AICPA Alert

by Ann E. Wilson, CPA

The 2001-2002 AICPA Annual Report is now available. It can be viewed at *www.aicpa.org/about/annrpt/homepage.htm*. Some sections of the annual report include:

- The Year in Brief: This section highlights the year's significant developments, including the issuance of a new fraud audit standard by the Auditing Standards Board; the creation of the Institute for Fraud Studies; the establishment of the CPAs in Support of America Fund, Inc.; and a disaster Recovery Resource Center 2001-2002.
- Message From the Chair and President: 2001-2002 AICPA Chair James G. Castellano and President and CEO Barry C. Melancon discuss the tremendous challenges faced by CPAs and the profession's response.
- The Road to the Sarbanes-Oxley Act of 2002: This summarizes the profession's unprecedented response and the events that led to the passage of the Sarbanes-Oxley Act of 2002.

Other sections highlight some of the year's initiatives, such as:

- Supporting CPAs in Fraud Prevention and Detection: This describes anti-fraud programs implemented by the institute, such as the issuance of standards, as well as the establishment of the anti-fraud summit, training programs, and the Institute for Fraud Studies.
- Empowering Women to Chart Their Financial Futures: This showcases the AICPA's efforts to "empower women to determine their own financial destiny" through the introduction of the Women's Financial Health Week program.
- CPAs Helping America and Each Other: This section highlights the contributions of CPA personal financial planners offering pro-bono services and the creation of the AICPA Disaster Recovery Resource Center in response to the events of Sept. 11.

I encourage you to review the entire AICPA Annual Report.

Ann E. Wilson, CPA, CFE, is a member of the AICPA's LDRS subcommittee. She is a sole practitioner, with offices in Solana Beach and Pasadena.

Keepin' It Legal

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divorce, the property is refinanced during marriage? Assume the property is refinanced and the $700,000 mortgage is replaced with a $1 million mortgage with $300,000 refinance proceeds to the borrower. The property is only 10 percent community before the refinance. But a refinance of the old separate loan produces a new mortgage. The new mortgage was created during marriage and is presumed community property.

Is it equitable to treat the extra $300,000 refinance loan proceeds as community when just before the refinance the community had only a $110,000 total interest in the entire property? Should the mere act of refinancing a property cause such a forfeiture of a separate interest in the property?

This situation of refinance and character of the refinance loan proceeds was addressed in *Walrath*. The Supreme Court found that separate property refinance proceeds could be traced from one property to another. *Walrath* has resolved some of the obvious inequities, but its reasoning may be at odds with several assumptions in the *Moore/Marsden* analysis.

First, the *Walrath* court calculated invested capital with a concept similar to the "Invested Principal" of *Moore/Marsden*. However, the *Walrath* court started its calculation with separate investment at date of marriage. *Walrath* thus allowed premarital separate appreciation to share in appreciation during marriage. Does this decision require *Moore/Marsden* calculations to use premarital appreciation as part of invested principal?

We have yet to see how far the Walrath *treatment of premarital appreciation as principal and characterization of new debt will extend to other tracings.*

Another interesting question is treatment of refinance debt. *Walrath* characterized the refinance proceeds as community or separate by reference to the underlying character of the property being refinanced. It did not determine the character of the loan entirely by when the loan was made or the lender's intent.

Does this mean there is an exception to the presumption that loans during marriage are community or that the lender's intent is now less relevant in *Moore/Marsden*?

Besides *Moore/Marsden*, other tracings and property characterizations involve allocation of premarital appreciation and characterization of new debt. These may be critical factors in an analysis of community and separate interests in property.

We have yet to see how far the *Walrath* treatment of premarital appreciation as principal and characterization of new debt will extend to other tracings. Stay tuned.

Donald A. Glenn, CPA, is a partner in Glenn & Dawson LLP in Walnut Creek, and is a former chair of the Family Law section.

SAS 99

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The forensic accountant discussed the situation with the audit senior on the job who realized that John Doe works at XYZ Company.

