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CPA
Client Bulletin
JULY 1997
BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

Detecting Fraud in a Financial Statement: The Auditor's Responsibilities

Recently, the American Institute of Certified Public Accountants (AICPA), issued a new statement on auditing standards regarding fraud in financial statements. These guidelines have received much attention because they provide expanded guidance on the auditor's responsibility to detect material fraud in financial statements, and the auditor's response if he or she does find a material misstatement. Following are some questions and answers about the new guidelines.

Q: *What is a financial statements audit?*

A: A financial statements audit is conducted by an outside public accountant who is independent of the organization being audited. The purpose of the audit is for the auditor to express an opinion on how fairly the financial statements present—in all material aspects—the financial position, the results of operations, and cash flows, in accordance with generally accepted accounting principles (GAAP).

Q: *Do the new guidelines change the auditor's responsibility to detect fraud?*

A: The auditor's detection responsibility will not change, but the auditor's performance requirements will be strengthened. The new guidelines clearly state that the independent auditor's responsibility is to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. The guidelines will aid the auditor in fulfilling that responsibility.

Q: *How will the guidelines help auditors?*

A: The new guidelines provide helpful guidance to auditors in detecting material misstatements resulting from fraud. Specifically, the guidelines:

1) Describe two types of fraud (fraudulent financial reporting and misappropriation of assets) that are relevant to the auditor's consideration of fraud in a financial statement audit.

2) Require the auditor to specifically assess the risk of material misstatement due to fraud in every audit and provide categories of fraud risk factors that the auditor should consider in making that assessment. They also provide examples of fraud risk factors that, when present, might indicate the presence of fraud.

3) Provide guidance on how the auditor responds to the results of the assessment.

4) Provide guidance on the evaluation of test results as they relate to the risk of material misstatements due to fraud.

5) Require the auditor to document risk factors identified as present and any related response.

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Do You Know...

where the first stock exchange in the United States was located? Contrary to popular belief, it was not in New York City; the first one was organized in Philadelphia in 1790. The New York Stock Exchange did not begin until 1817, when traders who met every day under a buttonwood tree on Wall Street decided to adopt the name the New York Stock Exchange Board.

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AN EXPENSE BY ANY OTHER NAME CAN BE A CAPITAL EXPENDITURE

Sometimes what an individual may think of as a "simple expense" may not be one under the Tax Code. Take, for example, a recent case where a couple's home was destroyed by fire, and was covered by insurance. The couple disagreed with the insurance company over how much should be covered.

Ultimately, the couple received insurance proceeds for the full amount of the cost for replacing their home, but in order to do so, they had to incur legal fees. The couple decided to claim part of those legal fees as a miscellaneous deduction on their tax return.

The IRS claimed that the purpose of the home was not to produce income, so it was not deductible as an "expense" against their income.

The Tax Court agreed with the IRS, and found that the house was a capital asset and that the insurance policy on the house could not be separated from and treated differently from the home. As a result, the legal fees surrounding the policy were a "capital expenditure" which were not deductible.

The court instead allowed the legal fees to be used to offset any gain the couple may have received with the replacement of their home, by adding the cost of the legal fees to the basis of the house.

Q: *What would be considered a "material misstatement" in financial statements?*

A: According to the guidelines, material means those misstatements or omissions that, given the surrounding circumstances, would influence or change the judgement of a reasonable person who is relying on the information.

Q: *What are some examples of the types of fraud mentioned in the guidelines?*

A: The guidelines describe two types of fraud that may occur in financial statements:

1) Fraudulent financial reporting. This type of fraud occurs when the assertions in the financial statements are intentionally misleading so that they do not meet the criteria of GAAP. For example, a company ships customer goods that have not been ordered, then records the revenue as if it met all the criteria for revenue recognition. Or, a company's personnel may provide a customer with a side agreement granting the right of return for any reason, or make the customer's payment for goods contingent on receipt of funding or some other event. In each case, neither transaction should be reflected in the financial statements because neither meets the GAAP criteria for revenue recognition.

