

DETAIL PLUS INC. (DPI) - AUDITING THE INCOME TAXES OF A FAMILY OWNED BUSINESS IN THE CARIBBEAN

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ABSTRACT

In this case, you assume the role of a tax auditor investigating a local family-owned business. Several aspects of this taxpayer's case lead you to feel uneasy with the income taxes paid to the government. Drawing on your knowledge of analytical audit procedures and financial statement analyses, your task is to identify and evaluate risks of income misreporting. Amid an adversarial environment, you will consider both qualitative and quantitative evidence challenging the taxpayer's position.

PART 1

After completing your business degree, you decide to pursue an accounting career, and accept a position as a corporate tax auditor with the Inland Revenue Department (IRD) in the Caribbean. As an IRD tax auditor, your primary responsibility is to ensure that companies accurately report revenues and expenses so that income taxes are properly reported and paid to the government. Companies operating in the Caribbean community follow International Financial Reporting Standards (IFRS). The impact of converting to IFRS has been negligible for many of the local Caribbean companies; the same basic rules of accrual accounting, as used in the United States and Canada, continue to apply.

We are grateful for comments received from the editor and anonymous reviewer, and for the participation of the students and tax practitioners in testing these materials.

The companies assigned to you are all local companies. Your current assignment is an audit of a family owned business named Detail Plus Inc. (DPI).¹

DPI operates as a retailer and wholesaler of clothing, hardware, small electronics, and auto parts and accessories on one of the main islands of the Caribbean. DPI has been very successful in establishing a broad customer base, and is viewed by most consumers as the “place to go.” About 75% of DPI’s revenues are generated by three retail outlets that are strategically located in the more populated areas of the island. The remaining revenues are generated from wholesale sales to small businesses that operate in remote regions of the island. DPI obtains about 90% of its goods through imports from North America and South America.

Prior to planning the DPI audit, you meet with your IRD audit manager – Timothy Timmonds (known around the office as TimTim). TimTim provides you with summaries of DPI’s operating results (Exhibit 1) and expense breakdown (Exhibit 2) for the past five years. These operating results are prepared from the tax filings of DPI, which include the taxpayer’s financial statements and a reconciliation of accounting to taxable income. TimTim mentions that you will be meeting with the managing director and controller of DPI

EXHIBIT 1
Detail Plus Inc. (DPI) Operating Results

Detail Plus Inc.

Income Statement

For the Years Ended June 30, 2003 to June 30, 2007

(amounts in thousands of U.S. dollars)

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Revenue	\$75,661	\$77,954	\$84,123	\$86,434	\$93,348
Cost of Sales					
Inventories at Beginning of Year	9,100	9,400	10,100	9,900	8,700
Purchases (including duty)	63,243	64,506	68,889	70,298	77,956
Less: Inventories at End of Year	<u>9,400</u>	<u>10,100</u>	<u>9,900</u>	<u>8,700</u>	<u>9,300</u>
Cost of Sales	<u>62,943</u>	<u>63,806</u>	<u>69,089</u>	<u>71,498</u>	<u>77,356</u>
Gross Profit	12,718	14,148	15,034	14,936	15,992
Administration and Selling Expenses	<u>8,074</u>	<u>8,710</u>	<u>10,187</u>	<u>11,162</u>	<u>11,678</u>
Income before Income Tax	4,644	5,438	4,847	3,774	4,314
Provision for Income Tax	<u>1,625</u>	<u>1,903</u>	<u>1,696</u>	<u>1,321</u>	<u>1,510</u>
Net Income	<u>\$3,019</u>	<u>\$3,535</u>	<u>\$3,151</u>	<u>\$2,453</u>	<u>\$2,804</u>

¹ This case is based on actual individuals and events encountered by one of the authors of this case, but some elements have been altered to conceal the identity of the individuals and organizations involved.

EXHIBIT 2
Detail Plus Inc. (DPI) Expense Breakdown

Detail Plus Inc.
General and Administrative Expenses
For the Years Ended June 30, 2003 to June 30, 2007
(amounts in thousands of U.S. dollars)

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Advertising	\$65	\$94	\$134	\$121	\$109
Business Travel and Entertainment	93	94	131	148	165
Depreciation	188	204	225	245	237
Electricity and Water	350	432	687	987	1,103
Insurance	393	324	333	365	341
Interest and Bank Charges	169	219	231	246	229
Office Expenses	191	203	214	234	245
Professional Fees	75	75	103	192	97
Petty Cash Expense	211	304	228	297	334
Property Rental	400	425	900	950	1,200
Repairs, Upkeep and Maintenance	237	342	311	366	387
Salaries, Wages, and Personal Costs	5,256	5,545	6,143	6,399	6,589
Telephone	201	243	221	237	244
Vehicle Operating Expenses	245	206	326	375	398
	<u>\$8,074</u>	<u>\$8,710</u>	<u>\$10,187</u>	<u>\$11,162</u>	<u>\$11,678</u>

next week, so you should analyze the financial summaries and identify risk areas to investigate more thoroughly during the audit. He adds that you should prepare a list outlining questions to ask and specific accounting records that you anticipate examining during your audit.

Before concluding the meeting, TimTim mentions that he had been a junior IRD auditor five years earlier, and also had been assigned the task of investigating DPI. At the time, he had been concerned about the possibility of underreported income, in part because DPI conducted many of its transactions in cash, at both the retail and wholesale levels. Also, DPI had entered into related party transactions that did not seem to have a rational economic purpose. When TimTim first met with DPI management, he received little cooperation and was denied access to the company's accounting records. DPI's executives did not act in the professional manner that TimTim had expected of individuals who had amassed significant wealth (see Exhibit 3) and presence in the business community. DPI's founder, managing director, and primary shareholder, Edward Storms, used his position as an influential member of the business community to complain to politicians and the public that IRD's questions were offensive and the requests for accounting documents were too onerous. Mr. Storms had claimed that his reputation in the business community was above reproach; he added that DPI was one of the island's main employers and was being harassed by IRD.

