

# Profit insights

thinking strategically to your best advantage

**BKJ**

Babush, Neiman, Kornman & Johnson, LLP  
Certified Public Accountants & Consultants

November 2006

## What are Auditors Actually Doing?

by Jim Lahm

Many businesses have their financial statements audited. Every year the auditors come out, feverishly copying and scribbling (these days probably typing) their little notes. They sprinkle some magic dust and “poof” – the statements are audited. This might lead some to wonder, “What are the auditors actually doing?” This question is a common one and has actually coined a phrase in the accounting profession: the Expectation Gap. This is the difference between what is actually required when preparing an audit and what the user of the financial statements thinks is being done.

### The Audit Defined

Let’s start with what an audit is. An audit is an examination, on a test basis, of evidence supporting amounts and disclosures in the financial statements.

### GAAP and GAAS

Many companies account for their activities under Generally Accepted Accounting Principles (GAAP). This is a broad body of knowledge that has been developed over time to test accounting activities consistently. If financial statements are prepared under GAAP, certain rules and conditions should have been followed. GAAP governs what is in the financial statements. When performing the audit, the auditor follows procedures and processes under Generally Accepted Auditing Standards (GAAS). GAAS has been developed over time and governs what you actually do to perform an audit. GAAP is how the financial statements are presented and GAAS governs how the audit is performed. This gives the user keys to what they are reading and how it was determined. It should be noted that other types of financial statements, such as cash basis, can be audited under GAAS, but GAAP statements are the most common. So, again, what do the auditors actually

do? Audits have many steps but they can be grouped into a few broad categories.

### The Steps of an Audit

First, auditors must develop an understanding of the company, the accounting system and the system of internal controls.

Internal controls are those procedures and systems that are designed to minimize errors as much as possible and to catch errors that inevitably occur. Checking deliveries against the shipping manifest and the purchase order is an example of a basic, and very good, internal control. It should be noted that an audit is not designed to provide assurance about the controls themselves, but an auditor must understand them in order to perform an effective audit.

Once the auditor understands the company and its procedures, he or she can design tests to determine if the amounts in the financial statements are presented fairly. These tests can take many forms but are all based on the premise that accounting data can be expected to behave in certain ways. The tests you are probably most familiar with are likely to be based on statistical sampling. If a representative sample is tested and yields a result, the whole can be expected to yield the same result. For example, when the auditors come out to do an inventory count, they are not there to recount everything. They are there to observe the procedures you use when taking inventory and to determine if they are adequate to generate the desired result: an accurate inventory. When the auditor does a test count, he/she is really testing your procedures more than the count itself. The test count is a random sample, i.e., unable to be predicted beforehand and representative of the

### In This Issue:

- What are Auditors Actually Doing?
- Alternative Minimum Tax—It’s Not Just for the Wealthy Anymore
- How to Handle the Uncertainty of Estate Tax Laws

*continued on page 2*

## What are Auditors Actually Doing?

*continued from page 1*

whole. Other tests use analytical procedures, again based on the premise that financial information should follow certain patterns. For example, if your sales go up and your costs go down, your gross profit should go up.

By understanding your system, then testing it, auditors can determine that your financial statements are fairly presented in all material respects. You'll notice two key words here: fairly and material. Fairly means the statements are reasonably, not absolutely, free of material misstatements. Material means a misstatement, if it exists, is not significant enough to change the financial statements users' conclusions about the company's financial position and results.

### What an Audit is NOT

Let's finish with what an audit isn't. An audit is not an absolute verification of the financial statements. This is both

impractical, as every transaction for the whole year would have to be tested, and unnecessary, since a careful and diligent audit will provide reasonable, therefore adequate, assurance. An audit is not specifically designed to detect fraud, although auditors are required to report fraud that is detected. Lastly, an audit is not a guarantee, rather it is a considered opinion based on experience, planning and careful testing. The failures of Enron and WorldCom lie with their auditors more than with the audit process.

The better auditors and their clients communicate and understand what an audit is, the smaller the expectation gap. The first step in achieving this is an understanding of what an audit is, what it involves, and what it should achieve. Look for future For Profit articles that will offer insights into using information gained in audits to your company's advantage.

## Alternative Minimum Tax— It's Not Just for the Wealthy Anymore

by Gill Fenerty

### What is Alternative Minimum Tax?

Nearly 37 years ago, the US Treasury Department and Congress established the Alternative Minimum Tax (AMT) to stop a small group of wealthy taxpayers from using loopholes to avoid paying taxes. The AMT has a special set of rules, deductions, exemptions, forms, etc., and once calculated, the taxpayer must pay whichever is the higher tax—AMT or the regular federal income tax.

