

Audits of Automobile Body and Repair Shops

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 auto body and repair shops.

Initial Interview

Since you are partly in the service industry if you operate a body or repair shop, the examiner will question you about the services you perform. They may ask you about the types of vehicles you work on and how much time it takes to complete an “average” job. Additionally, the examiner will inquire as to the nature of the people working with you. They will want to determine if you treat your workers as employees or independent contractors.

The examiner will also inquire as to the function of the officers, shareholders, and relatives within the business. Officer salaries are often subject to excess compensation issues, and the examiner will likely inquire about this issue. Some questions an examiner may ask are whether a shareholder or relative serves as a landlord, supplier, or customer. The examiner will also question the bookkeeper, controller, secretary, or accountant about the accounting records.

The list below contains some initial interview questions you can expect regarding the repair process, sales, and officer/shareholder duties. Questions about the business history, accounting methods, and internal controls are also likely to be included by the examiner during an initial interview:

- When are initial estimates made? Is any charge made for them?
- After the initial estimate is made, how are contacts made with the insurance company?
- Does the estimate vary with the final bill?
- Are repair orders used in sequential order?
- When are the repair orders dated? (Are these dated when the customer authorizes the repair either orally or in writing, or is it only when the customer signs the order, etc.?)
- What happens if a repair order is voided? Is it thrown away or retained? How many are voided?
- Do some repair orders require supplements? Is a new repair order written for the supplement? When will the supplement be paid for? Is the vehicle released prior to the receipt of the supplement? When will the supplement be recognized as income?
- When are parts ordered for a repair job?
- How often is paint purchased?
- At what discount do you purchase parts?
- What are the labor rates charged for repair?
- Do you supply loan cars? If so, do you get rebates from rental companies for the loaners?
- When will a job be booked as a sale?
- Do you have steady referrals from dealerships?
- Are deductibles ever waived? What would be the circumstances?
- Are liens ever placed on vehicles for sale or recovery of expenses?

- Do you maintain inventory? How is inventory valued and what types of inventory are included in the value? Are there any consigned items?
- How is the payroll determined for the repair staff? (hourly wage, salary, percentage of labor charge or a combination)
- Are your staff employees or independent contractors?
- What is the current percentage ownership of each shareholder?
- What are shareholder duties if any?
- How is officer compensation (salary, bonus, fringe benefits) determined?
- Does any officer, relative, or group of which an officer is a member, have dealings with the corporation other than as an employee? (that is as a lessor, vendor, consultant)
- Does the corporation own or lease vehicles assigned for the use of specific officer/shareholders?

Tour of Business

The examiner will conduct a tour of the facility where you are operating your business. The examiner will look for certain things based on the information you provided on your tax return. For example, if you did not report any inventory items, the examiner will look to see if there are parts lying around the premises waiting to be installed. The examiner may also look to see if you have equipment that appears to no longer be in use. This may signal that certain assets need to be removed from the financial records.

If you have indicated to the examiner that your workers are independent contractors, the examiner will look for indications that they are really independent contractors. For example, the examiner may look to see if the workers are wearing uniforms. This would signal that they are actually serving in an employee capacity. Additionally, the examiner will look to see if they are utilizing the major equipment provided by the Auto Body Shop and if they are actually working on the premises of the Auto Body Shop as this would also indicate that your workers are employees rather than independent contractors. This would result in an increase not only in employment taxes, but also any benefits because these workers would be given the same benefits as all other employees.

Books and Records

General Books and Records

Specific Documents

In performing an effective audit, examiners may request other helpful documents in addition to the usual purchase invoices, cancelled checks, etc. These additional items will further assist the examiner in performing an estimate on taxable income and may consist of the following:

- Estimates
- Repair Orders

- Supplements
- Sales Invoices
- Parts Invoices

The Mitchell Guides

The Mitchell Guides and Mitchell Software provide information which is one of the primary tools of the industry; therefore, examiners are trained to understand how the reference works. The examiner will utilize this tool in evaluating your estimates.

Since Mitchell also supplies the suggested labor time (in tenths of an hour) in addition to the costs of the parts, the examiner will utilize this information in determining how long it should take you to replace a particular part. This will allow the examiner to determine whether you have accurately reflected taxable income related to labor. Based on the number of jobs and the cost of labor per job, the examiner may calculate anticipated income from this source.

