

LONG-TERM AND TRUSTED EMPLOYEES – AN EMPLOYER’S DREAM OR A FRAUD NIGHTMARE?

Brandon Vance, CPA

The prevalence of fraud in today’s business world is daunting and is becoming more visible through high profile cases such as Enron and WorldCom. In fact, the Association of Certified Fraud Examiner’s 2002 *Report To The Nation On Occupational Fraud And Abuse* (The Report) estimates that fraud and abuse will cost U.S. organizations \$600 billion annually and that 6% of their total annual revenues will be lost due to fraud from its employees. *The Report* also identifies small businesses (those with fewer than 100 employees) as the most vulnerable to occupational fraud and abuse with the average scheme causing \$127,500 in losses.

I know you are thinking...“I trust my employees and fraud is not occurring in my business, so why should I read this article?” And I would present these questions to you in response...“Are you sure that fraud is not occurring? What steps have you taken to help prevent fraud from occurring?”

We have come across fraud numerous times in the agriculture industry and I have never heard an employer say, “I knew that employee was dishonest.” In contrast, the culprits were typically long-term employees who had earned the trust of their employers. For instance, a bookkeeper that had been with the company for many years was responsible for preparing the daily deposits. Each day the general manager would review the deposits before they were taken to the bank by the bookkeeper, and also reviewed the monthly bank statements to ensure that the deposits were made in full. However, as new projects came up and the general manager’s time became impacted, the review of the monthly bank statements no longer occurred. After all, the

bookkeeper had been with the company for so long and would *never* do something dishonest. Thousands of lost dollars later, the mistake was realized. The bookkeeper was absconding with portions of the daily deposits.

In another example, again involving a trusted, long-term employee, the company controller was given full authority to approve disbursements and sign checks (the checks only required one signature). In collusion with several vendors, duplicate and fictitious invoices were paid and the proceeds were split between the vendor and the controller. Again, thousands of dollars were lost! Other examples are numerous; however, a common theme runs through all of them...the culprits were trusted, long-term employees and oversight and internal controls were few or non-existent.

Baker, Peterson & Franklin recognizes the importance of fraud detection and investigation,

Are you sure that fraud is not occurring? What steps have you taken to help prevent fraud from occurring?

and has developed the necessary knowledge and skills to serve businesses in this capacity. Our ultimate goal is to serve the client by strengthening the internal control system, leaving you less susceptible to fraudulent activity, and by finding fraud or abuse that may have occurred. We offer the following services for fraud detection and investigation:

- Design of the internal control system—for businesses with little or no formal internal

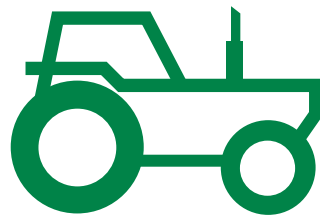
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***The culprits
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control system, we will design a system relevant to your needs and focus on fraud prevention and detection.

- Review of the current internal control system—to identify weaknesses in the current internal control system and provide recommendations for strengthening against fraud and abuse.
- Fraud investigations—the after-the-fact application of various tests and methods will be utilized to identify fraud and abuse resulting from stealing or misuse of company assets or from fraudulent financial reporting. This investigation necessitates a reporting of our findings to you and can be used as evidence for potential prosecution of the culprits.

For further information regarding these services, please contact Brandon Vance at (559) 432-2346.



PERFORMANCE REVIEW

By Nancy S. Ervin

How often do you really take a step back from your business and take a good look at overall performance? Banks may require you to calculate a few financial ratios if they are part of your loan covenants. But how often do you take the time to calculate and analyze key performance measures?

Baker, Peterson & Franklin can help you review your business's overall financial performance. From calculating a few key ratios, to a full-blown Business Review, our accountants and consultants can help you identify benchmarks important to your business, graph trends over time, and even compare your benchmarks to industry standards.

By using business "appraisal" techniques, we can help you calculate the fair market value of your business. This can be an excellent tool for measuring how well you are generating value from the assets in your company. A business valuation can also help you set exit strategy goals, whether it be to sell your business when you are ready to retire, or to transfer it to the next generation.

Other aspects of an overall business review may include:

- Look at financial structure (long-term vs. short-term debt) and exposure to risk.
- Highlight any potential cash flow problems.
- Research industry trends.
- Interview management and key personnel to determine internal control risk factors.

