2011

Financial reporting fraud : a practical guide to detection and internal control

Charles R. Lundelius

Charles R. Lundelius Jr., CPA/ABV/CFF, has worked in forensic accounting for 20 years at Big Four and other international firms. His experience in accounting includes securities and investment management with an active practice in consulting and litigation services. In 2009, the Inspector General (IG) of the U.S. Securities and Exchange Commission (SEC) retained Mr. Lundelius and a team of his colleagues to assist in the investigation of the failure of the SEC to uncover Bernard Madoff's Ponzi scheme, and his findings are cited in the IG's report of August 31, 2009, as well as a separate report containing recommendations for changes at the SEC.

Financial Fraud in the World of IFRSs

Inside this book, you will find the knowledge necessary to minimize fraud exposure for the CPA, employer, and client. Principles-based International Financial Reporting Standards (IFRSs) may provide more discretion to management than the more detailed and rules-based U.S. GAAP. When operating on the edge of GAAP or IFRSs permissibility, internal controls are stretched heavily, and one mistake in a seemingly small area can result in significant and drastic consequences.

COSO's Fraudulent Financial Reporting analysis of U.S. public companies found that when it came to executing financial reporting fraud, the most common kinds of fraud methods were:

1. Fictitious revenues
2. Premature revenues
3. Understatement of expenses and liabilities
4. Overstatement of assets
5. Fictitious assets
6. Capitalized expenditures that should be expensed
7. Misappropriation of assets

This book examines the SEC's criteria for determining critical accounting policies and estimates, building upon the actual examples used in the SEC's proposed rules, and discusses the role of senior management during an investigation and in the prevention of financial reporting fraud.

029890

ISBN 978-0-87051-890-4

9 780870 518904

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Financial Reporting Fraud

Charles R. Lundelius Jr.

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A Practical Guide to Detection and Internal Control

Second Edition

Fully Updated With New Coverage of U.S. GAAP and IFRSs

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10660-359

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1 2 3 4 5 6 7 8 9 0 CS 0 9 8 7 6 5 4 3 2 1 0

ISBN: 978-0-87051-890-4

Publisher: Amy M. Stainken
Editor: Martin A. Censor, Esq.
Senior Managing Editor: Amy E. Krasnyanskaya
Project Manager: M. Donovan Scott
Cover Design Direction: David McCradden

Dedication

To my children, Alexandria, Christina and Trey, who taught me to look at things from a fresh perspective.

To my wife, Patricia, who taught me to persevere until I found the answer.

Preface

Ever since the collapse of the savings and loan industry in the 1980s, financial reporting fraud has been a topic of great discussion, not only among accountants but also among regulators, legislators and the general public. In a broader context, accounting fraud was one of the principal causes listed by plaintiffs in class action suits brought by shareholders against public companies over the last several decades.

And then came Enron. Over the period of late 2001 through the first half of 2002, with a succession of high-profile bankruptcies of large companies related to accounting fraud, which included Enron, Global Crossing and WorldCom, the world changed for accountants. The US Congress responded with the passage of the Sarbanes-Oxley Act of 2002 that imposed heightened corporate governance and internal control standards, and Congress restructured the accounting profession by placing supervision of audits of public companies in the hands of a government-appointed entity.

This book, a revised edition of the original published in 2003, is an attempt to address the fraud issue from the practical perspective, using illustrations and examples to explore fraud concepts, in addition to references to research findings and authoritative literature. The material cited in this book frequently focuses on findings of professionals and academicians studying fraud in publicly traded companies because financial information from those companies is readily available, but the lessons learned from those studies are equally applicable to non-public companies, no matter the size or the industry. Furthermore, the heightened standards of corporate governance imposed on public companies by Sarbanes-Oxley and related regulations will spread to private companies as lenders and capital providers insist on better governance. A Certified Public Accountant (CPA) working in today's post-Sarbanes-Oxley world should be well-versed in these issues, regardless of the type of company involved.

Today, CPAs also have to address the potential of financial reporting fraud in the context in international as well as US domestic standards. This book will look at the challenges posed by the convergence of US Generally Accepted Accounting Principles (US GAAP) with International Financial Reporting Standards (IFRS). Also, for this revised edition, a new chapter 14 will explore financial reporting fraud under US GAAP and IFRS and illustrate how what is fraud under one set of standards may not be fraud under another, and why.

Finally, CPAs are transitioning to the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) that incorporates FASB pronouncements into a new structure. This revised edition cites to the ASC except when discussion of the individual pronouncements, such as the timing of the promulgation of a specific Statement of Financial Accounting Standards, is appropriate.

This book is written for CPAs at an advanced level and as such does not provide extensive discussion of basic financial accounting standards or concepts. In fact, the entire book could be seen as a conversation between an audit manager or partner and a counterpart in forensic accounting. However, references to the ASC and other literature should quickly and easily guide anyone looking for more information.

Section 1 of the book, titled "The Problem," lays the foundation for financial reporting fraud issues encountered by CPAs today. Section 2, "The Fraud Battle," discusses academic findings relating to financial reporting fraud and the response by business organizations. The final Section 3, "The CPA's Fraud Battle," discusses those items on a firm's financial statements that appear to be especially vulnerable to fraud and concludes with a discussion of financial reporting fraud under IFRS and its implications for the future.

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About the Author

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Charles has worked in forensic accounting for twenty years at Big Four and other international firms. His experience in accounting includes securities and investment management with an active practice in consulting and litigation services. In 2009, the Inspector General (IG) of the US Securities and Exchange Commission (SEC) retained Mr. Lundelius and a team of his colleagues to assist in the investigation of the failure of the SEC to uncover Bernard Madoff's Ponzi scheme, and his findings are cited in the IG's report of August 31, 2009 as well as a separate report containing recommendations for changes at the SEC.

Mr. Lundelius has consulted and testified in the areas of securities market pricing, investment suitability, securities fraud, accounting fraud, and compliance and due diligence practices, among others. He has qualified as an expert witness in securities trading and valuations, damages, financial analysis, accounting, statistics, and econometrics, having testified in federal and state courts and before administrative hearing of the US Securities and Exchange Commission. Mr. Lundelius also served as a chief financial officer of a life and health insurance company and as an investment banker. For seven years, Mr. Lundelius served on the NASDAQ Listing Qualifications Panel, the hearing forum that determines which stocks trade on NASDAQ. Currently, Mr. Lundelius serves on both the Finance Committee and the Audit Committee for the Episcopal Diocese of Washington.

SECTION 1

The Problem

Chapter 1

The Nature of Financial Reporting Fraud

Financial reporting fraud involves the alteration of financial statement data, usually by a firm's management, to achieve a fraudulent result. These altered financial statements are the tools then used by a company's managers to obtain some reward. The reward may consist of direct compensation, such as receiving a bonus that otherwise would not be paid without using altered, incorrect financial data to embellish management's operating performance. On the other hand, the compensation may be less direct, in that managers avoid being fired for failing to achieve promised results. Compensation may also be indirect (for example, management may use fraudulent financial statements to raise additional capital that, in turn, allows a firm to expand and, presumably, enhance the value of shares held by management).

What Constitutes Financial Reporting Fraud?

What constitutes financial reporting fraud has been the subject of much debate because the lines between fraud and discretion are not always clear. It is easy to define fraud as a conscious effort by management to produce financial statements with materially wrong accounting data. It is almost as easy to identify as fraud misleading accounting entries that management cannot justify under any applicable accounting standards. However, fraudulent acts become less obvious when cloaked in the mantle of accounting standards that are incorrectly applied. For example, the applicable accounting standard for most financial reporting in the United States is generally accepted accounting principles (U.S. GAAP), and those principles may allow management some discretion about when to recognize revenue or expenses. To an even greater degree, less detailed International Financial Reporting Standards (IFRSs) may provide more discretion to management than the more detailed and specific U.S. GAAP. Management is free to take full advantage of that discretion, but in pushing accounting concepts to their limit, management must be especially careful not to overstep. When operating on the edge of U.S. GAAP or IFRSs permissibility, internal controls are stretched heavily, and one mistake in a seemingly small area can result in significant and drastic consequences.

Honorable people can debate the most appropriate use of a principle when looking at the gray or more broadly permissive areas of accounting standards. However, less-than-honorable people might make use of these gray areas to produce misleading financial statements. This practice is found most often in concert with other misleading applications of accounting standards.

Those who commit fraud almost always fail to discuss their misuse of accounting and reporting principles in the notes to financial statements. Although the accounting for a certain transaction may appear to be supported by applicable literature, failure to disclose so as not to make the financial statements misleading takes the reporting entity out of compliance. Without knowledge of the impact of gray-area judgments in the preparation of financial statements, unsuspecting readers may mistakenly assume that revenues and expenses were accrued in a manner consistent with prior financial statements when, in fact, they were not. The end result may be that continuing operations appear to be profitable, although, in reality, there may be serious problems that the misuse of gray areas can cover up for a short period of time.

As with proving any type of fraud, one must generally show that there was *scienter*, meaning that the perpetrator knew that his or her actions were designed to mislead. For purposes of this book, a perpetrator with scienter—that is, a perpetrator who intends to use incorrect financial statements to mislead—will be referred to as a *fraudster*. Thus, when accounting decisions purportedly in conformity with U.S. GAAP or IFRSs produce financial statements intentionally designed (with scienter) to mislead the reader, those decisions cross the line into fraud.

Legal and Regulatory Guidance and Standards

Numerous sources exist for guidance on the nature and standards to establish the existence of financial reporting fraud. These sources help the CPA determine fraud, where to look for it, and who is responsible.

The Securities and Exchange Commission's Definition of *Fraud*

The principal concepts that govern fraud are codified in the U.S. securities laws and regulations, especially Securities and Exchange Commission (SEC) Rule 10b-5 that states

> [i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> a. To employ any device, scheme, or artifice to defraud,
> b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Public companies that list their stock to trade on U.S. exchanges must conform their reporting to U.S. GAAP (or IFRSs, which is allowed for certain foreign companies) and the rules and regulations promulgated by the SEC under U.S. securities laws. (Similar rules exist for companies that are listed on foreign exchanges; the European Union, for example, requires listed companies to report financial statements prepared in conformity with IFRSs.) The SEC drew heavily on U.S. accounting and auditing literature when it addressed the issue of accounting gray areas for materiality and other issues, and those standards provide substantial guidance to determine financial reporting fraud not only for publicly traded companies but also for all firms issuing financial statements in conformity with either U.S. GAAP or IFRSs.

Key Fraud Laws and Definitions

In addition to SEC Rule 10b-5, several other important laws and accounting statements guide the CPA in matters dealing with fraud.

The Foreign Corrupt Practices Act of 1977

One decades-old law that still carries significant weight today is the Foreign Corrupt Practices Act of 1977 (FCPA). This legislation, well known for cracking down on bribery of foreign businesses and officials, codified the requirement that all public companies maintain adequate internal controls. FCPA 78m states that the public company shall

> (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of issuer; and
> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
> (i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary ... to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements...

Management, therefore, had to take responsibility for the firm's financial statements and establish internal controls that ensured transactions were entered in accordance with management's instructions. Further, management had to prepare its financial statements in accordance with U.S. GAAP or other criteria, such as regulatory accounting for regulated industries. The FCPA held management accountable if fraud existed in the financial statements.

Federal Sentencing Guidelines

Another area of law, contained in the *Federal Sentencing Guidelines Manual (FSGM)* established by the U.S. Sentencing Commission, addresses the steps a company may take to mitigate criminal penalties if the company is ever found to have violated U.S. law. Those steps include establishing policies and procedures designed to implement an "effective compliance and ethics program" that would affect the culpability score calculated under the guidelines, as well as the conditions of a firm's probation. The *FSGM* requires that a company "exercise due diligence to prevent and detect criminal conduct" and that the firm would "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." The *FSGM* is quite detailed and provides a useful guide to the CPA desiring to implement an effective ethics program. The guidelines explain these concepts in Section 8B2.1, as follows:

(b) Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law ... minimally require the following:

(1) The organization shall establish standards and procedures to prevent and detect criminal conduct.

(2) (A) The organization's governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.

(B) High-level personnel of the organization shall ensure that the organization has an effective compliance and ethics program, as described in this guideline. Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program.

(C) Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.

(3) The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program.

(4) (A) The organization shall take reasonable steps to communicate periodically and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program, to the individuals referred to in subdivision (B) by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities.

(B) The individuals referred to in subdivision (A) are the members of the governing authority, high-level personnel, substantial authority personnel, the organization's employees, and, as appropriate, the organization's agents.

(5) The organization shall take reasonable steps—

(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;

(B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and

(C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

(6) The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.

(7) After criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.

(c) In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process.

Although these guidelines are designed to help judicial and law enforcement personnel evaluate the extent to which a company that has violated legal standards is willing to change, the guidelines provide a template for any firm that wishes to establish a program to address ethics and compliance. Such a program that involves all levels of management, as described in the preceding paragraph (b), is very useful in setting a proper tone at the top, a term that is discussed in greater detail in chapter 7.

However, even though the monitoring requirements of the *FSGM*, described in the preceding paragraph (c), existed for many years, many companies had been slow to implement any such reporting system until the enactment of the Sarbanes-Oxley Act of 2002 (see subsequent discussion) and other post-Enron reforms. Only as more recent legislation and regulations imposed greater requirements on corporate audit committees and boards of directors have companies rushed to install the fraud reporting hotlines and other reporting systems envisioned in the *FSGM*.

From the CPA's perspective if a company not under investigation by law or securities enforcement authorities implements the ethics and compliance provisions of the *FSGM*, that company and its management can hold up these actions as evidence of intent to prevent fraud. When the CPA is looking at an organization's seriousness about fighting fraud, a clear indicator is whether the organization has implemented the preceding steps.

Statement on Auditing Standards No. 53

In 1989, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1). This statement set out the basis for distinguishing the difference between fraud and honest error. Referring to accounting fraud as *irregularities*, SAS No. 53 stated

> [t]he term *irregularities* refers to *intentional* misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called *management fraud*, and misappropriation of assets, sometimes called *defalcations*. Irregularities may involve acts such as the following:
>
> - Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
> - Misrepresentation or intentional omission of events, transactions, or other significant information
> - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

Fraud had the element of intent that resulted in manipulation of financial statements, misrepresentation of transactions, or misapplication of accounting principles.

SAS No. 82

By 1997, the ASB had issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), which replaced SAS No. 53 but essentially retained the SAS No. 53 definition of *fraud* and added the concept of how fraud affects financial statement users. SAS No. 82 used the term *intentional misstatement* to characterize fraud, as follows: "*Misstatements arising from fraudulent financial reporting* are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users."

Now, in addition to the presence of management intent, *fraud's* definition was expanded to include its purpose, which is to deceive the user.

SAS No. 82 also provided a list of 25 fraud risk factors—that is, red flags—to guide auditors in assessing risk and planning for an audit. The statement allocated the 25 red flags among three broad categories:

1. Management characteristics and influence over the control environment
2. Industry conditions
3. Operating characteristics and financial stability

Examples of red flags included aggressive or unrealistic forecasts, ineffective communication and support of entity values or ethics, and domineering management behavior to attempt to influence the audit's scope.

Several years after the issuance of SAS No. 82, Barbara A. Apostolou, John M. Hassell, Sally A. Webber, and Glenn E. Sumners conducted research[1] that evaluated the weight placed by 140 external and internal auditors on each of the 3 categories and on the red flags in each category. The researchers found that auditors had some fairly uniform feelings about circumstances most conducive to finding financial reporting fraud:

> The aggregate decision model indicates that 58.2 percent of the total possible 100.0 percent decision weight is associated with the group of red flags dealing with management characteristics and influence over the control environment. Operating and financial stability characteristics were associated with 27.4 percent, while industry conditions red flags were associated with 14.4 percent of the total decision weight. Thus, red flags associated with management characteristics and influence over the control environment were rated about twice as important as operating and financial stability characteristics and about four times as important as industry conditions red flags. The three single-most important red flags, which account for almost 40 percent of the total decision weight, were all within the management characteristics category: (1) known history of securities law violations (14.6 percent), (2) significant compensation tied to aggressive accounting practices (12.9 percent), and (3) management's failure to display appropriate attitude about internal control (12.6 percent).

Management characteristics and the control environment clearly stood out among auditors as the most important indicators of potential fraud. Within that category, the red flags of history of violations, compensation tied to accounting, and lack of interest in internal controls led the list. Subsequent chapters of this book cover management characteristics and internal controls in greater detail.

SAS No. 99

The ASB continued to refine its auditing guidance with regard to fraud and in 2002 released a new standard, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to supersede SAS No. 82. The new standard has a more extensive list of red flags organized into categories that look at (1) the incentives and

[1] Apostolou, B.A. et al., "The Relative Importance of Management Fraud Risk Factors," *Behavioral Research in Accounting* 13, no. 1 (January 2001).

pressures on management to commit fraud, (2) opportunities to commit fraud, and (3) the attitudes and rationalizations found among those who commit fraud. See box 1-1 for a list of risk factors when fraudulent financial reporting results in misstatements.

Box 1-1: *Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting*

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations and an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

c. Information available indicates that management's or those charged with governance's personal financial situation is threatened by the entity's financial performance arising from the following:
- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow*
- Personal guarantees of debts of the entity

d. There is excessive pressure on management or operating personnel to meet financial targets set up by those charged with governance or management, including sales or profitability incentive goals.

Box 1-1: *Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting*

Opportunities

a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

b. There is ineffective monitoring of management as a result of the following:
- Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
- Ineffective oversight over the financial reporting process and internal control by those charged with governance

c. There is a complex or unstable organizational structure, as evidenced by the following:
- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, counsel, or board members

d. Internal control components are deficient as a result of the following:
- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving significant deficiencies or material weaknesses in internal control

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by those charged with governan-ace, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

(continued)

Box 1-1: *Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting (continued)*

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known significant deficiencies or material weaknesses in internal control on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

*Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

Reprinted from Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit *(AICPA,* Professional Standards*, vol. 1, AU sec. 316).*

When looking for early warning indicators, the CPA should first focus attention on the incentives and motives for fraud, then move on to opportunities and rationalizations. When, for instance, in the midst of well-known industry problems, a firm in that industry provides guidance to securities analysts that earnings will not be affected, a red flag emerges. Upon further investigation, the CPA may determine that management has another incentive in that the firm's compensation plan awards bonuses based on accounting results. Then, there may be opportunity to manipulate financial results because key senior managers dominate a fairly green and inexperienced staff that would not likely question management's decisions.

Finally, management would rationalize the use of fraudulent accounting because it enhances the value of company stock.

This book examines incentives and motives in some detail, and through the use of examples and illustrations, it looks at opportunities and rationalizations, as well.

Elimination of the Quantitative Materiality Loophole

Qualitative Materiality

With the publication of SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality*, in 1999, the SEC staff made clear that fraudulent accounting entries known to senior management could not be left unadjusted if they were deemed "immaterial" using some mechanical, quantitative standard, such as a percentage of net income. Relying purely on a quantitative basis, which was a common practice before the publication of SAB No. 99, was no longer acceptable. With the publication of SAB No. 99, qualitative materiality clearly took first position when the SEC staff stated, "Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." Therefore, any item that could alter a reader's perception of the financial condition of a company could be considered material. (Chapter 3 provides further analysis of materiality from the perspective of the users of financial statements, and the entire text of SAB No. 99 is found in appendix B found at the end of this book.)

The SEC staff provided examples, which are summarized in box 1-2.

Box 1-2: *SEC Example of Qualitative Misstatements*

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are—

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate [footnote omitted]
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

The following illustrates the first bullet point in box 1-2. Suppose management legitimately had to book an estimate of a patent asset's value when it was acquired (along with some other assets that were equally hard to value). Later in the reporting period, as the patented technology was licensed, the value of the patent became clearer, and that value was less than the originally booked amount. If the difference between the original and correct value was less than the firm's quantitative materiality threshold (for example, 5 percent of assets), then, applying just a quantitative standard, management would be able to argue that no adjustment was required. SAB No. 99 most likely would require management to make the adjustment because a more precise value is obtainable.

Likewise, when looking at income statement items, the SEC staff viewed the practice of indulging fraudulent and clearly erroneous entries up to some arbitrary percentage limit as a license for management to mislead:

> The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

Undoubtedly, auditors would continue to use quantitative standards when planning an audit, and SAB No. 99 does not require correction of "small misstatements" if correction requires "major expenditures." However, when examining financial statement accounts, in most cases, detected fraudulent intentional misstatements would be deemed material, according to SAB No. 99. Although SAB No. 99 is just a staff position and not approved by the SEC Commissioners, it's issuance effectively ended any loophole that fraudsters may have had before the issuance of SAB No. 99 to rely purely on a mechanical application of quantitative materiality as a means of justifying fraudulent entries.

Quantitative Materiality

In addition to imposing qualitative standards for materiality, the SEC pursued other steps to lower the triggers for quantitative materiality. In regards to *W.R. Grace & Co.*,[2] Grace's management set up and used reserves (called "cookie jar reserves"; see chapter 3) to manage the reported earnings of its principal health care subsidiary, National Medical Care, Inc. (NMC). In 1991 and 1992, NMC earned profits in excess of targets given to securities analysts, and NMC took the excess profits to a reserve account that had no stated purpose. In 1993 and 1994, NMC's actual profits were under the announced targets, so management drew down on the reserve to increase reported earnings. This technique is called earnings smoothing, and it is done to show consistent growth over several reporting periods (the rationale for smoothing earnings is discussed in detail in chapter 3). Grace's outside auditors knew about the reserve, recognized that it violated U.S. GAAP (see chapter 11 for a discussion of reserve accounting), and proposed adjusting entries. Grace's management refused to

[2] As cited in Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Release No. 1141 (June 30, 1999).

make the adjustments, and the auditors passed on the adjustments because, when looked at from the perspective of Grace's consolidated financial statements, the NMC subsidiary adjustments did not appear to be material.

The SEC disagreed. Grace's management had focused the attention of securities analysts on the performance of NMC and believed that NMC's perceived steady, consistent growth in earnings was important enough to Grace's stock value that management was justified in using reserves to manage NMC's earnings. In the SEC's decisions issued in this matter, the SEC bootstrapped materiality from Grace's Health Care Group, mostly consisting of NMC, to the overall company:

> ... the inclusion of the excess reserves in the Health Care Group segment information for the period 1991 through 1994 resulted in a material misstatement of segment information which, in turn, was material to Grace's consolidated financial statements taken as a whole for one or more periods during the relevant period.

In other words, because NMC was material to the Health Care Group and the Health Care Group was material to Grace, improper use of reserves to manage NMC earnings was material to Grace. Setting aside the fact that the reserve account itself would fail the qualitative materiality test because it was not set up in accordance with U.S. GAAP, the quantitative materiality test was lowered from the consolidated company level down to the segment level and even further to the level of a specific subsidiary in *Grace*. In the SEC's view, if management touts the performance of a specific subsidiary and then manages its earnings, *Grace* would indicate quantitative materiality at the subsidiary level.

Sarbanes-Oxley Act of 2002

Recordkeeping and Verification

When accounting frauds were tied to the collapse of Enron Corp., Global Crossing Ltd., and WorldCom, all occurring within the few months from December 2001 to June 2002, Congress reacted rapidly by passing the Sarbanes-Oxley Act of 2002 (SOX), which was signed by the president on July 30, 2002. SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee the audit and auditors of public companies (referred to as *issuers* in the act because those companies issue shares that are publicly traded).

Among the duties of the PCAOB, Congress wanted the newly formed entity to "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers."[3] With regard to auditing, quality control, and ethics, Congress mandated that auditors describe in each audit report the testing of the internal control structure and the procedures used by the company to implement those controls. Specifically, SOX states that the audit report must present

I. the findings of the auditor from such testing;

II. an evaluation of whether such internal control structure and procedures—

[3] Section 101(c)(2) of the Sarbanes-Oxley Act of 2002 (the act).

(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

III. a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.[4]

Thus, with SOX, the recordkeeping requirements of the FCPA are set out in greater detail, and the auditors are charged with testing and reporting on the adequacy of controls relating to the maintenance of those records. Auditors are also required to report material weaknesses or "any material noncompliance" relating to internal controls. Although one could argue that these steps are already required under U.S. generally accepted auditing standards, the requirements for these procedures now carry the force (and enhanced penalties under the act) of federal law.

Internal Control Report

In addition, SOX Section 404 of required management to submit to the SEC an internal control report with the company's annually filed financial statements and disclosures. That internal control report would

1. state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
2. contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.[5]

In addition to the previously described auditor's evaluation of internal controls under Section 103 of the act, under Section 404(b), outside auditors are required to "attest to, and report on" management's assessment of company internal controls, as well. To perform that assessment, the PCAOB promulgated auditing standards, first as Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules,* Auditing Standards), which for audits of fiscal years ending on or after November 15, 2007, was superseded by Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). These standards, especially Auditing Standard No. 5, provide useful guidance to CPAs for the assessment of internal controls. Specifically, paragraph 14 of Auditing Standard No. 5 states that

[4] SOX Section 103(a)(2)(A)(iii).

[5] SOX Section 404(a).

the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include—

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

Chapter 3 of this book provides examples of the preceding points by looking at major fraud-prone issues, such as loss contingencies, cost shifting, and revenue recognition, to show how controls were overridden or did not exist and how the CPA can detect the problem.

Audit Committee Requirements

Most noteworthy are the requirements in SOX relating to audit committees. The *audit committee* is defined as

A. a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

B. if no such committee exists with respect to an issuer, the entire board of directors of the issuer.[6]

At least one member of the audit committee must be a financial expert (or the company must disclose why it does not have such an expert). The *financial expert* is a person who has

1. an understanding of generally accepted accounting principles and financial statements;
2. experience in—
   A. the preparation or auditing of financial statements of generally comparable issuers; and
   B. the application of such principles in connection with the accounting for estimates, accruals, and reserves;
3. experience with internal accounting controls; and
4. an understanding of audit committee functions.[7]

SOX Section 202 requires the audit committee to approve all audit (and nonaudit) services, effectively giving the audit committee the power to hire and fire auditors. Section 204 of the act spells out the minimum content of reports that the auditor must provide to the audit committee, which consist of

[6] SOX Section 2(a)(3).

[7] SOX Section 407(b).

(1) all critical accounting policies and practices to be used;

(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

In short, SOX requires identification and discussion of the treatment of critical accounting policies, including any differences of opinion (alternative treatments) by and among company management and its outside auditors. Congress wanted to encourage a frank discussion among the audit committee, company management, and outside auditors of the use of accounting principles with material impact that were subject to different interpretations. However, in no place does the act define *critical accounting policies*. For help with the term, one must look to SEC pronouncements, in particular the proposed rules contained in Release Nos. 33-8098 and 34-45907, which set out the SEC's criteria for determining critical accounting policies and estimates. This book will examine those criteria in detail, building upon the actual examples used in the SEC's proposed rules.[8]

Clearly, the act places tremendous reliance on the audit committee as the last line of defense within the firm against financial fraud. If, as Congress intended, management and auditors make full disclosure to the audit committee of the material accounting policies most subject to differing interpretation, the audit committee becomes the final arbiter of any judgment calls before release of the financial statements.

The act also makes clear that the audit committee is not the only party responsible for overseeing the audit process and the adequacy of internal controls. Just to make sure that senior management understands its responsibilities, Section 302 of the act requires the principal executive officer and the principal financial officer to certify that the financial statements are fairly presented and that

4. the signing officers—
   A. are responsible for establishing and maintaining internal controls;
   B. have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
   C. have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
   D. have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

[8] Certain chapters draw upon the hypothetical assumptions presented in the SEC's examples. To illustrate specific types of financial reporting fraud, additional assumptions are added to the SEC examples. Subsequently, the SEC-recommended disclosures to the audit committee are presented to illustrate how those disclosures would have increased the likelihood of fraud detection. The examples, as modified for purposes of this book, reflect the opinions of the author, not the SEC. The reader is encouraged to read the SEC's proposed rules in their entirety, which are included in appendix A found at the end of this book.

5. the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—
   A. all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
   B. any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
6. the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.[9]

By requiring that principal officers certify they have disclosed material internal control weaknesses to the auditor and the audit committee, Congress has emphasized the officers' role in communicating material weaknesses and forced those officers to make a public declaration (subject to significant penalties for perjury) to that effect. In summary, Congress has placed responsibility for internal controls squarely on the shoulders of senior management. This book will also discuss in detail the role of senior management in the act and prevention of financial reporting fraud.

Although SOX principally applies to public companies, the act and related reform measures have set the tone for corporate governance in private companies, as well. Concerns about financial reporting fraud among those who provide capital to private entities, such as banks and venture capitalists, will drive implementation of public company standards into the nonpublic sectors. Indeed, a venture capitalist frequently looks to take private companies public, which is the preferred exit strategy to realize return on investment, and it is advisable that private companies in a venture capitalist's portfolio preparing to go public become fully compliant with the act because the window for initial public offerings in the primary capital markets opens and closes without much warning. Therefore, whether the CPA works with public or nonpublic entities, knowledge of all the relevant standards is essential.

Financial Fraud in the World of IFRSs

Effective March 4, 2008, the SEC allowed foreign private issuers to meet U.S. filing requirements using IFRSs financial statements without having to reconcile those financial statements to U.S. GAAP. This SEC decision opened the door to the use of IFRSs in the United States and laid the groundwork for the roadmap later adopted by the SEC that would require the use of IFRSs in place of U.S. GAAP for more U.S. registrants in future years. Although the roadmap sets out tests and requirements before the SEC mandates conversion to IFRSs, it is becoming ever more likely that U.S. financial fraud examiners will encounter IFRSs, if they haven't already.

[9] SOX section 302(a).

IFRSs are less detailed in their guidance than U.S. GAAP in that their standard setter, the International Accounting Standards Board (IASB), chooses to use simplified, broad-based standards in place of more detailed prescriptions whenever possible. Simplicity is one of the IASB's guiding principles, and the IASB will succeed in maintaining simplicity if it can resist pressure to promulgate detailed guidance for specific circumstances. IFRSs will purposely provide less detailed guidance to accountants, allowing for a wider range of presumably equally valid interpretations of a given standard. In other words, two separate reporting entities in the same industry could more readily reach different conclusions on the same standard and report different financial results under IFRSs. The impact of such latitude on financial fraud will be significant, and the chapters that follow will discuss IFRSs to the extent possible. In addition, chapter 14 will provide examples of IFRSs-related fraud issues and discuss what lies ahead with IFRSs implementation.

Research on Fraud

Research carried out in 1998 and 1999 for the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and published in COSO's *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, found that when it came to executing financial reporting fraud, the most common kinds of fraud methods were the following:

1. Fictitious revenues
2. Premature revenues
3. Understatement of expenses and liabilities
4. Overstatement of assets
5. Fictitious assets
6. Capitalized expenditures that should be expensed
7. Misappropriation of assets

Chapter 7 covers these methods in more detail; however, the preceding methods tend to fall into the following three broad categories:

1. Earnings manipulation
2. Earnings management[10]
3. Balance sheet manipulation

These three topics will be covered in each of the next three chapters.

[10] No distinction is made in accounting literature between earnings management and earnings manipulation. However, the author makes this distinction for ease in explaining different concepts of financial reporting fraud affecting the income statement.

Chapter 2

Earnings Manipulation

Earnings manipulation is the direct alteration of accounting data for the purpose of fraudulently changing reported income. For example, booking a sale that clearly does not meet the requirements for revenue recognition inappropriately increases revenues. Conversely, capitalizing marketing costs as an asset, contrary to guidance in accounting literature, inappropriately decreases current period expenses. Notice also that both examples affect the balance sheet, as well; recognizing fictitious sales inflates accounts receivable, and deferring marketing expenses creates some type of amortizable asset. However, because the primary intent of these manipulations is to increase earnings rather than create assets, these practices are classified as earnings manipulation.

Although there is no distinction in accounting literature between earnings management and earnings manipulation, to better explain the impact of financial reporting fraud on the income statement, earnings management is treated as a subset of earnings manipulation and is discussed separately in chapter 3. Earnings management generally involves the manipulation of a series of earnings data to achieve a perception of profitability or growth in earnings, or both, as illustrated in the *W.R. Grace & Co.* case,[1] discussed in chapter 1. The focus of this chapter is on the type of earnings manipulation designed to give a one-shot boost to earnings.

[1] Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Release No. 1141 (June 30, 1999).

Research has shed much light on the motives for earnings manipulation. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored research published in 1999 (the COSO report) that examined Securities and Exchange Commission (SEC) enforcement actions for the period 1987–97 (see chapter 7 for a more complete discussion of the findings). The COSO report found that motives for financial reporting fraud generally fell into the following three broad categories. Firms or individuals attempted to

1. increase the stock price to increase the benefits of insider trading and obtain higher cash proceeds when issuing new securities.
2. obtain national stock exchange listing status or maintain minimum exchange listing requirements to avoid delisting.
3. avoid reporting a pretax loss and bolster other financial results.

These three areas will be examined in detail in the following sections: "Earnings Improvement," "New Securities Price Enhancement," and "Exchange Listing."

Earnings Improvement

Stock Compensation and Insider Trading

The motive to improve earnings usually works in concert with other motives—rarely does it stand alone. For example, one of the most common ancillary motives for earnings manipulation may be found in a firm's management compensation plan. Such plans generally reward management based on reported earnings performance and, therefore, set the stage for potential manipulation. To compound the motive for fraud, the form of compensation paid to management for performing well is not just cash; stock (or some equivalent, such as options, stock appreciation rights, or deferred compensation plans) is frequently a large component of compensation, which increases in value if senior managers can fraudulently increase reported earnings before selling their shares.

Over the last several decades, management consultants, compensation committees, and academicians advocated the use of stock as a component of compensation to align the interests of management with those of the firm's shareholders. Without significant share ownership, the advocates claimed, management was free to pursue its own self-interests, granting to itself ever-higher cash salaries, benefits, and perquisites, and in a period of placid boards stocked with friends of management, the only recourse for unhappy shareholders was to sell their shares. The cost of paying for management was referred to as *agency cost* because management served as the agent for shareholders, and management was empowered to run the company on their behalf. Agency cost was presumably higher if management did not have significant equity ownership—hence, the push for equity-based compensation plans.

Once management received stock (or equivalent) awards under the compensation plan, managers immediately began to look for opportunities to sell some or all of their shares. The reasons behind managers' desire to dispose of their equity varied but most had to do with lack of diversification. Typically, a manager compensated with stock quickly finds his or her personal portfolio dominated with employer shares. Further, given that the source of the manager's cash earnings is the same source as the major securities holding in his or her portfolio, a significant amount of financial security for that manager rests in just one firm: the manager's employer. Therefore, the manager has every incentive to diversify as soon as possible.

However, for senior management who may have significant portions of their net worth reflected in employer shares and who may also have the ability to manipulate earnings (due to lax internal controls, for example), a tremendous incentive exists to maximize net worth by fraudulently increasing reported earnings to increase share price long enough to allow them to dispose of their shares. Due to the price/earnings (P/E) multiplier used to value securities, a small, fraudulent increase in earnings per share (EPS) may translate into a much greater increase in stock price on the order of 15–40 times, or more. When a senior executive is trying to liquidate large numbers of shares, such an increase is meaningful. If the fraudulent increase in reported earnings helps meet stock analysts' expectations or changes negative earnings to positive, the impact on share price may be much greater. During the late 1990's Internet boom market, then-SEC Chairman Arthur Levitt observed that companies missing the consensus estimate among securities analysts of EPS by as little as one penny per share saw their stock price hammered because investors sold immediately after earnings were announced. Senior executives wishing to avoid such a drop in share price would push hard to find the extra penny, probably through some type of manipulation.

Stock compensation provides a powerful motivator for income statement manipulation and subsequent illegal insider trading. A manager who is heavily compensated in stock will need to sell to diversify. If the stock is volatile, such that small changes in reported earnings have a significant impact on market price, and if actual earnings do not appear to be meeting expectations, the manager will come under pressure to manipulate earnings from the perspective of personal net worth and from colleagues in similar situations. If the manager gives in to the pressure and then sells shares, that manager likely trades on material nonpublic information—information that the books are cooked—and is guilty of illegal insider trading.

Contingent Compensation

In addition to the drive to pay management in stock, compensation experts added the requirement that pay (whether cash or stock) be made contingent upon performance. This contingency was also designed to align management's interests with those of shareholders. Management compensation agreements, for instance, may require the achievement of some absolute level of net income or an increase in net income over some benchmark to trigger bonus payments. Also, to give the contingent compensation plan the power to motivate managers, consultants urge compensation committees to make bonuses a significant part of total compensation. The end result is that managers certainly are motivated to increase reported earnings, but some managers, faced with the prospect of seeing their compensation fall significantly if they fail to hit their goals, succumb to the temptation to manipulate earnings. Even though the compensation experts may have been correct and justified, in theory, to try to align management's interests with shareholders', they may have unwittingly set up strong motivators for financial reporting fraud. Certainly, incentive compensation is a valid concept, but it must be implemented with well-designed and rigorously enforced internal controls.

New Securities Price Enhancement

The discussion of stock and insider trading thus far has largely centered on the impact of earnings manipulation on shares trading in the secondary securities markets (that is, the trading of previously issued shares on the regulated exchanges and other markets). In contrast, the primary securities markets consist of that group of investors (principally institutions and investment banks) who purchase newly issued stock; those investors may then begin trading that stock in the secondary markets after shares are issued. The primary markets present yet another opportunity for financial statement fraud, especially earnings manipulation, because share values are usually a function of projected future income.

When most people think about newly issued securities, they think of initial public offerings (IPOs) of shares of companies that were not previously publicly traded. True, IPOs constitute a part of the primary securities markets but so do the sales of new shares by firms that already have other identical shares trading publicly. The latter are referred to as *seasoned equity offerings* (SEOs) because at the time of the sale of new shares, other seasoned outstanding shares are already trading. Both IPOs and SEOs present unique opportunities for fraudsters, but in either case, the fraudsters' objective is usually the same: to raise more capital than they could if they told the truth about their firm's financial condition. With the extra capital, the fraudsters can then award themselves larger compensation packages, acquire related entities at overvalued prices, or simply stay afloat longer while incurring operating losses.

IPOs

Companies preparing to go public are under intense pressure to clean up their books and, if actual results are insufficient, to enhance historical earnings to be published in the offering prospectus through fraudulent methods. For firms that were privately held for some period of years before the IPO, numerous fraud motives and methods exist. (Chapter 5 also covers the special pressures exerted on private firms by venture capitalists.) In the privately held environment, a firm's primary reporting responsibilities are to banks and tax authorities; shareholders and management are typically closely aligned (if not one and the same), making their reporting needs secondary. However, for public companies, the reporting priority shifts to shareholders, especially those not in management, who do not have access to financial information about the firm beyond its published financial statements.

As discussed in chapter 5, one area of greatest concern for potential fraud in private firms is related party transactions. If one company out of a group of related companies plans to go public, the expense sharing and revenue allocations among the related entities, done most likely for tax minimization, needs careful review, as well as thorough documentation. A tax fraud scheme probably has elements of financial fraud, as well, except the financial fraud may not be effectuated until other people (investors) begin to rely on those financial statements. For example, say that two related firms shared manufacturing plant facilities in a number of locations, but due to heavy development costs, one firm's marginal income tax rate was only 10 percent and the other firm's rate was 35 percent. Assume that when management, which was presumably the same for both firms, began to allocate rent expense for the shared facilities, management devised a fraudulent expense sharing arrangement that allocated deductions away from the firm with a low marginal tax rate to the firm incurring a higher marginal tax rate, based on incorrect space usage assumptions. That scheme would violate various provisions of the Internal Revenue Code.[2] However, should the low marginal rate firm later go public, its historical financial statements would not reflect an accurate share of its expenses; rent expense would be too low. An investor or investment banker relying on those financial statements to value the shares may underestimate future rent expense. The end result is financial reporting fraud arising from tax fraud and an overvaluation of the IPO shares.

IPOs present interesting challenges to CPAs in that a private company is moving into the public reporting environment. Ideally, the process occurs over a period of years as internal and external auditors prepare for the control reviews and certifications mandated by the Sarbanes-Oxley Act of 2002 and Public Company Accounting Oversight Board Auditing Standard 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), reviewed in chapter 1. This process typically requires extensive mapping of controls to identified risks, with procedures described to address each risk.

Hopefully, any deficiencies in controls are identified and corrected. However, because the company is new to public reporting requirements, a real possibility exists that not all risks would be identified, sometimes simply because company personnel may have overlooked a risk that went unidentified in prior years without anyone raising a question. Continuing with the preceding rent allocation example, related party risks would certainly be a part of the IPO company's control mapping matrix, and the mapping may even include a procedure to assess rent agreements between related parties for appropriateness of rent rates, expense pass-throughs, and other provisions. But, if the space usage allocation had been in place for several years and no one raised any issues, it may not appear on the matrix at all, and the fraud would continue undetected.

As the rent allocation example illustrates, when fraudsters move from the private to the public environment, their motives shift, in this case from tax evasion to financial reporting fraud. Also, fraud schemes hatched to defraud lenders and tax authorities when a company is private take on new dimensions when that company goes public. To serve as a deterrent, the securities laws impose strict liability standards on company management when a company goes public. IPO shares are registered under the Securities Act of 1933, and that act does not require proof of scienter (knowledge) on the part of management to establish a securities fraud claim. Therefore, if the financial statements filed with an IPO registration are wrong, there is no need for plaintiffs who lose money (or the SEC) to prove that management knew about the misstatements; plaintiffs need only establish that they were harmed. This standard of proof differs from cases involving fraud that occurs subsequent to the IPO while the stock is trading in the secondary market. Any such claim relating to post-IPO trading would be pursued under the Securities Exchange Act of 1934,[3] and that act does require proof of scienter on the part of management.

[2] See Revenue Procedure 2002-18 for a discussion of IRS-imposed reallocations used to correct such schemes.

[3] Commonly referred to as a *10b-5 claim* in reference to the antifraud rule promulgated under the Securities Exchange Act of 1934 and cited in chapter 1.

SEOs

SEOs are not immune from fraud, either. Academic research has found several curious events surrounding firms that issue new shares in an SEO. Michael Gombola, Hei Wai Lee, and Feng-Ying Liu cited research that found share prices declined only slightly (approximately 3 percent) after a firm announced an SEO.[4] Some price decline is expected because the firm is increasing its outstanding shares, thus diluting earnings, at least in the near term; in the long run, the firm hopes new capital provided in the SEO will provide additional earnings that compensate for, and eventually reverse, any near term dilution. Reviewing other research, Gambola, Lee, and Liu found that actual performance declined after an SEO did not meet expectations:

> Despite the price decline at the announcement, Loughran and Ritter (1995) show further substantial declines after the SEO announcement. Their findings suggest that to account fully for the post-offering stock price underperformance over a five-year horizon, the price decline accompanying the announcement should be as large as 44%. Their research indicates that the stock of firms offering seasoned equity remains substantially overvalued long after the announcement is made public. Similarly, McLaughlin, Safieddine, and Vasudevan (1996) show a significant decline in profitability during the three years following the announcement. This finding is also consistent with the hypothesis that firms offering seasoned equity issues are overpriced following the offering.[5]

Clearly, something is amiss. The market may be consistently overoptimistic, hoping for quicker, higher returns from the new capital infusion than actually occurs, or the share prices at the time of the announcement may be inflated by fraudulent financial statements. The latter possibility appears to be more probable because fraud would result in raising more capital that, in turn, could have been invested to produce earnings that the fraudsters hope would cover up the fraud in later periods. The following example illustrates how this is done:

Example Scenario

The Operating System Co., a U.S. publicly traded company, designs and sells software that enhances the data processing performance of mainframe computers. Operating System recently acquired, in a purchase transaction, the assets of Data Mover Corp., a firm that develops and distributes software designed to improve distributed processing capabilities through quicker data transfers. The transaction was financed by junk bonds placed with institutional investors. Operating System's management believed that Data Mover's product would complement their own and that because the target market for both products was the same (mainframe user), there was an opportunity to reduce redundancies in the combined sales forces and achieve a synergistic benefit from the acquisition. In other words, only one salesperson was now needed to call on an Operating System or Data Mover customer instead of two.

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[4] Gombola, Micahel, Hei Wai Lee, and Feng-Ying Liu, "Evidence of Selling by Managers After Seasoned Equity Offering Announcements," *Financial Management* 26, no. 3 (1997): 37–53.

[5] Ibid.

Operating System's CFO recognized that trimming the sales force could have potentially adverse consequences for some customer relationships, so she set up loss contingencies for possible early contract cancellations, write-offs of accounts receivable, and product discounts to accommodate unhappy customers. The loss contingencies were set up under a balance sheet account titled "Acquisition Reserves." The charge for these reserves went to goodwill (see chapter 11 for a discussion on setting up acquisition reserves).

Soon after the acquisition, Operating System decided to float an offering of new shares and secured, at the company's annual meeting, the approval of its shareholders to issue the shares. Proceeds from the offering, net of offering expenses and underwriters' fees, would be used to pay down the high interest rate acquisition debt. When Operating System's CFO contacted the firm's investment bankers who would manage the offering, the investment bankers noted that Operating System's stock price had slumped after the Data Mover acquisition because the market did not believe that synergies from the acquisition would be significant. "You're going to have to prove to the Street that you will indeed have synergies from this acquisition in your next quarterly filing, or we will have to discount the offering price severely," said the managing director of the investment banking firm. This put the CFO under significant pressure because she had assured senior management that she believed the price the new shares would fetch would be close to the current price of shares already trading on the market. Her pricing assumption was important because management did not want to see significant dilution.

The next quarterly filing with the SEC was due in two weeks; the quarter had ended one month earlier. The CFO had to think fast. She knew that in the weeks after the acquisition, senior sales managers decided to have Data Mover sales personnel pair up with Operating System salespeople to make joint calls on common customers to minimize customer defections to competitors. As a result of this executive decision, the hoped-for redundancy reductions were not showing up as quickly as planned. On the other hand, the joint sales calls had so far resulted in fewer unhappy customers, so the acquisition reserves went largely untapped, although it was still too early to tell whether they would be needed.

The CFO concluded that she could, in her words, "recharacterize" the acquisition reserves to include redundant sales salaries as an acquisition expense. Even though anticipated personnel terminations were accounted for in a separate charge, she rationalized that carrying the extra sales personnel on the payroll was an expense incurred in lieu of the expected losses from unhappy customers. The CFO instructed the controller to charge the redundant salaries to acquisition reserves instead of payroll expense. The controller, when later asked why he did not question the CFO's instruction, said that he believed that because the account title for the reserves was so broadly worded, "the acquisition reserves could be used for just about any acquisition-related expense that came up."

By running the expense for redundant personnel through the balance sheet account, the CFO was able to show a reduced payroll cost, compared with the combined payroll of both Operating System and Data Mover before the acquisition, in the quarterly income statement filed with the SEC. The investment bankers were pleased and priced the offering of new shares with only a small discount from quoted prices on shares already trading. As an added bonus, when the market saw that payroll cost had declined due to perceived synergies in the acquisition, the price of Operating System's stock increased, covering most of the underwriting costs of the seasoned equity offering.

Example Analysis

Although this example deals with loss contingencies, as discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805, *Business Combinations* (specifically FASB ASC 805-20-25), the facts here do not require much analysis in that area (however, see chapter 11 for a more detailed discussion of reserves). Essentially, the CFO attempts to justify debiting salary costs against reserves set up for other purposes, which violates U.S. generally accepted accounting principles; moreover, it is not likely that redundant salary costs would even qualify as a loss contingency. The fact that the account title is ambiguous is irrelevant; the stated purposes for the reserves were to absorb anticipated financial consequences of unhappy customers. The fact that management spent more money than originally planned to keep the customers happy does not allow the company to access those reserves.

Furthermore, to use the reserves to effectively hide salary expense to give the appearance of improved operating results is deceptive without adequate disclosure, which was pointedly missing in the preceding example. Materiality may not even be a workable defense in this situation. The amount of the payroll costs squirreled away in reserves may not have been large relative to overall net income, from the perspective of quantitative materiality, but the fact that investment bankers and their clients, the primary capital market investors, were closely observing payroll costs caused that payroll item to rise in importance. Using the *W.R. Grace & Co.* standard discussed in chapter 1, the SEC would likely assert that materiality should be judged against the increase in operating income caused by reclassifying some of the payroll costs. From the perspective of qualitative materiality, relying on SEC Staff Accounting Bulletin No. 99, *Materiality*, the SEC would likely go further to assert that any knowing violation of accounting standards, such as using reserves for reasons contrary to their original intent, is material, regardless of the amount.

Exchange Listing

Finally, earnings manipulation may help a company obtain or retain its listing on a stock exchange. The initial and continued listing requirements of many exchanges provide for some type of net income test. Although companies failing this test may qualify for initial or continued listing under other tests, such as overall market capitalization, companies whose share prices have declined sharply in a weak market may find net income manipulation to be their only hope.

For example, a company that desires to become listed to trade on the NASDAQ Stock Market may apply under its choice of several different listing standards, which vary depending upon which NASDAQ market the company hopes to be listed: the NASDAQ Global Select Market for firms with large market capitalization, the NASDAQ Global Market for firms with midsized market capitalization, and the NASDAQ Capital Market (formerly, the SmallCap Market), as summarized in appendix 1 at the end of this chapter. To become listed on the NASDAQ Global Select Market for the first time, a firm must meet at least one of three initial listing standards.

The first NASDAQ Global Select Market initial listing standard requires a firm desiring to be listed to have reported pretax earnings of at least \$11 million in aggregate over the last 3 prior fiscal years and pretax earnings of at least \$2.2 million in each of the 2 most recent fiscal years, with positive pretax earnings in the 3 prior fiscal years. For pretax earnings, listing requirements state that "NASDAQ will rely on a company's annual financial information as filed with the Securities and Exchange Commission (SEC) in the company's most recent periodic report and/or registration statement." Initial listing requirements for both the NASDAQ Global and Capital Markets also provide an option to qualify using either pretax or posttax earnings, though at lower levels and shorter time periods. Therefore, fraudsters target reported earnings if earnings would otherwise come up short of the listing requirements.

Other ways exist to obtain an initial listing without referring to earnings, but the alternatives are subject to manipulation, as well. For example, the second and third NASDAQ Global Select Market initial listing standards do not have an income requirement but do require that the firm demonstrates certain levels of market capitalization and revenue. Revenues can be manipulated through a number of schemes (see chapter 13). *Market capitalization*, which is the product of the listing firm's outstanding shares in each class of stock outstanding multiplied by the respective price per share for each class of stock, is also subject to manipulation through financial reporting fraud, though less directly. As will be illustrated subsequently, the trading price of a listed stock can be a function of reported EPS, and a fraudster can manipulate those reported earnings. Similar to market capitalization, many of the NASDAQ listing standards also refer to *market value of listed securities*, the product of those shares listed on an exchange multiplied by the price per share, and the *market value of publicly held shares* (MVPHS), the product of price per share multiplied by the number of shares in the hands of nonaffiliated public shareholders. The latter would exclude shares held by an officer, director, or 10 percent shareholder of a listing firm. Manipulating the reported EPS can affect NASDAQ's definition and use of *market capitalization, market value of listed securities*, and *market value of publicly held shares*. It is not surprising that the COSO report found exchange listing to be a significant objective of fraudsters.

Mathematical formulas help illustrate how fraudsters manipulate share prices to increase a firm's market capitalization to fraudulently obtain a NASDAQ listing. For example, assume the fraudsters were targeting MVPHS, which is a function of shares outstanding (in the hands of nonaffiliated shareholders) multiplied by the price per share. Price per share is a function of the P/E multiple applied to forecast EPS, and analysts typically forecast earnings beginning with historical earnings. Substituting historical, basic EPS in the place of forecast EPS for simplicity, the MVPHS equation becomes the following:

$$\boxed{\begin{array}{c}\text{MVPHS} = (\text{Total shares outstanding} - \text{Shares held by directors, officers,} \\ \text{and major shareholders}) \times \text{P/E}_{\text{historical}} \times \text{Basic EPS}_{\text{historical}}\end{array}}$$

EPS is a function of earnings; therefore, from the equation, it is clear to see that reported earnings are an important driver in this listing standard.

Manipulating EPS can affect other NASDAQ listing metrics, such as the minimum bid price required for initial and continued listing on all NASDAQ markets. *Bid price* is the inside (or highest) bid quoted at the end of a trading day for a given stock, and the listing standards require a minimum bid price of $1 to remain listed on any of the NASDAQ markets. Bid price, using historical earnings in the place of forecast earnings, is simply the last two terms of the previous equation:

$$\text{Bid price per share} = \text{P/E}_{\text{historical}} \times \text{Basic EPS}_{\text{historical}}$$

Other factors can affect the price of a share of stock from day to day, such as institutions or market makers purchasing or selling large blocks of stock, limited trading volume (liquidity) in the stock on a given day, and overall market movements. However, over the long run, the earnings metric is the key driver.

Therefore, given that reported earnings are either an explicit or implicit component of the listing standards, income statement manipulation to achieve or maintain listing on an exchange becomes an important tool for fraudsters.

Why is exchange listing so important? A delisted or unlisted firm can trade its shares on the Over-the-Counter Bulletin Board (OTCBB) market, assuming the firm is current with its filings with the SEC. The OTCBB is an electronic market within which shares are traded between brokerage firms on behalf of their customers. However, unlike the NASDAQ markets, no requirement exists that a firm traded on the OTCBB have a minimum number of market makers. *Market makers* are securities brokerages that meet certain requirements and have publicly stated to the market that they stand ready to make a market in a given security. As such, a market maker usually maintains an inventory of shares in the security to accommodate an investor who wishes to purchase some shares when, at that moment, no ready sellers are in the market. The market maker is obligated under the SEC's Firm Quote Rule to stand behind its quotes with the capability to fulfill an order at the quoted price and quantity. In this manner, the market maker helps maintain an orderly market by providing liquidity. Without a market maker, a purchaser who comes to the market wishing to buy shares may find that, absent a ready seller, he or she may have to place an order at a substantial premium over the last trade just to attract a seller into the market. On the flip side, a seller who shows up and is not lucky enough to encounter a buyer at that moment may have to part with his or her shares at a steep discount to attract a buyer. Therefore, liquidity is important, and market makers provide that liquidity.

How much is liquidity worth? According to some studies, quite a lot. The Center for Research in Security Prices (CRSP) at the University of Chicago provides an extensive database of returns on stock investments dating back to 1925 and is used in a wide range of academic and research studies. The CRSP database omits some securities returns after the stock is delisted, so two researchers, Tyler Shumway and Vince Warther, studied the impact of delisting on the last returns reported for securities immediately before delisting.[6] Their findings told users of the CRSP database that if a specific stock was delisted for failure to meet the minimum maintenance standards of the exchange and the CRSP did not have a delisting

[6] Shumway, Tyler and Vincent A. Warther, "The Delisting Bias in CRSP's Nasdaq Data and Its Implications for the Size Effect," *Journal of Finance* 54, no. 6 (1999): 2361–79.

return, a decrease of 30 percent from the last return while the stock was listed would be a reasonable estimate of the impact of delisting if the stock had been traded on either the New York Stock Exchange or the American Stock Exchange. For stocks that had been traded on NASDAQ, the impact of delisting, according to the researchers, was an enormous decline of 55 percent; more than half the value of a NASDAQ firm's common stock would likely be lost if the stock is delisted.

Valuation studies of shares issued by public companies that are restricted (that is, not allowed to be traded like the companies' publicly registered shares) provide some additional guidance. Those studies compare the price of a given company's publicly traded securities with the price of restricted shares issued by the same company to determine the discount for lack of liquidity. Restricted shares may only be traded under strict time and weekly volume limits set by securities regulations.[7] Although OTCBB shares remain freely tradable, the market in which they trade is much less liquid than those exchanges that require a minimum number of market makers to support every listed stock; therefore, the OTCBB liquidity is in some ways similar to restricted stock liquidity. The studies found that the restrictions produced, on average, a 20 percent to 40 percent discount from the price of the publicly traded shares. Even at the low end, a 20 percent hit to a firm's market capitalization can be a serious blow and provides ample incentive for fraudsters to manipulate income to keep their firms listed on established markets.

Conclusion

Three primary motives for earnings manipulation cited in the COSO report (earnings improvement, new securities price enhancement, and exchange listing) provide a starting point for CPAs to identify issues that may lead to earnings manipulation. From the viewpoint of fraud prevention, the three areas signal the need for better internal controls—controls that address specific issues raised by each motive and controls that are rigorously enforced once in place.

For example, a firm with a management compensation plan tied to reported earnings may wish to carve certain internal accounting personnel out of the plan so their compensation is not tied to earnings. Under this internal control recommendation, personnel who have responsibility for signing off on earnings would not have a compensation-related motive to manipulate those earnings. To make sure that this internal control step functions as planned, the firm will need to establish a separate reporting chain so that, for compensation matters at least, those personnel do not report to managers in the incentive plan. A reporting line from the accounting personnel to the compensation committee of the board of directors may be appropriate, for example. In this recommendation, the internal controls address the fraud motives typically found in incentive compensation plans and are designed to rigorously enforce accounting standards by using a separate reporting line to a committee of the board.

[7] See SEC Rule 144.

Appendix 1
NASDAQ Listing Standards

The following tables summarize the initial and continued listing standards of the NASDAQ markets. NASDAQ uses a multitier market system that differentiates between more mature companies and smaller, usually younger, companies. The first set of tables summarize the listing standards for the NASDAQ Global Select Market, the market for the largest companies; the second set of tables summarize the listing standards for the NASDAQ Global Market, a market for midsized companies; the third set of tables summarize listing standards for the NASDAQ Capital Market, a market for smaller companies. Among the various listing standards, the requirements for earnings, bid price, and market value of publicly held shares tend to be the principal, though not exclusive, targets of fraudsters using earnings manipulation. Corporate governance requirements exist for all companies listed on any of the markets, and those standards include requirements for audit committees, which are discussed in more detail in chapters 7–8.

NASDAQ Global Select Market

Initial Listing

Companies must meet all of the criteria under at least one of the three financial standards and the applicable liquidity requirements.

Financial and Qualitative Requirements

NASDAQ Global Select Market Initial Listing Requirements[1]

Requirements	Standard 1 Listing Rules 5315(e) and 5315(f)(3)(A)	Standard 2 Listing Rules 5315(e) and 5315(f)(3)(B)	Standard 3 Listing Rules 5315(e) and 5315(f)(3)(C)	Standard 4 Listing Rules 5315(e) and 5315(f)(3)(D)
Pre-tax earnings[2] (income from continuing operations before income taxes)	Aggregate in prior three fiscal years ≥ \$11 million and Each of the two most recent fiscal years ≥ \$2.2 million and Each of the prior three fiscal years ≥ \$0	N/A	N/A	N/A
Cash flows[3]	N/A	Aggregate in prior three fiscal years ≥ \$27.5 million and Each of the prior three fiscal years ≥ \$0	N/A	N/A

NASDAQ Global Select Market Initial Listing Requirements[1] *(continued)*				
Requirements	Standard 1 Listing Rules 5315(e) and 5315(f)(3)(A)	Standard 2 Listing Rules 5315(e) and 5315(f)(3)(B)	Standard 3 Listing Rules 5315(e) and 5315(f)(3)(C)	Standard 4 Listing Rules 5315(e) and 5315(f)(3)(D)
Market capitalization[4]	N/A	Average ≥ $550 million over prior 12 months	Average ≥ $850 million over prior 12 months	$160 million
Revenue	N/A	Previous fiscal year ≥ $110 million	Previous fiscal year ≥ $90 million	N/A
Total assets	N/A	N/A	N/A	$80 million in the most recently completed fiscal year
Stockholders' equity	N/A	N/A	N/A	$55 million
Bid price[5]	$4	$4	$4	$4
Market makers[6]	3 or 4	3 or 4	3 or 4	3 or 4
Corporate governance[7]	Yes	Yes	Yes	Yes

[1] These requirements apply to all companies, other than closed-end management investment companies. A closed end management investment company, including a business development company, is not required to meet the financial requirements of Rule 5315(f)(3). If the common stock of a company is included in The NASDAQ Global Select Market, any other security of that same company, such as other classes of common or preferred stock, which qualifies for listing on The NASDAQ Global Market shall also be included in The NASDAQ Global Select Market.

