REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

February 17, 2003

REVENUE MEMORANDUM ORDER NO. 3-2003

SUBJECT: Prescribing Guidelines and Procedures in the Conduct of Inventory Taking/Stocktaking and Verification of Inventories Covering Taxable Year 2002 by the Large Taxpayers Audit and Investigation Division I, Large Taxpayers Audit and Investigation Division II, Large Taxpayers District Office – Makati, Large Taxpayers District Office - Cebu and Revenue District Offices

TO : All Internal Revenue Officers and Others Concerned

I. BACKGROUND

Under Section 6 (C) of the National Internal Revenue Code, as amended, the Bureau is empowered to conduct inventory-taking of goods of any taxpayer for purposes of determining his correct internal revenue tax liabilities, or it may place the business operations of any person under observation or surveillance, if there is reason to believe that such person is not declaring his correct income, sales or receipts for internal revenue tax purposes. While this power is inherently provided in the Tax Code, it has been observed that this tool has not been fully utilized by the Bureau to enhance taxpayer's compliance.

Over the years, the decline in reported sales and purchases of certain establishments resulted to substantial reduction in tax collections; and this unfavorable trend in financial reporting could also be attributable to erroneous reporting in the year-end inventory lists. Since inventories are major components in determining cost of goods sold, any inaccurate reporting of this account in the inventory lists and financial statements will result to distortion of taxable income. Accordingly, verification of inventories of taxpayers in relation to purchases and cost of sales must be pursued vigorously and the same must be conducted with regularity.

II. OBJECTIVES

1. To determine through the inventory verification method if taxpayers have declared the correct amount of sales and paid the corresponding internal revenue taxes;

2. To prescribe uniform guidelines and procedures for a comprehensive and effective verification of inventories, inventory lists, and inventory records as well as prescribe reporting requirements as a result thereof;

3. To monitor taxpayers' compliance with the registration of their warehouses, storage places and bodegas together with their books of inventories as provided under Revenue Regulations No. 5-94; and

4. To gather data through the inventory verification method in relation to the investigation of income tax, value-added tax, and other internal revenue tax liabilities of taxpayers.

III. SCOPE

This Order prescribes inventory-taking and verification of all inventories and inventory records of finished goods, work in process, raw materials, supplies and stock-in-trade as of the date of stocktaking and all inventory lists covering taxable year 2002 filed by taxpayers, except that for taxpayers subject to excise tax, a supplemental Revenue Memorandum Order shall still be issued.

IV. POLICIES

1. The verification of inventories under this Order shall be undertaken by the Large Taxpayers Audit and Investigation Division (LTAID), Large Taxpayers District Office (LTDO) – Makati, Large Taxpayers District Office (LTDO) – Cebu and Revenue District Offices (RDO) having jurisdiction over the taxpayers selected for stocktaking/inventory verification.

   Where a taxpayer selected for stocktaking has multiple branches, warehouses, bodegas, or facilities, simultaneous conduct of inventory taking/stocktaking shall be made on these premises to determine the correct total stocks on hand by the taxpayer. The inventory-taking activity shall be conducted by the LTAID/LTDO/RDO having jurisdiction over the taxpayer's head office.

2. Inventory verification shall be authorized through a Mission Order (MO) (BIR Form 0422) (Annex "A") and a letter to the taxpayer (Annex "B") duly signed by the Assistant Commissioner, Large Taxpayers Service (ACIR, LTS)/concerned Regional Director.

3. Revenue Officers (ROs) from the Assessment Group shall be authorized to conduct verification of inventories. However, the chief of the investigating office may assign ROs from the Collection and Document Processing Sections to assist in the verification of inventories.

4. The physical inventory-taking of stocks on hand as of the period covered by the stocktaking shall be conducted by four (4) ROs at the minimum with at least one (1) RO from the Assessment Group. The physical counting of stocks on hand shall be undertaken immediately upon service of the Mission Order without any prior arrangement with the taxpayer to verify the physical

existence of the stocks actually on hand as of the time of stocktaking/inventory-taking.

