

Chapter 3

Examination Techniques

General Techniques

The application of the general techniques discussed in this section will depend on the type of entity (individual, corporate, etc.) and on the classification of the entity (practitioner, facility, group). Additional considerations may be the ownership (closely held) and the size of the entity.

Auditing a small to medium size veterinary medical practice is much like an audit of any other type of corporation. The nature of the audit procedures selected and the extent of their application depends upon the degree of reliance that can be placed on their system of internal accounting controls. Many veterinary medical practice corporations are closely held and may have related parties working within the corporation. Inquiries into the corporation's accounting procedure and staff are a factor in determining the depth and scope of the audit.

Before beginning the audit, the following may be helpful in planning the depth and scope of the audit: Exhibit 3-1 is a sample Form 4564 Document Request to assist you in obtaining these records.

- > Articles of incorporation, bylaws, and stock certificate book
- > Minutes of board meetings
- > Organizational chart
- > Chart of accounts
- > Contracts and agreements, such as leases and agreements
- > Description of the accounting system and internal controls
- > Loan agreements and other debt instruments and relationship to a debtor (education loans of shareholders)
- > Copies of any prior audit reports by federal, state, or local agencies
- > Copies of prior/subsequent returns and related returns
- > Copy of pension plan, letter of determination, and F5500s

It is important to keep track of where you are in an examination, including what you have seen and what you have requested. Exhibit 3-2 is an Audit Plan containing a list of audit steps

which may be appropriate. The plan is not all inclusive and should be modified for the taxpayer under examination.

Veterinary Office Procedures and Records

A thorough understanding of the accounting systems is particularly important in the veterinary medical industry. The records created (hard copy or magnetic media) by these types of systems may provide a valuable source of information in the examination of the veterinary medical practices. A complete explanation of the accounting system, both in theory and practice, should be obtained from the taxpayer prior to beginning the examination of the books and records.

The following procedures and records are typical for the office of a private veterinary medical practice:

1. The first record of customer visits to a veterinarian's office is the ***Appointment Book***. This will reflect the patient's name, and the date and time of visit. This information should link to the sign-in sheet and individual customer account record. This record will be only as accurate as the office chooses to keep it. It may reflect appointments that were canceled, and no show appointments. It is not an exact record by itself.
2. The ***Sign-in Sheet*** will reflect the customer's name and the date of the office visit. It is merely a record of each customer coming into the office, as some customers have appointments while others could be walk-ins. This record may not always link to the customer individual account record, as the amount charged each customer is not shown on it, and sometimes there may not be a charge for an office visit, such as for a surgery, follow-up visit.
3. The ***Day Sheet***, usually completed for each day, will reflect the date, customer name, patient charges, payments received on the particular day, and the method of payment. Some collections on account may be for a charge prior to the current day. It may also contain a reconciliation of the day's receipts, bank deposits, and checks written as well as the amount of accounts receivable outstanding at the end of the day. Any charge or collection reflected on the day sheet should tie to a corresponding entry on the customer account card. Since the day sheet usually shows all receipts for a given day, it should also reconcile to daily deposits.

4. A *Statement of Procedures and Services*, the bill prepared at the time of service, will show the charge for each procedure and service provided, and will include the date and patient's name. These charges should be directly reflected on the individual customer's account.
5. The *Customer Account Card or File* will include all charges made to each customer, and all payments received on account. Receipts on account should be reflected in the income accounts of the books, and in bank deposits. Adjustments to the account, such as contractual allowances and discounts, should be reflected in the income or expense accounts of the books.
6. The *Bank Accounts* will reflect daily deposits, and should include both cash and checks. Generally, deposit slips will reflect the source of the deposit, checks from clients, and credit card receipts. Deposits should be traceable back to a customer account, and collections posted to customer accounts should be traceable to a deposit.

Veterinarians may receive payments under a variety of different names:

For individuals -- Dr. Jones, Dr. James Jones, Dr. J. Jones, etc.

For partnerships -- Drs. Jones, Smith, & White, Main Street Clinic, etc.

For corporations -- Dr. James Jones, P.C., Drs. Jones & Smith, P.C., Main Street Clinic, P.C., etc.

Initial Interview/ Internal Controls

A. Initial Interview

The initial interview is an extremely important element of any examination. Information provided during the initial interview can save significant time and effort in unnecessary examination steps. In addition to the general items usually covered, specific questions relating to the practice of veterinary medicine care practices should be included in the interview as noted in Chapters 1 and 2.