Subsequently, many additional red flags were raised which ultimately led to the conclusion that XYZ Company was shipping their goods to their own storage facility and recording these as sales.

Today, accounting firms are incorporating forensic accountants on the audit team. With this comes the concept of professional skepticism, or more importantly the investigative mentality, to the audit process.

Along with professional skepticism, other investigative techniques considered by forensic accountants include:

- Background Investigations: Know your client as well as the business and economic environment. Who are they? Who do they do business with? Are there any triggering events that may give rise to behavioral changes?
- Interviews: Obtain information needed to identify fraud risk areas. Does management have the ability to override internal controls? Are management, the audit committee, internal auditors, etc. aware of any fraudulent activity or whistleblower complaints?
- Analytical Procedures: Horizontal, vertical, and financial statement analyses are essential. Are there unusual or questionable entries at or near the end of the quarter or at year end? Have ACL or other technology-based program to identify attributes been used?
- Brainstorming: Review background information, work papers from prior audits, and other information. Was this information discussed with the engagement team?

The question to ask is, if SAS 99 was in existence and implemented during this audit, would the auditors have caught the questionable items in this example case?

The brainstorming session along with a heightened sense of professional skepticism may have raised the issue that the shipping document was indicative of goods being shipped to an address different from the customer's address.

Unfortunately however, a client who intentionally conceals information, colludes with others, and is untruthful in their responses to questions may be able to deceive an auditor. In this sample case, without searching for rental payments on the storage facility, closely examining the shipping document, or asking appropriate questions, the client's explanation was accepted by the auditor.

The investing public's perception that the audit is designed to detect fraud will never change. Therefore, to at least narrow the expectation chasm that exists, auditors need to be more skeptical, consider employing forensic procedures in their audits, and demand evidentiary support for every questionable transaction. We hope that SAS 99 will assist auditors in bridging the chasm.

Ronald L. Durkin, CPA, CFE, CIRA and Fraud Section chair is a partner at KPMG LLP's Forensic Practice in Los Angeles.

Donna L. Tamura, CPA, is a manager at KPMG LLP's Forensic Practice in Los Angeles.

HAPPENINGS

Litigation Sections Meetings

Business Valuation:	Thursday, Jan. 16, LAX
Economic Damages:	Wednesday, Feb. 19, LAX
Family Law:	Friday, Jan. 17, LAX
Fraud:	Tuesday, Feb. 18, LAX

Each section will send individual meeting notices. RSVP is required.

Education Foundation Course Offerings—(800) 877-5897

Advanced Litigation Institute	May 8–9, La Quinta, CA

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Cutting-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

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SAS 99–Is It Enough to Help Close the Expectation Chasm?

by Ronald L. Durkin, CPA, and Donna L. Tamura, CPA

The public believes that an audit is designed to detect fraud. Auditors maintain that an audit is not designed to detect fraud. This difference in perception has traditionally been referred to as the "expectation gap."

In light of the Sarbanes-Oxley legislation and the recently released *Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit* (SAS 99), th e expectation gap has now apparently widened to a chasm.

This was the term used by Lynn Turner, former chief accountant for the SEC, in a speech he delivered at the AICPA's Advanced Litigation/ National Conference on Fraud on Oct. 31, 2002

The purpose of this article is to address whether or not SAS 99 will close this expectation chasm.

The accounting profession, the roots of which trace back to ancient Egypt (J.T. Wells, "So That's Why It's Called a Pyramid Scheme," *Journal of Accountancy*, October 2000), has historically been required to conduct audits with the specific purpose of detecting fraud.

With the vast expansion of corporations into global behemoths, the nature and scope of the audit underwent an evolution, with fraud detection no longer the primary purpose.

As noted in *Statement on Auditing Procedure No. 1*, "to exhaust the possibility of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions … [resulting in] a prohibitive cost to the great majority of business enterprises."