2) Misappropriation of assets. Another type of fraud is misappropriation of assets, which includes the theft of cash, inventory, or securities. This can be harder to determine than it seems. For example, a retail business might reflect thefts in the cost of goods sold after inventories are adjusted to reflect the actual quantities at hand.

Q: *What are some of the risk factors that an auditor might look for?*

A: The guidelines provide examples of risk factors for both types of fraud. For fraudulent financial reporting, the guidelines list such factors as a known history of securities law violations and management being dominated by a single person or a small group, without compensating controls. Examples of risk factors relating to misappropriation of assets include lack of job applicant screening procedures for employees with access to assets susceptible to misappropriation, and poor physical safeguards over cash, investments, inventory, or fixed assets.

Q: *What does an auditor do once he or she finds a misstatement due to fraud?*

A: If fraud is found, the auditor has to first determine whether or not the misstatement is material to the financial statements. If it is not material, then the auditor should refer the matter to an appropriate level of management at least one level above those involved. For fraud that does have a material effect on the financial statements, or if the auditor is unable to determine the size of the misstatement, the auditor should take the same actions as above. In addition, the auditor should attempt to determine whether material fraud exists, and if so, its effect and, when appropriate, suggest that the client consult legal counsel.

Q: *How will the new guidelines affect entities being audited?*

A: The new guidelines will require auditors to ask management about the risk of

fraud and whether they have knowledge of fraud that has been perpetrated on or within the entity. If the entity under audit has a program that includes steps to prevent, deter, or detect fraud, the auditor will ask persons overseeing that program as to whether the program has identified any fraud risk factors. The auditor may communicate to management risk factors that he or she has identified. This is expected to encourage management to improve fraud prevention and detection techniques.

Q: *How will the guidelines affect audit fees?*

A: Many clients want to know how the guidelines will affect their audit fees; the effect will vary depending on the level of fraud protection in a particular organization.

Some organizations have one or more safeguards against fraud, such as very strong internal control, management that is concerned about fraud and its effects on the entity, and controls that are designed to prevent and detect fraud. For these organizations, the impact on audit fees should not be significant.

For organizations with fraud risk factors that are not effectively addressed by management, the costs will be greater. The profession believes that the public interest benefit will outweigh the additional cost. Also, organizations concerned about such costs can take measures to reduce them by implementing controls designed to prevent and detect fraud.

Q: *When do the new guidelines become effective?*

A: The new guidelines will go into effect for audits of financial statements for periods ending on or after December 15, 1997.

IRS Update—Private Delivery Companies Approved for IRS Filings

The IRS has announced that taxpayers can now mail tax returns and payments by using private delivery services (PDSs) and that proof of mailing with one of these services will be considered evidence of timely filing.

Previously, the IRS would consider tax returns and payments timely filed only if they were sent via the U.S. mail and postmarked no later than the due date. If a taxpayer elected to use a PDS, documents had to be received by the IRS by the due date in order to be considered timely.

The Taxpayer Bill of Rights 2, passed last year, allowed the IRS to designate PDSs that may be used, in addition to the U.S. mail service, to satisfy the timely filing rules. Effective April 11, 1997, tax returns or payments will be deemed timely if, on or before the due date, the documents are given to, or picked up by, one of the following delivery companies and sent via one of the indicated services to the IRS:

- **Airborne Express**—Overnight Air Express Service, Next Afternoon Service, Second Day Service.
- **DHL Worldwide Express**—DHL Same Day Service, DHL USA Overnight.
- **Federal Express (FedEx)**—FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2-Day.
- **United Parcel Service (UPS)**—UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M.

The IRS will now consider the date on which an item is given to a PDS and recorded in the PDS's electronic database as the postmark date for filing purposes. For items delivered after their due dates, the postmark date will depend on the type of delivery service chosen. For example, if a taxpayer chooses a two-day service, then the postmark date will be considered two days before the actual delivery date. If a taxpayer wants to overcome this presumption, he or she can do so by showing the date recorded in the PDS's electronic database is on or before the due date.

Other delivery companies may qualify as a designated PDS if they meet certain criteria. Twice a year, September 1 and March 1, the IRS will announce which PDSs qualify.

