

If the business expenditures paid by check are less than the deducted business expenses on the return, then the taxpayer may be overstating expenses, paying expenses by cash (unreported income), or paying expenses from an undisclosed source of funds.

If the analysis indicates significant commingling of funds, then the internal controls are weak and the books and records may be unreliable.

A cash basis taxpayer will sometime write a check and deduct the expense, but never actually use the check to make the transaction. This can be discovered by examining outstanding checks

(checks the bank statements do not show as paid), or by reviewing the dates checks were paid by the bank. Discovery may also be made by looking for a credit balance in the cash account- this indicates checks are drawn but not issued until later.

One way to test the checks written is to compare all of the cancelled checks for a sample period, such as one month, by comparing the names of payees with that of each endorser. If they do not agree or if the name of any officer, partner or other related individual appears as an endorser find out why. While testing the written checks, verify each payment in the cash disbursement book or check register. If there are any discrepancies the examiner must inquire further. Be alert for any payees who are related individuals and for any checks written to cash.

Analyze Business Ratios IRM 4.10.4.3.3.6

The books and records should always be used to evaluate the accuracy and reasonableness of the reported amount of income through the use of ratios. Consider the use of the ratios described in Chapter 2, especially when inventory is a factor in the business.

Example: *Analyzed Gross Profit Percentage, Inventory Turnover and Percentage Change in Inventory. GPP decreased significantly in 2006 from a consistent 59-61% to 32%. At the same time inventory turnover (a factor of sales) increased from 278% to 459%. This indicates more items were sold in 2006, but less profit was earned. In the following year GPP rose to 43% and inventory turnover that had increased to 459% dipped back to 297%. 2006 is anomalous and the income/inventory figures do not appear to be correct. Need an explanation for this situation.*

Analyze E-Commerce Activity IRM 4.10.4.3.6.4

The taxpayer should be asked about personal and business internet use. Ask the taxpayer how they use the internet. Do they:

- Check bank balances?
- Pay bills?
- Book travel?
- Make catalog purchases?
- Play computer games?
- EBay?

This will give the examiner an understanding of the taxpayer's expertise with online activities.

If a business has a website ask who designed and set up the website. If there are any advertising banners on the website, there will be revenue to the taxpayer. Ask the taxpayer if there are links from other websites to their website.

If the business sells product or takes orders over the internet, the examiner should be sure to record the process and ensure sales are included in income.

See Chapter 7 for a discussion of digital cash and other anonymous funds transfers.

Test Gross Receipts [IRM 4.10.4.3.3.5(6)]

If there are excessive cash register shortages, investigate the explanations for each individual shortage. Follow up by speaking with the employee who used the register. If the employee is no longer with the business, it may be worthwhile to locate the individual and ask about procedures at the business.

For a sample period, match cash reported to be received (less cash paid out for that day or days) on the daily sheet to the amount deposited. If no daily sheet is maintained, match one day's Z-tape cash (Z-tape total - check and credit payments = cash sales; ask the taxpayer to calculate checks and credit payments) to the bank deposit. Ask the taxpayer to explain any discrepancy. Similarly, if more cash was paid out on a particular day than was received, ask the taxpayer for an explanation. Try to write down the responses as accurately as possible.

For a sample period; look for voids, no sales and refunds. No sales are recorded on the cash register tapes when the drawer is opened but no sale is rung. This may be because change was made to a non customer. If it happens frequently it may be a sign of other activity. Make a list of no sales openings for a period and ask the taxpayer for an explanation. If the explanation is not credible, there may be unreported sales.

Account for all numbered invoices. If invoices are unnumbered or prepared on a computer, ask the owner how they are certain all invoices are present. Investigate further if you suspect invoices are missing.

Analyze Personal and Business Bank Accounts [IRM 4.10.4.3.3.2]

Remember, businesses that deal in cash do not deposit all of their cash receipts into bank accounts; some cash is retained for use in the business.

Analyze Business Ratios [IRM 4.10.4.3.3.2 & IRM 4.10.3.9.1]

Analyze business ratios and compare to industry averages to evaluate the reasonableness of the taxpayer's reported business. If there are differences, ask the taxpayer why and write down the reply.

Check for E-Commerce Activity [IRM 4.10.4.3.6]

Ask if the business purchases or sells anything over the internet, or if any suppliers allow online purchase orders.

Finally, when completed, the required Minimum Income Probe should indicate that either income is sufficient to support the taxpayer's financial activities and no further action is needed or there is a significant imbalance indicating the potential for unreported income. If this is the case, a reasonable likelihood of unreported income has been established and the use of an Indirect Method, or FSAT, should be considered.

Using Financial Status Audit Techniques

Once an examiner has established that there is a reasonable likelihood of unreported income, a more in-depth examination of income is warranted. Examiners will need to decide which techniques are best suited for the individual taxpayer. It may be most appropriate to use a specific item method when there is direct evidence of either omitted income or overstated expenses, or the source of the income can be identified. In other cases, one of the traditional indirect methods may be more appropriate. GAO specifically defined financial status audit techniques as the use of an indirect method; bank deposit analysis, net worth method, normal markup/unit of sales method, and the cash transactions (Cash-T) method. Therefore, Indirect Methods and any technique or procedure used to gather information to support an Indirect Method could be labeled a "financial status audit technique. "A "financial status audit technique," therefore, is defined by its purpose; a technique, analysis, or procedure used to gather information or determine the amount of unreported income based upon circumstantial evidence.

It is important to note that the results of the required Minimum Income Probe described above are not the only analysis that can trigger the use of a financial status audit technique. Even when the taxpayer's cash flows are in balance, there may be circumstances warranting the use of an in-depth analysis of income using an indirect method. For example, if the taxpayer's books and records are unreliable or incomplete, there are significant increases in net worth, previously undisclosed sources of funds are identified, or other information suggests unreported income, then the reasonable likelihood of unreported income has been established.

The Examination Specialization and Technical Guidance Audit Technique Guides (ATGs) discuss specific issues that are frequent or unique to a specific market segment. Also include is information on these areas of noncompliance, for example: underreporting of income, non-filer, and employment taxes.

Examination techniques in the guides includes: examples of documents to request, key interview questions, things to look for during tour of business, unique indirect methods, things to look for in books and records, and other known sources of information pertaining to the market segment.

Respecting the Taxpayer's Privacy

In-depth examinations of income may involve a thorough examination of the taxpayer's books and records or contacting third parties. Examiners should be sensitive to the burden this places on the taxpayer and the impact an in-depth examination may have upon the taxpayer's personal and professional life. The following guidelines should be followed.

Ask only for information relevant to and necessary for resolving the issue. Ask the taxpayer first; information should be collected directly from the taxpayer whenever possible. Contacting third parties for information is intrusive and should only be done if the taxpayer is unable or unwilling to provide the information. If a third party must be contacted, ask yourself whether the information is really needed, if there is a less intrusive alternative way to get the information, and be sure that the taxpayer's confidentiality is not breached. If possible, verify information obtained from third parties with the taxpayer before reaching a conclusion or proposing an adjustment based on the third party information.

Respect the taxpayer's right to representation. Examiners cannot require that a taxpayer participate in the audit or be interviewed without a summons. However, examiners need to talk with a knowledgeable person. If needed, the taxpayer's voluntary presence at an interview, or tour of the business site, can be requested through the representative.

Keep managers informed. Alert managers if a required Minimum Income Probe indicates a material imbalance and how the issue will be developed. Managerial involvement and support is important.