Toy central - assessing the possibility of fraud and illegal acts

Finance

Possibility of Fraud: Toy Central

1. The Public Company Accounting Oversight Board has clearly defined ‘ illegal acts by clients’ under AU Section 317. As in general case, AU Section 317 describes illegal acts as violations of laws or governmental regulations. Illegal acts recognized in financial statements under the audit are attributable to persons acting on behalf of the entity. The points described under the section “ definition of illegal acts” make the clients aware of situations that may hold them liable. The AU Section 317 clearly states that illegal acts may have direct or indirect impact on financial statements. Some illegal acts cause direct and material effect on the determination of financial amounts. In contrast, certain illegal acts raise material but indirect threats to the accuracy of financial statements. The next part of this section discusses with the “ auditor’s consideration of the possibility of illegal acts”. This section specifically requires how auditors must respond to illegal acts that may have a direct or indirect impact on financial statements. In order to comply with AU Section 317, clients must have specific provisions related to the prevention of illegal acts. Such a provision is very essential for auditors to deal with illegal acts in the absence of specific evidence. This section also indicates that auditors must get all possible assistance from client staff in order to perform a good audit work. The AU Section 317 precisely insists that auditors should be provided with adequate information regarding the scope of the work. This section’s requirements particularly deal with due diligence that an auditor has to give while performing an audit work.

2. The identified payment to the International Workers Transport Union

cannot be considered as an illegal act. The TCC's VP-Operations requisitioned the payment. It seems that the VP could provide reasonable explanation for its act. As the case writers (Earley and Phillips, 2008) point out, to VP, the payment was made with intent provide support for US transport workers. During that time, workers believed that they were significantly underpaid and were talking about organizing work stoppages and strikes. Hence, VP claimed that the payment would influence the union executives to discuss and resolve that issue with their members before things get rid of hand. In addition, the payment was approved by the CFO. Moreover, the case study reveals that the payment to International Workers Transport Union was approved and appropriately classified as an " other non-operating expense". The AU Section 317 also certifies the genuineness of the transaction. Under the " definition of illegal acts" part of AU Section 317, the paragraph 6 states that entities may be affected by additional laws or regulations which " more relate to an entity's operating aspects than to its financial and accounting aspects" (PCAOB). As a result, the identified transaction has not breached any regulation or corporate governance policies. The case study also reflects that the TCC is not directly affected by Sarbanes Oxley Act as it is a private firm. Hence, the auditor does not necessarily need to assess the firm's internal control system very thoroughly. Moreover, the management's major intention behind this payment was to promote organization's long term objectives. In other words, the management might not have intended to falsify its books of accounts by this transaction. In total, it is precise that TCC's management had met every legal requirement before issuing this payment.

3. In the opinion of experts, “ A valuation allowance reducing the deferred tax asset is required if an analysis of the sources of future taxable income suggests that it is more likely than not that some portion or all of the deferred tax asset will not be realized” (White, Sondhi & Fried, 2006, p. 299).

In general cases, if a company expects that it has only less than 50% chance to realize some of its deferred tax assets, it reports a valuation allowance to account for the issue. A company follows this practice when it believes that the firm’s future income would not be adequate enough to take full advantages of the tax breaks. From the case study, it seems that the management removed inventory valuation allowance despite the evidence suggesting that there is excess inventory. Hence, I strongly believe that the removal of valuation allowance is an attempt of management to “ manage earnings”. When TCC reports a valuation allowance, it points to the fact that the company is not expecting profit for next several years. Such a negative message may discourage shareholders and other third parties; and this situation may eventually lead to business failure. In contrast, the removal of valuation allowance may convince the investors that the company is regaining profitability.

References

Earley, C. E & Phillips, F. (2008). “ Assessing audit and business risks at Toy Central Corporation”. Issues in Accounting Education, 23,(2). 299-307.

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White, G. I., Sondhi, A. C & Fried, D. (2006). The Analysis And Use Of Financial Statements. New Delhi: John Wiley & Sons.