EXHIBIT 3
Compensation and Property Values of Detail Plus Inc. (DPI) Executives

Detail Plus, Inc.
Executive Compensation and Property Values

	<u>Annual Salary and Bonus</u>	<u>Real Estate</u>	<u>Vehicles</u>
Managing Director Edward Storms	\$150,000	\$1,750,000	\$250,000
COO Elmeade Jeffers	100,000	1,250,000	150,000
CFO Anita Jacobs	80,000	850,000	110,000

DPI's complaints were echoed by the managing partner of the local accounting firm, William Emerson. Mr. Emerson also was an influential member of the business community, and he pointed out that DPI had already been audited by his firm. He claimed that an IRD audit was unnecessary and would waste the time of DPI staff, who should instead be allowed to continue creating employment and servicing the island's public. TimTim confides in you that the lack of cooperation and the pressure being exerted by Edward Storms and William Emerson caused him to let the audit slide and eventually disappear. TimTim sees you as someone who can get the job done.

The taxpayer's accounting records are not the sole source of available information. As an IRD employee, you can obtain information from customs about goods imported into the country, from Social Services about wages paid by companies, from utility companies about the costs of electricity and water, and from the property division of IRD about registered property ownership.

Required:

Analyze the DPI financial summaries with the goal of identifying preliminary risks to investigate during the audit. Prepare a list of questions you plan to ask of DPI management and a list of specific accounting records that you will need to examine during the audit.

PART 2

Six months have passed since your initial meeting with DPI. Your stomach gets queasy every time you think of the confrontation with the controller and Mr. Storms, DPI's managing director. Simply put, they were rude and short with you. They stated that your questions were insulting and indicated that you did not know what you were doing. They pointed out that a previous IRD audit, conducted less than five years ago, had proven they were clean as a whistle. IRD had proposed no re-assessments or adjustments. They claimed they were pillars of the business community; they stated that another audit was tantamount to harassment and that they would be speaking with the Commissioner of IRD. When you asked about accessing DPI's accounting records, the controller said he would see what could be done but that all the accounting staff were very busy.

You held a subsequent meeting with DPI's external auditor, William Emerson. This meeting was just as unpleasant as your meeting with DPI. Mr. Emerson indicated that he had advised DPI on several matters, and he was particularly disturbed by your recent insinuations about DPI's integrity. When you requested access to the trial balance, journal entries, and lead sheets of his audit firm, Mr. Emerson chastised you, claiming the working papers were the property of the audit firm. He sarcastically stated that IRD would have to do its own audit work.

You followed up your requests to access DPI's accounting records with several phone calls and two letters. These attempts to contact DPI went unanswered, so you took a different approach to gaining information that could be used in the audit. As an IRD employee, you can obtain information from customs about goods imported by DPI, from Social Services about wages paid by DPI, from utility companies about the costs of electricity and water, and from the property division of IRD about DPI's registered property ownership. You have also completed industry benchmark analysis by searching the internet and examining other IRD tax files.

The customs information provides a curious result. It indicates that the total cost of goods imported by DPI, including all customs and duty charges, amounts to only about 75% of the cost of sales reported in DPI's income statements. You had always understood that 90% of DPI's goods were imported, which made sense given the nature of goods sold by DPI; it is highly unlikely that they would be manufactured on the island. Your internet research found that DPI operates affiliated companies in other island countries in the Caribbean. Customs would not have access to data regarding the imports of DPI-affiliated companies operating on other island countries.

You feel reassured about the reported value of salaries and wages because information from Social Services dovetails quite closely with the amounts reported on the income statements. However, in examining the details, you notice that the remuneration of the shareholder/manager and other top managers did not seem to match the estimated value of their known owned properties and motor vehicles (see Exhibit 3). You also note that DPI has not paid a dividend in the past five years.

You are able to discover two relevant pieces of information about DPI's property. First, information received from the utility companies showed that utility rates have increased substantially over the past five years. Second, IRD's property division indicated that Edward Storms owned two of the large retail outlet properties and leased these out to DPI. The total market value of these two properties was estimated at \$1.2 million. As a result of government policy incentives to encourage capital investment, no personal tax is charged on income derived from rental property.

Internet research has found that comparable publicly traded companies typically earn a retail gross margin ranging from 24% to 28%. Further, your reading of the tax files of other companies with wholesale sales of similar goods shows that they earn a wholesale gross margin of 16% to 20%. The wholesale division of DPI supplies the goods for the retail division and also sells to non-related retail stores. As a result, the retail sales of DPI will have earned both a retail and wholesale margin.

Tim schedules a meeting with you for the end of the week to review the progress on the DPI audit. He wants to better understand the various factors that could explain DPI's fluctuating taxable income, so that he can generate a reassessment by quarter end (only a

month away). You begin to reflect on the information gathered early in your audit (Part 1) as well as more recent discoveries (Part 2).

Required:

Prepare a memo for TimTim summarizing the information you have uncovered, the possible interpretations of that information, and the implications it may have for a tax reassessment. For each issue that provides quantitative measures, try to determine whether there is underreported income and, if so, estimate the dollar amount.

You may find it useful to organize your memo around each piece of information; after describing the information, explain the range of possible explanations of that information, discuss which explanation is most likely, and conclude by indicating its potential impact on the tax reassessment.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the “For Contributors” page of the journal website, <http://gpae.bryant.edu>.