If you are interested in finding out more about business services offered at Baker, Peterson & Franklin, contact Nancy Ervin at (559) 432-2346.

KEY FINANCIAL RATIOS

Current Ratio

Computation: Total current assets divided by total current liabilities.

Interpretation: This ratio is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater the "cushion" between current obligations and a firm's ability to pay them. The stronger ratio reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

Quick Ratio

Computation: Cash and equivalents plus trade receivables divided by total current liabilities.

Interpretation: Also known as the "Acid Test" ratio, it is a refinement of the current ratio and is a more conservative measure of liquidity. The ratio expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than 1 to 1 implies a reciprocal "dependency" on inventory or other current assets to liquidate short-term debt.

Payables Turnover

Computation: Cost of sales divided by trade payables.

Interpretation: This ratio measures the number of times trade payables turn over during the year. The higher the turnover of payables, the shorter the time between purchase and payment. If a company's payables appear to be turning more slowly than the industry, then the company may be experiencing cash shortages, disputing invoices with suppliers, enjoying extended terms, or deliberately expanding its trade credit. The ratio comparison of company to industry suggests the existence of these possible causes or others. If a firm buys on 30-day terms, it is

reasonable to expect this ratio to turn over in approximately 30 days. A problem with this ratio is that it compares one day's payables to cost of goods sold and does not take seasonal fluctuations into account.

Working Capital Turnover

Computation: Net sales divided by net working capital (current assets less current liabilities equals net working capital).

Interpretation: Working capital is a measure of the margin of protection for current creditors. It reflects the ability to finance current operations. Relating the level of sales arising from operations to the underlying working capital measures how efficiently working capital is employed. A low ratio may indicate an inefficient use of working capital while a very high ratio often signifies over-trading—a vulnerable position for creditors.

Times Interest Earned

Computation: Earnings (profit) before annual interest expense and taxes divided by annual interest expense.

Interpretation: This ratio is a measure of a firm's ability to meet interest payments. A high ratio may indicate that a borrower would have little difficulty in meeting the interest obligations of a loan. This ratio also serves as an indicator of a firm's capacity to take on additional debt.

Leverage Ratios

Highly leveraged firms (those with heavy debt in relation to net worth) are more vulnerable to business downturns than those with lower debt to worth positions. While leverage ratios help to measure this vulnerability, it must be remembered that they vary greatly depending on the requirements of particular industry groups.

The composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

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A high return, normally associated with effective management, could indicate an under-capitalized firm.

Equity in Fixed Assets

Computation: Fixed assets (net of accumulated depreciation) divided by tangible net worth.

Interpretation: This ratio measures the extent to which owner's equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth, and a better "cushion" for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of substantial leased fixed assets (not shown on the balance sheet) may deceptively lower this ratio.

Debt to Equity

Computation: Total liabilities divided by tangible net worth.

Interpretation: This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. The higher the ratio, the greater the risk being assumed by creditors. A lower ratio generally indicates greater long-term financial safety. A firm with a low debt/worth ratio usually has greater flexibility to borrow in the future. A more highly leveraged company has a more limited debt capacity.

Operating Ratios

Operating ratios are designed to assist in the evaluation of management performance.

Return on Equity (ROE)

Computation: Profit before taxes divided by tangible net worth and multiplied by 100.

Interpretation: This ratio expresses the rate of return on tangible capital employed. While it can serve as an indicator of management performance, the analyst is cautioned to use it in conjunction with other ratios. A high return, normally associated with effective manage-

ment, could indicate an under-capitalized firm. Whereas, a low return, usually an indicator of inefficient management performance, could reflect a highly capitalized, conservatively operated business.

Return on Assets (ROA)

Computation: Profit before taxes divided by total assets and multiplied by 100.

Interpretation: This ratio expresses the pre-tax return on total assets and measures the effectiveness of management in employing the resources available to it. If a specific ratio varies considerably from the ranges found in this database, the analyst will need to examine the makeup of the assets and take a closer look at the earnings figure. A heavily depreciated plant and a large amount of intangible assets or unusual income or expense items will cause distortions of this ratio.

Fixed Asset Turnover

Computation: Net sales divided by net fixed assets (net of accumulated depreciation).

