Audits of Retail Food and Beverage Establishments

If you are in certain retail businesses, industry specific audit procedures may be performed by the IRS in addition to the standard procedures performed during an audit of all retail businesses. Below are industry audit procedures performed during audits of entities engaged in certain food or beverage businesses.

Examination Techniques for the Food and Beverage Industries

Food and beverage industries make up a relatively large portion of the retail market. However, this broad category is broken down into additional industry groups. The following outlines some industry specific audit procedures for food and beverage retail stores in these various groups.

Retail Liquor Stores

Income

The following are some sources of receipts commonly seen in liquor stores:

- *Other grocery sales – lottery, cigarettes, snacks, food & candy items*
  These sales are taxable to the state taxing agency for sales tax purposes. The examiner may compare the reported gross receipts to those reported to the appropriate state sales tax returns. The examiner may even request all recent state audit reports or contact the state agency directly in order to compare gross income numbers because state agencies tend to audit more frequently than the IRS. Stores with cash registers are required to maintain the daily cash register tapes and present them for examination. If the examiner questions whether all sales are reported, or if there are missing tapes, an indirect method of predicting your income will be considered.
- *Lottery- scratch-off and machine sales*
  Income from lottery sales will be rung on the business cash register and included in total daily receipts. Income from scratch-off tickets can be predicted by verifying the amount you purchased from the third party and calculating appropriate sales. Income from machine tickets can be determined by the examiner from the monthly reports you make to the state that administers the program. This predicted income will be factored in to total taxable income calculation by the examiner.
- *Check cashing and customers payment on account*
  Retail stores do not cash checks as a courtesy; the retailer customarily charges between 3-5% of the check amount, even when a purchase is made. Some state laws dictate a maximum percent/amount that can be charged. Therefore, an examiner may attempt to estimate the number of checks you cash in a year and calculate a predicted income amount based on this customary percentage.

Cost of Goods Sold

In most states, liquor stores may purchase goods for resale only from authorized distributors, and not from discount or warehouse stores. Based on known purchase prices, the examiner will consider using a percentage markup on cost method to determine what your cost of goods sold deduction should be for income tax purposes. Additionally, the examiner may contact third-party suppliers directly to ensure cost of goods sold is not overstated.

Mobile Food Vendors

Income

Gross receipts will be the main focus for the examination of mobile food trucks because these businesses are very cash intensive. The examiner will expect to see large cash deposits to the business bank account.

To verify all cash is deposited or accounted for, the examiner must analyze the markup percentage (an indirect method utilized in retail audits). They will ask what markup you use, but they will expect that the markup percentage is consistent. Typically, they are looking for a markup of 100% on cold foods sold and about 200% on hot foods sold. The examiner will ask for your bank records to verify deposits and to ensure that you are not underreporting income if you utilize the bank statements to figure your taxable income. They will also use this gross markup to verify that your sales number makes sense.

If an indirect method is necessary, the examiner must obtain sufficient testimony from you in the interview. They will then evaluate this testimony by corroborating it with calculations. Additionally, they will require you to provide them with enough information to verify cost of goods sold with reliability. This may include obtaining enough information to perform multiple indirect methods of accounting for income and cost of sales and then comparing these results with one another.

Cost of Goods Sold

Inventories are seldom reported and may not be material in nature, since food must be sold or discarded soon after purchase and there is usually no space for storage. Therefore, examiners will likely verify third party purchase contracts or directly contact third parties for pricing information on your food purchases.

Furthermore, expenses may often be paid in cash. Therefore, the examiner will want to verify completeness of your cost of goods sold so that they can effectively use this number as a starting point to predict your gross receipts through the markup percentage method. This predictive calculation may then be compared with your bank statement deposits to verify completeness of taxable income in the event that you are using your bank statements to prepare your tax returns.