Income

Introduction

The repair process in a body shop typically begins with the preparation of an estimate by the shop, either on the premises, or in the field if the car is not drivable. The estimate includes detailed categories of expense for labor, parts (at the retail list price), the cost of work to be done off the premises, and towing, if necessary.

If the owner of the vehicle is to bear the full expense of the repair and chooses to deal with the shop, a repair order is written reflecting the figures already on the estimate with any additions or deletions specified by the customer. The customer signs the repair order to authorize the indicated work to be done.

If there is an insurer, the company is notified and dispatches an adjuster to the shop to make its own inspection and estimate of repair costs. This estimate is often lower than the one written by the shop because the insurer may not allow the full labor rate customarily billed and may eliminate part of the standard time to repair as duplication.

Indications of Underreporting

Estimating Sales

In the auto repair business, there are some calculations that can be made to give an idea of the range of sales that should be expected given a claimed level of costs, if those costs are accurately categorized.

The average discount received on factory parts by body shops and the repair shops is determined to be 20 percent to 25 percent off retail. This is equivalent of a markup of 25 percent to 33.3 percent. Examination of purchase invoices from a cross section of suppliers used by a specific business will be conducted to allow for a more accurate figure. However, the examiner may use the percentages as a starting point to conduct a top level calculation on what sales figures should be for a tax year.

Parts other than factory parts, especially those purchased in bulk from large supply houses have a much higher markup, though the shop may not bill at the suggested retail as shown on the invoice. Markups can range over 100 percent on parts like water pumps and much more on smaller items like gaskets and filters. The examiner may obtain an average by inspecting the detail invoices from the suppliers used and repair orders.

In auto body shops, examiners anticipate that you will try to keep labor costs down to 40 percent of labor sales, including any down time. In some cases, shops pay wages based on this sales percentage. Some body shops may pay body men at a 50 percent rate during the time it treated them as "outside labor," but changed to 40 percent when the status was changed to that of employee. Therefore, an examiner may double labor costs to initially estimate labor income.

If you as an owner work on the vehicles, the value of your labor will be added to the labor costs - reported in cost of sales. The examiner will use these figures from either the tax return or the trial balance as a starting point to determine a predicted range of taxable income. If the income actually reported is outside of this range, the examiner will perform additional inquiries to determine why. One reason suspected is underreported income. However, there are other reasons including:

- The above percentages are invalid for your particular business, especially for labor.
- Costs have been mis-categorized.
- Some labor costs may be paid "off the books." This will make imputed income from labor lower.
- There may be a large unreported inventory variance.

Examiners will make the determination during follow up inquiries whether your taxable income number should be increased. They will use another method of predicting sales or perform other testing procedures to determine if you underreported your taxable income.

Repair Orders

These are usually numbered and used consecutively. The examiner will ask about voided orders in an attempt to substantiate any missing numbers within a sequence. At the beginning and the end of a period, work may have been completed in the prior period or remain in process until the subsequent period. This could also result in some gaps in sequence. After consideration of these factors, the examiner may conclude that substantial numbers of invoices missing from the sequence are a result of unreported income. This procedure may be used by the examiner to test completeness of your income figure.

Other Income Issues

Waived Deductibles

An insured collision repair is payable in two parts: 1) the insurance company's check or draft and 2) the insured's deductible payment. If the copayment is fully waived, the insurance payment is considered payment in full and either method of accounting for the income outlined is an accurate representation. If, on the other hand, the repair cost is fully paid in the usual manner and the deductible is shown waived on the accounting records only, considerable income can be unreported.

Thus, examiners are trained to examine account records to assess if deductibles are routinely shown as waived when you have actually collected them. Therefore, the examiner may contact third party customers by phone to determine what payments were made for the work performed.

Cash Payments

Since most customers pay by check or credit card, examiners will check the detailed duplicate deposit slips against the bank deposits to determine if all income is appropriately accounted for. This will help the examiner determine if you understated any taxable income.

Cost of Sales

Introduction

Cost of sales for an auto body business will be the largest category of costs shown on the return. Because of the large dollar amount relative to the other expenses, cost of sales warrants special attention by the examiners.