Interpretation: This ratio is a measure of the productive use of a firm's fixed assets. Largely depreciated fixed assets or a labor intensive operation may cause a distortion of this ratio.



SUGGESTED RETENTION SCHEDULE FOR BUSINESS RECORDS

An agricultural business handles a tremendous volume of records. Whether you use a simple filing system or sophisticated electronic equipment to record your data, the basic problems remain—what records do you need, why do you need them, and how long should you keep them?

The following checklist is designed to help you determine what records to keep and how long to keep them. These time periods represent a consensus and are not absolutes to be followed without question.

4 to 5 years

- Bills of material
- Bond, paid-interest coupons
- Cash slips
- Claims, closed by company
- Correspondence, general
- Customer account records, closed
- Delivery receipts
- Freight bills
- Inspection records
- Manifests
- Petty cash records
- Purchase orders
- Receiving reports
- Remittance statements
- Requisitions
- Sales slips
- Service reports
- Shipping tickets
- Time cards

5 to 6 years

- Complaint records
- Correspondence: license, purchase and traffic
- Credit memos
- Employees' daily time reports
- Monthly trial balance
- Price exceptions and adjustments
- Safety reports

6 to 7 years

- Bank deposit slips
- Bank statements
- Bonds, cancelled
- Cancelled checks
- Claims, closed against company
- Credit files
- Employee records (terminated)
- Inventory records
- Invoices, copy of order
- Invoices, paid
- Payroll

7 to 8 years

- Accounts, charged off
- Commission statements
- Cost account records
- Entertainment records
- Expense reports, employees
- Purchase orders for capital expenditures
- Sales sheets
- Specification sheets

8 to 9 years

- Agreements, leases (after expiration)
- Salary and rate changes
- Vouchers, cash
- Vouchers, numeric copy

9 to 10 years

- Voucher register
- Voucher, A-Z copy

10 years

- Claims, workers' compensation
- Employee tax withholding statements
- Insurance claims (after settlement)
- Vouchers, capital

17 years

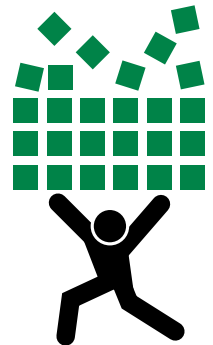
- Agreements, licenses

Permanent

- Accident reports
- Agreements, deeds
- Applications filed with regulatory agencies
- Contracts and leases
- Corporate stock records
- Engineering & research projects
- Financial statements
- Insurance policies, all types
- Labor contract and collective bargaining records
- Ledgers and journals: cash, general, customer journal, payroll, plant, etc.
- Minutes: executive, directors and stockholders
- Patents, records and assignments
- Pension records
- Plant surveys
- Proxies
- Real estate records
- Taxes: federal, state, property, sales and use
- Taxes: audit reports
- Tax and legal correspondence

Other

- Certificates of insurance — Period of coverage, plus 4 years
- Depreciation schedules — Life of asset, plus 4 years
- Insurance claims — 3 to 5 years after settlement



INTERVIEW QUESTIONS – WATCH WHAT YOU ASK

Before you proceed with your next round of interviews, you should carefully review the questions that will be asked in order to reduce your risk of asking illegal questions.

Numerous laws are in place to protect employees, and job applicants, from discrimination. These laws are designed to prevent discrimination based upon age, sex, disability, race, national origin, and other criteria. Questions asked (often innocently) in order to get to know someone may be illegal, if asked during the hiring process. The following is a partial list of questions that could be considered illegal:

- How many children do you have?
- Are you planning to have more children?
- Who will watch your children while you are at work?
- How old are your children?
- How old are you?
- When did you graduate from high school? College?
- Are you married? Single? Divorced? Engaged?
- Is that your maiden name?
- Is that Ms. or Mrs.?
- What does your husband/wife do? Where does he/she work?
- What church do you go to?
- Where were you born?
- Where were your parents born?
- What language do you speak at home?

While these questions may be acceptable in some social settings, they are not appropriate during the hiring process.

Questions asked of applicants during interviews, and throughout the hiring process, must be job related. If the question is not directly related to the job, it should not be a part of the hiring process.