Expenses

Penalties, Fines, Tickets - The examiner will be cognizant of possible violations of the health code that you may have deducted as a business expense. Some common health code violations include improper food temperatures, unsanitary conditions, infestations, sale of home prepared foods and operating without a valid health permit or business license. Costs incurred to remedy the situation, such as a repair to the heating device, would be a deductible business expense. However, fines, penalties or tickets are not deductible. Therefore, the examiner will make adjustments to your books and increase your taxable income they determine you improperly deducted these types of expenses. A review of your general ledger expense accounts (if you keep records) may be examined to verify that no improper deductions are run through these expense accounts.

Pizza Restaurants

Income

Examiners understand that these types of retail businesses are often cash intensive. Furthermore, family members can often remove currency from the register before sales are recorded. Therefore, the examination will focus on income and internal controls you have in place.

The examiner will be alert for income that can easily be excluded from gross receipts, such as delivery sales, faxed orders, internet orders and take-out business. The examiner may question you on the presence of these types of income and the accounting procedures behind recording income from these areas.

To help predict income, the examiner may utilize the unit volume markup method. To achieve this, the examiner may contact your supplier to obtain the original purchase invoices on all identified cases. The ingredients purchased and used in the making of pizzas and grinders are also used by examiners to determine total pizza and grinder sales. This predictive calculation allows the examiner to determine your approximate total taxable income.

Cost of Goods Sold

The examiner will likely obtain a copy of the menu and review the prices of all menu items with the taxpayer to identify the best-selling items and determine the cost of the ingredients.

Purchases may be paid in cash, so the examiner will likely inquire about the extent of cash payments. If purchase invoices are not available, third-party contacts can be made so that the examiner can identify an accurate cost of goods sold number. An accurate prediction of this number will help the examiner in calculating estimated gross income.

The number of pizza boxes you use may also be a factor in a markup calculation, so the examiner will attempt to accurately calculate this element of cost of goods sold. They may also determine the number of pizzas that can be made from 100 pounds of flour, since flour deliveries are fairly standard orders in this business. You will likely be asked how much flour is needed to make the dough for the day-to-day pizza orders.

Restaurants and Bars

Introduction

Many restaurants, especially smaller or closely held ones, are cash intensive and employees and/or owners handle large volumes of cash transactions every day.

For this reason, examiners will focus on evaluation of internal controls. When a sole proprietor counts cash at the end of the day, records all entries in the sales journal and makes the bank deposits, there is a possibility not all cash is reported and deposited. This can also be true when orders are taken and filled, payments are received, and payments are recorded with a balance of the cash register at the end of the day.

Restaurants have a high rate of turnover of employees who often have access to the inventories as well as the cash. As such, there is a potential risk of employee theft and embezzlement unless good internal controls are maintained.

Income

Restaurants and Bars usually have a large volume of transactions each day, they allow employees to handle cash sales and cash tips, and they receive significant cash receipts in a small period of time. For these reasons, the examiner will focus on your internal controls and examine your records for possible unreported income.

The examiner will have you explain how the business works staring with how food is ordered to payments received by a customer. They will also ask you how items get recorded. Tracing specific items is too time consuming and difficult because of the nature of the industry. Therefore, examiners may utilize the daily volume indirect method to figure daily sales.

The possible daily volume is the number of seats in the restaurant or bar multiplied by how many times throughout the day these seats are occupied. The volume can be further broken down into time periods in a day, such as breakfast, lunch, and dinner to obtain a more accurate taxable income figure. The average check per seat will most likely be a question asked during the initial interview or from examination of a sample of sales tickets. The annual taxable sales income may be estimated using this approach. The examiner will take into account vacant seats and people who walk their bill when using this calculation. Examiners will also take into consideration special circumstances such as discount advertising and specials. They will adjust foot traffic accordingly for these items.