This standard stood for more than 40 years until *Statement on Auditing Standards No. 82: Consideration of Fraud in a Financial Statement Audit* (SAS 82) was issued in 1997. SAS 82 was the first auditing standard to deal with fraud in the financial statement audit.

…the expectation gap has now apparently widened to a chasm.

Subsequent to high profile bankruptcies and other so-called audit failures in 2001 and 2002, the need for more guidance for auditors was demanded by the investing public, regulators, and lawmakers.

In response to this demand, SAS 99 was created. It states that "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

Key provisions in SAS 99 include:

- Information gathering regarding possible fraud risk areas and their characteristics;
- Brainstorming fraud risk areas;
- Increased emphasis on professional skepticism;
- Inquiries of management and others regarding their awareness of any fraud;
- Unpredictable audit tests; and
- Responding to management's override of controls.

In a recent case example, a staff auditor had previously reviewed purchase orders, invoices, shipping documents and other relevant information, and verified that the customer name and sale amount was correct and the purchase order, sales and shipping dates made sense.

The auditor then documented that his test work were completed without exception.

What the auditor overlooked, but the forensic accountant didn't, was an e-mail notation, detected only through a careful and skeptical scouring of the vendor file, that read, "When the driver gets to the storage facility, it's not under XYZ Company, it's under John Doe."

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Business Valuation

by Cynthia V. Craig, CPA

In November 1998, the first group of CPAs sat for an exam to determine whether or not they would qualify for the newly minted AICPA designation, Accredited in Business Valuation (ABV). Since then, annual exams have been given resulting in 1,434 ABVs through 2001.

Since the original designations were awarded, ABVs have operated under existing AICPA standards, including attestation, forecasting, and consulting services, as well as the *Code of Professional Conduct*.

As no valuation-specific standards have previously been provided by the AICPA, CPAs seeking valuation guidance frequently turned to business valuation standards promulgated by other organizations.

To provide more guidance in this area, in late 2002, a pre-exposure draft of the *Statement on Standards for Valuation Services No. 1* (Standards) was disseminated by the AICPA to specified appraisal groups and individuals.

The AICPA received a great deal of negative feedback on the pre-exposure draft, and as a result, it has delayed further release of the document. At this time, it is unknown to what extent the Standards will be revised. Given the potential impact this could have on the work we do, it is imperative that we follow the process and voice our opinions.

Cynthia Craig, CPA, ABV and Business Valuation Section vice chair, is a manager with Andersen & Company LLP, with offices in Santa Rosa, San Francisco, and Petaluma.

Economic Damages

by Troy Dahlberg, CPA

Do you consider the concept of price elasticity when preparing lost profits computations? The calculation of lost profits or diminution in value often involves projecting future sales. The key components in the projection of future sales are volume and price.

Price elasticity is an economic theory which relates to the laws of supply and demand. It is generally believed that buyers adjust their purchasing patterns in response to price changes.

Demand is referred to as elastic when an increase in price results in a decrease in the quantity demanded. The reverse—a drop in price results in an increase in demand.

The price elasticity of demand varies depending upon the type of product. Two main factors affecting the demand for certain products are the availability of good substitutes and the share of the buyer's budget expended on the product.

When computing future sales, price elasticity may or may not be a factor. If the company has good historical sales information in which pricing has remained fairly constant and no substantial increase or decrease in sales volume is projected, factors related to price elasticity may not be a major issue. However, if sales projections are for a new product, or if there are large increases or decreases in the projected volume or price levels, factors related to price elasticity may need to be considered.

Troy Dahlberg, CPA, JD and Economic Damages Section chair, is the partner-in-charge of Ernst & Young's Litigation Advisory Services practice for the Pacific Southwest.

Family Law

by David Black, CPA

Two cases were recently published regarding reimbursement claims against the family residence and both cases have an interesting outcome.