Purchases

The major cost associated with the purchases account will be for parts used in the replacement or repair process. These can be purchased new from auto dealers or parts stores, or may be purchased used from auto dismantling businesses. Purchases accounts also include the cost of materials used to restore the vehicle to its original state once the parts have been replaced or repaired. This category includes bond, primers, thinners, paints, sandpaper, etc. To perform an examination of these types of cost of goods sold, the examiner will likely request the following records and use the records to perform several of the procedures listed below.

Records to Request/Examine:

- General Ledger

- Disbursements and/or payables journals
- Journal entries or accruals
- Original Estimates - These documents may be prepared by the Auto Body Shop or by the insurance companies. Once the estimate has been approved, the total costs should agree with the total costs shown on the repair order.
- Repair Orders - This document should have the customer's authorization to begin the job. It can also provide other important information such as the customer's name and phone number, date a job was started, itemized listing of parts, supplies, labor, sublet expenses incurred at retail or wholesale, make, year, model of the vehicle, and the date of payment. It provides the examiner with a useful summary of costs for each job.
- Vendor Invoices - These invoices will list the parts prices at retail and wholesale. This allows an examiner to compute the discount provided to you for inventory and income recalculation.
- Additionally, examiners may request source documents for jobs completed. This will help the examiner trace the items on the source documents to journal entry listings to ensure you have appropriately accounted for all items.

Labor

Labor is usually an extensive component for body shops. Labor personnel can be paid either by the hour or on commission. The commission may be a percentage of the allowable amount determined by the insurance companies. Examiners will verify the payment calculations and examine for inclusion of these amounts in cost of goods sold to determine if cost of goods sold has been overstated.

Audit Procedures

Body shops often hire people as independent contractors because of the rise in labor related costs such as worker's compensation, health insurance, and employment taxes. The actual determination of whether individuals are employees or independent contractors will likely be conducted during the audit examination. The examiner will look for the following signs which may indicate you have an employment tax issue:

- During pre-audit of the return, the examiner will compare the employment tax deduction with the respective labor, wages, and salaries. Therefore, an estimate (restricting any large salaries to FICA maximums) of the wages should give the examiner a rough approximation of the true employment taxes. This preliminary procedure will tell the examiner whether your numbers for these deductions make sense from a top level perspective.
- Package Audit Steps – The examiner will likely reconcile the wages per the books to the employment tax returns. This reconciliation is recommended since this may highlight labor deductions which do not hit the employment tax returns. Another procedure that may be performed is the comparison of the employment tax returns associated with the year of audit to the subsequent returns filed up to the most current year. This may demonstrate a change in status of workers that will help the examiner determine what the appropriate classification of the worker should be for the year under audit.

- The examiner will likely inspect the general ledger for a breakdown of the various labor costs recorded. The source of the entries should be the payroll register. If the entries are flowing directly from a cash disbursements journal, this may indicate that straight disbursements without withholding have been made and will place the examiner on alert for an understatement of payroll tax liabilities.
- A request for Form 1099 statements issued by you will also help the examiner determine who is considered an independent contractor. Any unusual payees may be followed up on by the examiner.
- During the walk through of the place of business, the examiner will look to see if any individuals considered independent contractors are wearing uniforms. This indicates representation of your body shop on an employment status. If no taxes are withheld and paid in for these individuals, the examiner will likely require additional information to verify that these types of workers are truly independent contractors.

Expenses

Uniforms

Some shops withhold a moderate uniform charge from compensation paid with the withheld amounts generally offsetting the expense account. The examiners will look at your books for these types of withholdings and will consider this an indication that the individual is an employee because of the control exercised.

Non-cleared Checks

Examinations of the bank reconciliations at the end of the year will allow the examiner to determine if some checks are still outstanding after a substantial amount of time has passed since original issue. This is prevalent with payroll checks that are never cashed or deposited by the payee.

Finders or Referral Fees

The fees tend to mount up over the course of a year and sometimes no Form 1099s are filed. Both the Form 1099 penalties and backup withholding are appropriate in such a case. The examiner will likely total some of the fees paid to the same payee during a year to determine if you appropriately provided a Form 1099.

Insurance Fraud

Examiners are also trained to spot insurance fraud because it is such a relevant part of the body shop industry. If the examiner notes extremely high profit margins on your parts, but inspections of the PO's indicate you only received the typical 20 to 25 percent discount, this is an indication that you are billing

for parts that were neither required nor replaced. This will help the examiner determine if there are parts revenues not reported.

Brown, PC represents auto body and repair shop clients 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.