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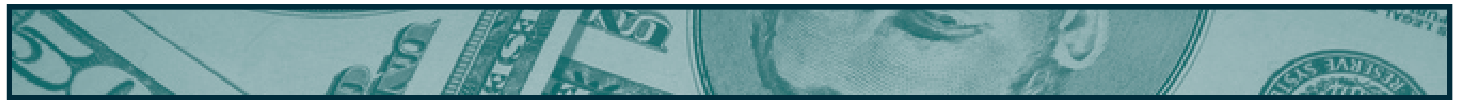
FOCUS ON FUN

Accountants & Humor
– A Sociological Fable

1. No one had seen Joseph of Philadelphia steal the credit card. And as he had carefully disguised himself, it was impossible for the clerk at the stereo store to identify the person who actually charged $2,700 for a premium sound system. How then were the police able to arrest him so quickly? It seems the hapless fraudster also had purchased extended warranties on the new gear – using his real name and address.

2. Looking for a bit of extra cash to pay for a computer and printer, Anthony of Madison, Wisconsin, hatched a plan: He'd print fake parking tickets and mail them to local citizens. Anthony even rented an extra-large post office box for the money that no doubt would be pouring in. But the only thing that poured in was the cops. How did they find him? Although the tickets looked real enough, all of them had the same identification number – which just happened to match the one on his own recent parking ticket.

3. Albert was serving a long sentence in a federal penitentiary near Tampa, Florida, when he came up with a plan to build a nest egg to use when he was released. He told fellow inmates that, for a fee, he could get anyone a pardon directly from the president of the United States. Albert managed to collect $90,000 before anyone had the sense to ask, "If you can get anyone a pardon, why are you still behind bars?"



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Is it a Profit? Is it a Loss? NO, It's Super-Manipulation

Whether a case involves a divorce, a minority stockholder suit, partnership dissolution, insurance claim – it is usually very important (many times the most important financial aspect of a situation) to determine the real income of a business entity, how much the business owner is making. This is so or even if we are not involved in a suit, but rather we are dealing with the valuation of a business for purposes of estate planning and/or gifting. In theory, this figure is shown in the statement of operations, which goes under various names – Profit & Loss Statement, Revenues & Expense Statement, Income Statement, etc. Regardless of its moniker, it is an indication of the income received and the expenses incurred by a business. It is an unusual business where no adjustments are necessary as to expenses and/or income. It is the exception to the rule where we are able to accept operational results as presented on the surface. This article will touch on just a few areas where adjustments are common.

One of the first issues with which we need to deal is the matter of **cash basis versus accrual basis**. Simply explained, the cash basis (very common for virtually all professional businesses and for many small companies) is a reflection of income received and expenses paid. A problem with this type of system is that it does not reflect income earned but not yet collected; nor does it reflect expenses incurred but not yet paid. This leaves room, sometimes much room, for significant distortions. The accrual basis of accounting is the one considered to be in accordance with generally accepted accounting principles – and is in theory the only appropriate way to reflect the income and expenses of a business.

Depending on the condition of a business' records, it is sometimes impractical to try to restate several years of cash basis figures in order to bring then in accordance with accrual basis requirements. Using a law firm as an example, to do so would require, at the very least, for each year that is involved, determining the extent of accounts receivable as well as work in progress (WIP) at the beginning as well as the end of each of those years. This would also entail making a judgment call as to the relative collectability of the receivables and the billability of the WIP. It would also require a similar exercise as to the extent of unpaid bills (accounts payable) at the beginning and the end of each of those years. As a practical matter, that is often either extremely difficult to do or would require a substantial time

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Calendar
Recent & Upcoming Events

Speeches:

September 2008
9 - Divorce & Valuation – Shenkman Seminar Series (Teaneck NJ)

26 - Divorce Taxation – NJ Society of CPAs (Iselin NJ)

December 2008
13 - Divorce Taxation – ICLE (New Brunswick, NJ)

January 2009
6 - Hot Issues in Business Valuation – CPA Club (Saddle Brook, NJ)

March 2009
24 - Business Valuation – Family Law Inns of Court

May 2009
26 - Business Valuation – Family Law Inns of Court

CLE Ongoing

* * *

Articles:

January 2009 issue of Middlesex County Bar Advocate – Civil Unions – Uncivil Taxes

Janet Barson & Laura Johnson
(Editorial, Design & Layout)

"The Majesty & Glory of Unreported Income" - our newest book, 40 pages. Available now – complimentary copies for the asking. Contact us if you haven't received your copy.

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commitment and expense that is perhaps unwarranted under the circumstances. Unless there are significant year-to-year differences (often the result of year-end planning or similar type "games"), while the balance sheet might be significantly impacted by reflecting the correct figures (i.e. accounts receivable), the year-to-year operations may barely be affected because the net variation between receivables, WIP, and payables from one year to the next may be de minimis.

