FOCUS ON FUN

Accountants & Humor
– A Sociological Fable

1. The IRS issued a special bulletin advising that Form 945 does not exist. This was in response to significant confusion that arose by the reference in Form 8109, the Federal Tax Deposit Coupon Book, to a Form 945, causing various taxpayers to fruitlessly search for that form.

2. As reported in a national newspaper, but with the names changed so as to avoid embarrassment, a California accounting firm provided a specimen financial statement (that is a proforma type statement, with a shell indicating the type of financial statement, and x's in place of numbers) to a business owner who subsequently became a client of that accounting firm. Some months later, that client called a partner in the CPA firm to complain that the financial statement made no sense – the Company's name was missing, and instead there was just all of these x's and no numbers. The partner was perplexed since the firm had not done a financial statement for that client. The client had submitted the specimen statement to its bank – a rather large bank – in applying for a $50,000 loan. The icing on the cake is that with all of its shortcomings - the overwhelming number of x's, and that the specimen financial statement indicated that the Company's business was (and this is a quote) "company is a California corporation engaged in the promotion and sale of xxxx". - the bank gave the Company the requested loan.

3. A taxpayer, who began to exhibit signs of mental illness shortly after his marriage, was advised by his psychiatrist to obtain a divorce in order to regain his mental health. The taxpayer submitted to his wife's demands in order to obtain the divorce as quickly as possible, and subsequently deducted his legal fees, his wife's legal fees and the divorce settlement as expenses for medical care. While I would like to be able to tell our readers that this story had a happy ending, the IRS held, and it was upheld by the Court, that none of those expenses were deductible – despite that indeed all of this did restore the taxpayer's mental health.

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The Construction & Deconstruction of Income

Part 2

In Part 1, we introduced our readers to some of the basic issues and complexities involved in determining income, especially unreported income. We addressed matters such as using forms 1099, labor hours/capacity, and gross profit margins. And, in all cases, we illustrated how to challenge unreported income conclusions for each area. In this issue, in Part 2, we extend our analysis to determining income based on volume, periods of time and comparisons to the norm. And, again, how to challenge conclusions reached in each such situation.

Volume – related to the preceding, is the approach of determining what revenues should have been based on the volume of what was sold. For instance, if we are dealing with a fuel oil delivery company, or a gas station, assuming that we have a solid handle on how much product (the number of gallons) were purchased, we also therefore know how much was sold (in these types of businesses, especially over a period of time, inventory tends not to fluctuate all that much). If we know what the sales price was per unit, we are in a position to be able to determine the volume of sales. Using a gas station as an example, if we know that during the year it purchased one million gallons of gasoline, and that it sold the gasoline for $2.50 per gallon, then we know that the revenues for the business were 2.5 million dollars. Typically, this type of business doesn't have a collection problem, so we know that what was sold was also collected.

Challenge – in this type of situation, typically the issue is not how much was purchased (and therefore how much was sold), since these are usually numbers that can be determined from reliable third parties. However, how was the sales price calculated? Using a gas station as an example, we know that prices fluctuate regularly – as often as a few times per week. In this example of one million gallons, each penny of variance in the assumed sales price represents $10,000.

..................continued on page 2

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Selected period of time – sometimes, we approach the determination of what revenues really were (so that we can compare it with what was reported) based on an analysis of a limited period of time (i.e. one week, one month, one week from each of four different months, etc.), extrapolating from that selected time frame to a full year. This can work well in a situation where we have good information for a limited period of time – for instance, the "real" set of books or records (whether it be an appointment book, chits, receipts or whatever) for two months. The idea is to determine what sales were for that period of time, and compare same to what was reported. The difference, appropriately extrapolated for a full year or more, would serve as our determination of unreported income.

Perhaps the non–business spouse was able to grab the real receipts for one month, or we had a type of product that is sold only during a specific period of time (perhaps pumpkins before Halloween) – and we had solid information on that product, and in some way were able to compare that with reported sales of that product. This is a difficult process and only works under limited situations. Using such data, we might determine real sales for the month were $200,000, but reported sales were only $150,000. That would suggest $50,000 a month of unreported income. Assuming all of that was done well, a logical question would be – is the unreported income $50,000 for that one month typical for the average month for the year? If so, the natural conclusion would be that unreported income runs $600,000 per year. Or, and this is generally a more accurate way to approach the issue, since reported sales for that month were $150,000, and since reported sales for the entire year were $1,000,000, that would suggest that the month you chose represents 15% of the total year (as contrasted with one month on its own which only represents 8.3% of a year). In such a case, the comparison would have to be based on the volume of the year represented by that one month, rather than the shortfall of that month. That means the $50,000 of unreported income in that one month represented one-third of the reported revenue. Using that as our benchmark, reported revenues for the year of $1,000,000 would suggest that the unreported element was $333,000 – considerably less than the $600,000 just suggested as one way to approach the matter.