5. In determining the pending inventory verification workload, each Mission Order is counted as one case of each and every RO assigned to the case.

6. In case the taxpayer subjected to inventory verification agrees to the findings resulting to corresponding adjustments to sales or cost of sales, the following courses of action shall be undertaken by the Revenue Officer:

   6.1 Require the taxpayer to pay resulting deficiency taxes upon conclusion of the inventory-taking activity, without prejudice to the issuance of a Letter of Authority upon recommendation of the ACIR, LTS/Regional Director and approval of the Commissioner.

   6.2 Record the findings discovered in the course of verification for reference in any subsequent audit of the concerned taxpayers subjected to stocktaking.

7. The Revenue Officers shall prepare a report of inventory verification/stocktaking within thirty (30) days after service of the Mission Order and letter to the taxpayer stating the inventory verification, unless an extended period is allowed by the Commissioner. In the event that no report is forthcoming, the revenue officers shall explain in writing why a report thereon could not be submitted. If the failure to render a report is due to the refusal of the taxpayer to provide the necessary information relative to the correct determination of inventory valuation, the corresponding recommendation for the issuance of Subpoena Duces Tecum shall be made under existing rules and regulations.

8. The Chief, LTAID/Chief, LTDO/Revenue District Officer shall transmit the dockets of the case together with the reports of inventory verification/stocktaking to the Review and Evaluation Group, LTS/Chief, Assessment Division for appropriate review prior to final review and approval by the ACIR, LTS/concerned Regional Director within ten (10) days from submission by the inventory team.

9. The list of candidates/taxpayers to be the subject of stocktaking, with mention of reasons for the selection of the candidates, shall be approved by the Commissioner before the start of the actual inventory-taking activity. (Figures and computation should be part of the list, if necessary.)

V. GUIDELINES AND PROCEDURES

1. The Chief, LTAID/Chief, LTDO/Revenue District Officer shall draw up a list of taxpayers selected for the conduct of inventory-taking/stocktaking stating the justification for his selection, such as where there is reason to believe that such taxpayer is not declaring his correct income, sales, or receipts for

internal revenue tax purposes. The taxpayer may be selected for inventory-taking if he falls under any of the following cases:

1.1 Taxpayers with no VAT payable/with excess input tax over output tax in all the quarterly VAT returns during the taxable year

1.2 Taxpayers maintaining an ending inventory of 100% or more of its gross sales during the taxable year as per example below:

Ending Inventory		P 5,000,000.00		
Gross Sales	=	P 5,000,000.00	=	100%

1.3 Taxpayers who were apprehended for violations of certain internal revenue laws and regulations as a result of surveillance pursuant to Revenue Memorandum Order No. 54-2000.

1.4 Taxpayers who were apprehended for violations relating to non-issuance of invoices.

2. The lists of taxpayers selected for stocktaking shall be recommended by the Chief, LTAID/Chief, LTDO/Revenue District Officer, through the ACIR, LTS/Regional Director, for approval of the Commissioner using the format prescribed in Annex " C" hereof. The ACIR, LTS/Regional Director shall furnish the Deputy Commissioner, Operations Group and Assistant Commissioner, Assessment Service with a copy of the said approved lists within three (3) days from approval thereof.

3. The Chief, LTAID/Chief, LTDO/Revenue District Officer shall prepare the MOs and letters addressed to the taxpayer for signature of the ACIR, LTS/Regional Director to be distributed as follows:

Distribution of MO:

Original	-	to the Revenue Officers assigned to conduct the stocktaking/inventory verification
Duplicate	-	to be furnished to the taxpayer (Subject of the Mission Order)
Triplicate	-	to be duly acknowledged by the taxpayer or his authorized representative. This serves as a file copy of the Office conducting the inventory verification. (A photocopy thereof shall be attached to the report.)
Quadruplicate	-	file copy of the Assessment Service

Distribution of letter addressed to subject taxpayer:

Original -	to be furnished to the taxpayer together with the duplicate copy of the MO
Duplicate -	to be attached to the report/docket
Triplicate -	file copy of the Assessment Service

All MOs issued shall be recorded sequentially in the Mission Order Register. Blank MOs to be issued under this Order shall be requisitioned by the ACIR, LTS/Regional Director from the Accountable Forms Division.