[2] In calculating income from continuing operations before income taxes for purposes of Rule 5315(f)(3)(A), NASDAQ will rely on a company's annual financial information as filed with the Securities and Exchange Commission (SEC) in the company's most recent periodic report and/or registration statement. If a company does not have three years of publicly reported financial data, it may qualify under Rule 5315(f)(3)(A) if it has: (i) reported aggregate income from continuing operations before income taxes of at least $11 million and (ii) positive income from continuing operations before income taxes in each of the reported fiscal years. A period of less than three months shall not be considered a fiscal year, even if reported as a sub period in the company's publicly reported financial statements.

[3] In calculating cash flows for purposes of Rule 5315(f)(3)(B), NASDAQ will rely on the net cash provided by operating activities reported in the statements of cash flows, as filed with the SEC in the company's most recent periodic report and/or registration statement, excluding changes in working capital or in operating assets and liabilities.
A period of less than three months shall not be considered a fiscal year, even if reported as a stub period in the company's publicly reported financial statements.

[4] In the case of a company listing in connection with its initial public offering, compliance with the market capitalization requirements of Rules 5315(f)(3)(B) and 5315(f)(3)(C) will be based on the company's market capitalization at the time of listing.

[5] The bid price requirement is not applicable to a company listed on The NASDAQ Global Market that transfers its listing to The NASDAQ Global Select Market.

[6] A company that also satisfies the requirements of Rule 5405(b)(1) or 5405(b)(2) is required to have three market makers. Otherwise, the company is required to have four market makers. An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.

[7] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

Liquidity Requirements

Companies must meet all of the criteria in their specific category:

NASDAQ Global Select Market Initial Listing Requirements				
		New Company Listings		
Requirements	Initial Public Offerings and Spin-Off Companies	Seasoned Companies: Currently Trading Common Stock or Equivalents	Affiliated Companies[1]	Listing Rules
Round lot shareholders **or** Total shareholders **or** Total shareholders and Average monthly trading volume over past twelve months[2]	450 **or** 2,200	450 **or** 2,200 **or** 550 and 1.1 million	450 **or** 2,200 **or** 550 and 1.1 million	5315(f)(1)
Publicly held shares[3]	1,250,000	1,250,000	1,250,000	5315(e)(2)
Market value of publicly held shares **or** Market value of publicly held shares and Stockholders' equity	$70 million	$110 million **or** $100 million and $110 million	$70 million	5315(f)(2)

[1] Companies affiliated with another company listed on The NASDAQ Global Select Market. For purposes of Rule 5315, a company is affiliated with another company if that other company, directly or indirectly though one or more intermediaries, controls, is controlled by, or is under common control of the company. For purposes of these rules, control means having the ability to exercise significant influence. Ability to exercise significant influence will be presumed to exist where the parent or affiliated company directly or indirectly owns 20% or more of the other company's voting securities, and also can be indicated by representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

[2] Round lot and total shareholders include both beneficial holders and holders of record.

[3] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company.

Continued Listing

Companies must meet all of the criteria under at least one of the three standards:

NASDAQ Global Select Market Continued Listing Requirements[1]			
Requirements	Equity Standard Listing Rules 5450(a) and 5450(b)(1)	Market Value Standard Listing Rules 5450(a) and 5450(b)(2)	Total Assets/Total Revenue Standard Listing Rules 5450(a) and 5450(b)(3)
Stockholders' equity	$10 million	N/A	N/A
Market value of listed securities[2]	N/A	$50 million	N/A
Total assets and Total revenue (in latest fiscal year **or** in two of last three fiscal years)	N/A	N/A	$50 million and $50 million
Publicly held shares[3]	750,000	1.1 million	1.1 million
Market value of publicly held shares	$5 million	$15 million	$15 million
Bid price	$1	$1	$1
Total shareholders[4]	400	400	400
Market makers[5]	2	4	4
Corporate governance[6]	Yes	Yes	Yes

[1] Companies must meet the bid price and total shareholders requirements as set forth in Rule 5450(a) and at least one of the Standards in Rule 5450(b).
[2] The term, "listed securities", is defined as "securities listed on NASDAQ or another national securities exchange."
[3] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company.
[4] Total shareholders include both holders of beneficial interest and holders of record.
[5] An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
[6] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

NASDAQ Global Market

Initial Listing

Companies must meet all of the criteria under at least one of the four standards:

NASDAQ Global Market Initial Listing Requirements[1]

Requirements	Income Standard Listing Rules 5405(a) and 5405(b)(1)	Equity Standard Listing Rules 5405(a) and 5405(b)(2)	Market Value Standard Listing Rules 5405(a) and 5405(b)(3)[2]	Total Assets/Total Revenue Standard Listing Rules 5405(a) and 5405(b)(4)
Income from continuing operations before income taxes (in latest fiscal year **or** in two of last three fiscal years)	$1 million	N/A	N/A	N/A
Stockholders' equity	$15 million	$30 million	N/A	N/A
Market value of listed securities[3]	N/A	N/A	$75 million	N/A
Total assets and Total revenue (in latest fiscal year **or** in two of last three fiscal years)	N/A	N/A	N/A	$75 million and $75 million
Publicly held shares[4]	1.1 million	1.1 million	1.1 million	1.1 million
Market value of publicly held shares	$8 million	$18 million	$20 million	$20 million
Bid price	$4	$4	$4[2]	$4
Shareholders (round lot holders)[5]	400	400	400	400
Market makers[6]	3	3	4	4
Operating history	N/A	2 years	N/A	N/A
Corporate governance[7]	Yes	Yes	Yes	Yes

[1] Companies must meet the bid price, publicly held shares, and round lot holders requirements as set forth in Rule 5405(a) and at least one of the Standards in Rule 5405(b).
[2] Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under the Market Value Standard must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.
[3] The term, "listed securities", is defined as "securities listed on NASDAQ or another national securities exchange."
[4] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company.
[5] Round lot holders are shareholders of 100 shares or more. The number of beneficial holders is considered in addition to holders of record.
[6] An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
[7] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

Continued Listing

Companies must meet all of the criteria under at least one of the three standards:

NASDAQ Global Market Continued Listing Requirements[1]			
Requirements	Equity Standard Listing Rules 5450(a) and 5450(b)(1)	Market Value Standard Listing Rules 5450(a) and 5450(b)(2)	Total Assets/Total Revenue Standard Listing Rules 5450(a) and 5450(b)(3)
Stockholders' equity	$10 million	N/A	N/A
Market value of listed securities[2]	N/A	$50 million	N/A
Total assets and Total revenue (in latest fiscal year **or** in two of last three fiscal years)	N/A	N/A	$50 million and $50 million
Publicly held shares[3]	750,000	1.1 million	1.1 million
Market value of publicly held shares	$5 million	$15 million	$15 million
Bid price	$1	$1	$1
Total shareholders[4]	400	400	400
Market makers[5]	2	4	4
Corporate governance[6]	Yes	Yes	Yes

[1] Companies must meet the bid price and total shareholders requirements as set forth in Rule 5450(a) and at least one of the Standards in Rule 5450(b).
[2] The term, "listed securities", is defined as "securities listed on NASDAQ or another national securities exchange."
[3] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company.
[4] Total shareholders include both holders of beneficial interest and holders of record.
[5] An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
[6] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

NASDAQ Capital Market

Initial Listing

Companies must meet all of the criteria under at least one of the three standards:

NASDAQ Capital Market Initial Listing Requirements[1]			
Requirements	Equity Standard Listing Rules 5450(a) and 5450(b)(1)	Market Value of Listed Securities Standard Listing Rules 5505(a) and 5505(b)(2)[2]	Net Income Standard Listing Rules 5505(a) and 5505(b)(3)
Stockholders' equity	$5 million	$4 million	$4 million
Market value of publicly held shares	$15 million	$15 million	$5 million
Operating history	2 years	N/A	N/A
Market value of listed securities[3]	N/A	$50 million	N/A
Net income from continuing operations (in the latest fiscal year or in two of the last three fiscal years)	N/A	N/A	$750,000
Bid price	$4	$4	$4
Publicly held shares[4]	1 million	1 million	1 million
Shareholders (round lot holders)[5]	300	300	300
Market makers[6]	3	3	3
Corporate governance[7]	Yes	Yes	Yes

[1] Companies must meet the bid price, publicly held shares, round lot holders, and market makers requirements as set forth in Rule 5505(a) and at least one of the Standards in Rule 5505(b).
[2] Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under the Market Value of Listed Securities Standard must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.
[3] The term, "listed securities", is defined as "securities listed on NASDAQ or another national securities exchange."
[4] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company. In the case of ADRs, at least 400,000 shall be issued.
[5] Round lot holders are shareholders of 100 shares or more. The number of beneficial holders is considered in addition to holders of record.
[6] An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
[7] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

Continued Listing

Companies must meet all of the criteria under at least one of the three standards:

NASDAQ Capital Market Continued Listing Requirements[1]			
Requirements	Equity Standard Listing Rules 5550(a) and 5550(b)(1)	Market Value of Listed Securities Standard Listing Rules 5550(a) and 5550(b)(2)	Net Income Standard Listing Rules 5550(a) and 5550(b)(3)
Stockholders' equity	$2.5 million	N/A	N/A
Market value of listed securities[2]	N/A	$35 million	N/A
Net income from continuing operations (in the latest fiscal year or in two of the last three fiscal years)	N/A	N/A	$500,000
Publicly held shares[3]	500,000	500,000	500,000
Market value of publicly held securities	$1 million	$1 million	$1 million
Bid price	$1	$1	$1
Public holders[4]	300	300	300
Market makers[5]	2	2	2
Corporate governance[6]	Yes	Yes	Yes

[1] Companies must meet the bid price, publicly held shares, market value of publicly held shares, public holders, and market makers requirements as set forth in Rule 5550(a) and at least one of the Standards in Rule 5550(b).
[2] The term, "listed securities", is defined as "securities listed on NASDAQ or another national securities exchange."
[3] Publicly held shares is defined as total shares outstanding, less any shares held directly or indirectly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding of the company.
[4] Public holders of a security include both beneficial holders and holders of record, but does not include any holder who is directly or indirectly an executive officer, director, or the beneficial holder of more than 10% of the total shares outstanding.
[5] An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
[6] In addition to the above quantitative requirements, companies must comply with all corporate governance requirements as set forth in the Rule 5600 Series.

Chapter 3

Earnings Management

A subtler variant of earnings manipulation is earnings management. Although both involve the manipulation of accounting data, earnings management attempts to manipulate reported earnings over multiple reporting periods to give the impression of consistent profitability and growth, usually with the objective of meeting previously published forecasts. However, the reasons fraudsters engage in earnings management go beyond simply trying to meet a forecast. A company that demonstrates consistency in growth reaps significant financial benefits, which translate into a higher stock price. If actual earnings for a given period undershoot or overshoot the desired level needed to show that consistency, the fraudster attempts to use improper accounting entries to adjust earnings up or down to meet that target.

Stock analysts and business appraisers like predictable trends. Their job, when it comes to valuing a company, is to forecast earnings, and a consistent trend in historical earnings makes predicting future earnings much easier. Moreover, predictability lowers the risk that the analyst's or appraiser's estimate is off and narrows the range of possible outcomes. A business experiencing consistent growth in earnings between 4 percent and 6 percent per year is much easier to value than a firm with earnings that swing from negative 15 percent to positive 25 percent. For that latter firm, a forecast looking 5 years out could have a number of widely divergent outcomes. For example, 5 years of negative 15 percent per year change in earnings puts earnings in year 5 at 44 percent of the base year earnings, whereas 5 years of 25 percent annual growth produce year 5 earnings equal to over 300 percent of base year earnings. In contrast, the more predictable firm, after 5 years, will have earnings ranging from 122 percent to 134 percent of base year earnings. Clearly, the more predictable firm is easier to value.

However, there is more to predictability than making an analyst's or appraiser's job easier. The capital markets respond in a similar fashion. The more predictable a firm's earnings, as a general rule, the lower its cost of equity capital, and lower capital costs, in turn, contribute to higher stock prices.

Manipulating Cost of Equity

The price of a share of a company's stock can be represented as the present value of future expected cash flows that consist of the regular and liquidating dividends forecast for all future years (that is, in perpetuity). Those cash flows are discounted to the present using the company's *cost of equity*, which is the rate of return required by outside investors to place their investment capital with the company. The lower the cost of equity, the lower the rate demanded by outside investors that is used in the denominator to discount future expected cash flows to the present, and the lower the discount rate, the higher the present value of the stock. For example, assume a company pays dividends of $20 per share annually, forecast to remain constant in perpetuity. If its cost of equity is 10 percent, the price per share will be $20 divided by 10 percent, or $200. However, if the firm's cost of equity is 15 percent, the extra 5 percent demanded by outside investors will lower the share price by $67 ($20/15% = $133).

Using the Capital Asset Pricing Model to Determine the Cost of Equity

Modern portfolio theory, as developed by William Sharpe, John Lintner, and others, demonstrated that a particular stock's return (both price appreciation and dividends) could be estimated with the capital asset pricing model (CAPM) frequently used by valuation experts to determine a firm's cost of equity capital. For illustration purposes, assume that there are two publicly traded companies: Consistent Co. and Volatile, Inc. Consistent's stock has risen steadily over the last decade and is fairly predictable. Volatile's stock gyrates significantly from period to period.

The CAPM formula, using Consistent as an example, is as follows:

$$R_{\text{Consistent}} = R_f + ß_{m,\text{Consistent}} (R_m - R_f)$$

in which

$R_{\text{Consistent}}$ is the total rate of return (from dividends and price appreciation) of Consistent's stock and reflects the return demanded by outside investors to invest capital in Consistent stock;

R_f is the risk-free rate (such as the rate on a Treasury bond);

R_m is the long term rate of return on all stocks in the market (usually approximated by the returns on the S&P 500 or a broader index);

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(R_m – R_f) is the amount by which returns of the overall market exceed the risk-free rate (that is, the equation in parentheses measures the excess returns of the market); and

$\beta_{m,Consistent}$, called by its Greek letter *beta*, is a measure of the change in excess returns of Consistent's stock relative to changes in excess returns of the overall market. In other words, a stock with a beta of 1.0 has excess returns (over the risk-free rate) that tend to track the excess returns of the market for any given period of time, whether the market is going up or down.

By way of example, if over the next year, the market is expected to increase 15 percent over the risk-free rate and Consistent stock has a beta of 1.0, the excess returns on Consistent's stock (returns from dividends and price appreciation in excess of the returns on Treasury bonds) should also increase by the same percentage. As another example, assume Volatile has a stock with a beta of 2.0. When the market increases by 15 percent in a given year, Volatile's stock has excess returns of 30 percent; however, if the market declines by 15 percent, Volatile's stock declines by 30 percent, but Consistent's stock declines only by 15 percent. Therefore, stocks with higher betas, like Volatile's, have greater volatility of returns.

The Price of Volatility

The market extracts a penalty for volatility. Using the CAPM formula as a predictive tool and continuing the examples of Consistent and Volatile, assume the risk-free rate is forecast to be 5 percent, and the market excess return is forecast to be 15 percent.

The expected return on Consistent's stock will be as follows:

$$R_{Consistent} = 5\% + (1.0 \times 15\%) = 20\%$$

The expected return on Volatile's stock will be as follows:

$$R_{Volatile} = 5\% + (2.0 \times 15\%) = 35\%$$

Because expected return reflects the rate of return required by outside investors to place their funds with either company, Volatile's cost of equity is 15 percentage points more than Consistent's cost of equity due to the fact that Volatile's stock moves twice as much (that is, is more volatile) relative to the overall market than Consistent's stock. Given that each firm's cost of equity discounts its future cash flows available for equity holders to the present, the discount rate for Consistent's forecast dividends are lower than the discount rate for Volatile.

To illustrate the impact of that lower discount rate, assume that Consistent's dividends are expected to be $10 per year, and Volatile's dividends are expected to be $15 per year (both cash flows are without growth and projected in perpetuity). The value of a share of Consistent's stock is $10 divided by 20 percent cost of equity, or $50.00. The value of a share of Volatile's stock is $15 divided by 35 percent cost of equity, or $42.86. Therefore, even though Volatile's stock pays a dividend expected to be 1.5 times that of Consistent's dividend, Volatile's stock has a lower value because it is more volatile.

Why Manipulate Earnings?

The motive for earnings management is closely tied to this example. If a firm is free to manipulate its earnings, financial theory says it will do so to make its earnings more predictable or, perhaps more to the point, to make the firm's growth in earnings more predictable. With steady, predictable growth in reported earnings that appears to be unaffected by the firm's industry sector or perhaps even the overall economy, returns on that stock appear to be less volatile than returns from its peer group and maybe even less volatile than the rest of the market. In other words, by earnings manipulation, the firm appears to be less risky than its peers and less risky relative to market returns, and it succeeds at lowering its beta. Then, with a lower beta, the manipulator's cost of capital declines, and therefore, without having to raise dividends, the manipulator is able to raise its stock price.

Manipulating Growth

The importance of steady growth does not just affect cost of equity. The perception of growth increases valuation in even more direct ways. For companies with high cost of equity capital, growth is the principal mechanism used to enhance share value. In other words, if a firm incurs high cost of equity due to high volatility of its returns relative to the market, the firm can make up for some of that cost by convincing investors that it will grow rapidly in future years.

Using a Gordon-Shapiro Model to Determine Share Value

To value stocks, securities analysts use a range of tools, including variants of the Gordon-Shapiro perpetual dividend discount model. To illustrate the model in its basic, single stage form, assume Volatile has no marketable debt. According to the single stage model, the share price of Volatile's stock is determined as follows:

$$P_{\text{Volatile}} = [D_{\text{Volatile}}\ (1 + g)]\ /\ (R_{\text{Volatile}} - g)$$

in which

P_{Volatile} is the current market price per share of Volatile stock;

D_{Volatile} is Volatile's current annual dividend per share;

R_{Volatile} is the return on Volatile's equity equal to its cost of equity capital (previously calculated); and

g is the annual compound growth rate for Volatile dividends.

To illustrate, assume Volatile has been able to demonstrate a long term growth rate, albeit a volatile one, of 15 percent. Volatile's initial annual dividend remains at $15, and cost of equity is 35 percent. The single stage model calculates the price of Volatile's stock as follows:

$$P_{\text{Volatile}} = [\$15\ (1 + 15\%)] \;/\; (35\% - 15\%)$$
$$= \$86.25$$

Therefore, adding a 15 percent growth rate, Volatile's stock price rises from $42.86, the value assuming no growth, to $86.25, or double its stock price. (The preceding equation used to value Volatile's stock without growth was actually the single stage model with *g* set to zero.)

The Reward of Consistency and Growth: Price/Earnings Multiples

Companies that are successful in combining both consistency and growth are rewarded with high price/earnings (P/E) multiples on their stock. For example, Consistent had a lower beta and cost of equity, but if it managed to achieve growth of 15 percent, its share price would be as follows:

$$P_{\text{Consistent}} = [\$10\ (1 + 15\%)] \;/\; (20\% - 15\%)$$
$$= \$230.00$$

Even though Consistent paid initial dividends of only $10 per share compared with Volatile's $15, with the same growth rate of 15 percent, Consistent's share price is much higher than Volatile's $86.25 per share due to lower cost of capital.

Why was Consistent's cost of equity capital less? Its more consistent earnings allowed the market to assign a lower beta, bringing its stock price (ignoring growth) to $50, or more than $7 over Volatile's (no-growth) price, even though Volatile paid a much larger dividend. Combined with growth, Consistent's stock price really took off, moving to $230 and achieving a price that was more than two and one-half times Volatile's $86.25.

The P/E multiple is the measure that ties all these concepts together. Assume both Consistent and Volatile pay 75 percent of their earnings in dividends (that is, their dividend payout ratio is 75 percent). To obtain the earnings per share (EPS) denominator component of the P/E multiple, EPS would equal the annual dividend divided by the payout ratio; in the present case, EPS would equal the current dividend divided by 75 percent. Consistent's EPS is $13.33 ($10 / 75%), and Volatile's EPS is $20.00 ($15 / 75%). To contrast consistency and growth, assume Consistent has both and Volatile has neither. As previously calculated, when both earnings consistency and growth were included in Consistent's stock price, that price was $230.00. Recall that when Volatile, with its high cost of equity capital due to its volatile earnings history, had no growth, its stock price was $42.86. The P/E multiples for each would then be as follows:

$$P/E_{\text{Consistent}} = \$230.00 / (\$10 / 75\%) = \$230.00 / \$13.33 = 17.25$$

$$P/E_{\text{Volatile}} = \$42.86 / (\$15 / 75\%) = \$42.86 / \$20.00 = 2.14$$

Although this example was designed to emphasize the differences, the firm that exhibits consistent earnings and earnings growth (Consistent) has a markedly higher P/E than the firm that exhibits volatile earnings and no growth (Volatile). The P/E ratios effectively convey the impact of both consistent earnings and predictable growth; that makes P/E the prime target for fraudsters, and earnings manipulation is the tool of choice they use to inflate P/E.

Sustaining Share Price: How Fraudsters Benefit

Fraudsters want to manage earnings to increase stock prices for many reasons. Chapter 2 discusses issues relating to executive stock compensation and bonus plans tied to a specific period's financial performance. For plans that pay out based on long term, multiperiod performance, fraudsters are similarly motivated to use a series of earnings manipulations (that is, earnings management) to achieve higher-than-justified stock and bonus awards. But the motives for earnings management are broader and may include fraudsters' efforts to use earnings management to support the share price of a publicly traded company until they can sell their holdings.

Getting Around Time Restrictions

The fraudsters may need to engage in such an effort if time restrictions prevented the granting or sale of company shares at an earlier date. Examples of stock granting, or sale restrictions and inducements, are outlined in box 3-1.

Box 3-1: *Time Restriction Fraud Examples*

1. Vesting provisions in employee stock ownership plans that postpone ownership until a future date
2. Stock option exercise restrictions that prevent managers from acquiring shares until specified dates or the occurrence of specific events
3. Securities and Exchange Commission (SEC) Rule 144 restrictions that limit the number of shares that can be sold on U.S. securities exchanges on a given trading day
4. Income tax provisions that afford more favorable tax treatment to long term capital gains on the disposition of shares that meet the holding period requirements
5. Corporate control requirements that necessitate holding significant blocks of stock past some event, such as an annual shareholders' meeting, before they can be sold

The following example ties together the concepts of earnings management and motive:

Example Scenario

Acme Aerospace Inc. had a long and storied record in the United States of achieving consistent earnings and dividend growth, and along with that growth, came a rising stock price that made investors and analysts happy. Acme's principal operating segments consisted of defense aircraft (30 percent of last fiscal year's earnings), civilian aircraft (50 percent of earnings), and satellite components manufacturing (20 percent of earnings). Acme had weathered the consolidations in the defense industry following the fall of the Berlin Wall by successfully implementing company-wide cost reduction measures and shifting its focus away from defense products. These adjustments kept growth on track and earned Acme's CEO the title of "miracle worker."

Not surprisingly, Acme's executives were well compensated. Although Acme's executive salaries were handsome, the bulk of executive compensation came in the form of cash and stock bonuses contingent on long term performance of the company:

1. The cash bonus plan paid significant bonuses if earnings targets were met for each year of a five-year period; if targets were not met for a given year, the bonuses were scaled back or eliminated. Acme reported earnings under U.S. generally accepted accounting principles (GAAP).
2. The stock bonus plan granted shares of stock to senior management if the price of Acme's shares reached certain levels and remained above those levels for a period of at least 90 days within each year of the 5-year measurement period. Acme's stock was traded on the New York Stock Exchange.

The compensation committee of Acme's board of directors believed that the emphasis on bonuses helped align management's interests with those of Acme's shareholders. The compensation committee, after conferring with its consultants, set the stock price targets for cash and stock bonuses each year (for each 5-year period), with objectives of achieving 15 percent growth over each prior year's earnings.

Budgets were set for each business segment such that as they rolled up to the corporate level, Acme could achieve both the cash bonus and stock bonus targets for that year. The cash bonus targets were keyed to earnings growth, and the budgets could be set accordingly, with a projected year-over-year increase in profits of 15 percent. The stock bonus targets, set to a specified stock price, were more difficult to gauge. Acme had recently achieved a P/E ratio of 22, and if that ratio could be maintained and if the cash bonus earnings target could be met, Acme's CFO felt that the stock bonus would come in, as well. The budgets for the current fiscal year were a stretch and left little room for error, but management thought they were achievable.

However, by the end of the first quarter, the satellite components manufacturing division began to experience problems. Commercial launches were postponed or canceled because satellite communications ventures failed to attract new customers and traffic on existing satellites did not grow as expected. Several of Acme's contracts were terminated, idling a plant and some equipment; other customers announced that they would not exercise renewal provisions in their contracts after current production was complete, so it was probable that more equipment would be idled later. Needless to say, the satellite division was falling further and further away from its budget goals, placing the entire Acme budget in jeopardy.

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The CFO had a serious problem if the satellite division failed to perform. Due to news of problems with Acme's satellite customers, Acme's stock was starting to gyrate as rumors of customers declaring bankruptcy came and went. Acme's treasury department routinely tracked share price volatility to measure the firm's *weighted average cost of capital*—the average of Acme's cost of equity and cost of debt weighted for the market value of each. The treasury group was responsible for assessing an internal finance charge, for performance measurement purposes, for funds from financing activities used by a given division based on each division's capital expenditures and working capital demands. The corporate treasurer reported to the CFO that if Acme's stock continued to oscillate widely, the cost of equity component would have to increase as Acme's beta increased. The CFO knew that a higher cost of equity not only would affect Acme divisions that were net users of capital funds but also would cause the securities analysts who track Acme stock to adjust, at some point, their discounted cash flow models and lower their P/E forecasts. With a lower P/E ratio, the CFO knew that achieving the stock bonus target would be close to impossible.

To allay market concerns about the satellite division's impact on Acme's earnings, the CFO believed that reported earnings over the next several quarters would be key. Those earnings needed to come in on target with analysts' expectations to demonstrate that Acme could weather the problems in the satellite industry just as it had earlier weathered those in the defense industry. The CFO's most immediate problem was the idle plant and equipment: an impairment charge, he thought, would tank earnings and eliminate any chance for Acme's stock to hit the bonus target. To complicate matters, more equipment would likely be idled in future quarters as work was completed on existing contracts that would not be renewed or replaced. In addition, the CFO would have to assess how the company could find a way to make up the profit lost on the canceled satellite contracts. Finding more revenue would be quite a challenge because demand for components in the aerospace industry was tied to contracts that have already been awarded and did not fluctuate much over a one-year period.

Over a series of late nights, the CFO and his staff came up with a plan. The corporate controller noted that the plant and most of the equipment that were idled were initially acquired in a purchase combination earlier in the current calendar quarter when the satellite division acquired the assets of Orbit Company. The controller recommended an adjustment of the purchase price to allow for a contingency for idled plant and equipment, which he believed was permitted under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805-20-25. The controller proposed to debit goodwill from the purchase transaction and credit a reserve account on the balance sheet for the plant and equipment that was idled now. Then, Acme could take the impairment charge for the idle plant and equipment in the current quarter and debit the contingent liability instead of an income statement account. The CFO thought this was "a brilliant solution." In regard to the equipment that would likely become idle in future quarters (and was not part of the Orbit transaction), the CFO instructed the controller to list the equipment as "in transit" to several of Acme's defense division aircraft components plants to be used in aircraft parts production. The CFO did not check with the aircraft components plant managers to see if they actually needed the equipment.

Turning to the problem of lost profits on cancelled contracts, the CFO asked his contract analyst to "revisit" the estimates she made for profitability on certain long term aircraft components contracts. Acme recognized revenue and related costs on its long term contracts on the percentage of completion method. In most cases, Acme served as subcontractor to a prime contractor, and in Acme's defense segment, the prime contractors were fulfilling procurement contracts with the U.S. Department of Defense (DOD). The CFO pointed out to the contract analyst that depreciation, storage, and relocation costs from the idled equipment that was "in transit" needed to be included in the estimates for those DOD contacts that were bid on a cost plus basis: as the cost of the contract increased, the CFO knew that the revenues and recognized profit would increase, as well. In each successive quarter, as more equipment was idled, the equipment immediately generated revenue as related expenses were added to the cost base for defense contracts. The CFO also told the controller that charges to the reserves and redesignations of "in transit" equipment costs were not to be handled by plant controllers nor reflected on plant financial statements; he wanted these items to be handled at the corporate level "so as not to burden plant controllers with these issues."

At year-end, the CFO carefully supervised the analysis of goodwill under FASB ASC 350-20-35 to make sure there was no impairment. The Orbit transaction was not quantitatively material to overall operations, he thought, so he hoped that his revenue estimates for the remaining Orbit assets would not be scrutinized too thoroughly by auditors. Even if he did have to write down the Orbit goodwill, the CFO felt he could explain the impairment as a onetime event with no impact on future earnings. After all, the cost shifting he had accomplished with regard to the idled plant and equipment had protected Acme's gross margin and allowed the firm to meet its earnings growth target. As the securities markets saw Acme report earnings in line with expectations, trading in Acme stock calmed down, and the P/E ratio remained at 22, thus allowing Acme management to meet that year's stock price target. When the CEO announced the year-end cash and bonus awards, he threw a dinner party in honor of the CFO.

Example Analysis

This case illustrates the misuse of acquisition-related contingencies (see chapter 11) and the failure to take impairment charges to income. For a manufacturer, the unanticipated write-off of plant and equipment is generally a serious threat to achieving a performance bonus because it is next to impossible for the manufacturer, in the near term, to find enough new customers and bring its products into production to make up for the charge to net income. If performance bonuses are tied to tight budgets, management will find taking write-offs to be quite difficult because those write-offs will likely sacrifice a major portion of management's compensation.

In this example, the fraudsters had two objectives in mind. First, they wanted to protect the budget so earnings growth targets were achieved, keeping management on track to receive the entire cash performance bonus. Second, the fraudsters wanted to avoid alerting the securities markets to the fact that problems in the satellite industry would affect Acme. If the markets were to detect problems in that segment, securities analysts

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might adjust their cash flow projections or discount rates to reflect slower growth due to the drag on future profits caused by satellite industry problems. Even though current reported EPS might not be greatly affected because the satellite division accounted for only 20 percent of Acme's net income, lowering the growth rate would increase the discount rate used in the single stage model and lower the P/E ratio. With a lower P/E, the fraudsters believed they would miss the stock bonus target.

To pull off these objectives, the fraudsters needed to hide asset impairments over several quarters (that is, engage in earnings management). To lower the chance of detection, they split the impairment charges between two schemes. The first would create contingencies from a previous acquisition that would then absorb the impairment charge relating to currently idle plant and equipment. The second scheme would route the cost of soon-to-be idle equipment over to the defense division, where Defense Department (DOD) cost plus contracts could turn the extra expense into income. Both schemes violated U.S. GAAP, and if the company reported under International Financial Reporting Standards, it would have violated related standards, as well.

For the acquisition contingency scheme, the controller's reference to FASB ASC 805 was only, at best, partially correct. FASB ASC 805-20-25 does provide for contingencies, but the criterion for recognizing such a liability requires the acquirer in a business combination to determine that it was probable that a liability had been incurred as of the acquisition date, meaning that it was probable at the acquisition date that one or more future events confirming the existence of the liability will occur.[1]

The issue of idle plant and equipment was likely not even contemplated at the time of the Orbit acquisition. The acquisition probably was made because, at that time, management thought there were few foreseeable problems with the satellite business. Therefore, it would not be possible at a later date to create a contingent liability for idle equipment that met the probable standard as of the acquisition date. Without being considered a part of Orbit's purchase price, the contingency could not create or increase goodwill, as the controller did when he debited goodwill and credited a contingency account.

The second scheme of placing idled equipment in some state of limbo was a more straightforward fraud, but the CFO hoped to avoid detection by dribbling in small amounts over several quarters in future periods. Here, the fraudsters actually violated a second U.S. GAAP principle, in addition to failing to take an impairment charge. The example stated that "it was probable that more equipment would be idled later" due to discussions with Acme's satellite customers. Accordingly, assuming the amount of equipment that would be idled could be reasonably estimated, a loss contingency under FASB ASC 450-20 should have been established (with a charge to current earnings) for that entire amount in the current quarter, not spread out over several future quarters. Such a hit to earnings coming in an early quarter was not what the fraudsters wanted because the write-off would have alerted the markets to problems Acme was having in the satellite division and would have imperiled the P/E ratio. However, loss contingencies are required under U.S. GAAP for precisely that reason: to alert financial statement readers of future problems.

[1] Financial Accounting Standards Board *Accounting Standards Codification* 805-20-25-20.

Being a public company, the fraudulent accounting used to hide losses was, if deemed material, a violation of federal securities laws. Specifically, the accounting scheme likely violated SEC Rule 10b-5 because it was designed to defraud with the "intent to omit to state a material fact [that is, the asset impairments] necessary in order to make the statements made [Acme's quarterly income statements], in the light of the circumstances under which they were made [problems with the satellite industry market], not misleading."

In addition to violating U.S .GAAP and SEC rules by allocating unmerited equipment expenses to DOD contracts, the fraudsters also likely violated U.S. *Federal Acquisition Regulation* (FAR) and are liable under federal procurement fraud statutes (also, if material, SEC regulations would have required disclosure of FAR violations, as well).

The example contained some clues that could have signaled these frauds. Adjustments to a purchase price after the acquisition should be scrutinized carefully. Looking at the requirements to qualify as an acquisition-related contingency, the contingency must have existed at the time of the acquisition, and the contingency must have been probable to occur. Facts should generally emerge at the time of acquisition that help determine the probable threshold and provide sufficient inputs for a fair value estimate. Any delay beyond that time should be a red flag to the CPA.

Another flag is found in the recurring reclassifications of idle equipment into a holding category, such as "in-transit" in the example. Setting aside the audit question regarding whether the machines would actually be moved and put back in service, just looking at the series of entries in the holding category account would indicate that equipment was being idled and placed "in-transit" on a regular, recurring basis. Those recurring entries beg the question, did management see this coming? If the answer is "Yes," a loss contingency for, at the least, estimated moving costs and downtime may be needed for future periods. More important, in the process of investigating the need for the loss contingency, the CPA would likely discover that the equipment in the example never went back into productive service.

The goodwill impairment analysis was the CFO's Achilles' heel because the controller's "brilliant idea" manufactured additional goodwill from the Orbit acquisition that might not withstand the first step of the goodwill impairment test under FASB ASC 350-20-35. Assuming the satellite segment is the appropriate reporting unit, if the fair value of that segment did not equal or exceed the segment's carrying value on Acme's books, Acme might have to take a write-down to earnings under the second step of the goodwill impairment test. Adding more goodwill for the idled plant and equipment would increase the carrying value of the satellite segment on Acme's books. An honest analysis of the lower fair value under the first step due to reduced prospects for the satellite industry might have triggered a reassessment of implied fair value of goodwill under the second step, reversing all the CFO's efforts to cover up the problems in the satellite segment. Therefore, a possible addition to audit procedures would be the review of activity in setting acquisition-related contingencies, especially any contingencies set up or adjusted at, or long after, the acquisition date. Indeed, possibilities exist for fraudsters to exploit the first step test performed at the operating segment or reporting unit level in such a manner to shield their fraud from the second step analysis, and this issue will be explored in greater depth in chapter 11.

Flexibility in Accounting: A Numbers Game?

Management, fearing the precipitous decline that can result if analysts scale back their growth estimates, may believe that the company must engage in earnings management to meet analysts' expectations. In this environment, the moral issue of reporting earnings that truly measure the company's economic activity is a matter of management intent. The very nature of accrual accounting leaves open the possibility that management judgment, even within the bounds of relevant accounting literature, may be colored by the intent to show the company in the best possible light. Accrual, deferral, and allocation procedures designed to permit the allocation of revenues and expenses, gains, and losses across reporting periods also allow management considerable leeway about when to declare earnings. When, within this process, does discretion become the intent to deceive? Within what limits should management be acting to permit investors to properly price the company's securities in the market? How much earnings smoothing actually misrepresents the trend of economic performance versus the irregularities of cash flows?

Earnings management is fraudulent if improper accounting is used to hide true company performance. Arthur Levitt, when serving as chairman of the SEC, expressed the SEC's concern about this subject in a 1998 speech titled "The Numbers Game" when he stated that "[f]lexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this pliancy. Trickery is employed to obscure actual financial volatility. This in turn, masks the true consequences of management's decisions."

Thus, Levitt acknowledged that there is flexibility in accounting. CPAs may reach different, though defensible, conclusions when applying accounting literature. Earnings management occurs when company management, in Levitt's words, attempts to "exploit" accounting flexibility by reaching a conclusion that "masks the true consequences" of its actions.

Failure to Perform Punishes the Stock Price

Within this range of discretion, management of publicly traded companies, especially growth and high-tech companies, have been under tremendous pressure to perform from both analysts and investors. Failure to report continued profit growth has resulted in dramatic punishment to the stock price, even if the shortfall is by only a few cents per share. Even performance that was good by historical standards can cause a price decline if earnings are below analysts' expectations. This kind of market reaction has been an incentive for companies that are just meeting analysts' forecasts or even falling slightly below to show a modest increase in reported profit.

Discovery of earnings manipulation can lead to the dismissal of senior executives, lawsuits by shareholders, and sharp declines in the price of the company's stock. Other consequences will be a decline in the number of analysts following the company and an increase in the number of short sellers.

Types of Earnings Management

In his 1998 speech, Levitt focused on three main fraudulent practices used to enhance earnings:

1. Big bath restructuring charges
2. Cookie jar reserves
3. Materiality

Big Bath Restructuring Charges

Big bath restructuring charges are the large one-time charges associated with a restructuring. Management may take a big bath charge on the assumption that the company stock price will get pummeled whether the restructuring charge is large or small. Using that logic (which may be correct), management opts for the big charge by establishing large loss contingencies for shutting down operations or shifting operations to other areas. If the contingency estimates are too large and actual expenses do not consume the entire contingency, management can later reverse the unused portion back into income. As an added bonus, the reversal back to income may occur at a time when earnings need a boost because of disappointing current operating results. Hence, Levitt observed that overestimation can leave charges that are "miraculously reborn as income when estimates change or future earnings fall short."

Cookie Jar Reserves

Fraudulent managers tend to cloak their deception in an accounting rule, although, in reality, the accounting rule is not properly applied or other accounting rules are broken. The use of loss reserves is a good example of the abuse of an accounting principle to manage the final earnings figure. In a calendar quarter in which a company expects to outperform market expectations, it might create a loss contingency—frequently referred to as a *reserve*—for future losses on such items as long term contracts to create the effect of lowering earnings closer to the market consensus forecast. Then, in a future quarter, after the company has internally predicted it will not make enough income to meet market expectations, management can reverse some of the reserves on the grounds that future contract losses no longer appear probable.

On the surface and viewed in isolation, the creation and reversal of the loss contingencies may appear unrelated to earnings expectations. U.S. GAAP provides for the booking of loss contingencies, provided that the loss contingencies are both quantifiable and probable. However, when misused by a fraudster, the possibility of losses on future contracts most likely existed before the establishment of the loss contingency and continued to exist after the contingency was reversed into income. The reserves become an accounting artifice used by management to manage earnings to meet market expectations. Moreover, in this example, management violated U.S. GAAP either by creating the loss contingency without justification or reversing the contingency without any change in the degree of risk that the loss would in fact occur. Such loss contingencies, manipulated to manage earnings, are known as *cookie jar reserves* because management can reach into the cookie jar and pull them into income whenever the need arises.

Materiality

Underlying the discussion of financial statement fraud to this point is the assumption that the accounting manipulations cited are all material, in that the manipulations significantly change the information presented in the financial statements. Much of the accounting literature contains provisions that except immaterial amounts from a given accounting standard. However, the evolution of the definition of materiality has introduced another element of judgment into determining whether there is fraud.

The SEC decided to weigh in on this matter when it issued Staff Accounting Bulletin (SAB) No. 99, *Materiality* (discussed initially in chapter 1; the full text is included in appendix B found at the end of this book), which helped clarify some of the key materiality concepts. One issue the SEC addressed head-on was the use of quantitative materiality to waive accounting violations. A blind application of quantitative materiality essentially looks at the monetary amount of an accounting entry (or series of entries) that was indefensibly improper. If the amount was less than some arbitrary standard, such as 5 percent of net income, neither management nor company auditors would insist on changing that entry, even though it blatantly violated accounting standards. The SEC said that although quantitative standards may serve as a starting point for investigating potential accounting irregularities, relying exclusively on an arbitrary percentage to avoid the application of appropriate accounting standards has no basis in accounting literature (or in U.S. securities laws).

In 1980, FASB issued Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, which addressed materiality in paragraph 132, as follows:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

In other words, materiality is viewed from the standpoint of the reader of financial statements. If the correction of an erroneous accounting item would probably cause the reader to come to a conclusion different from the conclusion reached upon reading the uncorrected statement, the item is material.

When the International Accounting Standards Board looked at materiality, the board adopted a similar definition, with the clarification that materiality bears upon the economic decisions made by users of financial statements:

> Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.[2]

Before the release of FASB Concepts Statement No. 2 and International Accounting Standard 1, *Presentation of Financial Statements*, the Supreme Court, in reviewing a securities case[3] involving materiality issues, ruled that a fact is material if there is "a substantial

[2] Paragraph 11 of International Accounting Standard 1, *Presentation of Financial Statements.*

[3] *TSC Industries, Inc. v. Northway, Inc*, 426 U.S. 438 (1976).

likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Therefore, both accounting literature and the Supreme Court look to the reader or user of the financial statements and ask whether it is probable or substantially likely that the reader would have come to a different conclusion. If the answer is "Yes," the item in question is material.

Conclusion

Earnings management is one of the most subtle areas of financial statement fraud because it takes place over several reporting periods and frequently involves judgment calls on materiality. The materiality issues, especially the qualitative issues, are difficult because they require the CPA to climb into the mind of the financial statement user and ask what information would change his or her opinion. More guidance now exists in the form of SAB No. 99 and case decisions coming from the SEC, such as the *W.R. Grace & Co.* case.[4] The CPA's challenge is to place all information that was available to readers of financial statements in the context of the events occurring at the time that the information was available. Did management focus attention on one specific segment or performance metric that elevated seemingly immaterial accounting misstatements to a material level? Conversely, did financial statement or other disclosures mitigate or lessen the impact of a misstatement because readers had better information from the disclosures and were likely relying on those disclosures instead of specific elements of the financial statements? These are questions the CPA must weigh and assess using professional judgment.

[4] Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 1141 (June 30, 1999).

Chapter 4

Balance Sheet Manipulation

The balance sheet used to be the backwater of financial statement fraud. The more sophisticated fraudsters were supposed to focus on earnings because multiples of earnings drove valuations, and inflated valuations led to illicit gain. Due to the multiplier effect of the price/earnings (P/E) ratio, a small fraudulent change in earnings could produce a much larger inflated stock value. According to conventional wisdom, only second-tier fraudsters bothered with the balance sheet because potential monetary rewards were smaller for the fraud effort required. Now, however, balance sheet frauds have become more complex and the potential rewards much greater as the balance sheet has grown in importance and the fraudsters have devised more sophisticated ways to implement their schemes.

Growing Importance of the Balance Sheet

A balance sheet represents a firm's financial position as of a certain date. Although historical cost was the primary basis of accounting under both U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs), literature is evolving about the valuations of balance sheet assets and liabilities. Over the last decade, accounting standard setters have moved closer to reflecting values for assets and liabilities at current prices, or fair value, especially if the values of those assets and liabilities are volatile and subject to significant change over short periods of time. For example, financial assets may be marked to their fair values under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 825-10-15-4 or chapter 4 of IFRS 9, *Financial Instruments*. Even presumably less volatile assets, such as plant and equipment, under certain circumstances, must be written down due to impairment under FASB ASC 360-10-35 and International Accounting Standard (IAS) 36, *Impairment of Assets*. FASB ASC 360-10-35 and IAS 36 also allow reversal of impairment charges (a write-up of asset value) under certain circumstances. Thus, the balance sheet, with some justification, has gained more importance because it has become a more accurate reflection of current values of assets and liabilities. Lenders and investors have come to place more reliance on the balance sheet. Indeed, numerous academic studies, starting with work done by Eugene Fama and Kenneth French in the early 1990s, have tracked the relationship between a firm's book value (that is, its shareholders' equity as reflected on its balance sheet) and its market value and found that book value contains meaningful information for investors looking for undervalued stocks.[1]

Fraudsters manipulate balance sheets either directly through the booking of incorrect accounting entries or indirectly by keeping transactions off the books entirely. The latter category (the indirect method) has grown significantly in sophistication and importance.

The motives for balance sheet manipulation frequently relate to reporting requirements established by lenders, rating agencies, and regulators who tend to focus more heavily on balance sheet items. Typical bank revolving loan covenants, for example, may set out one or more of the following requirements:

- A minimum amount of shareholders' equity
- A maximum debt-to-equity ratio
- A minimum current ratio

If the borrowing company's balance sheet accounts violate the loan covenants, two events occur:

1. The firm may be in default under the terms of the loan and subject to accelerated repayment of the loan.
2. The firm may be precluded from any future loan advances.

Therefore, the fraudster may wish to increase the stated value of short term assets, such as receivables and inventory, in order to improve a current ratio, or the fraudster may need to keep the debt-to-equity ratio down by not recording liabilities.

Moreover, a publicly traded firm that was in trouble on its bank revolving line of credit, or *revolver* for short, would have additional incentive to commit a fraud because it would otherwise have to report to securities regulators that it was in default under its revolver loan covenants and, as a likely consequence, suffer a decline in its stock price. Similarly, companies in regulated industries, such as insurance and banking, must maintain certain amounts of capital to meet regulatory requirements. Failure to do so may result in sanctions or even closure by the regulators.

[1] Fama, Eugene F. and Kenneth R. French, "Size and Book-to-Market Factors in Earnings and Returns," *Journal of Finance* 50, no. 1 (1995): 131–55.

Direct Methods of Balance Sheet Manipulation: Fraudulent Entries

The most straightforward form of balance sheet manipulation involves the use of fraudulent entries that inflate the recorded values of assets or reduce the values of liabilities. These entries require overriding internal controls and, to be sustained over long periods of time, fooling internal and outside auditors (and the audit committee, if constituted by the firm's board of directors). If there is collusion, especially among senior personnel, the fraud may be especially difficult to detect, but collusion is risky from the fraudster's perspective because there is always the possibility that one of the conspirators could turn in the others. For that reason, indirect methods of balance sheet fraud, which rely less on outright collusion (see the following section), have become more popular.

The motives for direct manipulation are usually straightforward and relate to raising capital, both debt and equity, for the firm. By inflating booked asset values on the balance sheet or reducing liabilities, the fraudster establishes an illicit basis for greater borrowing capacity. Also, the same actions may make a firm look more financially sound to a potential equity investor. For example, an asset-based lender that loans funds to a firm as a percentage of reported values of inventory may unwittingly extend more credit than it should if inventory values are overstated. Similarly, a factor that discounts a firm's accounts receivable may overextend credit if there are fictitious receivables.

However, direct balance sheet manipulation does not necessarily take place in a vacuum. Through earnings manipulation, for example, cost of goods sold may be understated using a fraudulent system that fails to relieve inventory as products are shipped. The result is not only a lower cost of goods sold on the income statement but also an inflated inventory figure on the balance sheet.

An asset-based lender may have the impression that there is more collateral than is actually present. In the same manner, earnings manipulation that increases sales revenue probably increases accounts receivable, as well, assuming the fraudster has fabricated sales for which no one has paid. As receivables increase, the factor, in the short-run at least, is led to believe the firm expects to receive more accounts receivable cash flows in the future. With greater expected, though fraudulent, future cash flows, the factor is tricked into extending more credit and then is left without collateral if the firm declares bankruptcy.

Indirect Methods of Balance Sheet Manipulation: Hiding Transactions

The indirect method of balance sheet manipulation is more devious. Here, the fraudsters attempt to hide transactions or deflect transactions to another entity when those transactions should have been recorded on the company's books. These maneuvers are done for many reasons:

- Fraudsters may wish to bolster the assets of another entity.
- Fraudsters may wish to keep asset values at unsustainably high levels to hide management mistakes by failing to record impairments and write-downs.
- Fraudsters may wish to hide liabilities to avoid difficult questions from lenders, current investors, potential investors, and regulators.
- Fraudsters may wish to manipulate financial ratios to make a firm look stronger than it really is.

What makes these frauds so devious is that they are more difficult to detect because the CPA is most likely faced with trying to find transactions that did not get booked in the firm's transactions journals. Failing to record an asset impairment, for example, requires special procedures to detect and correct the fraud, and as an example later in this chapter illustrates, determining whether an actual fraud has been committed requires a significant amount of judgment. It is not always clear when an asset is impaired, and fraudsters take advantage of every element of accounting judgment to avoid the write-down.

Compounding the devious nature of an indirect balance sheet fraud, such as failing to record an asset impairment, is that the fraudster can concoct a passingly plausible story for why the impairment is not necessary, and that story may, for a time, convince coworkers and senior managers that all is well. Therefore, armed with a seemingly credible story, the fraudster does not need to engage in the dangerous task of building a conspiracy or expanding an existing conspiracy beyond a few people. The fraud is implemented with a much lower risk of detection.

Manipulation Techniques: Examples

The following examples illustrate how fraudsters accomplish balance sheet manipulation. The first example scenario demonstrates a direct method fraud; the second example shows the indirect method.

Direct Method Example: The Case of the Vanishing Payables

This example looks at a number of issues, but the principal fraud is an inappropriate write-down of debt on the balance sheet. The firm used in the example, Betascott (a name taken from a Securities and Exchange Commission [SEC] proposed rule release),[2] is shown as a publicly traded company to cover some issues that arise due to public disclosure requirements, but the fraud and motives illustrated can be found in nonpublic companies, as well.

[2] This example is taken from examples contained in Securities and Exchange Commission (SEC) Release Nos. 33-8098; 34-45907. To illustrate certain aspects of financial reporting fraud, additional assumptions are added to the SEC examples. Subsequently, the SEC-recommended disclosures to the audit committee are presented to illustrate how those disclosures would have increased the likelihood of fraud detection. The examples, as modified for purposes of this book, reflect the opinions of the author, not the SEC. The reader is encouraged to read the SEC releases in their entirety, which are included in appendix A at the end of this book.

Example Scenario

Betascott Company manufactures and sells data storage devices, principally computer hard drives, and files its financial statements with the SEC under U.S. GAAP. Betascott has two subsidiaries, each focused on different markets: the Megadrive subsidiary manufactures and assembles hard drives for mainframe systems, and the Pocketdrive subsidiary assembles hard drives for personal computers.

Pocketdrive buys some of its components from Megadrive and records a credit to intercompany payables with each purchase. Megadrive periodically uses Pocketdrive assembly personnel during peak demand periods. The intercompany payables are rarely settled in cash; usually, Pocketdrive offsets those payables against amounts Megadrive owes. No bills are produced; the subsidiary controllers merely keep a running tally of the components shipped and labor used. Discrepancies at the end of the fiscal year are closed to a balance sheet account labeled "Intercompany" because, according to the controllers, the discrepancies tend to reverse themselves every few years and are not worth the time to track down. "After all," Megadrive's controller told the outside auditors, "the amounts will simply wash out in the intercompany eliminations when the consolidated financial statements are prepared." No one has reconciled the "Intercompany" account since the two subsidiaries were formed over 15 years ago.

When talking to investors and securities analysts, Betascott's management touts Pocketdrive's rapid earnings growth because Megadrive's profits have been declining significantly over the last several years due to increased competition. Both Betascott's and Pocketdrive's management determined that, due to Megadrive's poor profitability, it was better for Pocketdrive to arrange its own bank financing. Pocketdrive's revolving credit facility requires it to maintain certain balance sheet ratios, including a current ratio of at least two-to-one. However, in the present year, even Pocketdrive is experiencing problems with lower margins on its products, and the profit forecast for the rest of the year is bleak. To make matters worse, some of Pocketdrive's customers have gone bankrupt, and Pocketdrive has had to write off significant accounts receivable. The write-offs threaten to bring the current ratio below the two-to-one threshold, at which point the bank could accelerate Pocketdrive's loan or, at a minimum, refuse to give the company any more credit. Pocketdrive depends heavily on the bank line to meet its obligations because Betascott is already strained trying to keep Megadrive afloat.

Pocketdrive's controller, whose bonus is contingent on Pocketdrive performance, presented a plan to Pocketdrive's management to "clean up" the accounts payable. The controller's plan essentially reversed any unbilled payables outstanding for more than 90 days. "If our vendors have not sent us a bill within 3 months of delivering components," he told the subsidiary's managing vice president, "they've probably forgotten about the shipment, and we certainly are not going to remind them!" The vice president asked which vendors have failed to send a bill, and the controller named some unaffiliated suppliers who have overlooked a few shipments. The vice president then asked how much the "clean-up" will contribute to their problem with the current ratio, and the controller responded that the ratio should climb to 2.5:1 by year-end. The vice president approved the plan, suspecting that most of the improvement in the ratio is attributable to write-offs of intercompany payables owed to Megadrive. However, the vice president conveniently forgot to tell Betascott management about the "clean-up" plan, and Pocketdrive's controller reported to the bank that Pocketdrive was in compliance with all requirements of the credit facility agreement, including the minimum current ratio.

Example Analysis

This example illustrates how deficient internal controls, particularly at a firm's subsidiary level, can contribute to, and make possible, a fairly simple scheme to write off payables. Although the scheme was originated to avoid problems with an outside lender, there were many motives involved. The subsidiary's managing vice president wanted to avoid making what might have been a career-limiting report to senior management at Betascott stating her company was going to violate loan covenants. The violation would have probably been a reportable event that would have triggered a filing with the SEC explaining that a key source of financing was no longer available and that the debt may become immediately due and payable. Moreover, because Betascott management had focused investor and analyst attention on the performance of Pocketdrive, any negative news would likely devastate the stock price, and lawsuits filed by plaintiffs' attorneys purporting to represent shareholders would follow.

As for the Pocketdrive controller, he was probably motivated mostly by cash. His bonus depended on earnings performance of Pocketdrive, and although the "clean-up" plan was designed to solve the problem with the bank, the controller knew that the payables write-off would help reduce cost of goods sold on the income statement and increase gross margin. With a higher gross margin, reported profits would be higher. Because Pocketdrive's margins were being squeezed by competition, the "clean-up" would bring those margins closer to their historical average and, thus, probably escape notice of auditors who rely on historical averages to detect anomalies. The controller set out to manipulate the balance sheet and produced the ancillary benefit of manipulating the income statement so that he would get his bonus.

Was there collusion? Most likely. Even though the vice president was not told about the write-off of payables to Megadrive, the reduction in total payables was so significant that she had to suspect that intercompany payables were a primary contributor because it was very unlikely that unaffiliated vendors would forget to bill for such large quantities of shipments. Furthermore, the vice president's failure to inform Betascott's management implies that she knew something was amiss and did not want any internal auditors looking into the matter. At the very least, the vice president was negligent in failing to make further inquiry herself.

One can readily see a number of ways this fraud could have been detected earlier or stopped. Tightening up on internal controls by simply reconciling the "Intercompany" account would have highlighted the write-off and led to some follow-up inquiry. But the root of the problem was grounded in the visibility of Pocketdrive, purposely engineered by Betascott's management. Whenever management focuses attention in such a specific manner, the pressure on that operating segment is intense. Therefore, the focus of internal and external auditors should likewise follow.

This illustration also points out to auditors the importance of treating business segments that operate as stand-alone entities as separate audit entities, as well. In the *W.R. Grace & Co.* case,[3] management attempted to assert that fraudulent accounting entries on the books of a division were not material when looked at in the context of Grace's consolidated financial statements. The SEC's enforcement division prevailed by pointing out that Grace's management had trumpeted the division's earnings growth and prospects, thereby moving the materiality test down from the corporate level to the division level. The message to auditors is clear: if management is talking up a certain segment of the company, that segment should be subjected to additional testing procedures using a materiality standard geared to the financial statements of the segment.

[3] SEC Accounting and Auditing Enforcement Release No. 1141 (June 30, 1999).

Indirect Method Example: The Missing Impairment Loss

Continuing with the Betascott example, the following scenario looks at the failure to book an impairment loss on assets:

Example Scenario

The hard drive industry is subject to intense competition and significant shifts in market share among the competitors. In the last three years, Betascott's Megadrive subsidiary has reported falling sales and market share, which caused Betascott to incur an overall loss from operations in the prior fiscal year. Betascott discussed this trend in the "Management's Discussion and Analysis" (MD&A) section of its Form 10-K filing with the SEC for that year.

As of year-end, Megadrive had a carrying value of $200 million in property, plant, and equipment (PP&E) used in producing hard drives serving as collateral on approximately $160 million of secured debt. Debt covenants provided that Megadrive would be in default if collateral value declined below the balance of the loans, and default would immediately accelerate payment of the entire principal. The company's accounting policies require that it test long lived assets for impairment whenever indicators of impairment exist. Megadrive's controller knew that the prior fiscal year loss from operations in that subsidiary, coupled with Megadrive's falling sales and market share, were indicators of a potential impairment of the hard drive-related PP&E.

The controller asked his assistant to prepare a cash flow projection over the expected lives of the assets, in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 360-10-35. That accounting standard sets out a two-step process:

1. If the sum of the future cash flows expected to result from the assets, undiscounted and without interest charges, is less than a company's reported value of the assets, the full carrying value of the asset is not recoverable.
2. If the asset is not recoverable, as determined in the first step, an impairment charge must be recognized equal to the excess of the carrying value of the assets over the fair value of those assets.

So that the controller could get a sense of the amount of the impairment should they fail the first test, he asked his assistant to determine the fair value of Megadrive's PP&E, as well.

For the first test, the assistant consulted several industry forecasts, including one study commissioned by Betascott last year. Most of the forecasts predicted a moderate turnaround in sales and gross margins over the next several years. Then, in preparing a forecast of future sales, the assistant looked at recent sales data for existing products, planned timing of new product launches, customer commitments related to existing and newly developed products, and current unsold inventory held by distributors. From those data, she constructed a current estimate of expected future cash flows for Megadrive's PP&E, undiscounted and without interest charges. To her chagrin, she found the sum of those undiscounted cash flows, no matter which industry forecast she used, was under the reported value of the PP&E, indicating that the assets were impaired.