In performing this procedure, examiners will trace the process and test amounts performing one or more of the following procedures:

- Examine the customer checks for a sample shift, for example the 6:00 a.m. to 2:00 p.m. shift, and total the customer checks and determine where the income is initially recorded.
- Count the number of checks the servers turned in for the shift. This is the number of customers that each server waited on during their shift. The examiner will compare this with information obtained from you during the initial interview.
- They will look to see if COGS items are replenished within a day or two. This could lead to the discovery that items not reported as sold are continually being replenished since these two items should somewhat correlate in this industry. This could be indicative of underreported income or overstated COGS.
- Total the checks turned in by each server and match their entry to accounting records, such as daily sheets. These amounts will then be traced to the monthly records and verified against the amount reported in the Statement of Profits and Losses.
- They will note the ratio of cash, check, debit card and credit card payments by customers to see if it is consistent with information you provided during the initial interview.
- An examiner will determine how cash is stored, used and/or deposited. Cash is frequently not deposited. A set amount of cash may be retained to be used as change or to pay vendors. Examiners will sample a day and inquire with you why any cash received is not deposited.
- An examiner will also apply your stated mark-up to purchases reported in the books. They will then compare this number with reported gross receipts because the amount should be consistent. They will ask you to explain any differences. Any unreconciled differences will signal to the examiner that you underreported taxable income.

Cash management practices are a good indicator to the examiner regarding the reliability of your internal controls. If your restaurant or bar has no point-of-sales system that requires all transactions to be recorded, the examiner will inquire as to how you insure proper reporting and what measures you have in place to discourage theft. Examiners will also inquire what process you have in place to verify that cash tips are recorded. If you do not have a good system in place, examiners will likely perform testing procedures to verify reporting of cash tips. Examiners will likely perform a series of tests on your income using the full bank deposit analysis, the net worth method, a source and application of funds analysis, or the specific item method. These are discussed in further detail under the general retail audit technique guide.

Since the bar or restaurant industry is largely a cash-based one, the indirect methods discussed in this section may only show that an understatement of income exists. It may be hard or impossible to detect how the understatement was achieved. Therefore, examiners may visit the operation during your normal business hours and observe how transactions are handled.

Bar Income

As in any income tax examination, the auditing techniques used depend on the quality and availability of the taxpayer's books and records. If you are operating a large bar that maintains inventory records which detail the daily and/or monthly purchases and sales of liquor, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit that you should be reporting.

If you are a small "Mom and Pop" bar that does not maintain detailed purchase and sale records, it may be difficult and time consuming to compute the purchases for one day or one month. In this case, the examiner will likely rely in part on information from a third-party to verify purchases and compute the mark-up on cost. The examiner may then apply this markup to total purchases of similar items to approximate the business gross receipts and gross profit that you should be reporting.

Using the Liquor Cost Percentage to Compute Gross Receipts

To compute gross receipts using the liquor cost percentage, the following steps will be performed by the examiner:

1. Determine the cost of some of the more popular brands of liquor.
2. Determine the sales values of the bottle if all liquor out of these bottles were sold.
3. Divide the sales value into the cost to get the potential pouring cost.

Using the Mark-up on Cost Method to compute the Gross Receipts

If it is difficult for the examiner to determine your daily or monthly purchases, they will use the Mark-up on Cost Method to predict gross receipts and gross profit. This method works closely with the liquor cost percentage method; however, different percentages are being determined.

As with the cost percentage method, the cost and sales value of the various items needs to be computed. Then, the mark-up on cost can be computed. Mark-up on cost is the amount of the sales price over the cost of an item. Therefore, the examiner will request documentation to verify the inputs used in these calculations.

The following steps will be taken by the examiner to compute gross receipts based on mark-up on cost:

1. Determine the mark-up of the various alcoholic items you sell. The mark-up will be determined most likely during the initial interview. If you do not know the mark-up of the bar items, the examiner will compute it based on the sales price of drinks and the cost of the drinks.
2. Determine the purchases you made. The examiner will obtain this information from invoices you provide, so long as the examiner determines these items are accurate. If accurate records are

not available, the examiner will request that you provide a list of the vendors. The examiner will contact these individuals to request records of purchases you made for the years under examination.

3. The examiner will then apply the mark-up method to the various types of alcohol (or other products sold).

Sales price per drink/Cost per drink/ mark-up of drink

Computing the mark-ups on the various types of drinks

The same calculation formula applies to this mark-up method as those previously discussed. The components used in the calculation of the mark-up method for a bar are discussed below for various items.

