INVENTORY NOTICE

We want to warn you of how the IRS reviews physical inventories. All indications are that tax returns will receive substantially increased scrutiny of actual ending inventory amounts reflected on your tax returns. Because of this increased exposure to audit adjustment, we want to review the inventory rules from three perspectives.

<u>IRS Requirements</u>
The Internal Revenue Service requires any business which maintains inventory to physically count the inventory on hand **every year.** This means that, in the event of an audit, you will be asked to provide physical count sheets reflecting actual inventory on hand at the end of the year. Additionally, the agent will physically tour the facility and observe actual inventory on hand. If the IRS examines your return and finds that an actual physical inventory was not taken substantial penalties may be assessed, including a 25% penalty for substantial understatement of income. Many companies find that a video record of the physicals count will aid in the proof of the inventory amount claimed.

<u>Management issues</u>
Most businesses find that their largest current asset is inventory. Every well run business in America monitors and records inventory because of the need to control the invested amount, respond to competitive pricing issues, and adjust to changing market conditions. One of the first signs of financial problems can be a loss of control over the amount invested in inventory. It is evident that for your business to continue to be profitable you must know the amount your company has invested in inventory, so from a management perspective losing sight of the actual inventory investment could quickly cause major financial problems. The IRS annual inventory requirement is actually secondary to the requirement to correctly manage your business by carefully controlling your investment in inventory.

<u>Disaster Losses</u>
Most business owners have never been through a disaster such as fire or flood. We have had clients experience such disasters and they are always shocked at the insurance payment for inventory. In the event of a disaster the insurance adjuster will base any inventory payment on the amount of inventory reflected on your most current financial statement. If you have been understating inventory you will experience a substantial economic loss in the event of a fire, flood or other disaster.

In summary, we are very concerned that many of our clients are not taking an annual physical inventory, and we want to close by re-emphasizing our worries for clients exposed to major IRS adjustments, collapsing management controls and inadequate insurance. We therefore recommend in the strongest terms that all of our clients physically count inventory at or near December 31, 2021 and provide us with a copy of their physical count and costing sheets.