Capstone Research Project

This paper elucidates on an auditing study carried out on a Fortune 1000 company that had issued its initial public offer about five years ago. Furthermore, the research investigates the possible acts of fraud that may have taken place because of excluding inventory write-downs on tax returns from financial statements of the company.

Evaluation of Damaging Financial and Ethical Repercussions

Firstly, the negative ethical and financial consequence of excluding inventory write-downs from financial statements of an organization is loss of public confidence and reliability (Botzem, 2002). This implies that clients and shareholders will no longer trust the management with running of company’s financial affairs. Consequently, this may result in the suspension of responsible offenders to pave way for further investigation to find out whether the exclusion of inventory is done intentionally or by mistake. In addition, the company may lose potential investors for fear of being defrauded off their future investment. For this reason, the company is put at a disadvantage in comparison to other competing firms in the industry.

In order to prevent acts of civil frauds on the premises of the company, chief financial officer (CFO) and other managers should establish mechanisms and procedures that are aimed at achieving specific objectives (Botzem, 2002). These measures enhance the effectiveness and efficiency of business transactions and operations of the company, hence increase reliability of financial reports and statements. Such recommendations include establishment of polices that safeguard assets of the company as well as ensuring that government tax rules and regulations are strictly followed among others. The management should therefore incorporate well-designed internal control measures that are both preventive and detective. Preventive measures deter the occurrence of fraudulent activities. This maybe exemplified by management's insistence on

thorough documentation and strict authorization practices by responsible employees. Alternatively, the CEO and the CFO can integrate detective control systems that are aimed at identifying undesirable financial practices within the organization (Bryer, 2005). Such measures include reconciliation of the published financial statements with the intention of identifying the root cause of deceitful financial activities.

Negative Effects on Stakeholders and Financial Results

The results of subsequent IRS audit financial reports of the company have a negative impact on stakeholders and financial statements. This is because stakeholders have to incur implicit expenses and urgency finances in addition to surplus taxes and penalties related to duplicitous activities. As a result, stakeholders and the company are likely to suffer losses due to a continuous reduction of the inventory stock at a rate of 10% per annum. Consequently, the dividends that stakeholders are entitled to at the end of the financial year decrease proportionally, which is inconsistent with the going concern principle.

Applicable Federal Tax Laws and Regulations

Applicable tax rules and regulations on inventory write-downs include loss laws and shrinkage laws. Federal tax regulations on inventory write-downs allow the company to write off the portion of the stock that has been damaged or stolen. The company can evade additional taxes by claiming losses as tax deductions (Dagwell, 2007). This decreases the amount of tax that the company was supposed to pay hence reducing company’s tax obligations and financial liabilities. Additionally, federal laws allow the company to claim tax deductions due to the loss of inventory by means of shrinkage. This happens when the book value of the inventory is greater than its intrinsic value. Due to this, the company can claim its shrinkage amount in the

on-going tax year. These laws are useful because they cut down financial losses of the company due to riskiness of the industry brought about by the acts of fraud.

Evaluation of the Current Treatment of Company's Percentage FFDS

The current treatment of stock option accounting is that the top-level executives are entitled to a share based compensation plan of the existing stock options. In accordance with the requirements of the Generally Accepted Accounting Principles (GAAP), the value of the options dispensed during the financial year should be disclosed in the financial statements (Dagwell, 2007). Contrary to these requirements, top-level management failed to reflect the amount of stock options exercised during the year. This act constitutes lack of transparency and reliability on the part of management team, and, therefore, is a cause of perpetrating fraud. Financial benefits of a share-based compensation plan are that it aligns the interests of employees with those of the upper level management as opposed to SARS. Due to this, the rewards that employees are authorized to receive at the end of the year increase with the raise in the price of company's stock. However, this plan has its shortcomings in that the upper level management has the tendency to artificially inflate short-term earnings by flat-out manipulation by pulling the future benefits into current earning. This means that stakeholders are not entitled to a share of stock options in the future should the company perform well.

Another alternative of dispensing stock options are financial-based stock appreciation rights. The financial advantage of this option is that employees do not need money to exercise the options in return for cash. Employees automatically receive the value of shares without the need of having to pay their cost. For the evaluation of the two stock options, the upper level management of the company should adopt SARS policy because it is less costly and unsusceptible to artificial manipulation of employees' future earnings.

Reporting Requirements for Lease Reporting Under GAAP

The following proposal on the future lease transactions explores the application of the best alternative of various leasing arrangements available to a chief financial officer. Leasing options include the use of capital leases, off-the-balance sheet financing arrangements, and operating leases. Currently, the company has several capital and operating leases in place. All these options have business and financial risks, hence the CFO should analyze them critically before leasing the assets for future use (Gaffikin, 2005). For instance, the CFO may opt for an operating lease arrangement in leasing capital assets of the company. In this arrangement, the company only transfers the right to use the leased assets, whereas ownership rights remain with the firm. This means that the lessee returns the asset to the company at the end of the leasing agreement because he does not assume the risk of ownership. In contrast, the company transfers the risk of ownership of an asset to the lessee in case of capital leasing arrangement (Gaffikin, 2005). This implies that all implicit expenses, such as depreciation and maintenance expenses, are transferred from the company to a lessee. This is advantageous because it leads to a reduction of total financial liabilities of the company. Additionally, the lessee pays in return for the ownership of the leased asset. Such funds are used to finance operations of the company both in current and future periods.

