

Advice for **TAX PREPARERS**

A blog devoted to making your life in public accounting easier.



Reconciling Schedule L & M-2 for Corporations and Partnerships

In a perfect world, the financial statement information the client sends a CPA firm would be at the same quality as the practice problems an accounting major receives in college. In college, the balance sheet always balances and the retained earnings account always rolls forward without an issue. The student's only problem is understanding the tax or accounting issue on the related test question.

But you are preparing a tax return in the real world. You have finished entering the data into the trial balance and importing the data into the tax software. Unfortunately, you see that your balance sheet does not balance or the retained earnings account does not roll forward.

You look at the tax return and the client workpapers. But you can't figure out if the problem is related to:

- Bad client data.
- An error in your input.
- Tax software problems.
- A combination of all of the above.

Your manager is willing to help you if needed and says that he wants you to ask questions. But you do not want to appear helpless to your boss.

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Therefore, you stare at the computer screen hoping something will become obvious. An hour later, you ask your boss for help and he finds the answer in five minutes. You shake your head and wonder if you will ever learn how to do this stuff.

No, your boss did not use magic. He did not get lucky. It's not that he understands the Internal Revenue Code or the client better than you. Your boss has simply learned through experience a system as to how to divide and conquer where to find the problem. As he crosses off each checkpoint in his head, he eventually finds the problem.

This five step guide and the following flowchart should solve more than 80 percent of the problems that you find in this area. If you want to help with changes or additions to the guide then please contact me at my website at www.advicefortaxpreparers.com.

- **Step 1.** Does the ending total assets on Schedule L match the client's balance sheet?
 - If yes then proceed to Step 2.
 - If not then check the trial balance software balance sheet report (all the major tax software products have one) to see if the ending total asset balance matches the amount on the client provided balance sheet. If you do not know how to view the report then ask a tax senior.
 - If they match then you have an import problem. Reimport the TB into the tax return. If the reimport of the trial balance does not change the Schedule L balance sheet then you have a software import problem. Check with a tax senior that you are using the appropriate import procedures.
 - If they do not match then you have coded a trial balance account to the wrong balance sheet account (e.g., an asset account as a liability).
- **Step 2.** Does the ending total liabilities plus equity on Schedule L match the client's balance sheet?
 - If yes then proceed to Step 3.

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- If the total difference is out of balance by the retained earnings / partnership capital account or the balance sheet balances but your equity account does not roll forward (Schedule M-2) then skip to Step 3.
- If it is not just an equity problem then check each Schedule L liability total against the trial balance summary report for that line. As with Step 2, if the amounts match then you have an import problem. If not it is a problem with coding the accounts.
- **Step 3.** Does the beginning retained earnings/partner's capital per Schedule L match the client's financial statement?
 - If yes then proceed to Step 4.
 - If the beginning amounts do not match then there is a prior period adjustment issue. If the amount is small compared to the size of the company then add an "other increases and decreases" adjustment to the Schedule M-2 to account for the balance and make a preparer note on the issue for the reviewer. If the difference is a large amount (it is a judgment call on this one) then send the reviewer an e-mail on the difference. The reviewer might decide to contact the client to determine the reason for the difference.
- **Step 4.** Does the book net income or loss on Schedule M-1, line 1, match the client's income statement?
 - If yes then proceed to Step 5.
 - If not then check the TB software income statement report to see if the net income or loss matches the client's income statement.
 - If it does not match then (assuming you did Steps 1, 2 and 3) you did not enter a tax destination code in the trial balance for an income statement account. Confirm that all of the income statement accounts have a tax destination code on the TB software.

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- If it matches then it is likely that one of your TB income statement accounts was coded to an automatic adjustment account that needs to have a book to tax adjustment. For example, there are occasions when the tax software ignores the TB depreciation amount and uses the amount from Form 4562. Therefore, you might need to set up the appropriate Schedule M-1 adjustment in the TB for the tax return to balance. Check that the following book and tax balances are the same in the TB and the tax return:
 - Depreciation (Form 4562)
 - Amortization (Form 4562)
 - Meals and entertainment
 - Charitable contributions
 - Gains and losses (Form 4797)
 - Schedule K-1. Any data directly entered from a Schedule K-1 into the tax return versus the trial balance.
 - COGS. This account only needs to be reviewed when an adjustment is made to the purchases account or a §263A tax adjustment was made.
- **Step 5.** Does the balance sheet on Schedule L balance and Schedule M-2 work correctly?
 - If yes then you can move forward with the completing the rest of the tax return.
 - If the retained earnings/partnership capital account still does not work then the client made a current year adjustment to the equity account. It is either an owner contribution or distribution or a direct adjustment to equity. Check to see if you have a detailed analysis of the equity account from the client. If not then record the difference

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as a prior period adjustment on Schedule M-2 and add a preparer note for the reviewer about the difference. As with Step 3, you may need to check with the reviewer before moving forward if the adjustment is large. They might want the client to resolve the difference before you complete the return.

