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Any Questions?

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Summary of Articles

Internal Control: Closing the Gap

Internal Control. How does one define internal control? Is it the result of a process, or the process itself? The perception of internal control has evolved over time due to the increasing complexities of the business environment and changes in the financial reporting landscape. Our current article discusses the definition of internal control and its major components as currently utilized for SOX Section 404 and United States financial statement auditing purposes.

Who is Providing Services, an Employee or an Independent Contractor?

Have you ever had difficulties in determining whether an individual who performs services for a business is an employee or an independent contractor? Definitions of an employee and an independent contractor are not simple and detailed factors need to be considered in making a proper determination. Proper determination by the employer is essential in complying with tax withholding, payment, and reporting requirements mandated by the IRS and state tax authorities.

In this article, specific factors are described to make a proper decision. Tax requirements are summarized for both an employee and an independent contractor.

I.M. at Work

As the old saying goes, "You can't teach an old dog new tricks." True, for the most part. What was once used exclusively by adolescents is now being used by their parents. It has now evolved and many businesses and corporations are utilizing it in the workplace. It's quicker and easier to use than email and is less bothersome than a phone call. What is it? It's Instant Messaging.

New temporary regulations for submitting corporate income tax return (Form 1120/1120S) were issued on January 12, 2005 by the Internal Revenue Service (IRS). The temporary regulations require certain large corporations and S corporations to file their income tax returns electronically. It is important that you understand how these new "e-file" requirements may affect your company.

Internal Control: Closing the Gap

Good corporate governance. More ethical business practices. Greater accountability for financial reporting. In the countless number of articles written about the Sarbanes-Oxley Act of 2002 (“SOX”) and specifically in articles about SOX Section 404, “Internal Control” and its effectiveness will almost always be the primary focus of the story.

How does one define internal control? Is it the result of a process, or the process itself? The perception of internal control has evolved over time due to the increasing complexities of the business environment and changes in the financial reporting landscape. Although there have been several attempts of defining internal control, there had been no common definition of internal control, nor a standard in which an organization could rely on to determine whether their internal control systems were effective. In September 1992, the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) released “*Internal Control – Integrated Framework*” (the “COSO Report”) which provided a standard definition of internal control and introduced an internal control framework that entities can assess their internal control systems. Presently, in the United States, the COSO framework is the most widely acknowledged and utilized in the area of internal control. For privately held companies, auditors rely on the AICPA’s Statement of Auditing Standards (“SAS”) No. 55 – “*Consideration of Internal Control in a Financial Statement Audit*”, as amended by SAS No. 78 (issued in December, 1995)* for guidance on internal control. This statement recognizes the definition and description of internal control as provided by the COSO Report. For publicly held companies, the COSO framework is also considered by the SEC to be a suitable internal control framework for management to base its evaluation of the effectiveness of internal control over financial reporting. In July of 2006, COSO released its latest report titled “*Internal Control over Financial Reporting – Guidance for Small Public Companies*” designed for use by smaller public companies in an effort to implement and/or improve upon internal control systems in a cost effective manner.

As defined in SAS No. 55 and the COSO Report, “internal control is a process, effected by an entity’s board of directors, management and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in one of the following categories:

- (a) reliability of financial reporting
- (b) effectiveness and efficiency of operations
- (c) compliance with applicable laws and regulation”

As stated in SAS No. 55 and the COSO Report, internal control consists of five interrelated components:

- (1) *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- (2) *Risk assessment* is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- (3) *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- (4) *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

(5) *Monitoring* is a process that assesses the quality of internal control performance over time.

Management incorporates these five integral components in the operation of an entity; these components also function as the criteria for the effectiveness of internal control. As discussed in SAS No. 55, the five components apply to every entity, and should be considered in the context of:

- the entity’s size
- the entity’s organization and ownership characteristics
- the nature of the entity’s business
- the diversity and complexity of the entity’s operations
- applicable legal and regulatory requirements
- the nature and complexity of systems that are part of the entity’s internal control

Small and mid-sized businesses will often utilize these five components differently from large businesses; the structure in which these components will take shape will depend on the factors noted above. Noted in the following are a few examples of areas in which smaller companies may have additional exposure or treat differently than larger companies:

Control Activities – segregation of duties is a frequent concern due to the limited number of employees. Appropriate segregation can be effected by the participation of upper management in the review and approval process.

Control Environment – the integrity of upper management will be essential to establishing and communicating a strong control environment. Visibility and direct involvement of upper management will be fundamental to the promotion of ethical behavior.