As an audit aid, Exhibit 3-3 includes a listing of specific questions which may be appropriate. The list is not all inclusive and some of the questions may not be pertinent in all

examinations. The initial interview should be tailored to the taxpayer under examination.

B. Evaluating Internal Controls in a Small Business Environment

Internal controls are another area that must be explored during the initial interview in order to determine the accuracy and reliability of the taxpayer's books and records. Along with internal controls, consideration should be given to the taxpayer's financial status.

Control procedures in many small businesses are often weak or nonexistent. This may be due to cost factors, the lack of well-trained accounting staff or a lack of concern with this aspect of the business. Smaller businesses generally have a higher level of "control risk." 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' internal control structure, policies, or procedures.

Evaluate the control structure of the business early in the examination process. The level of control risk should be assessed to determine the depth of the income probe. At a minimum, acquire a knowledge of how the business operates on a day-to-day basis. Furthermore, the veterinarian's financial position must be understood to evaluate the likelihood that the profitability of the business supports the taxpayer's financial status. See Chapter 4 for additional examination techniques.

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 thorough observations of the business operations.

The first area to explore is the control environment of the business. This is made up of many factors that affect the policies and procedures of the business. Such factors include management philosophy, management operating style, organizational structure, personnel policies, and external influences that can affect the business. A good first step is to draw up an overview of the business operations.

The second key area of internal control is the accounting system. Be familiar with the normal flow of each type of transaction including the accounting records which are involved in the processing and reporting of transactions. Generally, there are two significant elements to a transaction:

1. the recording of the transaction from its initiation to its inclusion in the financial statement, and
2. the flow of funds into or out of the business.

Control procedures are the last area. These are the policies and procedures established by management to achieve the objectives of the business. Separation of duties is the primary control procedure that should be documented. 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. Formal control procedures are more likely to exist as the number of employees increases and the structure of the business becomes more complex.

In summary, a complete and thorough examination of the veterinarian practice cannot be undertaken without an overview of the entire operation. An in-depth review of the practice and the financial status of the owner/shareholder can only be accomplished through an evaluation and documentation of internal controls, including the control environment, the accounting system, and the control procedures.

***Examination
Techniques –
Balance Sheet***

The following section outlines techniques which may be used in performing audits of veterinary medical practices. This section also highlights some of the issues commonly found during the examination. While not all issues will be evident in every examination, these descriptions can serve as guidelines in preplanning the examination.

**A. Reconciliation of
Books to Return**

IRC section 446(a) requires conformity with book income. Book and taxable income must be compared and the differences reconciled. The starting point for the examination of books and records is the reconciliation of tax return to the books. There are numerous differences between Generally Accepted Accounting Principles (GAAP) used for book purposes and tax law. These differences for corporate taxpayers should appear on Schedule M-1 of the income tax return. Reconciliation can be accomplished by comparing the amount on line 1 of the Schedule M-1 to the net income per books and the amount on line 10 of Schedule M-1 to line 28 on page 1 of the return. Often, off-book entries are made to adjust book income. If this is the case, Schedule M-1 will not reconcile directly to the books

and the taxpayer or representative will need to provide these entries. See sections "O" and "P" for additional techniques.

For individual taxpayers reporting on a Form 1040, Schedule C or partnership return, the reconciliation of the return to the books and records will usually be a memorandum item maintained by the return preparer.

B. Cash

Cash may include cash on hand, money in checking and savings accounts, time deposits, and other cash investments. Multiple checking accounts may be maintained by veterinary medical practices. A main checking account may be used for depositing daily client receipts, paying expenses, and disbursing refunds to clients while separate accounts are utilized for payroll or other purposes. 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.

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Recently drawn checks that have not been issued. Check that the bank made payment.	1. Overstatement of expenses in the current year (Cash-basis dates taxpayer).
2. Checks with unusual endorsements; officers, partners shareholders, etc.	2. Unauthorized withdrawal, diversion of funds.
3. Review sequence of numbers for several months and note any missing numbers.	3. Diversion/withdrawal of income.
4. Unusual entries in the cash ledger account or cash receipts journal.	4. Sales of assets not recorded on the books or omission of income.
5. Check interest earned CD's or brokerage accounts.	5. Possible omission from income.

C. Accounts Receivable The method of reporting revenue must be determined. In closely-held situations, inclusion of loans to related parties in receivables should be considered.

There are companies which will purchase the receivables of veterinary medical practices. Any sale of receivables should be reviewed to insure correct reporting of income based on the taxpayer's method of accounting.

Analyze accounts by the following categories: customer accounts, affiliated companies, shareholders, officers, and employees.

