# Are Immaterial Amounts Ever Material?

## *Gary D. Zeune, CPA*

According to the Association of Certified Fraud Examiners, the average organization loses 6 percent of revenue, or $9 per day per employee, to fraud, theft and abuse. Think about how many dollars in sales it takes to recoup that. So why don't we realize the magnitude of these losses? They are scattered all over the financial statements. For example, if you catch someone cheating on his or her expense report, you probably say, "Don't do that again" and let the stolen money stay in T&E (the thief is your top sales person and it is **only** a $58 'lunch' that never happened). Inventory thefts end up in Cost of Goods Sold.

So if you **really** want to do something about fraud losses, create an account called STOLEN MONEY and put all such amounts in the account. When management sees how much is in the account they will do something about the problem. Be sure to include all of the personal expenses the owners run through the company. Because you might very well get fired, not many CPAs have the courage to properly classify such personal expenses as tax fraud. What will you do when the company owner or executive director says, "It's my company. I can do whatever I want"? You have to make the decision whether or not you are an ethical CPA.

### It's Okay, the Boss Is Doing It

Some employees feel justified in taking advantage of a company. Why? Times are tough. The monthly mortgage payment has dramatically increased; your employee cannot make the payments, and does not want to lose the house. So she starts 'borrowing' just enough to make the house payment, promising herself she will pay it back. When no one notices the money is missing (can you say poor internal controls?), the employee realizes she does not have to pay the money back. Of course, the employee is not legally 'borrowing' the money. It is always stealing, but the psychological rationalization often changes to "I work hard. The company owes me this." So the employee switches from "I'll pay it back" to "I don't have to pay it back."

One of the things I see over and over is an employee who steals the company blind. The company owner, who runs personal expenses through the company, is dumb founded at what the employee did. "Joyce worked here for 17 years. I treated her like family. Then she steals from me!" Where do you think "Joyce" learned it was okay to steal? For more on how honest people talk themselves into stealing and otherwise do you wrong, watch accounts payable supervisor TeriLyn Norwood explain why she 'borrowed' $18,000 from employers at www.TheProsAndTheCons.com and click VIDEOS on the home page.

### Immaterial = Material

So when is an immaterial amount material? In Statement on Auditing Standards No. 107 (one of the SASs in the new Risk Assessment Standards), Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it **probable that the judgment of a reasonable person relying on the information would have been changed or influenced** [bold added] by the omission or misstatement."

Note there is NO percentage or dollar amount in the definition. Materiality is in the 'eye of the beholder.' In other words, if the user of the financial statements would have made a different decision, then the missing or incorrect information was material. For example, if a client has a bank

loan covenant requiring $1 million of income to automatically renew the loan, and the client changes the calculation of bad debt expense increasing the bottom line from $980,000 to $1,011,000, the $31,000 change in bad debt expense is material. Why? The $31,000 is material to the bank loan officer, who, absent the 'adjustment,' would not have automatically renewed the loan. In other words, an immaterial amount is material if it accomplishes a material event.

Another fundamental flaw in the profession is thinking we can wait until an amount is material to do something. Think about this. By the time an amount becomes material, and it is in the financial statements, the auditors will almost always get sued. Why? Many times the 'problem' was on the passed adjustment list, and nothing was done.

The biggest issue is 'rationalization.' For example, when faced with a 'road block,' bosses and clients often say "Can't you call it something else" or "Can't you treat it like it is something else?" **Do NOT succumb to the pressure.**

### Immaterial but NOT legal

You are a CPA. Your ultimate duty is neither to the client, nor to your boss. Your ultimate duty is to the user of the financial statements and to do the right thing. That means not letting the little immaterial amounts slide that are clearly illegal. Just because an amount is immaterial for financial reporting does NOT mean it is legally okay. If you are an auditor, do not put the $5000 of the client's vacation expenses on the passed adjustments list. The $5000 is an illegal deduction for tax purposes. If you are the controller, do not write the check to reimburse your boss. Stand your ground and 1099 it, or set up a receivable. Do something to properly account for it. Think about this, how are you an ethical CPA if you let a client cheat on a tax return, or if you work someplace where management/owners cheat on the tax return?

Being a CPA requires you to be independent and objective. Another fundamental flaw in the profession is that the client pays for the work. You cannot be truly objective when you have a vested interest in the outcome. Do you think you are objective? I bet you think you are a better than average driver. That's okay. More than 90 percent do. Aren't your kids smarter than average? Of course they are. Even though independence is required by our Professional Code of Conduct, as long as the client pays for your work, either as an employee or client, it will always be nearly impossible to be truly independent. Until the profession tackles this problem, small, but illegal, amounts will end up on the passed adjustments list and controllers will write checks to reimburse illegal expenses. As noted above, illegal amounts by definition are material. If you allow the illegal amounts, there is no discussion as to whether or not you are an ethical CPA. We only have to talk about how much you will allow before drawing a line in the sand. It does not have to be an illegal amount. It can be anything that results in the financial statements not being 'good enough' for a reader to make an informed decision: manipulating an estimate, overly optimistic revenue projection, competitive pressures or regulatory changes that threaten a business.

Andrew Carr Conway, Jr. CPA, FCPA, CFE, CFI, chief financial officer, Axion Power Battery Manufacturing Inc., New Castle, Penn, suggests two guiding principles:

1. Decide what you will do when presented with an ethical dilemma before you start a job or accept an engagement. It is far easier and better to resolve to do right at that time rather than when you are in the heat of the moment and must make a snap judgment.
2. Would I want my decision printed in *The Congressional Record?* If your decision would not withstand that scrutiny, revise your thinking.

After all, when you let the little stuff go, you are compromising your ethics. Once the compromising starts, where do you draw the line? To steal someone else's thought: Ethics is what you do when no one is watching.

*©Gary D. Zeune, CPA. Mr. Zeune is a nationally recognized speaker and writer on fraud, and founder of The Pros & The Cons, the nation's only speakers' bureau for white-collar criminals at www.TheProsAndTheCons.com. He teaches fraud classes for the FBI and numerous professional associations, and is the author of The CEO's Complete Guide to Committing Fraud and Outside the Box Performance. He can be reached at gzfraud@bigfoot.com, or 614-761-8911.*

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