If you cannot resolve the issue with Steps 1 to 5 then ask the reviewer for help. But you should attempt to discover which of the steps is likely to be the problem. The reviewer will help you. But they would rather not have to solve your problem from scratch.

Request

Since the blog is new, I am going to make a small request of you. I want the information on my blog to help as many people as possible. Therefore, if you have found the information in this free guide and the blog to be helpful I would like you to do one or more of the following things:

- Connect with me on LinkedIn.
- Share three or more of the blog posts on your LinkedIn account.
- Share three or more of the posts on your Facebook account.
- E-mail five or more tax preparers or accounting majors about the blog.
- Send me three ideas for posts on the blog through my contact page.

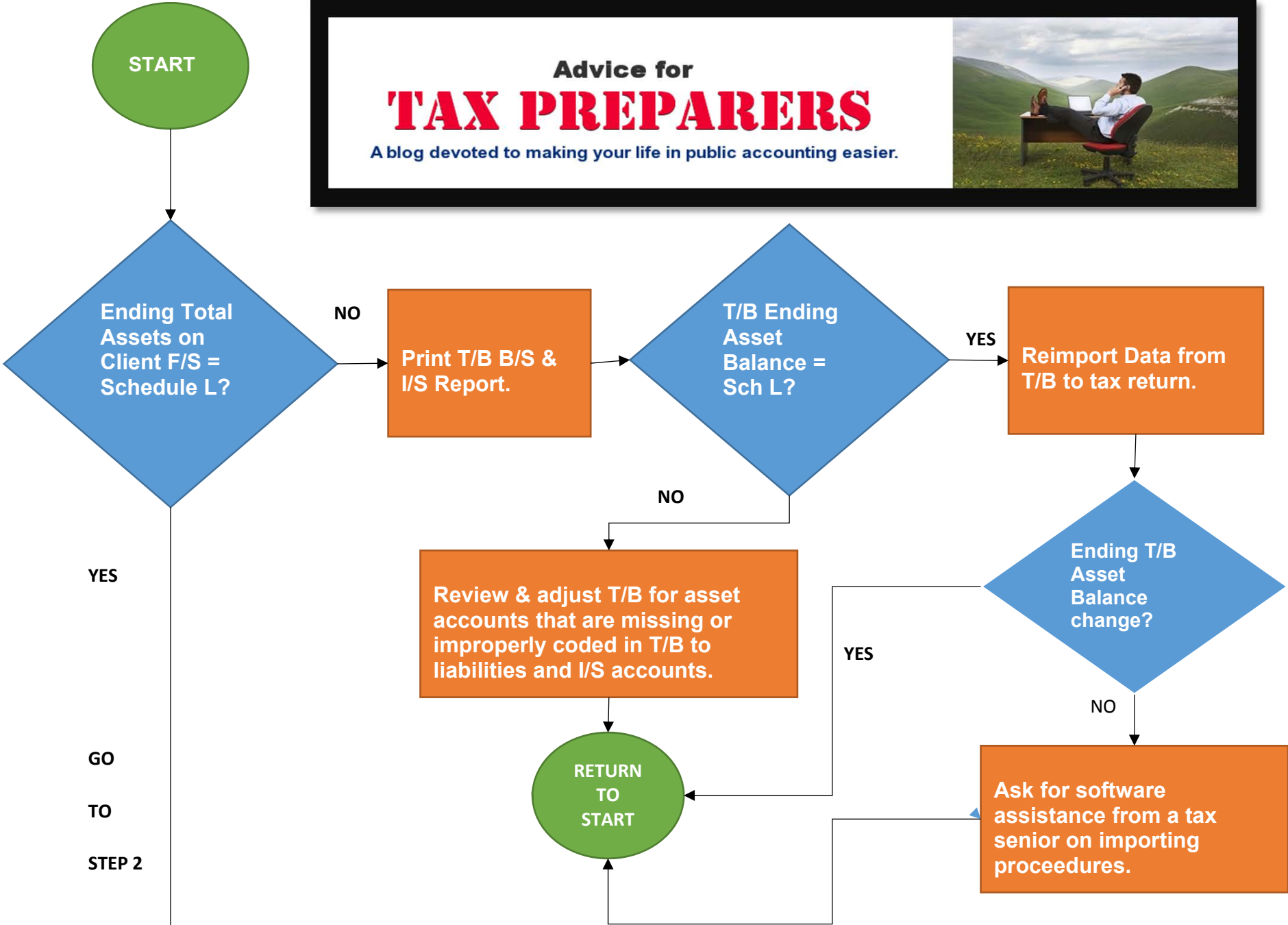
Obviously, my request is completely voluntary. But more people coming to the blog and giving me comments and ideas will increase the quality and amount of information that I can provide to you. In the end, any help would be appreciated.