In addition to capital leases and operating leases, the CFO may consider the use of off-the-balance sheet financing arrangements in leasing of company's assets. In this arrangement, subsequent capital expenditures are kept off the balance sheet of the company. This method is advantageous because the company retains tax benefits resulting from the ownership of the asset. The company is also able to retain control of the leased asset and, therefore, is able to monitor it

from time-to-time to ensure proper usage. In the light of these advantages, I recommend to use off-the-balance sheet financing arrangements in leasing of company's assets in the future.

Argument For and Against a Single Set of International Accounting Standards

A single set of International Accounting Standards is based on the global market and cross-border leases of assets that are related to lease accounting. It has its advantages and disadvantages for financial operations of the company (Bryer, 2005). A benefit of having a uniform set of accounting standards is that the company is able to avoid fraudulent dealings by the employees who may take advantage of the presence of conflicting accounting standards. Therefore, this greatly reduces the risk of misrepresentation of financial leases of the assets of the company. Additionally, an integrated international accounting system provides greater assurance and confidence to all parties interested in leasing of assets. This is because the company can present a true and fair value of leasing financial information to all concerned stakeholders. Conversely, there are drawbacks in the application of internationally accepted accounting standards in leasing of assets of a company. This is exemplified by the managers, who actively manipulate accounting information because they are aware that all investors and creditors accept the IAS lease results. Therefore, these managers exploit a single set of regulations with the purpose of deceiving potential investors and creditors. For this reason, a single set of accounting standards leads to perpetuations of fraud in the operations of any given company.

Major Implications of SAS 99

In his analysis, Dagwell (2007) established that the major implications of the observance of the new rules and regulations under SAS 99 are that auditors require more facts and information regarding business transactions of the company from the past in order to detect

fraud. The positive impact of SAS 99 is that it restores confidence of the investors in the activities of the firm, hence ensuring continuous funding. This therefore requires IRS auditors to overcome the problem of professional skepticism during the evaluation of company's past activities. During the evaluation of the company, the major risk factors that are affected by the implementation of the requirements of SAS 99 by the company are pressure to permit fraud, opportunity to carry out the fraudulent activities, and the attitude of employees to rationalize the fraud (Brown, 2013). Furthermore, evaluation of information presented by employees of the company should be critically analyzed without any bias. The process also allows the idea of brainstorming, which increases effectiveness and improves quality of the auditing results.

Potential for Material Misstatement

Based on the initial evaluation of the financial statements of the company, the probability of misstatement is high due to fraudulent activities. Misstatement in financial statements refers to an inclusion of artificial information, which is aimed at wrongly reconciling financial reports of the company. It may result from an error or an act of fraud by the top-level management, therefore, not reporting the true fair value. There are problems that may arise due to ignorance of the management of restated financial reports aimed at correcting the error of misstatement. Firstly, the users of financial statements may suffer from economic and financial loss. This is because the reported financial information does not reflect the fair value of current financial transactions of the company. Secondly, the company may be prone to similar future acts of fraud if the defrauders are not held accountable. Therefore, it creates an opportunity for the upper level management to manipulate financial statements and reports of the company. Consequently, the overall risk of misstatement that the company has increases financial losses of the stakeholders. Lastly, the risk of misstatement leads to the inadequacy in the level of capital that the company

needs to support its operations. This happens due to a continuous embezzlement of funds that belong to the company by the top-level management (Brown, 2013). Such acts are hidden in the misstated financial statements, which may eventually lead to a total collapse of the company.

Economic Effect of the Restatement of Financial Statements

The economic effect of the restatement of financial statements is both negative and positive to employees, creditors, customers, and investors (Gaffikin, 2005). This is because restatement of financial statements sends out the message that cases of fraud have been proved beyond doubt, hence the restatement. The implication of this act affects the confidence of all stakeholders of the company either in a positive or negative manner (Gaffikin, 2005). For example, the confidence of investors may be restored if the management has put in place proper internal control mechanisms that are aimed to prevent and detect fraud at the earliest opportunity. This reduces the risk of losing their portion of investment in business. On the other hand, restatement of financial statements may lead to the erosion of confidence that employees, creditors, investors, and customers have in the business. Creditors may restrict the amount of credit sales to the company for fear of being defrauded. The business may also lose its customers to other competing companies that are reliable and responsible in their business activities. Therefore, this signals the collapse of the company operating in the capital market.

References

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