WHAT TO LOOK FOR

1. Interest-bearing notes.
2. Credit balances on the trial balance or in the subsidiary receivable ledger.
3. Loans to officer/shareholders, affiliates or other related parties.
4. Receivables on installment sales.
5. Credits to receivable accounts, other than collections and bad debts.
6. Check subsidiary ledger for unusual items, entries arising from other than sales or cash journals.

WHAT TO CONSIDER

1. Interest properly recorded?
2. Deposits or overpayments, additional income or unrecorded sales.
3. Possible disguised dividend or compensation.
4. Interest should be reported as collected.
5. The offsetting debit means that an asset was received.
6. Unreported income.

D. Investments

Veterinarians often hold stocks, bonds, real estate (for example, farms), or other types of investments through their corporations.

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Review acquisitions.	1. Determine source of funds; omission of income.
2. Write-up or write-down to reflect market values.	2. The taxpayer is taking an unauthorized deduction on the tax return. Proper treatment is a M-1 entry.
3. Purchases and sales should be recorded at FMV; look to underlying journal entry to determine the sales price.	3. Correct income or loss should be reported; independent sources may have to be used to verify sales price.
4. Review investment income account and dividends and interest in conjunction with portfolio; review GL account for investments; increases or decreases.	4. Ensure sales and purchases are being picked up; ensure interest and dividends are properly recorded.
5. Test acquisitions to determine if basis was properly recorded.	5. Over or understatement of income.
6. Test dispositions to determine if gain or loss was properly recorded.	6. Over or understatement of income.
7. Sales of depreciable property to related parties; sales below FMV to shareholders.	7. Ordinary income to corp. or unallowable losses; sales below FMV are ordinary income (dividend) to the recipient.
8. Real estate holdings and no rents, or inadequate rents on a yearly basis.	8. The corporation may be carrying the personal residence of the shareholder; constructive dividends.
9. Investment account, for an accrual basis taxpayer; interest receipt dates.	9. Failure to set up the accruals from the interest receipt dates to the year end; omission of income.

E. Inventory

As previously discussed in Chapter 2, the veterinarian should analyze sales to determine whether the items purchased and their generation of income is material and should therefore be separately identified as inventory.

Remember inventory items frequently include medicine, drugs, feed supplements, as well as a large variety of pet items such as carriers, shampoos, collars, etc. Inventory versus supplies is a major issue in many situations.

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Inventory valuation method conforms to methods prescribed by IRC section 471 and the regulations thereunder (inventory write-downs Rev. Rul. 80-60, 1980-1 C.B. 97).	1. If nonconforming, over or understated inventories and over or understatement of income.
2. Compare prior and subsequent year inventory balances with current year balances and note any discrepancies.	2. Possibility of over/under statement of cost of goods sold and under/over statement of net income.
3. Are year-end purchases included in closing (ending) inventory?	3. If not, COGS is overstated and net income is understated.
4. Unauthorized changes in inventory valuation method.	4. The Commissioner may refuse to accept the unauthorized change. In addition, there is a possibility of a distortion of income if no IRC section 481(a) adjustment was taken into account.
5. Removal of inventory for personal use by owners.	5. Constructive dividend to shareholder and an increase in income to the corporation.
6. Check for gross profit variations.	6. Withdrawal of inventory for personal use, understatement of net income.
7. Notes or qualifying statement on financial statements with respect to inventories.	7. Change in valuation method (unauthorized), inventory write-downs, under or overstatement of inventory and net income.

F. Other Current Assets

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Review current and prior year balances along with subsequent year balances.	1. Account for large or unexplained variations, under or overstated income.
2. Determine the taxpayer's procedure for writeoff's; check cost basis.	2. Over or understated income.
3. Prepaid expenses are deductible in the year to which they apply; absence of prepaid expenses.	3. Understatement of income, improper handling of expenses; expenses may have been prematurely written-off.

G. Loans to Shareholders

As with other closely held corporations, loans to shareholders have potential for audit adjustment to both the corporation and the shareholder. The corporation represents a legal entity, separate and apart from the shareholders. The shareholders will look for ways to take money out of their corporation. Loans to shareholders may include advances paid in varying amounts over a continuing period. These advances may include the personal expenses of the shareholder paid by the corporation. In many instances, 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:

1. Signed note.
2. Security or collateral given.
3. Definite repayment date.
4. Periodic repayments of prior withdrawals.
5. Interest charged and paid.
6. Shareholder has available funds to repay the outstanding balance.