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To assess the amount of the impairment, the assistant applied a discount rate to the cash flows to determine its fair value, in accordance with the provisions of FASB Statement No. 144. The assistant recognized that both hard drive sales and margins had declined over the last 3 years, producing an operating loss last year. To predict a turnaround, as the industry forecasts had done, the assistant believed there was significant risk in the cash flow forecast she had prepared. Therefore, the assistant selected a discount rate that was in excess of Betascott's cost of capital, assuming that market participants valuing these assets would discount expected cash flows at a higher rate for the same reason. Using that discount rate, she discounted her forecast cash flows to the present and determined that the PP&E had a fair value of $170 million. Megadrive would have been required to recognize an impairment loss of approximately $30 million if the assistant's estimate of those discounted future cash flows was correct.

Upon seeing the assistant's analysis, the controller realized that there was a serious problem and went to Megadrive's managing vice president. An impairment charge of $30 million would lower the value of Megadrive's PP&E to a point just $10 million above the minimum default trigger under the debt covenants with Megadrive's lenders. Although the vice president thought she might be successful in shopping around for a valuation from outside valuators that did not produce as large an impairment, she felt that any disclosure of an impairment, no matter how small, would likely cause the lenders to bring in their own valuation experts who would not be as pliable, and the $10 million margin was just too close for comfort. Also, thanks to disclosures in the "MD&A" section of Betascott's Form 10-K about deteriorating margins, she knew that lenders were already skittish about the security of their loans. An additional disclosure of impairment would bring attention she did not need.

However, the vice president knew that a recently introduced product for high-speed data access applications was seeing some success. The new product was called the Stored line of hard drives. The controller's assistant had used an estimate of future Stored sales that adjusted down the rosy forecasts prepared by the marketing department; the marketing numbers were always adjusted by a discount factor that historically had proven to be a good estimate of the percentage of deals marketing would actually close. The vice president told the controller that the assistant's reliance on the historical discount for the Stored line was inappropriate because she personally knew of potential sales not recorded in marketing's sales pipeline analysis. "This time," she told the controller, "the marketing guys are being conservative, and we should use their forecasts for the Stored line without any discount. Rerun the numbers accordingly." In actuality, the potential sales referred to by the vice president were nothing more than casual conversations she had with attendees at a trade convention the prior month, but no one else knew that was the case.

The assistant reran the forecast, as instructed. The undiscounted future cash flows totaled $220 million, mostly due to the marketing department's hope that future sales of the Stored line would achieve 40 percent market share within 3 years. Therefore, using the inflated sales data, the first step of the FASB ASC 360-10-35 test was apparently met because undiscounted future cash flows now exceeded the $200 million carrying value of the PP&E. Megadrive barely escaped reporting an impairment charge.

Example Analysis

The vice president concocted a story that others bought into, partly because of the power of her position and partly because the others may have desperately wanted a solution. This indirect fraud—the failure to book an impairment—was achieved without the overt need for the vice president to recruit a conspiracy due, in large measure, to the strength of the story.

In retrospect, the controller should have questioned abandoning the historical haircut given to marketing's forecasts, but the controller probably saw some of marketing's forecasts come true in the past and, not being a marketing expert himself, most likely felt he was out of his field of expertise to question the vice president's judgment. One item, though, may have been gnawing at the controller's conscience: how often is it that marketers leave potential sales out of their forecasts? If the answer is not often, if ever, the controller may have sought out help, but where does he turn? This is the point where an audit committee designated to take up and confidentially investigate questions raised by employees could step in. That committee could then access the necessary expertise to assess the cash flow forecast. The controller, therefore, should have had a mechanism to bring this issue to the attention of the audit committee.

Obviously, this is a hard fraud to catch without some insider sounding the alarm, and the warning signs that independent auditors may notice are few. In all likelihood, the audit plan for asset impairment will call for the auditors to review Megadrive's management forecast of future cash flows and assess the reasonableness of the forecasts. There is a good chance the auditors may notice and inquire about the lack of a reduction in marketing's forecast for the Stored line, but because there is little historical data on that line, the auditors may conclude that the forecast is reasonable under the circumstances.

However, the auditors can go further. Paragraph .34 of Statement on Auditing Standards No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol 1, AU sec. 380), states that

> The auditor should communicate with those charged with governance the following matters:
>
> *a.* The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.

Therefore, the auditor is required to inform those charged with governance, the audit committee in this example, of the qualitative aspects of significant accounting estimates. In doing so, it may help the audit committee, if the auditor also spelled out the range of possibilities for those accounting estimates that are most critical and subject to material change. In the example of Betascott, the auditors could point out that although Megadrive did not record an asset impairment on its PP&E, the cash flow forecast provided only a 10 percent margin before an impairment was required. That disclosure may then prompt the audit committee to review the issue more thoroughly. Such a review might lead, in turn, to reconsideration of the Stored line forecast.

Assuming that the estimate of sales for the Stored line is defensible, the following is a suggested disclosure for Betascott, taken from the SEC's proposed rule release (included in appendix A at the end of this book):

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Application of Critical Accounting Policies

We evaluate our property, plant and equipment ("PP&E") for impairment whenever indicators of impairment exist. Accounting standards require that if the sum of the future cash flows expected to result from a company's asset, undiscounted and without interest charges, is less than the reported value of the asset, an asset impairment must be recognized in the financial statements. The amount of impairment to recognize is calculated by subtracting the fair value of the asset from the reported value of the asset.

[W]e reviewed our hard drive-related PP&E [in our Megadrive subsidiary] for impairment as of [year-end], due to a trend of declining sales and market share. We determined that the undiscounted sum of the expected future cash flows from the assets related to [Megadrive's PP&E] exceeded the recorded value of those assets, so we did not recognize an impairment in accordance with [U.S.] GAAP. [Megadrive's PP&E] represents approximately two-thirds of our total PP&E.

We believe that the accounting estimate related to asset impairment is a "critical accounting estimate" because: (1) it is highly susceptible to change from period to period because it requires company management to make assumptions about future sales and cost of sales over the life of the hard drive-related PP&E (generally seven years); and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet as well as our net loss would be material. Management's assumptions about future sales prices and future sales volumes require significant judgment because actual sales prices and volumes have fluctuated in the past and are expected to continue to do so. Management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it ....

Our estimates of future cash flows assume that our sales of hard drive inventory will remain consistent with current year sales. While actual sales have declined by an average of approximately 2% per year during the last three years, our introduction of the Stored line of hard drives in August ... has resulted in a 0.5% increase in market share over the last five months of [this year], and a corresponding increase in sales of 5% over the comparable 5-month period last year. We therefore have assumed that sales will not continue to decline in the future. We have also assumed that our costs will have annual growth of approximately 2%. This level of costs is comparable to actual costs incurred over the last two years ....

In each of the last two years, we have tested [Megadrive's] PP&E for impairment and in each year we determined that, based on our assumptions, the sum of the expected future cash flows, undiscounted and without interest charges, exceeded the reported value and therefore we did not recognize an impairment. Because [this year's] sales were lower than those in [the prior two years], despite the improvement in the latter part of the year, and because our estimates of future cash flows are assumed to be consistent with current year sales, the current year impairment analysis includes estimated sales that are 2% and 5% less than those assumed in the [prior] impairment tests ....

As of [year-end], we estimate that our future cash flows, on an undiscounted basis, are greater than our $200 million investment in hard drive-related PP&E. Any increases in estimated future cash flows would have no impact on the reported value of the hard drive-related PP&E. In contrast, if our current estimate of future cash flows from hard drive sales had been 10% lower, those cash flows would have been less than the reported amount of [Megadrive's] PP&E. In that case, we would have been required to recognize an impairment loss of approximately $30 million, equal to the difference between the fair value of the equipment (which we would have determined by calculating the discounted value of the estimated future cash flows) and the reported amount of [Megadrive's] PP&E. A $30 million impairment loss would have reduced PP&E and Total Assets [of Betascott as of year-end] by 10% and 3%, respectively. That impairment loss also would have increased Net Loss Before Taxes, for the [current year], by 100%.

> If we had been required to recognize an impairment loss on [Megadrive's] PP&E, it would likely not have affected our liquidity and capital resources because, even with the impairment loss, we would have been within the terms of the tangible net-worth covenant in our long-term debt agreement [with our lenders].[4]

The SEC's proposed rule that would require such extensive disclosure in public filings, as previously illustrated, has not been approved by the SEC. However, at the very least, a company's senior management or auditors could provide a statement similar to this proposed disclosure to the company's audit committee. Then, the audit committee would clearly be on notice that not only was there an important issue involving asset impairment but also that the magnitude of the issue was significant, as well.

Conclusion

As accounting standard setters move from the traditional historical cost basis toward a fair value standard for the balance sheet, the balance sheet has become more valuable and, likewise, a greater target for fraud. Manipulation of the balance sheet occurs directly when fraudulent accounting entries are made that alter account balances or indirectly when fraudsters deliberately fail to record a transaction. The indirect method of fraud is the most difficult to catch because it requires the CPA to look for something that was not booked (that is, no audit trail exists).

The motives of balance sheet manipulation include the following:

- Pressure from management to avoid write-downs so as not to appear to be caught off guard
- Potential violations of lending covenants and the perceived actions creditors would take
- Pressure from senior management and investors to attain certain performance goals that would be at risk should financing be cut off
- Need to convince lenders and investors to increase the firm's capital
- Desire to manipulate earnings, combined with balance sheet manipulation, to obtain other objectives, such as performance bonuses

The general warning signs of balance sheet manipulation include those found in all areas of financial statement fraud: poor tone at the top of the organization (see chapter 7), lax internal controls, and external pressure to perform. The pressures that tend to give rise to balance sheet fraud typically come from creditors (and regulators in regulated industries) that use balance sheet accounts as measures of financial security (also see box 1-1 in chapter 1).

The best preventative measures are good internal controls and a functioning internal audit mechanism that allows employees to raise issues confidentially with the audit committee and have those issues thoroughly investigated. Outside auditors can also play an important role by identifying critical accounting policies and estimates and flagging them for the audit committee. In addition to flagging the issues, auditors can also explain the range of values used for key estimates and the consequences if lower (or higher) values turn out to be correct. Armed with the right information, the audit committee can better perform its function and assess whether decisions made by management require further inquiry.

[4] SEC Release Nos. 33-8098; 34-45907.

Chapter 5

Special Issues for Closely Held Companies

Publicly traded companies have received much attention with regard to financial statement fraud for two reasons. First, market reaction to the disclosure of the frauds is generally swift and severe, accompanied by significant share price declines, with the news media devoting extensive coverage to the issues related to the fraud. Second, the Securities and Exchange Commission (SEC), with jurisdiction over public companies listed on U.S. stock exchanges, has been in the forefront of both setting standards by which fraudulent actions are judged and, working in concert with the Department of Justice and other agencies, the prosecution of fraud in publicly traded companies. However, closely held private companies can equally well experience every type of fraud discussed in this book; only the motives and timing are slightly different

Although the management of closely held companies might not have to worry about securities analysts' expectations, other parties, such as outside shareholders, bankers, and venture capitalists (VCs), may demand better earnings performance. These demands might lead management to employ any of the earnings manipulation schemes discussed in earlier chapters. Of course, if management bonuses are a function of increased earnings, a motive for earnings manipulation exists, regardless of whether the company is publicly traded. The timing of these pressures may differ from that of public companies, though. If the outside investors are passive, the moment of performance assessment for management will most likely be the end of the fiscal year. Management of public companies, on the other hand, may feel pressure to hit targets quarterly, which is when they have to publish their financial statements. However, whether the pressures come annually or quarterly, the motives for fraud still exist.

The flip-side of earnings manipulation that improperly creates additional income for financial reporting purposes is earnings manipulation that improperly lowers income for tax reporting purposes—tax fraud. To achieve this result, the manipulator may be operating with two sets of books that do not properly reconcile: one for investors and bankers (the financial reporting books) and one for the tax authorities (the tax books). Most companies, of course, maintain separate, tax-basis books that allow them to determine tax gains and losses from asset dispositions, for instance. The difference between the fraudster's tax books and legitimate tax books is that the fraudster's books do not reconcile to the financial reporting books through legal reconciling entries. For example, if for tax purposes, a fraudster improperly shifts costs from low tax rate affiliates to high tax rate affiliates, the tax books of the affiliates will not correctly reconcile with the financial reporting books, even though the consolidated financial reporting statements may appear to be just fine.

The Pressure to Placate Outside Shareholders

Those shareholders of private companies who are not part of management may find themselves in the minority. The founders of the company usually serve in management positions, and if the need to raise capital is not so great to force the company to go to VCs (see "The Pressure to Go Public From VCs" section of this chapter), the founders and key managers can retain control as they sell shares to outsiders.

The minority outsiders, although they are outvoted by insiders, can nevertheless make demands on management. State laws generally protect minority shareholders if the majority owners attempt to implement a financial or share distribution plan that favors the majority over the minority. Setting up a stock bonus plan for management, for instance, may require minority shareholder approval. To obtain approval, management may attempt to placate minority shareholders' concerns by demonstrating strong financial performance, and if actual firm performance is lacking, management may seek to dress up the income statement with some earnings manipulation.

The Pressure to Satisfy Bank Lenders

For the closely held firm, the bank is the typical source of debt financing. When bankers make loans, they generally tie covenants in the debt instrument to a firm's balance sheet to provide some assurance that there will be sufficient assets available to collect on the loan in the event of default. For instance, the covenants may require the firm to maintain a maximum debt-to-equity ratio and a minimum amount of shareholders' equity. The covenants also define the events that cause a default, and balance sheet accounts may be a part of the numerical and ratio tests the bank imposes to determine whether the firm has suffered a material adverse change that would allow the bank to call the loan due and place the firm in bankruptcy, if necessary. In addition, for revolving credit facilities that allow for periodic borrowing, repayment, and borrowing again, banks usually establish a borrowing base. That base is a calculated dollar amount that is usually a percentage of receivables and inventory. The firm may borrow up to the amount of the base but no more, effectively limiting the use of the bank's funds to financing current assets.

The motives for, and methods of, balance sheet fraud on lenders apply to the closely held company, as well as public companies (see chapter 4). However, in light of the importance of bank financing to the closely held company, the CPA should be especially aware of the potential for fraud in this context. The motives for private firm management to manipulate the balance sheet to avoid a cutoff of bank financing are especially important because alternative sources may not be readily or cheaply available. Therefore, the CPA should carefully watch those accounts (usually balance sheet items) that are used in the tests imposed by the bank.

Also, the CPA should keep in mind that there is a potential for fraud, not just to avoid a material adverse change or default event, but also to improperly expand the borrowing base. For example, the borrowing base calculation may be set at 80 percent of accounts receivable, but only those receivables outstanding for less than 90 days are counted. If the firm receives partial payment from a customer for a recent bill, the firm may apply that payment to an older bill, perhaps for a different customer, to keep the recent bill in the borrowing base. Likewise, the firm may attempt to cancel old bills and reissue them just to keep a larger balance in the under 90 days category. Therefore, the CPA needs to pay special attention to the activity within accounts receivable when receivables are part of the borrowing base.

The Pressure to Go Public From VCs

If the private firm is funded by VC, pressure to perform can be enormous. For instance, VCs in high technology ventures generally look to cash out of their investments within 3–5 years, earning an annualized rate of return in excess of 40 percent over their entire portfolio of early stage companies. However, the VCs also expect that most of the firms they back will fail, a few will break even, and only about 10 percent to 20 percent will succeed. For those companies lucky enough to succeed, the VCs expect annualized rates of return of approximately 100 percent or more to make up for the losses sustained in firms that did not succeed.

The Uncertain Initial Public Offering Window

The exit plan for most VCs is usually an initial public offering (IPO) of stock to be publicly traded. Part of the shares offered to the investing public consist of those shares held by the VCs. In some public offerings, the VCs cash out all their shares through the IPO; in other offerings, the VCs may retain some of their ownership after the firm goes public. However, the IPO market is fickle, and favorable conditions come and go based on the direction of the overall stock market and how the firm's peer group is performing. Therefore, when an IPO window opens, investment bankers may join with the VCs to push firm management to go public, regardless of the firm's financial position. The VCs are looking for their exit so they can book a handsome return to show their investors; the investment bankers are looking for a big fee.

Stricter Securities Laws

Consequently, the period leading up to going public is a time of intense pressure and negotiation. For this reason, the Securities Act of 1933 sets stricter liability standards for firms going public than the standards under the Securities Exchange Act of 1934 that govern trading in securities after firms go public. Essentially, if there is fraud in the IPO filing, referred to as the *registration statement*, Section 11 of the Securities Act of 1933 imposes strict liability, such that there is no need to show that firm management had knowledge of that fraud; management is presumed to know about the fraud and is held accountable. Conversely, under Section 10 of the Securities Exchange Act of 1934, if fraud occurs in the secondary, post-IPO market, management must have knowledge of the fraud (that is, scienter) in order to be held responsible.

Nevertheless, the CPA must be especially alert when looking at the books and records of firms planning to go public. Prior to going public, a private firm may not have been as meticulous in its recordkeeping as needed to comply with financial reporting standards. Despite the strict liability standards imposed by the Securities Act of 1933, management may attempt to manipulate financial data, not so much to deliberately mislead but to make up for past sloppiness, though both may be a factor. Sloppiness may prompt management to change accounting methods to cover up past inaccuracies or to use improper estimates to give the appearance of compliance. The CPA should watch out for changes in accounting methodology management makes just before the IPO to improve reported earnings, as illustrated in the following example:

Example Scenario

Link Company develops and installs software applications that perform supply chain management functions. Link is based in the United States, is privately held, and reports its financial results using U.S. generally accepted accounting principles (GAAP). Link's principal product is JIT, a package that allows manufacturers to control the level of inventories so components arrive just in time on the production line. Link was founded 3 years ago by a management team that left a competitor and located seed capital from a VC firm. Link ownership was split 20 percent to management and 80 percent to the VCs.

Link management had aggressively pushed the development of JIT over the years, focusing principally on adding features demanded by customers. As Link added features as new modules and integration capability to JIT, the development staff made little attempt to track and separate which changes constituted minor modifications and which were significant additions; their attention was purely on the development process. As a result, documentation was sloppy, and it was not clear when planning, designing, coding, and testing were completed for any given JIT module.

Because management and the VCs were interested only in the monthly cash burn rate, neither paid much attention to the financial statements. Link's CFO, a 28-year-old who had previously worked at Link's auditing firm before coming to Link, simply expensed all development costs because she felt that trying to separate capitalizable costs under Financial Accounting Standards Board *Accounting Standards Codification* 985-20-25 would be too much trouble, and it did not appear that anyone cared.

(continued)

Then, Link's CFO received a call from her VC counterpart. The VC director explained that his investment banker had determined that the recent surge in tech stocks had opened the window for Link to go public. The VC director went on to say that his investors view this opportunity as the best time to exit and cash out all their shares. Because the VC firm held voting control, the CFO knew Link management would have to comply, even though she wanted another year to show improved profitability.

However, the VC director had an additional request. To allow the VC shares to be cashed out entirely in the IPO, the new investors would want some comfort that Link's earnings were improving sufficiently over time. Otherwise, it would look like the VCs were bailing from a bad investment and leaving the IPO investors with "a dog." The director said that his investment banker told him that Link's "earnings need to be spruced up a bit" to achieve that result. The VC added that he wanted a restatement that would capitalize enough development costs to achieve a "20 percent reduction in development expense on the income statement"; he wanted the adjustments made quickly because he did not know when the IPO window would close, and outside auditors would be coming soon.

Link's CFO concluded that because documentation was so poor and the time was so short, she would implement the 20 percent reclassification. "After all," she rationalized, "20 percent seems like a reasonable amount, and if we are called into question about the amount we capitalize, we ought to be able to find sufficient documentation when we have the time to look for it." The CFO also knew that the auditors performing due diligence, being rushed as well, would likely rely on her "analysis" of capitalized development costs and accept a "judgmental sample" she selected from what little documentation she had to support the capitalization reclassification.

Example Analysis

The principal warning sign for possible fraud was that there was a change in accounting method just before the IPO. Hopefully, the CFO's hunch is wrong, and the auditors would, upon discovering the change, insist upon making a thorough examination. The auditors may have to spoil the IPO party by insisting that more study of development costs be performed, but it would not be the first time auditors held up an IPO.

An additional warning sign was the relative inexperience of the CFO. Lack of experience probably meant that she did not have an appreciation for the strict liability standards of the securities laws that would likely affect her and the other members of the management team, even though others may not have known about the fraud.

However, other members of Link's accounting staff would have to be involved to make the reclassification. If the other staff had little accounting experience themselves, they might accept the CFO's rationale that 20 percent seemed the right amount, and documentation could be done later. However, an inexperienced staff should serve as an additional warning sign because a more experienced accountant might have questioned the reclassification. Because Link was going public, the exchange listing requirements probably mandated that the firm establish an audit committee (if it did not have one already), so an experienced accounting staff member could have taken the issue to that committee.

Special Valuation Issues

The need to value shares in a closely held company may also give rise to earnings management. If shares are being valued for sale or any other purpose, such as collateral for a bank loan to a major shareholder, earnings management may be employed to achieve the appearance of a steady rise in earnings, which, in turn, could produce a higher-than-justified valuation.

Although valuation specialists will use a variety of methods to value privately held companies and their stock, one of the most common is the discounted cash flow (DCF) method. Using DCF, the valuation specialist forecasts cash flows for future years, usually 5–10 years from the valuation date. After the last forecast year, the specialist will calculate a terminal value using a formula similar to the single stage model discussed in chapter 3 but with a few changes:

$$TV_{Private} = [CF_{Private\ T}\ (1 + g)] / (R_{Private} - g)$$

in which

$TV_{Private}$ is the market value in the terminal year of the forecast of the private company;

$CF_{Private\ T}$ is the private company's forecast annual net cash flow in the terminal year;

$R_{Private}$ is the cost of capital for the private company; and

g is the annual compound growth rate for the private company's cash flows after the terminal year.

Notice that in contrast to the formula in chapter 3, the preceding formula calculates the value of the entire firm (called the *enterprise value*) as of a future date, not just the value of a share of stock in that firm. To get to share value, one must deduct the value of debt from enterprise value and divide the remainder by the number of shares outstanding (assuming one class of stock).

The valuation specialist will discount the forecast future net cash flows, including the terminal value, to the present using the firm's cost of capital. For a five-year projection period, the equation is as follows:

$$\begin{aligned} PV_{Private} = \; & [CF_{Private\ 1} / (1 + R_{Private})] + \\ & [CF_{Private\ 2} / (1 + R_{Private})^2] + \\ & [CF_{Private\ 3} / (1 + R_{Private})^3] + \\ & [CF_{Private\ 4} / (1 + R_{Private})^4] + \\ & [CF_{Private\ 5} / (1 + R_{Private})^5] + \\ & [TV_{Private} / (1 + R_{Private})^5] \end{aligned}$$

in which

PV_{Private} is the present value of discounted forecast net cash flows for the private company, including the discounted present value of the terminal value at the end of the fifth year (the last term of the equation);

$CF_{\text{Private } y}$ is the forecast annual net cash flow for the private company at the end of a given year;

$(1 + R_{\text{Private}})^y$ is the discount formula for year y using the private company's cost of capital as the discount rate; and

TV_{Private} is as defined previously.

In many cases, especially with high growth companies, the terminal value (TV_{Private}) will be the single largest component of the present value of the firm (PV_{Private}), even with discounting, because it is an estimate of earnings into perpetuity. Therefore, a fraudster, desiring to get the most for his or her fraud efforts, will focus his or her manipulation on influencing that terminal value. To see how, it is useful to break out the components of the terminal value equation: $CF_{\text{Private T}}$, R_{Private} and g.

To influence $CF_{\text{Private T}}$ in the terminal year, the fraudster essentially needs to spin a good story and convince the valuation specialist that, in spite of weak net cash flows in the past, the firm will be increasingly profitable in future years so that by the terminal year it is printing money. Such a story may not be compelling, and even if the valuation specialist buys it, the specialist will likely raise the cost of capital (R_{Private}) to compensate for the higher risk associated with an aggressive cash flow forecast. However, higher R_{Private} will defeat the fraudster's efforts by lowering the discounted present value of the firm.

The fraudster may have better luck manipulating past years' earnings to give the impression of a steady high rate of growth. That manipulation will likely affect the valuation specialists' selection of R_{Private} and g. Although the benefits to the fraudster of manipulating growth (g) is obvious, the manipulation of cost of capital (R_{Private}) is a little more nuanced. The *cost of capital* is the weighted value of the cost of equity and the posttax cost of debt:

$$R_{\text{Private}} = [W_{\text{E}} \times R_{\text{Private Equity}}] + [W_{\text{D}} \times R_{\text{Private Debt}}]$$

in which

W_{E} and W_{D} are the weights for equity and debt, respectively, to reflect the current or expected capital structure of the firm that together add to 100 percent and

$R_{\text{Private Equity}}$ and $R_{\text{Private Debt}}$ are the private company's cost of equity and posttax cost of debt, respectively.

The posttax cost of debt is estimated by multiplying the current market rate, as of the valuation date, on long term debt instruments similar in quality to those of the private company by one minus the effective tax rate. The cost of equity, when the firm's stock is not publicly traded, is usually estimated using the following components:

$$
\begin{aligned}
R_{\text{Private Equity}} = \ & \text{Risk Free Rate} + \\
& [\text{Equity Risk Premium} \times \text{Average Guideline Companies Beta}] + \\
& \text{Firm Size Premium} + \\
& \text{Firm-Specific Risk Premium}
\end{aligned}
$$

The first four terms, risk free rate, equity risk premium, average guideline companies beta and firm size premium, are available from market data sources or valuation studies. Depending on the parameters of the valuation, the risk free rate could be the rate on a long term U.S. Treasury bond, as of the valuation date, taken from auction or bond market quotes. The average beta for guideline companies, generally publicly traded companies in the same industry as the private company, is available from market data services (a publicly traded firm's *beta* is a measure of that firm's share price volatility relative to the overall market—see chapter 3). The *equity risk premium*, a measure of long term returns in excess of the risk free rate, and the *firm size premium*, a measure of additional risk found empirically in small firms, can both be obtained from academic studies and valuation services.

However, the last term, *firm-specific risk premium*, is more judgmental in that there may be no studies or sources that provide empirical quantities. Instead, firm-specific risk will reflect the valuation specialist's opinion of the risks relating to the cash flow projections used in the DCF model that are unique to the firm. The fraudster hopes to shape that opinion by manipulating historical earnings to create the illusion of steady predictable growth. Just as the appearance of predictable growth lowered the discount rate for publicly traded Constant Company, compared with Volatile, Inc., as discussed in chapter 3, to produce a higher share value for Constant, the fraudster's manipulation to create the appearance of steady growth for the private company gives the valuation specialist a false sense of comfort that the private company will achieve its forecast cash flow and growth targets, thus lowering the specialist's selected firm-specific risk premium. In addition, the valuation specialist may be especially impressed, through the fraudster's deceit, by the appearance of consistent growth relative to the guideline companies used to provide the average beta; the specialist would then select a lower firm-specific risk premium (which could actually be a negative adjustment) to compensate for the perceived difference in risk between the private company and the guideline peers.

To see the magnitude of impact of such a fraud, assume the private company's cost of equity before the firm-specific risk premium is 15 percent. Assume further that a reasonable estimate of the private company's firm-specific risk premium is 10 percent, but the fraudster has convinced the valuation specialist that the premium should be 3 percent due to the illusion of steady uninterrupted growth in prior years' earnings. Therefore, an appropriate cost of equity is 25 percent, and the manipulated cost of equity is 18 percent. For simplicity, assume there is no debt so that the cost of capital equals the cost of equity. If the forecast cash flow in the terminal year is $1 million and the expected growth rate is 3 percent, the terminal values for the appropriate and manipulated cost of capital are as follows:

$$TV_{\text{Private Appropriate}} = [\$1{,}000{,}000 \times (1 + 3\%)] / (25\% - 3\%) = \$4{,}681{,}818$$

$$TV_{\text{Private Manipulated}} = [\$1{,}000{,}000 \times (1 + 3\%)] / (18\% - 3\%) = \$6{,}866{,}667$$

The manipulation raised the terminal value of the private company by nearly 50 percent. However, the fraudster gets an additional bonus by manipulating cost of equity because the terminal value and cash flows from previous forecast years are discounted at the lower manipulated rate (18 percent in the preceding illustration) instead of the appropriate rate (25 percent). To continue the illustration, assume for simplicity the forecast period is 5 years and that the discounted present value of cash flows from the first 5 years adds to zero; therefore, the value of the private company equals the discounted terminal value. Then, using the appropriate and manipulated cost of equity as previously calculated, the private company's value is as follows:

$$PV_{\text{Private Appropriate}} = \$4{,}681{,}818 / (1 + 25\%)^5 = \$1{,}534{,}138$$

$$PV_{\text{Private Manipulated}} = \$6{,}866{,}667 / (1 + 18\%)^5 = \$3{,}001{,}483$$

Therefore, the manipulation of one single component, firm-specific risk, nearly doubled the calculated value of the firm. If the fraudster had also succeeded in manipulating growth assumptions, the results would be even more dramatic because growth affects not only the g value in the preceding formulas but also influences the net cash flow components of the forecast. The end result of earnings management in a closely held company is similar to the effect of earnings management on the price/earnings (P/E) multiple of publicly traded companies (see chapter 3): both can significantly influence valuations.

Use of Nonaccrual Accounting Standards

For most publicly traded companies listed on a U.S. stock exchange, U.S. GAAP is the standard of accounting because those firms must file financial statements with the SEC, and the SEC requires those statements to conform to U.S. GAAP. Foreign companies listed in the United States are allowed to file under either U.S. GAAP or International Financial Reporting Standards (IFRSs), and the SEC is studying whether to allow U.S. registrants to file under IFRSs in future years, assuming certain conditions are met. Private companies may use other accounting methods, sometimes referred to as *other comprehensive basis of accounting*, such as cash basis or tax basis methods. Both alternative methods offer unique opportunities and methods for fraudsters.

Cash Basis and Accrual Basis

For a closely held company, reducing fraud in the financial statements starts with requiring that financial statements presented to the board of directors and outsiders be in conformity with accrual basis standards of either U.S. GAAP or IFRSs. Some closely held firms use cash basis accounting, but the timing of cash flows in cash basis accounting can lead to the manipulation of financial statements. For that reason, U.S. tax laws generally require corporations to report on an accrual basis when gross receipts exceed an average of $5 million per year over the prior 3 tax years.[1]

Accrual basis accounting looks to economic events to determine whether a debt is incurred or revenue is earned; the time of the occurrence of those events may be quite different from when cash is paid or received. Accrual basis accounting limits the possibility for fraud because it is not dependent upon the timing of cash payments. For example, cash basis accounting may not require financial statement recognition of a debt, and the debt would not be apparent to a reader of those statements until the debt is paid and an expense is recorded. Conversely, cash basis accounting can accelerate revenue recognition if the firm receives cash payments for services to be rendered in future periods and records the receipts as revenue in the current period. Under both cases, accrual basis accounting would properly reflect the existence of the debt and deferral of revenues.

Tax Incentives

One of the most common uses of financial information from private companies is for income tax reporting purposes, and most taxable entities will strive to reduce reported income to minimize income taxes. Firms can and do maintain separate records for book and tax reporting with the objective of reporting as much income in the former and as little income in the latter as possible. Firms can legally lower taxable income to levels well below book net income through a number of allowable exclusions, deductions, and accelerated write-offs. For example, when a firm sells assets at a gain on an installment sale basis under which the seller will receive payments over a period of years, that firm can defer recognizing a portion of the gain until future tax periods for income tax purposes.[2] Under U.S. GAAP and IFRSs, the gain is recognized entirely in the year of sale.

However, the corporate alternative minimum tax imposed on earnings and profits through the adjusted current earnings (ACE) mechanism[3] has reduced, to some extent, the perceived advantage of using two sets of books. The ACE adjustment was designed to bring alternative minimum taxable income to a level closer to book-basis (financial reporting) net income. Gains from installment sales, for instance, are recognized in the year of sale under ACE, just as they are under U.S. GAAP.

To achieve fraudulent income minimization as a tax reduction strategy, a private firm may be willing to take on expenses that should otherwise be shared with other related parties, including owners. Conversely, a firm that has significant net operating loss (NOL) carryforwards for tax purposes may be willing to absorb income from other related parties. For

[1] Internal Revenue Code (IRC) Section 448.

[2] IRC Section 453.

[3] IRC Section 56.

example, assume two firms are under common ownership, and one firm (a manufacturer) makes products used by the second firm (its customer). However, the manufacturer has a sizeable NOL from prior tax years. The related party customer, wishing to minimize its taxes, may allow the manufacturer to mark up the price of products it sells so the manufacturer reports more income to use up its NOL carryforward. The (illicit) markup has the effect of increasing the customer's inventory cost that, eventually, reduces its income and taxes and does not cause the manufacturer to pay any current period tax. Aside from being subject to penalties and other measures for tax fraud,[4] the manufacturer's and customer's financial reporting-basis books are fraudulent, as well. Moreover, the manufacturer appears to be more profitable than it otherwise is. Thus, tax reduction can be an incentive for private companies to manipulate earnings.

The Correlation of Company Size and Fraud

Additional fraud reduction measures for private companies include the implementation of internal controls and promoting an ethical environment, as described in reports by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and discussed in chapter 7. The findings of COSO are especially applicable to private companies because research conducted and sponsored by COSO found that smaller companies (those with less than $100 million in assets) were more susceptible to fraud.

The importance of financial statement fraud reduction measures increases directly with company size. For a very small company, fraudulent financial statements that slightly inflate earnings or assets could be used to secure a bank loan or small investment, but little else. Steps taken to prevent fraud at that level should reflect the potential for damages resulting from such misstatement. For larger companies, or small companies fraudulently representing themselves as larger companies, potential damages are more serious; steps taken to reduce fraud should therefore be more visible and systematic. For example, a *middle market company*—a firm with $10 million to $100 million in assets—should implement reviews of internal controls at least once per year by outside CPAs and more frequently by internal accounting staff. If budgets allow, a significant fraud reduction measure would include hiring an internal auditor, who is a CPA, to assess the effectiveness of each business unit's controls. Assessments of internal control adequacy would help significantly with early fraud detection.

The Audit Committee's Role

As illustrated in the Link Company example, the reporting of irregularities to an audit committee comprising independent board members is one of the most important fraud prevention measures available to closely held companies. The opening of such a formal reporting channel increases the likelihood that corrective action will be taken. Without such a reporting channel, management, even if not directly involved in a fraud, might be inclined to sweep

[4] IRC Section 6663.

the problem under the rug for fear of reprisal or embarrassment. Private companies are not required to have an audit committee; however, they should at the very least have independent directors (see chapter 8 for a discussion of the independence of outside directors). The closely held firm that has no outside directors has a high potential for financial statement fraud, and a significant step to reduce the risk of fraud would be the appointment of such directors. Indeed, in an era of heightened sensitivity to the potential of fraud, the presence of an active audit committee is one of the best signals to capital providers, such as commercial bankers, investment bankers, and venture capitalists, that a firm is taking seriously the validity of its reported financial results.

Conclusion

Closely held companies present special and unique fraud opportunities and motives. Pressures from outside investors, banks, and VCs tug and pull firm management in many directions and may vary in intensity, depending on the financial objectives of the firm. A firm looking to minimize dilution of ownership will likely be more reliant on bank financing and, thereby, more susceptible to bank-related financial statement fraud, probably focused on the balance sheet. A firm looking at venture capital financing will come under different, and perhaps unexpected, pressures, probably focused on the income statement, if the VC's exit strategy is to take the firm public. For firms that do not intend to go public, outside investors may be a key source of capital and a key target of fraud. To add more complexity to this mix of funding scenarios, the closely held company may report its financial results on a basis other than accrual accounting.

To adequately detect and prevent against fraud in closely held companies, the CPA must either be a bit of a generalist or have access to a wide range of expertise. The CPA should have an understanding of how closely held companies are financed and the pressures they face. The CPA should also have a feel for how tax minimization affects management decisions. A functioning audit committee is also a key resource and fraud prevention measure for closely held businesses, and the CPA should strongly encourage clients to adopt such a committee or designate at least one outside board member to function in that capacity. See chapter 8 for more discussion on the topic of audit committees.

Chapter 6

Not-for-Profits and Government Entities

It may come as a surprise to some, but management in not-for-profit entities (NFPs) and government entities does have reason to engage in financial statement fraud. Instances of management pilfering the assets of a charitable organization and using financial fraud to cover up the theft have been well publicized. Likewise, most people think of government fraud as asset theft or conversion. However, both NFPs and governmental entities have motives and means that lie below the obvious; auditors and CPAs simply need to dig a little and be aware of the circumstances—some similar to companies in the public and private sector and some completely unique—that can lead to fraud.

NFPs: Similar to and Yet Separate From the For-Profit World

For the most part, motives and issues that affect closely held companies (see chapter 5) also affect NFPs, but the terms are somewhat different. In a desire to secure or retain bank financing, for instance, the NFP may wish to show itself to be fiscally responsible by showing a positive reported change in net assets on the NFP's statement of activities. To accomplish this objective, management may attempt to record contributions as revenue before receiving firm commitments from donors. This scheme is essentially the same as a for-profit entity prematurely recognizing revenue to produce positive net income on its income statement.

Similarities exist with closely held companies, as well. Issues that a for-profit company has with outside shareholders are akin to those that NFP management encounters with the board or trustees empowered with overseeing NFP activities. If management wishes to secure a pay raise, for example, showing improved financial results (a positive change in net assets) would help support the request.

However, some differences set NFPs apart.

Reputation Over Compensation

The one key difference between NFPs and for-profit firms is that management compensation may not be quite as strong a motivator. Instead, NFPs and their managers, especially those looking to the public for support and donations, are very concerned about their image (perhaps more so than for-profit companies). As a result, management of an NFP that is facing financial problems may hope to cover up the issues so the reputations of management and the NFP are not tarnished. The desire to protect reputations can be as strong an inducement for NFP management to manipulate financial data as any contingent bonus in the for-profit world.

Revenue Recognition

Unlike in closely held companies, recognizing revenue may be difficult for the NFP because it is not always clear when a donor has made a firm commitment or merely an expression of interest. Also, as will be seen in the following example, not all funds coming into an NFP are revenue: the NFP may be acting as an agent or transferor for other beneficiaries.

Classifying and Tracking Restricted Funds

When an NFP receives donations, the revenue may be restricted in regard to how it can be spent or invested (and the earnings from the investments also may be restricted). In addition to purpose restrictions, restrictions may be time limited (that is, temporary) or exist in perpetuity (that is, permanent). Paragraphs 3–4 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-605-45[1] state

> Contributions received by not-for-profit entities (NFPs) shall be reported as restricted support or unrestricted support. An NFP shall distinguish between contributions received with permanent restrictions, those received with temporary restrictions, and those received without donor-imposed restrictions. Contributions without donor-imposed restrictions shall be reported as unrestricted support that increases unrestricted net assets.
>
> Restricted support increases permanently restricted net assets or temporarily restricted net assets. A restriction on an NFP's use of the assets contributed results either from a donor's explicit stipulation or from circumstances surrounding the receipt of the contribution that make clear the donor's implicit restriction on use. Contributions

[1] International Financial Reporting Standards do not address accounting for not-for-profit entities; therefore, all citations in this section are to U.S. generally accepted accounting principles.

> with donor-imposed restrictions shall be reported as restricted support; however, donor-restricted contributions whose restrictions are met in the same reporting period may be reported as unrestricted support provided that an NFP has a similar policy for reporting investment gains and income (see paragraph 958-320-45-3), reports consistently from period to period, and discloses its accounting policy.

Therefore, donor restrictions must be carefully observed because they determine whether and how contributions are classified. Then, once recorded, temporarily restricted contributions must be monitored to determine if and when they become unrestricted, as discussed in FASB ASC 958-205-45-9:

> An NFP shall recognize the expiration of a donor-imposed restriction on a contribution in the period in which the restriction expires. A restriction expires when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions shall be recognized in the period in which the last remaining restriction has expired.

These requirements to properly account for restrictions present significant classification, reporting, and documentation challenges that require extensive attention to detail. Given that NFPs try to limit administrative costs (see the next section), it is frequently the case that an NFP's accounting personnel are strained to keep up, either because the NFP cannot hire accountants with sufficient training and experience or there simply are not enough on staff to get the job done.

Strain on accounting personnel presents an opportunity for a fraudster who may wish to show more unrestricted funds available to allow, perhaps, an increase in compensation or some other benefit. The fraudster may be able to convince inexperienced personnel to incorrectly book a transaction or, if personnel are too busy, to simply not bother to verify or monitor how funds are classified.

Expense Ratios

Many NFPs desire to demonstrate to potential donors that a significant portion of each contribution goes into worthwhile programs and is not spent on administrative functions, referred to as *supporting activities* by FASB ASC 958-720-20. An example of a measure used to assess the relative amount spent on nonprogram costs is the ratio of support expenses as a percentage of total revenues. Such expense ratios are typically compared with ratios of other NFPs in the same field to determine which are more efficient. The lower the expense ratio, the more funds are presumably employed in charitable activities rather than being consumed in administration or other functions. A strong incentive exists to classify as much expense as possible away from support to program activities to minimize the ratio.

FASB ASC 958-720-45-3 defines *program services* as follows:

> Program services are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists. Those services are the major purpose for and the major output of the NFP

and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others.

FASB ASC 958-720-45-6 defines *supporting activities* as follows:

Supporting activities are all activities of an NFP other than program services. Generally, supporting activities include the following activities:

a. Management and general activities
b. Fundraising activities
c. Membership development activities.

In discussing management and general activities, paragraphs 7–8 of FASB ASC 958-720-45 state the following:

Management and general activities include the following:

a. Oversight
b. Business management
c. General recordkeeping
d. Budgeting
e. Financing, including unallocated interest costs pursuant to paragraph 958-720-45-24
f. Soliciting funds other than contributions, including exchange transactions (whether program-related or not), such as government contracts, and related administrative activities
g. Disseminating information to inform the public of the NFP's stewardship of contributed funds
h. Announcements concerning appointments
i. The annual report
j. Related administrative activities
k. All management and administration except for direct conduct of program services or fundraising activities.

The costs of oversight and management usually include the salaries and expenses of the governing board, the chief executive officer of the NFP, and the supporting staff. If such staff spend a portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses shall be allocated among those functions.

In discussing fundraising activities, paragraphs 9–10 of FASB ASC 958-720-45 state the following:

Fundraising activities include the following:

a. Publicizing and conducting fundraising campaigns
b. Maintaining donor mailing lists
c. Conducting special fundraising events
d. Preparing and distributing fundraising manuals, instructions, and other materials

> e. Conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.
>
> Fundraising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in the Contributions Received Subsection of Section 958-605-25.

In discussing membership development activities, FASB ASC 958-720-45-11 states the following:

> Membership development activities include the following:
>
> a. Soliciting for prospective members and membership dues
> b. Membership relations
> c. Similar activities.

As the following example demonstrates, these definitions are not always as easy to implement as they appear:

Example Scenario

The Snail Darter Foundation is an NFP organization established by environmental activists to perform research and educate others on behalf of endangered species. It is a qualified tax-exempt entity under Internal Revenue Code (IRC) Section 501(c)(3), and its primary source of revenues consists of solicited, tax-deductible contributions from individuals. Snail Darter also receives about 30 percent of its funding from grants provided through the Environmental Protection Agency (EPA) to perform certain research.

The executive director of Snail Darter is tasked with overall management of the foundation's operations, as well as fundraising, and reports to the foundation trustees. The staff numbers between 20 and 30 people in various full- and part-time positions, and the current year budgeted revenues are $6 million.

In past years, the executive director had been rather successful in raising funds, including grants from the EPA, but he was getting restless with his current position and had his eye on a more prestigious job at the Sierra Club. He knew a senior program director at the Sierra Club was due to retire at the end of next year, creating an opening. To be a serious contender, the executive director needed to show strong continued fundraising and operating skills in the current year and next year.

However, in January of the current year, a new administration took office in Washington, D.C., and the EPA severely cut back on funding for research conducted by nongovernmental organizations, such as Snail Darter. Although grants made under the previous administration would be funded into the current year, the result of the change in policy was that several of Snail Darter's research grant applications submitted a few months earlier were returned, and no more would be accepted. When the executive director asked the bookkeeper (Snail Darter had no controller) to assess the impact of the loss of the research grants, the bookkeeper responded that grant revenue for the current year would be approximately one-third of the amount budgeted, causing a shortfall of $600,000 in total revenues.

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To be in the running for the Sierra Club position, the executive director had to demonstrate an ability to grow fund revenues over time, and if he could show an increase in revenues in a changing political environment, he thought that would put him at the top of the list. The executive director projected that fundraising from individuals would increase in the current year by $300,000 to $500,000, but with the loss of $600,000 of government research funds, his plan for advancement was in peril. Moreover, a net loss of revenues could potentially affect the standing of the executive director's reputation among fellow environmentalists, as well: a decline in Snail Darter's revenues would be seen as a loss of political influence.

The executive director's first action was to prepare to operate at a lower level of revenues. He could pare back the research program staff as their grant-funded work came to an end, but his supporting activities costs would still remain. Making any reductions to administrative staff was next to impossible because they were already thinly spread. The end result would be the likely increase in Snail Darter's supporting expenses as a percentage of revenues. However, that increase would cause embarrassment for the executive director in the future because he frequently stressed to potential donors the high percentage of revenues going to programs at Snail Darter, relative to other organizations.

After giving the matter some thought, the executive director instructed the bookkeeper to allocate 20 percent of the supporting expenses to the various programs because "at least a portion of the work performed by our administrative staff directly helps our programs." That reason made sense to the bookkeeper, who felt underappreciated and thought that including a portion of the cost in the program budgets would elevate the status of administrative staff. Thus, the executive director put in place some "insurance," as he referred to the expense allocation, to protect Snail Darter's historically low expense ratio in the event that he could not replace the lost grant revenues in the current year.

Making up for the revenue shortfall would prove more challenging. The executive director had previously been approached by Trees Unlimited Foundation, an NFP that was just starting, to share Snail Darter's mailing list of donors. The executive director jealously guarded that list and would not let anyone have it, but he offered to make a mailing on behalf of Trees Unlimited whereby contributions from the mailing would come to Snail Darter, and Snail Darter would, in turn, make distributions of the funds to Trees Unlimited. Not only did this method protect the names of people on the donor list from disclosure to outsiders, it gave the executive director—he thought—a way to recognize the contributions as revenue to Snail Darter that would replace some of the shortfall. Under the plan, the funds would flow through to Trees Unlimited, net of any out-of-pocket costs and a fee for staff time.

Although the donor list was tapped out for contributions to Snail Darter, the Trees Unlimited appeal struck a responsive chord, and donors came up with approximately $100,000 of contributions, but that was not enough to restore growth. The executive director had one more idea. In previous lawsuits filed by Snail Darter to halt plant relocations to environmentally sensitive areas, the executive director had come to know officials at a labor union that had supported Snail Darter in the suits. The union now wanted to make donations to certain prolabor candidates for public office; however, because of past legal problems and a pending criminal investigation, the candidates did not want to accept the money from the union. A union official suggested to the executive director that the union make the contributions to Snail Darter and that Snail Darter send those contributions on to the appropriate candidates (after deducting a "handling fee"). To the executive director, the concept sounded similar to the Trees Unlimited proposal, and because the union's list of candidates had positions supportive of Snail Darter's cause, the executive director believed he could not object.

The union's contributions, when added to the Trees Unlimited funds, covered the shortfall due to loss of the research grants. The increase in donor contributions to Snail Darter, forecast by the executive director, materialized, as well, bringing in a 15 percent increase in revenues over the budgeted amount and giving the executive director the strong fundraising performance he needed to be a serious candidate for the Sierra Club position. As an added benefit, the allocation of a portion of administrative costs to program expenses, combined with the increase in contributions, caused the expense ratio for the current year to decline markedly as supporting expenses dropped and revenues went up. The executive director made sure the bookkeeper recorded the outflow of funds to Trees Unlimited and the candidates as program costs, so the statements given to the trustees "would not raise any unnecessary questions."

Example Analysis

This example sets up a number of issues to discuss. First, the executive director's allocation of 20 percent of administrative costs to program expenses was arbitrary and unsupportable under U.S. generally accepted accounting principles (US GAAP). Perhaps after appropriate analysis, some of the fundraising costs could be allocated to programs, in accordance with FASB ASC 958-720-45-28, because a portion of fundraising typically includes education materials, and environmental education is a purpose of Snail Darter. Management and staff expenses may only be allocated to programs if, according to FASB ASC 958-720-45-8, "such staff spend a portion of their time directly supervising program services." There was no evidence in the example scenario that any staff directly supervised research or education programs. The 20 percent was probably selected to scale back supporting expenses to stay in line with rebudgeted revenues that were expected to drop by the same percentage due to loss of government grants. The result was precisely the "insurance" the executive director mentioned: protection for the NFP's expense ratio. The lesson for CPAs is to insist on documentation for expense allocations, even though such documentation may be hard to come by given the typical workload handled by NFP staff.

The Trees Unlimited funds create a more subtle complication. Appropriate U.S. GAAP guidance is found in FASB ASC 958-605-25-24, which states

> Except as described in the following paragraph and paragraph 958-605-25-27 [regarding variance power and financially interrelated entities, respectively], a recipient entity that accepts assets from a donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary is not a donee. It shall recognize its liability to the specified beneficiary concurrent with its recognition of cash or other financial assets received from the donor.

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Therefore, unless an exception applies, funds that simply flow through an NFP on their way to another beneficiary must be recorded as a liability of the NFP, not as revenue when received or program expense when disbursed. Because Snail Darter and Trees Unlimited are not financially interrelated entities,[2] the only exception potentially relevant in this case is found in FASB ASC 958-605-25-25, which states that the contributions can be booked as revenues "if the donor explicitly grants the recipient entity variance power—that is, the unilateral power to redirect the use of the transferred assets to another beneficiary." For the example scenario, no specific mention is made of variance power. Whether there is variance power frequently becomes an issue of the latitude granted to the recipient organization from the donors. In this case, when Snail Darter solicited contributions to go to Trees Unlimited, Snail Darter may have made an explicit or implicit promise that all funds raised, net of expenses, would go to Trees Unlimited. It is likely that the understanding of the donors was such. It would fall to the executive director to make a case that his organization had variance power, and his case looks weak. This example of the flow-through charitable contributions illustrates a key area CPAs should examine in the context of potential financial statement fraud at NFPs.

The case of the political contributions is clearer and has graver repercussions. Setting aside whether running the union contributions through the NFP is a violation of campaign finance laws, the contributions to political candidates violate the IRC Section 501(c)(3) prohibition on participating in any political campaign. As such, the contributions fall outside the stated purpose of Snail Darter's program activities. The stated activities were research and education; if political campaigning had been listed as one of the NFP's activities, the IRS would not likely have granted it 501(c)(3) status. Therefore, it would not qualify as a program expense, and Snail Darter, acting as an agent for the union, would have to record the funds as a liability until dispersed. The political contributions would not increase revenues. More important, loss of 501(c)(3) status may severely hamper the NFP's ability to raise funds in the future because those contributions would no longer be tax deductible.

In this example, the motives for the executive director were not explicitly monetary. His desire to present himself as a qualified candidate for a more prestigious position at a larger organization was a key driver, but his and his organization's reputation was just as important. Therefore, the CPA, when looking for motives, may find nonmonetary motives playing a larger role with NFPs.

The lack of internal controls is evident but, unfortunately, not that uncommon. If an NFP truly cannot afford to hire a knowledgeable accountant, the trustees or board members must step in and take on some review, and perhaps approval, functions. If those functions make the trustees or board members uneasy, perhaps priorities should be rearranged to allow for retaining the appropriate personnel. Frequently, the establishment of strong internal controls within an NFP is a matter of priorities competing with the NFP programs. The CPA must carry the argument for strong controls and spell out the consequences if controls fail. Working in favor for the CPA are state laws that impose civil and criminal penalties on NFP management and its trustees in the event of fraud. For NFP trustees who frequently have distinguished business and social careers and who serve for little or no pay, the prospect of litigation or prosecution in the event of fraud is not at all welcome. In addition, the consequences of financial fraud for the NFP itself may include irreparable harm to the NFP's reputation, loss of tax-exempt status, and loss of government grants and public donations.

[2] Financial Accounting Standards Board *Accounting Standards Codification* 958-605-25-27.

Government Entities

Governmental entities have motives to publish misleading financial statements, and those motives are quite similar to those for NFPs. This section looks at motives and methods used within governmental entities.

The Significance of Compensation and Reputation

Compensation actually can be a motive in government. Even though salaries in grade are set by governing bodies (such as legislatures), promotions depend, at least in part, on perceived capabilities. Perceived capabilities in government, to no small degree, depend on reputation. Managers who, due to adverse circumstances, find their governmental units in difficult financial condition may find that the desire to protect their reputations will cause them to attempt to manipulate financial reports. Therefore, the motivational elements present in NFPs are also found in government.

The Dangers in Greater Disclosure

New reporting standards may also provide incentive for fraud. As Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* was implemented at various levels of government through 2003, the format for financial reporting by governmental entities became more like the reporting by publicly traded companies. In fact, GASB Statement No. 34 mandated a "Management's Discussion and Analysis" (MD&A) section as required supplemental information that is similar in nature and objective to the MD&A required by the Securities and Exchange Commission. The "Summary" section of GASB Statement No. 34 stated

> MD&A should provide an objective and easily readable analysis of the government's financial activities based on currently known facts, decisions, or conditions. MD&A should include comparisons of the current year to the prior year based on the government-wide information. It should provide an analysis of the government's overall financial position and results of operations to assist users in assessing whether that financial position has improved or deteriorated as a result of the year's activities. In addition, it should provide an analysis of significant changes that occur in funds and significant budget variances. It should also describe capital asset and long-term debt activity during the year. MD&A should conclude with a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations.

These MD&A requirements have expanded since GASB Statement No. 34 was issued and are now listed in GASB *Codification of Governmental Accounting and Financial Reporting Standards* (GASB Codification) Section 2200.106-.109.

With the additional MD&A disclosures, come motives for fraud. For instance, if a governmental fund is faced with having to report that its financial position has deteriorated as a result of the year's activities, its managers may attempt to manipulate either the balance sheet or the statement of revenues, expenditures, and fund balances.

For the most part, fraudulent manipulation techniques discussed elsewhere in this book apply to governments, as well, but the following sections discuss a few fraud areas that are unique to government.

Methods for Hiding Problems

In the past, governments may have been able to report only selected information to the public, thus avoiding embarrassing disclosures of bad news, until the problem became so severe that it required drastic action. However, with the issuance of GASB Statement No. 34, governments were required to issue government-wide financial statements with certain larger funds broken out and then reconciled to the government-wide statements. Will all this disclosure reduce fraud? Not likely; it simply will force fraudsters to become more creative.

Fraudsters in government may try to hide problems by shifting them among different funds, and a plethora of different types of funds are used in government. GASB Codification Section 1100.103 lists the following fund types:

> In fund financial statements, governments should report governmental, proprietary, and fiduciary funds to the extent that they have activities that meet the criteria for using those funds.
>
> a. Governmental funds (emphasizing major funds)
>   (1) The general fund
>   (2) Special revenue funds
>   (3) Capital projects funds
>   (4) Debt service funds
>   (5) Permanent funds
>
> b. Proprietary funds
>   (6) Enterprise funds (emphasizing major funds)
>   (7) Internal service funds
>
> c. Fiduciary funds (and similar component units)
>   (8) Pension (and other employee benefit) trust funds
>   (9) Investment trust funds
>   (10) Private-purpose trust funds
>   (11) Agency funds.

If within one government-wide reporting unit, one fund has problems and another does not, a loan or transaction from one to the other may cover up the issue, at least for a short period of time.

Gray Areas in Revenue and Asset Classification

To the government, revenues are taxes, fees, fines, and other assessments. However, some revenues come to the government for special purposes, such as building a convention center or funding secondary education. Those revenues are restricted and must be separately tracked. Similarly, on the balance sheet, as first set out in GASB Statement No. 34, "[t]he net assets of a government should be reported in three categories—invested in capital assets net of related debt, restricted, and unrestricted."[3] Therefore, just as with NFPs, governments must properly determine how revenues create net assets in each of those categories.

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[3] Now as codified in Governmental Accounting Standards Board *Codification of Governmental Accounting and Financial Reporting Standards Section* 2200.115.

There are often ambiguities that provide ample room for fraudsters to maneuver. For example, a fund set up to receive revenues earmarked for a special purpose may fulfill that special purpose, at least for the current fiscal year, and have excess funds left over. A fraudster trying to deal with a shortfall of revenues in the general fund may be able to loan money from the special purpose fund, although that would require some documentation and would leave a paper trail.

A more clever solution would be to leave the excess funds where they are and simply allocate the excess funds to the general fund's assets. One method to accomplish recording the assets in a different fund would be to reclassify the revenues in excess of special purpose needs as those revenues are received, hoping that the multiple small reclassifications will go unnoticed.

Another more straightforward method would be to consolidate the special purpose fund into the general fund if the special purpose fund was not so large that it did not need to be separately disclosed. Indeed, GASB contemplated this issue when developing its financial disclosure requirements, as contained in GASB Codification Section 2300.104–.105:

> One of the key aspects of the reporting entity concept is that users should be able to distinguish between the primary government and its component units. Thus, because the notes and required supplementary information (RSI) are integral parts of the financial statements, they should distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units.
>
> Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component unit basis. A specific type of disclosure might be essential for one component unit but not for another depending on the component unit's significance relative to the total component units included in the component units column(s) and the individual component unit's relationship with the primary government.

If the CPA suspects fraud in a governmental entity, the investigation should include, and perhaps start with, an analysis of the component unit-by-component unit basis that originally determined which units were included or excluded from the financial statements.

Conclusion

Financial statement fraud at NFPs and governmental units has common motivators in compensation and reputation, with both playing equal roles. This shift away from the dominant role compensation plays in for-profit company financial statement frauds will require CPAs to approach suspected fraud in NFPs and governments in a different way. In the for-profit company, if the CPA can figure out who got rich from the fraud scheme, he or she may be close to identifying the perpetrators. In an NFP or government unit, no one may be rich as a result of the fraud scheme—someone just may have kept his or her job and reputation (until caught), and that may be motivation enough.

The rules of accounting for NFPs and governments are markedly different from those of for-profit companies, but the methods to implement financial statement fraud still deal with the basic concepts of manipulating assets, revenues, expenses, and other items. The challenge for the CPA is to master the specific accounting rules in these specialized areas because the fraudsters have done so and will attempt to hide their moves in the arcane technicalities embedded in NFP and governmental accounting.

SECTION 2

The Fraud Battle

Chapter 7

Research Findings on Fraudulent Accounting

Significant and path-breaking research into financial statement fraud has been conducted since the 1980s when the savings and loan industry collapsed and audit failures were contributing factors. The AICPA, among others, led the research effort by participating in the Committee of Sponsoring Organizations (COSO), a voluntary private sector organization dedicated to improving the quality of financial reporting. COSO was sponsored and funded the National Commission on Fraudulent Financial Reporting, chaired by James C. Treadway, Jr., then executive vice president and general counsel of PaineWebber Incorporated, and it came to be known as the Treadway Commission.