Another area commonly requiring adjustments is income – whether because of **unreported income** or, perhaps more benignly, the **deferral** of one year's income into the next. The area of unreported income is one of the most difficult (and if you'll pardon an accountant's perspective, one of the most exciting) aspects of investigative accounting. Sometimes, the income adjustment is as relatively simple as recognizing that an invoice (or a series of invoices) near the end of one year is not reflected in the company's books (or, if for a cash basis company, that deposits received in the last week or two of the year were held back and not deposited until the following month – which is in the following year). These of course distort the income of each year. If this is something done somewhat consistently from year-to-year, one year's deferral is the next year's gain – and if we, in doing our jobs, add that income to the year in which it was not reflected or deposited, we must also recognize that the following year, to the extent of that adjustment just made, has been overstated. What typically happens of course is that a similar type "game" is played at the end of that following year, and the appropriate correction of that year will involve the same type of adjustment. Sometimes however, whether for financial reasons, tax reasons, or sloppy internal record keeping, the deferrals can be very different from year-to-year – even to the extent that for one or more years, no deferrals exist, while for one or more years, significant deferrals exist.

Payroll is another area where we often need to make adjustments to reflect reality. Putting aside the issue of reasonable compensation for the business owner, the payroll expense area is sometimes fruitful in the investigative process because of the possibility of no-show jobs, or unusual payment arrangements. No-show jobs typically take the form of either payments to family members (i.e. children) done as a tax maneuver, or payments to a paramour done for potentially many different reasons, two of which include ensuring a harmonious relationship and contributing towards being able to show less income available to the business owner. It is also common practice when such findings are made to similarly adjust payroll tax expense – if the payments for payroll are unjustified, then the attendant payroll taxes resulting from that payroll should not be permitted as a business expense.

Depreciation – an occasionally heard refrain is that depreciation is not a real expense since it does not represent (as it is) a cash outlay. While it is true that depreciation is not a cash outlay, it is wrong (except in certain limited situations) to believe that depreciation is not an expense – it most certainly is a very real expense. The problem is attempting to define the timeframe over which that expense should be recognized. When a business purchases a machine for the factory, or a computer, or a desk, it either pays for it outright (thereby reduces its cash) or it buys it over time (typically taking out a note with a bank, and paying monthly installments). In either case, there is definitely a cash outlay – however, it might not (and usually does not) correlate closely with the using up of that asset. And, it is using up the asset that is indeed a real expense. Regardless of how paid for, over a period of time (whether it be a few years, several years, or many years) that asset will be used to the extent that at some point it will no longer serve a function for the business. The asset is then either junked, or perhaps traded in at a nominal value for a replacement. Clearly, the business has incurred an expense – we just have to figure out over how many years that total expense should be amortized. The tax laws (with perhaps the exception of automobiles) generally allow write-offs that are faster than the actual economic depreciation of an asset. Whether or not the difference is substantial enough to warrant an adjustment, is a separate case-by-case determination. Also, present law allows a first year bonus deprecation write-off of in excess of $100,000. A machine which costs $100,000 and might be useful for 10 years can be written off as if an expired expense at the time of purchase. This too is an adjustment in the deprecation area commonly required of the investigative accountant.

There are many other areas where it might be necessary to adjust reported figures – whether assets, liabilities, income or expenses. That is often the real challenge in a business investigation.

Being Sans Fraud

Once a business goes beyond having only the founder as an employee, the chance of it being the victim of fraud increases. As the company expands and hires more people and they are out of direct control of the owner, that likelihood increases dramatically. Having multiple owners also increases the chances of fraud. While it may be impossible to create 100% effective bulwarks against fraud, there are certainly various procedures that can be employed that will help to prevent or minimize fraud, or in the event that it happens, detect fraud relatively soon.

The following are just a few suggested areas for the institution of company policies or procedures intended to prevent or minimize fraud.

- Consider the immediate dismissal of any employee found to have committed fraud
- Management must set by example, adhering to a code of ethics and ethical business conduct
- It is important to have a corporate culture that avoids unethical behavior, including such things as a hostile or overly competitive environment, and the pushing of employees to burnout
- Procedures involving the handling of funds and company books should be designed with fraud prevention and detection in mind
- The appropriate use of IDs, passwords and other qualification thresholds for access to computer systems and files
- Segregation of duties to avoid overriding sound internal controls
- Possibility of requiring dual signatures for checks over a specified amount
- Training staff, at all levels, but especially supervisors and managers, to be aware of signs of fraud
- Implementing rules that prohibit override of, or interference with, company policies
- Having an independent, external audit on a regular basis
- The regular and prompt reconciliation of bank accounts and accounts receivable
- Strict prohibitions against the acceptance of gratuities, gifts, etc. from vendors and contractors
- Strict prohibition on bribing
- Prohibition as to such improper actions as stealing company property, falsifying time or attendance reports, falsifying expense reports

Of course, probably the most important aspect and reality of all of these rules, is that they must be respected by, and the example set by, top management and supervisory personnel. If that is not done, none of the rules will matter because the message will be clear that they are for show only.

A reminder to our readers – be sure to download our "FRAUD AWARENESS & COMPANY POLICY CHECKLIST" on our website

Still available – our previous books: Reading & Understanding Tax Returns, Financial Issues in Divorce Practice; Business Valuation – The Basics – complimentary copies for the asking. Contact us if you haven't received your copy.