

# McLean, Koehler, Sparks & Hammond

Certified Public Accountants/Business Consultants

## Industrial Manufacturing

### Case study: The case of the creative managers

On Dragnet, one of the first detective shows on television, each show opened with Sergeant Joe Friday advising the audience, "The story you are about to see is true. The names have been changed to protect the innocent." The same can be said about this story.

ABC Company had a number of locations in several states, each run by a manager. Managers had limited authority to incur business expenditures without approval from the home office.

For example, managers had the authority to contract for the repair of assets at their location, but the purchase of additional assets required a complex review and approval by the home office.

During a routine IRS examination, the agent determined that virtually all of the managers had become quite creative in authorizing "repairs."

Office equipment was repaired by returning an old item and receiving a new one. Office furnishings were repaired by adding additional desks and chairs. Repairs to plant equipment could involve significant mechanical and electrical work, often resulting in a much improved machine. Even repairs to building walls and roofs sometimes created additional plant space.

The managers had become so adept at "repairing" their locations that they shared their techniques with one another.

As a result of the IRS agent's discovery, the company found itself facing a Special Agent, flashing a badge and talking about a criminal investigation. The IRS was concerned that it had uncovered a fraudulent pattern of company executives colluding to create tax deductions for repair expenses, while disguising the purchase of fixed assets that should have been depreciated.

Fortunately, ABC acted quickly and called in legal counsel and outside auditors to investigate.

With the help of their advisers, ABC was able to convince the IRS that the pattern of abuse represented poor business practice and poor oversight. As pervasive as the activity was, none of the managers had considered the impact of their actions on the company's tax position. The IRS decided not to pursue the criminal tax fraud case.

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