In October 1987, the Treadway Commission published the *Report of the National Commission on Fraudulent Financial Reporting* (1987 Treadway report). The report covered a wide range of research projects, but chief among them was a review of all accounting and disclosure cases brought by the Securities and Exchange Commission (SEC) against public companies over the prior five years. In 1999, to continue the work begun with the 1987 Treadway report, COSO sponsored further research published under the title *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (the 1999 research report). That report sought to identify and examine company and management characteristics in corporations involved in financial statement fraud by reviewing SEC enforcement actions over the 1987–97 period, picking up where the 1987 Treadway report left off. In addition, between the 1987 Treadway report and the 1999 research report, in 1992, COSO published *Internal Control—Integrated Framework* (the internal control report) in an effort to derive a common definition of internal control and identify its key components. In 2010, COSO updated the 1999 research report with the publication of *Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies* (the 2010 research report), available at www.coso.org.

The 1987 report, and the 1999 and 2010 research reports provided the basis used today to identify the motives and conditions found in companies that engage in fraudulent financial reporting. The reports also identified numerous internal control weaknesses addressed by the internal control report. This chapter reviews report findings that are important from the CPA's viewpoint. One key area in all the reports was the audit committee's role, which, because of its importance, is covered in a separate chapter (see chapter 8).

The 1987 Treadway Report

In addition to reviewing a large quantity of published research in the area of fraudulent financial reporting, the Treadway Commission sponsored 10 research projects with external academicians and practitioners and launched 20 studies conducted by its own staff (paid for by COSO). Among the external studies were such topics as following:

- Expansion of nonaudit services and auditor independence
- Surprise write-offs—financial reporting, disclosure, and analysis
- The independent public accountant's responsibility for the detection of fraudulent financial reporting

It is interesting to see that these particular topics were discussed in the 1980s because each returned to the forefront of discussions among practitioners in the recent past:

- Prior to passage of the Sarbanes-Oxley Act of 2002, nonaudit services to audit clients had been the focus of extensive discussions between the SEC and major accounting firms. Nonaudit services were sharply limited by the Sarbanes-Oxley Act of 2002 as part of the post-Enron reforms.
- Surprise write-offs were one of the topics chosen by Arthur Levitt, former SEC chairman, for a speech delivered in 1998, one decade after the 1987 Treadway report. He referred to them as "'big bath' restructuring charges" (see chapter 3). The write-offs were addressed in SEC Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*, issued in 1999.
- The accountant's responsibility for the detection of fraud has been a long-standing ongoing issue and was specifically addressed in Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, and subsequently in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which replaced SAS No. 82 in 2002 (see chapter 1).

One study conducted by the COSO staff is of particular interest: the review of SEC cases involving fraudulent financial reporting. Looking at all accounting and disclosure cases from July 1, 1981, to August 6, 1986, the staff reached the following conclusions:

- Forty-four percent of the cases against public companies occurred in industries that were experiencing, or about to experience, a general economic decline.
- Eighty-seven percent of the cases against public companies involved manipulation of the financial disclosures versus misappropriation of assets for personal gain (3 percent). Frequently used techniques were
  - improper revenue recognition methods (47 percent),
  - deliberate overstatements of company assets (38 percent), and
  - improper deferral of current period expenses (16 percent).
- In 27 percent of the cases against public companies, the SEC alleged that other information disseminated to the public was inadequate or otherwise contained false and misleading statements.
- In 45 percent of the cases against public companies, the SEC alleged that the fraud occurred because of a breakdown of the company's internal controls. In many of these instances, the company had adequate internal accounting controls; however, these controls were overridden by management.
- The SEC cited a member of upper-level corporate management (CEO, president, or CFO) as being involved in 66 percent of the cases against public companies.
- Although 84 percent of all public companies are audited by national public accounting firms, 74 percent of the actions brought against independent public accountants were against smaller, regional, or local firms or sole practitioners.

The findings place senior management at the scene of the fraud in two-thirds of the cases, setting the stage for the internal control report to conclude that the tone at the top of an organization was very important, a message echoed by the 1999 and 2010 research reports, as well. Regarding the methods used by fraudsters, the findings gave early warnings of revenue recognition and asset overstatement problems that would continue into the next several decades.

Standard Setters Play Catch-Up

In the 1990s, accounting standard setters attempted to address the issues raised by COSO and others. Concerning revenue recognition problems, in December 1999, the SEC issued SAB No. 101, *Revenue Recognition in Financial Statements*, later revised in 2003 with SAB No. 104, *Revenue Recognition* (see chapter 13 and Appendix C). In the United States, some of the overstatement problems were addressed in Financial Accounting Standards Board (FASB) Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, issued in March 1995 and later superseded in August 2001 by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and now codified in FASB *Accounting Standards Codification* 360, *Property, Plant, and Equipment*. The U.S. accounting standards literature in both areas has since been modified and expanded by later pronouncements of the SEC, FASB, and the Emerging Issues Task Force. The International Accounting Standards Committee, the predecessor to the International Accounting Standards Board (IASB), issued International Accounting Standard 36, *Impairment of Assets*, in 1998, and the IASB has updated the standard several times.

The 1999 and 2010 Research Reports

In 1998, COSO commissioned a study led by three academicians, Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson, to follow up on the findings of the 1987 Treadway report. The researchers surveyed SEC Accounting and Auditing Enforcement Releases (AAERs) issued over the period 1987–97 to identify approximately 300 companies involved in alleged financial statement fraud. Of those companies, the researchers randomly selected 204 to review in-depth, and they published their findings in March 1999.

The 2010 research report, authored by the same academicians with the addition of Terry L. Neal, followed the same methodology looking at AAERs over the period of 1998–2007, identifying 347 cases of alleged fraudulent financial reporting. This study period, though, picked up the quantitatively large, headline-grabbing cases of Enron and Worldcom, among others. As a result, the average (or mean) size of reported frauds increased from $25 million in the 1999 research report to $400 million in the 2010 research report. Admittedly, these averages were skewed by those large fraud cases, but even measuring by the median size fraud (the fraud in the middle of the list of frauds ranked from smallest to largest), the study found an increase from $4.1 million in the 1999 research report to $12.05 million in the 2010 research report. Therefore, by either measure, the magnitude of fraud increased from the 1987-1997 period of the 1999 research report to 1998-2007 period of the 2010 research report.

Some of the principal report conclusions of interest to accountants today deal with findings about the operating and financial condition of the companies that were the subject of SEC fraud investigations, the quality of internal controls at those companies, and the nature of the frauds committed. The following sections summarize the findings of the 2010 research report in each area.

Operating and Financial Condition

Size and Market Listing

Outside of the well-publicized fraud companies, the typical company cited in an AAER was middle-market with median assets of $93 million and median revenues of $72 million, and at least three-quarters of the firms cited had less than $674 million in either assets or annual revenues. Nevertheless, these data are about four to six times the magnitude of similar data in the 1999 research report.

The percentage of fraud firms cited in the AAERs was disproportionately high for The NASDAQ OMX Group markets. Over the period of the 2010 research report study, the number of fraud companies that traded on a NASDAQ market was 50 percent of all fraud companies; however, NASDAQ accounted for only about 24 percent of all listed companies. For that reason, this book refers to NASDAQ listing standards often when examining the impact of stock markets on financial reporting fraud.

Financial Stress

Earnings reported in the years preceding the fraud gave the researchers information about earnings trends. For 313 of the 347 companies in the sample, the researchers were able to obtain clean financial statements for the years prior to frauds identified in the AAERs. With data from those companies, the researchers concluded:

> Some of the sample companies were financially stressed in the period preceding the fraud period. The median net income was only $875,000, with the 25th percentile facing net losses of nearly $2.1 million. The 75th percentile had net income just over $18 million in the year before the fraud allegedly began. Similarly, cash flow from operations averaged $246 million, while median cash flow from operations was only $317,000. This closeness to break-even positions was consistent with what was observed in COSO's 1999 study.

Leadership and Board Committees

Just as the 1987 Treadway report found top management was heavily involved in fraudulent activity, the percentages were worse in the 1999 and 2010 research reports. The researchers recorded the positions of individuals named in the AAERs who were related to a cited financial statement irregularity. Aggregating those individuals by title, researchers found that 83 percent of the cases studied in the 1999 research report and 89 percent of the cases studied in the 2010 research report, the CEO or CFO, or both, were involved. The 1987 Treadway report placed the percentage of senior level involvement at 66 percent. Thus, the trend in fraud is more senior management involvement, and the tone at the top of an organization becomes a paramount issue.

The researchers, after reviewing the motives for fraudulent behavior of senior managers, determined that incentive compensation plans were a key concern. They also found that outside pressures, such as meeting analysts' expectations, played a role. The 1999 research report concluded the following:

> The frequency of CEO and CFO involvement highlights the importance of assessing key performance pressures faced by senior executives. Boards of directors and audit committees need to consider the potential for these pressures when designing executive compensation plans for their key executives. Board of director and audit committee members need to exercise professional skepticism when evaluating top management actions. Boards and audit committees may also look for pressures from outside the organization for meeting key company performance targets. Monitoring perceived pressures from the investment community to meet stated performance expectations, for example, may be warranted for boards, audit committees, and auditors.

The 2010 research report, while citing compensation structure as a recurring issue raised in AAERs, reached the statistically significant finding that "fraud firms were significantly less likely to have maintained a compensation committee than no-fraud firms." Without a separately constituted compensation committee, review of compensation plans falls entirely upon the board of directors, and perhaps weighed down with other responsibilities, the entire board does not thoroughly consider how plan structures may encourage fraud. Thus, CPAs have another clue to examine if a firm does not have a compensation committee.

The 1999 research report also found problems with audit committees. First, audit committees of AAER companies met only once per year or were nonexistent. Furthermore, approximately two-thirds of audit committee members had little accounting or finance experience. Also, 60 percent of audit committee members who were supposed to be independent actually had significant ties to the company, making them what the researchers called "grey directors." In addition, approximately 40 percent of the AAER companies had family relationships between officers and directors.

Concurrent with the publication of the 1999 research report, in 1999 the New York Stock Exchange and the National Association of Securities Dealers (now the Financial Industry Regulatory Authority) jointly issued *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (BRC report), which resulted in enhanced audit committee requirements. Drawing upon the 1987 Treadway report findings, among others, the BRC report recommended, and the national stock markets implemented through their listing standards, changes to improve audit committee competence and independence.

The NASDAQ OMX Group, for example, now sets a standard for most listed companies that requires three independent directors, at least one of which must be financially literate:

> **Marketplace Rule 5605(c)(2)(A)—Audit Committee Composition**
> Each Company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be independent as defined under Rule 5605(a)(2); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the [1934 Securities Exchange] Act (subject to the exemptions provided in Rule 10A-3(c) under the Act); (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement. Additionally, each Company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

In Marketplace Rule 5605(a)(2), NASDAQ defines an *independent director* by describing relationships that could interfere with the exercise of independent judgment:

> "Independent Director" means a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. For purposes of this rule, "Family Member" means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. The following persons shall not be considered independent:
>
> (A) a director who is, or at any time during the past three years was, employed by the Company;

(B) a director who accepted or who has a Family Member who accepted any compensation from the Company in excess of $120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:
    (i) compensation for board or board committee service;
    (ii) compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or
    (iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

    Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 5605(c)(2).
(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company as an Executive Officer;
(D) a director who is, or has a Family Member who is, a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than the following:
    (i) payments arising solely from investments in the Company's securities; or
    (ii) payments under non-discretionary charitable contribution matching programs.
(E) a director of the Company who is, or has a Family Member who is, employed as an Executive Officer of another entity where at any time during the past three years any of the Executive Officers of the Company serve on the compensation committee of such other entity; or
(F) a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.
(G) in the case of an investment company, in lieu of paragraphs (A)–(F), a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

Even though it is worthwhile to see how the securities markets addressed the issue of audit committee quality, it is just as important for CPAs who consult to private companies to understand these standards, as well. The audit committee is the linchpin to the internal control mechanism (see chapter 8). Many types of material financial fraud perpetrated by firm management can be detected (and perhaps prevented) by an effective audit committee. Although private nonlisted companies are not subject to these rules by statute, any private company that is serious about demonstrating its commitment to high business ethics should nevertheless adopt an audit committee structure similar to those imposed on public companies by the nation's securities markets.

Nature and Duration of Fraud

Regarding how fraud was committed, the 2010 research report[1] found that the number of companies was split somewhat evenly between improper revenue recognition and asset overstatement, with the former slightly edging out the latter, as shown in table 7-1. Fictitious revenues and premature recognition of revenues were common in the revenue recognition category; overstating existing assets dominated the asset overstatement category. Table 7-1, taken from the 2010 research report, summarizes the findings:

Table 7-1: *Common Financial Statement Fraud Techniques*

Methods Used to Misstate Financial Statements	Percentage of the 204 Sample Companies Using a Fraud Method*
Improper Revenue Recognition: Recording fictitious revenues—48% Recording revenues prematurely—35% No description/"overstated"—2%	61%
Overstatement of Assets (excluding accounts receivable overstatements due to revenue fraud): Overstating existing assets or capitalizing expenses—46% Recording fictitious assets or assets not owned—11%	51%
Understatement of Expenses/Liabilities	31%
Misappropriation of Assets	14%
Inappropriate Disclosure (with no financial statement line item effects)	1%
Other Miscellaneous Techniques (acquisitions, joint ventures, netting of amounts, etc.)	20%
Disguised through use of related party transactions	18%
Insider trading also cited	24%

* The subcategories such as premature revenues or fictitious revenues and assets do not sum to the category totals due to multiple types of fraud employed at a single company. Also, because the financial statement frauds at the sample companies often involved more than one fraud technique, the sum of the percentages reported exceeds 100 percent.

The researchers elaborated on the methods cited in the AAERs to perpetrate the alleged frauds:

> the revenue misstatements were primarily due to recording revenues fictitiously or prematurely by employing a variety of techniques that include the following:

[1] Beasley, Mark S. et al. *Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies*. Committee of Sponsoring Organizations of the Treadway Commission (COSO). 2010.

- **Sham sales.** To conceal the fraud, company representatives often falsified inventory records, shipping records, and invoices. In some cases, the company recorded sales for goods merely shipped to another company location. In other cases, the company pretended to ship goods to appear as if a sale occurred and then hid the related inventory, which was never shipped to customers, from company auditors.
- **Conditional sales.** These transactions were recorded as revenues even though the sales involved unresolved contingencies or the terms of the sale were amended subsequently by side letter agreements, which often eliminated the customer's obligation to keep the merchandise.
- **Round-tripping or recording loans as sales.** Some companies recorded sales by shipping goods to alleged customers and then providing funds to the customers to pay back to the company. In other cases, companies recorded loan proceeds as revenues.
- **Bill and hold transactions.** Several companies improperly recorded sales from bill and hold transactions that did not meet the criteria for revenue recognition.
- **Premature revenues before all the terms of the sale were completed.** Generally this involved recording sales after the goods were ordered but before they were shipped to the customer.
- **Improper cutoff of sales.** To increase revenues, the accounting records were held open beyond the balance sheet date to record sales after the goods were ordered but before they were shipped to the customer.
- **Improper use of the percentage of completion method.** Revenues were overstated by accelerating the estimated percentage of completion for projects in process.
- **Unauthorized shipments.** Revenues were overstated by shipping goods never ordered by the customer or by shipping defective products and recording revenues at full, rather than discounted, prices.
- **Consignment sales.** Revenues were recorded for consignment shipments or shipments of goods for customers to consider on a trial basis.

Several of these issues were addressed by the SEC in SAB No. 101 and later in SAB No. 104 (see chapter 13).

Asset overstatements fell into a number of categories, but the most common were inventory and accounts receivable, as shown in table 7-2.

Table 7-2: *Asset Accounts Frequently Misstated*

Asset Accounts Typically Overstated	Number of Sample Companies Involved
Inventory	51
Accounts receivable	43
Property, plant and equipment	24
Loans or notes receivable Cash/Marketable Securities	19
Loans/Notes Receivable/Mortgages	13
Investments	12
Prepaid Expenses	11

The finding that inventory and accounts receivable fraud accounted for nearly half of asset overstatements directs the CPA back to those steps that auditors rely upon to test existence and valuation: performing physical inventory; sending confirmations to third parties; and testing values using marketplace data, including data on customer solvency.

Duration

The 2010 research report found that the period of time over which financial reporting frauds are committed has lengthened compared to findings in the 1999 research report:

> Fraud periods extended on average for 31.4 months, with the median fraud period extending 24 months. This was slightly longer than the average and median fraud periods of 23.7 months and 21 months, respectively, reported in COSO's 1999 study. ... The longest problem period was 180 months (and it was 168 months for two other companies).

While looking at duration, though, the researchers found something even more interesting in that the frauds generally started with quarterly reports and then continued to include annual reports. This finding tells CPAs to watch for the warning signs of fraud, well before the end of the fiscal year. For instance, a regional manager engaging in improper revenue recognition may brag at a firm-sponsored conference in the middle of a fiscal year that he or she was able to meet sales goals when most other regions had great difficulty. If not investigated early and stopped, his or her practices may spread to other regions in subsequent quarters as other managers see revenue manipulation as the only way to keep up, and they rationalize that because another region got away with it, they can, as well.

Internal Control Report

After the 1987 Treadway report pointed to internal control failures that gave rise to the frauds, COSO published an analysis of the internal control framework in 1992. One objective of the internal control report was to reach a common definition of *internal control*. COSO concluded that internal control was

> 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 the following categories:
>
> 1. Effectiveness and efficiency of operations.
> 2. Reliability of financial reporting.
> 3. Compliance with applicable laws and regulations.

COSO recommended implementation of five interrelated components of internal control to ensure reliability of financial reporting and compliance with applicable laws. Actually, the five components are closer to steps in a process of implementing internal controls, and the steps follow a specific order:

- *Control environment*. This is the term COSO used to express the organization's tone at the top that is charged with setting ethical standards to establish a control consciousness among the people, management, and board of an organization.

- *Risk assessment.* The organization must identify, assess, and then manage risk. More importantly, it must implement a process that addresses risks associated with change.
- *Control activities.* The organization must implement the policies and procedures that affect the risk management concepts identified in the previous step.
- *Information and communication.* Having developed policies and procedures, the organization must communicate them internally and externally to customers, suppliers, and shareholders.
- *Monitoring.* An ongoing process assesses the quality of internal controls through independent evaluation of internal and external auditors.

These concepts, or steps, provide the CPA with a simple but workable model for determining the adequacy of internal controls. When fraud that went undetected for a period of time finally materializes, a failure in one or more of the internal control steps is usually present, as well.

For example, the Boeing Company adopted recommendations from the internal control report and came up with a list of criteria to be used to establish an unsatisfactory rating. Dennis Applegate and Ted Wills, in their 1999 article "Struggling to Incorporate the COSO Recommendations into Your Audit Process? Here's One Audit Shop's Winning Strategy," described Boeing's warning signs for each step:

- Control environment
  - "Hard controls" [specific procedures] are missing or inadequate.
  - There are verified instances of breakdowns of "soft controls" [general policies].
- Risk assessment
  - Management has not predefined relevant objectives.
  - Such objectives are incompatible with broader objectives.
  - Management has not identified relevant risks to achieving its objectives.
  - Management does not have a basis for determining which risks are most critical.
  - Management has not ensured mitigation of critical operating risks.
  - Audit tests detect key risks not previously contemplated by management.
- Control activities
  - Key control activities are not functioning as intended.
  - Management's risk mitigation strategy is not adequately reflected within control activities.
- Information and communication
  - Key metrics are not identified, collected, and communicated.
  - Employees do not understand their control responsibilities, and this is pervasive.
  - Customer or supplier complaints and disputes are not resolved, or remedial action is not undertaken in a timely manner.
- Monitoring
  - Management has not established a means of determining the quality of the internal control system over time, either through independent evaluations or ongoing, structured, and independent process checks.

- Overall
  - The ratings of all components should be considered to determine whether controls provide reasonable assurance that management objectives will be achieved. A strength in the internal controls of one component may compensate for a control weakness in another.

The last sentence illustrates some of the compromises that are made when internal controls are implemented. It was the authors' contention that strength in one area could possibly compensate for weakness in another. Many companies, when implementing procedures such as these, have to operate knowing that certain controls may be inadequate. CPAs, who tend to see any control deficiency as a chance for fraud, should try to understand the cost-benefit analysis that allows companies to operate with less-than-perfect controls. That said, CPAs should not hesitate to bring all observed weaknesses to management's attention because such weaknesses may provide the opening fraudsters need. Then, by quantifying the fraud potential, the CPA may be able to drive the cost-benefit analysis to a different conclusion that results in strengthening of internal controls.

Conclusion

COSO brought attention to the nature of financial reporting fraud through its studies, and its findings helped shape the development of a significant amount of accounting literature and securities regulations. For CPAs, COSO studies provide a roadmap to help look for fraud.

Internal control failures, which include lack of appropriate ethical standards set by senior management, were found to be the root cause of the frauds COSO investigated. The key check and balance that assures compliance with internal controls is the audit committee, and here, COSO identified the weaknesses in audit committees so the securities markets could modify their listing criteria to address those problems. The audit committee role is indeed critical, and chapter 8 examines its role in greater detail.

Chapter 8

Role of the Audit Committee

The audit committee is at the epicenter of the fight against financial statement fraud. Answerable to the board of directors and comprising members of that board, the audit committee sits at the crossroads of information flow between other key players in the internal control process. For that reason, in September 1998, the New York Stock Exchange and the NASDAQ Stock Market sponsored the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the Blue Ribbon Committee) to explore operational and regulatory means to enhance the functions of audit committees. Many of the Blue Ribbon Committee's recommendations were implemented, including the audit committee member requirements discussed in chapter 7.

CPAs should understand the role of the audit committee in preventing, detecting, and correcting financial statement fraud so that should fraud occur as a result of internal control failure, they are in a position to recommend appropriate corrective action.

Key Players in Internal Control

To appreciate how the audit committee functions, CPAs must understand the role of other participants in the internal control process. Each participant operates within prescribed bounds, but those bounds either intersect or overlap to provide checks and balances. The following discussion is a simplified illustration of how the various parties interact and portrays the participants in roles they typically perform.

Financial Management

Members of financial management primarily responsible for the functions of internal controls include the CFO, the corporate controller, and the corporate treasurer, among others. If there is an internal audit function within a company, the chief audit executive (CAE) is certainly another management member responsible for internal controls, but internal auditors' duties and responsibilities are operationally different from the other listed positions in that internal auditors do not originate accounting transactions. For that reason, internal auditors comprise a distinct and separate function within the internal control framework.

The CFO, controller, treasurer, and other financial management personnel are primarily responsible for preparing financial statements and the related disclosures. Their role in the control framework is to implement the policies and procedures established by senior management (see chapter 7 for a discussion of the process used to develop those policies). They are the front line in the battle against financial statement fraud because they are the ones who propose, approve, and book financial accounting entries.

Many people perform these functions in order to maintain segregation of duties, a fundamental internal control concept. Firms implement segregation of duties to cause, as best as possible, a fraudster wishing to alter accounting data to collude with another person. Collusion raises the risk of detection because it may force the fraudster to reveal his or her scheme to others who may not only reject the idea but turn the fraudster in, as well. If collusion works initially, such that accounting data are manipulated, the conspirators may break ranks with each other at a later point when others inquire into questionable transactions. Thus, collusion forces more than one person to participate in a scheme, and the more schemers involved, the greater the chance of detection.

Senior Management

Fraudsters can circumvent the internal control protections, such as segregation of duties, if policies and procedures are weak or if there is a corporate climate of lax enforcement of controls. Both policies and procedures and the control environment are the responsibility of senior management. Establishing adequate control policies and demonstrating a commitment to those policies in the day-to-day decisions senior managers make are principal components of setting the proper tone at the top.

Failure to set a proper tone invites opportunities for senior managers and others to impose their will on subordinates to violate accounting rules, although they may rationalize the process by saying they are only bending the rules or taking advantage of accounting gray areas. When performance pressures arise, as they inevitably do, senior managers operating in an environment of poor controls may, in turn, exert pressure on subordinates to manipulate accounting data. With such weak controls, the subordinates either go along out of ignorance or believe they have no alternative.

Internal Auditors

The internal auditors are the onsite verifiers of financial accounting data, but they cannot be everywhere at once or catch every irregularity. They provide long term and continuous monitoring of accounting and other corporate functions. If the internal auditors adequately identify key areas of risk, and if corporate management gives them adequate resources, they can test and evaluate those accounting functions most likely to experience problems. However, they must be selective because the internal audit budget is always limited (as are all corporate resources), and in being selective, internal auditors have to be effective in identifying areas of potential fraud, or they may overlook problems entirely.

Audit Committee

If internal auditors or others within a corporation do discover an accounting irregularity, there must be a mechanism to report the issue to the appropriate people who will take corrective action. If the suspected fraudsters are in senior management, that reporting mechanism becomes critical because the fraud detectors cannot be made to report their findings to the fraud perpetrators. Here is where the audit committee comes in. It is a committee of the board of directors that acts under a grant of authority from that board to receive reports from internal auditors and other company personnel on suspected financial statement fraud. Upon receiving such a report, the audit committee is empowered to investigate the issue and present its finding to the entire board of directors.

Because the audit committee may receive information about misdeeds of senior management, in most cases, the securities markets have limited the membership of audit committees to outside directors who have few, if any, ties to senior management. Therefore, the audit committee, in theory and hopefully in practice, provides a safe refuge for fraud detectors if senior management is implicated.

The audit committee is also responsible for fulfilling the board's obligation to oversee the establishment of adequate financial internal control policies and procedures. Effectively, the audit committee reviews and assesses the adequacy of controls that are the responsibility of senior management to develop. In a sense, the audit committee provides an objective second opinion on management's policies.

Finally, the audit committee is charged with hiring the external auditors and communicating with those auditors on important accounting judgments and internal control issues.

External Auditors

External auditors perform more functions than just the annual audit. As discussed in chapter 1, the Sarbanes-Oxley Act of 2002 requires auditors of public companies to attest to, and report on, management's assessment of the company's internal controls. The Blue Ribbon Committee recommended, and the Securities and Exchange Commission (SEC) adopted, rules that require auditor review of interim quarterly financial statements before filing with the SEC, so an audit committee should have frequent discussions relating to accounting issues and controls over the course of the year. In particular, according to paragraph .34 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1)

> [t]he auditor should communicate with those charged with governance the following matters:
>
> *a.* The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.
>
> *b.* Significant difficulties, if any, encountered during the audit.
>
> *c.* Uncorrected misstatements, other than those the auditor believes are trivial, if any.
>
> *d.* Disagreements with management, if any.
>
> *e.* Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process. [References omitted.]

The need to inform the audit committee or, more generally, those charged with governance, as audit literature reads, about significant difficulties, uncorrected misstatements, and disagreements between the auditor and management when they occur is obvious. With regard to item (a) listed above, the additional guidance in paragraphs .37–.38 of AU section 380 may be helpful:

> Generally accepted accounting principles provide for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices....
>
> The auditor should explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, request changes. If requested changes are not made, the auditor should inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

Therefore, the auditors provide an objective opinion on accounting positions taken by management over the course of the year, including accounting estimates and policies and financial statement disclosures.

If external auditors detect fraud by senior management or any fraud that has a material effect on the financial statements, they are required, under generally accepted auditing standards (GAAS), to report that fraud directly to the audit committee. Paragraph .17 of AU section 317, *Illegal Acts* (AICPA, *Professional Standards*, vol. 1), states the following:

> The auditor should assure himself that those charged with governance are adequately informed with respect to illegal acts that come to the auditor's attention [footnote omitted]. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements. Senior management may

> wish to have its remedial actions communicated to the audit committee simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control activities. If senior management is involved in an illegal act, the auditor should communicate directly with those charged with governance. The communication may be oral or written. If the communication is oral, the auditor should document it.

If the company is publicly traded (or otherwise required to make filings with the SEC), then upon notification of fraud by the auditors, the audit committee must act decisively and quickly to force changes by senior management. Section 10A(b)(2)–(4) of the Securities Exchange Act of 1934 provides explicit instructions:

> If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such accountant, the registered public accounting firm concludes that—
>
> (A) the illegal act has a material effect on the financial statements of the issuer;
>
> (B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and
>
> (C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement; the registered public accounting firm shall, as soon as practicable, directly report its conclusions to the board of directors.
>
> An issuer whose board of directors receives a report under subparagraph (C) above shall inform the [Securities and Exchange] Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period, the registered public accounting firm shall—
>
> (A) resign from the engagement; or
>
> (B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.
>
> If a registered public accounting firm resigns from an engagement under subparagraph (A) above, the firm shall, not later than 1 business day following the failure by the issuer to notify the . . . furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

Therefore, if the audit committee fails to act appropriately when fraud is reported, the external auditor, referred to as the *registered public accounting firm* because auditors of public companies must register with the Public Company Accounting Oversight Board, must notify the audit committee that, in the auditor's opinion, the committee and the board have failed to act. At that point, within one day of receipt of the auditor's notification, the audit committee must notify the SEC that it received such a notice, at which point it is likely that the SEC would begin an investigation of its own. If the audit committee fails to notify the SEC within the required time, the external auditor must inform the SEC the next day.

The provisions of Section 10A place significant responsibilities upon the audit committee to take corrective action in the event material fraud is detected by external auditors because failure to do so will result in rapid notification to the SEC.

Principal Blue Ribbon Committee Recommendations

It is worthwhile for CPAs to know at least some of the key recommendations of the Blue Ribbon Committee because, even if they have not been implemented by standard setters yet, several are on their way to being implemented as part of the post-Enron reforms, and all serve as guidelines for the effective functioning of audit committees.

Charter and Reporting Lines

The Blue Ribbon Committee recommended, and the stock markets adopted, the requirement that audit committees write and publish their charters. The committee explained its rationale, "Just as good boards often adopt formal guidelines on how they should operate, a good audit committee should memorialize its understanding of its role, responsibilities, and processes in a charter." NASDAQ Marketplace Rule 5605(c) spells out the requirements of a charter (see box 8-1):

Box 8-1: *NASDAQ Marketplace Rule 5605(c)*

(1) Audit Committee Charter

Each Company must certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the Company, … and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; and

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company.…

Box 8-1: *NASDAQ Marketplace Rule 5605(c)*

IM-5605-3. Audit Committee Charter

Each Company is required to adopt a formal written charter that specifies the scope of its responsibilities and the means by which it carries out those responsibilities; the outside auditor's accountability to the audit committee; and the audit committee's responsibility to ensure the independence of the outside auditor. … Rule 10A -3(b)(3)(ii) under the Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed Company of concerns regarding questionable accounting or auditing matters. The rights and responsibilities as articulated in the audit committee charter empower the audit committee and enhance its effectiveness in carrying out its responsibilities.

Paragraph (C) in box 8-1 implements another Blue Ribbon Committee recommendation: that external auditors are ultimately accountable to the board and the audit committee of the board that nominates, hires, and fires the auditor. Thus, the reporting lines are clearly established from the audit committee (or board) directly to the external auditor, and notably, company management is not in that reporting line. That is not to say that auditors should ignore or refuse to confer with company management; to the contrary, auditors should engage in active and frequent discussions with management about audit execution and findings. However, if external auditors defer to management when seeking explanations for potential irregularities without bringing those irregularities to the attention of the audit committee (or others charged with governance), that behavior infers that management has indeed moved into the reporting chain where it should not be: between the audit committee and the external auditors. Management was precisely kept out of that chain so that it could not filter the findings of the auditors before presenting information to the audit committee.

With reporting lines come lines of communication. The Blue Ribbon Committee summed up the objective of an effective flow of information:

> [T]he lines of communication and reporting should facilitate independence from management and encourage the outside auditors and the internal auditors to speak freely, regularly and on a confidential basis with the audit committee.

Thus, both outside and internal auditors are brought into the same line of communication. To effect this line of communication for internal auditors, at least some part of their reporting requirements should be to the audit committee, as well. The end result should be that internal auditors cannot be unduly influenced by management evaluations and resistant to raising accounting and reporting issues with the audit committee. The CPA should observe that the CAE has frequent and, if necessary, private meetings with the audit committee. Also, those meetings should occur even if the CAE has nothing to report because it is important that audit committee members be allowed an opportunity to explore any issues or concerns they may have, and because any system of internal controls can be improved, such meetings would be time well spent. Lack of direct contact between internal auditors and the audit committee over the course of a fiscal year should be a warning flag that complacency has set in, and with complacency, comes the opportunity for fraud.

Communications Between the Auditor and Audit Committee

The discussion to this point has focused on the quantity and direction of communications between auditors and the audit committee, but the Blue Ribbon Committee also addressed the quality of those communications, as well. As previously stated, AU section 380 requires auditors to provide their opinions to the audit committee regarding a company's accounting estimates, accounting policies, and financial statement disclosures. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), adds affirmative obligations for the auditor to inquire of management about whether there was knowledge of fraud or suspected fraud (paragraph .20) and for the auditor to make similar inquiries of the audit committee (paragraph .22).

The Blue Ribbon Committee went further:

> The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

The SEC has proposed regulations that would implement this suggestion by requiring company management to identify a limited number (perhaps three to five) of critical accounting policies (CAP). The Sarbanes-Oxley Act of 2002 requires audit committees to review CAP, but the SEC proposals provide more explicit guidance. CAP would consist of either an accounting policy that management adopted when there were other choices or an accounting estimate that was subject to material changes if there were other equally valid estimates available. For each CAP, management would provide a range of alternative accounting policies or estimates that the audit committee would review (or state in the company's annual filing with the SEC why the audit committee did not review CAP). To see how this proposal would work, see the indirect method example in chapter 4.

Therefore, if management provides the audit committee with management's selection of CAPs, at the very least, this starts a dialogue between the audit committee and management on where the potential problems lie. The audit committee may believe that management's list was not large enough or that it glossed over a serious issue, at which point the committee can send management back to do more analysis. The end result is that the audit committee is better informed about potential problem areas and, preferably, that management has been challenged on its selection and analysis of CAPs. Here, a CPA who is not the auditor may be able to perform a special service as a consultant to the audit committee to help the committee evaluate management's CAP submissions.

Audit Committee Overload

After having reviewed the issues related to audit committees, it is easy to see that tremendous responsibility rests upon committee members. Although much has been said about the audit committee members' legal risks possibly being more than the risks faced by other board members, the CPA should focus on whether the audit committee is attempting to do too much without the proper resources. John Olson, who served on a panel looking into the function of audit committees for the National Association of Corporate Directors, compiled a list of audit committee duties in 1999[1] (see box 8-2):

Box 8-2: *1999 NACD Audit Committee Duties*

> Several recent examples of audit committee charters identify more than twenty separate "duties" frequently assigned to audit committees. These duties include private meetings with both the external and internal auditors and a review of:
>
> (i) financial statements and accompanying notes;
> (ii) the 10-K Annual Report filed with the SEC;
> (iii) quarterly and other private reports filed with the SEC;
> (iv) financial press releases;
> (v) the external audit plan;
> (vi) the internal audit plan;
> (vii) staffing and quality of internal audit;
> (viii) audit fees;
> (ix) non-audit (consulting and other) work and fees of the external auditors;
> (x) codes of conduct;
> (xi) the system of internal controls;
> (xii) compliance with codes of conduct and internal controls;
> (xiii) litigation exposure;
> (xiv) risk identification and risk management;
> (xv) performance of the chief financial officer, chief accounting officer, and head of internal audit;
> (xvi) the annual "management letter" (from the outside auditors);
> (xvii) expense reports of senior management;
> (xviii) management "conflict of interest" transactions with the corporation; and
> (xix) alleged fraudulent actions or violations of law reported by internal compliance programs or, under the terms of the Private Securities Litigation Reform Act of 1995 (PSLRA), by the outside auditor.
>
> Of course, the audit committee is generally charged with selecting, or at least recommending, the external auditors, periodically reviewing their performance, approving their fees and, where the committee deems appropriate, recommending a change in auditors.

(Excerpted from "How to Really Make Audit Committees More Effective," by John F. Olson, 1999, Business Lawyer, 54:3.

[1] Olson, John F., "How to Really Make Audit Committees More Effective," *The Business Lawyer* 15(3): 1097-1111 (May 1999).

Given that the list was compiled in 1999 before the implementation of stock market listing changes brought about by the Blue Ribbon Committee and before proposed SEC regulations related to critical accounting policies, the list has expanded and will most likely continue to expand. If Olson's list were contained in a single audit committee charter, the committee would clearly be spread too thin, and that is a dangerous condition that CPAs should try to identify.

With knowledge of the proper functions of internal controls and the role of the audit committee, the CPA should help the board of directors remove unnecessary duties from the audit committee charter. For instance, performance assessments of financial management should be assigned to a compensation committee, if that is a function that the board wishes to take on; otherwise, senior management can assess all firm personnel, with the possible exception of the CAE, who should have board-level input. Reviewing expense reports and potential conflict of interest situations can also be assigned to other board committees. For other functions, the audit committee may require additional resources (and perhaps its own budget). The audit committee, for example, should be able to hire consultants to assist in its review of financial reports, internal controls, and legal requirements if the demands of the workload so require or additional expertise is needed.

Conclusion

The audit committee occupies a pivotal position in the fight against financial reporting fraud. The structure proposed by the Blue Ribbon Committee requires both internal and external auditors to report to the audit committee. The Sarbanes-Oxley Act of 2002 (discussed in chapter 1) mandates that for public companies, the audit committee approve all audit services, and private firms would be well-served to follow this requirement, as well. GAAS requires external auditors to both confer with the audit committee and make inquiries of that committee about actual or potential fraud.

However, one of the most important developments in the prevention of financial reporting fraud is the audit committee's review of critical accounting policies (which is required for public companies under the Sarbanes-Oxley Act of 2002). If those policies, and the related accounting estimates, are brought to the attention of the audit committee, the committee will have a platform from which to make further inquiry and launch investigations, if necessary. The key issue is whether the audit committee sees all material policies and estimates. The chapters found in section 3 will examine some of the more difficult fraud issues and how the audit committee, working in concert with internal and external auditors, can identify those issues.

Chapter 9

Quantitative Predictors of Financial Statement Fraud

Can fraud be predicted from the characteristics of companies that are the subject of Securities and Exchange Commission (SEC) enforcement actions? Can fraud be predicted using the financial data of fraudster companies? According to empirical studies, the answer is a qualified "Yes." There appear to be common characteristics among companies that subsequently engage in financial statement fraud. If a company has some or all of those characteristics, though, that does not necessarily mean the company will commit fraud. The quantitative predictors merely serve to provide warning signs to the CPA, in addition to the qualitative warning signs discussed in the preceding chapters.

Academic Research

In addition to the research conducted by the Committee of Sponsoring Organizations (COSO), discussed in Chapter 7, other researchers examined financial statement fraud. One important study published in 1999, "The Detection of Earnings Manipulation," was performed by Messod D. Beneish of Indiana University, who asked whether one could predict financial fraud just by examining publicly available financial statements. Beneish's study (the prediction study) looked for quantitative fraud warning signs by analyzing financial ratios and other data from companies that were known manipulators and those that were nonmanipulators. Like the COSO-sponsored studies, Beneish used SEC Accounting and Auditing

Enforcement Releases (AAERs) and published reports of restated financial statements to identify 74 companies as earnings manipulators from 1987 to 1993.

Characteristics of Sample and Control Companies

Similar to findings in COSO's research, the prediction study found that most manipulators were located in the manufacturing and services industries. In total, Beneish identified 74 manipulator companies and then matched those companies by 2-digit Standard Industrial Classification code to data from 2,332 other companies that presumably were nonmanipulators. For each manipulator company, he obtained data for the fiscal year immediately before the year the manipulation occurred (similar to the methodology used in COSO's research) and compared that company's data with its nonmanipulator peers' financial statements for the same period. As with COSO's research, the prediction study reported that in each manipulator and nonmanipulator category, there were many small companies, with relatively few large companies, with small medians for assets and sales contrasted with the large mean values. Comparing the two categories of companies, manipulators were smaller in terms of assets and sales; they were also less profitable, slightly more leveraged, and growing much faster than nonmanipulating companies.

When looking at the AAERs and press reports, earnings manipulation typically occurred by (1) recording fictitious revenues or inventory or unearned or uncertain revenues or (2) capitalizing costs improperly.

Ratio and Index Analysis

Based on prior academic research, the prediction study hypothesized that earnings manipulation was more likely to occur (1) when companies' prospects were poor, (2) when cash flows did not match accrued income, and (3) when management had compensation incentives to manipulate earnings. This analysis led to eight different financial statement ratios that were tested on each manipulator company by first looking at the change in that company's ratio from the year before manipulation to the manipulation year. Then, the same analysis was run on the nonmanipulators from the same industry and the same period. If a given ratio for the manipulators was statistically different from those for the nonmanipulators, it was likely that the ratio had some predictive value. In other words, if a ratio passed this test, a CPA looking at any two successive fiscal years of financial data for a company could use the ratio to see if there was a warning sign to indicate that the second year's data may be manipulated.

Of the eight ratios, five passed the test as statistically significant. The following describes each statistically significant ratio. Beneish converted most of the ratios into indexes to provide more easily applied benchmarks. For the formulas presented, current year income statement and balance sheet items are indicated with a subscript t, and prior year items have a $t\text{-}1$ subscript. The change in account balances from one year-end to the next year-end is denoted by Δ. The formulas were adapted from Beneish, Messod D., "The Detection of Earnings Manipulation," *Financial Analysts Journal* (September/October, 1999): 27.

Days' Sales in Receivables Index

Days' Sales in Receivables Index = $(\text{Accounts Receivable}_t / \text{Sales}_t) / (\text{Accounts Receivable}_{t-1} / \text{Sales}_{t-1})$

When a company attempts to inflate revenues by booking fictitious sales, receivables may provide a telltale sign because the fictitious customers have failed to pay. If receivables spike relative to sales levels, the possibility exists that some of the sales were fictitious. The days sales in receivables index (DSRI), designed to capture this effect, is the year-over-year comparison of the annual receivables/sales ratio, with the current year's ratio in the numerator and the prior year's ratio in the denominator. Thus, the index, like all the other indexes in this study, should be roughly equal to 1 if receivables as a percentage of sales do not change from year to year. However, if receivables are beginning to become large in relation to sales and the index increases significantly beyond 1:1, fraudulent sales practices may be coming into place. The predictive study actually found that the index for manipulators was close to 1.5:1. The year-over-year change in days sales in receivables was about 3 percent for nonmanipulators but over 46 percent for manipulators. Manipulators showed an increase of about 42 percent in days sales in receivables over the average change for the nonmanipulator peer group. Of course, one should look for other explanations, such as a more liberal credit policy, that could have resulted in increased receivables, but an exceptionally large increase in receivables relative to sales might suggest revenue manipulation.

Gross Margin Index

Gross Margin Index = $[(\text{Sales}_{t-1} - \text{Cost of Sales}_{t-1}) / \text{Sales}_{t-1}] / [(\text{Sales}_t - \text{Cost of Sales}_t) / \text{Sales}_t]$

Companies facing poor earnings prospects have a greater incentive to manipulate earnings. Based on metrics used in analysts' reports, Beneish selected gross margin as a proxy for future profitability. If gross margin shrinks from one year to the next, future prospects of profitability are dimming, and management may be more inclined to resort to earnings manipulation, perhaps by booking fictitious revenues or through some other method. The gross margin index (GMI) is the year-over-year comparison of gross margins taken as a ratio, with the most recent year in the denominator. If the GMI is greater than 1, gross margins have weakened. Statistically, this index was one of the stronger predictors, so a GMI significantly greater than 1 is a red flag that financial statement manipulation may be present. The predictive study found that the GMI for manipulators was about 1.2:1.

Asset Quality Index

$$\text{Asset Quality Index} = \frac{1 - [(\text{Current Assets}_t + \text{Net Fixed Assets}_t) / \text{Total Assets}_t]}{1 - [(\text{Current Assets}_{t-1} + \text{Net Fixed Assets}_{t-1}) / \text{Total Assets}_{t-1}]}$$

Manipulators may try to hide expenses by capitalizing them as intangible assets (see chapter 12 for a discussion of these techniques). In the first year this capitalization occurs, the quality of the assets on the balance sheet will decline. The predictive study defined *poor asset quality* as the amount of noncurrent assets, exclusive of property, plant, and equipment (PP&E), relative to total assets in a given year. The noncurrent assets, outside of PP&E, were assumed to be most subject to manipulation and would include goodwill, deferred costs, and other intangibles. The asset quality index (AQI) ratio measures the proportion of the current year's percentage of presumed poor quality noncurrent, non-PP&E assets to the prior year's percentage. An AQI greater than 1 indicates that more costs may be capitalized in the current year, and thus, reported expenses may be too low. The end result is a warning flag for earnings manipulation. AQI for manipulators in the study was found to be 1.25:1.

Sales Growth Index

$$\text{Sales Growth Index} = \text{Sales}_t / \text{Sales}_{t-1}$$

Exceptionally strong sales growth from one year to the next may, by itself, indicate the presence of financial statement fraud in the form of revenue manipulation. The sales growth index (SGI) is the ratio of sales for the current year over sales from the previous year, and it turns out to be the strongest indicator of manipulation in the predictive study, with manipulators showing 60 percent 1-year growth compared with 10 percent growth for nonmanipulators. Any dramatic increase in the SGI on the order found in the study, which for manipulators ranged from a 34 percent to 58 percent increase over nonmanipulator peers, should alert the CPA to possible problems.

Total Accruals to Total Assets

$$\text{Total Accruals to Total Assets} = \frac{\Delta\,\text{Working Capital}_t - \Delta\,\text{Cash}_t - \Delta\,\text{Current Taxes Payable}_t - \Delta\,\text{Current portion of LTD}_t - \Delta\,\text{Accumulated depreciation and amortization}_t}{\text{Total Assets}_t}$$

A firm running short of cash may also be motivated to engage in balance sheet manipulation to secure additional sources of capital. To identify cash trends, Beneish looked at changes in working capital and reasoned that a firm running low on cash would see the composition of its working capital shift away from cash to receivables and inventory. He then devised the total accruals to total assets (TATA) measure (which was not an index) to assess the amount of working capital (net of cash) relative to total assets. In other words, a firm with a lot of cash will have a lower TATA compared with a firm that has a little cash. To make TATA less subject to fluctuation from company to company, he deducted from working capital the change in current maturities in long term debt and income taxes payable. He then deducted the change in accumulated depreciation and amortization balances as a proxy for capital expenditures. A firm running short of cash will have a higher TATA measure. The study found that TATA for nonmanipulators was 0.018; the measure for manipulators was 0.031, or about 72 percent higher. A TATA measure in excess of 0.03 would be an indicator of a potential fraud motive arising from cash shortages. In addition, the TATA measure, which reflects noncash working capital to total assets, probably picks up the increases in receivables that typically accompany revenue manipulation.

These characteristic measures provide a quick and easy means of detecting the possibility of financial statement fraud. They are indicators and do not by themselves prove fraud. However, CPAs may want to consider including these characteristic measures in their financial statement analyses. Also, as an element of internal control, an internal auditor or controller could apply these measures when reviewing financial information, especially data from subsidiaries and divisions. An increase in the magnitude of any of the characteristic measures previously discussed should trigger additional inquiries. Such inquiries may very well head off an incipient fraudulent scheme.

Application of Predictive Measures

The following example demonstrates how the characteristic measures can indicate the potential for fraud and how those measures interrelate with one another. The facts and data are simplified to allow the reader to follow the characteristic measure calculations:

Example Scenario

Medical Products Specialties (MPS) is a wholesaler and distributor of pharmaceutical products. Its customers include major drug store chains and independent drug stores. It provides both prescription and over-the-counter products. Early in the previous fiscal year, MPS was acquired by Great Drug Co., a major pharmaceutical manufacturer, in a purchase transaction for a price that many considered to be high, relative to MPS's historical earnings.

As a result of the high price paid, MPS's management was under pressure from Great Drug to at least maintain, if not grow, its earnings. A decline in earnings so soon after the acquisition, although not very significant to Great Drug overall, would make Great Drug's senior management look bad.

The once-lucrative prescription drug market had changed markedly over the last few years as insurers changed their formularies to favor lower cost generic drugs. Thus, margins were dropping as more generics were prescribed. On the other hand, the ability of health care providers to substitute drug treatment regimens for more expensive procedures, such as surgery, meant that prescription drug sales were increasing. In its monthly reports to Great Drug senior management, the MPS unit reported that these trends continued throughout the year, causing MPS sales to increase significantly while its gross margin declined. With that explanation, Great Drug senior management was content with MPS's performance, as long as earnings did not decline.

MPS closed its books on the current year in preparation for the year-end audit. The current year was MPS's second fiscal year as a subsidiary of Great Drug. As part of the closing process, Great Drug's internal audit department received the following preliminary MPS income statements and balance sheets for the prior year and current year just ended (all amounts in millions):

(continued)

(continued)

Income Statements	Year 1	Year 2
Sales	$1,000	$1,500
Cost of goods sold	600	1,200
Gross profit	$ 400	$ 300
Selling, general, and administrative expenses	300	200
Net income before taxes	$ 100	$ 100

Balance Sheets, as of the Last Day of	Year 1	Year 2
Cash	$ 400	$ 200
Receivables	300	700
Inventory	300	500
Plant, property, and equipment	2,000	2,100
Less: Accumulated depreciation	(1,200)	(1,300)
Intangibles	500	800
Total assets	$2,300	$3,000
Current payables	$ 200	$ 400
Long term debt (all noncurrent)	600	1,000
Equity	1,500	1,600
Total liabilities and equity	$2,300	$3,000

Although MPS was not considered an important profit center by Great Drug management and did not get much attention, the chief audit executive (CAE) became interested in the subsidiary when she observed sales increasing dramatically without any increase in pretax profit. She knew sales of generics were increasing, but she was not aware of any expansion of the sales staff or channels of distribution that would readily explain such a large increase in sales. The CAE then asked one of her staff members to prepare an analysis of predictive ratios to see if warning flags emerged.

The results of the staff analysis are as follows:

DSRI = (700 / 1,500) / (300 / 1,000) = 1.56
GMI = [(1,000 – 600) / 1,000] / [(1,500 – 1,200) / 1,500] = 2.00

$$AQI = \frac{\{1 - [(200 + 700 + 500 + 2{,}100 - 1{,}300) / 3{,}000]\}}{\{1 - [(400 + 300 + 300 + 2{,}000 - 1{,}200) / 2{,}300]\}} \quad 1.23$$

SGI = 1,500 / 1,000 = 1.5
Δ Working capital = (200 + 700 + 500 – 400) – (400 + 300 + 300 – 200) = 200
Δ Cash = (200 – 400) = –200
Δ Accumulated depreciation = 1,300 – 1,200 = 100
Current maturities of LTD and income taxes payable are assumed to be zero.
TATA = [200 – (–200) – 100] / 3,000 = 0.10

Comparison to peer group benchmarks:

Characteristic	MPS	Peer group	% over peers
DSRI	1.56	1.03	51%
GMI	2.00	1.10	82%
AQI	1.23	1.04	18%
SGI	1.50	1.20	25%
TATA	0.10	0.05	100%

Based on the analysis, the CAE drew the following conclusions:

- MPS's significant sales growth could not be justified by the switch to generics alone; it was well ahead of the peer group that would presumably experience the same effect in their reported sales. Peer group sales did increase by 20 percent, but MPS was well ahead of that benchmark, with 50 percent growth. The CAE had to acknowledge the SGI was a red flag.
- In a similar analysis, the CAE concluded that the decline in gross margin at MPS was out of line with the rest of the industry. Yes, the peer group experienced some deterioration in margins but not to the extent of MPS, which had a GMI that was 82 percent greater than its peers. The GMI suggested that MPS was not as profitable as in the past, and the CAE was suspicious about how it could maintain its pretax profit.
- The CAE noted that the DSRI was well over peer group levels, as well. Receivables growth accompanied by large sales growth were indicators of possible fictitious sales, so the CAE then looked at a recent receivables run for additional insight. The accounts receivable by customer file showed that a large number of new accounts were opened in the last few months of year 2 and had yet to be paid. Inflated sales could be one explanation for how profits were maintained.
- Looking further, the CAE observed that the TATA measure was significantly high, confirming her preliminary belief that some sales may be fictitious because MPS was running low on cash. Using the increase in receivables as a reason, MPS requested and received from Great Drug an additional $400 million in interest-only loans over the course of year 2. The question that ran through the CAE's mind was, where did the money go? She saw $200 million probably provided for increased inventory, but that left another $200 million unaccounted for.
- The CAE got her answer when she looked at the AQI. The AQI is generally rather stable for wholesalers because intangibles and other noncurrent assets rarely fluctuate significantly. Here, MPS's change in noncurrent assets was 18 percent over the peer group change, and that index caused the CAE to examine the large change in intangibles—an increase of $300 million over year 2. Her investigation later revealed that $100 million of sales expenses had been capitalized because, according to the MPS controller, the expenses were incurred as part of a major marketing push for certain pharmaceutical products and should have a "long term impact" on future sales. Because this marketing effort was performed with existing personnel, the effect of the capitalization was to shift $100 million from selling, general, and administrative expenses to the balance sheet. The CAE then noted that the shift helped MPS make up for a $100 million decline in gross profit and thereby maintain its pretax profit.
- However, there was more to the intangible assets analysis. Spending $200 million of cash from Great Drug's loan, MPS had purchased a series of prospective customer lists through various sources, several the CAE had never seen before. When her staff investigated the list purchases, they found that the firms that sold the lists were owned by senior members of MPS's management.

Example Analysis

The characteristic measures were not proof in themselves that MPS had committed fraud, but they did prove to be good indicators. Analysis of the indicators helped direct the CAE to certain areas of the financial statements that, in turn, led to further investigation, such as looking more closely at accounts receivable and intangibles. The characteristic measures also interrelate with each other: For example, the SGI and the DSRI, when giving the same signal, add weight to the possibility of revenuemanipulation.

Conclusion

COSO and academic research can provide useful guidelines for internal and external auditors, as well as forensic accountants, in helping prioritize areas of investigation. Rarely does the CPA receive sufficient funding, whether as an internal or external auditor, to allow examination of every financial statement account. Indeed, generally accepted auditing standards require the auditor to assess at an early stage the possibility of financial statement fraud in order to perform the audit efficiently and effectively.

Furthermore, the analytical procedures described in this chapter can guide external auditors in the additional procedures required by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when there are specifically identified risks of material misstatement due to fraud. Paragraph .52 of AU section 316 states that the nature, timing, and extent of procedures may need to be changed if there are specific risks. An increase in SGI that is out of line with peer companies may indicate that the nature of evidential matter collected may change to include more independent sources to verify the existence of customers. Similarly, an increase in DSRI may suggest a shift in the timing of receivables testing to the end of the period. An increase in TATA, for example, may point to an increase in the extent of testing performed on intangible assets. Analytical procedures have long been a part of the audit process, but with empirical evidence providing certain indicators, auditors now have better tools that will allow them to fulfill their responsibilities.

SECTION 3

The CPA's Fraud Battle

Chapter 10

Loss Contingencies and Asset Impairments

Fraud related to loss contingencies and asset impairments tends to follow the same formula: ignore the issue and cover it up if necessary. Accounting literature requires recognition to warn financial statement readers that there may be problems ahead; fraudsters want to keep those problems out of sight. Disclosure of a problem poses difficulties for management in that

1. investors and analysts may begin to adjust downward their expectations of future cash flows due to the problem, thus reducing the firm's share price.
2. lenders may become nervous if they detect a material adverse change in the firm's financial position (or if there is an outright breach of a lending covenant that sets minimum asset or equity values) and call their loans.
3. management may lose its performance-linked incentive compensation (or perhaps even face employment terminations).

For these reasons, loss contingencies and asset impairments tend to be swept under the carpet, with management thinking that if they can be kept out of sight, they can be kept off the financial statements. As such, the CPA faces some especially difficult challenges in detecting these irregularities, but some useful warning signs exist that may appear and lead the CPA to an unrecorded liability.

Loss Contingencies

A *loss contingency* is defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary as "[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."

FASB ASC 450-10-05-5 adds that the "[r]esolution of the uncertainty may confirm … the loss or impairment of an asset [or the] incurrence of a liability." In a financial statement fraud context, the resolution of a material and probable uncertainty that was known to management beforehand should generally not be the first time readers of the financial statements learn of the uncertainty.

FASB ASC 450-20-05-3 lists examples of loss contingencies that include the following:

a. Collectibility of receivables
b. Obligations related to product warranties and product defects
c. Risk of loss from catastrophes assumed by property and casualty insurance entities including reinsurance entities
d. Guarantees of indebtedness of others
e. Obligations of commercial banks under standby letters of credit
f. Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

FASB ASC 450-20-05-10 lists additional examples of contingencies:

a. Injury or damage caused by products sold
b. Risk of loss or damage of property by fire, explosion, or other hazards
c. Actual or possible claims and assessments
d. Threat of expropriation of assets
e. Pending or threatened litigation.

A firm is required to accrue a loss contingency when that contingency is both probable and able to be estimated. FASB ASC 450-20-25-2 states the following:

> An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:
>
> a. Information available before the financial statements are issued or are available to be issued … indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated.

According to the FASB ASC glossary, a future event is probable if it is likely to occur. The following discussion principally focuses on failure to accrue a probable loss contingency. However, violations of U.S. generally accepted accounting principles (GAAP) (and securities laws if the company files with the Securities and Exchange Commission [SEC]) may occur if the firm has a reasonably possible loss contingency, according to FASB ASC 275-10-50-8, but fails to make the required disclosure of that contingency in its financial statements. The FASB ASC glossary states that a contingency is reasonably possible if "[t]he chance of the future event or events occurring is more than remote but less than likely."

Having set the ground rules, it is worthwhile to examine some specific examples in the following sections to see how CPAs can detect fraud related to loss contingencies. The discussion will focus on warranty and product claims because the issues surrounding those claims are complex and occur with ever-greater frequency. Collectability of receivables, which is another major loss contingency that may give rise to fraudulent financial statements, is discussed in the example scenario in chapter 2.

Warranty and Product Claims Reserves

If a manufacturer experiences postproduction problems with a certain product, it may begin to experience higher-than-expected returns or, more likely, claims for reimbursement or repair. Those claims may arise under a specific warranty, product tort law, or consumer protection laws and regulations. At that point, the manufacturer must assess its overall cost exposure. It might be possible to estimate the extent of future claims as a percentage of production based on past experience with other products subject to similar problems. It might also be possible to estimate the cost of each claim, meaning the cost of replacement or repair for each defective unit or product. If both an estimate of future claims and the cost of each claim are available, the amount of loss can be reasonably estimated. FASB ASC 450-20 would require the booking of a loss contingency if the future claims were likely to occur. However, if the manufacturer is already seeing large numbers of claims before or soon after the close of its financial reporting period, it would be reasonable to assume that the likelihood of future claims is high and that a loss contingency, or reserve, as the term is used in common practice, should be accrued with a charge to current earnings. Actually, FASB ASC 450-20-25-2 requires the assessment of contingencies arising from "[i]nformation available before the financial statements are issued or are available to be issued." Therefore, if claims relating to a prior period come to the attention of management during the preparation of financial statements for that prior period, management should consider booking a contingency as of the end of that period.

However, a manufacturer under pressure to achieve increased earnings may be very reluctant to accrue a warranty or product claims loss contingency. Management may take the position that the problem does not exist or cannot be quantified; however, an alert CPA may detect certain red flags that indicate a problem does indeed exist and that its extent can be estimated. The red flags that indicate the existence of a contingency can be found in box 10-1.