Challenge – this is another one of those areas that has many avenues of challenge. We gave you one example in the preceding paragraph – was the magnitude of unreported income based purely on that sample without regard to its relationship to the rest of the year? That could result in a monumental mistake. Of course, it could also go in the other direction. Was the sample chosen reasonable under the circumstances? For instance, if a business sells pumpkins for the Halloween season, and that was a basis for determining unreported income, there is certainly the possibility that the conclusion is distorted based on a seasonality-type issue. You wouldn't want to have to rely on the determination of unreported income for a greeting card business by calculating same based on what it sells for Mother's Day (unless you had a valid way to "normalize' that to put it on a proper footing in comparison to the rest of the year). Similarly, it would be dangerous to determine revenue based on capacity for a beauty parlor using Fridays and Saturdays (traditionally their busiest days) and ignore that Tuesdays and Wednesdays are nearly always less busy. In a similar vein, the determination of unreported income must proceed cautiously where a time frame is selected that might not be reflective of an "average" time frame – certain holiday periods for a retail greeting card store, the November/December time frame for a toy store, a time which might include a major vacation (especially as to a small business), etc.

Comparison to the Norm – one approach to calculating unreported income is to benchmark the subject company to its industry peers. That is, proceed under the belief or assumption that what is normal (in terms of margins, production, whatever) for that industry, is appropriate/applicable for the subject entity. For instance, if the normal gross profit margin for a particular type of business is 42%, but the business being investigated is showing a 35% gross profit, then it is possible you might see an attempt to reconstruct income of this business by assuming that it should have the 42% "normal". A calculation on that basis would conclude with significant unreported income because of the lower gross profit margin.

Challenge – you probably don't need to be a CPA to realize that the type of approach just described is seriously flawed. The use of a norm or industry average by itself, without much stronger support and substantiation as to the specific business, has the potential to conclude with grossly erroneous figures. That there is an industry norm or average also means that there are businesses that do better and that do worse. Without significantly more insight, how would we know whether the business being investigated operates more efficiently, less efficiently, is in any way average, sells the type of product or the segment of the market that would sustain average, etc.? It is very dangerous, and open to devastating cross-examination, to rely on no more than an industry standard in recalculating profit margins and net income.

Challenge – one general, all-purpose defense against an unreported income conclusion, is that the unreported income is simply a business expense because the stealing is by the employees not by the owner of the business. Certainly, in many types of cash/retail businesses, there is the concern, and often the reality, that theft is going on by the employees. Sometimes this is by goods walking out the back door, sometimes it's by the employees simply pocketing some of the cash. This type of unreported income is really employee theft of one form or another, and is indeed an operating expense. However, it does seem to strain credulity if one were to suggest that the employees steal but the owner doesn't. Also, though this might be overreaching, there may be an argument made that the magnitude of the employee theft is too much, illogical, suggestive of management negligence or incompetence, etc. None of that by the way would necessarily mean that the owner was taking anything, but merely perhaps was not running the business well. How that translates into a reconstruction of what might be the real income and what might be the right value is a completely different story.

Challenge – depending of course on the type of business, there are many times when a calculation as to sales, and therefore unreported income, based on even an excellent analysis of the business' operations and margins, would be deficient because it fails to take into account things such as shrinkage or wastage. For instance, it might have been determined that it takes 1 lb. of product to produce a certain dollar volume of sales. As a result, sales were re-calculated based on the number of pounds of product purchased. However, was some of the poundage wasted, perhaps in the form of scrap; or depending on how durable that item, maybe spoiled? Also, and this can be a very significant item, certain processes cause the raw materials to shrink or compress. Therefore, if a calculation was done that showed a certain volume of material was purchased, to then figure out what the correct sales volume should be based on the volume (i.e. pounds) of that product that was purchased, might lead to an inflated conclusion if it is not recognized that product is subject to shrinkage or compression in the manufacturing process. If it was determined that the business purchased 10 million lbs. of product, and but it was not recognized that it takes 10 million lbs. of product input to create 8 million lbs. of a saleable product output, there would be a very significant error in any type of income calculation.

Clearly, as exciting as the area of unreported income is for investigative accountants and valuation experts, it is an area that has the potential for very serious miscalculations and incorrect conclusions. This article should have provided the reader with a good sense of how we approach the determination of unreported income in a wide variety of situations – as well as a similar good sense in terms of how those conclusions can be challenged. This area is difficult, as well as interesting, but requires much effort (work, time) to arrive at a solid calculation of unreported income.