Monitoring – due to employee turnover and changes in a company’s operations, it is critical that internal controls be monitored on an ongoing basis to verify that controls continue to be relevant or that new risks are being addressed.

The benefits of an effective internal control structure can ultimately increase a company’s value by:

- safeguarding assets
- promote and enhance accurate and reliable accounting records
- improved flow of information producing better business decisions
- improved compliance with policies, procedures, and applicable laws and regulations
- evaluation of the efficiency of operations
- better management of resources

Compliance regarding internal control requirements is mandated for publicly traded companies in the United States and is fast approaching for companies in other countries as well. As mentioned in our previous article, Japan has passed legislation that incorporates, in substance, SOX Section 404; companies expected to be affected are publicly listed companies in Japan including their subsidiaries.

We would be happy to assist your company in meeting your internal control requirements; please consult us if you should have any questions. ♦

* SAS No. 55 will be superseded by SAS No. 109/110, effective for audits of financial statements for periods beginning on or after December 15, 2006; SAS No. 109 continues to incorporate the COSO framework.

Who is Providing Services, an Employee or an Independent Contractor?

Distinction between an employee and an independent contractor:

As an employer, there is a responsibility to determine whether an individual who performs services for a business is an employee or an independent contractor. If the proper determination is not made, the employer may fail to comply with tax withholding, payment, and reporting requirements mandated by the IRS and state tax authorities, and as a result, may be subject to penalties. Although the determination is not simple, an employer needs to know what factors are used to determine the status of a worker in order to properly classify the individual, and to protect both parties. A better understanding of the different requirements for an employee versus an independent contractor is helpful in understanding why the classification is significant.

Examination of the relationship of business and worker:

To determine a worker's status, the relationship of the business and the worker needs to be examined for the right to control and independence. Generally, a worker is an employee if the business has the right to control the result of services and the details of how it will be achieved. However, the degree of control and independence should be determined by examining three categories: behavioral control, financial control, and relationship of the parties.

Behavioral Control:

- Instructions – If there are detailed instructions regarding how the work should be done, this implies that the worker is an employee. Examples of instructions are:
 - ◊ How, when or where to perform the work
 - ◊ What tools or equipment to use
 - ◊ What assistant to hire to help with the work
 - ◊ Where to purchase supplies and services
 - ◊ What order or sequence to follow
- Training – If there is training for required procedures and methods, this suggests that the worker may be an employee.

Financial Control:

- Unreimbursed expenses – If some or all of the business expenses are not reimbursed, the worker could be considered an independent contractor.
- Worker's investment – An independent contractor tends to have a substantial investment in performing services for someone else.
- Availability of services to the relevant market – In general, there is no limitation in seeking business opportunities for an independent contractor.
- Payment system – Usually, an employee is guaranteed a regular wage amount for a period of time. On the other hand, a payment for an independent contractor is made as a flat fee with the exception for payment to some professionals where it is common practice to bill by the hour.
- Realization of a profit or loss – Only independent contractors can realize a profit or loss.

Relationship of the parties:

- Written contracts – A contract should describe the intention of both the worker and the business. This may be very important if it is difficult to classify the worker's status based on the other facts.
- Employee benefits – If benefits such as pension, insurance, or paid leave is provided by the business, the worker is likely to be classified as an employee.
- Permanency of the relationship – If the working relationship is expected to continue indefinitely and not for a specified period of time, this may be evidence of the intention to create an employer-employee relationship.
- Services performed – If a key aspect of regular business activity is performed by a worker, it is more likely that the employer has the right to direct and control.

A worker can be classified as either an employee or an independent contractor based on all of the facts as no single fact can provide an answer. In situations in which the facts are not enough to make a proper determination, Form SS8 should be completed and submitted to the IRS for a determination of the status.

Different requirements – an employee and an independent contractor:

Even if an employer is able to identify a worker's status correctly, the employer may fail to meet the IRS requirements if the appropriate tax treatment is not understood for each status. The major differences in tax withholding and reporting requirements are as follows:

If s/he is an employee:

- An employer needs to withhold income tax and the employee's portion of social security and Medicare taxes.
- An employer is responsible for paying social security, Medicare, and unemployment taxes on the gross payment for the services rendered.
- For reporting purposes, an employer provides a Form W-2 to show the wages paid and taxes withheld.

