Forensic Forum

published by The BARSON GROUP

Volume 8 - Issue 3 **Fall 2009**

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Playing The Defense

Unexplained shortfalls, money missing from the bank, overpaying on supplies, sales being diverted, false shipping documents… how many of these sound familiar? They are but some of the consequences and/or warning signs of fraud and embezzlement. It is an all too unusual business which, over a long period of time, succeeds in avoiding being the victim of this type of a financial crime.

Over the years, from the various fraud engagements we have directed, we have found that while luck (in simply having honest employees) certainly plays a factor, there is far more than luck involved, and even having honest employees itself involves more than just luck. Avoiding being victimized usually means implementing the right procedures, standards, and company culture to avoid becoming an easy target.

- ❖ Separation of duties – among the most conducive situations for fraud is where one employee wears many harts and thereby has much unsupervised authority;
- ❖ A company culture which makes it clear that dishonesty is unacceptable – and that the guilty will be prosecuted. A major deterrent is the knowledge that, if you do wrong, you will suffer far more than a slap on the wrist and a demand for recompense;
- ❖ Sound internal control procedures in all phases of paperwork, ordering and purchasing, writing checks, filling orders;
- ❖ Being willing to pay your accountant to test the system and spend time looking so as to prevent fraud and embezzlement. Prevention is far cheaper (and much more satisfying) than cleaning up a damaged operation;
- ❖ A wary set of eyes as to some of the classic warning signs that should put you on notice that your company may have a problem.

One of the problems with a small business trying to implement various preventive measures is that it is often not cost effective to, for instance, have the appropriate separation of responsibilities. To do so might require having one or even two people only partially employed and very

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Calendar

Recent & Upcoming Events

Speeches:

May 2009

26 - Business Valuation – Family Law Inns of Court (Bridgewater, NJ)

August 2009

21 - Business Valuation in a Recession – ICLE (Atlantic City, NJ)

September 2009

10 - Current Issues in Business Valuation – Rhode Island CPA Society (Providence, RI)

November 2009

5 - Unreported Income in a Divorce Action – Louisiana CPA Society (Lafayette, LA)

CLE Ongoing

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inefficient in their job performance merely for the sake of spreading various job functions over several people. The reality is that many small businesses have no need for and cannot afford more than even one person to fill several job functions. A classic example is the bookkeeper/office manager who approves sales and purchases, writes checks, receives and opens the mail, and even does the bank reconciliations and perhaps even has check signing authority. Hardly an unusual situation – but one which accords that individual many opportunities to steal.

Recognizing that this article has been written by a CPA, and is appearing in a CPA firm's newsletter, the simple factual reality is that in many small businesses the only cost effective way to protect that business from fraud is to give the accountant adequate rein (which also means a cost to the company for accounting fees) to spend the time testing the various financial areas so as to detect improprieties as early as possible. It is a well known fact that routine, recurring and regular accounting services are not geared for nor are intended to uncover anything but the most egregious fraud. Even then, where the accountant's role is essentially that of preparing tax returns - typically where the accountant's role is severely limited, and he/she is not engaged to get into the books and operations – there is the risk of fraud being conducted with impunity until it is too late. A very involved business owner may be the best, or second best, defense against such activity.

Take a step back and consider whether you are at risk. Unless you are certain you are not, talk to your accountant. For some of our readers, this applies equally to yourselves as well as to your clients.

Bring a Balance to the Balance Sheet

Even a completely clean set of books, even an audited financial statement, can require adjustments in order to properly reflect the balance sheet as well as the income statement of the business entity for purpose of valuation. Many times these adjustments have nothing to do with suggestions of wrongdoing, distortions, or any other heinous actions by the business owner or his/her accountant. The purpose of this article is to give the reader insight into some of the balance sheet adjustments or corrections commonly seen.

Briefly, a balance sheet is a snapshot of a business at a point in time – typically at the year-end dated (i.e. December 31), though often at other financial statements dates (i.e. mid-year or quarterly). If one were to present the balance sheet of a business the day before or the day after, there would be differences – in some accounts no differences, in other accounts very minor differences, and perhaps in some accounts (typically cash in the bank) there might be significant differences. That is because a business is an operating entity, one which has changes/transactions occurring on a daily basis. That does not invalidate yesterday's balance sheet – rather it indicates that today the business is slightly different than it was yesterday, and one can expect that tomorrow, it will again be slightly different.

Most of the time, these differences, from a day-to-day basis, are insignificant. For instance, a typical change is a bill is paid that was a liability the day before. In a properly recorded set of books, all that does is reduce cash in the bank, evidencing the payment, and at the same time, reducing what was a liability (often a trade payable). The actual financial position of the company hasn't changed at all – it has somewhat less cash (reduction in its assets) and the same amount less in payables (a reduction in its liabilities). There are a multitude of other possible transactions and changes. Since the purpose of this article is to explain how the accountant doing an appraisal needs to make adjustments to the balance sheet, we won't go into greater depth in explaining the mechanical functioning of a balance sheet. However, if our readers have any such questions, we invite them to give us a call so that we might address their concerns.

The following gives you some ideas as to where even a "clean" set of books may require adjustments to its balance sheet:

1. **Accounts Receivable (and reserve for bad debts)** – typically, a business builds up receivables over time, and (hopefully) collects them. What also typically happens is that some of those receivables take a long time to be collected, some can't be collected at full face, and some even have to be written off. If we have a receivables schedule (and it is always preferable to get an aged schedule), it may be obvious that some of those receivables aren't being collected as rapidly

as they should be, and perhaps some reserve (which is a precursor to actually writing off – and for economic purposes is really the same thing) may be necessary to reflect the doubtfulness as to collectability. This type of reserve might take the form of writing off part of a receivable, writing off a percentage of all those over 120 days, or writing off specific receivables in full.