Box 10-1: *Red Flags for Contingencies*

1. The incidence of claims before the issuance of financial statements (previously discussed)
2. Discussions with (and bills from) outside legal counsel
3. Internal correspondence within production and research staffs about the need to address a critical problem with a product already on the market
4. Internal correspondence among department heads of production, research and development (R&D), general counsel, and senior management about postproduction problems and product claims
5. External correspondence between the manufacturer and its customers about a given product concerning special price concessions or special return privileges
6. The incidence of special or overbudget freight charges to accommodate returns or the shipment of replacement products, or both
7. Shifting of production schedules to manufacture replacement products
8. Halt to manufacturing of the product in question
9. Shifting of R&D staff away from planned research projects to applications engineering relating to the redesign of existing products
10. Payments in sometimes seemingly immaterial amounts to customers on a regular basis over a period of weeks or months that indicate some arrangement to compensate for product defects

Many of the flags in this list come from areas outside the accounting department, such as production, R&D, legal, and sales. The key to detection of a warranty loss contingency, or any other contingency for that matter, is for the CPA to take a firm-wide perspective and probe into departments that typically do not have much contact with accountants.

Once the existence of a loss contingency or the likelihood that it will occur has been established, the next step is to determine whether the potential loss can be quantified. In this case, if the firm itself does not have actual experience with product claims or if that experience is not relevant to the product in question, the CPA should look outside the firm. Industry statistics on product liability and the incidence of claims may be available from trade associations, government regulators, or independent research organizations. However, in the course of examining internal correspondence between department heads and within departments, the CPA will likely find some internal estimates of the extent of the problem. This becomes especially obvious if the correspondents are attempting to justify the allocation of additional staff and financial resources to combat the problem or to explain why production was shifted or halted. In short, the members of management not directly involved in manipulating the financial statements may speak quite frankly about the loss contingency.

Estimation Issues

Estimating a loss contingency is rarely easy and is subject to manipulation. The following example, taken from an SEC rule proposal,[1] illustrates the complexities involved:

[1] This example is taken from examples contained in Securities and Exchange Commission (SEC) Release Nos. 33-8098; 34-45907. To illustrate certain aspects of financial reporting fraud, additional assumptions are added to the SEC examples. Subsequently, the SEC-recommended disclosures to the audit committee are presented to illustrate how those disclosures would have increased the likelihood of fraud detection. The examples, as modified for purposes of this book, reflect the opinions of the author, not the SEC. The reader is encouraged to read the SEC releases in their entirety, which are included in appendix A at the end of this book.

Example Scenario

Alphabetical Company manufactures and distributes electrical equipment used in large-scale commercial pumping and water treatment facilities. The company's equipment carries standard product warranties extending over a period of 6–10 years. If equipment covered under the standard warranty requires repair, the company provides labor and replacement parts to the customer at no cost. Historically, the costs of fulfilling warranty obligations have principally related to providing replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in replacement parts constituted approximately 35 percent to 40 percent of the total cost of warranty obligations.

Alphabetical's accounting policies accrue a liability for the expected cost of warranty-related claims when equipment is sold. The amount of the warranty liability accrued reflects the company's estimate of the expected future costs of honoring its obligations under the warranty plan. Because of the long term nature of the company's equipment warranties, estimating the expected cost of such warranties requires significant judgment. Alphabetical's CFO oversees the estimation process performed by Alphabetical's finance group every calendar quarter. Alphabetical is able to hedge its exposure to copper price movements in the commodities markets for a period of up to 5 years; beyond that point, Alphabetical is exposed to price risk for the remainder of the warranty period. Also, throughout the warranty period, Alphabetical is exposed to the risk that it may need to acquire more copper in a given year than forecast, thus exceeding the quantity that may be hedged in that year and forcing Alphabetical to buy copper in the cash market for the going price. In each of the last 3 years, warranty expense represented approximately 19 percent to 22 percent of cost of sales, and 35 percent to 40 percent of that warranty expense represented the cost of copper used in replacement parts.

The forecasting model used by the finance group to estimate the company's exposure to copper price movements 6–10 years out used data from historical commodities prices looking back 10 years and data from the commodities futures market. Historically, the price of copper has been quite volatile. Eight years ago, the price increased by 72 percent in 1 year; last year, the price declined by 19 percent. Changes of that magnitude had a material impact on Alphabetical's warranty costs and cost of sales.

With a recent improvement in the economy, sales were increasing in the current year but so was the price of copper, as well. As Alphabetical prepared to enter the final quarter of its fiscal year, the CFO was concerned that the rising cash market price for copper had already begun to affect the futures market prices, which were an important component of the forecasting model. In the last month alone, the futures prices for copper had jumped by approximately 7 percent for all delivery dates. An increase in warranty costs as a percentage of sales would affect the gross margin, and the CFO knew that securities analysts watched that margin carefully as a sign of future profitability. The CFO had hoped the recent increase in sales would provide enough support for key analysts to upgrade Alphabetical's stock, which many analysts had at a lackluster "hold" rating. Alphabetical needed to retire some high interest rate debt, and the CFO wanted to float a seasoned equity offering of stock to pay down the debt. The CFO believed that an increase in analysts' ratings would increase the price of shares already outstanding, as well as the price of the new shares to be sold through the offering. However, a rise in warranty costs relative to sales would likely kill any chance of an upgrade from analysts, making any stock offering more expensive in terms of the number of shares Alphabetical would need to sell to raise the necessary capital.

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In addition, the CFO, as well as other members of senior management, wished to exercise and sell some of their vested company stock options that had languished for over three years because Alphabetical's stock price had not moved much from the time the options were issued (the options' exercise price was set at the market price at the time of issue). Finally, with the increase in Alphabetical's sales, senior management believed they would soon have their chance to cash in the options at a profit if the stock price would increase. The CEO had spoken with the CFO on several occasions about "finally getting the stock price we deserve," so that by exercising the options, "we can finally get the compensation we deserve." The CEO emphasized to the CFO that "we're all counting on you" to convince the analysts to upgrade their ratings.

The copper price forecast had a dramatic impact on warranty costs because even a small increase in price affected all warranty work performed 6–10 years out. The rapid rise in futures prices recently signaled that by the end of the fourth quarter, just as analysts would be reassessing their ratings on Alphabetical's stock, the copper pricing model would show a significant increase. The CFO believed he needed to modify the model to "compensate" for the increase likely to come from rising futures prices. He instructed the finance group to run another version of the model using historical data for only 5 years instead of the 10-year look-back currently used in the model. By truncating historical data at 5 years, the CFO knew the model would not pick up the 72 percent price increase of 8 years ago. When the finance group reported the results of the modified model, the truncated historical data produced enough of a downward estimate to counter the upward estimate from the futures market data. The end result was no change in the copper price estimate for 6-10 years out and, therefore, no need to increase the warranty cost as a percentage of sales.

By the end of the fourth quarter, the modified model performed to the CFO's expectations, and warranty costs came in at a tolerable 40 percent of cost of sales for the year. The auditors, who never spent much time analyzing the model and viewed it as a "black box" that was hopelessly difficult to understand, did not note any exception to the change in historical data used. When the CFO saw that he "got this past the auditors," he decided he would not even "bother" with making any disclosure in the footnotes to the financial statements. Soon after Alphabetical announced its fiscal year results, the CFO received phone calls from two analysts saying that they were upgrading their ratings, and the stock price moved accordingly.

Example Analysis

The auditors did not call on the CFO to defend this change in his modeling methodology, but if they had, the CFO would have probably claimed he simply made a change in accounting estimate that does not need to be disclosed. Indeed, U.S. GAAP would give him some support. Paragraphs 4–5 of FASB ASC 250-10-50 state:

> The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in

> service lives of depreciable assets. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material.... If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.
>
> The disclosure provisions of this Subtopic for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

The change in methodology for warranty costs could fall under this provision, especially if the CFO successfully asserts that the change in estimate was due to a change in valuation technique.

One could argue that the warranty cost estimates affect several future periods and, thus, need to be disclosed. The debit-to-warranty cost each period credits or adds to a loss contingency reserve on the balance sheet. That reserve is then debited as actual warranty work is performed in future periods. However, an allowance for uncollectible accounts works essentially the same way and yet is considered by FASB ASC 250-10-50-4 to be made "each period in the ordinary course of accounting," which does not require disclosure, though disclosure is required if the item is material.

However, the CFO may violate U.S. GAAP when he files Alphabetical's financial statements with the SEC. The filing requirements for year-end statements filed with the SEC on Form 10-K set a minimum of three years of comparative income statements and two years of balance sheets ending with the filing year. Accompanying the current year income statement will be income statements for at least the previous two years. Then, when comparative financial statements are presented to be comparable, according to FASB ASC 205-10-45-3, any exceptions to comparability must be clearly disclosed. Therefore, the change in accounting estimate for calculating warranty costs would need to be disclosed if it is deemed material.

However, from the perspective of securities fraud, the provisions of Rule 10b-5 apply. In this tightly constructed scenario, the analysts' opinions would have likely changed if they saw warranty costs increasing relative to sales because analysts tracked Alphabetical's gross margin closely. Warranty costs, in turn, were very sensitive to changes in the estimate of future copper prices. Therefore, a change in the method of calculating those future prices very likely would be information that analysts would need to know to be sure that the gross margin from the current year was comparable to prior years' margins. Recall from chapter 1 that Rule 10b-5 states:

> [i]t shall be unlawful for any person, directly or indirectly, ...
>
> b. to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Thus, the omitted disclosure of the change in estimation methodology may rise to the level of a Rule 10b-5 violation under the facts presented in this example because the omission led analysts to think gross margins were comparable and consistently presented

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with prior years' margins. Also, in light of the pending seasoned equity offering of stock, the strict liability provisions of the Securities Act of 1933 may apply, and the stakes are raised. If there is securities fraud, the purchasers of new stock may be able to recover the amount of any market price correction without having to prove management intended to deceive. In addition, existing shareholders could sue under the Securities Exchange Act of 1934 provisions, and with management selling stock acquired through option exercises, there could be adequate motive to plead a case. However, in real-life situations, the facts are rarely so clear.

Of course, the auditors should test the adequacy of the warranty loss contingency and review management's methodology in the process of examining the warranty accounts. Indeed, U.S. generally accepted auditing standards guidance relating to consideration of fraud in audit planning (see chapter 1) tells auditors to focus on revenues and expenses based on significant estimates that involve unusually subjective judgments or uncertainties. Clearly, the copper estimates contained in the warranty cost would qualify.

The SEC has proposed rule changes that would address issues with critical accounting estimates, such as the preceding (see chapter 8). The proposals would require management to identify key estimates and present an explanation of the range of possibilities, along with a discussion of the possible impact on financial statements and company operations. The critical accounting estimates would then be disclosed in the "Management Discussion and Analysis" (MD&A) section of SEC filings. For Alphabetical, the SEC-proposed disclosure reads as follows:

> Alphabetical's products are covered by standard product warranty plans that extend 6 to 10 years. A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects our estimate of the expected future costs of honoring our obligations under the warranty plan. We believe the accounting estimate related to warranty costs is a "critical accounting estimate" because: changes in it can materially affect net income, it requires us to forecast copper prices in the distant future which are highly uncertain and require a large degree of judgment, and copper is a significant raw material in the replacement parts used in warranty repairs....
>
> Historically, the costs of fulfilling our warranty obligations have principally related to replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in our parts constituted approximately 35% to 40% of the total cost of warranty repairs. Over that same period, warranty expense represented approximately 19% to 22% of cost of sales.
>
> Over the past 10 years, the price of copper has exhibited significant volatility. For example, [eight years ago], the price of copper rose by approximately 72%, while [last year] the price decreased by approximately 19%. Our hedging programs provide adequate protection against short-term volatility in copper prices, ... but our hedging does not extend beyond 5 years. Accordingly, our management must make assumptions about the cost of that raw material in periods 6 to 10 years in the future. Management forecasts the price of copper for the portion of our estimated copper requirements not covered by hedging....

Each quarter, we reevaluate our estimate of warranty obligations, including our assumptions about the cost of copper....

If, for the unhedged portion of our estimated copper requirements, we were to decrease our estimate of copper prices as of [the end of the current year] by 30%, our accrued warranty costs and cost of sales would have been reduced by approximately $27 million or 6% and 4%, respectively, while operating income would have increased by 9%. If we were to increase our estimate as of [the end of the current year] by 50%, our accrued warranty costs and cost of sales would have been increased by approximately $45 million or 10% and 7%, respectively, while our operating income would have been reduced by 23%.

A very significant increase in our estimated warranty obligation, such as one reflecting the increase in copper prices that occurred [eight years ago], could lower our earnings and increase our leverage ratio (leverage refers to the degree to which a company utilizes borrowed funds). That, in turn, could limit our ability to borrow money through our revolving credit facilities....

Our management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

This disclosure clearly sets out the impact on earnings when a volatile component, such as copper prices, changes. Readers of financial statements can then better assess the risks involved and value the firm or its stock accordingly.

The process of drafting this disclosure would involve the audit committee, as well as outside auditors, in the review of the methodology used to forecast copper prices. With the audit committee tasked to review these critical accounting estimates, it would be more likely that (1) the change in methodology would be uncovered and (2) the rationale for the change would be questioned. Although this disclosure would not be mandatory for private companies, providing similar disclosure, if only to the audit committee, would be a valuable addition to standard financial statement disclosures.

Asset Impairments

Physical Assets

An asset is not always worth its balance sheet carrying value. Even if an appropriate depreciation schedule is established when the asset is acquired, over time, the needs of the business enterprise may change. Because of rapid changes in engineering and materials applications, for example, manufacturing processes may need to be updated to remain economically competitive. The machinery used in the old processes may become obsolete well before the machines themselves actually wear out and are depreciated down to salvage value. Similarly, changes in customer demand may force a manufacturer to discontinue a certain product line and render useless equipment specially designed to build that product. Firms operating in highly competitive markets may lose business to a low cost competitor and be forced to idle production lines. Occasionally, to obtain or retain a customer relationship, a firm may even deliberately quote a price for its products that does not cover the cost of acquiring and operating the equipment used to produce those products. In all these cases, management should assess whether the equipment carrying value is impaired, especially if there are no reasonable prospects of finding an alternative use for the equipment. In the event an impairment loss should be taken, management may fraudulently postpone that charge if it causes earnings to fall below a managed earnings target.

To detect this fraud, the CPA must be particularly adept at seeing through management's pretensions to get to the facts. The best place to begin is to review fixed assets with divisional or production personnel. FASB ASC 360-10-35-21 provides the following list of possible events that may give rise to an impairment of a single asset or a group of assets:

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

The CPA may wish to draw questions for firm personnel from this list and look for evidence of changes in production and product demand to determine whether an asset is impaired.

Clearly, if equipment has been moved off the shop floor into storage and there are no plans for future use of that equipment, an impairment loss is highly likely. The more difficult issues arise if equipment is still in use but profitability is less certain. Profitability is at issue because assets may be impaired if they are not recoverable. FASB ASC 360-10-35-17 states, the "carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group)." Therefore, the CPA must ascertain the projected net cash flows for a given asset or an asset group if it is not possible to forecast cash flows for a single asset. Under FASB ASC 360-10-35, the cash flow projections generally must extend to the end of an asset's estimated useful life (which is presumably the remaining depreciable life of the asset). If the asset is not recoverable, the firm may need to recognize an impairment charge if the fair value of that asset is less than the carrying value. Fair value is frequently determined by using the forecast cash flows and discounting those cash flows by an appropriate discount rate, so if an asset fails the recoverability test using undiscounted cash flows, it has to trigger an impairment charge if discounted cash flows are used to calculate fair value. For that reason, fraudsters desiring to maintain the inflated value of assets on the balance sheet will strive to manipulate the cash flow forecast used in the recoverability test. If the fraudster can deceptively pass the recoverability test, the asset will not be subjected to the impairment test.

Getting a handle on cash flow forecasts is the key to halting asset impairment fraud. Most management information systems measure profitability by product line or customer; in today's competitive environment, it is rare to find a business operating without this information. Indeed, the activity-based costing initiatives begun in the 1980s were a direct result of the need for management to understand a product's contribution to overall firm profitability. CPAs may not be accustomed to reviewing product line profitability reports because they typically work from trial balances or traditional income statements, but product line reports source revenues to the costs to produce them and can answer directly whether a given production process has been historically profitable. Internal budgets and management reports are other good resources to use.

If the CPA can obtain forecasts directly from the personnel with line responsibility for production, those personnel might be inclined to render a more accurate estimate because they may be unaware of management's earnings target. One should keep in mind that line managers may have an incentive to show as positive a picture as possible to avoid a shutdown of production. Also, line managers may receive hints or outright requests from management to produce an overly favorable forecast. However, in either case, if the forecasts are accompanied by written narratives, the narratives generally list all the downside possibilities to provide political cover for the line manager should events not turn out as planned. If there are no narratives, the CPA can probably obtain a list of potential downside possibilities simply by asking the line managers. Then, the CPA may be able to assess the reasonableness of the forecast, given the known conditions at the time and the likelihood of those downside possibilities.

In addition, sales personnel may prove to be a good source of information for forecast revenues. However, the CPA should always question how thoroughly the sales person constructed the forecast and the probabilities for closing sales.

Proving fraud in a forecast is difficult because a forecast is by its very nature a best guess (see AT section 301, *Financial Forecasts and Projections* [AICPA, *Professional Standards*, vol. 1]). However, if that forecast was based on facts known to be incorrect, such as a major customer's known unwillingness to buy the product, the forecast was fraudulently constructed. A forecast may also become fraudulent if it is used at a later time to justify a management decision because management knows that significant facts have changed. For example, a forecast may accurately reflect that at the time of preparation, there was a possibility that a certain major customer wanted to buy the product. However, if by the balance sheet date, management knows the customer is not interested and there are no alternative buyers, it would be fraudulent to assert that the forecast is still accurate and then use it to justify not writing down the value of assets used to produce that product.

Private Company Securities

Another area of asset valuation that can fall victim to fraud relates to investments in the nonpublicly traded securities of companies. Such securities are difficult to value because transaction prices are not publicly available. Moreover, the valuation of private company holdings is of growing importance as investment funds flowing to private equity and venture capital funds increase. Investments in private companies may take the form of common or preferred stock or debt with an equity feature (such as convertible debt); for purposes of this discussion, all such investments will be referred to as *private company securities*.

General guidance for the CPA on valuation of private company securities is available in FASB ASC 820, *Fair Value Measurements and Disclosures*; 825, *Financial Instruments*; and 320, *Investments—Debt and Equity Securities*, among others. In a fraud context, the issues relating to private company valuation tend to center around misleading forecasts of financial performance because those forecasts drive valuation models. Principally, valuation of nonpublicly traded securities relies on two types of valuation models: discounted cash flow and peer company multiples. Chapter 5 discussed special valuation issues concerning the manipulation of discounted cash flow models used to value closely held companies. The same manipulative techniques can be employed to fraudulently maintain or increase the value of a private company's securities held by venture capitalists (VCs) and private equity providers.

Models based upon peer company multiples essentially look to publicly traded firms that are comparable to the company being valued and develop metrics that tie projected performance to value. For example, a valuation specialist may calculate the ratio of a comparable publicly traded firm's forecast operating income to its total market capitalization. Income projections for public companies are generally available from research analysts. Hopefully, several comparable publicly traded companies exist so that several ratios can be calculated and averaged to obtain a peer company multiple. Then, using that multiple, the valuation specialist would calculate a market approach value of the private firm by multiplying the private firm's forecast operating income by the peer company multiple. Unfortunately, techniques used by fraudsters, discussed in chapter 5, to manipulate historical data used as inputs to forecast future income will affect valuations from peer company multiples by inflating the private company's forecast income, and with inflated forecast income, the peer company multiple approach will yield an inflated valuation.

A CPA suspecting fraud in the valuation of private company securities should initially focus on the forecast income. To assess whether income in future periods will potentially decline, a useful starting point is the list of impairment indicators in FASB ASC 320-10-35-27:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates *d.* A bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

A fraudster will attempt to hide any of these indicators, so a CPA must have access to information directly from the investee private company or other third party sources, such as financial news media or trade sources.

If a CPA suspects an unrecognized decline in private company securities, determining the amount of the decline can be difficult. Without valid quoted market price inputs to determine the value of private company securities, the CPA might have to look at financial information from the investee company. The investor, if it holds a significant position in the investee, should have financial information on file (if not, this should be a red flag that something may be amiss). Those data would likely include results of operations that would provide historical profitability. For future profit estimates, one should look to company forecasts to evaluate any valuation analysis prepared by investor or investee management that are used to justify security values. Forecasts of future financial performance and company valuations are typically found in board minutes of either the investor or investee. VCs and private equity firms frequently have representation on the board of directors of investee companies; therefore, minutes of investee firms should be available to the CPA assessing private company securities values on the investor's books (again, if there are no minutes, this is another red flag). However, the CPA should assess the validity of those forecasts based on known relationships, if any, between the management of the investor and investee. If there exists common management of both investor and investee companies, further inquiry may be necessary to determine the validity of any forecast.

Finally, use of one type of valuation model may serve as a useful check on another type of valuation model. For example, if management relies upon a discounted cash flow model, a peer company multiples model may serve as a validation of any value obtained using discounted cash flow. From comparable public companies, the CPA may be able to establish an average peer company multiple of either sales or operating income to the respective market capitalization of each public company. With that average ratio, the CPA can then evaluate investor management's calculated value of the investee private company, assuming the CPA is comfortable with management's forecast income. If management's discounted cash flow model used a calculated discount rate that is excessively low, thus creating an inflated valuation due to the small discount of future cash flows, use of peer company multiples may detect the inflated value. Further inquiry by the CPA may lead to discovery of industry-wide negative issues or trends that management had failed to incorporate into the forecasts. Whether this failure was intentional is a matter for further investigation by the CPA.

Conclusion

Detection of fraud in loss contingencies, asset impairments, and private company securities is difficult because it is a search for a valuation that was not booked. Successful detection requires drilling down within and outside an organization to obtain information from

a. lower level accounting personnel who may have specific knowledge of facts pointing to the fraud without a desire (or knowledge) sufficient to cover up the fraud.

b. personnel in other departments, such as sales and legal, who may know relevant facts but may not be aware of any attempt to hide those facts.

c. suppliers, customers, industry publications, news articles, and other data from outside the firm.

From various sources, the CPA may be able to piece together that picture of a contingent loss that was not recognized, an impaired asset that is carried at original cost, or a stock that is overvalued.

Estimates play a significant role in loss contingencies, asset impairments, and securities valuation and are subject to manipulation. Detecting that manipulation requires an internal control process that challenges the estimation assumptions, beginning with the examples of loss contingencies and impairment lists previously cited and continuing into all the key building blocks of the valuation models employed.

An audit committee that is aware of the sensitive areas most subject to valuation issues will, at the very least, be in a position to make inquiries that may lead to detection of frauds. The key to the audit committee's success is the flow of information from management and internal and external auditors that point to these issues.

Chapter 11

Manipulation of Acquisition Contingencies

If one company acquires another using the purchase method of accounting for the transaction, as required under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805, *Business Combinations*, the purchase price paid is allocated to the identifiable tangible and intangible assets of the acquired company based on the fair value of those assets. Any excess of purchase price over the fair value of acquired identifiable assets, net of liabilities assumed, is booked as goodwill.[1]

The purchase price can be paid with cash, stock of the buying company, or other assets conveyed to the seller. Liabilities can also be transferred from the seller to the buyer or accrued in the transaction. Those liabilities assumed by the purchaser effectively decrease acquired net assets. The greater the liabilities assumed, the lower the amount of assets, net of liabilities (net assets), and because goodwill is generated when the purchase price exceeds net assets, increasing liabilities will likely increase goodwill.

One type of liability that managers of an acquiring company may need to book are acquisition-related loss contingencies, as provided under FASB ASC 805-20-25-18A, usually for potential problems inherited when the target company is acquired. These loss contingencies (sometimes referred to as *acquisition reserves*) typically increase goodwill paid for the

[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805-30-30-1.

acquired company. The entry establishing the loss contingency is a credit to a liability and a debit to goodwill. Under FASB ASC 350-20, goodwill remains on the books at its unamortized carrying value unless it is impaired. However, the loss contingency on the balance sheet, with its credit balance, serves to absorb debits from certain expenses related to the loss contingency in future years (that is, as long as goodwill remains unimpaired, the loss contingency expenses never get to the income statement). This makes the acquisition-related loss contingency a particularly useful tool for fraudsters who want to hide expenses.

FASB ASC 805-20-25-18A states that an acquisition-related contingency must meet the condition of being "[a]ssets acquired and liabilities assumed that would be within the scope of Topic 450 if not acquired or assumed in a business combination." Such a contingency arises at the time of the acquisition. Presumably, a loss contingency that existed prior to an acquisition should have already been recorded under FASB ASC 450, *Contingencies*; therefore, acquisition-related loss contingencies under FASB ASC 805-20-25-18A generally arise due to the acquisition itself. For example, a horizontal acquisition of a competitor may result in confusion or dissatisfaction among the customer base of either the acquirer or acquiree, so a loss contingency for cancelled sales contracts or product discounts may be appropriate. The example scenario in chapter 2 illustrated these contingencies. FASB ASC 450-20-25-2 requires that a loss contingency be both probable and capable of being estimated to be recognized. Acquisition-related loss contingencies have an additional feature in that there is a measurement period that extends the time to determine if the contingency will be probable and can be estimated.

Measurement Period

The measurement period begins with the acquisition and, according to FASB ASC 805-10-25-14, ends "as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date."

Therefore, U.S. generally accepted accounting principles (GAAP) require that all acquisition-related loss contingencies be identified during the measurement period. After the measurement period ends, any loss contingencies are run through the income statement.

The rationale for the measurement period is to allow time to adequately value the components of a transaction. However, fraudsters will use the measurement period to reclassify postacquisition losses and expenses as acquisition-related loss contingencies. During the measurement period, the fraudster can peruse postacquisition expenses and recharacterize those of his or her choosing as acquisition-related loss contingencies by fabricating a story that links the expenses to fictitious contingencies at the time of the acquisition. The following example scenario illustrates how the CFO of an insurance carrier improperly recharacterized postacquisition claims losses as acquisition-related loss contingencies by taking advantage of the measurement period.

An acquisition-related loss contingency can also become a "cookie jar reserve," as former Securities and Exchange Commission (SEC) Chairman Arthur Levitt used the term (see chapter 3). Because the contingency is created by debiting goodwill, no income statement charge is taken to book the loss contingency. If the fraudster can convince others that goodwill is not impaired, no charge reaches the income statement in the following periods. However, in those following periods, if costs arise that the fraudster wishes to hide, he or she can debit the contingency account and keep those costs off the income statement, as well. In the end, acquisition-related loss contingencies appear to be a fraudster's paradise, except when confronted with a CPA who is wise to the fraudster's ways.

Acquisition-Related Loss Contingency Example

Fraud using contingencies may seem easy at first look, but if used to hide significant quantities of costs, this type of fraud can be quite sophisticated. The following example illustrates the balancing act required for a fraudster to successfully employ acquisition-related loss contingencies to commit financial statement fraud:

Example Scenario

Great Strength Life and Health Insurance Company, a publicly traded stock insurance company, specializes in underwriting whole life and term insurance products sold through independent agents throughout the United States. The fiscal year had recently closed, and the GAAP-basis financial statements were being prepared; the insurer's accounting staff had just finished financial statements prepared according to statutory accounting practices to be filed with the states' insurance commissioners.

The year had not been a good one due to recent unfavorable claims experience that suggested that certain products had been underpriced. However, Great Strength's CEO, a former insurance salesman who rose through the ranks, paid no attention to the warnings from his CFO and all through the year declared that "Great Strength was on track to continue its long record of 15 percent per year increases in earnings per share."

The company's actuaries had steadily increased the claims reserve throughout the year. However, in the fourth quarter, the actuaries decided that due to a large surge in reported claims, incurred but not reported (IBNR) claims had to be growing, as well. With the increase in IBNR, came a large increase in the claims reserve in the fourth quarter. For each quarterly filing with the SEC, the CFO had been able to compensate for some of Great Strength's problems with an increasing claims reserve by allocating some administrative and general marketing costs to the deferred policy acquisition costs account, a deferred expense account on the balance sheet that is amortized into expense over the life of policies in force. However, by the fourth quarter, the problem with claims was just too bad to cover so easily. The CFO tried to have a conversation with the firm's actuaries to convince them to lower their estimate of IBNR claims, but he found that talking to the actuaries produced no reaction whatsoever; they simply said "No" and went back to crunching numbers.

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Stymied, the CFO asked the controller to "reassess" the acquisition-related loss contingencies set up when Great Strength acquired another insurance carrier, Old Life and Health Insurance Company, late in the previous year. When the controller pointed out that the measurement period ended after one year, the CFO responded that because they had not formally closed the fourth quarter, there was still time.

The controller examined the claims experience by book of business (that is, by policy type) and found that a significant quantity of policies with larger than expected claims were underwritten by Old Life, although the claims problem did not occur until this fiscal year. She was not sure whether the recent adverse claims experience could be linked back to the acquisition period, but the CFO had no doubts when he saw the analysis. "The Old Life underwriters," he said, "made a mistake in not establishing a large enough claims reserve." The controller brought up the fact that Great Strength had retained an outside actuarial consulting firm to evaluate the adequacy of the reserves when it bought Old Life, but the CFO simply said, "Well, they were wrong, too!"

The price paid for Old Life was in excess of its identifiable assets, net of liabilities, so there already was a goodwill account from the transaction. The CFO asked the controller to make the following entry to record a retroactive increase in the claims reserve for Old Life policies:

Dr. Goodwill—Old Life		$20,000,000	
Cr.	Claims reserve		$20,000,000

This entry had the effect of doubling the amount of goodwill from the Old Life transaction, so the CFO knew that another challenge lay ahead: testing goodwill for impairment under FASB ASC 350-20-35. If the impairment test resulted in a write-down of goodwill, all the CFO's scheming to keep costs off the income statement would be for naught.

Goodwill impairment was a real possibility, even before the preceding loss contingency entry was recorded. FASB ASC 350-20-35 required testing the Old Life goodwill by treating all the assets acquired in that transaction, including goodwill, as a reporting unit and then valuing the reporting unit as a whole at fair value. If the fair value of the reporting unit turned out to be less than the carrying amount of all the assets, all the nongoodwill assets of the reporting unit would then be valued, with the difference between the value of the individual assets and the value of the reporting unit being imputed to goodwill. If that imputed goodwill was less than the carrying amount of goodwill, the difference would be the amount of the write-down charged to current earnings. For Old Life, its value as a reporting unit was declining rapidly as the claims reserves were increased. Effectively, the Old Life policies were not as valuable as when Old Life was purchased, and Great Strength overpaid. An impairment of the original goodwill booked in the transaction was possible; with goodwill doubled by the acquisition-related loss contingency adjustment, a write-down was almost certain.

However, the CFO was not going to give up. Out of the CFO's fertile mind sprang more ideas. Like Great Strength, Old Life was an underwriter of whole life insurance policies, but Old Life's policyholders tended to be higher risk due to past medical conditions, which probably contributed to the higher than expected claims. Great Strength also had policies targeted to high risk groups, except Great Strength's policies were appropriately priced and very profitable. When Great Strength tested its lines of business for premium deficiencies, in accordance with FASB ASC 944-60-25, it combined the Old Life and Great Strength high risk policies into one line of business because they were similar products. Indeed, for previous quarters, the combination of the unprofitable Old Life policies and the profitable Great Strength policies allowed the CFO to increase deferred policy acquisition costs, a component in the test, without taking a premium deficiency charge. The CFO did some quick calculations and decided that the combined high risk products would show a profit healthy enough to carry the newly enlarged amount of goodwill. So he asked the controller to prepare a FASB ASC 350-20-35 goodwill impairment test including the Great Strength high risk products. When the controller voiced concern about including the Great Strength products in the Old Life goodwill impairment test, the CFO responded that because the Great Strength and Old Life high risk products were combined for purposes of premium deficiency testing, it was appropriate to include the Great Strength high risk products in the reporting unit for goodwill impairment because the company considered all products to be part of the same operating segment.

The controller prepared the goodwill impairment test as instructed. The sum of the discounted cash flows for the redefined reporting unit exceeded the carrying value, thanks to the inclusion of the Great Strength policies. The CFO was quite pleased when the controller gave him the analysis.

The CFO also instituted a policy renumbering process that, officially, was designed to "bring the Old Life policy numbering system into conformity with Great Strength's." The Great Strength numbering system used the suffix "HR" for policies issued under its high risk underwriting; effectively all of Old Life's policies were recoded with the same number of digits in the prefix and the same "HR" suffix as the Great Strength policies in that risk group. The effect was that policies obtained from the Old Life acquisition became much harder to distinguish from those of Great Strength.

During the year-end audit, the audit manager questioned the increase in goodwill from the Old Life acquisition. When the CFO showed him the goodwill impairment analysis prepared by the controller, the audit manager asked an audit senior to verify the calculations. The audit senior then requested a listing of policies that supported the calculations, and the controller provided a listing of all policies with the "HR" designation without mentioning the inclusion of Great Strength's products.

By diverting the unanticipated additional claims cost to the goodwill account, the CFO kept reported claims expense within budget, and Great Strength hit its earnings per share target.

Example Analysis

This example illustrated a number of fraud schemes. First, the CFO engaged in a simple diversion of costs from the income statement to the balance sheet by reclassifying administrative and general marketing expenses as deferred (policy) acquisition costs (DAC). According to FASB ASC 944-30, DAC should include only those costs that vary with, and are primarily related to, the selling or acquisition of the policies, such as insurance sales commissions and underwriting costs. Most administrative and general marketing expenses do not vary with, and are too remote from, the acquisition process and, therefore, are not eligible for DAC treatment.[2]

However, the simple cost-shifting scheme does not solve the entire problem of higher claims, so the CFO has to employ other schemes. The CFO devises a plan to use acquisition-related loss contingencies related to the Old Life acquisition, but the plan

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[2] FASB ASC 944-30-25-2.

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calls for a doubling of goodwill booked from that transaction. That increase in goodwill causes another problem in that it might trigger an impairment. Thus, the CFO has to balance how far he can go with this scheme; if he gets too greedy in creating or adding to goodwill, he may see his efforts unraveled when goodwill is tested for impairment.

So the CFO creates cover by finding an excuse to include more profitable policies from Great Strength's book of business in the impairment test for Old Life's goodwill. To bring the more profitable policies into the impairment test, the CFO improperly recharacterizes the reporting unit based upon the presumably legitimate procedure for running the premium deficiency test. His thinking runs along the lines of "if the Great Strength policies were appropriately included in the premium deficiency test, then they should be included in the goodwill impairment test, as well." Although flawed, the logic is simple and convinces the controller.

Improper practices, such as the blurring of boundaries for the purposes of running different tests, often become institutionalized over time, leading to years of misstatements. In this scenario, there was an identified culprit, in the person of the CFO, who started the improper practice, but many times, no one can point to how an improper practice began. CPAs need to question practices that appear to lack proper support, even if those practices have been in operation for a long period of time.

The doctored impairment analysis is successful only if the inclusion of Great Strength's policies goes undetected. To hide this deception, the CFO initiates the policy renumbering process that blurs the distinction between an Old Life policy and a Great Strength policy. His success in carrying out this scheme depends on how much attention auditors have paid to the Old Life acquisition in the past to see if the data used in his most recent goodwill impairment analysis conformed to the quantity of policies originally acquired.

However, the auditors stopped short of asking the more important question regarding the propriety of the entire acquisition-related contingency. The auditors and the controller appeared to accept the concept that there is generally a one-year measurement period to identify and book acquisition-related contingencies. In this case, though, Great Strength hired outside actuaries to assess the adequacy of claims reserves, and according to FASB ASC 805-10-25-14, the "measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable." Therefore, the rendering of the actuaries' opinion should have fulfilled the requirements for closing the measurement period, with regard to claims reserves. Any change to loss contingencies subsequent to closing the measurement period should have been recognized in the income statement. Consequently, by not following up on the rationale for the acquisition-related loss contingency, the audit manager lets the fraud slip by.

Conclusion

Use of acquisition-related loss contingencies to commit fraud is complex and difficult to pull off, but this type of fraud is also very lucrative for fraudsters and, unfortunately, worth the effort if they are successful. With a fraudulently constructed acquisition-related loss contingency, fraudsters can hide or divert significant quantities of current expenses, such as higher claims costs in the preceding example, to create or maintain the appearance of profitability.

Without restrictions on the booking of loss contingencies after an acquisition, the management of an acquiring company could constantly (and conveniently) create reserves to absorb current losses from an acquired company simply by increasing goodwill. However, at some point, current management must take responsibility for current period results. CPAs should carefully review the measurement period cutoff, as provided in FASB ASC 805-10-25-13, to make sure that it is not abused. Management crosses the line into fraud when its only justification for extending the measurement period is to create unmerited cookie jar reserves in the form of loss contingencies.

Chapter 12

Cost and Debt Shifting

Chapter 11 discusses the methods fraudsters use to move costs from the income statement to acquisition-related loss contingency accounts on the balance sheet. This chapter explores the techniques used to move costs and debts from a company's financial statements to the financial statements of another, probably related, entity. The process of illicitly moving costs and debts to another entity is tricky because it frequently involves legal and financial issues, such as setting up a separate entity and convincing third parties (suppliers, investors, and lenders) that the separate entity is creditworthy. However, with the greater challenges come greater rewards for the fraudster in that, if successful, costs and debts do not appear anywhere in the company financial statements, making them very difficult for auditors and others to locate.

Cost Shift to Related Entity

Sometimes fraudsters can deceive by moving costs from one entity to another under common control. This technique is most often found in industries that customarily use joint ventures and partnerships to accomplish specific objectives. For instance, due to the high risks associated with locating and extracting oil and gas, exploration and production firms typically establish joint ventures with other parties to share the risk. If these other parties consist of passive investors, a fraudster may wish to take advantage of the lack of oversight and allocate costs that should be sourced to other ventures or the fraudster's company over to that joint venture. Other industries, such as real estate development, operate in a similar fashion using multiple limited partnerships, and those partnerships may also be tempting targets for fraudsters.

Cost Shifting at Livent, Inc.

The entertainment industry also provides an example of cost shifting in the *Livent, Inc.*, case.[1] Livent was a Canadian theater company that produced a number of successful Broadway shows, including *Phantom of the Opera*, *Show Boat*, and *Ragtime*. In January 1999, the SEC concluded an enforcement proceeding against nine former employees of Livent alleging

> a multi-million dollar kick-back scheme designed to misappropriate funds for their own use; the improper shifting of preproduction costs, such as advertising for *Ragtime*, to fixed assets, such as the construction of theaters in Chicago and New York; and the improper recording of revenue for transactions that contained side agreements purposefully concealed from Livent's independent auditors.

This scheme operated from 1990–98. It inflated net income over that period by CAD$98 million, causing the share price of Livent's stock to fall 95 percent when the fraud was revealed, wiping out more than US$100 million of market capitalization.

Of the many fraud schemes used at Livent, the one called the "amortization roll" was most interesting. Under Livent's accounting policies, production costs, such as advertising, sets, and costumes, that were incurred before the opening of a show were capitalized. When the show commenced, the capitalized production costs were to be amortized over the expected life of the show (up to a maximum of five years). Under the amortization roll scheme, though, production costs for a show currently running would be transferred to a show that had yet to open or to a show with a longer amortization period remaining. The effect of the transfer was to delay the commencement of amortization, to lengthen amortization beyond periods stated in Livent's financial statements, and to make current shows appear to be more profitable.

As was the custom in this industry, shows produced by Livent had many different rights owners who were to receive profit participations in certain shows run in specific geographic areas. Therefore, as was the case with oil and gas and real estate ventures, Livent had to maintain separate accounts for each show, such as *Ragtime* or *Show Boat*, and perhaps even separate accounts for shows running in certain locations. The amortization roll, then, had the effect of sending costs of an earlier show cascading down through the accounts of later shows or later productions of the same show running in different locations. The SEC stated that for 1996 and 1997, "approximately $12 million relating to seven different shows and twenty-seven different locations was transferred to the accounts of approximately thirty-one different future locations and ten other shows then in process." From a fraudster's point of view, this scheme must have appeared to be a masterful display of both cunning and brazen manipulation.

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[1] Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 1095 (January 13, 1999).

With so much cost shifting and other schemes going on, management had to maintain separate books to keep track of the true state of affairs. The IT manager also managed to devise ways to electronically hide the movement of expenses. When costs were first incurred, they were recorded on the accounts of a certain production. When those costs were shifted, the IT manager overrode the accounting software's audit trail such that when those shifted costs arrived on the books of another show, they appeared to be original entries. The altered accounting system also secretly kept track of the net effect of the amortization roll and other schemes, so management could translate fraudulent financial statements into accurate ones. These fraudsters were no dummies.

Fraud Detection at Livent

There were clues, though, that could have tipped off the frauds. The financing of *Show Boat* and *Ragtime* provides an insight. In 1996–97, Livent sold the rights for various North American show locations to Pace Theatrical Group, Inc., for fees totaling US$11.2 million. In return, the sale contract gave Pace the right to reimbursement of theater production costs and, according to the SEC, "a limited percentage of adjusted gross ticket sales as profit participation." Moreover, the fee Pace paid was nonrefundable, and Livent was not required to actually run the shows in North America. Under these facts as presented, Livent convinced its auditors to allow it to book the rights transaction as sales revenue.

Unknown to the auditors were side letters that allowed Pace to recoup its fees and earn additional profit as the shows were performed. From a financial perspective, the Pace transactions made little sense without the side letters. According to the agreements shown to the auditors, for significant, presumably nonrefundable fees, Pace would essentially receive a small profit participation. The side letters, which auditors did not see, provided downside protection and a more reasonable profit interest. Clearly, the poor economics of the transaction, as presented to the auditors, could have signaled a problem.

In the auditors' defense, they did ask for and receive confirmations from Pace that there were no agreements other than those known to the auditors because Livent's management told Pace that the auditors already had the side letters. Pace responded without raising any red flags. Therefore, to catch such a scheme, in the future, CPAs will have to go further by specifically asking whether any side letters exist and insist on seeing those letters. Moreover, the line of inquiry with outside parties needs to probe into the rationale of the transaction to ask, essentially, "What do you get out of this?" If the answer does not make sense on the surface, the CPA may need to investigate further, looking, for instance, for related party connections or undisclosed agreements. Many times, the third party does not have as much interest in hiding the fraud as the fraudster and may explain everything to avoid the possibility of being linked to the fraud.

Other Fraud Detection Steps

To say that this fraud was difficult to catch would be an understatement. In 1998, new management at Livent, which was not aware of the schemes, discovered one of the side letters with the profit participant that had rights to *Ragtime* and *Show Boat* in the United Kingdom. This discovery led to an internal investigation that brought down the entire house of cards.

Without that discovery, many of the schemes could have continued for some time. The amortization roll could have continued until either:

1. a disgruntled rights owner insisted on an audit of specific show expenses or
2. Livent ran out of funding for new shows to keep the roll going.

When adequate audit trails exist, CPAs would be well served to look for credits appearing in expense accounts to detect cost shifting. Such credits may indicate that the entity incurring the cost accrued the expenses on its books as debits and then transferred the expenses out with offsetting credits. However, it is not safe to assume that the subsidiary incurring the expense initially recorded it as such. There may be a special contingency or liability account on the balance sheet set up to record the initial debits, with the transfer credits appearing later. As the expenses are being booked, significant debit balances in the liability account will grow until the transfer is made. Such debit balances in a liability account should stand out. Also, if the transfers take place over time, some correspondence spelling out the procedures is likely, especially if the initial debit is to an unusual account, such as a loss contingency.

With Livent, internal controls that were compromised by extensive collusion made detection of the amortization roll difficult because shifted expenses had the appearance of an original entry. Nevertheless, sourcing the expenses of a given show to the accounts for that show may have revealed a difference as some of those costs were shifted to later shows. For the occurrence of one of the events previously described, the only person standing in the way of fraudsters running such a cost shifting scheme is a CPA who insists on looking at the source documents.

"Hidden" Debts and Transferred Financial Assets

The collapse of Enron Corp. in 2001 brought extensive attention to the role of off-balance sheet financing vehicles, then known as special purpose entities (SPEs). Critics alleged that Enron's SPEs were used to "hide" debts by moving them from Enron's balance sheet to the SPEs' balance sheets.

Enron was not the first company to use SPEs. SPEs (or, more broadly, securitization entities) had long been in use. For many years, financial institutions had used securitization entities to securitize loans. The securitization process used by a bank was fairly straightforward. The bank would package a group of loans, such as credit card debt, and have one of the bond rating agencies assess the portfolio of loans and the structure of the SPE for creditworthiness. The bank would fund the securitization entity with a small amount of capital provided by outsiders and then cause the securitization entity to issue bonds in sufficient quantity to purchase the loan portfolio. The bonds would fall into different tiers, or tranches, based upon the amount of repayment security, with the first tranch entitled to cash flows before the second and successive tranches. Consequently, the rating agency would award a higher safety rating to the first tranch bonds, usually an investment grade rating. The second and other tranches may also qualify for investment-grade ratings, depending upon the quality of loan assets in the securitization entity. Those bonds that received investment-grade ratings would be marketable to institutional investors, such as pension plans and retirement funds. With the proceeds of the bond sale, the securitization entity would purchase the loans from the bank. After the transaction, the bank had additional capital with which to go out and make more loans. Indeed, many borrowers today have securitization entities to thank for providing a mechanism for banks to extend them credit.

Fraudsters "Hide" Continuing Involvement

Were the bonds issued by the securitization entity and used to acquire the loans "hidden" from the bank's balance sheet? The securitization entity holds the debt, along with the loan assets the bank transferred. As long as there was a legitimate sale of assets between the bank and securitization entity, for financial reporting purposes, U.S. generally accepted accounting principles (U.S. GAAP) do not require the bank to show the securitization entity's bonds on its balance sheet. Whether a sale occurs is the key U.S. GAAP criterion that determines whether debts are to be shown on or off the balance sheet. A sale does not occur if there is *continuing involvement*, defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary as "[a]ny involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer."

For example, during the credit crisis of 2008, some banks that had securitized mortgage loans through securitization entities, which, in turn, placed bonds with major bank customers, were pressured by those customers to reacquire the securitized mortgages as defaults rose; the banks complied to avoid a loss of business from the major customers in other areas. Was there a continuing interest of the bank in the securitization entity because the bank's major customers held the entity's bonds and perhaps there was an implied repurchase agreement should the loans turn sour? If so, then there may not have been a true sale.

Fraudsters trying to "hide" debt will attempt to fabricate a sale when the quality of the assets or the sale price is such that the fraudster-transferor needs to provide additional guarantees that are "hidden" to create the appearance of a sale. Those additional guarantees are elements of continuing involvement and, if discovered, will negate the sale.

U.S. accounting literature provides a list of elements of asset transfers (see "Pending Content" in FASB ASC 860-10-05-4) that may indicate that there is continuing involvement on the part of the transferor:

> Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee has not been controversial. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement with the transferred financial assets include, but are not limited to, any of the following:
>
> a. Servicing arrangements
>
> aa. Recourse arrangements
>
> aaa. Guarantee arrangements …

c. Agreements to purchase or redeem transferred financial assets
d. Options written or held
dd. Derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer
ddd. Arrangements to provide financial support
e. Pledges of collateral
f. The transferor's beneficial interests in the transferred financial assets.

Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings.

Assessing whether continuing involvement is sufficiently material to prohibit sale treatment of the transfer is a matter of professional judgment, and the CPA should "consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer."[2]

In addition, U.S. GAAP forbids a transferor from exercising effective control over the assets that are transferred. "Pending Content" in FASB ASC 860-10-40-5(c) states that

> A transferor's effective control over the transferred financial assets includes, but is not limited to, any of the following:
>
> **1.** An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 860-10-40-23 through 40-27)
>
> **2.** An agreement, other than through a cleanup call (see paragraphs 860-10-40-28 through 40-39), that provides the transferor with both of the following:
>   i. The unilateral ability to cause the holder to return specific financial assets
>   ii. A more-than-trivial-benefit attributable to that ability.
>
> **3.** An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see paragraph 860-10-55-42D).

That said, a securitization entity can be manipulated by fraudsters to make it appear to be effectively controlled by the transferee when, in fact, it is not.

Asset Quality

To continue the bank example, the bank benefited by moving the loan assets from its balance sheet because the securitization turned the loans into cash. With more cash, the bank could originate new loans. In a sense, the bonds used by the securitization entity to finance the purchase of the credit card loan assets could be called the "hidden" debt of the bank because the bonds did not show up on the bank's balance sheet. What critics of securitization entities often fail to clearly state is that there are "hidden" assets (the loans in this example) that

[2] Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40-4.

move off the balance sheet, as well. Their criticism of securitization entities has merit, to the extent that the assets transferred to the securitization entity are not worth the amount of the debt issued against them. Intentionally selling assets that are worth less than the amount paid is not only a contractual fraud but is also an accounting fraud when the transfer is recorded as a sale at fair value equal to the amount paid. The quality of those assets becomes another issue in assessing whether the transfer of assets was a sale.

Fraud Methodology

Fraudsters attempt to exploit weaknesses in both continuing involvement and asset fair value standards of U.S. GAAP. Fraudsters manipulate both when they use the vehicle of a securitization entity to move debts off the balance sheet. The methods fraudsters use essentially break down into three steps:

1. Fraudsters attempt to locate assets on or off the company balance sheet that present difficulties in valuation, such as complex financial instruments, real estate, or other assets that are not publicly traded, to place in the securitization entity at inflated values. Fictitious assets, such as illusory accounts receivable, also work if fraudsters can manufacture them.
2. By inflating the value of these nonpublicly traded assets, the fraudsters can then move large quantities of debt equal to the inflated asset values from the company balance sheet to the securitization entity when the securitization entity issues its own debt and remits the proceeds back to the fraudster company.
3. Because bondholders for the securitization entity may be skittish because assets of dubious value are collateralizing their bonds, they will likely require some financial pledge from the fraudster-transferor to keep them happy. That pledge could be a commitment to repurchase bad assets at inflated prices or a commitment to simply make up any shortfalls on payments due from the securitization entity to the bondholders. The pledge to repurchase a bad asset is an element of effective control; a guarantee against cash shortfalls is an element of continuing involvement.

Importance of the Source of Capital

A fraudster may be able to obviate the need for financial guarantees in the preceding scheme by providing investment capital to the securitization entity through a related party bondholder or a fronting organization. If there is no outside capital in the securitization entity, the assets and liabilities must be consolidated with the transferor firm that set up the securitization entity. In effect, the assets and liabilities that the firm tried to move off its balance sheet come right back on if there is no outside investment.

The fraudster tries to create the appearance of outside investment in the securitization entity containing assets of dubious value. Moving funds through a related party may be too obvious, so a fraudster may employ a fronting organization using a scheme popular during the savings and loan (S&L) scandals that provided down payments for real estate loans made to straw-man borrowers. Under the old S&L scam, the lender would front funds to the borrower for the down payment on a real estate purchase through another borrower. That second borrower would then make an "investment" in the straw-man borrower equal to the funds needed for the down payment, and the S&L would provide the rest of the funds to the straw-man borrower needed to complete the purchase. A securitization entity fraud may work the same way, with funds coming from the firm that is trying to unload the assets and debts transferred to the securitization entity by using intermediaries to cover the movement of firm funds to the straw-man investor.

The source of the capital invested in the securitization entity is a key element in uncovering fraud. If real outside capital is at risk, a legitimate investor generally makes sure that the assets are valued at fair value. If asset values appear to be insufficient and a legitimate investor insists on guarantees, that investor is usually quite willing to reveal the existence of those guarantees because the investor may, at some future date, need to assert claims based on those guarantees.

Conclusion

Cost and debt shifting pose serious challenges to CPAs. However, the schemes are usually revealed when CPAs ask seemingly obvious questions about the vigilance exercised by the outside parties that enter into transactions with the fraudsters. In the case of cost shifting, if the outside parties, such as joint venturers or limited partners, did not insist on, and failed to exercise, the right to audit the financial statements of the joint venture or limited partnership, the potential exists for fraudsters to move costs from one project to another. Similarly, should fraudsters attempt to hide debts using a securitization entity, if the putative outside investor did not insist on an appraisal of hard-to-value assets sold to the securitization entity by the fraudsters and did not insist on periodic audits of operations, then it is possible that the investor is not independent or is a straw-man. In short, the behavior of third parties provides the best clues to identifying this type of fraud. The CPA needs to look beyond the operations of the firm and delve into the activities of business partners to find these clues.

Chapter 13

Recognizing Fictitious Revenues

In 1999, the Committee of Sponsoring Organizations (COSO) sponsored research published under the title *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (the 1999 research report), which found that one-half of the financial reporting frauds in the period 1987–97 were attributable to overstating revenue. In 2010, COSO's subsequent study of the 1988-2007 period, titled *Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies* (the 2010 research report) found that revenue recognition fraud had increased to 61 percent. Of those companies overstating revenue, both the 1999 and 2010 research reports found that recording fictitious revenues and recording revenues prematurely were the primary sources of fraud.

By 2002, findings such as these led the Auditing Standards Board to conclude in paragraph .41 of Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), that there is a **presumption of fraud** relating to revenue recognition when planning an audit:

> Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

Revenue recognition issues have occupied the accounting profession for many years. In 1984, the Financial Accounting Standards Board (FASB) issued FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83 of that statement sets out the following two basic requirements for recognizing revenue:

a. *Realized or realizable.* Revenues and gains generally are not recognized until realized or realizable. [footnote omitted] Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

b. *Earned*. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, [footnote omitted] and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

More recently, with complexities in the sale of software and with products that involve support after the sale (postcontract customer support), accounting standard setters developed Statement of Position 97-2, *Software Revenue Recognition* (AICPA, *Technical Practice Aids*, ACC sec. 10,700), now codified under the same heading in FASB *Accounting Standards Codification* (ASC) 985-605, as well as Emerging Issues Task Force Issue 00-21, "Revenue Arrangements with Multiple Deliverables," now codified in FASB ASC 605-25.

In 2003, the Securities and Exchange Commission (SEC) staff set out its interpretation of accounting literature regarding revenue recognition in Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*, and concluded the following:

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists, [footnote omitted]
- Delivery has occurred or services have been rendered, [footnote omitted]
- The seller's price to the buyer is fixed or determinable, [footnote omitted] and
- Collectibility is reasonably assured. [footnote omitted]

With regard to a fixed or determinable selling price, the SEC staff amplified its position by stating a *fixed fee* is a "fee required to be paid at a set amount that is not subject to refund or adjustment." If the buyer retains a right to a refund of the purchase price, collectability cannot be assured. Indeed, it would be difficult to meet the FASB Concepts Statement No. 5 realization test if the cash or other payment tendered was subject to refund at the buyer's discretion. Yet, refund arrangements are a common area for revenue recognition fraud. If company management wishes to inflate revenues by booking fictitious sales, in all likelihood, one or more of the SEC's conditions will have been violated. These conditions are described in the following sections.

Lack of an Agreement When Booking Sales

As the reporting quarter draws to an end, companies straining to achieve a revenue target face pressure to close sales by the last day. That pressure may lead to the fraudulent booking of premature or nonexistent sales. In the rush to close transactions by a certain date, sales personnel may represent to management that there is an oral agreement with a customer when, in fact, there is none.

Persuasive Evidence

Because of pressures and possible misrepresentations, the SEC standard requires persuasive evidence, which generally means some written documentation from either the buyer or a third party, such as a purchasing agent. For example, assume that Selling Company's salesperson has obtained verbal approval from Customer Company's management about the terms of a sale. Further, assume that Customer Company's management must obtain approval of the sale's terms from Customer Company's legal department, and the agreement is held up at the end of the quarter due to legal department review. Without a requirement for written documentation of the sale, Selling Company's salesperson may represent (perhaps accurately) that Customer Company's purchasing decision maker has signed off on the sale but misrepresent that all conditions for revenue recognition are met. However, with the requirement for a signed contract, recognition of the sale would not occur at quarter-end and for good reason: Customer Company has not agreed to the terms until the legal department review is complete. Such a policy is put in place to ensure the company conforms to U.S. generally accepted accounting principles (U.S. GAAP). Violating that policy causes a violation of U.S. GAAP if, in the footnotes to the financial statements or elsewhere, management represents that sales are not recognized without a written agreement.

Actually, the SEC looked beyond company policies in SAB No. 104. A hypothetical posed in the bulletin stated the normal and customary business practice was to obtain written agreements and did not mention the existence of a company policy to obtain written agreements. The staff's position was that companies could not book sales lacking written agreements as revenue, regardless of company accounting policies, when the normal and customary business practice for the industry was to obtain written agreements.

Detecting Fake Agreements

Good sales cutoff procedures can generally detect lack of proper agreements, but if written agreements are fabricated, detection is much more difficult. Random sampling of orders booked as revenue near the end of a quarter should provide a list of customers to call to verify that documents are authentic. However, for a document fabrication scheme to succeed over several quarters or years, the fabricated agreements must be replaced by authentic agreements and real sales or there will be significant reversals of prior period sales. Therefore, CPAs can compare, perhaps on a random basis, contracts on file at the end of a given reporting period with contracts on file for the same transaction at a later period of time. If the original (fake) contract has been switched, there probably was an attempt at fabrication. Conversely, if the authentic document does not appear, the sale may never have been completed, in which case there would be a reversal in the subsequent period. Numerous instances of such reversals would point to internal control problems.

Nondelivery

What constitutes delivery varies from industry to industry but generally occurs when title and risk of loss pass to the buyer. Delivery of some products requires shipping documents that provide a paper trail that can be audited. Delivery of products such as software may occur over the Internet at near instantaneous speed with lagging paper documentation or none at all. Nevertheless, there should be some follow-up hard copy documentation or electronic receipt verification.

Attempts at achieving fraudulent deliveries usually involve some person or entity willing to hold the product until such time as its sale can be arranged. As part of the fraud scheme, the recipient executes documents or e-mails that appear to confirm delivery to an entity that appears to be the ultimate customer. This recipient is sometimes part of the scheme or can be a customer who inadvertently accepts delivery before consummating the sale. The inadvertent error may be easier to detect because customers receiving products before they are wanted tend to complain to company management.

Third party recipients who park goods temporarily may be harder to detect but usually require some payment for their services. Payment may come in the form of above-average discounts if the third parties resell the products over future periods, or there may be special terms allowing for product returns. An analysis of average product selling prices may point to one customer who stands out from the rest by receiving better deals.

If returns from a given customer are abnormally high, that fact may also indicate special arrangements, especially if the returns occur in a later reporting period. If one customer receives such favorable treatment, the CPA should make additional inquiries. In addition, delivery schemes involving resellers typically become more apparent if other resellers cannot sell the product as expected because of a change in market conditions. If a reseller is still taking substantial deliveries of a product after many others are experiencing sales declines, the CPA should attempt to understand why that reseller's channels of distribution are clear but others are blocked.

No Fixed Price

A price may not be fixed due to design or deceit. A price not fixed due to design may arise from a sales price being a function of royalty percentages, sliding scales, or other features that depend on future events before the price becomes fixed and determinable. A price not fixed by deceit usually consists of hidden agreements that allow the buyer to pay less than the stated, presumably fixed, sales price.

Royalties

Sometimes, prices are difficult to determine, particularly if the product is to be combined with other products before being sold to an end user. Such sales may involve a royalty payment that is a function of the selling price. It would be inappropriate to book anticipated future royalties as current revenues until the amount of those royalties becomes fixed upon ultimate sale. However, minimum royalties may be booked when they become due. Fraud occurs when royalties are recognized on fictitious or anticipated ultimate sales. Such royalty arrangements typically require the royalty payor to report to the royalty recipient the quantity of ultimate sales on a periodic (usually quarterly) basis. This permits an accounting of the final sales that can be used to verify reported royalty income.