If you are not certain whether a question may be considered illegal, ask yourself, “Why is this question being asked?” Try to establish the reason behind the question and ensure it is worded in a manner that will not be interpreted as discriminatory. For example, while it is not acceptable to ask, “Does your husband/wife support your decision to work?” you may ask, “Do you have any responsibilities that would conflict with your work schedule?”

Questions asked...in order to get to know someone may be illegal if asked during the hiring process.

Additional information is available from the U.S. Equal Employment Opportunity Commission at <http://www.eeoc.gov> and the U.S. Department of Labor at <http://www.dol.gov>.

There is no doubt that the candidates who are not hired will analyze your hiring process in an attempt to determine why they were not selected. Any illegal questions asked during the hiring process may result in expensive legal action. By taking precautions prior to conducting interviews, you can reduce the chance that these applicants will conclude that they were not selected because of discrimination.



TAX TIDBITS

I.R.C. SECTION 1231

By Dennis Veeh, C.P.A.

It is not uncommon for many taxpayers to assume that when farmland is sold at a loss, the loss recognized will not be 100% deductible because of the limitations applicable to capital losses. Generally, capital losses can only be used against capital gains. In addition, any excess capital loss to the extent of \$3,000 can reduce ordinary income.

However, Internal Revenue Code (I.R.C.) Section 1231 allows a more favorable tax treatment for farmland sold that is used in a trade or business. Net losses recognized from the sale of farmland used in a trade or business are treated as ordinary losses, and are available to be used to reduce all types of ordinary income. It is not considered a capital loss, subject to the restrictions previously mentioned. On the other hand, when farmland used in a trade or business is sold at an overall gain, the gain is treated as a capital gain. Capital gains are taxed at a more favorable tax rate, generally a maximum federal tax rate of 20%.

I.R.C. Section 1231 is one of the few code sections that allow losses to be treated as ordinary, while gains are treated as capital gains. There are, however, certain restrictions included in Code Section 1231 that do deny capital gain treatment if a taxpayer has previously recognized a Section 1231 loss in the past five years. Be sure to review the various restrictions and rules in order to qualify property under I.R.C. Section 1231.

QUICK FACTS

- 88,000** Number of farms in California, which is about 4 percent of the nation's total.
- 20** The number of cents of every consumer food dollar that reaches the farmer.
- 10,064** The number of farms operated by women in California.
- 77** The number of agricultural commodities California leads the nation in production.
- 318** The average number of acres on a California farm. It is actually smaller than the national average of 434.
- 3** The percentage of agricultural income in California derived from federal government payments.
- 8** The number of the top ten agricultural producing counties in the nation that are in California (Tulare, Fresno, Kern, Monterey, Merced, Stanislaus, San Joaquin, and Riverside).
- 1 BILLION** The number of dollars California farmers have invested in water conservation irrigation systems since 1975.
- 38** The number of days the average American works to earn enough to feed the family for a year.
- 75** The reduction percentage in the use of pesticides achieved by farmers using integrated pest management.



Source: California Farm Bureau Federation

CALENDAR

- March 1** Due date for tax returns of taxpayers filing as farmers
- March 15** Due date for tax returns of calendar year-end corporations
- March 20** Common Threads event at CSUF. Ticket information (559) 278-4266
- Check-in 9:30 to 10:00 at the Renaissance Hall
 - Workshop Liz Summer from Atascadero speaking on “The Gift of Giving”
 - Holly King to moderate panel discussion. Participants are Sharon Clauss, Pat Heiskell Hillman, Betsy Reeves and Dorcas Thille.
 - Luncheon 12:00 to 1:30 at Residence Dining Hall
- April 15** Due date for individual tax returns
- May 9** Ag One Turf Day Golf Classic. For ticket information call (559) 278-4266
- August 23** Ag One Community Salute honoring Fred Machado, CPDES hall in Easton, cocktails at 6:00 pm, dinner at 7:00 pm. For ticket information call 278-4266
- September 7** Ag Boosters’ Barbeque, Coombs Ranch in Madera. Ticket information (559) 432-2346 or (559) 278-4266
- September 16** BP&F Neil Harl Farm Seminar at Piccadilly Inn West Shaw. Reservation information (559) 432-2346

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• KEY FINANCIAL RATIOS • PERFORMANCE REVIEW • FRAUD PREVENTION

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