In *In re Nicholson and Sparks*, (Dec. 11, 2002) 1 Civ A094731, A096862, A0997023, Div 1 (Stein) 2002 DAR 13983, the parties could not qualify for a home loan due to the existence of too much credit card debt. The husband paid off the credit card debt with separate property and the home was acquired.

Upon dissolution, the husband claimed the $30,000 paid on the credit card debt created a Family Code Sec. 2640 reimbursement claim against the residence or a loan to be repaid. The trial court did not find an enforceable loan but did find a Sec. 2640 reimbursement.

Upon appeal, the court vacated the order for Sec. 2640 reimbursement because the credit card payment did not contribute directly or indirectly to the equity acquisition and the credit card debt existed prior to the purchase of the residence.

In *In re Marriage of Lange*, 02 DJDAR 11031, Sept. 23, 2002, the parties both contributed separate funds toward the acquisition, principal paydown, and improvement of the joint tenancy family residence. The wife contributed more than the husband and presented him with a promissory note for $250,000 at 10 percent interest secured by a deed of trust to secure her separate property contributions.

The husband executed the note but no payments were made. Upon dissolution, the amount due on the note, including interest, was $870,000.

The trial court found that the note and deed of trust were valid, but Family Code Sec. 721 and 2640 precluded enforcement because the wife obtained a financial advantage presumed to have been obtained through undue influence.

The Court of Appeal agreed, reasoning that Sec. 2640 does not allow interest as provided in the note.

David Black CPA, ABV, ASA is the Family Law Section chair. His practice is based in Sacramento.

Fraud

by Karin Rohn, CPA

As 2002 ended, few could deny that it was an eventful year, especially in the business world.

Shocking stories of frauds, accounting misstatements, and other business irregularities have appeared regularly in the headlines, from Enron to Tyco to WorldCom. These events have affected almost all of us in some way, including the loss of money, the loss of jobs, and the loss of confidence in the economy.

Those who have been particularly affected by these events are directors of corporations. Sometimes branded the villain in these scandals, sometimes labeled just plain ignorant, directors have been caught in the middle of the recent tumultuous events. Despite their association with these scandals, directors are integral to the functioning of our corporate economy and will be required to play a key role in the years ahead.

By law, directors are responsible for managing corporations by providing oversight of management. The Sarbanes-Oxley Act has imposed some new requirements which will affect corporate directors. Significant changes for directors come from increased monitoring, review, and enforcement activities of the government, as well as from the changes in the business environment and the public's perception of the business world.

Changes have led to directors being held to an increased level of accountability for their actions. The proliferation of shareholder lawsuits and the promulgation of the idea that directors be held personally liable for corporate irregularities seem to indicate that the public's perception of corporate accountability has changed.

It is expected that these changes will result in directors becoming more vigilant in their duties, more skeptical in their oversight, more involved in management, and more committed to shareholders. That is the hope as we face the new year ahead.

Karin Rohn, CPA, CFE is a manager in KPMG LLP's Forensic Practice in Los Angeles.

Message from the Chair

by D. Paul Regan, CPA

The Litigation Sections Steering Committee's Nov. 13, 2002 meeting provided an in-depth look at a number of critical issues facing the Litigation Services Practitioner (LSP), including the following:

- AICPA's Consulting Services Special Report 02-01 titled *Litigation Services and Applicable Professional Standards*, dated Oct. 17, 2002: This version still has to undergo additional reviews and edits, but it is not expected that there will be significant changes made. Each member is encouraged to become familiar with this document, which contains helpful definitions, comments, and practice aids for the LSP.
- *Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit* (SAS 99): SAS 99 was approved on Oct. 15 to give U.S. auditors expanded guidance for detecting material fraud. This standard is the cornerstone of a multifaceted effort by the AICPA to help restore investor confidence in U.S. capital markets and to re-establish audited financial statements as a clear picture window into corporate America. (See article on Page 1 for the key provisions of SAS 99).
- Litigation Sections discussion paper, titled *Working Papers, Work Product and Writings in the CPA's Performance of Litigation Services*: Since this document was issued in 1991, much has changed in our practice area. As a result of our analysis, the Steering Committee voted to review and update this discussion paper. There will be a further presentation and analysis of this discussion paper during our meeting in January. It is expected that a task force will undertake a major revision of this document which will then be reissued.
- AICPA's *Statement on Standards for Valuation Services No. 1*: Committee members had many substantial and broad criticisms of this document, which were collected, summarized, and communicated to the AICPA in the week following the meeting.