Side Agreements

The more deceptive form of fraud used to circumvent the fixed price requirement is the clandestine use of side letters or arrangements that allow for refunds or discounts at the buyer's option or in certain circumstances. Under tight market conditions, or perhaps because the product is new and untested, it may be necessary to use these side letters to make a sale. The use of side letters is legitimate as long as any price discounts or return privileges are properly reflected in the accounting records, generally deferring revenue recognition until the price becomes fixed or the return period ends. Side letters become tools of fraud when they are hidden from accounting personnel or are not recorded properly in the firm's books and records.

The most likely perpetrators of side letter fraud are sales personnel with some discretion and authority, such as divisional managers and above. Implementation of such a scheme requires their authority to alter records or invent excuses should the buyer exercise his or her rights under the side agreement. As a general rule, fraudulent side letters are the result of some type of internal control failure when the divisional manager is both able to affect economic outcomes and alter accounting records.

Side letters are quite hard to detect because the buyer usually realizes he or she is receiving a special deal and does not want to publicize it. Of course, the fraudsters in the selling company will attempt to keep such agreements secret. These schemes usually come to the surface if the buyer exercises his or her rights under the agreement. A more senior member of management may be involved to cover up the refund with a fabricated reason or another transaction. Nevertheless, typically some documentation of the refund exists if corporate controls are in place. The CPA who suspects the existence of side letters can certainly look for refunds and discounts that are out of the ordinary, such as outsized refunds or discounts going to one customer or multiple refunds to one customer stretching over different reporting periods.

The CPA should keep in mind that the customer probably demanded the right to obtain a refund or discount in the course of negotiations for the sale. To catch the existence of side letters before refund demands are made, a suspicious CPA may review sales files for correspondence, notes, or other evidence of such demands from the prospective customer. Further, if the products involved require personnel, such as engineers, to install or service the products, those personnel not directly reporting to the fraudsters may know details of the side agreement. An inquiry from the CPA to the service personnel may unearth significant information about the sales transaction relating to customer demands and how those demands were handled. It is also likely that if fraudsters used side letters with one customer, there might be side letters with other customers, as well.

AICPA Professional Issues Task Force Practice Alert 03-1, *Audit Confirmations*, provides some useful warning signs that may indicate the presence of side agreements or, at the least, a need to confirm the terms of a transaction:

- Significant sales or volume of sales at or near the end of the reporting period.
- Use of nonstandard contracts or contract clauses.
- Use of letters of authorization in lieu of signed contracts or agreements.
- Altered dates on contracts or shipping documents (this may indicate an increased risk of fraud).
- Concurrent agreements or "linked" contracts and transactions.
- Lack of evidence of customer acceptance.
- Existence of bill-and-hold transactions.
- Existence of extended payment terms or nonstandard installment receivables.
- Accounting/finance department's lack of involvement in sales transactions or in the monitoring of arrangements with distributors/retailers.
- Unusual volume of sales to distributors/retailers.
- Sales, other than sales of software, with commitments for future upgrades.
- Sales where significant uncertainties or obligations, or both, to the seller exist.
- Sales to value-added-resellers and distributors lacking financial strength.
- Increasing receivables from a customer, which may be an indicator of the customer's perception of the payment terms (for example, payments not due until resale to end users).
- Aggressive accounting policies or practices (for example, tone at the top regarding pressures for revenue and earnings).

It is interesting that several of these points in the practice alert mention sales to distributors. Distributors and other intermediaries make good targets for fraudsters because

a. the intermediaries typically handle large volumes of products, so the impact of the fraud on revenue recognition is significant.

b. fewer people are involved in the fraud scheme, as compared with the fraudster trying to recruit a large number of retailers to have the same economic impact, and the fewer the conspirators, the lower the chance of detection.

Side agreements with intermediaries, whether written or oral, provide the mechanism to implement the fraud and typically allow the intermediary to return a purchased product or delay or avoid payment until the product is sold to the ultimate user or retailer.

Receivables Are Not Collectible

Financially weak firms may not pay their bills. To prevent sales to firms in poor financial condition, some type of customer approval process independent of the sales function needs to be in place to assess customer health, especially if the customer is placing large orders. This review function should be integrated with the approval process for customer refunds and discounts to prevent the implementation of fraudulent side letters, which also affect collectability, as previously discussed. From a CPA's point of view, an unusual concentration of orders from small or distressed customers, particularly near the end of a reporting period or sales campaign, should raise concerns.

Fraudsters attempt to hide the customers' poor financial condition by fabricating financial statements, misrepresenting the buyer's financial condition, or falsely representing that there are adequate financial guarantees. Typically, to accommodate these misrepresentations, the fraudsters extend credit and payment terms so that when the seller's financial statements are prepared, the financially weak customer's lack of payment is not an immediate red flag. The CPA may be able to detect such a scheme by combining analysis of changes in credit policies with analysis of new customers. New customers buying significant quantities of product near period-end under relaxed credit terms should be carefully reviewed. If the new customers do not publish or provide audited financial statements and lack other means of verification, they may be potential fraud vehicles.

The following scenario is drawn from SEC corporate governance proposals setting out a disclosure mechanism for critical accounting estimates.[1] It illustrates the issues involved in revenue recognition, set in foreign countries:

Example Scenario

MQB Corp., based in San Diego, CA, is a developer and marketer of desktop publishing software. MQB's customers consist of third party distributors, resellers, and retailers, and collectively, they comprise MQB's channels of distribution. MQB also sold directly to large corporate customers through its corporate sales group. MQB's products are sold in a highly competitive market, and to accommodate its customers, MQB has a liberal product return policy that has historically accepted significant product returns. MQB permits its customers to return software titles published and distributed by the company within 120 days of purchase. This policy allows the customers to return products to MQB should a competitor's product or weakened economic conditions affect sales.

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[1] This example is taken from examples contained in Securities and Exchange Commission (SEC) Release Nos. 33-8098; 34-45907. To illustrate certain aspects of financial reporting fraud, additional assumptions are added to the SEC examples. Subsequently, the SEC-recommended disclosures to the audit committee are presented to illustrate how those disclosures would have increased the likelihood of fraud detection. The examples, as modified for purposes of this book, reflect the opinions of the author, not the SEC. The reader is encouraged to read the SEC releases in their entirety, which are included in appendix A at the end of this book

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MQB recognized revenues under FASB ASC 905-685 (for simplicity, assume there are no postcontract customer support or other multiple element arrangement issues). MQB recognizes revenue upon shipment of its software products, provided that payment collection is determined to be probable and no significant obligations on MQB's part remain. At the time revenue is recorded, MQB accounts for estimated future returns by reducing sales by its estimate of future returns and reducing accounts receivable by the same amount. For example, MQB reduced its gross sales and accounts receivable by 12 percent for its current fiscal year to reflect estimated product returns. In the last 3 years, the range in which the company has reduced its gross sales and accounts receivable to reflect product returns has been between 11 percent and 13 percent.

MQB had recently expanded into Europe and established a separate division for its European operations based outside Paris. The European division head had been heavily recruited, and when he came on board six months ago, he insisted on complete autonomy to design and implement his marketing plan. "After all," the division head stated, "the European market is quite different from the U.S. market and requires a completely different approach." That autonomy extended to financial and marketing operations management in Europe, but the European controller had a "dotted line," or secondary reporting requirement, to the corporate controller in the United States. The European division head hired all personnel, drawing upon French colleagues he had worked with at previous firms. With the exception of a few software technicians who had to come from the United States because no one in Europe was yet trained, he declined to take on any other American personnel. "French laws are very restrictive," he said, "and impose onerous taxes on foreign workers." The software technicians were on call to help with potential integration problems with MQB's larger corporate customers.

Although the division head commanded a sizeable compensation package, MQB senior management had insisted on setting performance goals that, if met, would constitute a substantial part of the cash and company stock he was to receive. Overall, the company was straining to meet the forecast financial results published by securities analysts and could not afford to carry an unprofitable division any longer; by this point in time, the European division had to show profitability in the current quarter or the company would miss the consensus earnings target set by analysts. The division manager's compensation was also tied to achieving profitability in the current quarter.

When he came on board six months earlier, the European division head initiated a three-prong strategy that targeted the following:

1. Direct sales to large corporate customers
2. Sales to the rapidly growing number of resellers that were achieving significant market penetration among small businesses in both Great Britain and on the continent
3. Sales to retailers that were opening new stores in areas with well-educated and technically savvy populations, such as Germany

For the current quarter, the sales goal needed to achieve breakeven operating income was, in euros, €32,000,000 (or about US$44 million at an exchange rate of €1 to $1.38).

The marketing efforts progressed adequately, but toward the end of the current quarter, the division was behind its sales goal by €1,700,000 and was headed toward reporting another operating loss. Sales to major accounts had slowed because a weakened European economy had stalled corporate buyers. Sales to resellers were also beginning to decline because qualified resellers were becoming more difficult to identify as financial conditions deteriorated, and retailers were now reporting that their inventory stocks were high and that they did not need more product.

One week before the end of the quarter, the situation was critical. The division head met with his marketing director to discuss plans they had developed earlier in case sales were short of their goal. The marketing director then contacted two potential customers that were retailers with multiple store locations throughout Germany (ComputerWerken AG in Düsseldorf and UberComputer AG in Bonn) to see if they could make their purchase decisions before the quarter ended. On another front, the division head contacted Compagnie des Machines Française SA in Tours, a large integrated computer manufacturer and distributor, to see if that firm could proceed with its purchase.

All the last minute efforts met with apparent success because large purchase orders were faxed in to the Paris office. The two German retailers had ordered €362,000 of product each, and the French distributor ordered €1,500,000. The software was packed and shipped over the last few days remaining in the quarter, and with those sales, the European division was set to report better than breakeven sales for the quarter of €32,524,000.

When the sales contracts were faxed to San Diego, the corporate controller contacted the European division head with some questions. First, with regard to the German firms, the terms of the sale did not require payment until 120 days after the sale; MQB's standard policy was for payment to be received within 30 days. The division head responded that a provision of German law, the *Ladenschlussgesetz*, requires that German retailers purchasing products originating outside the European Union be allowed extra time to pay to effect currency conversion and transfer of funds. When asked why this provision was not stated in sales agreements with other German retailers, the division head responded that with the prior sales agreements, "we were technically violating the law, but I wanted to get into compliance as quickly as possible."

The corporate controller then asked if the European sales group had complied with company policies to obtain and review the financial statements of firms purchasing more than US$100,000 (roughly €72,000), and the division head replied, "Certainly!" In actuality, for the German firms, the division head had only an unaudited German-language income statement and balance sheet for each, with little footnote commentary. These financial statements did satisfy MQB's credit requirements, though, because the credit policies did not require audited financial statements from customers unless orders for a given quarter exceeded US$500,000. Because the orders from each of the German firms were €362,000, which translated to about US$499,560, audited financial statements were not required. Because Compagnie des Machines Française SA was publicly traded, it did have audited financial statements prepared in accordance with International Financial Reporting Standards (IFRSs). The IFRSs financial statements satisfied the credit requirements for the French distributor's €1,500,000 order because when MQB opened its European office, it made allowances in its credit policy for firms reporting on standards other than U.S. GAAP.

When the corporate controller received the financial data, she saw that both German firms appeared to have substantial assets in excess of liabilities, but most of the assets consisted of goodwill. The corporate controller readily saw that her ability to understand the financial data, particularly the income statement, was limited and called the European controller, who confirmed that the firms indeed did have substantial historical earnings. One oddity that the U.S. corporate controller noticed were statements in the otherwise scarce footnotes that both companies had Dutch shareholders with Netherlands Antilles charters, but she did not think to pursue that issue because it seemed irrelevant.

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As for the sale to the French firm, the corporate controller had only one question about a condition in the sales agreement referencing "l'action du Ministère d'Etat Provencial."She asked what that meant, and the division head said, "Don't worry about that; all contracts with companies that are owned by the government have that clause."

"I didn't realize we were selling to the French government," replied the corporate controller, and the division head responded, "Oh, not really, Compagnie des Machines Française SA is publicly held and traded on the Paris Bourse; it's just that the government is the majority shareholder." According to the division head, the clause meant that the contract was subject to government review, which he insisted was perfunctory.

Because the explanations seemed plausible and because all members of MQB senior management desperately wanted the European division to begin reporting operating profits, the corporate controller decided to recognize these last-minute revenues. MQB reported earnings for the quarter that fell within the range of analysts' estimates, and the stock price continued its climb that had run for several quarters in a row.

Pursuant to company practice, the controller's staff prepared an estimate of sales returns under MQB's 120-day return policy. However, the company's sales history in Europe was limited, so the staff based their estimates for European sales on the company's sales return experience in the United States. The company's overall sales return estimate was 12 percent, so the staff set European returns at €3,902,880 for the quarter that just ended.

As the following quarter's European results were reported to San Diego, the corporate controller noticed additional large sales to the German and French firms. The corporate controller, not entirely comfortable with the large concentrations of sales to a few firms, carefully analyzed accounts receivable agings on a monthly basis. She was satisfied to see that although the large firms' balances owed to MQB grew, intermittent payments were also being recorded.

Pursuant to the company's internal control policies, the corporate controller dispatched an internal auditor to review the sales, returns, and receivables records of the European division (external auditors did not see European operations to be sufficiently material to merit on-site visits). The auditor spent much of his time verifying receivables and tying those receivables to cash remittances. He noticed that the software engineers never seemed to be very busy, but the European controller stated that "there just were not many calls for assistance" from their large corporate customers.

Then, suddenly, without explanation, the European division head departed to take a position with Compagnie des Machines Française SA. The corporate controller decided she would make a trip to Paris to take a look at the financial records before a new division head was appointed. When she arrived, she uncovered a number of disturbing facts:

- The German firms were both experiencing financial difficulty and collectability of the outstanding balances was highly uncertain. When the corporate controller asked the European controller why the firms were in such poor financial condition when the income statements they tendered looked so strong, her European counterpart responded that the German economy must have turned down "very suddenly." When the corporate controller asked how many retail locations each firm had running, she was surprised to hear that there were no more than 5 between the 2 firms. The U.S. internal auditor did not address this issue because at the time of his visit, most of the sales were within the 120-day payment period and were not past due.

- The corporate controller discovered that the French customer, under instruction of the Ministère d'Etat Provencial, had actually rejected the software shipments under provisions of a domestic content law: government-controlled firms were supposed to purchase certain products only from French firms. Because the software had been developed in the United States and French alternatives were available, the company was required to purchase from the French competitor, even though its software reliability, scalability, and technical support were inferior.
- Payments had been "inadvertently" posted to the account of Compagnie des Machines Française SA, according to the European controller, presenting the appearance that the customer had accepted delivery and was paying. The U.S. auditor had not picked up on this issue. The incorrectly posted payments were made by wire transfers, and when he examined the wire records, he was not able to trace them beyond the originating bank. Figuring that other customers would complain if the payments had been misapplied, he passed on attempting to source the wire transfers further.
- When asked why more licenses and product were sold to Compagnie des Machines Française SA after the large initial sale, the European controller had no explanation other than "it must have taken some time for the government ministry to act."

The following day, the European controller and the sales manager resigned and both went to work for Compagnie des Machines Française SA. The corporate controller spent the day on the phone explaining to the CFO that MQB was faced with having to take a charge for previous quarter sales to these companies in the range of £1.5 million (net of allowance for returns) and that current quarter sales were also much lower than previously reported.

Example Analysis

This scenario illustrates the "dumb American" theme repeated so many times when U.S. companies naïvely forge into foreign markets. It also illustrates the difficulty in catching revenue recognition fraud in the short run.

The situation was worse than the corporate controller detected in that the fraud was much more devious; all the controller saw were the consequences of the fraud. First, though, for the record, the French and German companies in the scenario are fictitious, as is the French ministry. To some extent, the French domestic content law and the Netherlands Antilles restrictions are fabrications, but such laws are common and can snag or fool the unwary. However, the German *Ladenschlussgesetz* is quite real and does apply to retail stores, but the law sets out the hours of operations for those stores, not the terms under which stores make payments on bills.

The warning flags were numerous, but it would have required a controller experienced in European operations to catch most of them. Beginning with the German companies, the accountants who prepared the unaudited financial statements nevertheless found it important to mention the Netherlands Antilles charters for a reason: under certain provisions, Dutch law restricts the disclosure of the identities of shareholders when a company is chartered in the Dutch protectorate. Certainly, firms that are chartered in known tax havens should merit extra scrutiny.

In this case, the retail store chains were probably related, and although definitively determining common ownership could have been quite difficult given Dutch legal constraints,

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a related party red flag should have gone up, based on other facts. First, aside from tax reasons, one should wonder why firms operating in Germany need Netherlands Antilles charters unless they are availing themselves of the Dutch secrecy provisions. Second, the large sales to the two chains were split evenly between two firms in the same geographic market and with the same peculiar ownership structure, and the split sales were just under amounts that would have triggered MQB's more stringent credit screening standards requiring audited financial statements. Assuming the unaudited financial statements were not complete fabrications, they were likely prepared under standards that would defer impairment of the large amounts of goodwill carried on their balance sheets. Had goodwill been subject to impairment testing, its write-down would have signaled decreased (or no) expected future profitability.

Another troubling fact is that both chains were relatively small (each chain consisting of at most three stores) and yet those stores were ordering large quantities of product, making only occasional payments. The corporate controller also overlooked important industry indicators that were signaling that other retailers throughout Europe had a glut of product and were cutting back on new orders. The controller should have asked, what makes their stores different? A side agreement allowing the chains to return excess inventory was highly likely.

Finally, in spite of the fact that the U.S. corporate controller was bamboozled by the European division head's mischaracterization of the *Ladenschlussgesetz*, she should have recognized that the extension of payment terms to 120 days, combined with the 120-day return policy, meant that the products were effectively sold on consignment. No payment would be made until the customer's return privilege expired; therefore, the customer had nothing invested in the purchase until that point in time. Given the lack of history with these customers, these terms should have caused MQB to defer revenue recognition until after the return period expired.

As for the French firm, it is clear that the corporate controller should have gained a better understanding of local laws and procedures, especially when dealing with a different, in this case socialist, government system. However, there were other clues that something was not right. The internal auditor noticed, but failed to report, that the software technicians were mostly idle. If he had talked with them, they may have told him that they thought it odd that after a major corporate account, such as Companie des Machines Française SA, purchased a significant amount of software, there were no requests for help with integration issues.

Further, because the technicians were not a part of the team hired by the European division head, they may have been more forthcoming. The division head succeeded in defrauding MQB largely with the help of the European controller and the marketing director, who were both rewarded later with jobs at the firm that subsequently hired the division head. It is doubtful that the division head would have attempted to bring the technicians into his scheme because he did not know them as well as he knew the others he had hired. The division head was able to gather all the conspirators he needed because he had complete hiring autonomy; the technicians were the weak link in his scheme that the internal auditor overlooked.

Overall, the returns allowance was quite insufficient, not just because the corporate controller missed the warnings already discussed. Applying returns data from the United States to Europe was not supportable. A more reasonable estimate should have come from the returns experience of other firms in Europe, or if those data were not available, MQB should have used a significantly larger estimate reflecting the weakened European economy relative to the United States. Monitoring the inventory levels of its customers in Europe would also have signaled that higher returns were likely.

Clearly, one can see that the returns allowance was a critical accounting estimate for MQB. In this example, had the allowance been under audit committee review (as it should have), the likelihood is greater that committee members would have asked some probing questions—questions that management was not so eager to ask given the need to hit analysts' consensus estimates. Those questions likely would have started with why the European returns estimate was not more carefully researched. Then, there may have been questions about the large sales to three European firms that were not known to U.S. managers. Those questions may have caused the corporate controller to make her visit to Europe earlier to meet with the customers personally. With an active and engaged audit committee, issues that get glossed over by management eager to achieve financial targets may be brought under more intense scrutiny at an earlier date.

If MQB management were required to present its critical accounting estimates to the audit committee for review, the SEC staff suggested the following disclosure:

> Our recognition of revenue from sales to distributors and retailers (the "distribution channel") is impacted by agreements we have giving them rights to return our software titles within 120 days after purchase. At the time we recognize revenue, upon shipment of our software products, we reduce our measurements of those sales by our estimate of future returns and we also reduce our measurements of accounts receivable by the same amount.
>
> For our products, a historical correlation exists between the amount of distribution channel inventory and the amount of returns that actually occur. The greater the distribution channel inventory, the more product returns we expect. For each of our products, we monitor levels of product sales and inventory at our distributors' warehouses and at retailers as part of our effort to reach an appropriate accounting estimate for returns. In estimating returns, we analyze historical returns, current inventory in the distribution channel, current economic trends, changes in consumer demand, introduction of new competing software and acceptance of our products.

Of course, in this example, MQB management failed to monitor and report on product inventory for the European customers. The audit committee could have used this statement as the policy by which to judge the adequacy of the methodology used to estimate the European returns allowance, and if European management had failed to provide proper support for its return estimates, then the audit committee should have initiated its own investigation.

Conclusion

Frequently, revenue recognition fraud is difficult to detect in the short run. The schemes usually depend on improving sales in future quarters to provide cover for the fraudsters. The fraudsters hope that improved sales in future periods will allow them to charge off the phony sales they booked earlier without anyone noticing or minding. If future sales do not improve, the fraud schemes become more difficult to cover up. Customers who did not order products begin to complain, deadbeats who will not pay come to light, and buyers with side agreements begin to exercise their right to return products. These developments usually reveal the fraud scheme.

The best chance the CPA has to catch this kind of fraud early is to throw a broad net when asking questions. The CPA should always strive to determine the economic justification of a transaction, particularly if one customer is buying product in quantities that are unusually high relative to other firms in that industry. The CPA should spend some time talking with people outside the accounting function of a firm; those employees in service, shipping, and sales may possess knowledge that clearly points to fraud. Finally, as the example illustrates, the CPA should be especially wary of grants of autonomy to division or subsidiary heads because the autonomy allows them to override controls or form conspiracies to implement their fraud schemes.

Chapter 14

International Financial Reporting Standards and Financial Reporting Fraud

International Financial Reporting Standards Have Come to the United States

To aid the flow of capital between different countries, a need exists for a high quality set of accounting and financial reporting standards that can be implemented worldwide to provide equity and debt capital providers with the tools to compare and evaluate the performance of firms located in different countries. The International Accounting Standards Board (IASB) has attempted to fulfill that need with the development of International Financial Reporting Standards (IFRSs). For the most part, those standards were implemented in the European Union in 2005, and they have spread to over 100 countries since then.

In the United States, certain foreign companies with securities listed on U.S. stock exchanges (foreign private issuers) are permitted to file their financial statements with the Securities and Exchange Commission (SEC) under IFRSs without having to reconcile those financial statements to U.S. generally accepted accounting standards (U.S. GAAP). The SEC has tentatively adopted a process that would lead to broader use of IFRSs among U.S. companies by 2015, and because the SEC requires at least two prior years of comparative financial statements to be presented with each annual filing, U.S. companies moving to IFRSs will likely need to begin implementing IFRSs in parallel to their U.S. GAAP reporting systems in 2013. In addition, the Financial Accounting Standards Board (FASB) and the IASB, the standard setters for U.S. GAAP and IFRSs, respectively, have agreed to a timetable to converge the two standards as best as possible by 2011. Therefore, whether through adoption of IFRSs or convergence of standards, for both SEC registrants (public companies) and non-SEC registrants (private companies), accounting standards in the United States likely will be moving closer to IFRSs over the next several years.

IFRSs and Financial Reporting Fraud

From the aspect of financial reporting fraud, IFRSs present new issues for the CPA. The common wisdom is that IFRSs are more principles based than the presumably more rules based U.S. GAAP, allowing for more flexibility for financial statement preparers under IFRSs. Indeed, the printed codification of U.S. GAAP consists of over 7000 pages contained in 4 volumes; the printed IFRSs, including applicable International Accounting Standards promulgated by a predecessor to the IASB, number just under 1200 pages in 1 volume, with another 1800 pages of accompanying documents, such as the bases for conclusions, in another volume. Clearly, IFRSs could not be as specific in its guidance as U.S. GAAP because IFRSs uses fewer words. However, whether fewer words makes IFRSs more principles-based than U.S. GAAP is not a conclusion that one can reach simply by comparing word counts; it is necessary to examine each standard, and even elements of each standard, to make a proper comparison, and as will be demonstrated in the following example, the findings may be surprising.

A corollary of the common wisdom that IFRSs are more principles-based is that a principles-based standard is more flexible, making IFRSs more susceptible to financial reporting fraud. It is far from clear whether the corollary is true, and the common wisdom, as discussed subsequently, does not always hold, as well.

Need for Transparency Under Principles-Based Standards

A key component to restraining financial reporting fraud under a principles-based system is disclosure. For example, if a company is adopting a revenue recognition policy that accelerates revenue under IFRSs that would otherwise have been deferred under U.S. GAAP, a footnote describing the policy and quantifying its impact on the financial statements may provide sufficient detail to allow users of the financial statements to adjust the revenues, if necessary, to allow for comparisons with peer companies in the same industry or for other reasons. Indeed, securities analysts reviewing the filings of public companies will likely demand such disclosure precisely for comparisons with peer companies. With comprehensive disclosure, fraud becomes more difficult.

Financial reporting transparency is already a part of U.S. securities laws, contained in U.S. GAAP and expanded for public companies in SEC Regulation S-X, with additional disclosures in SEC Regulation S-K relating to critical accounting policies as part of management's discussion and analysis. Furthermore, as discussed in chapter 3, the Supreme Court (in *TSC Industries, Inc. v. Northway, Inc.*) ruled that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Continuing with the preceding revenue recognition hypothetical, if a firm reporting under IFRSs recognizes revenue more rapidly than its peers reporting under U.S. GAAP, then without adequate disclosure, the IFRSs firm may appear to have outperformed its peers when, using a comparable standard such as U.S. GAAP, it had not. On the other hand, if the IFRSs firm had disclosed its revenues on a basis comparable with its U.S. GAAP peers, then that disclosure may have significantly altered the "total mix" of information made available to investors. With disclosure, investors are less likely to be misled.

Fraud Under U.S. GAAP Versus IFRSs: An Insurance Accounting Example

That said, there are areas to which the CPA should pay closer attention as IFRSs become more widely used in the United States. Definitions will change, and applications of the new (to U.S. users) IFRSs accounting terms may open the door to more creative fraud. Insurance accounting provides a good example.

Under U.S. GAAP, as well as IFRSs, insurance contracts must transfer a sufficient amount of risk in order to qualify for insurance accounting. With risk transfer, the insurance company, often referred to as a *carrier*, takes in periodic payments (called *premiums*) from the insured and assumes, or carries, a risk of having to pay a significant amount back to the insured if a certain event occurs (such as death for a life insurance contract or a natural disaster for a property insurance contract). The premium is considered revenue to the insurance company when earned. Without risk transfer, the purported insurance contract may be nothing more than a deposit arrangement whereby the insurance company takes in money over time and then pays it back, perhaps with interest, on a later date (that is, little risk is assumed by the insurance company, and the cash flows coming in and going out are rather certain). The periodic cash inflows to the company under a deposit arrangement are not revenues but are recorded as deposit liabilities on the insurance company's balance sheet, similar to a bank deposit. The presence or absence of risk transfer determines whether the insurance company recognizes income from a contract, and the impact on earnings can be significant.

Risks can be transferred from one insurance company to another through reinsurance, and some carriers prefer to retain some risk while transferring other risk. For example, a property and casualty carrier may be willing to carry the first $100,000 of risk on a given type of policy while transferring, or ceding, any claims risk over $100,000 to reinsurers (the assuming carriers). If the policy limit on claims is $1,000,000, then the carrier issuing the policy retains $100,000 of risk and reinsures $900,000. Several reinsurers may assume the

\$900,000 of risk transferred, with one, perhaps, assuming a "layer" of risk from \$100,001 to \$500,000 in claims and another assuming risk from \$500,001 to \$1,000,000 in claims. The assumption of risk by a reinsurer is accomplished by a contract known as a *reinsurance treaty.* Because risks are defined and limited for each of the reinsurers in this example, the contracts for each of the reinsurers are called *finite risk reinsurance.* The issuing carrier will have to pay some of the premium it receives to the reinsurers to compensate the reinsurers for the finite risks they assume.

Finite risk reinsurance became the focus of regulatory investigations in the early 2000s when certain insurers and reinsurers transferring risks to others in outbound treaties made promises to make whole other reinsurers that assumed those risks. Such a promise would negate risk transfer from the ceding carrier because if the assuming reinsurer suffered a loss under its inbound treaties, the ceding carrier would be obligated to reimburse the assuming reinsurer. The make whole promises typically came in the form of side letters or e-mails that were outside the reinsurance contracts and were thus harder to detect.

The following example scenario demonstrates the fraud incentive to the ceding carriers to enter into side agreements to make whole the assuming carriers related to expected claims. The scenario will first set out the assumed facts and then examine the possibility of fraud under both U.S. GAAP and IFRSs:

Example Scenario

P&C Insurance Company is a publicly traded worldwide property and casualty insurance carrier insuring homes and businesses in the United States and Europe for a variety of risks, including windstorms, floods, and earthquakes, with policy limits up to \$10,000,000 per occurrence. Competition had prevented P&C from raising its premiums relative to its exposure to risks. The chief actuary at P&C was concerned that a major loss, known in the industry as a *catastrophe*, or *cat loss* for short, would not only affect earnings in the current year but also make clear to securities analysts and investors what the chief actuary already knew: that premiums were not keeping up with the potential losses from the risks P&C insured. Such a revelation would likely cause analysts to adjust their profitability forecasts for P&C and lower their target stock prices.

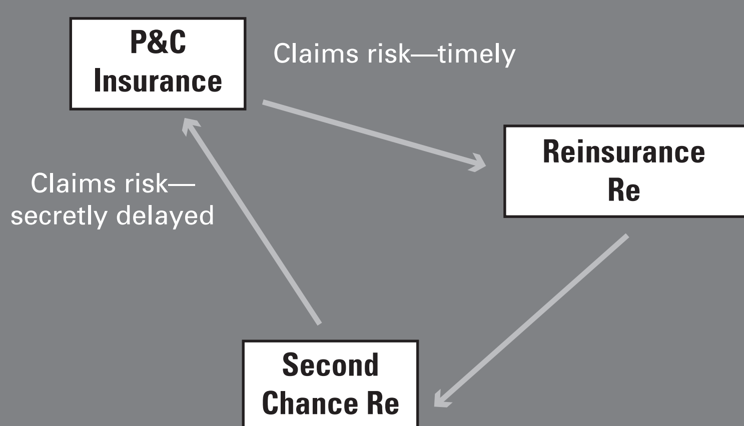
Eventually, what the chief actuary feared came to pass: news reports stated that a windstorm swept through areas of Europe where P&C had extensive exposure to risk. The chief actuary immediately went to the CFO and relayed the bad news that major claims were on their way. However, the CFO had an idea that may avert a charge to earnings by using reinsurance. The CFO had avoided entering into reinsurance agreements in the past because they were expensive, and P&C had a hard enough time achieving profitability without paying reinsurance premiums to a reinsurer. However, for this identified windstorm risk, the time was right, so the CFO thought, to call in a favor. He knew the CEO of P&C was friends with the CEO of Reinsurance Re (ReRe), a reinsurer that specialized in property coverage, and ReRe would have the capital available to assume a large portion of the windstorm risk. The CEO, upon hearing the bad news and the possible solution, went to his friend and negotiations commenced. The actuaries at ReRe were no dummies, though, and they quickly determined that a catastrophe loss was emerging. However, ReRe's CEO wanted to develop a stronger business relationship with P&C and told his actuaries to find a solution.

There was a dilemma in that if ReRe charged P&C a premium large enough to cover the expected loss from windstorms, it would be about the same size as the expected claim expense and would serve no purpose. The CEO of P&C met privately with the CEO of ReRe and agreed to a solution that would allow P&C to get some relief from expected claims now and then pay ReRe in later periods as the claims emerged. The two CEOs memorialized this agreement in a side letter that guaranteed that P&C would make ReRe whole some time after ReRe paid claims under a reinsurance agreement between the two companies. The side letter, which contained specific dates and terms of payment, would not be referenced in the reinsurance agreement, and the reinsurance premium would be set at a standard for the industry—as if there were no emerging claims exposure—so as not to raise any suspicion. The reinsurance contract would begin, or incept, nine months prior to the current date to further allay concern that it was entered into with knowledge of the expected windstorm losses.

Much to the delight of P&C's CFO, ReRe agreed to assume most of the risk from P&C relating to windstorm risks, and when the claims materialized as expected, P&C was able to offset the claims expense with a reimbursement due from ReRe. The net impact on P&C's financial statements was minimal, and securities analysts did not see a need to revise their earnings estimates downward.

The windstorm cat loss was mitigated, but P&C's CEO was concerned that another cat loss would be more difficult to hide, so he visited ReRe's CEO again with the idea to share a broad range of risks between multiple reinsurers, with the risk returning to P&C eventually so that P&C did not suffer a significant net loss of premium. ReRe's CEO, who resided in Hamilton, Bermuda, lived next door to Second Chance Re's CEO and knew him well. Together, the three of them worked out a series of reinsurance treaties that would shift risk from P&C to ReRe, then from ReRe to Second Chance Re, then from Second Chance Re back to P&C.

Roundtrip Treaties Example



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Premium would follow risk with each step, with a "haircut" going to each reinsurer as a convenience fee. Also, the contracts would not be signed simultaneously but would incept on different dates over approximately three month's time. Through a side letter, the timing of payment on any claims made by Second Chance Re on P&C would be delayed for five years, with an interest rate charged for the delay. The side letter pushed claims recognition by P&C down the road should any covered cat loss emerge. With the side letter kept secret, P&C could currently recognize premiums from Second Chance Re while delaying recognition of any claims made under the Second Chance Re treaty until later years. Because claims in the insurance business typically take several years to settle, the delay would not likely arouse suspicion.

When auditors for P&C reviewed the carrier's reinsurance, they saw an outbound treaty transferring certain risks to ReRe and an inbound treaty from Second Chance Re transferring certain risks into P&C. However, due to the use of different definitions and risk descriptions in each treaty and different inception dates, the treaties appeared to be separate and unrelated. Moreover, without knowledge of the side letter, the inbound Second Chance Re treaty appeared to transfer risk to P&C, allowing P&C to recognize as revenue the annual payments from Second Chance Re under the treaty terms. Therefore, P&C got a five-year delay on claims payments should certain cat losses emerge, whereby management could tout to analysts and investors their superior reinsurance program while pushing the claims far into the future. P&C's earnings were more consistent, regardless of the occurrence of natural disasters, and the securities markets rewarded the company's stock with a lower cost of capital and a higher price/earnings ratio. Executive bonuses were also plentiful.

Example Analysis

Make Whole Provision

Under either U.S. GAAP or IFRSs, the make whole side letter for the windstorm coverage in the first ReRe treaty negates risk transfer, and when P&C books a claims reimbursement receivable from ReRe due to the windstorms in Europe, it commits fraud when it fails to record a charge for its promise to repay ReRe. That said, an accepted practice exists in the insurance industry to make a nonbinding pledge to do business with a reinsurer over long periods of time so that should the reinsurer suffer from a major claim, that reinsurer can recoup some or all of its loss with premiums in future years, assuming another major loss does not occur. Under this practice, a carrier could pledge to make whole a reinsurer, but no guarantee exists that another significant loss will occur or that the carrier will continue to do business with the reinsurer. The side letter in this example scenario went well beyond a pledge in that it was a guarantee with specific terms that presumably would make it legally binding.

The CEOs of P&C and ReRe attempted to hide their make whole agreement by deliberately omitting reference to the side letter in the reinsurance treaty and attempting to keep the reinsurance premium within normal limits for treaties covering that type of risk. They also backdated the treaty in an attempt to deceive others into thinking that the terms were agreed to nine months before the windstorms arrived. In the United States, where insurers file financial reports with state insurance commissioners under statutory accounting principles (SAP), backdating a reinsurance agreement is allowed under certain circumstances. Paragraph 24 of the National Association of Insurance Commissioners Statement of Statutory Accounting Principles (SSAP) No. 62R, *Property and Casualty Reinsurance,* states

> [i]t is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the agreement is substantively prospective shall be determined based on the facts and circumstances. However, … if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement.

SSAP No. 62R reflects the industry practice in which two companies may reach agreement on risk coverage but not document the agreement until a later date, but there must be an agreement in principle at the beginning of the policy period. In this example, nine months prior to the signing of the ReRe windstorm treaty, the two CEOs had not even discussed the issue, much less reached an agreement on coverage, because the windstorms had not occurred. Therefore, the nine month backdating was another attempt to make the treaty appear to incept well before the loss event while taking advantage of the leeway afforded in SAP.

For the CPA, this example illustrates that specialized knowledge of the industry is essential. Knowing when a make whole pledge crosses the line from an expression of intent to continue to do business to a legally enforceable promise to negate risk is critical. The CPA must watch out for attempts to abuse industry practices, such as the nine months provisions of SSAP No. 62R. The sudden appearance of reinsurance just before large claims arise is suspicious and bears investigation. There should be some evidence of discussions near or on the inception date, and that date should be independent of loss events. Evidence of earlier discussions should be found in discussions with those employees who typically handle risk exposure and those who monitor the status of outstanding reinsurance treaties. Also, actuaries are typically involved to assess the adequacy of risk transfer, and their absence may be another red flag.

Roundtrip Treaties

In regard to the roundtrip treaties between P&C, ReRe, and Second Chance Re, U.S. GAAP and IFRSs take different paths. At issue is the definition of an *insurance contract*: in this example, if the treaty that shifts risk from P&C to ReRe can be defined to include the treaty that shifts essentially the same risk from Second Chance Re back to P&C, then there is clearly no risk transfer; if the contracts stand alone, there may be risk transfer depending on other factors. For U.S. GAAP, the definition of an *insurance contract* is quite broad. According to FASB *Accounting Standards Codification* (ASC) 944-20-15-40

> [d]etermining … whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that do either of the following:

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a. Limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract)

b. Delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

> This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at the time.

A complete understanding requires the CPA to look for and incorporate other contracts and agreements between the ceding entity and related reinsurers. For P&C (the ceding entity in the example), the outbound treaty with ReRe would be combined with the inbound treaty from Second Chance Re, and it would be obvious, except for the clever attempts to hide similarities using obfuscatory language in the treaties, that there was no risk transfer. From the example, it is clear, if discovered, that ReRe and Second Chance Re were "related" in that there was a treaty between them. For a CPA at P&C, finding out about the existence of that treaty may be a difficult forensic exercise if the parties were intent on hiding it. Even without knowledge of the ReRe-Second Chance Re treaty, one could argue that because the outbound and inbound treaties at P&C ceded and then reassumed the same risk, the two reinsurers would be related. At the very least, properly implementing FASB ASC 944-20-15-40 typically requires the CPA to review and analyze the ceding and assumption of various types of risk and can be quite detailed and complicated. Even if reinsurance contracts were executed at different times under different market conditions and even if any roundtriping of risk were accidental, the CPA would need to aggregate all the contracts and assess whether there was, on net, significant risk retained by the carrier to allow it to use insurance accounting and recognize premium receipts as revenues.

IFRSs utilize a simpler definition of an *insurance contract* for risk assessment. According to paragraph B25 of IFRS 4, *Insurance Contracts*

> An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements.* Thus, insurance risk may be significant even if there is minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract.

The IFRS 4 approach is more specific in that risk is assessed contract by contract, and risk may be deemed significant even if other contracts reduce risk so that there is a minimal probability of material losses for a whole book of contacts. The footnote is important in that the CPA is instructed to look outside the four corners of the insurance contract if, and only if, there are other contracts that were "entered into simultaneously with a single counterparty (or ... are otherwise interdependent)" and then incorporate any such contracts into the contract under review. In the example scenario, there was an attempt to disguise the simultaneous timing of the roundtrip contracts by using different inception dates, but the fact that the contracts were indeed simultaneous would trigger the footnote provision under IFRS 4 and collapse the contracts into one, thereby negating all risk in the example. If there were some net risk exposure left after P&C The IFRS 4 approach is more specific in

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

that risk is assessed contract by contract, and risk may be deemed significant even if other contracts reduce risk so that there is a minimal probability of material losses for a whole book of contacts. The footnote is important in that the CPA is instructed to look outside the four corners of the insurance contract if, and only if, there are other contracts that were "entered into simultaneously with a single counterparty (or ... are otherwise interdependent)" and then incorporate any such contracts into the contract under review. In the example scenario, there was an attempt to disguise the simultaneous timing of the roundtrip contracts by using different inception dates, but the fact that the contracts were indeed simultaneous would trigger the footnote provision under IFRS 4 and collapse the contracts into one, thereby negating all risk in the example. If there were some net risk exposure left after P&C ceded risk to ReRe and then assumed risk from Second Chance Re, such that there was a minimal probability of material losses for a whole book of contracts, then P&C may have a better argument for insurance, rather than deposit, accounting under IFRSs than under U.S. GAAP (in contrast, FASB ASC 944-20-15-41 requires significant insurance risk rather than the lower standard in IFRS 4 of minimal probability).

U.S. GAAP and IFRSs Differences

Assume that the roundtrip contracts were not entered into simultaneously, as set out in the example, but were the product of separate and unrelated negotiations over different periods of time, and by coincidence, they covered the same underlying insurance contracts and risks in overlapping periods. Such an outcome is not uncommon for major risks that are first insured, then reinsured, then reinsured again (retroceded), and then perhaps reassumed by one of the ceding carriers under another treaty that covers a wide range of risks and happens to include risks that were earlier ceded away. U.S. GAAP, under FASB ASC 944-20-15-40, would apply the principle of looking to all other contracts and collapse the risk exposure; IFRSs would apply the contract-by-contract rule and, lacking simultaneity, would assess risk for each contract separately. Collapsed risk would likely lead to deposit accounting with no revenue recognition of receipts; separate risk assessments would likely lead to insurance accounting with revenue recognition of receipts. Radically different outcomes result from the same set of facts, depending on the accounting standards used.

Which set of standards cited in this discussion were principles based and which were rules based? Contrary to popular belief, U.S. GAAP was more principles based, and IFRSs were more rules based. Perhaps a better generalization of IFRSs is that IFRSs are simpler. IFRSs' simplicity may result in fewer rules such that some IFRSs standards rely more on principles than their U.S. GAAP counterparts; however, for other standards, IFRSs' simplicity may result in reducing some complex U.S. GAAP to more basic rules under IFRSs, as in the case with the definition of *insurance contracts*.

IFRSs Impact on Fraud and Regulation

What do simpler IFRSs standards imply for fraud detection and regulatory enforcement? For the CPA, simpler standards allow for more straightforward and, hopefully, clearer directives to apply. Consider the CPA working for a major international insurance carrier with multiple reinsurance agreements. Under U.S. GAAP, the CPA must thoroughly examine how reinsurance treaties may interrelate to assess risk retention. In doing so, the CPA most likely would have to drill down to the underlying insurance contracts under each treaty, become familiar with the extent of risk ceded or assumed relating to those underlying contracts, and assess interrelationships. Under IFRSs, the CPA would have greater certainty that the relevant contract is the one in his or her hands and does not include others that may reside in other divisions or subsidiaries of the same company or other treaties that have yet to be written. Under IFRSs, the CPA may still have to search for evidence of other simultaneous contracts, which would include a review of correspondence and other agreements executed in close proximity, but an analysis of previous treaties would likely not be as comprehensive.

Under IFRSs, regulators can focus on important and clearer violations, such as the CEOs in the example scenario who entered into treaties simultaneously while plotting to hide the fact. It should be less likely that regulators would snare someone who inadvertently violates an IFRS standard if the standard is simpler. If an insurance company CPA applying U.S. GAAP fails to detect an old treaty that negates risk transfer, he or she has exposure to regulatory punishment; if that same CPA is applying IFRSs, he or she may likely not be held accountable for the old treaties at all when deciding whether to use insurance or deposit accounting.

However, the CPA using IFRSs does not get a free pass when it comes to disclosure. Because IFRS standards are simpler (that is, fewer words), transparency of financial reporting rises in importance to better explain decisions made by management when implementing IFRSs. For insurance contracts, paragraphs 38–39 of IFRS 4 state

> [a]n insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.
>
> To comply with paragraph 38, an insurer shall disclose:
>
> (a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks. ...
>
> (c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:
>
> (i) sensitivity to insurance risk [reference omitted].
>
> (ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (eg type of insured event, geographical area, or currency).
>
> (iii) actual claims compared with previous estimates (ie claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year.

Paragraph 39(c) requires disclosure of "information about *insurance risk* (both before and after risk mitigation by reinsurance)" that would reveal the impact of offsetting treaties, as well as risks ceded and assumed. If management, following IFRSs, decided to use insurance accounting for otherwise risk-canceling material, inbound and outbound treaties, the net exposure (zero) would have to be explained in footnotes to the financial statements, and users of those financial statements, such as securities analysts, would then know to inquire about the premium revenue impact of those offsetting treaties. With knowledge of the revenue impact, analysts could adjust the insurance carrier's premiums, removing the revenue impact of the inbound treaty if necessary, to better evaluate the carrier's performance relative to its peers on a more consistent and comparable basis.

Conclusion

Disclosure will be front and center on the CPA's fraud battleground of the future. Disclosure has always been important, but simpler standards, such as IFRSs, will place greater emphasis on adequacy of disclosure within the total mix context of U.S. securities laws. The total mix will likely take into account the accounting policies implemented within an industry by and among members of a peer group of firms. If a given firm, utilizing the flexibility afforded by IFRSs, adopts a policy that is different from the peer group without disclosing the departure, that difference may be material if its disclosure would affect the total mix of information evaluated by investors in making buy and sell decisions. Without disclosure, the investor may assume the firm implements accounting policies similar to those of its peers when, in reality, it does not. In the IFRSs environment, the CPA will probably have to evaluate the adequacy of disclosure in the context of disclosures and policies adopted by peer firms. With the coming of IFRSs, disclosure (actually comprehensive disclosure) will be of paramount importance.

APPENDIX A

Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*

[**Author's Note:** *Even prior to the bankruptcy of Enron, the Securities and Exchange Commission staff had discussed the concept of companies making disclosure of critical accounting policies and estimates. In May of 2002, the SEC proposed this rule to better define the disclosure concept. When the Sarbanes-Oxley Act of 2002 was enacted in June 2002, Section 204 of the Act required auditors to discuss critical accounting policies in reports made to audit committees. The Act also incorporated other concepts discussed in the proposed rule. This book expands upon the examples given in this proposed rule.*

Appendix A reproduces relevant portions of the rule for this book's discussion only. The complete rule is available on the SEC's Web site.]

Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies

Securities and Exchange Commission

17 CFR Parts 228, 229 and 249

*Source: The complete proposed rule can be found at http://www.sec.gov/rules/proposed/33-8098.htm.

[Release Nos. 33-8098; 34-45907
International Series Release No. 1258
File No. S7-16-02]

RIN 3235-AI44

Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies

Agency: Securities and Exchange Commission (''Commission'')

Action: *Notice of proposed rulemaking*

Summary: As an initial step in improving the transparency of companies' financial disclosure, the Commission is proposing disclosure requirements that would enhance investors' understanding of the application of companies' critical accounting policies. The proposals would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of the proposals, a company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations. A company's disclosure about these critical accounting estimates would include a discussion of: the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates. Under the second part of the proposals, a company that has initially adopted an accounting policy with a material impact would have to disclose information that includes: what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles. Companies would place all of the new disclosure in the ''Management's Discussion and Analysis of Financial Condition and Results of Operations'' section (commonly referred to as ''MD&A'') of their annual reports, registration statements and proxy and information statements. In addition, in the MD&A section of their quarterly reports, U.S. companies would have to update the information regarding their critical accounting estimates to disclose material changes.

Dates: Comments should be received on or before July 19, 2002.

Addresses: You should send three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. You also may submit your comments electronically to the following address: rule-comments@sec.gov. All comment letters should refer to File No. S7-16-02; this file number should be included in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549-0102. We will post electronically-submitted comment letters on the Commission's Internet Web site (http://www.sec.gov). We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

For Further Information Contact: Questions about this release should be referred to Anita Klein or Andrew Thorpe, Division of Corporation Finance (202-942-2980) or Jackson Day or Jenifer Minke-Girard, Office of the Chief Accountant (202-942-4400), Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Supplementary Information:
We are proposing amendments to Item 303[1] of Regulation S-K,[2] Item 303[3] of Regulation S-B[4] and Item 5 of Form 20-F[5] under the Securities Exchange Act of 1934[6] (''Exchange Act'').

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I. Executive Summary

One important challenge facing our capital markets today is the need to improve the quality and transparency of corporate disclosure. Our capital markets could reach a higher level of efficiency and investor confidence if companies were to provide higher-quality, more insightful financial information. To serve that purpose, we issued cautionary advice in December 2001 regarding MD&A disclosure.[7] In that release, we recognized the need for disclosure that allows investors to understand more completely the manner in which, and degree to which, a company's reported operating results, financial condition and changes in financial condition depend on estimates involved in applying accounting policies that entail uncertainties and subjectivity. We also asked companies to begin better addressing investors' need for this disclosure.

As contemplated in that release, we are now proposing to amend the MD&A requirements[8] to mandate improved disclosure in a new ''Application of Critical Accounting Policies'' section in companies' filed annual reports, annual reports to shareholders, registration statements and proxy and information statements.[9] The new section would encompass disclosure both about accounting estimates resulting from the application of critical accounting policies and the initial adoption of accounting policies that have a material impact on a company's financial presentation. The proposed disclosure requirements would apply to all companies except small business issuers that have not had revenues from operations during the last two fiscal years. The proposed MD&A disclosure requirements would cover the most recent fiscal year and any subsequent interim period for which financial statements are required to be presented.

To determine whether an accounting estimate[10] involved in applying the company's accounting policies would entail disclosure under the proposals, a company would have to answer two questions:

1. Did the accounting estimate require us to make assumptions about matters that were highly uncertain at the time the accounting estimate was made?
2. Would different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, have a material impact on the presentation of our financial condition, changes in financial condition or results of operations?

If the answers to both questions are ''yes,'' the accounting estimate would be a ''critical accounting estimate,'' and disclosure would be required in the new ''Application of Critical Accounting Policies'' section.

The proposed disclosure about these accounting estimates would involve three basic elements.[11] The first element would be the basic disclosures needed to understand the accounting estimates. A company would have to describe them, identify where and how they affect the company's reported financial results, financial condition and changes in financial condition, and, where material, identify the affected line items. It would have to describe the methodology underlying each critical accounting estimate, the assumptions that are about highly uncertain matters and other assumptions that are material. If applicable, a company would have to discuss why it could have chosen in the current period estimates that would have had a materially different impact on the company's financial presentation. Similarly, a company would have to discuss, if applicable, why the accounting estimate is reasonably likely to change in future periods with a material impact on the company's financial presentation.[12]

A company would have to identify the segments[13] of its business that a critical accounting estimate affects. A company also would have to provide appropriate parts of the proposed disclosure for affected segments where a failure to present that information would result in an omission that renders the disclosure materially misleading.

The second element of the proposed disclosure about critical accounting estimates would give investors a better understanding of the sensitivity of the reported operating results and financial condition to changes in those estimates or their underlying assumption(s). For each critical accounting estimate, a company would discuss changes that would result either from: (i) making reasonably possible, near-term changes in the most material assumption(s) underlying the estimate; or (ii) using in place of the recorded estimate the ends of the range of reasonably possible amounts which the company likely determined when formulating its recorded estimate. The company would describe the impact of those changes on the company's overall financial performance and, to the extent material, on the line items in the company's financial statements. In addition, the proposals would require a quantitative and qualitative discussion of management's history of changing its critical accounting estimates in recent years.

The third element of the proposed disclosure about critical accounting estimates would require a company to state whether or not senior management discussed the development, selection and disclosure of those estimates with the company's audit committee. This part of the proposals is designed to inform investors about whether there is oversight of critical accounting estimates by audit committee members and may incidentally encourage such oversight and increase reliability of the proposed MD&A disclosure about critical accounting estimates.

Our proposals also address MD&A disclosure regarding initial adoption of an accounting policy. If an accounting policy initially adopted by a company had a material impact on the company's financial presentation, the company would provide certain disclosures about that initial adoption unless it resulted solely from new accounting literature issued by a recognized accounting standard setter. The initial adoption of an accounting policy may occur in situations such as when events or transactions affecting the company occur for the first time, or were previously immaterial in their effect but become material, or events or transactions occur that are clearly different in substance from previous ones.

The proposed MD&A disclosure about the initial adoption of accounting policies seeks more qualitative information from companies about those types of situations. The disclosures we are proposing would include a description of:

- The events or transactions that gave rise to the initial adoption;
- The accounting principle adopted and the method of applying that principle; and
- The impact, discussed qualitatively, on the company's financial presentation.

In addition, if upon initial adoption the company had a choice between acceptable accounting principles under generally accepted accounting principles (GAAP), the company would disclose that it made a choice, explain the alternatives and state why it made the choice that it did. Further, if no accounting literature governed the accounting upon initial adoption, the company would have to explain which accounting principle and method of application it decided to use and how it made its decision.

All of the proposed MD&A disclosure regarding the application of critical accounting policies would have to be presented in language and a format that is clear, concise and understandable to the average investor. Boilerplate disclosures, or disclosures written in overly technical accounting terminology, would not satisfy the proposed requirements.

Our proposals do not attempt to address all circumstances where a company may exercise discretion in its accounting under GAAP. We focus our proposals on two areas involving the application of critical accounting policies in which there is a clear need for improved disclosure—critical accounting estimates and the initial adoption of accounting policies that have a material impact. As discussed below, disclosure in many other areas of accounting judgment is provided by existing MD&A requirements, materiality standards and financial statement disclosure requirements.

II. Background

A. Current MD&A Disclosure

For decades, the regulations governing disclosure in registration statements under the Securities Act of 1933 (''Securities Act'') and the Exchange Act, as well as annual and quarterly reports and proxy and information statements by public companies under the Exchange Act, have mandated MD&A disclosure.[14] MD&A disclosure should satisfy three related objectives:

1. to provide a narrative explanation of companies' financial statements that enables investors to see the company through the eyes of management;
2. to improve overall financial disclosure and provide the context within which financial statements should be analyzed; and
3. to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[15]

In MD&A, a company must discuss its results of operations, liquidity and capital resources and other information necessary to an understanding of the company's financial condition or changes in financial condition. A well-prepared MD&A discussion focuses on explaining a company's financial results and condition by identifying key elements of the business model and the drivers and dynamics of the business, and also addressing key variables. A company currently must disclose known trends, demands, commitments, events and uncertainties that are reasonably likely to occur and have material effects.[16]

In addition to these general subjects, a company must include in MD&A historical and prospective analysis of its financial statements, and identify the cause of material changes from prior periods in the line items of the financial statements where those changes are reflected. A company must analyze significant components of revenues or expenses needed to understand the results of operations. It also must discuss significant or unusual economic events or transactions that materially affected results of operations. Finally, a company also must discuss its ability to generate adequate amounts of cash to meet its short-term and long-term needs for capital and identify the anticipated sources of funds necessary to fulfill its commitments.

These requirements do not call for, and indeed we have discouraged and continue to discourage companies from providing, rote calculations of percentage changes in figures in the financial statements combined with boilerplate recitations of a surfeit of inadequately differentiated material and immaterial factors related to such changes. Rather, companies should emphasize material factors and their underlying reasons and preferably omit, or at least differentiate, immaterial information.

Recognizing the paramount importance of MD&A information to investors, in addition to today's proposal, we intend to continue to focus on improving disclosure in this area. In particular, we are considering MD&A proposals that will focus discussion on the three key objectives of MD&A noted above. We are considering a more explicit requirement for a summary of the MD&A section that would, in relatively short form, identify what management considers the most important factors in determining its financial results and condition, including the principal factors driving them, the principal trends on which management focuses and the principal risks to the business. We also are considering how to adjust the relative attention devoted in MD&A towards a more general discussion of material matters and away from a detailed description of business results that too often recites information that is otherwise available or is not material to investors.

In addition, we are continuing our consideration of subjects as to which we believe MD&A disclosure is particularly important, including the topics discussed in our January 22, 2002 release regarding MD&A.[17] For example, investors have become increasingly concerned about the sufficiency of disclosure regarding structured finance transactions, including those consummated using special purpose entities. A company's relationships with those types of entities may facilitate its transfer of, or access to, assets. Investors need to know more about the liquidity risk, market price risks and effects of ''off-balance sheet'' transaction structures and obligations. Another item of concern is a lack of transparent disclosure about transactions where that information appeared necessary to understand how significant aspects of the business were conducted. Investors would better understand financial statements in many circumstances if MD&A included descriptions of all material transactions involving related persons or entities, with a clear discussion of terms that differ from those which would likely be negotiated with clearly independent parties. Investors should understand these transactions' business purpose and economic substance, their effects on the financial statements, and any special risks or contingencies arising from them.

Finally, we are considering improvements to MD&A disclosures relating to trend information. We believe that investors may be better able to see the company through management's eyes if MD&A includes information about the trends that a company's management follows and evaluates in making decisions about how to guide the company's business. As with today's proposal, that disclosure would naturally entail a certain degree of forward-looking information.

B. Current Disclosure in Financial Statements about Accounting Estimates

Currently, GAAP and generally accepted auditing standards acknowledge that there are numerous circumstances in which companies, in applying accounting policies, exercise judgment and make estimates for purposes of the financial statements. For example, they call for companies to communicate in a number of circumstances about the use of estimates in the preparation of financial information. The use of estimates results in the presentation of many amounts that are in fact approximate rather than exact.[18] For example, APB No. 20 notes that ''changes in estimates used in accounting are necessary consequences of periodic presentation of financial statements'' because preparing financial statements requires estimating the effects of future events, and future events and their effects cannot be perceived with certainty.[19] Estimating the impact of those events therefore requires the exercise of judgment. Because the preparation of financial statements requires estimates that are likely to change over time, APB No. 20 requires disclosure about changes in estimates that are expected to affect several future reporting periods and that are not made each period in the ordinary course of accounting. It recommends disclosure if the effects of other changes in the estimate are material.[20]

In addition, AICPA Statement of Position No. 94-6[21] requires general disclosure in notes to financial statements that the preparation of financial statements requires the use of estimates in the determination of the carrying amounts of assets or liabilities, including gain or loss contingencies.[22] That Statement also requires note disclosure regarding those specific estimates when known information indicates that it is at least reasonably possible[23] that the estimate will change in the near term and the effect would be material to the financial statements.[24] A company must disclose the nature of the uncertainty, in addition to stating that a change in the estimate in the near term is at least reasonably possible. SOP 94-6, encourages, but does not require, disclosure of the factors that cause an estimate to be susceptible to change from period to period.[25]

SOP 94-6 references SFAS No. 5, which itself requires certain disclosures about accounting estimates -- specifically, estimated losses that arise from loss contingencies. A company is required to accrue (by a charge to income) an estimated loss from a loss contingency if certain criteria are met.[26] If an estimated loss does not meet the criteria for accrual, but there is at least a reasonable possibility that a loss may have been incurred, the company is required to disclose the nature of the contingency and an estimate of the possible loss or range of loss, or state that an estimate of the loss cannot be made. Although SFAS No. 5 elicits useful disclosure about certain accounting estimates, not all uncertainties inherent in the accounting process give rise to loss contingencies as that term is used in SFAS No. 5, and therefore that Statement does not apply to all estimates in the financial statements.[27]

Further, while not specifically requiring disclosure about estimates, APB Opinion No. 22 requires disclosure about the application of accounting policies which may entail generalized disclosure about estimation techniques.[28] APB No. 22 notes that a company's accounting principles, and their method of application, can affect significantly the presentation of its financial position, results of operations and cash flows,[29] and accordingly, requires disclosure that describes those accounting principles and the company's methods of applying them.[30] In particular, APB No. 22 indicates that a company should provide disclosure when:

- unusual or innovative applications of accounting principles materially affect the determination of financial position, results of operations or cash flows (such as the recognition of revenue);
- a selection is made among alternative permissible policies; or
- policies are unique to the industry of the reporting company.[31]

Under APB No. 22, a company's disclosure also should encompass important judgments as to appropriateness of principles relating to revenue recognition and allocation of asset costs to current and future periods. Although the particular format or location of these APB No. 22 disclosures in financial statements is not prescribed by GAAP, a summary of these significant accounting policies is customarily the first note to the financial statements.

