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Rectifying Tax and Financial Statement Pitfalls in Manufacturing

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Internal Revenue Service (IRS) Audits

Who gets audited:

- Random selection
- Audits to related parties
- Amended returns
- Red flags



Why do red flags matters:

- The IRS audits thousands of business returns annually
- Red flags increase the likelihood of an audit or penalties
- Accurate reporting protects clients and firms from legal risk

... Internal Revenue Service (IRS) Audits

What We'll Cover:

- Common audit triggers and suspicious deductions
- Navigating the audit process

Who it Helps:

- CPAs and tax professionals
- Business owners filing their own returns
- Accounting staff learning risk indicators

Types of Red Flags

... 1. Unreported Income

Mismatch with 1099s/third party reports:

- Income reported on Form 1120, 1120S, 1065, or Schedule C differs from what is reported to the IRS on Forms 1099-NEC, 1099-MISC, or 1099-K

Bank deposit analysis:

- IRS may compare deposits to reported income and flag discrepancies

Cash-heavy businesses:

- Industries like restaurants, hair salons, and car washes are often scrutinized for unreported cash income

2. Excessive Deductions or Losses

Large expenses relative to revenue:

- Deductions (meals, travel, supplies, etc.) seem disproportionately high compared to gross receipts

Repeated net losses:

- Multiple years of net losses may lead the IRS to question whether the activity is a hobby rather than a business (hobby loss rules under §183)



... 3. Personal Expenses Deducted as Business Expenses

Luxury vehicle expenses:

- Deducting full costs or depreciating high-end cars may raise questions about personal use

Meals, travel and entertainment:

- Must be ordinary, necessary and properly substantiated

Family members on payroll:

- Paying large salaries to spouses or children without proper roles or documentation

... 4. Improper Classification of Workers

Independent contractor vs. employee:

- Misclassifying employees to avoid payroll taxes and benefits

Missing Form 1099-NEC filings:

- Business hires contractors but doesn't issue required 1099s



... 5. Missing Forms and Inconsistent Filing

Missing required schedules:

- Schedule M-1 (Reconciliation of book income to tax income)
- Schedule M-2 (Reconciliation of AAA/OAA or partners capital)
- Schedule L (Balance sheet)

Not filing Form 1125-A for cost of goods sold (COGS)

Not filing Form 1125-E for officer's compensation

6. Inconsistencies Across Years

Sudden changes in deductions or income without clear justification

Revenue not matching industry trends:

- IRS has access to industry benchmarking data and may flag outliers



... 7. Non-Filing or Late Filing

- Late or missing business income tax returns
- Late or missing 941, 940, W-2, or W-3 payroll filings
- May trigger penalties and further scrutiny

What happens if I get selected for audit?

... Audit Process

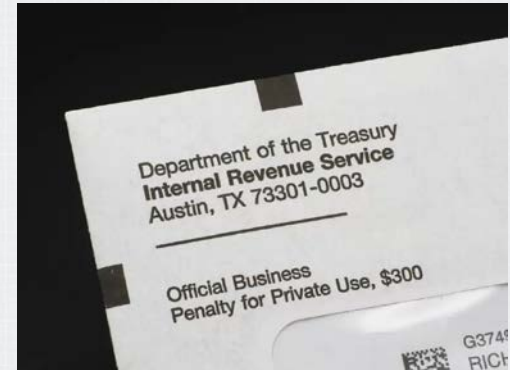
Audit selection notifications come via mail

- The IRS never initiates audits via telephone, email, etc.

Can be conducted via mail or through in-person interview

- At an IRS office or at the Taxpayers place of business

List of requested documentation to be reviewed



... Audit Process

Length of audit depends on complexity of issues and availability of information

Audit conclusions:

No change = all items reviewed were substantiated and no changes are made

Agree = the IRS proposed changes, and you agree

Disagree = the IRS proposed changes, and you disagree

- Request a conference with an IRS manager
- File an appeal

Operational & Financial Red Flags

... Operational and Financial Red Flags

Importance of Identifying Red Flags:

- Detecting financial red flags helps owners and managers mitigate risks and make informed decisions in the operations of the businesses

Key Financial Metrics to Monitor:

- Profitability, inventory levels, cost of goods sold, debt and efficiency ratios

Comprehensive Financial Analysis:

- Analyzing financial statements alongside operational understanding is critical for effectively identifying and addressing red flags

Inventory and Cost Management

... Inventory and Cost Management – Excessive Inventory Levels

Warning Signs:

- Indicators include rising inventory to sales ratio, inventory growth without revenue increase and high obsolete inventory stock

Causes:

- Overproduction, declining demand and poor inventory management

Consequences:

- Leads to obsolescence, spoilage, and increased storage costs which can affect cashflow and further impact profitability

Adjustments:

- Align material purchases and production schedule with sales forecast
- Update sales forecast more frequently
- Evaluate how you are monitoring inventory levels - inventory tracking systems

Inventory and Cost Management – Unusual Changes in Cost of Good Sold

Warning Signs:

- Sudden unexplained spikes or fluctuations in cost of goods sold accounts

Causes:

- Materials - Increased costs of raw materials from supplies
- Labor - Inefficiencies in production
- Overhead - Mismanagement of resources

Consequences:

- Decrease gross profit margin and net income

Adjustments:

- Evaluate vendors and vendor pricing and in result customer pricing
- Communicate with production staff
- Evaluate production issue and resolve

Capital Expenditures

... Capital Expenditures - Excessive or Aggressive CapEx

Warning Signs:

- High CapEx relative to peers; Project delays
- Increasing CapEx without matching revenue growth

Causes:

- Misaligned projects or poorly planned investments
- Poor cashflow budgeting and forecasting

Consequences:

- Project overruns or impairment costs
- Excess debt, cashflow, and profitability

Adjustments:

- Cashflow budgeting & forecasting
- Each CapEx Project - Budget/Schedule/Scope; Per approval and ongoing

Revenue and Debt

... Revenue – Unexplained or Inconsistent Revenue Growth

Warning Signs:

- Significant deviation from industry trends or prior periods

Causes:

- Aggressive or inaccurate accounting practices

Consequences:

- Inaccurate financial reports

Adjustments:

- Keep consistent recording and accounting practices and policies

... Excessive or Growing Long-Term Debt

Warning Signs:

- Increasing debt-to- equity ratio
- Declining profitability or cashflow

Causes:

- Financing an aggressive expansion
- Increase in interest expense without a cores

Consequences:

- Tight on cashflow
- Missing interest payments

Adjustments:

- Ongoing analysis of cashflow
- Monitor debt levels and forecast debt payments

Profitability and Cash Flow

... Profitability – Declining Gross Profit Margin

Warning Signs:

- A significant or sustained decline in gross profit margin over several periods

Causes:

- Production inefficiencies
- Pricing strategy
- An increase in sale of lower-margin products

Consequences:

- Lower profitability = less cashflow

Adjustments:

- Ongoing review of vendor pricing and production costs
- Review product mix and evaluate production schedule with product margins

... Cash Flow – Declining Cash Flow but Continued Profitability

Warning Signs:

- Declining cash flow with continued profitability

Causes:

- Profits are being driven by non-cash related items (depreciation)
- Unsustainable revenue recognition practices

Consequences:

- Lower Cashflow for company's daily operations, paying its debts, and reinvesting in growth

Adjustments:

- Cashflow budgeting & forecasting
- Monitoring and evaluating profit on an ongoing basis
- Evaluated accounting policies

Questions





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