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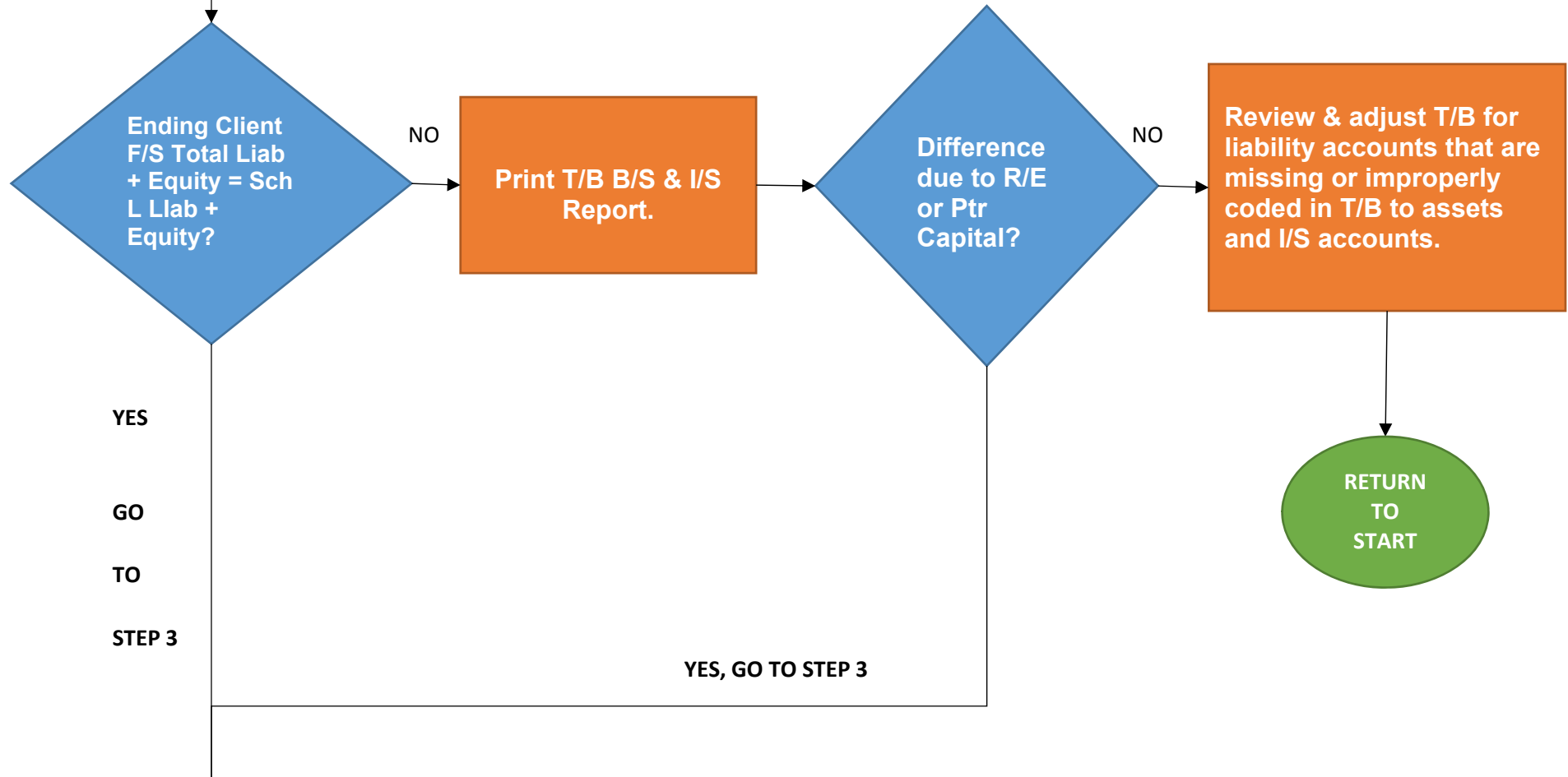
YES
GO
TO
STEP 2