COMPANIES NOT REQUIRED TO GIVE ADVANCE NOTICE OF CHANGES IN RETIREMENT PLANS

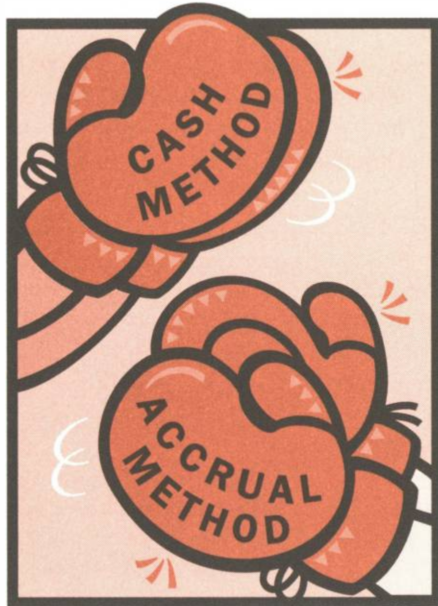
A recent court case demonstrates the obligations a company may have to notify its employees about changes in retirement plans.

An employee voluntarily retired, just before the company announced an early retirement package. The employee would have received much larger benefits had he waited to retire after the announcement. When the employee learned of the changes, he sued, arguing that the company had a fiduciary duty to inform employees of pending changes that would affect their benefits.

The Court of Appeals held that plan changes do not have to be disclosed until they are adopted. Until that point, changes to a benefit plan are only "possible" changes. The court stated that requiring companies to disclose any "possible" changes would be costly, cause confusion, and could deter businesses from using or updating benefit plans.

Court Sides with Taxpayer on Method of Accounting

Recently, the Tax Court held in favor of a corporate taxpayer who challenged the IRS's attempt to change its method of accounting. This is one of several cases where courts have rejected the IRS's attempts to place cash method taxpayers on the accrual method of accounting.



The taxpayer, an S corporation, was a service business that generated less than $5 million a year in gross receipts. The corporation had always used the cash method of accounting. The IRS argued that the cash method of accounting did not clearly reflect the income of the corporation, because it resulted in a mismatching of income and deductions.

The court agreed with the IRS that a mismatching occurs when the cash method is used. But, the court also stated that mismatching is inherent to the cash method, and as long as the method was used consistently, as the taxpayer had, a clear reflection of income would result. The court viewed the IRS's action as "clearly unlawful, plainly arbitrary, and not substantially justified," and held for the taxpayer. The court ordered the IRS to reimburse the taxpayer for attorney's fees and other costs incurred in the case.

Tax Calendar

JULY

July 10

Employees who work for tips. If you received $20 or more in tips during June, report them to your employer. You can use Form 4070.

July 15

Partnerships. File a 1996 calendar-year return (Form 1065), if you were given an automatic three-month extension. Each partner should get a copy of Schedule K-1.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies. The monthly rule applies for a calendar year if the total amount of taxes you reported in the look-back year is not more than $50,000.

July 31

Employers. For Social Security, Medicare, and withheld income tax, deposit any undeposited tax and file Form 941 for the second quarter of 1997. If you have deposited the tax for the quarter in full and on time, you have until August 11 to file the return.

If you maintain an employee benefit plan, such as a pension, profit-sharing or stock bonus plan, file Form 5500, 5500-EZ, or 5500-ER for calendar year 1996. If you use a fiscal year as a plan year, then file the form by the last day of the 7th month after the plan year ends.

AUGUST

August 11

Employees who work for tips. If you received $20 or more in tips during July, report them to your employer. You can use Form 4070.

Employers. For Social Security, Medicare and withheld income tax, file Form 941 for the second quarter of 1997. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, you should have filed the return by July 31.

August 15

Individuals. If you have an automatic four-month extension to file your income tax return for 1996, file Form 1040 and pay tax, interest, and penalties due. If you need an additional two-month extension, file Form 2688.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies. The monthly rule applies for a calendar year if the total amount of taxes you reported in the look-back year is not more than $50,000.

The CPA. Never Underestimate The Value.

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