Finally, some accounting standards currently prescribe specific disclosures about accounting estimates or the underlying methodologies and assumptions.[32] For example, Statement of Financial Accounting Standards No. 132 requires specific disclosures of the assumptions used in accounting for pensions and other post-retirement benefits.[33] Statement of Financial Accounting Standards No. 140 requires disclosure regarding the measurement of retained interests in securitized financial assets, including the methodology, assumptions and sensitivity of the assumptions used in determining their fair value.[34]

C. Current Disclosure in Financial Statements about Initial Adoption of Accounting Policies

Certain general requirements under GAAP may elicit information about the initial adoption of an accounting policy by a company. When companies present comparative financial statements, any exceptions to comparability between the most recent period and prior periods must be clearly presented.[35] In addition, if a company initially adopts an accounting policy and considers that policy to be a significant accounting policy, the company would provide certain disclosures about that policy as required by APB No. 22.[36]

APB No. 20 provides financial statement disclosure requirements for accounting changes, which include changes in an accounting principle, an accounting estimate and the reporting entity.[37] Neither ''(a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring'' are considered, however, to be ''accounting changes'' under GAAP.[38] As discussed below, our proposals about initial adoption of accounting policies address these circumstances that are not accounting changes under GAAP if they have a material impact on a company's financial presentation.

III. PROPOSED RULES

A. Objectives of the Current Proposals

Our proposals would promote greater investor understanding of a company's important accounting estimates that reflect significant management judgment and uncertainty, and of a company's initial adoption of accounting policies that may reflect such judgment and uncertainty. Our primary objectives are:

- to enhance investors' understanding of the existence of, and necessity for, estimation in a company's financial statements;
- to focus investors on the important estimates that are particularly difficult for management to determine and where management therefore exercises significant judgment;
- to give investors an understanding of the impact those estimates have on the presentation of a company's financial condition, changes in financial condition or results of operations;
- to give investors an appreciation for how sensitive those estimates are; and
- to give investors an understanding of new material accounting policies as they arise and affect a company's financial results.

Our aim is to increase the transparency of the application of those accounting policies where management is the most prone to use judgment, generally because objective data and methodologies do not exist for the estimates or management is given initial policy choices under GAAP. We believe that it is these accounting policies that are least understood by investors and that mandated disclosure regarding areas of the application of them would provide meaningful insight into the importance of estimates and adoption of policies to a company's financial presentation. With a greater understanding of the application of critical accounting policies, we believe that investors would be in a better position to assess the quality of, and potential variability of, a company's earnings.

We propose to mandate enhanced disclosure of critical accounting estimates and initial adoption of material policies by specifically linking them to the objectives of MD&A, and the type of disclosure presented in MD&A. A focused discussion of these areas is well-suited to MD&A because it would further explain to investors the company's financial condition ''through management's eyes.'' Moreover, MD&A's emphasis on disclosure of significant uncertainties and favorable or unfavorable trends naturally dovetails with disclosure of the more subjective aspects used in arriving at critical accounting estimates or selecting which accounting policies to adopt initially. Finally, as we have noted previously, the less technical language customarily used outside the financial statements may be conducive to a clearer explanation to investors of the effects of estimates, assumptions, methodologies and initial accounting policy adoption on a company's financial reporting.[39]

B. Scope of the Proposals

Our proposals address estimates that a company makes in preparing financial statements using accounting policies under GAAP and the initial adoption by a company of an accounting policy under GAAP that has a material impact on its financial presentation.[40] We believe the proposals address directly and clearly two areas where there is a need for improved disclosure. While certain elements of our proposed critical accounting estimates disclosure are subsumed in existing general MD&A requirements, we believe more direct and complete requirements in our rules would lead to improved disclosure. In addition, while there are financial statement disclosure requirements that would elicit certain information about initially adopted accounting policies in some cases, our proposals are designed to provide additional MD&A disclosure that would assist investors to understand better a company's new accounting policies.

We are leaving disclosure about other circumstances where a company may exercise discretion over its accounting under GAAP to existing MD&A disclosure requirements, materiality standards and existing financial statement disclosure requirements. Our proposals do not, for example, alter disclosure requirements regarding a company's change from an accounting policy it has been using to another policy acceptable under GAAP.[41] The proposals also do not require disclosure of a company's adoption of a new accounting pronouncement where the company must make its best judgment as to how to apply the new accounting pronouncement in the absence of interpretive guidance.

Discipline surrounding a company's changes in accounting policies is provided under GAAP and the federal securities laws. When a company changes an accounting policy, the company must determine that the alternative principle is preferable under the circumstances.[42] We require that the company file a letter from its independent public accountant confirming its opinion to that effect.[43] In addition, a company is required to make certain disclosures in the financial statements about the accounting change, including the nature and justification for the change and its effect on income when the change is made.[44] In its justification for the change, the company is required to explain clearly why the newly adopted accounting principle is preferable.[45]

In addition to the existing disclosure requirements in the financial statements, scrutiny over management's discretion and judgment in applying accounting policies occurs on a number of different levels. Auditors are required to inform audit committees about management's ''initial selection of and changes in significant accounting policies or their application'' and about management's judgments and estimates.[46] We have encouraged companies, management, audit committees and auditors to consult with our accounting staff if they are uncertain about the application of GAAP.[47] We also have committed to provide assistance to companies in a timely fashion to address problems before they happen.

We recognize that the circumstances where a company may exercise discretion over its accounting policies under GAAP could yield significantly different financial results. Given the existing disclosure regime, we are not currently proposing additional MD&A disclosure to address all of these cases. Companies should provide complete, transparent disclosure under the applicable requirements. While we believe the proposed disclosure may be sufficient to achieve our currently stated objective, we may revisit the other circumstances where a company may exercise discretion over its accounting policies under GAAP at a later date.

We solicit comment with regard to broadening the scope of our proposals to achieve a more expansive objective.

- Should we require additional MD&A disclosure specifically regarding the effects of a change by a company from one accounting policy to another acceptable (and preferable) accounting policy under GAAP?
- Should we require in MD&A a discussion of the impact that alternative accounting policies acceptable under GAAP would have had on a company's financial statements even when a company did not choose to apply the alternatives?

- What costs would companies incur if they had to prepare disclosure about the effects of alternative accounting policies that could have been chosen but were not?
- Beyond a company's initial adoption of those policies, should we require disclosure in MD&A regarding a company's reasons for choosing, and the effects of applying, accounting policies used for unusual or innovative transactions or in emerging areas? Similarly, should we require companies to disclose in MD&A the effects of accounting policies that a company could have adopted, but did not adopt, for unusual or innovative transactions or in emerging areas?
- Should we require more disclosure by companies about their process of making estimates, or in other areas of discretion relating to recognition and measurement in financial statements? If so, please describe in detail.
- Should we require in MD&A a discussion of the impact of a company's choice among accounting methods under GAAP that are used in the company's industry (for example, the completed contract and the percentage of completion methods of accounting for construction-type contracts[48])? Should we require that type of disclosure only where a company uses a method under GAAP that is not generally used by other companies in the industry?

C. Proposed Disclosure about Critical Accounting Estimates

To inform investors of each critical accounting estimate and to place it in the context of the company's financial presentation, we would require the following information in the MD&A section:[49]

- A discussion that identifies and describes:
  - the critical accounting estimate;
  - the methodology used in determining the critical accounting estimate;
  - any underlying assumption that is about highly uncertain matters and any other underlying assumption that is material;
  - any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or the assumptions described;
  - if applicable, why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period; and
  - if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation;

- An explanation of the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company's financial statements affected by the accounting estimate;
- A quantitative discussion of changes in overall financial performance and, to the extent material, line items in the financial statements if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in the most material assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;[50]
- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes, and the effect on line items in the financial statements and overall financial performance;[51]
- A statement of whether or not the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the audit committee of the company's board of directors;
- If the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects; and
- A discussion of the accounting estimate on a segment basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading.

Unless otherwise stated, the discussion would cover the financial statements for the most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.[52]

1. Accounting estimates covered under the proposals

A number of circumstances can require a company to make accounting estimates. For example, a company typically will estimate the net realizable value of its accounts receivable and of its inventory.[53] Not all accounting estimates in a company's financial statements, however, will necessarily be critical accounting estimates to which the proposed disclosure relates. An accounting estimate would be a critical accounting estimate for purposes of the proposed disclosure only if it meets two criteria. First, the accounting estimate must require a company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made. Second, it must be the case that different estimates that the company reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.[54]

For purposes of the first criterion, a matter involves a high degree of uncertainty if it is dependent on events remote in time that may or may not occur, or it is not capable of being readily calculated from generally accepted methodologies or derived with some degree of precision from available data. Accordingly, a matter that is highly uncertain requires management to use significant judgment in making assumptions about that matter. The application of management's judgment in those circumstances typically results in management developing a range within which it believes the accounting estimate should fall.

The second criterion focuses the proposals further on two types of accounting estimates involved in the application of accounting policies. First, it includes accounting estimates for which a company in the current period could reasonably have recorded in the financial statements an amount sufficiently different such that it would have had a material impact on the company's financial presentation. Second, it includes any accounting estimate that is reasonably likely to change from period to period to the extent that the change would have a material impact on the company's financial presentation. Thus, whether management's judgment has an impact primarily in the current period or on an ongoing basis (or both), the estimate would qualify.

Under the proposals, a company would discuss any accounting estimate that it determines to be critical. We believe that few of a company's accounting estimates generally would meet those thresholds. We do not currently propose an outside limit to the number of accounting estimates that a company must discuss under the proposals. As the term ''critical accounting estimate'' implies, however, the disclosure should not encompass a long list of accounting estimates resulting from the application of accounting policies which cover a substantial number of line items in the company's financial statements.[55] While the number of critical accounting estimates will vary by company, we would expect a very few companies to have none at all and the vast majority of companies to have somewhere in the range of three to five critical accounting estimates. The number could be at the high end of the range, or be slightly higher, for companies that conclude that one or more critical accounting estimates must be identified and discussed primarily because of particular segments. Investors, however, will not benefit from a lengthy discussion of a multitude of accounting estimates in which the truly critical ones are obscured. If we adopt the proposals without a maximum number, we may monitor disclosure to determine whether disclosure would be improved if a maximum number were set.

We seek comment on the proposed definition of critical accounting estimates.

- Is the definition appropriately tailored?
- Does the definition capture the appropriate type and scope of accounting estimates?
- Is the definition appropriately designed to identify the accounting estimates that require management to use significant judgment or that are the most uncertain? If not, what other aspects descriptive of that type of estimate should be included?
- Is the definition appropriately designed to identify the accounting estimates involving a high potential to result in a material impact on the company's financial presentation?
- Would it be difficult for a company to discern which of its accounting estimates require assumptions about highly uncertain matters? If so, how could the proposal better target them?
- Should we consider setting a minimum percentage impact on results of operations in the second criterion of the definition, or would that be unnecessary because the proposed definition would not capture changes that have an insignificant impact?
- How many accounting estimates would a company typically identify as critical accounting estimates under the proposed definition?
- Would a company with multiple segments have a greater number of critical accounting estimates than a company without multiple segments? If so, please provide an explanation.
- Should we establish a maximum number of accounting estimates that may be discussed as critical accounting estimates (*e.g.,* seven)? If so, what should the maximum number be and what criteria should be applied to set the number so as to strike the appropriate balance between information truly useful to investors and overly extensive disclosure of marginal use? If a maximum were set, should the number of segments a company has be considered?
- Should we expand the definition to include MD&A disclosure of volatile accounting estimates that use complex methodologies but do not involve significant management judgment? Should we do so only when the underlying assumptions or methodologies of those estimates are not commonly used and therefore not understood by investors?

2. Identification and description of the accounting estimate, the methodology used, certain assumptions and reasonably likely changes

A company first would have to identify and describe each critical accounting estimate in such a way that it gives the appropriate context for investors reading that section and reflects management's view of the importance of the critical accounting estimate.[56] A company would have to disclose the methodology it used in determining the estimate. It also would have to disclose the assumptions underlying the accounting estimate that reflect matters highly uncertain at the time the estimate was made as well as other assumptions underlying the estimate that are material. We recognize that a critical accounting estimate may involve multiple assumptions. The proposed disclosure would focus in the first instance on those that are about highly uncertain matters because they have the greatest potential to make the accounting estimate highly susceptible to change.

If applicable, the company would have to describe why different estimates could have been used in the current period and why the accounting estimate is reasonably likely to change from period to period in the financial statements. For example, a critical accounting estimate related to a significant portfolio of over-the-counter derivative contracts may require that a company estimate the fair value of such contracts using a model or other valuation method. In that case, the company would disclose the methods it employs to estimate fair value, *e.g.,* the types of valuation models used such as the present value of estimated future cash flows, and assumptions such as an estimated price in the absence of a quoted market price.[57]

A company also would have to explain known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the assumptions made or the methodology used. Like the requirements elsewhere in MD&A, disclosure would be required if the trend, demand, commitment, event or uncertainty is currently known, it is reasonably likely to occur and it is reasonably likely to have a material impact. Disclosure would not be required if management could affirmatively conclude that the trend, demand, commitment, event or uncertainty is not reasonably likely to come to fruition or that a material effect is not reasonably likely to occur.[58]

3. Impact of the estimate on financial condition, changes in financial condition and results of operations

For each critical accounting estimate, a company would have to explain its significance to the company's financial condition, changes in financial condition and results of operations and, where material, identify its effect on the line items in the company's financial statements.[59] Because not all estimates themselves are line items in the financial statements,[60] their existence and their effect may not be readily apparent. Thus, this disclosure would provide additional information and clarity for investors.

4. Quantitative disclosures

There are two areas of the proposed MD&A disclosure relating to critical accounting estimates in which we explicitly would require a presentation of quantitative information.[61] First, the proposals would require disclosure that demonstrates the sensitivity of financial results to changes made in connection with each critical accounting estimate. Second, the proposals would require quantitative disclosure relating to historical changes in a company's critical accounting estimates in the past three years.

a. Quantitative disclosures to demonstrate sensitivity

We propose to require that a company present quantitative information about changes in its overall financial performance and, to the extent material, line items in the financial statements that would result if certain changes relating to a critical accounting estimate were assumed to occur. The company would identify the change being assumed and discuss quantitatively its impact on the company. Because the point of the disclosure is to demonstrate the degree of sensitivity, the impact on overall financial performance would be discussed regardless of how large that is.

As proposed, a company would have two possible choices of changes it would assume for purposes of the sensitivity analysis. First, the company could choose to assume that it changed the most material assumption or assumptions underlying the critical accounting estimate and discuss the results of those changes. Second, the company could choose to assume that the critical accounting estimate itself changes. In addition to providing two choices of methods to demonstrate sensitivity, we allow a company to determine the amount of the change that it assumes for this analysis rather than attempting to standardize those amounts. Under the first choice, a company could select the alternative material assumption or assumptions to use as long as the alternative represents a change that is reasonably possible in the near term. ''Reasonably possible'' means the chance of a future transaction or event occurring is more than remote but less than likely.[62] ''Near-term'' means a period of time going forward up to one year from the date of the financial statements.[63] Under the second choice, the company would use the upper and the lower ends of the range of reasonably possible estimates which it likely determined in formulating its recorded critical accounting estimate. It would substitute the upper end of the range for the recorded estimate and discuss the results. It would do the same for the lower end of the range.

We believe the most informative disclosure about sensitivity would result if we allow companies significant flexibility to customize these analyses. Our approach would accommodate different types of companies, different critical accounting estimates and different types of underlying assumptions. The parameters selected for the sensitivity analysis must, however, be realistic and meaningful measures of change.[64] For purposes of the sensitivity analysis, a company should disclose, if known or available, the likelihood of occurrence of the changes it selects, such as estimated probabilities of occurrence or standard deviations where applicable.

Under the first choice for demonstrating sensitivity, we would provide that a company choose its most material assumption underlying the critical accounting estimate and alter it at least twice[65] to reflect reasonably possible, near-term changes.[66] A company would have to complete the analysis assuming a positive change in the assumption. It would also have to complete the analysis assuming a negative change. In some cases, a company may not be able to select a single most material assumption to use for purposes of these analyses, or it may believe that using a single assumption would not provide meaningful sensitivity information for investors. If that were to occur, a company either could select the second choice for analyzing sensitivity (*i.e.,* using the ends of the range) or it could demonstrate the effects of near-term reasonably possible changes in more than one material assumption underlying the critical accounting estimate. If the company chooses the latter course of action, it also would have to disclose clearly the separate effect of each changed assumption.

In general, we believe the impact of a positive change and the impact of a negative change would both have to be disclosed where a company is assuming changes in its most material assumption (or assumptions). There may be cases, however, where both types of changes would not be applicable. In some instances, an increase in an assumption, but not a decrease in an assumption, or vice versa, would have no effect on the line items or the overall financial performance and therefore would not have to be discussed other than noting that fact.[67] It is conceivable that in other cases either a decrease or an increase would not be reasonably possible and therefore would not have to be discussed other than noting that fact.

With the proposed analysis, a company would demonstrate sensitivity of reported results to changes that affect its critical accounting estimates. Investors would have a better understanding of the extent to which there is a correlation between management's key assumptions and the company's overall financial performance. Investors also would understand better which particular line items in reported results would be materially affected and how much. In addition, a company would be required to state whether those assumed changes could have a material effect on the company's liquidity or capital resources. If they could have such an effect, the company would have to explain how, as a company currently is required to explain in MD&A when factors affecting liquidity or capital resources are present.[68]

From the proposed disclosure, the average investor should be able to ascertain the general degree to which the company's results of operations, liquidity and capital resources are susceptible to changes in management's views relating to critical accounting estimates. Along with the other provisions in the proposal, this quantitative and qualitative disclosure conveys information about the impact of management's subjective assumptions on current and future financial results.

We request comment on the proposed identification and analysis of changes.

- Are there some types of critical accounting estimates or some circumstances where the proposed disclosure relating to sensitivity would not be meaningful or otherwise helpful to investors? If so, which estimates or what circumstances?
- In addition to the two choices we propose for assuming changes relating to the critical accounting estimates to analyze sensitivity, are there others that we should permit? Should we require instead that all companies use the same method? If so, which one?
- Should we require a company to use whichever of the two proposed choices demonstrates the greatest impact on the company's financial presentation?
- Are there circumstances under which a company should be required to demonstrate sensitivity using both of the proposed choices?
- Are there any critical accounting estimates for which neither of the two choices for selecting the assumed changes would be appropriate?
- Will companies be able to select appropriate changes in their most material assumption or assumptions, or should we provide further guidance?
- To enhance an investors' ability to compare the sensitivity of various companies' financial statements to changes relating to a particular type of accounting estimate, should we standardize the changes that companies must assume for various types of estimates? If so, what should they

be and why? For example, should we set a specified percentage increase and decrease to assume (*e.g.,* a 10% increase and decrease), or a presumptive increase and decrease, provided that degree of change is reasonably possible in the near term?

- Conversely, would any changes we standardize not be equally meaningful to measure sensitivity, or equally probable, for various accounting estimates, industries and companies, and thus reduce the value of any disclosure about sensitivity?

b. Quantitative and qualitative disclosures concerning past changes in the estimate

We recognize that a company will change its accounting estimates over time as new events occur or as management acquires more experience or additional information. Existing MD&A disclosure rules would call for discussion of the effects of changes in accounting estimates where those changes are material to an investor's understanding of financial position or results of operations. For example, MD&A currently requires companies to disclose:

- information necessary for an understanding of financial condition, changes in financial condition and results of operations;[69]
- significant components of revenues or expenses that should, in the company's judgment, be described in order to understand results of operations;[70]
- a material change in the relationship between costs and revenues resulting from a known event;[71]
- matters that will have an impact on future operations and have not had an impact in the past;[72] and
- matters that have had an impact on reported operations and are not expected to have an impact upon future operations.[73]

Notwithstanding the existing MD&A disclosure requirements, we believe it would be appropriate to require specific disclosure regarding past changes in critical accounting estimates. This type of information required under the proposal would give investors a clear understanding of a company's recent history of those changes. A company other than a small business issuer would have to include the proposed quantitative and qualitative discussion of any material changes in those accounting estimates under the proposals during the past three fiscal years.[74] A small business issuer would discuss material changes in its critical accounting estimates during the past two years.[75] Companies would have to identify how the material changes affected measurements in the financial statements and their overall financial performance.[76] This would enable investors to evaluate management's formulation of critical accounting estimates over time.

Companies also would be required to describe the reasons for those changes. If no material changes in the critical accounting estimates were made in the prescribed time period, or if a company did not make that estimate during any part of that period, a company would only be required to disclose that fact.

Although the period covered for the proposed disclosure of past changes in critical accounting estimates would be two years for small business issuers and three years for other companies, our proposed requirement relating to past changes would be put into effect in stages. Thus, when a small business issuer or other company files its first covered report, registration statement or proxy or information statement following adoption of the proposed rules, the rules would require it to provide the proposed specific past changes disclosure only for the past one or two years respectively. For example, if the first report were an annual report on Form 10-K for the fiscal year ended December 31, 2002, the company would include that information in the ''Application of Critical Accounting Policies'' section of MD&A about changes in 2001 and 2002 (and a small business issuer would include it only for 2002). In the first annual report, registration statement or proxy or information statement filed by a company more than one year following the effective date of the rules, it would have to provide that information for the past three years (two years for a small business issuer).[77]

We solicit comment on the proposed disclosure of past material changes in critical accounting estimates.

- Is sufficient disclosure of these changes already required under current MD&A requirements?
- Is a three-year period the most appropriate period of time over which investors should consider changes? If not, why would a shorter or longer period be more appropriate?
- Would requiring disclosure over a longer period, such as five years, make it easier for investors to identify trends? If so, over how many years should we phase in a longer period requirement?
- Should we mandate a standardized format for quantitative disclosure about past changes in critical accounting estimates (*e.g.,* a chart illustrating the dollar value of the change from the prior year for each year showing the impacted line items and other effects in each year)?

5. Senior management's discussions with the audit committee

Independent auditors discuss accounting estimates with management in order to conduct an audit, and the auditors may discuss them with the audit committee. In 1999, following the recommendations in the Report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, we adopted a rule that would require an audit committee report in proxy or information statements connected to board of director elections.[78] Among other items, the audit committee report must state whether the audit committee has discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards (''SAS'') No. 61 (codified in AU §380), as may be modified or supplemented.[79] SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. With respect to accounting estimates, SAS 61 states, ''[t]he auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.''[80] In addition, in connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality of the entity's accounting principles as applied in its financial reporting. The discussion should include items that have a significant impact on the financial statements (for example, estimates, judgments and uncertainties, among other items).[81]

In addition to the disclosure relating to SAS 61 (as amended), the audit committee report must state whether the audit committee has reviewed and discussed the audited financial statements with management.[82] Because that item relates to the financial statements generally, a focused discussion on critical accounting estimates may or may not result from it. Moreover, the newly required disclosure in MD&A would not be a part of the financial statements, and therefore would not necessarily be covered by that proxy statement disclosure requirement.

The existing audit committee report also requires audit committees to state whether, based on discussions with management and the auditors, the committee recommended to the board of directors that the audited financial statements be included in the company's Form 10-K or 10-KSB for the last fiscal year.[83] This disclosure requirement conveys whether the audit committee review of the financial statements and discussions with management and the auditors have provided a basis for recommending to the board that the audited financial statements be filed with the Commission. This item too does not require any specific discourse between management and the audit committee about critical accounting estimates.

We believe that senior management should discuss the company's critical accounting estimates with the audit committee of its board of directors.[84] If specific discussions between senior management and audit committees regarding the development, selection and disclosure of the critical accounting estimates were to take place, the audit committee may seek to understand the company's critical accounting estimates, the underlying assumptions and methodologies, the appropriateness of management's procedures and conclusions, and the disclosure about those accounting estimates. This type of oversight would have the potential to improve the quality and the transparency of disclosure.

Requiring a company to disclose in MD&A whether or not senior management has engaged in discussions with the audit committee about the critical accounting estimates would give investors a better understanding of whether such oversight by those responsible for the general oversight of the financial reporting process was applied to those accounting estimates and the disclosure about those accounting estimates. We therefore are proposing to require such disclosure.[85] When senior management and the audit committee have not had those discussions, we would require disclosure that they have not, and an explanation of the reasons why they have not.[86] If the company does not have an audit committee, then the proposed disclosure would address discussions with the board committee that performs equivalent functions to those of an audit committee or, if no such committee exists, the entire board of directors.[87] Unlike the audit committee report, our proposed disclosure of discussions between the audit committee and senior management would not be limited to proxy and information statements that involve the election of directors.[88]

We do not propose to require disclosure of the substance of the discussions between senior management and the audit committee. We believe that such a requirement could deter the type of open discourse that we expect to take place in those discussions.

We request comment on the proposed disclosure about discussions between senior management and the audit committee regarding the development, selection and disclosure of critical accounting estimates.

- To what extent does senior management currently discuss critical accounting estimates with the audit committee of the board of directors and the company's auditors?

- Would the proposed requirement provide useful information to investors?
- Would the proposed disclosure be a catalyst for discussion between audit committees and senior management? Could it chill discussions?
- Is there other related disclosure that should be required for the benefit of investors?
- Should we require that companies disclose any unresolved concerns of the audit committee about the critical accounting estimates or the related MD&A disclosure?
- Should we require disclosure of any specific procedures employed by the audit committee to ensure that the company's response to the proposed disclosure requirements is complete and fair?
- Should we consider requiring disclosure of whether the audit committee recommends the disclosure be included in the MD&A, which is akin to the disclosure required in the Item 306 audit committee report?
- Instead of the proposed disclosure, should we amend Item 306 of Regulation S-K and Regulation S-B to require that the audit committee report disclose whether the audit committee has reviewed and discussed with senior management the development, selection and disclosure regarding critical accounting estimates?
- If we were to amend Items 306 in this manner, should we also expand them to include the discussions about critical accounting estimates between senior management and the audit committee as one of the bases for the audit committee's recommendation to include the financial statements in the annual report?
- Should we expand Items 306 to require disclosure of whether, based on an audit committee's review of and discussions about the MD&A, the audit committee recommended to the board of directors that the MD&A be included in the company's annual report?
- Should we expand Items 306 to require disclosure of whether the audit committee has reviewed and discussed the entire MD&A disclosure (current and proposed) with management and/or the auditors?
- If any of a company's accounting policies diverge, to its knowledge, from the policies predominately applied by other companies in the same industry, should we require that the company disclose, possibly in connection with the audit committee report, whether the audit committee has had discussions with senior management about the appropriateness of the accounting policies being used? When such discussions have taken place, should we require that the company disclose the audit committee's unresolved concerns about the divergent accounting policies being applied? Prior to the adoption of our proposals, to what extent would a company know that its accounting policies diverge from those of other companies in its industry?

6. Disclosure relating to segments

Current MD&A disclosure requirements provide companies with the discretion to include a discussion of segment information where, in the company's judgment, such a discussion would be appropriate to an understanding of the company.[89] In 1989, we stated in an interpretive release, ''[t]o the extent any segment contributes in a materially disproportionate way to [revenues, profitability, and cash needs], or where discussion on a consolidated basis would present an incomplete and misleading picture of the enterprise, segment disclosure should be included.''[90] In accordance with this interpretation, we are proposing disclosure regarding the impact of critical accounting estimates on segments of a company's business.[91] Where applicable, we believe that this disclosure would be important for investors because it would enable them to determine which reported segments' results are dependent on management's subjective estimates, and material information would be provided on a segment basis.

Under the proposals, if a company operates in more than one segment[92] and a critical accounting estimate affects fewer than all of the segments, the company would have to identify the segments it affects. A company also would have to determine whether it must include, in addition to the disclosure on a company-wide basis, a separate discussion of the critical accounting estimates for each identified segment about which disclosure is otherwise required.[93] That determination would follow an analysis similar to that in the 1989 guidance. A company would have to provide a discussion on a segment basis to the extent that discussion only on a company-wide basis would result in an omission that renders the disclosure materially misleading.[94] We would not mandate repetition on a segment basis of all matters discussed on a company-wide basis. Rather, a company would have to disclose only that information necessary to avoid an incomplete or misleading picture.

We request comment regarding identification of the segments affected and the proposed additional disclosure of the critical accounting estimates on a segment basis.

- Should we provide more guidance for determining the circumstances that warrant segment disclosure?
- Should we require the additional segment discussion only when more than one segment is affected?

D. Examples of Proposed Disclosure about Critical Accounting Estimates

To assist in understanding the scope of the MD&A disclosure that is proposed, we have developed three examples. Each example examines how a fictional public company that has identified a critical accounting estimate could draft MD&A disclosure to satisfy the proposal. The examples are illustrative only. In addition, our January 22, 2002 release provides an example of disclosure that companies should consider when discussing in MD&A trading activities involving contracts that are accounted for at fair value where a lack of market price quotations necessitates the use of fair value estimation techniques.[95]

Example 1

Background

Alphabetical Company manufactures and distributes electrical equipment used in large-scale commercial pumping and water treatment facilities. The company operates in four business segments. The company's equipment carries standard product warranties extending over a period of 6 to 10 years. If equipment covered under the standard warranty requires repair, the company provides labor and replacement parts to the customer at no cost. Historically, the costs of fulfilling warranty obligations have principally related to providing replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in replacement parts constituted approximately 35% to 40% of the total cost of warranty obligations.

A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects the company's estimate of the expected future costs of honoring its obligations under the warranty plan. Because of the long-term nature of the company's equipment warranties, estimating the expected cost of such warranties requires significant judgment. Based on management's evaluation of analysts' forecasts for copper prices, management believes a 30% decrease in copper prices or a 50% increase in copper prices is reasonably possible in the near term. In each of the last three years, warranty expense represented approximately 19% to 22% of cost of sales.

Possible MD&A disclosure under the proposal

Application of Critical Accounting Policies

Alphabetical's products are covered by standard product warranty plans that extend 6 to 10 years. A liability for the expected cost of warranty-related claims is estab-

lished when equipment is sold. The amount of the warranty liability accrued reflects our estimate of the expected future costs of honoring our obligations under the warranty plan. We believe the accounting estimate related to warranty costs is a ''critical accounting estimate'' because: changes in it can materially affect net income, it requires us to forecast copper prices in the distant future which are highly uncertain and require a large degree of judgment, and copper is a significant raw material in the replacement parts used in warranty repairs. The estimate for warranty obligations is a critical accounting estimate for all of our four segments.

Historically, the costs of fulfilling our warranty obligations have principally related to replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in our parts constituted approximately 35% to 40% of the total cost of warranty repairs. Over that same period, warranty expense represented approximately 19% to 22% of cost of sales.

Over the past 10 years, the price of copper has exhibited significant volatility. For example, during 1994, the price of copper rose by approximately 72%, while in 2001 the price decreased by approximately 19%. Our hedging programs provide adequate protection against short-term volatility in copper prices, as described in ''Risk Management,'' but our hedging does not extend beyond 5 years. Accordingly, our management must make assumptions about the cost of that raw material in periods 6 to 10 years in the future. Management forecasts the price of copper for the portion of our estimated copper requirements not covered by hedging. Our forecasts are based principally on long-range price forecasts for copper which are published by private research companies specializing in the copper markets.

Each quarter, we reevaluate our estimate of warranty obligations, including our assumptions about the cost of copper. During 2001, we decreased our estimated cost of unhedged copper purchases over the next 10 years by 15%, reflecting a growing excess of supply over forecasted demand, which reduced our accrued warranty costs and our cost of sales (and, accordingly, increased operating income) by $15 million. In contrast, during 2000, long-term price forecasts were essentially unchanged, so we made no adjustments to our estimated cost of unhedged copper purchases over the next 10 years. During 1999, copper prices increased by approximately 28% over the prior year. Long-term prices also reflected increases in prices over those projected in 1998. Thus, in 1999, we increased our estimated cost of unhedged copper purchases over the next 10 years (through 2009) by 15%. That increase in our estimate resulted in an $18 million addition to our accrued warranty cost and our cost of sales, and an equal reduction in our operating income.

If, for the unhedged portion of our estimated copper requirements, we were to decrease our estimate of copper prices as of December 31, 2001 by 30%, our accrued warranty costs and cost of sales would have been reduced by approximately $27 million or 6% and 4%, respectively, while operating income would have increased by 9%. If we were to increase our estimate as of December 31, 2001 by 50%, our accrued warranty costs and cost of sales would have been increased by approximately $45 million or 10% and 7%, respectively, while our operating income would have been reduced by 23%.

A very significant increase in our estimated warranty obligation, such as one reflecting the increase in copper prices that occurred in 1994, could lower our *earnings and increase our leverage ratio (leverage refers to the degree to which a company utilizes borrowed funds). That, in turn, could limit our ability to borrow money through our revolving credit facilities described in ''Liquidity and Capital Resources.''*

Our management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

Example 2

Background

MQB Corp. is a developer and publisher of desktop publishing software that operates in two segments. MQB distributes its products primarily through third-party distributors, resellers, and retailers (customers). Like many companies in the software industry, MQB has a product return policy and has historically accepted significant product returns. MQB permits its customers to return software titles published and distributed by the company within 120 days of purchase.

MQB recognizes revenues under SOP 97-2, ''Software Revenue Recognition.'' The company ships its products FOB (Free on Board) shipping point. Therefore, legal title to the products passes to the customers upon shipment, and the company has no legal obligation for product damage in transit. Accordingly, MQB recognizes revenue upon shipment of its software products, provided that collection of payment is determined to be probable and no significant obligations on MQB's part remain. Payment is due from customers 30 days after shipment. At the time revenue is recorded, MQB accounts for estimated future returns by reducing sales by its estimate of future returns and by reducing accounts receivable by the same amount. For example, MQB reduced its gross sales and accounts receivable by 12% for its fiscal year ended December 31, 2001 to reflect estimated product returns. In the last three years, the range in which the company has reduced its gross sales and accounts receivable to reflect product returns has been between 11% and 13%.

MQB receives weekly reports from distributors and retailers regarding the amount of MQB products in their inventory. A historical correlation exists between levels of inventory held by distributors and retailers (together, the distribution channel) and the amount of returns that actually occur. The weekly reports from distributors and retailers provide the company with visibility into the distribution channel such that MQB has the ability to estimate future returns. In each of the past few years, actual returns have varied from period to period, although they have not exceeded the estimated amounts by more than 5%. The company's products are, however, subject to intense marketplace competition, including several recently introduced competing products. If actual returns significantly exceed the previously estimated amounts, it would result in materially lower sales and net income before taxes in one or more future periods.

Possible MD&A disclosure under the proposal

Application of Critical Accounting Policies

Our recognition of revenue from sales to distributors and retailers (the ''distribution channel'') is impacted by agreements we have giving them rights to return our software titles within 120 days after purchase. At the time we recognize revenue, upon shipment of our software products, we reduce our measurements of those sales by our estimate of future returns and we also reduce our measurements of accounts receivable by the same amount.

For our products, a historical correlation exists between the amount of distribution channel inventory and the amount of returns that actually occur. The greater the distribution channel inventory, the more product returns we expect. For each of our products, we monitor levels of product sales and inventory at our distributors' warehouses and at retailers as part of our effort to reach an appropriate accounting estimate for returns. In estimating returns, we analyze historical returns, current inventory in the distribution channel, current economic trends, changes in consumer demand, introduction of new competing software and acceptance of our products.

In recent years, as a result of a combination of the factors described above, we have materially reduced our gross sales to reflect our estimated amount of returns. It is also possible that returns could increase rapidly and significantly in the future. Accordingly, estimating product returns requires significant management judgment. In addition, different return estimates that we reasonably could have used would have had a material impact on our reported sales and thus have had a material impact on the presentation of the results of operations. For those reasons, we believe that the accounting estimate related to product returns is a ''critical accounting estimate.'' Our estimate of product returns is a critical accounting estimate for both of our segments. Management of the company has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

We are aware of several recently introduced products that compete with several of our significant products. These new competitive factors have not, to date, materially impacted returns; therefore, we have made no adjustment as a result of these factors in our estimated returns for 2001. In our highly competitive marketplace, these factors have some potential to increase our estimates of returns in the future. The introduction of new competing products has impacted our estimate of returns *in the past. In 1999, we increased our estimate of returns over the previous year by 1%, as a percentage of gross sales, because of increased inventory in the distribution channel due to new products introduced by two of our competitors.*

In preparing our financial statements for the year ended December 31, 2001, we estimated future product returns for all of our products to be $145 million, and we reduced our gross sales by that amount. Our 2001 estimate for returns was $20 million greater than our estimate in 2000 and $15 million greater than our estimate in 1999. From 1999 to 2000, products introduced by two of our competitors in 1998 lost market share to our products and our sales increased. Due to our increased sales in 2000, the distribution channel inventory declined over levels in 1999, which also resulted in a 2% decline in the estimated amount of returns, as a percentage of gross sales. In 2001, with the slow down in consumer spending over the prior period, distribution channel inventory grew faster than sales, necessitating an increase in the estimated returns equal to 1% of gross sales. The estimates for returns represented approximately 12%, 11% and 13% of our gross sales for 2001, 2000 and 1999, respectively.

If we were to assume that our estimate of future product returns for all of our products was changed to the upper end or lower end of the range we developed in the course of formulating our estimate, the estimate for future returns as of December 31, 2001 would range from $130 million to $160 million. Accordingly, the amounts by which we would reduce gross sales and operating income also would range from $130 million to $160 million as compared to the recorded amount of $145 million. In each of the years in the three-year period ended 2001, our actual returns have not deviated from our estimates by more than 5%. Our actual returns for 2000 and 1999 were $129 million and $134 million, respectively. If we were to change our estimate of future product returns to the high end of the range, there would be no material impact on our liquidity or capital resources.

Example 3

Background

Betascott Company manufactures and sells data storage devices including computer hard drives. The hard drive industry is subject to intense competition and significant shifts in market share amongst the competitors. In the last three years, Betascott has reported falling sales and market share, which has contributed to a fiscal year 2001 loss from operations in the hard drive segment. (This trend is separately discussed in MD&A.)

As of December 31, 2001, the company had $200 million in property, plant and equipment (''PP&E'') used in producing hard drives. The company's accounting policies require that it test long-lived assets for impairment whenever indicators of impairment exist. The 2001 fiscal year loss from operations in that segment, coupled with the company's falling sales and market share, are indicators of a potential impairment of the hard drive-related PP&E.

The company follows the provisions of FASB SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*[96] That accounting standard requires that if the sum of the future cash flows expected to result from the assets, undiscounted and without interest charges, is less than a company's reported value of the assets, then the asset is not recoverable and the company must recognize an impairment. The amount of impairment to be recognized is the excess of the reported value of the assets over the fair value of those assets.

The hard drive-related PP&E accounts for approximately 67% of Betascott's PP&E. The sum of Betascott's current estimate of expected future cash flows from its hard drive-related PP&E, undiscounted and without interest charges, is near the reported value of that PP&E. In the year ended December 31, 2001, Betascott would have been required to recognize an impairment loss of approximately $30 million if its estimate of those future cash flows had been 10% lower.

Possible MD&A disclosure under the proposal

Application of Critical Accounting Policies

We evaluate our property, plant and equipment (''PP&E'') for impairment whenever indicators of impairment exist. Accounting standards require that if the sum of the future cash flows expected to result from a company's asset, undiscounted and without interest charges, is less than the reported value of the asset, an asset impairment must be recognized in the financial statements. The amount of impairment to recognize is calculated by subtracting the fair value of the asset from the reported value of the asset.

As we discuss in the notes to the financial statements, we operate in four segments, one of which is the hard drive segment. In our hard drive segment, we reviewed our hard drive-related PP&E for impairment as of December 31, 2001, due to a trend of declining sales and market share. We determined that the undiscounted sum of the expected future cash flows from the assets related to the hard drive segment exceeded the recorded value of those assets, so we did not recognize an impairment in accordance with GAAP. The PP&E in our hard-drive segment represents approximately two-thirds of our total PP&E.

We believe that the accounting estimate related to asset impairment is a ''critical accounting estimate'' because: (1) it is highly susceptible to change from period to period because it requires company management to make assumptions about future sales and cost of sales over the life of the hard drive-related PP&E (generally seven years); and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet as well as our net loss would be material. Management's assumptions about future sales prices and future sales volumes *even with the impairment loss, we would have been within the terms of the tangible net-worth covenant in our long-term debt agreement discussed in note 5 to the financial statements.*

E. Auditor Examination of MD&A Disclosure Relating to Critical Accounting Estimates

A company's management bears primary responsibility for its accounting estimates. Auditors also have important responsibilities regarding a company's accounting estimates. A company's auditor currently is responsible for evaluating the reasonableness of the accounting estimates made by management in the context of the financial statements taken as a whole.[97] When a company's audited financial statements are included in an annual report filed with the Commission, the independent auditor is required to read the information in the entire filed document, including the MD&A, and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[98]

Despite the current auditing standards, and the auditor's consideration of the proposed MD&A disclosure that may take place by virtue of them, we are considering whether to take additional steps with a view to ensuring the accuracy and reliability of the proposed disclosure. Subjecting the MD&A disclosure to the auditing process itself would require the imposition of auditing standards, including examination of the disclosure itself, application of auditing processes regarding internal controls, coverage in management representations of material relevant to the disclosure and other procedures. One possible approach would be to adopt a requirement that an independent auditor must examine, in accordance with Attestation Standards,[99] the new MD&A disclosure relating to critical accounting estimates.

The American Institute of Certified Public Accountants has established standards and procedures when an auditor is engaged by a company to examine and render an opinion that the disclosure in a company's MD&A satisfies applicable Commission requirements.[100] An auditor's objective in an examination is to express an opinion on:

- whether the MD&A presentation includes in all material respects the required elements of the disclosure mandated by the Commission;
- whether the historical financial amounts have been accurately derived, in all material respects, from the company's financial statements; and
- whether the underlying information, determinations, estimates and assumptions of the company provide a reasonable basis for the disclosures contained in the MD&A.[101]

To complete an examination, an auditor must examine documents and records and accumulate sufficient evidence in support of the disclosures and assumptions and take other steps to get reasonable assurance of detecting both intentional and unintentional misstatements that are material to the MD&A presentation.[102] To accept an examination engagement, an auditor must have sufficient knowledge about the company and its operations. AT §701 therefore requires that an auditor must have at least audited the company's financial statements for the most recent period covered by the MD&A, and the other periods covered by the MD&A must have been audited by it or another auditor.[103]

Auditor examinations of MD&A disclosure are, we believe, undertaken on few occasions. Some companies have engaged independent auditors to conduct an examination of their MD&A disclosures either in connection with their initial public offering or after a major restructuring or acquisition when the company disclosure is being presented on a pro forma basis.[104] In one case, an auditor examination of MD&A was undertaken pursuant to a settlement with the Commission of an enforcement action alleging material deficiencies in the company's past MD&A disclosure.[105]

We solicit comment with respect to independent auditor examinations of the proposed MD&A disclosure regarding critical accounting estimates.

- Should we require that the critical accounting estimates disclosure in the MD&A undergo an auditor examination comparable to that enumerated in AT §701?
- Would these engagements significantly improve the disclosure provided in MD&A?
- In practice, when companies engage auditors to examine the MD&A pursuant to AT §701, does it elicit a higher quality of disclosure than when auditors consider only, as currently required, whether an MD&A is materially inconsistent with the financial statements?
- If we were to require examinations by auditors of part or all of MD&A disclosures, should we also require that a company file, or disclose the results of, the auditor's reports?
- If we do not require auditors' examinations of MD&A disclosure but an auditor nonetheless examines MD&A disclosure on critical accounting estimates, should we require that the auditor's report be filed or the results be disclosed?
- What would be the relative benefits and costs of a requirement for an auditor examination with respect to the critical accounting estimates portion of the MD&A?

- Should we require an auditor ''review'' under standards comparable to AT §701,[106] as opposed to an auditor ''examination'' of the critical accounting estimates MD&A disclosure?
- Do current requirements relating to what an auditor must consider make an examination or review of the proposed MD&A disclosure under standards comparable to AT §701 unnecessary?
- If we do not require auditor examination or review, are there other steps we should take to help ensure the quality of disclosure in this proposed section of MD&A?

F. Quarterly Updates

Material changes relating to critical accounting estimates may occur from fiscal period to fiscal period. For example, management could materially change an accounting estimate previously disclosed as a critical accounting estimate because it changes the methodology for computing it. A company could determine that an additional accounting estimate met the standards and is a critical accounting estimate for the period subsequent to its most recent annual or quarterly report. A company also could materially change one of the important assumptions underlying an existing critical accounting estimate (which may or may not result in a change to the critical accounting estimate depending on what changes in other assumptions underlying the estimate are made). Any of those changes could have a material effect on the company's financial condition, changes in financial condition or results of operations. We expect that U.S. companies would be evaluating accounting estimates and the underlying assumptions and methodologies on at least a quarterly basis[107] and therefore we believe that quarterly updates to reflect material developments would be appropriate. Disclosure of material developments made only at the end of each fiscal year also may not identify changes quickly enough to inform investors adequately.

In quarterly reports on Form 10-Q or Form 10-QSB, companies would be required to provide an update to the MD&A information related to critical accounting estimates discussed in the company's last filed annual or quarterly report under the Exchange Act.[108] Newly identified critical accounting estimates would be disclosed in the same manner as in an annual report. If other material changes have occurred that would render the critical accounting estimates disclosure in the company's latest report materially out of date or otherwise materially misleading, we propose that those changes and their effect be described in the quarterly report. The proposed rules would not, however, require quarterly updates with regard to the proposed quantitative and qualitative discussion concerning past material changes in critical accounting estimates in annual reports, registration statements and proxy and information statements.

We solicit comment on the quarterly updating requirement for U.S. companies.

- Are there some accounting estimates or material assumptions or methodologies that would normally be considered by companies only on a less frequent basis than quarterly? If so, which ones? Should they be omitted from the quarterly updating requirement on that basis?
- Is the scope of the disclosure required in a quarterly update appropriate? If not, what should be added or omitted?

G. Proposed Disclosure about Initial Adoption of Accounting Policies

A company initially adopts an accounting policy when events or transactions that affect the company occur for the first time, when events or transactions that were previously immaterial in their effect become material, or when events or transactions occur that are clearly different in substance from previous events or transactions. For example, a company may for the first time enter into transactions involving derivative instruments, such as interest rate swaps, or may begin selling a new type of product that has delivery terms and conditions that are different from those associated with the products the company has previously been selling.

If an initially adopted accounting policy has a material impact on the company's financial condition, changes in financial condition or results of operations, that impact will likely be of interest to investors, to financial analysts and others. If a company considers an accounting policy that it has initially adopted to be a significant accounting policy, the company would provide certain disclosures about that accounting policy as required by APB No. 22. Those disclosures are typically in the first note to the financial statements.[109] The disclosure provided in the notes to the financial statements, however, may not adequately describe, in a qualitative manner, the impact of the initially adopted accounting policy or policies on the company's financial presentation. We are therefore proposing additional MD&A disclosure to further describe, where a material impact exists, the initial adoption of accounting policies.[110] The proposed MD&A disclosure would be provided in companies' filed annual reports, annual reports to shareholders, registration statements and proxy and information statements and would include description of:

- The events or transactions that gave rise to the initial adoption of an accounting policy;
- The accounting principle that has been adopted and the method of applying that principle; and
- The impact (discussed qualitatively) resulting from the initial adoption of the accounting policy on the company's financial condition, changes in financial condition and results of operations.

If, upon initial adoption of one of those accounting policies, a company is permitted a choice among acceptable accounting principles,[111] the company also would be required to explain in MD&A that it had made a choice among acceptable alternatives, identify the alternatives, and describe why it made the choice that it did. In addition, where material, the company would have to provide a qualitative discussion of the impact on the company's financial condition, changes in financial condition and results of operations that the alternatives would have had. Finally, if no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption of a material accounting policy (*e.g.,* the events or transactions are unusual or novel or otherwise have not been contemplated in past standard-setting projects), the company would be required to explain its decision regarding which accounting principle to use and which method of applying that principle to use.

We seek comment on the proposed disclosures related to initial adoption of accounting policies.

- Would the proposed disclosures about initial adoption of accounting policies provide useful information to investors and other readers of financial reports?
- Are there particular situations involving the initial adoption of a material accounting policy for which we should require additional disclosure? If so, what are those situations and what additional disclosure should we require?
- Should we require companies to disclose, in MD&A or in the financial statements, the estimated effect of adopting accounting policies that they could have adopted, but did not adopt, upon initial accounting for unusual or novel transactions?
- What would be the costs for companies to prepare disclosure about the effects of alternative accounting policies that could have been chosen but were not?
- Would investors be confused if companies presented disclosure of the effects of acceptable alternative policies that were not chosen?

- Should we require in MD&A a discussion of whether the accounting policies followed by a company upon initial adoption differ from the accounting policies applied, in similar circumstances, by other companies in its industry, and the reasons for those differences? Please explain. If such a discussion should be required, please identify the specific disclosures companies should make.
- Would a company know the policies applied in similar circumstances by other companies in its industry? If not, would auditing firms or other financial advisors be able to assist companies in determining whether their accounting policies generally diverge from industry practices?

H. Disclosure Presentation

The proposals would require that a company present the required information in a separate section of MD&A. While the proposed disclosure may relate to other aspects of the discussion in MD&A, such as the results of operations or liquidity and capital resources, we have chosen to separate it both to highlight the discussion and because we believe the proposed discussion would present information that is better communicated separately to promote understanding.

The proposed MD&A discussion must be presented in language, and a format, that is clear, concise and understandable to the average investor.[112] The disclosure should not be presented in such a way that only an investor who is also an accountant or an expert on a particular industry would be able to understand it fully. To reinforce the importance of the disclosure being presented in a manner that investors will understand, we also would specify that the proposed disclosure must not be presented, for example, solely as a single discussion of the aggregate consequences of multiple critical accounting estimates or the aggregate consequences of the initial application of multiple new accounting policies.[113] Because a company may identify and discuss more than one critical accounting estimate or more than one newly adopted accounting policy, and those estimates or those policies could materially affect a company's financial presentation in differing ways, a separate discussion of the application of each estimate and each new accounting policy will facilitate investors' understanding of the implications of each one.

Boilerplate disclosures that do not specifically address the company's particular circumstances and operations also would not satisfy the proposed requirements.[114] Disclosure that could easily be transferred from year to year, or from company to company, with no change would neither inform investors adequately nor reflect the independent thinking that must accompany the periodic assessment by management that is intended under the proposal. Finally, the purpose of the proposed disclosure would be hindered if a company were to include disclosures that consisted principally of blanket disclaimers of legal responsibility for its application of a new accounting policy or its development of its critical accounting estimates in light of the uncertainties associated with them. While the Commission fully expects companies to craft the proposed disclosure responsibly to take advantage of any available safe harbors, simple disclaimers of legal liability would be contrary to the disclosure goals underlying the proposal and would not be permitted.[115]

We solicit comment on the disclosure presentation aspects of the proposals.

- Should the proposed disclosure be presented in a separate section of MD&A or should we require that it be integrated into the other discussions of financial condition, changes in financial condition, results of operations and liquidity and capital resources when the proposed disclosure is closely related to an aspect discussed in those separate sections of MD&A?
- Should other requirements relating to the language and format be added to the requirement for clear, concise and understandable disclosure? If so, what requirements?

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[Appendix A reproduces relevant portions of the rule for this book's discussion only. The complete rule is available on the SEC's Web site at http://www.sec.gov/rules/proposed/33-8098.htm.]

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Endnotes

[1] 17 CFR 229.303.
[2] 17 CFR 229.10 *et seq.*
[3] 17 CFR 228.303.
[4] 17 CFR 228.10 *et seq.*
[5] 17 CFR 249.308b.
[6] 15 U.S.C. §78a *et seq.*
[7] *See* Securities Act Release No. 8040, FR-60 (Dec. 12, 2001) [66 FR 65013]. *See also* Securities Act Release No. 8056, FR-61 (Jan. 22, 2002)[67 FR 3746]. In addition, we recently announced our intention to propose other changes in disclosure rules to improve the financial reporting and disclosure system. *See* SEC Press Release No. 2002-22 (Feb. 13, 2002).
[8] We propose to amend Item 303 of Regulation S-K, and the parallel provisions in Regulation S-B (which applies to small business issuers) and Form 20-F (which applies to foreign private issuers).
[9] The proposals would not alter which documents require presentation of an MD&A. MD&A disclosure is only required in proxy and information statements themselves if action is to be taken with

respect to: (1) the modification of any class of securities of the registrant; (2) the issuance or authorization for issuance of securities of the registrant; or (3) mergers, consolidations, acquisitions and similar matters. *See* Items 11, 12 and 14 of Schedule 14A, 17 CFR 240.14a-101. Investors otherwise receive the MD&A disclosure in the annual report to shareholders that must accompany or precede any proxy or information statement relating to an annual meeting at which directors are to be elected. *See* 17 CFR 240.14a-3.

[10] An accounting estimate is an approximation made by management of a financial statement element, item or account in the financial statements. Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. *See Codification of Statements on Auditing Standards* (including related Auditing Interpretations) (''AU'') §342, *Auditing Accounting Estimates* (''AU §342''), paragraphs 1-3. For purposes of the proposals, an accounting estimate would include one for which a change in the estimate is inseparable from the effect of a change in accounting principle. See Accounting Principles Board (''APB'') Opinion No. 20, *Accounting Changes* (July 1971) (''APB No. 20''), paragraph 11. *See also* proposed Item 303(b)(3)(ii)(A) of Regulation S-B, 17 CFR 228.303(b)(3)(ii)(A); proposed Item 303(c)(2)(i) of Regulation S-K, 17 CFR 229.303(c)(2)(i); and proposed Item 5.E.2.(a) of Form 20-F, 17 CFR 249.220f.

[11] In the MD&A section of quarterly reports, U.S. companies would have to update their critical accounting estimates disclosure to reflect material changes.

[12] The statutory and Commission rule safe harbors for forward-looking statements would be available to companies satisfying their terms and conditions in making forward-looking statements in connection with the proposed critical accounting estimates discussion*See* Securities Act Section 27A, 15 U.S.C. §77z-2, Securities Act Rule 175, 17 CFR 230.175, Exchange Act Section 21E, 15 U.S.C. §78u-5, and Exchange Act Rule 3b-6, 17 CFR 240.3b-6.

[13] A segment for financial reporting purposes is defined by Financial Accounting Standards Board (''FASB'') Statement of Financial Accounting Standards (''SFAS'') No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997) (''SFAS No. 131'').

[14] *See* Item 303 of Regulation S-K, 17 CFR 229.303, Item 303 of Regulation S-B, 17 CFR 228.303 and Item 5 of Form 20-F, referenced in 17 CFR 249.220f. Although the current MD&A disclosure requirements were adopted starting in 1980, earlier versions date back to 1968.*See* Securities Act Release Nos. 6231 (Sept. 2, 1980) [45 FR 63630] and 4936 (Dec. 9, 1968) [33 FR 18617]. *See also* Securities Act Release No. 5520 (Aug. 14, 1974) [39 FR 31894].

[15] *See* Securities Act Release No. 6711 (Apr. 23, 1987) [52 FR 13715], Section II.

[16] In assessing whether disclosure of a trend, event, etc. is required, management must consider both whether it is reasonably likely to occur and whether a material effect is reasonably likely to occur. As the Commission noted when it adopted the requirement, the ''reasonably likely to occur'' test is to be used rather than the *Basic v. Levinson* probability and magnitude test for materiality of contingent events. *See* Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427] at fns. 27-28 and accompanying text.

[17] Securities Act Release No. 8056; FR-61 (Jan. 22, 2002) [67 FR 3746].

[18] *See* American Institute of Certified Public Accountants (''AICPA'') Statement of Position (''SOP'') No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (Dec. 1994), (''SOP 94-6''), paragraph B-20; *See also* AU §380, *Communication with Audit Committees*(''AU §380'') and AU §508, *Reports on Audited Financial Statements* (Apr. 1998).

[19] *See* APB No. 20, paragraph 10.

[20] *See* APB No. 20, paragraph 33.

[21] *See* SOP 94-6, particularly paragraphs 11-19.

[22] *See* FASB SFAS No. 5, *Accounting for Contingencies*(Mar. 1975) (''SFAS No. 5''), paragraph 1, which defines a contingency as ''an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.''

[23] The term ''reasonably possible'' as used in SOP 94-6 is consistent with its use in SFAS No. 5. *See* SOP 94-6, fn. 7. SFAS No. 5 states that ''reasonably possible'' means the chance of a future

transaction or event occurring is more than remote but less than likely. Reasonably possible events are less likely to occur than probable events.

[24] SOP 94-6, paragraph 17, notes: ''Whether the estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.''

[25] *See* SOP 94-6, paragraph 14.

[26] *See* SFAS No. 5, paragraph 8. An estimated loss should be accrued when *both* it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Also, when it is probable that an asset has been impaired or a liability has been incurred and the reasonable estimate of the loss is a range, the company is required to accrue an amount for the loss. *See* FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (Sept. 1976), paragraph 3.

[27] *See* SFAS No. 5, paragraph 2.

[28] *See* APB Opinion No. 22, *Disclosure of Accounting Policies* (Apr. 1972) (''APB No. 22'').

[29] *See* APB No. 22, paragraphs 6-7. APB No. 22 defines accounting policies of a reporting entity as ''the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, results of operations, and cash flows in accordance with generally accepted accounting principles. . . .'' APB No. 22, paragraph 6, as amended.

[30] *See* APB No. 22, paragraph 12.

[31] *Id.*

[32] In addition to the examples cited in the paragraph, see the disclosure requirements in FASB SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (Dec. 1991); FASB SFAS No. 123, *Accounting for Stock-Based Compensation* (Oct. 1995) (''SFAS No. 123''); and FASB SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (Aug. 2001) (''SFAS No. 144'').

[33] *See* FASB SFAS No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (Feb. 1998).

[34] *See* FASB SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (a replacement of FASB Statement No. 125) (Sept. 2000).

[35] *See* Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953), Chapter 2, ''Form of Statements,'' Section A, ''Comparative Financial Statements,'' paragraph 3, and paragraph 2 (''the well recognized principle that any change in practice which affects comparability should be disclosed'').

[36] *See* APB No. 22, paragraph 12.