### Who is subject to AMT?

Unfortunately, AMT is not adjusted for inflation. This has vastly expanded its scope. Prior to 2001, only one percent of all taxpayers were subject to AMT. However, as regular tax rates have been reduced in the last few years, the number of taxpayers who are subject to AMT is rising quickly. (In 2003, 2.4 million households were subject to AMT, versus 19,000 in 1970.) Some sources project that as many as 33 percent of all taxpayers will owe some amount of AMT this year, specifically middle income taxpayers with incomes

between \$75-100,000. (This was not the intent when AMT was established.)

### Why might AMT be higher than regular federal income tax?

AMT treats deductions very differently than the regular tax system. Unlike the regular system, state and local income tax payments and property taxes are not deductible for AMT purposes. Other noteworthy items not AMT favorable are municipal bond income on private activity bonds, investment management and tax preparation fees, home equity interest not used for the home and employee business expenses. Incentive stock options can also generate AMT.

### What should a taxpayer do?

With AMT in place, and no plans by Congress to materially change AMT, tens of millions of taxpayers must prepare and manage in essence TWO complex tax returns. What should a taxpayer do? Tax planning is essential. Plan early in order to determine if you will be in AMT. Look at your options. If you are in AMT, it is to your advantage to plan the timing of your income and expenses. For example, it is important to determine the proper timing of your fourth quarter state estimated tax payment. Consult with your tax advisor before year end.



# How to Handle the Uncertainty of Estate Tax Laws

by Scott Pohar

**M**any of our clients have been asking about the estate tax repeal, and most of you have probably been following the numerous bills as they try to become law. It is important to stay tuned to any changes in estate tax laws, as your family and charitable giving could be greatly affected.

The latest estate tax proposal was contained in the “trifecta bill” (H.R. 5970). Despite what the name may imply, this bill is not an attempt to gamble with the estate tax. This controversial bill, which had passed the House in late July, contains estate tax reform as well as a minimum wage increase and extensions of some tax relief measures like the research credit. It was defeated in the Senate by four votes. At this point, there is much rhetoric from the senators, but it doesn’t appear to have much steam and probably won’t be passed this year.

Although many republicans would like to repeal the estate tax, they are now asking for a \$5 million exemption per person with a top tax rate of 15 percent. The top tax rate doesn’t appear to be enough to pass. We at BNKJ think that, with this being an election year, the repeal won’t pass. If we’re right, the current law will remain in place, which increases the exemption amount over the next three years to \$3 million, no estate tax in 2010, and then back to \$1 million exemption in 2011.

Since we are expecting no change this year in the estate tax area, we’re recommending that our clients generally follow the below guidelines when estate planning:

- Maximize your current gifting using the annual exclusion of \$12,000 per person. You can give up to \$12,000 away each year without paying any tax, or using your gift tax credit.
- You can provide medical and educational benefits to your

family without paying gift tax or using your credit, as long as you pay those directly to either the doctor or the university.

- You can prepay for college using a “529 Plan.” You can contribute to a 529 Plan up to \$60,000 per person, which is five years of annual exclusions. You will not be able to make other gifts to that individual for the next five years without using your gift tax credit.
- If you haven’t used all of your gift exemption amount (currently \$1 million), you may want to make a large gift to use some of the exemption.

There is a new item regarding Individual Retirement Accounts (IRA) in the pension protection act which relates to donations to charities. If you are over age 70 ½, you can contribute money directly to a “public charity” up to \$100,000 from your IRA. Donor advised funds and supporting organizations do not qualify. The transfer counts towards your “Required Minimum Distribution” (RMD) for the year, and none of the amount transferred is considered taxable income to you. This tax incentive is only good for 2006 or 2007.

If your estate is very large, there are many other planning techniques we might recommend depending on your situation, including: Family Limited Partnerships (FLP), Grantor Retained Annuity Trusts (GRAT), Charitable Remainder Trusts (CRT), Charitable Lead Trusts (CLT), Qualified Personal Residence Trusts (QPRT), or Life Insurance Trusts.

Wealth transfer and estate planning may become trickier as new legislation is introduced and passed. Please let us know if we can help in your estate planning, either by making some calculations to see what the best plan is for you and your situation, or reviewing what you currently have in place to see if it still makes sense.

# Biography

**James W. Lahm, CPA, ABV**

**Partner**

**770-261-5452**

**jlahm@bnkj.com**



Jim operates from a simple, core philosophy- the answers lie in asking the right questions. Whether providing accounting or consulting services

to his clients, he applies this philosophy to an entrepreneurial outlook and a direct approach. His experience, technical and intuitive skills make him a valued advisor and trusted partner.

