Woman C.P.A.

Volume 40 | Issue 2 | Article 5

4-1978

Internal Revenue Audit: To Refer, or Not To Refer

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To Refer, or Not To Refer

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The giant firms in certified public accounting have staffs of thousands; departments specializing in auditing, small business, management advisory services and taxation; specialists with unique training in each area; and extensive sophisticated research facilities readily accessible.

In contrast to that array, the small practitioner in public accounting is generally the sole specialist working with only one or two employees and limited resources.

In such divergent structures similar services are requested and performed. The approach to handling these requests for services obviously has to be different. A common problem that clients present to each type of certified public accounting firm is the handling of the Internal Revenue audit of a tax return.

A large certified public accounting firm when presented with this request has a tax department, a tax counsel or a staff member who is familiar with the audit procedures. An audit poses no real problem for that type of firm; it is handled by the experts routinely.

The small firm is not in that same enviable position of summoning the staff expert. Generally, there is not a specialist for Internal Revenue Service examinations. Contrary to general feelings, the return itself, which has been prepared according to Section 10.22 of the Treasury Department Circular No. 230 (which states that the certified public accountant is required to exercise due diligence in preparing the tax return), is not what determines whether to refer or not to refer.

The preparing firm has the choice of representing the client or referring that client to another certified public accounting firm. To prevent numerous headaches, this decision should be made before preparing the return and setting the fee for the client. An engagement letter should be drawn up spelling out the fee for the return and stating whether that fee entitles the client to audit representation at a subsequent time. The engagement letter should also state whether the preparer actually will represent the client in case of an audit. Plausible reasons for not handling the audit phase of tax work can then be given immediately so the client's confidence can be maintained.

The advantages of handling the audit are (a) as the preparer, all background information and reasons for the listed figures are known or readily accessible on working papers which saves much time and money, and (b) the handling of the examination effectively instills in the client further confidence in the firm.

The advantages of referring the audit phase to another firm are (a) the client will be receiving better representation from a firm that is a specialist in this area, and (b) the referring practitioners can pick up techniques and knowledge to enable them to handle their own audits in the future. The disadvantages or fears of possibly losing the client and having the credibility of the firm questioned can be overcome by establishing the firm's policy in initial interviews with new clients.

Considering advantages and disadvantages, should the small practitioner who prepares a tax return then represent the client in discussions with, or the audit conducted by, the Internal Revenue Service? The following criteria should be considered.

Should A Certified Public Accounting Firm Handle Its Own Audit?

Yes, the small firm should handle the audit if:

(1) The firm is familiar with Internal Revenue Service audit procedures and what an agent looks for.
(2) The firm has successfully represented clients with the Internal Revenue Service in the past and has developed techniques of audit success.
(3) The certified public accountant's personality is not abrasive.
(4) The certified public accountant has an understanding of behavioral techniques.
(5) The firm has experience in "gray areas."

No, the small firm should not handle the audit if:

(1) The firm has never handled an audit before.
(2) The firm has handled an audit in the past which generated adverse results for the client.
(3) The firm has so little experience that they have no "Audit Theory"

developed.

(4) The firm is on the "red flag" list for poor tax return preparers.

In small certified public accounting firms it is apparent that for the first few years referral is the preferable technique. After that, the firm develops its own audit philosophy and techniques. The most practical techniques that seem to be employed are listed as follows:

Six Techniques Of Audit Success

Know Your Agent

The first area of concern is the assigned Internal Revenue Agent. The agent has been through an intensive tax training course and has pored continually over the Internal Revenue Service published guidelines for audits, but the agent still has no uniform auditing standards for application in each case. The agent's personality and favorite areas of investigation will determine the thrust of the examination. When an audit is scheduled, the agent's identity is known. By previous exposure to that agent or by query of other practitioners, it is not difficult to evaluate the agent and determine that a target area of interest is, such as inventory or promotion. It is well to remember that the revenue agent looks for conformity with the Internal Revenue Code and its regulations, correct interpretation of the Code by the preparer, and documentary proof by the taxpayer of the amounts on his return.