Items indicative of a dividend:

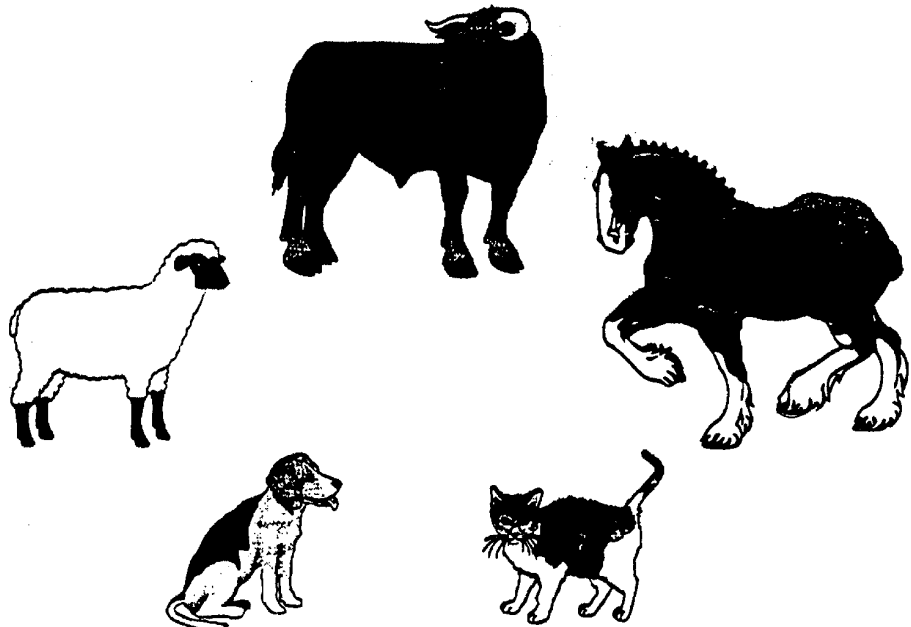
1. No note or open account.
2. No security given.
3. No specified repayment date.
4. No repayments to date.

5. No interest charged.
6. Shareholder cannot repay his or her outstanding balance unless his or her interest in the corporation is liquidated.

Additional Considerations:

1. Closely-held corporations.
2. Poor dividend history.
3. Corporation's retained earnings account.
4. Efforts made by corporation to enforce collection.
5. Ultimate use of the funds borrowed.
6. Moderate compensation is paid to shareholders.
7. Withdrawals or advances are proportionate to stock holdings.
8. 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 Treas. Reg. section 1.301-1(m).



**H. 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 sections 446 and 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.

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Review acquisitions to ascertain that basis has been properly recorded.	1. Over or understated income.
2. For asset acquisitions where other than cash was the consideration, determine how basis was arrived at.	2. Over or understated income.
3. Basis should include all expenditures required to place the asset in service.	3. Understated income.
4. Review retirement policy of fixed assets; proper recording of receipts from dispositions.	4. Understated income.
5. Write-up of assets to appraised value on the books.	5. Not permissible for tax purposes; overstated depreciation and understated income.
6. Prior Revenue Agent Reports (RARs) that capitalized items or changed the method.	6. The taxpayer must follow those changes in subsequent years.
7. IRC section 351 transfers of assets; transferee must use the transferor's basis.	7. Overstated depreciation and understated income.
8. Decreases in asset account balances during the year.	8. Sales have taken place; check for gain or loss; possible sale to shareholder at less than FMV; recapture.
9. Transfers of assets from shareholder to related corporation.	9. Under IRC section 351, the transferee must use the transferor's basis; be alert to inflated basis and inflated depreciation deductions followed by understated income.

I. Intangible Assets

Old Law:

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 nonamortizable goodwill as a matter of law.

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 Co.*, choosing instead to focus on the goodwill argument, the case should not be read as sanctioning any particular 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 Industry Specialization Program paper on customer-based intangibles for all industries, issued February 19, 1996, should also be consulted when examining such intangibles.

New Law:

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 section 197 intangibles include goodwill, going concern value, customer lists, core deposits, know-how, information base, workforce in place, 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.

J. Changing a Taxpayer's Method of Accounting

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 sections 446 and 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.