4. Prior to the service of the Mission Order to the taxpayer, the Revenue Officer shall secure the following data from the ITS records or from any available records within the Bureau:

   4.1 Inventory of all printed accountable forms covered by permits issued by the Bureau (e.g. sales invoices, official receipts, delivery receipts, etc.);

   4.2 All books of accounts and other accounting records registered with the investigating office/RDO (e.g. general ledger, general journal, sales books, purchase books, subsidiary sales and purchase books, etc); and

   4.3 Registration data of all branches, warehouses, bodegas, or facilities maintained including their corresponding addresses;

   4.4 Annual inventory list filed with the BIR for the immediately preceding year to establish the beginning inventory for the taxable year covered by the inventory verification.

5. After serving the Mission Order, the RO/s shall perform immediately the following inventory verification procedures:

   5.1 Familiarize with the taxpayer's business and its products. Interview the taxpayer and other knowledgeable personnel of the company and conduct a tour of the business premises. Discuss the cost components, inventory pricing system adopted including the procedures for ordering, receiving, recording and issuing stocks or inventories.

   5.2 Request/secure from the taxpayer copies of the following:

      a. List of all inventory items;

b. Records of sales, purchases, sales returns, purchase returns and other records/documents, such as stock cards, pertinent to the taxpayer's records of inventories; and

c. Inventory lists at the end of the year based on inventories segregated per location where the same are stored or maintained.

5.3 Conduct immediate physical count of all accountable forms and establish cut-off thereof.

a. Control the taxpayer's inventory records or stock cards, accountable forms and inventory books during the time of inventory test to preclude any alterations thereof.

b. Account for all issued and unissued accountable forms and note any break in their pre-printed series. Require the taxpayer to explain/justify reasons therefor.

c. Sign the duplicate/file copy of the last sales invoice/delivery receipt/ sales return document issued indicating the date and time thereon.

d. Mark the Sales Book to identify the last recorded invoice used on the day before the conduct of stocktaking. The same shall also be done on the Purchase Book to tag the last recorded inventory receipt of the previous day. Marking of the books or records may be made by drawing two straight lines under the last transaction entry, and affixing the signature of the concerned ROs, with the date of the start of the physical count. The marking of the books must be done to establish proper inventory cut-off.

e. Request for the stock ledgers/books of inventories, if maintained by the taxpayer, and proceed to the warehouses, storage places, bodegas, facilities, and other premises where inventories are being stored, maintained or displayed for sale. Require the taxpayer to segregate consigned goods, "inter-company" stocks, obsolete items, and other items not properly includible in inventories and to submit documentary proofs to validate the segregation of such items.

Depending on the taxpayer's treatment of inter-company transfers of inventories (whether or not the title to the goods were transferred among the different units of the taxpayer), these items should generally not be disregarded since not all inter-company transfers are excluded in inventories.

5.4 From the list of inventory items, select a representative sample of at least 10% of the total number of inventory items.

5.5 Determine fast-moving items and slow-moving items in the inventory that can be feasibly counted based on the stock cards. Prioritize the counting of the fast-moving stocks over the slow-moving items in the inventory.

5.6 Prepare pre-numbered inventory count tags or any other medium in duplicate indicating the name of the inventory item, stock number, plant/warehouse location and count measurement. The duplicate of the tags should be attached to the goods until the inventory summary is completed while the original tags should be kept together with the summary sheets. Inventory compilation sheets should also be prepared so that the data recorded on tags or count media can be transferred, priced, extended and totaled.

5.7 Conduct a full or detailed physical inventory count in the presence of the taxpayer or his authorized representative. Put duplicate count tags on the items counted. Ensure that the quantities and units of measurement (i.e., pieces, boxes, dozens, drums, etc.) on the tags and inventory sheets are stated in the same unit used by the taxpayer in his record of transactions and on the inventory records/stock cards.