Gain Client's Confidence

If a client is referred to another firm for the Internal Revenue Service audit, the referring firm has the responsibility of explaining the special qualifications of the certified public accountant who will be handling the audit. A conference should be arranged among the two firms and the client so that *all* the information about the return is available. The Internal Revenue agent can then ask no surprise questions. The inability to answer shakes credibility and confidence, and generally leads to more extensive investigation by the agent.

Ask for Agenda

By obtaining from the agent a written list of the records and documentation that need to be assembled, the accountant can more efficiently handle the examination. It is also helpful to secure a list of the questions that the Internal Revenue agent wants the client to answer. Since the client is paying for representation, he or she is not interested in spending the time necessary to be present at the examination, being asked a question that cannot be answered immediately, and going back to the audit site after the answer is obtained. Expedite this phase by impressing upon the agent that the list of questions will save everyong time and allow the examination to be conducted more efficiently

Cooperate Fully

(a) Answer every question asked, but only that question. Never volunteer more information than asked for.

Actual Example:

A client maintained a house in Florida and a yacht for entertainment purposes. The agent came across the house expense and asked, "What is this?"

Client's response, "I have to entertain lavishly because I sell to large chain stores that buy from $200,000 to $600,-000 at a time. They expect to be wined and dined."

Several subjects and one hour later. Agent: "What car expense is this?"

Client: "We have two cars; the one I drive for business is this expense you're looking at. The other car isn't even in this state, my wife keeps it in Florida."

Agent: "Why?"

Client: "She lives at the house most of the time."

That extra item of information opened up an extensive audit of the house-entertainment area which had been accepted previously.

(b) Give whatever records are asked for, but only those required. Although many practitioners do not agree with this approach and believe in passive resistance, there are several reasons why cooperation appears to be the more effective attitude. If the certified public accountant or client does not cooperate, the agent through other methods will obtain the records anyway, along with other items that were not required. The lack of cooperation will produce for the agent the human-nature reaction of antagonism. Mutual antagonism perpetuates the audit, accumulating immense amounts of time which creates an unreasonable and unnecessary fee for the client. Ethically, overbilling should be controlled by handling a routine audit effectively.

(c) Be truthful in all replies. Evasiveness generates more thorough investigation and open up the problem of credibility. The agent will then expand the size of the examination to cover all areas on the tax return. To destroy credibility destroys the effectiveness of the accounting practitioner.

(d) Avoid a conference between the agent and the client. The tax return is primarily the client's responsibility and represents that client's operations for the tax period. Although it is true that whatever decisions have been made on the return are the client's, decisions were made without anticipation of or familiarity with the audit process. If a conference is required the client should be briefed as to procedure and probable questions, and accompanied to the conference by the accountant.

If good rapport exists between practitioner and agent the latter is more likely to disclose some possible area that might be beneficial for the client to research, or to grant a no-change audit if it is merited rather than continually seeking ways to fight back. The agent may also make constructive suggestions for preparing future tax returns.

Stand Firm On Gray Areas

The certified public accountant, in preparing the tax return, is serving as a tax advisor. The primary responsibility of that advisory position is to see that the client pays the correct amount of tax, but no more than that. The AICPA Statements on Responsibilities in Tax Practice No. 10.02 states: "A CPA may take a position contrary to a specific section of the IRC where there is reasonable support for this position."

In this area the certified public accountant's responsibility is to defend and explain the rationale for the item being questioned. The agent has ample authority to compromise in most gray regions. It is important to keep an eye on practicality in any such defense because the point can be reached very quickly where the cost outweighs the benefit for a specific questioned item.

Guard Your Reputation

Nothing is more important to the professional than reputation. If tax returns have gone through numerous examinations with glaring and flagrant errors the Internal Revenue Service flags the name of the preparer. Thereafter, all returns by that preparer are scrutinized carefully with a larger probability of audit.

Just as practitioners discuss agents, agents discuss practitioners. The esteem or regard that is held for the preparer certainly sets the stage for the audit.

Once the firm decides to handle its own Internal Revenue Service audits, a review of the "Six Techniques of Audit Success" may prove helpful, and should lead to efficient audit handling at minimal cost to both client and firm.