Alcoholic Drinks

Sales Price per Drink

The examiner will take an average of the more popular drinks served in your bar based on information obtained during the initial interview. They will determine the amount of alcohol in each drink, comparing your statements to a bartender recipe guide.

Cost per Drink = Bottle price / Number of drinks in bottle

The bottle price is an average price of alcohol based on information obtained from a local liquor dispensary. Once the cost per drink and sales price per drink have been figured, the examiner may estimate taxable income related to this part of sales.

Draft Beer

Draft beer is sold by the one quarter keg and one half keg. A one quarter keg contains 992 ounces of beer. A one half keg contains 1,984 ounces of beer. The beer distributors calculate that there are approximately 190 glass servings per one half keg and 93 servings from a one quarter keg. This calculation accounts for foam and spillage.

Sales price is based on the price of the beer as listed on the menu and confirmed by the examiner during the initial interview. Therefore, the examiner can divide the sales price by the size of the drink to get the sales price per ounce. This can then be used to account for total revenue.

Bottled/ Canned Beer

Sales price of the bottled/canned beer is based on the price for the bottle according to the menu and the statements you make in the initial interview.

Cost of the beer is an average cost of beers you have available for sale. Bottles and cans are usually sold by 12-pack or case (24); therefore, the examiner will divide the cost by 12 or 24.

Wine

Sales price per glass is based on the price listed in your menu. The examiner divides the sales price by the size of the glass to get sales price per ounce. Then the total ounces served are used to predict income once this price is obtained.

Wine Coolers

Sales price by the bottle is based on the menu price and confirmed during the initial interview. Cost of the bottle is an average cost of wine available for sale. Wine coolers are usually sold in case lots of 24. Therefore, the examiner will divide the cost by 24 to get the cost per the bottle.

Employee Tip Income Reconstruction Using Indirect Methods

Employee tip income is income under the IRC. It will often be reconstructed by examiners using indirect methods. The percentage markup method is one of the most often used methods by examiners to reconstruct unreported tips, although the cash expenditures method is also used.

The McQuatters formula is also a common method to determine the tips as an hourly amount, a percentage of gross sales or receipts, or a percentage of the wages. The McQuatters formula is performed by: (1) total sales of food and beverages reduced by 10 percent to allow for low or no tips and tip-sharing; (2) this amount (that is, sales subject to tips) is divided by the total number of hours worked by all waiters/waitresses during the year to arrive at sales-per-person-per-hour average; (3) this average is multiplied by the number of hours in each year that are worked to determine yearly sales; and (4) the yearly sales are multiplied by 12 percent to compute the yearly tip income.

Income from Coin-Operated Activities

Coin-operated machines serve as another source of income. If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine. Examiners will look for agreements to determine the percentage you should be reporting in income under these circumstances.

If you own the machine, interviews and other indirect procedures (such as the bank deposit analysis) may be performed by the examiner to predict the amount of income. If a review of the bank deposit analysis reveals low currency deposits, examiners may use another method to estimate taxable income from coin-operated machines.

Other Potential Sources of Income Activities include:

- Lottery tickets
- Gaming pools
- Vending machines
- Franchise rebate income
- Tenant/fixture allowance
- Supplier or advertising rebates/incentives/reimbursement
- Sales of assets
- Cover charges for admissions
- Selling concessions at sporting events/banquets/high schools
- Renting out rooms for weddings and birthdays, etc.
- Catering
- Banquets
- Bartering
- Related party transactions
- Kickback from vendors
- Renting space for signs and video machines

These possible sources of income will be considered by the examiner during the initial interview. They will ask pertinent questions to determine if you engage in these activities and how much income, including cash, is derived from these activities. Furthermore, they will want to develop an understanding of how you are reporting for such activities. The weaker your internal control structure appears, the more likely the examiner is to conduct thorough indirect methods of determining income from these sources.