5.8 Record counted items on the Inventory Count Worksheet (Annex “D”). Ensure that the tags/cards, count sheets and final summaries have been signed/initialed by the concerned ROs who did the physical count and countersigned by the taxpayer’s representative(s) on the date of the stocktaking.

5.9 Ascertain the level of internal control relative to the processing/handling of inventories adopted by the taxpayer. In case the internal control is weak and substantial discrepancies were noted during the initial inventory verification, a full or detailed inventory count of all the items must be made.

5.10 Verify the method of inventory valuation adopted by the taxpayer and ascertain if it conforms to the acceptable valuation methods prescribed under the Tax Code, as implemented by Sections 145-151 of Revenue Regulations No. 2.

5.11 Check if all books of inventories are registered with the BIR pursuant to Sec. 13 of the Bookkeeping Regulations, as amended by the Revenue Regulations No. 5-94. Match with the registration data of books of accounts secured from ITS or other sources within the Bureau.

5.12 Reconcile Actual Inventory Summaries with Inventory Records/Stock Cards kept by the taxpayer.

a. Verify the extensions, footings, and totals on inventory sheets. Quantities and unit prices must be stated in correct units (e.g., dozens and price per dozen; tons and price per ton, etc.).

b. Compare the result of the actual physical count with the balance on taxpayer's inventory lists and stock cards. Perform the following procedures in case of existence of discrepancies:

    b.1 Secure copies of all Purchase Orders, Receiving Records, Related Invoices, Debit Memoranda for returned items, and verify the accounting entries from the beginning of the taxable year (or the end of the period covered by the inventory list) to the date of stocktaking.

    b.2 Check all sales and purchases transactions of the same items starting January 1 (or the first working day of January) or the beginning of the fiscal period, as the case may be, up to the date of the test verification or stocktaking.

    b.3 Verify the series of the sales invoices issued and recorded during the period and account for any break in the series. Be alert on the possibility that the unaccounted series of sales invoices may indicate unrecorded sales.

    b.4 Perform work-back procedures to determine actual inventory quantities and peso values at year-end. Reconcile inventory lists submitted with the result of the work-back procedures. Inquire and investigate reasons for discrepancies noted.

    b.5 Secure third-party information on sales, purchases, and import transactions from internal and external sources, in accordance with the provisions of existing rules and issuances.

    b.6 Ascertain the tax implication of confirmed third-party data or information that were not taken up or reflected in the taxpayer's inventory records. For this purpose, illustrative examples of tax implications of some possible discrepancy scenarios are shown in Annex "E" hereof.

    b.7 Ascertain the sales in quantity of items verified from the duplicate copies of sales invoices, delivery receipts, and sales book/general journal (for transfers not covered by sales/delivery invoices) and compare the quantity with the quantity sold per investigation. Any discrepancy may indicate undeclared sales.

b.8 Ascertain the actual quantity of goods purchased or received from the original copies of purchase invoices, importation documents, copies of receiving reports or similar documents, purchase books, and general journals. Compare the same with the quantity of goods received/handled per investigation. Any discrepancy thereon may indicate undeclared sales or overstatement of costs.

b.9 Deduct the quantity on hand of the test-checked items from the quantity available for sale (Inventory Beginning plus Purchases, net of purchase returns). The difference in quantity should represent the quantity sold from January 1 (or the first working day of January) or the beginning of the fiscal period, as the case maybe, up to the time of physical count or stocktaking. Trace difference in quantity sold from the accounting records relative to credit transactions on the inventory account such as sales invoices, delivery receipts, and credit memoranda for returned sale items. Any discrepancy in quantity should be verified. If the taxpayer cannot justify the same, these may represent undeclared sale of the same item or inventory.

b.10 Account for any over/understatement of inventory by applying the following pro-forma analysis:

COMPUTATION OF OVER/UNDERSTATEMENT OF INVENTORY

As of December 31, 200__

Count Date ____________

Ending Inventory per Inventory List/Audited F/S		P XXX
Inventory of Goods per Physical Count (Refer to Inventory Count Sheet)	P XXX	
Add (Deduct) Adjustments:*		
Disposal of items/goods evidenced by Sales Invoices	XXX	
Withdrawal of goods evidenced by materials issuance slip/delivery receipts	XXX	
Receipt of items/goods evidenced by materials receiving report/delivery receipts	(XXX)	
Other receipt of goods evidenced by materials receiving report/delivery receipts	(XXX)	
Importation of goods evidenced by importation documents	(XXX)	
Adjusted Inventory of Goods per Physical Count As of December 31, 200__		XXX
Difference Over/(Under)		XXX

- Pertains to movement of items/goods from cut-off date to inventory count date.