This process is supposed to be done by the accountant (or the business) in the preparation of the financial statements. If a business is having a bad year, there is perhaps no motivating tax reason to take additional writeoffs – so that bad receivables continue to be carried. Alternatively, when a business is having a good year, writing off receivables may take the opposite (generous) tack, with past sins being written off, and even (often merely for tax reasons) other receivables being written off which perhaps are not quite that bad, and which perhaps will be collected in a subsequent period. Therefore, when we do our job in trying to determine the accuracy of a presented balance sheet, it may be necessary for us to allow for more doubtful receivables (provide for a larger write-off) recognizing that some of those being carried are questionable; or perhaps the opposite, concluding that there was an aggressive position taken as to the writing off of receivables, and we need to put some back onto the company's books.

2. **Inventories** – this is one of the most commonly abused areas in altering balance sheets, and also one of the most difficult for an outsider (i.e. the investigative accountant) to correct. Sometimes businesses overstate their inventories – typically we'll find these on financial statements for the purpose of misleading (defrauding?) lenders or potential investors. More commonly, particularly with closely-held businesses, and particularly for tax reasons, we see businesses understating inventories. Understating an inventory means overstating the cost of goods sold – resulting in the reflection of higher costs and a lower profit. Overstating an inventory means reducing the cost of goods sold, and as a result increasing profits. Typically, adjusting the inventory also means adjusting the income statement – often for a several year period, inasmuch as correcting an inventory usually involves spanning more than one year of operations.

3. **Fixed Assets and Accumulated Depreciation (often referred to as Property, Plant & Equipment)** – closely-held businesses, even when they prepare financial statements, usually reflect depreciation on a tax (rather than economic) basis. As a general rule, the Tax Code permits faster write-offs of assets than is warranted from a purely economic life basis. Therefore, many times it is necessary to reduce the accumulated depreciation account (wherein the past depreciation taken is reflected as an accumulation of same – applied against the cost of the assets), as well as make the appropriate adjustments to the depreciation expense taken on an annual basis. For many small businesses, this need not be done because it is simply immaterial. However, it can amount to significant sums, especially where a businesses is growing, and especially where it has heavily invested in machinery and equipment. While it is the rare accountant who is also an equipment appraiser, the practical reality of appraising many small and even medium-sized businesses is that there may be severe reservations as to the economics of engaging an equipment appraiser for what might perhaps only be $50,000 to $100,000 of equipment at cost, and likely less value currently. A common alternative is for the accountant to make whatever adjustments are necessary, based on established guideline lives, or in some situations, with the benefit of published books (i.e. for automobiles) that are in the public domain. Finally, this area can present the need for significant adjustments where a business owns real estate – particularly if it has for several years. While it may have been depreciating the building on that real estate, because of various economic forces, that property might have been appreciating, rather than depreciating.

The above are just a few illustrations of balance sheet areas commonly needing adjustments. These can be many others, particularly in a larger and more complex business, especially one which has been in existence for a number of years.

"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.

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.

FOCUS ON FUN

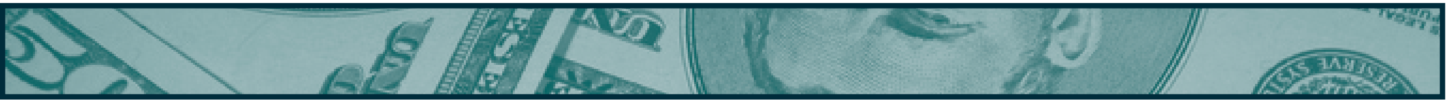
Accountants & Humor

– A Sociological Fable

1. A New Orleans grocery store customer, Ashley, finished her shopping and wrote a check to the store in the amount of $259.17. The clerk, Jennifer, asked to see some identification. After examining the ID, Jennifer said, "I'll need to get the manager's approval on this." She left the customer standing in the checkout line. Within minutes Ashley was arrested for forgery. It didn't take Jennifer a lot of detective work to figure out the attempted fraud. The distinctive check had a Looney Tunes background – the kind the clerk herself had. Then there was the name on the check, "Jennifer" – same as the clerk's – whose purse, containing her checkbook and driver's license, had been stolen days earlier. Yet, there was Ashley, standing in front of Jennifer, trying to pass herself off as the clerk. Though the stolen purse held four different picture IDs, Ashley apparently hadn't looked too carefully. Jennifer said "I still don't know how she didn't realize it was me."

2. Humberto of San Antonio, Texas, was a big fan of a radio talk show. So when the station invited listeners to call in and reveal the biggest lie they'd ever told, he just couldn't resist. Referring to himself as John, he bragged about having a friend steal his truck so he could file a false insurance claim and collect $7,000. The fraudster even provided details on where and when the truck was "stolen". Unfortunately for him, Steve of the FBI was listening to the same program. A quick check of stolen vehicle reports led Steve to Humberto, who now faces up to five years in prison.

3. A lost balloonist lands in a field and asks a man out walking his dog, "Where am I?" The man replies, "You are three feet in front of me in the middle of a field." "You must be an accountant!" retorts the balloonist. "How did you know that?" the man asks incredulously. "Easy. What you just told me is 100% accurate, but absolutely useless!"



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