There is a great deal going on in our practice area. I encourage all of you to monitor these developments and assist in determining our best responses.

D. Paul Regan, CPA, CFE, is president and chair of Hemming Morse Inc. CPAs, Litigation and Forensic Consultants, in San Francisco.

Keepin' It Legal

Trace This! Determining Community Property Interest

by Donald A. Glenn, CPA

California family law allows a community interest in real property held solely in the name of the other spouse.

Since the early 1980s, accountants have used the *Moore/Marsden* [*In re Moore* (1980) 28 Cal.3d 366, *In re Marsden* (1982) 130 Cal.App.3d 426] analysis to determine the community interest in a spouse's otherwise separate property. However, a 1998 Supreme Court case [*In re Walrath* (1998) 17 Cal.4th 907] brings into question some basic tenants of *Moore/Marsden*.

Moore/Marsden apportions community and separate interests based on the ratio of the community and separate principal investment. Principal investments include cash and loans to acquire a property.

For example, a residence purchased before marriage with a $200,000 down payment and an $800,000 mortgage would be separate because it was acquired before marriage. However, what if during marriage, community funds are used to make payments on the separate mortgage? In that case, the separate and community character of the "principal investment" in the residence is adjusted. As the mortgage is paid with community funds, the "investment" from separate debt is also reduced.

Furthermore, if $100,000 of community funds are paid on the separate mortgage, a $100,000—or 10 percent—community investment in the residence would result. Thus, as additional debt payments or investments occur, the *Moore/Marsden* produces a different community interest.

What about other residence costs of interest, maintenance and property taxes? They are ignored because they do not contribute to the acquisition cost. Improvements, to the extent they increase the value of the property, are treated as principal investments.

Finally, *Moore/Marsden* follows the general presumption of Family Code Sec. 760 that new loans during marriage are community, and before marriage are separate.

However, a loan during marriage may be considered separate [*In re Grinius* (1985) 166 Cal.App.3d 1179] if the lender intended to rely on separate property for repayment.

During the evolution of the *Moore/Marsden* approach, two significant decisions deserve mention. First, the *Marsden* court determined that appreciation before marriage was separate property. Second, *Frick* [*In re Frick* (1986) 181 Cal.App.3d 997] determined that premarital separate property appreciation could not be considered separate principal invested in the property at the date of marriage. The court's refusal to allow premarital appreciation as invested capital and to participate in the allocation of appreciation has little support in economic theory.

Table A is an example of the *Moore/Marsden* analysis. Rows A through G of the table contain assumed facts.

During marriage, 10 percent of the principal was contributed by community funds used to pay the separate mortgage. The *Moore/Marsden* analysis derives the community interest in the property in rows H and I. It includes the mortgage payments and the community share of the appreciation, which is 10 percent of $100,000 appreciation during marriage. The total community interest is $110,000.

What happens if instead of a

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Table A
Moore/Marsden Analysis

	Col. 1	Col. 2
Assumptions		
A Separate Down Payment	$200,000	20%
B Separate Mortgage	700,000	70%
C Mortgage paid with community funds	100,000	10%
D Total cost (principal)	$1,000,000	100%
E Appreciation before marriage	300,000	
F Appreciation during marriage	100,000	
G Value at divorce	$1,400,000	
Community Interest		
H Mortgage paid with community funds (Row C, Col. 1)	$100,000	
I Community appreciation during marriage [10% (Row C, Col. 2) of $100,000 (Row F)]	10,000	
J Community Interest	$110,000	