Cost of Goods Sold

Examiners often perform preliminary analytics, such as gross profit ratios, when auditing a business. These can tell the examiner if the Cost of Goods Sold is overstated or out of balance in comparison with reported Gross Receipts. This serves as a starting point for the examiner to determine if you have underreported income or overstated expenses. These will not be the only tests conducted to determine the accuracy of income.

In Gross Profit Analysis, the examiner anticipates that there will be consistency each year and that the percentage will approximate information you provided during the initial interview phase. Any discrepancy will result in follow up procedures and will require an explanation from you.

Inventory turnover is another ratio examiners use. This ratio computes the number of times the inventory 'turned over' or was sold during the year. It is an indicator of a business's profitability because when inventory turnover decreases, sales and net profit decrease because inventory is moving less frequently. When inventory turnover increases, sales and profits increase since inventory is moving faster.

Examiners will compare the inventory turnover rate with the ratios of similar businesses. The expectation is that inventory turnover should be consistent with industry standards. Additionally, examiners expect inventory turnover to be consistent when comparing it with previous periods, unless business has picked up or slowed down. If this is the case, examiners may request that you provide proof of the changes to the business. Changes may also be a result of purchase frequency changes. This will also be inquired by the examiner as to why purchases have increased or decreased from year-to-year. Any low inventory turnovers will also be questioned. Examiners may request specific documents to corroborate the answers you provide.

The examiner will also compare your inventory turnover rates with your gross profit percentage. It is expected that these ratios will parallel one another. For example, if your gross profit percentage decreased, but the inventory turnover has increased, the examiner will suspect that the Cost of Goods Sold may be overstated and/or the inventory amounts are not correct.

The percentage change in inventory is also a ratio frequently utilized by examiners. It shows any significant variations from year to year. It can serve as an indicator of an overstatement in Cost of Goods Sold. This percentage change will be compared with prior years. Any significant increases or decreases will be questioned by the examiner.

Certain ratio patterns tip off examiners to unreported income and suggest a need for additional income examination. For example, an analysis of a restaurant return indicates that the restaurant has suffered losses for 3 consecutive years or longer and has a high ratio of cost of goods sold to sales. It is reasonable to question the source of the cash necessary for the restaurant to continue operating under these circumstances. Therefore, the examiner will likely perform other extensive income testing procedures. Additionally, inspecting the cash flow statement (if one is available) may explain where your operation sources are coming from. If a restaurant shows an increasing inventory turnover rate (indicative of increased profits), it would be reasonable to question the veracity of the inventory and purchases because overstated cost of goods sold lowers taxable income.

Sales per employee is another frequently utilized ratio when auditing this industry. If this ratio is low relative to the industry, examiners may want to verify as to the turnover ratio of employees. They may inspect W-2 records and other payroll records to verify employee turnover. If it appears that employee turnover is high, the recurring cost of employee training may be a legitimate cause of a relatively low sales per employee ratio.

Other Ratios

Following are some additional ratios that examiners may calculate using the facts from your books and records and compare to industry statistics. The examiner will question any discrepancies noted.

1. Prime Cost % = Prime Cost (cost of food and beverage sold plus Labor cost)/Total Sales
2. Food Cost % = Food Cost /Food Sales
3. Labor Cost % = Total Labor Cost/Total Sales
4. Liquor Cost % = Liquor Cost/Liquor Sales
5. Wine Cost % = Wine Cost/Wine Sales
6. Beer Cost % = Beer Cost/Beer Sales
7. General and Administrative % = General Administrative Cost/Total Sales
8. Sales per Seat = Total Sales/Number of Restaurant Seats
9. Sales per Square Foot = Total Sales/Restaurant Square Footage
10. Sales per Labor Hour = Sales/Full Time Employees
11. Inventory Turnover = Cost of Goods Sold/Average Inventory

Brown, PC represents clients in retail food and beverage businesses throughout Texas and across the United States. If you have questions regarding an IRS Audit, please call 888-870-0025 or contact us online for a confidential consultation.