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FROM STEP 1

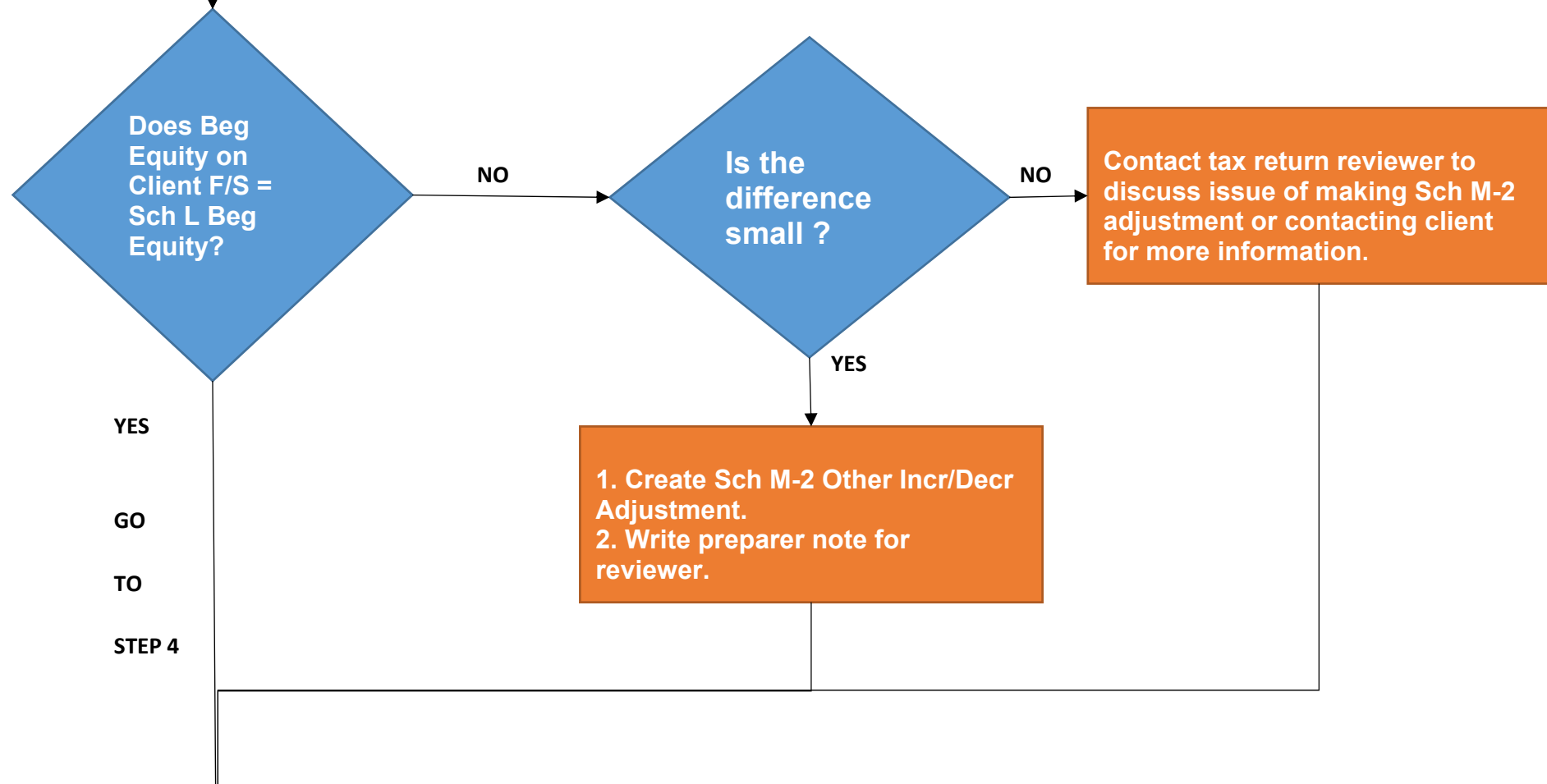


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FROM STEP 2



YES

