

### Case 89-3

#### **Hidden Treasures Construction Company - Whose Treasures Now?**

Hidden Treasures (HT), a family-owned business is a Guam-based construction company, which builds custom homes with special features, such as hidden rooms and hidden wall safes.

You began auditing HT three years ago. You are about to sign off on a "clean" opinion on HT's current annual financial statements when Art Hyde, the VP-Finance, calls to tell you that U.S. Customs has seized about \$4,000,000 of company funds. HT had deposited the funds as bearer certificates of deposit in a Swiss bank to avoid taxes. An attempt to cash the certificates through a local bank resulted in their seizure, because HT had not filed with Customs an information declaration of monetary instruments leaving the U.S.

In response to your questions about the origin of the funds, Art assures you that the funds, though not recorded as revenue, had been obtained legitimately. He explains that all of the money came from separately billed but unrecorded change orders to items in contracts completed before you became HT's auditor. You subsequently determine that there is insufficient evidence to enable you to reconstruct the transactions. None of the change orders were connected with any federal or federally subsidized project. Art also informs you that HT has agreed to pay a 20 percent local income tax on the funds within 120 days as required by a recently enacted rule that provides amnesty for tax evaders.

After several conversations with Sojourner Just of the law firm of Truth, Wise, and Just, you determine that there are two possible outcomes ahead:

- 1) Customs will release the funds after deducting a 25% penalty (could be higher or lower, but this is the best estimate) and HT will pay an additional 20% in local income taxes. The net receipt to HT under this scenario would be \$2.2 million.
- 2) Customs will keep the funds and the Company will pay 20% taxes. HT would suffer a net loss of \$800,000 under this scenario.

Art and Sojourner believe that the first outcome is the most likely and all the documents that you subsequently review lead to the same conclusion. However, this is the first case of its kind. Further, Sojourner is unwilling to state her views in an attorney's letter, because she fears that disclosure of the probable maximum penalty in HT's financial statements might influence the Customs authorities to assess the maximum.

As a result of inquiries in the business community, you determine that HT has a good reputation in terms of its relations with banks, its customers, and its vendors. Further, you find out that the law firm of Truth, Wise, and Just has an excellent reputation.

#### **Required:**

- How would you account for this situation?
- What would you say about it in your auditor's opinion?

- How does the information about HT's reputation affect your reliance on management's representations in view of your knowledge that HT had not recorded income to avoid taxation?
- Should the fact that HT's law firm has an excellent reputation have a bearing on the treatment of the unrecorded revenues?
- Based on the the accounting literature, what are the possible alternative methods to treat the unrecorded revenues and the tax liability?
- Should the revenue be recorded currently or can it be attributed to a particular prior financial reporting period?
- Are there audit implications that should be considered?