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Basis of asset should include all elements of cost; legal fees, application fees, and proper costs of acquisition.	1. Under or overstated income.
2. 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.	2. IRC section 197 intangibles (see above).
3. Covenants not to compete; computer software; copyrights and patents, sound recordings, video tapes, film, and books.	3. Treated as IRC section 197 intangibles only if acquired in connection with the acquisition of a business. Otherwise, amortizable under IRC section 167.
4. Organizational expenses.	4. Amortizable over 60 months or more, not currently deductible.
5. Lease acquisition costs.	5. Amortized over lease term. Check for renewal option and over/understated amortization.
6. Lessee Improvements.	6. Improvements to real property subject to the Modified Accelerated Cost Recovery System. Recovery period is generally the same as property to which the improvement was made.
7. Exchange, clearing, or suspense accounts; question why the accounts were set up and for what purpose.	7. Possible diversion of income, inflated expenses, loans to shareholders. Over/understatement of income.
8. R & D expenditures taken as a current year deduction or capitalized; check for proper amortization.	8. Over/understated income.
9. Request engineering services when applicable.	9. Determination of correct valuation of asset acquired.

K. Liabilities - Current and Accrued

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Large expenses charged to the first month of the tax year under exam.	1. These expenses may have been accruable for the preceding tax year.
2. Security Deposits.	2. If applied to last month's rent, then taxable upon receipt.
3. Year-end accruals and reversals including purchases. Purchases should be included in ending inventory. Acceleration of subsequent expenses into current year. Review invoices.	3. 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.
4. Read minutes, being alert for contingent liabilities.	4. If an accrual was set up, consider IRC section 461 for proper year of deduction; expenses can not be contingent, must be fixed, and the amount reasonably determinable.
5. Accounts payable -- tie in trial balance to general ledger; check for adjusting entries or reclassification and netting of related accounts receivable.	5. Potential unreported income; understatement of sales.

L. Loans From Shareholders

<u>WHAT TO LOOK FOR</u>	<u>WHAT TO CONSIDER</u>
1. Large liabilities in relation to capital stock (especially with a new company). Thin capitalization exists.	1. Thin capitalization. Disallow interest expense and treat payments to the shareholder as dividends.
2. The loan is not a bona fide debt and the shareholder took a bad debt deduction.	2. In addition to Item 1 above, disallow the bad debt deduction.

M. Deferred Credits**WHAT TO LOOK FOR**

1. Credit balance accounts, reserve accounts, contra-balance in receivables.
2. 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.

WHAT TO CONSIDER

1. Deferred credits exit. The taxpayer has the free and unrestricted use of assets. Income should be recorded. Cash or accrual basis is irrelevant.
2. Should be a Schedule M-1 entry. Possible under/overstatement of income.

N. Capital Stock**WHAT TO LOOK FOR**

1. New issues or additions.
2. Reduction or cancellation of stock, by complete or partial liquidation.

WHAT TO CONSIDER

1. Was stock issued for services rendered or for property? Check for FMV and gains/losses to shareholder.
2. Determine recipient's basis and gain/loss if it is a taxable transaction. Refer to IRC sections 337, 338, 1245 -- depreciation recapture.

O. Retained Earnings**WHAT TO LOOK FOR**

1. Reconcile income per books with income per tax return (go back to general ledger, not just the balance sheet).
2. Reconcile opening balance with year-end balance.
3. Determine if there is an unreasonable accumulation of funds.

WHAT TO CONSIDER

1. Note any differences and review those that present tax problems.
2. Investigate increases or decreases. Credit items may be income items.
3. Consider imposition of IRC section 531, accumulated earnings tax.

P. Schedule M-1

Schedule M-1 items normally will be groupings of many amounts. In order to adequately consider these adjustments, detailed schedules showing each individual adjustment should be obtained. Analyze prior and subsequent year adjustments in conjunction with the current year and verify that all timing adjustments have been reversed in subsequent periods.

Items to look for:

- Line 4 -- advanced rental income, other advance payments, that is, service contracts.
- Line 5 -- depreciation variances, deferred compensation, self-insurance, IRS penalties, contingent liabilities, inventory adjustments, officers' life insurance, limitation on meals and entertainment.
- Line 7 -- IRS adjustments, tax-exempt interest, deferred service income.
- Line 8 -- depreciation variances, deferred research and development costs, capitalized interest and tax during construction.

Q. Schedule M-2

1. Reconcile income per books with income per return. (Schedule M-2, line 2 equals Schedule M-1, line 1)
 2. Reconcile opening balance with prior year end balance. (Schedule M-2, line 1)
 3. Analyze all increases and decreases.
 4. Verify that no deduction has been claimed for expenses related to stock dividends. (Schedule M-2 line 5b and line 6)
 5. Determine that income items recorded as credits have been properly included in income. For example: recovery of bad debt, prior period adjustments.
 6. Consider imposition of IRC section 531 tax. (Accumulated earnings, greater than \$250,000 or greater than \$150,000 if a PSC)
 7. Reconcile ending balance to book balance.
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