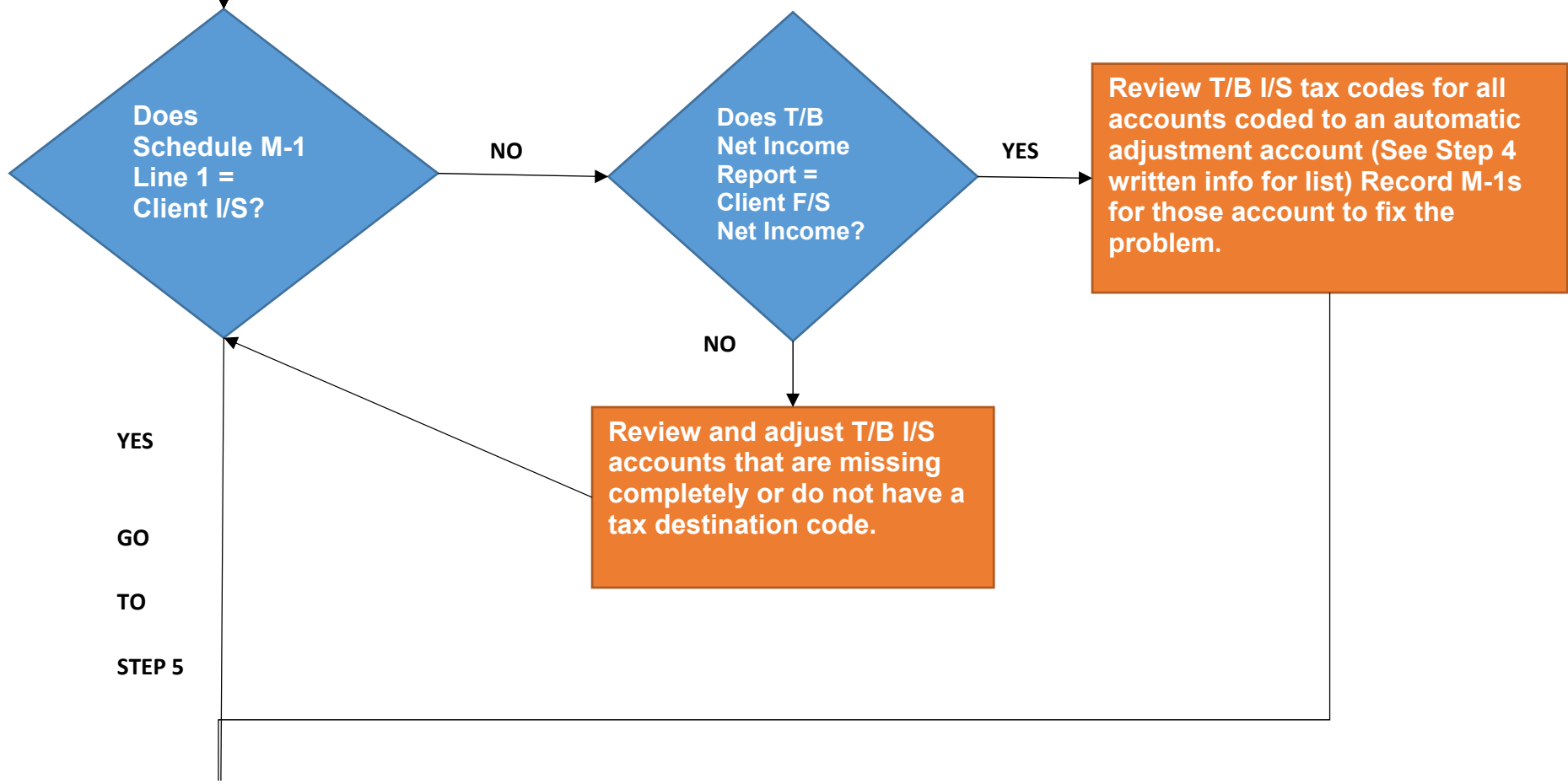
GO

TO

STEP 4

FROM STEP 3

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YES
GO
TO
STEP 5

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FROM STEP 4