5.13 Compute for the value of the undeclared sales by multiplying the discrepancy in quantity by the unit selling price of the test-checked item. In the event that there were increases in the selling prices of goods, specific identification of selling prices of affected goods must be made in computing the undeclared sales.

5.14 If the taxpayer does not maintain inventory records/books or stock cards, the Revenue Officer shall determine the discrepancy by using the beginning Inventory List as submitted by the taxpayer. From the beginning balance, add all items of purchases with adjustments on returned items and materials/goods in transit, to arrive at the total items for sale. From this quantity, deduct all the items sold with adjustments on returns, to get the number of items as ending inventory. Match the resultant figure per item of inventory with the quantities reflected in the physical inventory count and verify discrepancies, if any. If the taxpayer cannot validly justify the discrepancy(ies) noted, consider the same as undeclared sales.

5.15 Consolidate the results of all inventory verification made involving the same taxpayer with multiple inventory locations where simultaneous stocktaking of stores, warehouses, or bodegas was undertaken.

5.16 Compute the applicable deficiency taxes arising from over/understatement of inventories by using the following pro-forma computation:

a. COMPUTATION OF OVER/UNDER DECLARED INVENTORIES

Ending Inventory per Return	P XXX
Ending Inventory per Physical Inventory Count	
(Refer to Inventory Count Sheet as Adjusted)	XXX
Difference Over/(Under)	P XXX

b. COMPUTATION OF GROSS MARK-UP ON COST OF SALES

Gross Profit per Audited F/S	P XXX
Cost of Sales (COS) per Audited F/S	P XXX
Percentage of Gross Mark-Up on Cost of Sales	XX%

c. COMPUTATION OF ESTIMATED GROSS PROFIT
(Applicable only for overstated inventory in computation (a) above)

Amount of Overstated Inventories	P XXX
Multiply by: Rate of Gross Mark-Up vs. COS [computation (b) above]	XX%
Estimated Gross Mark-Up	P XXX

d. COMPUTATION OF DEFICIENCY TAXES

d.1 Assumption I – Overstatement of Ending Inventory

(a) Computation of Deficiency Income Tax shall be computed as follows:

Taxable Income per Return	P XXX
Add: Estimated Gross Mark-Up [Computation [c] above]	XXX
Taxable Income per Investigation	P XXX
Tax Due Thereon (xx%)	P XXX
Tax Paid per Return	XXX
Basic Deficiency Income Tax	P XXX

(b) Computation of Deficiency VAT shall be computed as follows:

Amount of Overstated Inventory	P XXX
Add: Estimated Gross Mark-Up [Computation [c] above]	XXX
Amount not subjected to VAT	P XXX
Basic Deficiency VAT (1/11 of the above amount)	P XXX

d.2 Assumption II – Understatement of Ending Inventory

(a) Computation of Deficiency Income Tax shall be computed as follows:

Taxable Income per Return	P XXX
Add: Amount of Understated Inventory [Computation (a) above]	XXX
Taxable Income per Investigation	P XXX
Tax Due Thereon (xx%)	P XXX
Tax Paid per Return	XXX
Basic Deficiency Income Tax	P XXX

(b) No tax implication for Value-Added Tax purposes on the premise that undeclared inventories do not constitute items/goods deemed sold.

While this Order aims to provide the most possible comprehensive procedures in the conduct of inventory verification, it cannot accommodate all possible scenarios the Revenue Officers may encounter in the conduct thereof. Accordingly, the concerned Revenue Officers are not precluded from performing other procedures and techniques which they may deem appropriate and relevant under the circumstances.