Jim takes complex, technical issues and breaks them down into simple, easy to manage components. This is especially helpful to business owners

who want to know about financial options, innovative opportunities and creative productivity methods.

Jim has vast experience in financial reporting and tax services, drawing on economics, finance, and accounting analysis to help his clients. He has a background in performing business valuations, with skills and experience that have proven helpful to clients involved with sales or acquisitions and business succession planning. This knowledge has also helped his traditional clients, because understanding how to measure value can lead to improving value.

A believer in lifelong learning and an avid reader, Jim continually pursues

advanced education in accounting and consulting skills. Whether beginning a relationship or broadening an existing one, Jim offers top notch credentials, experience, technical understanding and dedication. He is an ABV (a CPA Accredited in Business Valuation), a member of the Georgia Society of Certified Public Accountants and the AICPA. Jim earned his B.S. in accounting at Kean College.

A music lover since childhood, he listens to everything from classical and world music to modern jazz and rock and roll. Jim and his wife Bernadette also enjoy the visual arts, international cuisine and traveling. He is a long time movie buff.

**Scott Pohar, CPA**

**Manager, Estates and Trusts**

**770-261-5456**

**spohar@bnkj.com**



Scott Pohar has been providing estate planning and tax compliance services for nearly 20 years, and manages the firm's estate and trust department.

He has extensive experience, having worked with many wealthy families and executives to accomplish estate, tax and financial planning goals. Scott has especially strong experience in multi-

generational estate planning, fiduciary income tax compliance, charitable planning and private foundations.

Scott has reviewed hundreds of 706 estate tax returns. This tremendous experience enables him to advise clients on the best ways to minimize estate taxes and ensure maximum transfer of wealth to family members. In addition, Scott has reviewed thousands of charitable trusts and private foundations, and has helped them comply with these complex areas and maximize the benefit to the charities.

Prior to joining BNKJ, Scott spent 18 years with SunTrust Bank, where he

managed the Trust Tax Department for the State of Florida, Trust Real Estate, and Personal Trust Administration.

Scott earned his Bachelor of Science degree in accounting from Georgia State University, and obtained his CPA license from the State of Georgia. He was a past board member for the Estate Planning Council of Ft. Lauderdale. Scott was interviewed by CNN in 2003 regarding his opinions on the Florida intangible tax.

Scott lives in Dunwoody with his wife and two children, and spends his free time on the golf course.

**Gill Fenerty, CPA**  
**Federal and State Tax Manager**  
**770-261-5472**  
**gfenerty@bnkj.com**



Gill Fenerty has more than 10 years experience providing accounting and tax services to public companies and privately held businesses. Gill often works with businesses and individuals on complex matters related to multi-state taxation. His industry focus has been primarily with business services, real estate and distribution.

Gill gained unique experience when he worked at KPMG, where he was instrumental in the development of a new tax accounting strategies (TAS) group in KPMG's New Orleans office. The TAS group analyzed company accounting methods to identify possible tax saving opportunities involving income deferral and expense

acceleration. In almost all cases, the method changes required the approval of the IRS.

Gill also has built a niche with both federal and state income tax audits. He recently initiated a major income deferral project for a client in the marine construction industry involving the accounting for long term contracts. Gill's team was able to defer over \$10 million of income for three years. In addition, the method was challenged in an IRS audit and approved.

Between Gill's work at KPMG and his current work here at BNKJ, Gill served as tax manager for Holland & Knight, LLP, the fifth largest law firm in the United States. In addition to his duties involving partner capital maintenance, Gill honed his state and local skills, advising firm partners throughout the country on their federal, state and local taxes. In addition, Gill maintained the firm's compliance for all taxes and registrations in more than 20 states.

Gill chose to return to his public accounting roots because of his enjoyment of client service and relationships. He continues to have the drive and determination he had during his athletic career, now focusing his energy on providing excellent service to BNKJ's clients.

Upon graduating from Holy Cross College with a BA in History, Gill spent three months in Italy promoting and participating in a local football league. He was then recruited to play professional football for the Toronto Argonauts. After three successful years with the team, Gill joined the New Orleans Saints and played with them for two years.

Athletics still remain a big part of Gill's life. Whether he's cycling, playing tennis or golf or getting together with Atlantans for some flag football, he spends much of his free time outdoors.



**Babush, Neiman, Kornman & Johnson, LLP**  
Certified Public Accountants & Consultants



5909 Peachtree Dunwoody Road  
Suite 800 • Atlanta, GA 30328  
770.261.1900 • [www.bnkj.com](http://www.bnkj.com)