If s/he is an independent contractor:

- Tax withholding and payments are not required.
- An employer may be required to prepare a Form 1099-Misc in order to report payment amounts for an independent contractor.
- Generally, an independent contractor is responsible for paying his/her income tax, as well as self-employment tax.

Determination of the status of a worker is complicated, but the proper determination is necessary in order to comply with the requirements imposed by the IRS and state tax authorities. Please consult us if you should have any questions.♦

Instant Messaging in the Workplace

The recent crop of college graduates, those born in the early 1980s, a.k.a. Generation Y, has marched boldly into the adult workforce over the past four years. They have brought with them a set of technological tools that make fax machines, voice mail, and spreadsheet software look positively quaint. They have grown up around scanning, text messaging, Googling, and Instant Messaging (IM), and they are not about to stop once they've hit the working world.

Nor should they. These skills are big assets when it comes to multi-tasking and productivity. Instant messaging has obviously evolved from its roots as a facilitator of teenage chats to a vital workplace collaboration tool. A growing number of businesses depend on IM to communicate and collaborate internally, as well as with customers and partners.

Instant Messaging systems enable computer users to stay aware of a selected list of users and immediately start an interactive text chat with anyone on the list. The popularity of IM has been growing; proven by the number of IM systems recently offered (e.g., AOL Instant Messenger, Lotus Same time, MSN Messenger Service, ICQ). AOL Instant Messenger currently boasts 50 million registered users and a peak usage of over 2.4 million simultaneous users. The strategic value of IM in the computer industry was demonstrated in the summer of 1999 when Microsoft and AOL clashed over access to users of their respective IM systems.

IM has become popular primarily through services offered by Internet Service Providers (ISPs) to computer users at home. Having discovered the value of using IM to contact remote people from home, users began employing IM at work, where more and more teams are distributed across different sites. The popular press has noted this migration in IM use from home to work, and some research projects have begun to explore the use of IM-like capabilities in the workplace. Early experience with IM at work suggests that some of the advantages of IM, such as the immediacy of contact, might introduce too many unwelcome distractions at work.

What is Instant Messaging?

Instant messaging made its big splash in 1996. Mirabilis, an Israeli startup, began distributing its real-time chat client ICQ through the Web for free. People all over the globe were able to communicate in near real-time over the Internet, forgoing the e-mail lag as well as expensive long-distance phone calls.

ICQ wasn't the first online chat client, but it was the first one that was completely free to anyone who wanted it. At the time, America Online had offered its instant messaging program (with its well known "buddy list") only to subscribers. Prompted by ICQ's mass appeal and usage, AOL released a free instant messenger to the general public, allowing AOL users to chat with registered AOL Instant Messenger (AIM) users via their buddy lists. AOL later acquired Mirabilis, effectively eliminating a major competitor.

Since the joining of the two companies, in 1998, the market for instant messaging widgets has exploded. While most of these tools are not compatible and cannot talk to one another, a few clients allow users to chat across platforms, including the infant Imici instant messenger. AIM and ICQ are only the beginning, and today's users have a myriad of choices. MSN Messenger and others continue to grow and

acquire new customers as more people give up the ringing of the telephone for the "pinging" of the Internet.

A Study of IM Use in the Workplace

No longer just a tool of the idle masses exchanging rumors and recipes, IM applications have encroached into the working world, where professionals swap industry information, gossip, and expertise in the blink of an eye. Instead of traipsing down the hall, making an abrupt phone call, or waiting for an e-mailed response, employees can communicate with one another via online text. Employees can "ping" each other questions and requests, speeding up reaction rate and increasing productivity. For employees working on location and supervisors stationed outside at home offices, IM is rapidly becoming the industry standard.

An observational study of the use of IM in the workplace was conducted, which identified some common patterns of use:

- Establishing contact—In the workplace, IM is often used to make initial contact, but the interaction often transitions to another communication channel (e.g., phone, face-to-face, e-mail).
- Parallel communication—IM is often used as a parallel channel in conjunction with the phone, especially among subsets of people in a teleconference. IM is also used to avoid interruptions with people who are on the phone.
- Lightweight communication—IM is often used for more lightweight, interactive, and expressive communications coinciding with other communication channels (e.g., e-mail, phone, face-to-face).

The study also revealed how concerned workplace users are about being interrupted and interrupting others when initiating contact. Some IM users found it less disruptive than the phone. But they found a small percentage of users who resisted using IM because of the distracting potential of having windows automatically pop-up on their computer desktops .♦

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