VI. REPORTING REQUIREMENTS

1. Reports by Revenue Officers

   The following documents shall form part of each and every report on inventory verification to be submitted by concerned Revenue Officers:

   1.1 A Standard Verification Report Form (Annex "F") shall be used for the reports on all the tax liabilities affected by the inventory verification.

   1.2 A narrative memorandum report shall be prepared setting forth the result of the verification and should contain the following information:

   a. The basis of authority to verify the inventory (Mission Order Number, dates of issuance and service and the period covered);

   b. Profile of the taxpayer, particularly the type of business organization, nature of business, product line(s), other sources of income, information of its registration with other agencies such as the SEC, BOI, PEZA, etc.;

   c. The tax liability(ies) to which the taxpayer is subject, whether income tax, value-added tax, percentage tax or other internal revenue taxes;

   d. A brief description as to the circumstances surrounding the service of the Mission Order, inventory count undertaken, delays encountered and reasons therefor, other verification procedures adopted, relevant records checked, actual status of inventory records, and dates and result of conferences;

   e. Results of verification summarizing the discrepancies discovered and basis of computation of recommended deficiency taxes, if any, and

f. A recommendation as to issuance of termination letter after collection of the deficiency tax, if any, and approval of the case or issuance of assessment notice for deficiency taxes.

1.3 The Revenue Officers shall attach all working papers and all documentary evidences that relate to their findings in the course of the inventory verification.

1.4 The following documents shall likewise be attached to the docket:

a. Photocopy of Mission Order;

b. Copy of the inventory list as of December 31, 2002 (or end of applicable fiscal periods) duly received by the concerned office;

c. Copy of the inventory list and supporting count sheets at the time of the stocktaking or physical count duly signed by the taxpayer, his representative or any responsible company personnel;

d. Revenue Officer's Audit Reports (BIR Form 0500 Series);

e. Copy of Payment Form (BIR Form 0605), if deficiency tax was paid;

f. Informal Conference Letter with the taxpayer and the summary of the results of said conference(s);

g. Agreement form, if applicable;

h. Table of contents.

2. Report by Chief, LTAID/Chief, LTDO/Revenue District Officers

2.1 Monthly Report of Closed Cases on Inventory Verification (Annex "G")

2.2 Monthly Report of Pending Cases on Inventory Verification (Annex "H")

The above reports shall be prepared and submitted not latter than the 10th day of the following month and to be distributed as follows:

Original	-	ACIR, Assessment Service
Duplicate	-	ACIR, LTS/Regional Director
Triplicate	-	Review and Evaluation Group, LTS/Chief, Assessment Division

Quadruplicate - File copy

3. Report by the Head, Review and Evaluation Group (LTS)/Chiefs, Assessment Divisions

   The Monthly Report of Terminated/Assessed Cases on Inventory Verification (Annex "I") shall be distributed as follows:

   Original - ACIR, Assessment Service

   Duplicate - ACIR, LTS/Regional Director

   Triplicate - File copy

   This report shall be submitted on or before the 15th day of the following month.

4. Report by the ACIR, LTS/Regional Director

   The List of Mission Orders Issued for Inventory Verification (Annex ("J) shall be prepared on or before the 5th day of the following month to be distributed as follows:

   Original - ACIR, Assessment Service

   Duplicate - Review and Evaluation Group, LTS/Chief, Assessment Division

   Triplicate - File copy

5. Report by the ACIR, AS

   The Consolidated Monthly Report on Assessments/Collections Arising from Stocktaking/Inventory Verification (Annex "K") shall be distributed as follows:

   Original - DCIR, Operations Group

   Duplicate - File copy

   This report shall be submitted on or before the 25th day of the following month.

VII. REPEALING CLAUSE

The provisions of Revenue Memorandum Order No. 18-95 and all other issuances inconsistent herewith are hereby modified or repealed accordingly.

VIII. EFFECTIVITY

This Order shall take effect immediately upon approval.

(Original Signed)
GUILLERMO L. PARAYNO, JR.
Commissioner of Internal Revenue

I-1