[37] *See* APB No. 20, paragraph 6.

[38] *See* APB No. 20, paragraph 8.

[39] *See* Securities Act Release No. 7793 (Jan. 21, 2000) [65 FR 4585] (suggesting that additions to financial disclosure outside the financial statements could help address concerns relating to lack of transparency in some aspects of financial reporting within the financial statements).

[40] These could include estimates made on a one-time basis, on a few occasions, or on a recurring basis.

[41] When a company has selected an accounting policy from acceptable alternatives, it is required under GAAP to make certain disclosures about that accounting policy. See APB No. 22, paragraph 12. *See supra* fns. 28-31 and accompanying text. U.S. GAAP provides only a limited number of situations in which more than one method of accounting would be considered acceptable. Over the years, the combined efforts of accounting standard setters, the accounting profession, public and non-public companies, and regulatory agencies have significantly reduced the number of acceptable alternatives in U.S. GAAP. *See* APB No. 22, paragraph 5. Areas remaining in U.S. GAAP in which there are acceptable alternatives include inventory pricing and depreciation methods. *See* APB No. 20, paragraph 9. *See also* SFAS No. 123 (providing a choice of accounting methods for an employee stock option or similar equity instrument).

[42] *See* APB No. 20, paragraph 16.
[43] *See* Accounting Series Release No. 177 (Sept. 10, 1975) [40 FR 46107], as codified in the Codification of Financial Reporting Policies §304.02, *Preferability Letters,* Fed. Sec. L. Rep. (CCH) ¶73,096. *See also* Item 601(b)(18) of Regulations S-K and S-B, 17 CFR 229.601(b)(18) and 17 CFR 228.601(b)(18). A preferability letter generally is not required when a company adopts a new accounting policy as a result of implementing a new accounting pronouncement or rule issued by the FASB, AICPA or SEC.
[44] *See* APB No. 20, paragraphs 17-30.
[45] *Id.*
[46] *See* AU §380, paragraphs 7 and 8.
[47] *See, e.g.,* Securities Act Release No. 8040, FR-60 (Dec. 12, 2001) [66 FR 65013].
[48] *See* SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (July 1981).
[49] In addition to the information specifically required, a company would be required to provide any other information necessary to keep its disclosure from being materially misleading. *See* Securities Act Rule 408, 17 CFR 230.408, and Exchange Act Rule 12b-20, 17 CFR 240.12b-20.
[50] If those changes could have a material effect on the company's liquidity or capital resources, then the company also would have to explain that effect.
[51] As described below, we would phase in the three-year period and use two years for small business issuers.
[52] The proposed rules would apply equally to business development companies. Business development companies are defined in Section 2(a)(48) of the Investment Company Act of 1940. *See* 15 USC §80a-2(a)(48). Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act, but file Forms 10-K and 10-Q, and also include MD&A in their annual reports to shareholders.
[53] Other examples of accounting estimates include: property and casualty insurance loss reserves, current obligations that will be fulfilled over several years, future returns of products sold, the amount of cash flows expected to be generated by a specific group of assets, revenues from contracts accounted for by the percentage of completion method and pension and warranty expenses. *See* AU §342, paragraph 2. For a more detailed list, *see* the Appendix to AU §342.
[54] ''Critical accounting estimate'' is defined in proposed Item 303(b)(3)(ii)(B) of Regulation S-B, 17 CFR 228.303(b)(3)(ii)(B); proposed Item 303(c)(2)(ii) of Regulation S-K, 17 CFR 229.303(c)(2)(ii); and proposed Item 5.E.2.(b) of Form 20-F, 17 CFR 249.220f.
[55] *See* proposed Instruction 3 to paragraph (b)(3) of Item 303 of Regulation S-B, 17 CFR 228.303(b)(3); proposed Instruction 4 to paragraph (c) of Item 303 of Regulation S-K, 17 CFR 229.303(c); and proposed Instruction 3 to Item 5.E of Form 20-F, 17 CFR 249.220f.
[56] *See* proposed Item 303(b)(3)(iii)(A) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(A); proposed Item 303(c)(3)(i) of Regulation S-K, 17 CFR 229.303(c)(3)(i); and proposed Item 5.E.3.(a) of Form 20-F, 17 CFR 249.220f.
[57] *See also* Securities Act Release No. 8056, FR-61 (Jan. 22, 2002)[67 FR 3746], Section II.B. (providing an example of a critical accounting estimate related to non-exchange traded contracts accounted for at fair value).
[58] *See supra* fn. 16.
[59] *See* proposed Item 303(b)(3)(iii)(B) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(B); proposed Item 303(c)(3)(ii) of Regulation S-K, 17 CFR 229.303(c)(3)(ii); and proposed Item 5.E.3.(b) of Form 20-F, 17 CFR 249.220f.
[60] For example, an estimate of fair value used to measure an impairment loss on a long-lived asset may not itself appear as a line item in the financial statements.
[61] *See* proposed Item 303(b)(3)(iii)(C) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(C); proposed Item 303(c)(3)(iii) of Regulation S-K, 17 CFR 229.303(c)(3)(iii); and proposed Item 5.E.3.(c) of Form 20-F, 17 CFR 249.220f.
[62] ''Reasonably possible'' would have the same meaning as defined in SFAS No. 5. *See supra* fn. 23. *See also* proposed Item 303(b)(3)(ii)(D) of Regulation S-B, 17 CFR 228.303(b)(3)(ii)(D); proposed Item 303(c)(2)(iv) of Regulation S-K, 17 CFR 229.303(c)(2)(iv); and proposed Item 5.E.2.(d) of Form 20-F, 17 CFR 249.220f.

[63] ''Near-term'' would have the same meaning as defined in SOP 94-6 at paragraph 7. *See* proposed Item 303(b)(3)(ii)(C) of Regulation S-B, 17 CFR 228.303(b)(3)(ii)(C); proposed Item 303(c)(2)(iii) of Regulation S-K, 17 CFR 229.303(c)(2)(iii); and proposed Item 5.E.2.(c) of Form 20-F, 17 CFR 249.220f.
[64] For example, companies would be required to select meaningful changes in material assumptions and not ones so minute as to avoid, or materially understate, any demonstration for investors of sensitivity. *See* proposed Instruction 1 to paragraph (b)(3) of Item 303 of Regulation S-B, 17 CFR 228.303(b)(3); proposed Instruction 1 to paragraph (c) of Item 303 of Regulation S-K, 17 CFR 229.303(c); and proposed Instruction 1 to Item 5.E of Form 20-F, 17 CFR 249.220f.
[65] Where use of only one positive change, or use of only one negative change, would render the analysis materially misleading, companies would have to include more than one assumed positive change, or more than one assumed negative change, to avoid that result.
[66] In completing the analysis, companies would have to consider whether assumed events that alter the most material assumption also could have some impact on other assumptions made in formulating the critical accounting estimate. For example, if a company were to assume a reasonably possible near-term change in fuel prices occurred, that change may impact multiple assumptions underlying a critical accounting estimate that each take fuel prices into account. Companies would have to determine whether and how their other assumptions would change and disclose the aggregate effect of all of those changes.
[67] For an example of when this could take place, *see infra* Example 3 in Section III.D.
[68] *See, e.g.,* Item 303(a)(1)-(2) of Regulation S-K, 17 CFR 229.303(a)(1)-(2).
[69] *See, e.g.,* Item 303(a) of Regulation S-K, 17 CFR 229.303(a).
[70] *See, e.g.,* Item 303(a)(3)(i) of Regulation S-K, 17 CFR 229.303(a)(3)(i).
[71] *See, e.g.,* Item 303(a)(3)(ii) of Regulation S-K, 17 CFR 229.303(a)(3)(ii).
[72] *See, e.g.,* Instruction 3(A) to Item 303(a) of Regulation S-K, 17 CFR 229.303(a).
[73] *See, e.g.,* Instruction 3(B) to Item 303(a) of Regulation S-K, 17 CFR 229.303(a).
[74] *See* proposed Item 303(c)(3)(iv) of Regulation S-K, 17 CFR 229.303(c)(3)(iv), and proposed Item 5.E.3.(d) of Form 20-F, 17 CFR 249.220f. As part of its disclosure, a company would have to include discussion of assumptions that changed materially from a prior period but did not cause the estimate itself to change by a material amount. For example, a company could change two or more material assumptions underlying an accounting estimate, but the changes in the assumptions could have an offsetting impact, resulting in no material change to the amount of the accounting estimate recorded in the financial statements.
[75] *See* proposed Item 303(b)(3)(iii)(D) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(D). These periods correspond to the time frame currently encompassed by the MD&A requirements applicable to each of those types of companies.
[76] *Compare* APB No. 20, paragraph 33, which requires financial statement disclosure of the effect on income before extraordinary items, net income, and related per share amounts of the current period for a change in an estimate not made in the ordinary course of accounting that materially affects several future periods.
[77] Of course, the phase-in of the specific MD&A disclosure about changes in estimates would not delay the effect of the rest of the proposed changes or affect the requirements for disclosure under current MD&A rules.
[78] *See* Exchange Act Release No. 42266 (Dec. 22, 1999) [64 FR 73389] and Item 306 of Regulation S-K, 17 CFR 229.306.
[79] *See* Item 306(a)(2) of Regulation S-K, 17 CFR 229.306(a)(2), SAS No. 61, *Communication with Audit Committees* (Apr. 1988) (''SAS 61'') and SAS No. 90, *Audit Committee Communications* (Dec. 1999) (''SAS 90'') (amending SAS 61 and AU §380).
[80] SAS 61, paragraph 8.
[81] *See* AU §380, paragraph 11 (added by SAS 90).
[82] *See* Item 306(a)(1) of Regulation S-K, 17 CFR 229.306(a)(1).
[83] *See* Item 306(a)(4) of Regulation S-K, 17 CFR 229.306(a)(4).
[84] *See* Securities Act Release No. 8040, FR-60 (Dec. 12, 2001) [66 FR 65013].
[85] *See* proposed Item 303(b)(3)(iii)(E) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(E); proposed Item 303(c)(3)(v) of Regulation S-K, 17 CFR 229.303(c)(3)(v); and proposed Item 5.E.3.(e) of Form 20-F, 17 CFR 249.220f.

[86] The proposed MD&A disclosure is distinguishable from the audit committee report in annual proxy or information statements. Under the proxy requirements, the audit committee must prepare a report and state whether it recommended, based on its review and discussions with management and the auditors, that the financial statements be included in the Form 10-K. In our proposals, we would not require an audit committee report or recommendation, but only that the company state whether or not discussions between the audit committee and senior management occurred and, if they did not, why not. We therefore are not convinced that a liability exemption like that applicable to the audit committee report is necessary for disclosure in MD&A of whether or not a company's senior management has discussed the development and selection of critical accounting estimates, and the disclosure in MD&A regarding them.

[87] If the registrant is not a corporation, the disclosure would address senior management's discussions with the equivalent group responsible for the oversight of the financial reporting process.

[88] This disclosure would be required in annual reports filed with the Commission, annual reports to shareholders, registration statements and proxy and information statements. When a new critical accounting estimate is identified in a quarterly report, there also would be disclosure in the Form 10-Q or Form 10-QSB regarding whether the development, selection and disclosure regarding the estimate was discussed by management with the audit committee of the board of directors.

[89] *See* Item 303(a) of Regulation S-K, 17 CFR 229.303(a).

[90] *See* Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427].

[91] *See* proposed Item 303(b)(3)(iii)(F) of Regulation S-B, 17 CFR 228.303(b)(3)(iii)(F); proposed Item 303(c)(3)(vi) of Regulation S-K, 17 CFR 229.303(c)(3)(vi); and proposed Item 5.E.3.(f) of Form 20-F, 17 CFR 249.220f.

[92] *See* SFAS No. 131 for requirements as to presentation of segment disclosure in the financial statements.

[93] Certain foreign private issuers providing disclosure under Item 17 of Form 20-F are not required to provide segment disclosure in their filed financial statements and therefore would not be required to provide a quantitative discussion of the identified segments.

[94] Any discussion on a segment basis would appear in the section of MD&A devoted to critical accounting estimates, and not in the separate discussion of segment results in MD&A.

[95] *See* Securities Act Release No. 8056, FR-61 (Jan. 22, 2002)[67 FR 3746], Section II.B.

[96] SFAS No. 144 superseded SFAS No. 121 and is effective for financial statements issued for fiscal years beginning after December 15, 2001.

[97] *See* AU §342, paragraph 4. In evaluating the reasonableness, the auditor's objective is ''to obtain sufficient competent evidential matter to provide a reasonable assurance that—

a. All accounting estimates that could be material to the financial statements have been developed.
b. Those accounting estimates are reasonable in the circumstances.
c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.''

AU §342, paragraph 7. The auditor normally focuses on key factors and assumptions that are significant to the accounting estimate, that are sensitive to variations, that are deviations from historical patterns or that are subjective and susceptible to misstatement and bias*See* AU §342, paragraph 9.

[98] *See* AU §550, *Other Information in Documents Containing Audited Financial Statements*(''AU §550'').

[99] *See* Codification of Statements on Standards for Attestation Engagements (''AT'') §101,*Attest Engagements* and AT §701, *Management's Discussion and Analysis.*

[100] AT §701 contemplates two levels of service by an auditor with respect to MD&A: an ''examination'' of an MD&A presentation and a more limited ''review'' of an MD&A presentation. Unlike an examination, a review culminates with the auditor giving negative assurance. The auditor's review report states whether any information came to the auditor's attention to cause him or her to believe that: the MD&A presentation taken as a whole does not include in all material respects the required elements of the disclosure; the historical financial amounts have not been accurately derived, in

all material respects, from the company's financial statements; or the underlying information, determinations, estimates and assumptions of the company do not provide a reasonable basis for the disclosures contained in the MD&A. In undertaking a review, an auditor is expected to apply analytical procedures and make inquiries of people at the company who are responsible for financial, accounting and operational matters, but is not expected to test accounting records through inspection or observation, obtain corroborating evidence in response to inquiries, or take other steps required during an MD&A examination. An auditor's review report is not intended to be filed with the Commission. *See* AT §701, paragraph 2.

[101] *See* AT §701, paragraph 5.

[102] *See* AT §701, paragraphs 28-29.

[103] *See* AT §701, paragraph 6.

[104] Goldman Sachs engaged an auditor to review its MD&A disclosure in connection with its initial public offering. See Form S-1, Commission File No. 333-74449. In addition, in the course of reading agreements between issuers and their underwriters created in connection with registered offerings, the staff has noted that approximately 50 companies have agreed to engage an auditor to conduct an examination of the company's MD&A disclosure as a condition to closing.

[105] In 1998, we issued a cease-and-desist order in a settlement with Sony Corporation that required Sony to engage an independent auditor to examine its MD&A disclosure for the fiscal year ending March 31, 1999. *See SEC v. Sony Corporation,* Litigation Release No. 15832 (Aug. 5, 1998).

[106] *See supra* fn. 100.

[107] The procedures performed by an independent accountant to issue a review report on the financial statements filed in a Form 10-Q generally would include reading information such as that found in the MD&A section of the Form 10-Q. Further, the independent accountant's association with those financial statements would require the independent accountant to read the MD&A. *See* AU §722, *Interim Financial Information,* paragraph 35 and AU §550, paragraph 4.

[108] *See* proposed Item 303(b)(3)(v) of Regulation S-B, 17 CFR 228.303(b)(3)(v), and proposed Item 303(c)(5) of Regulation S-K, 17 CFR 229.303(c)(5). To assist companies in preparing quarterly updates, we would allow them to presume that investors have read, or have access to, the discussion of critical accounting estimates in their previously filed Exchange Act annual reports and any quarterly reports filed subsequent to the most recent annual report.

[109] *See* APB No. 22, paragraphs 12 and 15.

[110] *See* proposed Item 303(b)(3)(iv) of Regulation S-B, 17 CFR 228.303(b)(3)(iv); proposed Item 303(c)(4) of Regulation S-K, 17 CFR 229.303(c)(4); and proposed Item 5.E.4. of Form 20-F, 17 CFR 249.220f. These proposed disclosures would not be required if the initial adoption of an accounting policy solely results from adoption of new accounting literature issued by a recognized accounting standard setter (including, in the U.S., new accounting pronouncements or rules issued by the FASB, AICPA or SEC or a new consensus of the Emerging Issues Task Force (EITF)).

[111] *See supra* fn. 31 and accompanying text.

[112] *See* proposed Instruction 3 to paragraph (b)(3) of Item 303 of Regulation S-B, 17 CFR 228.303(b)(3); proposed Instruction 4 to paragraph (c) of Item 303 of Regulation S-K, 17 CFR 229.303(c); and proposed Instruction 3 to Item 5.E. of Form 20-F, 17 CFR 249.220f.

[113] *Id.*

[114] *Id.*

[115] *Id.*

APPENDIX B

SEC STAFF ACCOUNTING BULLETIN NO. 99—MATERIALITY*

[**Author's Note:** *For some time, the staff of the Securities and Exchange Commission studied and analyzed the relative merits of quantitative versus qualitative materiality. In August of 1999, the staff issued* SAB No. 99—''Materiality'' *coming down solidly on the side of qualitative materiality as the standard accountants should apply. The staff rejected exclusive reliance on quantitative measures to determine if an item was material. This appendix reproduces SAB No. 99 as originally issued. For the latest updates, readers should refer to the SEC's Codification of Staff Accounting Bullentins, Topic 1:* Financial Statements*, Section M. Materiality, found at* www.sec.gov/interps/account/sabcodet1.htm#1m]

SEC Staff Accounting Bulletin: No. 99—Materiality

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 211
[Release No. SAB 99]
Staff Accounting Bulletin No. 99

Agency: Securities and Exchange Commission

Action: Publication of Staff Accounting Bulletin

Summary: This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.

*Source: SAB No. 99 is available at http://www.sec.gov/rules/acctrps/sab99.htm.

Date: August 12, 1999

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Supplementary Information: The statements in the staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz

Secretary

Date: August 12, 1999

Part 211–(AMEND) Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 99 to the table found in Subpart B.

Staff Accounting Bulletin No. 99

The staff hereby adds Section M to Topic 1 of the Staff Accounting Bulletin Series. Section M, entitled ''Materiality,'' provides guidance in applying materiality thresholds to the preparation of financial statements filed with the Commission and the performance of audits of those financial statements.

Staff Accounting Bulletins

Topic 1: Financial Statements

* * * * *

M. Materiality

1. Assessing Materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from generally accepted accounting principles (''GAAP'') is immaterial and that the accounting is permissible.[1]

Question: Each Statement of Financial Accounting Standards adopted by the Financial Accounting Standards Board (''FASB'') states, ''The provisions of this Statement need not be applied to immaterial items.'' In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as ''rules of thumb'' to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[2] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a ''rule of thumb'' as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is ''material'' if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[3]

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is—

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ''total mix'' of information made available.[4]

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the ''surrounding circumstances,'' as the accounting literature puts it, or the ''total mix'' of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the ''total mix'' includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both ''quantitative'' and ''qualitative'' factors in assessing an item's materiality.[5] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature[6] have all considered ''qualitative'' factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement No. 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a ''minority view,'' stating—

The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.[7]

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures.[8] And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a ''rule of thumb'' of five to ten percent of net income.[9] The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.[10]

The FASB rejected a formulaic approach to discharging ''the onerous duty of making materiality decisions''[11] in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that—

[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.[12]

Evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.[13]

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are—

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate[14]
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation

- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement.[15] Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself ''too blunt an instrument to be depended on'' in considering whether a fact is material.[16] When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.[17]

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to ''manage'' earnings, are immaterial.[18] While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to ''manage'' reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.[19] The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to ''manage'' earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole.[20] ''A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity''[21] is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information—as with materiality generally—situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.[22]

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements.[23] A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and ''consider whether, in relation to individual line item amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.''[24] This requires consideration of the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole. . . .[25]

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of ''individual amounts'' causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.[26]

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.[27]

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements That are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings ''management'' has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions Under the Exchange Act

Even if misstatements are immaterial,[28] registrants must comply with Sections 13(b)(2)-(7) of the Securities Exchange Act of 1934 (the ''Exchange Act'').[29] Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act,[30] or required to file reports pursuant to Section 15(d),[31] must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.[32] In this context, determinations of what constitutes ''reasonable assurance'' and ''reasonable detail'' are based not on a ''materiality'' analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.[33] Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance[34] regarding the ''reasonableness'' standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams.[35] In his address, Chairman Williams noted that, like materiality, ''reasonableness'' is not an ''absolute standard of exactitude for corporate records.''[36] Unlike materiality, however, ''reasonableness'' is not solely a measure of the significance of a financial statement item to investors. ''Reasonableness,'' in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2)-(7) of the Exchange Act.[37]

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate ''in reasonable detail,'' registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- **The significance of the misstatement.** Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is ''reasonable'' to treat misstatements whose effects are clearly inconsequential differently than more significant ones.
- **How the misstatement arose.** It is unlikely that it is ever ''reasonable'' for registrants to record misstatements or not to correct known misstate-

ments—even immaterial ones—as part of an ongoing effort directed by or known to senior management for the purposes of ''managing'' earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate ''in reasonable detail.''[38]

- **The cost of correcting the misstatement.** The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.[39] Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be ''reasonable.''
- **The clarity of authoritative accounting guidance with respect to the misstatement.** Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate ''in reasonable detail.'' Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of ''reasonableness'' that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that ''allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way.''[40]

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an ''illegal act.''[41] The statute specifies that these obligations are triggered ''whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer. . . .'' Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is ''adequately informed'' with respect to the illegal act.

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is ''adequately informed'' about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any ''netting'' of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, Statement on Auditing Standards No. (''SAS'') 54, ''Illegal Acts by Clients,'' and SAS 82, ''Consideration of Fraud in a Financial Statement Audit.'' Pursuant to paragraph 38 of SAS 82, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS 82 states that ''misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users.''[42] SAS 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements.[43] The clear implication of SAS 82 is that immaterial misstatements may be fraudulent financial reporting.[44]

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.[45]

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.[46] As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

The tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.[47]

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.[48]

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.[49]

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.[50] This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

Footnotes

[1] American Institute of Certified Public Accountants (''AICPA''), Codification of Statements on Auditing Standards (''AU'') §312, ''Audit Risk and Materiality in Conducting an Audit,'' states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with generally accepted accounting principles. The purpose of this Staff Accounting Bulletin (''SAB'') is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (i.e., (b) above). This SAB is not intended to provide definitive guidance for assessing ''materiality'' in other contexts, such as evaluations of auditor independence, as other factors may apply. There may be other rules that address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

[2] As used in this SAB, ''misstatement'' or ''omission'' refers to a financial statement assertion that would not be in conformity with GAAP.
[3] FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information (''Concepts Statement No. 2''), 132 (1980). See also Concepts Statement No. 2, Glossary of Terms—Materiality.
[4] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require ''delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . .'' TSC Industries, 426 U.S. at 450.
[5] See, e.g., Concepts Statement No. 2, 123–124; AU §312.10 (''. . . materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.''); AU §312.34 (''Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.''). As used in the accounting literature and in this SAB, ''qualitative'' materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.
[6] See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU §§312.10 - .11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release No. (''AAER'') 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).
[7] Concepts Statement No. 2, 131 (1980).
[8] Concepts Statement No. 2, 131 and 166.
[9] Concepts Statement No. 2, 167.
[10] Concepts Statement No. 2, 168–69.
[11] Concepts Statement No. 2, 170.
[12] Concepts Statement No. 2, 125.
[13] AU §312.11.
[14] As stated in Concepts Statement No. 2, 130: Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second. This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion No. 20, Accounting Changes 10, 11, 31–33 (July 1971).
[15] The staff understands that the Big Five Audit Materiality Task Force (''Task Force'') was convened in March of 1998 and has made recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about unadjusted misstatements. See generally Big Five Audit Materiality Task Force, ''Materiality in a Financial Statement Audit—Considering Qualitative Factors When Evaluating Audit Findings'' (August 1998). The Task Force memorandum is available at www.aicpa.org.
[16] See Concepts Statement No. 2, 169.
[17] If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.
[18] Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 38 and 50 infra.
[19] Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

[20] See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).
[21] AUI §326.33.
[22] Id.
[23] The auditing literature notes that the ''concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles.'' AU §312.03. See also AU §312.04.
[24] AU §312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.
[25] AU §508.36.
[26] AU §312.34.
[27] AU §380.09.
[28] FASB Statements of Financial Accounting Standards (''Standards'' or ''Statements'') generally provide that ''[t]he provisions of this Statement need not be applied to immaterial items.'' This SAB is consistent with that provision of the Statements. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.
[29] 15 U.S.C. §§78m(b)(2)-(7).
[30] 15 U.S.C. §78l.
[31] 15 U.S.C. §78o(d).
[32] Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. §§78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, ''No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.''
[33] 15 U.S.C. §78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act (''FCPA''). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated,
The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.
Cong. Rec. H2116 (daily ed. April 20, 1988).
[34] So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., Lamb v. Phillip Morris Inc., 915 F.2d 1024 (6th Cir. 1990) and JS Service Center Corporation v. General Electric Technical Services Company, 937 F. Supp. 216 (S.D.N.Y. 1996).
[35] The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).
[36] Id. at 46 FR 11546.
[37] Id.
[38] For example, the conference report regarding the 1988 amendments to the FCPA stated,
The Conferees intend to codify current Securities and Exchange Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that

criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement.

Cong. Rec. H2115 (daily ed. April 20, 1988).

[39] As Chairman Williams noted with respect to the internal control provisions of the FCPA, ''[t]housands of dollars ordinarily should not be spent conserving hundreds.'' 46 FR 11546.

[40] Id., at 11547.

[41] Section 10A(f) defines, for purposes of Section 10A, an ''illegal act'' as ''an act or omission that violates any law, or any rule or regulation having the force of law.'' This is broader than the definition of an ''illegal act'' in AU §317.02, which states, ''Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.''

[42] AU §316.04. See also AU §316.03. An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AU §§110 n. 1, 316 n. 1, 317.05 and 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case. See AU §316 note 3.

[43] AU §316.04. Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 82 requires the auditor to evaluate several fraud ''risk factors'' that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 82 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties. See AU §§316.17a and .17c.

[44] AU §§316.34 and 316.35, in requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, make clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be ''inconsequential'' and still involve fraud.

Under SAS 82, assessing whether misstatements due to fraud are material to the financial statements is a ''cumulative process'' that should occur both during and at the completion of the audit. SAS 82 further states that this accumulation is primarily a ''qualitative matter'' based on the auditor's judgment. AU §316.33. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

[45] AU §§316.34 and 316.36. Auditors should document their determinations in accordance with AU §§316.37, 319.57, 339, and other appropriate sections.

[46] See, e.g., AU §316.39.

[47] Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

[48] AU §325.02. See also AU §380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states,

The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements. . . .

[49] See AU §411.05.

[50] The FASB Discussion Memorandum, Criteria for Determining Materiality, states that the financial accounting and reporting process considers that ''a great deal of the time might be spent during

the accounting process considering insignificant matters . . . . If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial.'' This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

APPENDIX C

SEC Staff Accounting Bulletin No. 104—Revenue Recognition

[**Author's Note**: *After promulgating the bulletin on materiality (No. 99), the staff of the Securities and Exchange Commission issued bulletin No. 101 on another important issue, revenue recognition, in December 1999. After publishing the initial bulletin, though, companies that filed with the SEC asked for more time to examine the impact of this bulletin on their revenue recognition policies and procedures, and the staff granted two extensions with the issuance of bulletins Nos. 101A and 101B. For the latest updates, readers should refer to the SEC's Codification of Staff Accounting Bulletins, Topic 13:* Revenue Recognition*, found at* http://www.sec.gov/interps/account/sabcodet13.htm.]

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 104]

Staff Accounting Bulletin No. 104

AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: This staff accounting bulletin revises or rescinds portions of the interpretative guidance included in Topic 13 of the codification of staff accounting bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The principal revisions relate to the rescission of material no longer necessary because of private sector developments in U.S. generally accepted accounting principles.

This staff accounting bulletin also rescinds the Revenue Recognition in Financial Statements Frequently Asked Questions and Answers document issued in conjunction with Topic 13. Selected portions of that document have been incorporated into Topic 13.

DATE: December 17, 2003

FOR FURTHER INFORMATION CONTACT: Chad Kokenge or Shelly Luisi in the Office of the Chief Accountant (202) 942-4400, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1103.

SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Margaret H. McFarland

Deputy Secretary

Date: December 17, 2003

Part 211 – (AMEND)

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 104 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 104

[<u>Note</u>: The text of SAB 104 will not appear in the Code of Federal Regulations.]

The staff hereby revises Topic 13 of the Staff Accounting Bulletin Series as follows:

1. Topic 13.A.1 is modified as follows:

    a. The examples of existing literature referenced in the first paragraph are deleted.

    b. The last paragraph, including footnote 7, is added to make reference to EITF Issue 00-21, "*<u>Revenue Arrangements with Multiple Deliverables</u>*," which governs how to determine if revenue arrangements contain more than one unit of accounting.

2. Topic 13.A.2 is modified as follows:

    a. Question 3 (formerly Question 1 of the staff's Revenue Recognition in Financial Statements Frequently Asked Questions and Answers document (FAQ)) is added.

3. Topic 13.A.3 is modified as follows:

    a. The subheading <u>Bill and hold arrangements</u> is added.

    b. Topic 13.A.3(a) Question is formerly Question 3.

    c. The subheading <u>Customer acceptance</u> is added.

    d. Topic 13.A.3(b) Question 1 (formerly Question 5 of the FAQ) is added. The question format is conformed.

e. Topic 13.A.3(b) Question 2 (formerly Question 6 of the FAQ) is added. The facts, question and interpretive response are modified to reflect the evaluation of the arrangement in the context of separate units of accounting. In addition, the last paragraph of the interpretive response is deleted due to the issuance of EITF Issue 00-21.

f. Footnote 29 is added to highlight that the changes to Topic 13.A.3(b) Question 2 are to facilitate an analysis of revenue recognition, not interpret EITF Issue 00-21.

g. Topic 13.A.3(b) Question 3 (formerly Exhibit A Example 1 Scenario A of the FAQ) is added.

h. Topic 13.A.3(b) Question 4 (formerly Exhibit A Example 1 Scenario B of the FAQ) is added.

i. Topic 13.A.3(b) Question 5 (formerly Exhibit A Example 1 Scenario C of the FAQ) is added.

j. The subheading <u>Inconsequential or perfunctory performance obligations</u> is added.

k. Topic 13.A.3(c) Question 1 (formerly Question 2 of the FAQ) is added. The question and interpretive response are modified from the FAQ to reflect the evaluation of the arrangement in the context of a single unit of accounting. The question format is conformed.

l. Topic 13.A.3(c) Question 2 (formerly Question 3 of the FAQ) is added. The question and interpretive response are modified from the FAQ to reflect the evaluation in the context of a single unit of accounting.

m. Topic 13.A.3(c) Question 3 (formerly Question 7 of the FAQ) is added. The facts, question and interpretive response are modified to reflect the evaluation of the arrangement in the context of combined deliverables, which result in a single unit of accounting. In addition, the interpretive response is modified to delete the last four sentences as this guidance is no longer necessary due to the issuance of EITF 00-21.

n. The segue sentence and related footnote discussing delivery or performance of multiple deliverables is deleted to eliminate redundancy.

o. The subheading License fee revenue is added.

p. Topic 13.A.3(d) Question (formerly Question 9 of the FAQ) is added. The interpretive response is modified to eliminate redundancy.

q. The subheading Layaway sales arrangements is added.

r. Topic 13.A.3(e) Question is formerly Question 4.

s. The subheading Nonrefundable up-front fees is added.

t. The examples in Topic 13.A.3(f) Question 1 (formerly Question 5) are modified to include the examples from what was formerly Question 10 of the FAQ. Guidance in the interpretive response is added and conformed from Question 10 of the FAQ which clarifies the incurrence of substantive costs does not necessarily indicate there is a separate earnings event, and that the determination of a separate earnings event should be evaluated on a case-by-case basis.

u. Footnote 36 is added to clarify the staff's view regarding the vendor activities associated with up-front fees.

v. Topic 13.A.3(f) Question 2 (formerly Question 6) is modified to reflect the evaluation in the context of a single unit of accounting.

w. Footnote 29 is deleted. The subject matter of footnote 29 is conformed and included in Topic 13.A.3(f) Question 3; accordingly, Topic 13.A.3(f) Question 3 reflects the guidance formerly located in footnote 29.

x. Topic 13.A.3(f) Question 4 (formerly Question 15 of the FAQ) is added. The question format is conformed.

y. Topic 13.A.3(f) Question 5 (formerly Question 16 of the FAQ) is added. The question format is conformed.

z. The subheading Deliverables within an arrangement is added.

aa. Topic 13.A.3(g) Question (formerly Question 8 of the FAQ) is added and is modified to reflect the evaluation of the question under EITF Issue 00-21.

bb. Footnote 45 is added to clarify the staff's view of the obligation described in Topic 13.A.3(g) Question under FIN 45.

4. Topic 13.A.4 is modified as follows:

a. The subheading <u>Refundable fees for services</u> is added.

b. Topic 13.A.4(a) Question 1 is formerly Question 7.

c. Footnote 56 is added to include guidance from Question 23 of the FAQ.

d. Topic 13.A.4(a) Question 2 (formerly Question 18 of the FAQ) is added.

e. Topic 13.A.4(a) Question 3 (formerly Question 19 of the FAQ) is added. The question format is conformed.

f. Topic 13.A.4(a) Question 4 (formerly Question 20 of the FAQ) is added.

g. Topic 13.A.4(a) Question 5 (formerly Question 21 of the FAQ) is added. The question format is conformed.

h. Topic 13.A.4(a) Question 6 (formerly Question 22 of the FAQ) is added.

i. The subheading Estimates and changes in estimates is added.

j. Topic 13.A.4(b) Question 1 is formerly Question 9.

k. Topic 13.A.4(b) Question 2 (formerly Question 24 of the FAQ) is added.

l. Topic 13.A.4(b) Question 3 (formerly Question 25 of the FAQ) is added. The question format is conformed. The last two sentences of the interpretive response are deleted to eliminate redundancy.

m. Topic 13.A.4(b) Question 4 (formerly Question 26 of the FAQ) is added.

n. Topic 13.A.4(b) Question 5 (formerly Question 27 of the FAQ) is added.

o. The subheading <u>Contingent rental income</u> is added.

p. Topic 13.A.4(c) Question is formerly Question 8.

q. The subheading Claims processing and billing services is added.

r. Topic 13.A.4(d) Question (formerly Question 28 of the FAQ) is added. The facts are modified to reflect to evaluation in the context of a single unit of accounting.

5. Topic 13.A.5 is deleted. This topic provided guidance on income statement presentation and whether transactions should be presented on a gross as a principal or net as an agent basis. EITF Issue 99-19, "*Reporting Revenue Gross as a Principal versus Net as an Agent*", which was issued subsequent to SAB 101, provides such guidance. Therefore, this guidance is no longer necessary.

6. Topic 13.B is modified as follows:

a. The interpretive response to Question 1 is modified to reference multiple units of accounting in lieu of multiple elements.

b. Question 2 is modified to delete the reference to Question 10 of Topic 13.A and Topic 8.A.

c. Question 3 (formerly Question 29 of the FAQ) is added.

d. Question 4 (formerly Question 30 of the FAQ) is added.

e. Question 5 (formerly Question 31 of the FAQ) is added.

Topic 13: REVENUE RECOGNITION

A. Selected Revenue Recognition Issues

1. Revenue recognition - general

The accounting literature on revenue recognition includes both broad conceptual discussions as well as certain industry-specific guidance.[1] If a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied. However, in the absence of authoritative literature addressing a specific arrangement or a

[1] The February 1999 AICPA publication "Audit Issues in Revenue Recognition" provides an overview of the authoritative accounting literature and auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

specific industry, the staff will consider the existing authoritative accounting standards as well as the broad revenue recognition criteria specified in the FASB's conceptual framework that contain basic guidelines for revenue recognition.

Based on these guidelines, revenue should not be recognized until it is realized or realizable and earned.[2] Concepts Statement 5, paragraph 83(b) states that "an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues" [footnote reference omitted]. Paragraph 84(a) continues "the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)" [footnote reference omitted]. In addition, paragraph 84(d) states that "If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes."

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,[3]
- Delivery has occurred or services have been rendered,[4]

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[2] Concepts Statement 5, paragraphs 83-84; ARB 43, Chapter 1A, paragraph 1; Opinion 10, paragraph 12. The citations provided herein are not intended to present the complete population of citations where a particular criterion is relevant. Rather, the citations are intended to provide the reader with additional reference material.

[3] Concepts Statement 2, paragraph 63 states "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent." The staff believes that evidence of an exchange arrangement must exist to determine if the accounting treatment represents faithfully the transaction. See also SOP 97-2, paragraph 8. The use of the term "arrangement" in this SAB Topic is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.

[4] Concepts Statement 5, paragraph 84(a), (b), and (d). Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.

- The seller's price to the buyer is fixed or determinable,[5] and
- Collectibility is reasonably assured.[6]

Some revenue arrangements contain multiple revenue-generating activities. The staff believes that the determination of the units of accounting within an arrangement should be made prior to the application of the guidance in this SAB Topic by reference to the applicable accounting literature.[7]

2. Persuasive evidence of an arrangement

Question 1

Facts: Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A's normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta's purchasing department has orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A's next fiscal quarter.

Question: May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta's authorized representative within a few days after the end of the current fiscal quarter?

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[5] Concepts Statement 5, paragraph 83(a); Statement 48, paragraph 6(a); SOP 97-2, paragraph 8. SOP 97-2 defines a "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties." Paragraphs 26-33 of SOP 97-2 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in paragraphs 26 and 30-33 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that paragraphs 27 through 29 specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high.

[6] ARB 43, Chapter 1A, paragraph 1 and Opinion 10, paragraph 12. See also Concepts Statement 5, paragraph 84(g) and SOP 97-2, paragraph 8.

[7] See EITF Issue 00-21 paragraph 4 for additional discussion.

Interpretive Response: No. Generally the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period.[8] Further, if an arrangement is subject to subsequent approval (e.g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and processes may also vary within individual companies (e.g., based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or on-line authorizations that include the terms of the sale and that are binding on the customer. In that situation, that documentation could represent persuasive evidence of an arrangement.

The staff is aware that sometimes a customer and seller enter into "side" agreements to a master contract that effectively amend the master contract. Registrants should ensure that appropriate policies, procedures, and internal controls exist and are properly documented so as to provide reasonable assurances that sales transactions, including those affected by side agreements, are properly accounted for in accordance with GAAP and to ensure compliance with Section 13 of the Securities Exchange Act of 1934 (i.e., the Foreign Corrupt Practices Act). Side agreements could include cancellation, termination, or other provisions that affect revenue recognition. The existence of a subsequently executed side agreement may be an indicator that the original agreement was not final and revenue recognition was not appropriate.

[8] AU Section 560.05.

Question 2

Facts: Company Z enters into an arrangement with Customer A to deliver Company Z's products to Customer A on a consignment basis. Pursuant to the terms of the arrangement, Customer A is a consignee, and title to the products does not pass from Company Z to Customer A until Customer A consumes the products in its operations. Company Z delivers product to Customer A under the terms of their arrangement.

Question: May Company Z recognize revenue upon delivery of its product to Customer A?

Interpretive Response: No. Products delivered to a consignee pursuant to a consignment arrangement are not sales and do not qualify for revenue recognition until a sale occurs. The staff believes that revenue recognition is not appropriate because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee.

Other situations may exist where title to delivered products passes to a buyer, but the substance of the transaction is that of a consignment or a financing. Such arrangements require a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties, and the seller's customary business practices in such arrangements. The staff believes that the presence of one or more of the following characteristics in a transaction precludes revenue recognition even if title to the product has passed to the buyer:

1. The buyer has the right to return the product and:

    (a) the buyer does not pay the seller at the time of sale, and the buyer is not obligated to pay the seller at a specified date or dates.[9]

    (b) the buyer does not pay the seller at the time of sale but rather is obligated to pay at a specified date or dates, and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product or subsequently consumes or uses the product,[10]

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[9] Statement 48, paragraphs 6(b) and 22.

[10] Statement 48, paragraphs 6(b) and 22. The arrangement may not specify that payment is contingent upon subsequent resale or consumption. However, if the seller has an established business practice permitting customers to defer payment beyond the specified due date(s) until the products are resold or consumed, then the staff believes that the seller's right to receive cash representing the sales price is contingent.

(c) the buyer's obligation to the seller would be changed (e.g., the seller would forgive the obligation or grant a refund) in the event of theft or physical destruction or damage of the product,[11]

(d) the buyer acquiring the product for resale does not have economic substance apart from that provided by the seller,[12] or

(e) the seller has significant obligations for future performance to directly bring about resale of the product by the buyer.[13]

2. The seller is required to repurchase the product (or a substantially identical product or processed goods of which the product is a component) at specified prices that are not subject to change except for fluctuations due to finance and holding costs,[14] and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the buyer in purchasing and holding the product (including interest).[15] The staff believes that indicators of the latter condition include:

(a) the seller provides interest-free or significantly below market financing to the buyer beyond the seller's customary sales terms and until the products are resold,

(b) the seller pays interest costs on behalf of the buyer under a third-party financing arrangement, or

(c) the seller has a practice of refunding (or intends to refund) a portion of the original sales price representative of interest expense for the period from when the buyer paid the seller until the buyer resells the product.

3. The transaction possesses the characteristics set forth in EITF Issue 95-1 and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes.[16]

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[11] Statement 48, paragraph 6(c).
[12] Statement 48, paragraph 6(d).
[13] Statement 48, paragraph 6(e).
[14] Statement 49, paragraph 5(a). Paragraph 5(a) provides examples of circumstances that meet this requirement. As discussed further therein, this condition is present if (a) a resale price guarantee exists, (b) the seller has an option to purchase the product, the economic effect of which compels the seller to purchase the product, or (c) the buyer has an option whereby it can require the seller to purchase the product.
[15] Statement 49, paragraph 5(b).
[16] See SOP 97-2, paragraph 25.

This list is not meant to be a checklist of all characteristics of a consignment or a financing arrangement, and other characteristics may exist. Accordingly, the staff believes that judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing, or other arrangement for which revenue recognition is not appropriate. If title to the goods has passed but the substance of the arrangement is not a sale, the consigned inventory should be reported separately from other inventory in the consignor's financial statements as "inventory consigned to others" or another appropriate caption.

Question 3

Facts: The laws of some countries do not provide for a seller's retention of a security interest in goods in the same manner as established in the U.S. Uniform Commercial Code (UCC). In these countries, it is common for a seller to retain a form of title to goods delivered to customers until the customer makes payment so that the seller can recover the goods in the event of customer default on payment.

Question: Is it acceptable to recognize revenue in these transactions before payment is made and title has transferred?

Interpretive Response: Presuming all other revenue recognition criteria have been met, the staff would not object to revenue recognition at delivery if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment. This limited form of ownership may exist in some foreign jurisdictions where, despite technically holding title, the seller is not entitled to direct the disposition of the goods, cannot rescind the transaction, cannot prohibit its customer from moving, selling, or otherwise using the goods in the ordinary course of business, and has no other rights that rest with a titleholder of property that is subject to a lien under the U.S. UCC. On the other hand, if retaining title results in the seller retaining rights normally held by an owner of goods, the situation is not sufficiently different from a delivery of goods on consignment. In this particular case, revenue should not be recognized until payment is received. Registrants and their auditors may wish to consult legal counsel knowledgeable of the local law and customs outside the U.S. to determine the seller's rights.

3. Delivery and performance

a. Bill and hold arrangements

Facts: Company A receives purchase orders for products it manufactures. At the end of its fiscal quarters, customers may not yet be ready to take delivery of the products for various reasons. These reasons may include, but are not limited to, a lack of available space for inventory, having more than sufficient inventory in their distribution channel, or delays in customers' production schedules.

Question: May Company A recognize revenue for the sale of its products once it has completed manufacturing if it segregates the inventory of the products in its own warehouse from its own products?

May Company A recognize revenue for the sale if it ships the products to a third-party warehouse but (1) Company A retains title to the product and (2) payment by the customer is dependent upon ultimate delivery to a customer-specified site?

Interpretative Response: Generally, no. The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point").

The Commission has set forth criteria to be met in order to recognize revenue when delivery has not occurred.[17] These include:

1. The risks of ownership must have passed to the buyer;

2. The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;

[17] See In the Matter of Stewart Parness, AAER 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., et al, LR 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER 971 (September 30, 1997); In the Matter of Cypress Bioscience Inc., AAER 817 (September 19, 1996). Also see Concepts Statement 5, paragraph 84(a). and SOP 97-2, paragraph 22.

3. The buyer, not the seller, must request that the transaction be on a bill and hold basis.[18] The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;

4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);

5. The seller must not have retained any specific performance obligations such that the earning process is not complete;

6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and

7. The equipment [product] must be complete and ready for shipment.

The above listed conditions are the important conceptual criteria that should be used in evaluating any purported bill and hold sale. This listing is not intended as a checklist. In some circumstances, a transaction may meet all factors listed above but not meet the requirements for revenue recognition. The Commission also has noted that in applying the above criteria to a purported bill and hold sale, the individuals responsible for the preparation and filing of financial statements also should consider the following factors:[19]

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;[20]

2. The seller's past experiences with and pattern of bill and hold transactions;

3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods;

4. Whether the seller's custodial risks are insurable and insured;

5. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold (i.e., that the business reasons for the bill and hold have not introduced a contingency to the buyer's commitment).

[18] Such requests typically should be set forth in writing by the buyer.
[19] See Note 17, supra.
[20] Such individuals should consider whether Opinion 21 pertaining to the need for discounting the related receivable, is applicable. Opinion 21, paragraph 3(a), indicates that the requirements of that Opinion to record receivables at a discounted value are not intended to apply to "receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year" (emphasis added).

Delivery generally is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred.[21]

b. Customer acceptance

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.[22] Customer acceptance provisions may be included in a contract, among other reasons, to enforce a customer's rights to (1) test the delivered product, (2) require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e.g., a seller is required to install or activate delivered equipment), or (3) identify other work necessary to be done before accepting the product. The staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Accordingly, when such contractual customer acceptance provisions exist, the staff generally believes that the seller should not recognize revenue until customer acceptance occurs or the acceptance provisions lapse.

Question 1

Question: Do circumstances exist in which formal customer sign-off (that a contractual customer acceptance provision is met) is unnecessary to meet the requirements to recognize revenue?

Interpretive Response: Yes. Formal customer sign-off is not always necessary to recognize revenue provided that the seller objectively demonstrates that the criteria specified in the acceptance provisions are satisfied. Customer acceptance provisions generally allow the customer to cancel the arrangement when a seller delivers a product that the customer has not yet agreed to purchase or delivers a product that does not meet the specifications of the customer's order. In those cases, revenue should not be

[21] SOP 97-2, paragraph 22.

[22] SOP 97-2, paragraph 20. Also, Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." If an arrangement expressly requires customer acceptance, the staff generally believes that customer acceptance should occur before the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues, especially when the seller is obligated to perform additional steps.

recognized because a sale has not occurred. In applying this concept, the staff observes that customer acceptance provisions normally take one of four general forms. Those forms, and how the staff generally assesses whether customer acceptance provisions should result in revenue deferral, are described below:

(a) Acceptance provisions in arrangements that purport to be for trial or evaluation purposes.[23] In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance. These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

In contrast, other arrangements do not purport to be for trial or evaluation purposes. In these instances, the seller delivers a specified product pursuant to a customer's order, establishes payment terms, and transfers title to the delivered product to the customer. However, customer acceptance provisions may be included in the arrangement to give the purchaser the ability to ensure the delivered product meets the criteria set forth in its order. The staff evaluates these provisions as follows:

(b) Acceptance provisions that grant a right of return or exchange on the basis of subjective matters. An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product.[24] The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with Statement 48. Statement 48 requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights.[25] That estimate may not be made in the absence of a large

[23] See, for example, SOP 97-2, paragraph 25.
[24] Statement 48, paragraph 13.
[25] Statement 48, paragraph 6(f).

volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent.[26] Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

(c) Acceptance provisions based on seller-specified objective criteria. An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor's published specifications for the product.[27] Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with Statement 5. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions.[28] However, if the seller has not previously demonstrated that the delivered product meets the seller's specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

(d) Acceptance provisions based on customer-specified objective criteria. These provisions are referred to in this document as "customer-specific acceptance provisions" against which substantial completion and contract fulfillment must be evaluated. While formal customer sign-off provides the best evidence that these acceptance criteria have been met, revenue recognition also would be appropriate, presuming all other revenue recognition criteria have been met, if the seller reliably demonstrates that the delivered products or services meet all of the specified criteria prior to customer acceptance. For example, if a seller reliably demonstrates that a delivered product meets the customer-specified objective criteria set forth in the arrangement, the delivery criterion would generally be satisfied when title and the risks and rewards of ownership transfers unless product performance may reasonably be different under the customer's testing conditions specified by the acceptance provisions. Further, the seller should consider whether it would be successful in enforcing a claim for payment even in the absence of formal sign-off. Whether the vendor has fulfilled the terms of the contract before customer acceptance is a matter of contract law, and depending on

[26] Statement 48, paragraphs 8(c) and 8(d).
[27] Statement 5, paragraph 24 and Statement 48, paragraph 4(c).
[28] Statement 5, paragraph 25.

the facts and circumstances, an opinion of counsel may be necessary to reach a conclusion.

Question 2

Facts: Consider an arrangement that calls for the transfer of title to equipment upon delivery to a customer's site. However, customer-specific acceptance provisions permit the customer to return the equipment unless the equipment satisfies certain performance tests. The arrangement calls for the vendor to perform the installation. Assume the equipment and the installation are separate units of accounting under EITF Issue 00-21.[29]

Question: Must revenue allocated to the equipment always be deferred until installation and on-site testing are successfully completed?

Interpretive Response: No. The staff would not object to revenue recognition for the equipment upon delivery (presuming all other revenue recognition criteria have been met for the equipment) if the seller demonstrates that, at the time of delivery, the equipment already meets all of the criteria and specifications in the customer-specific acceptance provisions. This may be demonstrated if conditions under which the customer intends to operate the equipment are replicated in pre-shipment testing, unless the performance of the equipment, once installed and operated at the customer's facility, may reasonably be different from that tested prior to shipment.

Determining whether the delivered equipment meets all of a product's criteria and specifications is a matter of judgment that must be evaluated in light of the facts and circumstances of a particular transaction. Consultation with knowledgeable project managers or engineers may be necessary in such circumstances.

For example, if the customer acceptance provisions were based on meeting certain size and weight characteristics, it should be possible to determine whether those criteria have been met before shipment. Historical experience with the same specifications and functionality of a particular machine that demonstrates that the equipment meets the customer's specifications also may provide sufficient evidence that the currently shipped equipment satisfies the customer-specific acceptance provisions.

If an arrangement includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's

[29] This fact is provided as an assumption to facilitate an analysis of revenue recognition in this fact pattern. No interpretation of Issue 00-21 is intended.

site, the staff believes that revenue recognition should be deferred until it can be demonstrated that the criteria are met. This situation usually will exist when equipment performance can vary based on how the equipment works in combination with the customer's other equipment, software, or environmental conditions. In these situations, testing to determine whether the criteria are met cannot be reasonably performed until the products are installed or integrated at the customer's facility.

Although the following questions provide several examples illustrating how the staff evaluates customer acceptance, the determination of when customer-specific acceptance provisions of an arrangement are met in the absence of the customer's formal notification of acceptance depends on the weight of the evidence in the particular circumstances. Different conclusions could be reached in similar circumstances that vary only with respect to a single variable, such as complexity of the equipment, nature of the interface with the customer's environment, extent of the seller's experience with the same type of transactions, or a particular clause in the agreement. The staff believes management and auditors are uniquely positioned to evaluate the facts and arrive at a reasoned conclusion. The staff will not object to a determination that is well reasoned on the basis of this guidance.

Question 3

Facts: Company E is an equipment manufacturer whose main product is generally sold in a standard model. The contracts for sale of that model provide for customer acceptance to occur after the equipment is received and tested by the customer. The acceptance provisions state that if the equipment does not perform to Company E's published specifications, the customer may return the equipment for a full refund or a replacement unit, or may require Company E to repair the equipment so that it performs up to published specifications. Customer acceptance is indicated by either a formal sign-off by the customer or by the passage of 90 days without a claim under the acceptance provisions. Title to the equipment passes upon delivery to the customer. Company E does not perform any installation or other services on the equipment it sells and tests each piece of equipment against its specifications before shipment. Payment is due under Company E's normal payment terms for that product 30 days after customer acceptance.

Company E receives an order from a new customer for a standard model of its main product. Based on the customer's intended use of the product, location and other factors, there is no reason that the equipment would operate differently in the customer's environment than it does in Company E's facility.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: While the staff presumes that customer acceptance provisions are substantive provisions that generally result in revenue deferral, that presumption can be overcome as discussed above. Although the contract includes a customer acceptance clause, acceptance is based on meeting Company E's published specifications for a standard model. Company E demonstrates that the equipment shipped meets the specifications before shipment, and the equipment is expected to operate the same in the customer's environment as it does in Company E's. In this situation, Company E should evaluate the customer acceptance provision as a warranty under Statement 5. If Company E can reasonably and reliably estimate the amount of warranty obligations, the staff believes that it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 4

Facts: Assume the same facts about Company E’s equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to fit into a space of specific dimensions while still meeting all of the published vendor specifications with regard to performance. In addition to the customer acceptance provisions relating to the standard performance specifications, the customer may reject the equipment if it does not conform to the specified dimensions. Company E creates a testing chamber of the exact same dimensions as specified by the customer and makes simple design changes to the product so that it fits into the testing chamber. The equipment still meets all of the standard performance specifications.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: Although the contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, Company E demonstrates that the equipment shipped meets that objective criterion, as well as the published specifications, before shipment. The staff believes that the customer acceptance provisions related to the standard performance specifications should be evaluated as a warranty under Statement 5. If Company E can reasonably and reliably estimate the amount of warranty obligations, it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 5

Facts: Assume the same facts about Company E's equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to be integrated into the customer's new assembly line while still meeting all of the standard published vendor specifications with regard to performance. The customer may reject the equipment if it fails to meet the standard published performance specifications or cannot be satisfactorily integrated into the new line. Company E has never modified its equipment to work on an integrated basis in the type of assembly line the customer has proposed. In response to the request, Company E designs a version of its standard equipment that is modified as believed necessary to operate in the new assembly line. The modified equipment still meets all of the standard published performance specifications, and Company E believes the equipment will meet the requested specifications when integrated into the new assembly line. However, Company E is unable to replicate the new assembly line conditions in its testing.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: This contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, and Company E cannot demonstrate that the equipment shipped meets that criterion before shipment. Accordingly, the staff believes that the contractual customer acceptance provision has not been met at shipment. Therefore, the staff believes that Company E should wait until the product is successfully integrated at its customer's location and meets the customer-specific criteria before recognizing revenue. While this is best evidenced by formal customer acceptance, other objective evidence that the equipment has met the customer-specific criteria may also exist (e.g., confirmation from the customer that the specifications were met).

c. Inconsequential or perfunctory performance obligations

Question 1

Question: Does the failure to complete all activities related to a unit of accounting preclude recognition of revenue for that unit of accounting?

Interpretive Response: No. Assuming all other recognition criteria are met, revenue for the unit of accounting may be recognized in its entirety if the seller's remaining obligation is inconsequential or perfunctory.

A seller should substantially complete or fulfill the terms specified in the arrangement related to the unit of accounting at issue in order for delivery or performance to have occurred.[30] When applying the substantially complete notion, the staff believes that only inconsequential or perfunctory actions may remain incomplete such that the failure to complete the actions would not result in the customer receiving a refund or rejecting the delivered products or services performed to date. In addition, the seller should have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating the remaining costs. If revenue is recognized upon substantial completion of the terms specified in the arrangement related to the unit of accounting at issue, all related costs of performance or delivery should be accrued.

Question 2

Question: What factors should be considered in the evaluation of whether a remaining obligation related to a unit of accounting is inconsequential or perfunctory?

Interpretive Response: A remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting (or a right to a refund or to reject) the products delivered or services performed to date. The terms of the sales contract regarding both the right to a full or partial refund and the right of return or rejection should be considered when evaluating whether a portion of the purchase price would be refundable. If the company has a historical pattern of granting such rights, that historical pattern should

[30] Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled the benefits represented by the revenues."

also be considered even if the current contract expressly precludes such rights. Further, other factors should be considered in assessing whether remaining obligations are inconsequential or perfunctory. For example, the staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

- The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.

- The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another.

- The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.

- The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting.

- The period before the remaining obligation will be extinguished is lengthy. Registrants should consider whether reasonably possible variations in the period to complete performance affect the certainty that the remaining obligations will be completed successfully and on budget.

- The timing of payment of a portion of the sales price is coincident with completing performance of the remaining activity.

Registrants' determinations of whether remaining obligations are inconsequential or perfunctory should be consistently applied.

<u>Question 3</u>

<u>Facts</u>: Consider a unit of accounting that includes both equipment and installation because the two deliverables do not meet the separation criteria under EITF Issue 00-21. This may be because the equipment does not have value to the customer on a standalone basis, there is no objective and reliable evidence of fair value for the installation or there is a general right of return when the installation is not considered probable and in control of the vendor.

<u>Question</u>: In this situation, must all revenue be deferred until installation is performed?

Interpretive Response: Yes, if installation is essential to the functionality of the equipment.[31] Examples of indicators that installation is essential to the functionality of equipment include:

- The installation involves significant changes to the features or capabilities of the equipment or building complex interfaces or connections;
- The installation services are unavailable from other vendors.[32]

Conversely, examples of indicators that installation is not essential to the functionality of the equipment include:

- The equipment is a standard product;
- Installation does not significantly alter the equipment's capabilities;
- Other companies are available to perform the installation.[33]

If it is determined that the undelivered service is not essential to the functionality of the delivered product but a portion of the contract fee is not payable until the undelivered service is delivered, the staff would not consider that obligation to be inconsequential or perfunctory. Generally, the portion of the contract price that is withheld or refundable should be deferred until the outstanding service is delivered because that portion would not be realized or realizable.[34]

d. License fee revenue

Facts: Assume that intellectual property is physically delivered and payment is received on December 20, upon the registrant's consummation of an agreement granting its customer a license to use the intellectual property for a term beginning on the following January 1.

Question: Should the license fee be recognized in the period ending December 31?

Interpretive Response: No. In licensing and similar arrangements (e.g., licenses of motion pictures, software, technology, and other intangibles), the staff believes that delivery does not occur for revenue recognition purposes

[31] See SOP 97-2, paragraph 13.
[32] See SOP 97-2, paragraphs 68-71 for analogous guidance.
[33] Ibid.
[34] Concepts Statement 5, paragraph 83(a) and Statement 48, paragraph 6(b).

until the license term begins.[35] Accordingly, if a licensed product or technology is physically delivered to the customer, but the license term has not yet begun, revenue should not be recognized prior to inception of the license term. Upon inception of the license term, revenue should be recognized in a manner consistent with the nature of the transaction and the earnings process.

e. Layaway sales arrangements

Facts: Company R is a retailer that offers "layaway" sales to its customers. Company R retains the merchandise, sets it aside in its inventory, and collects a cash deposit from the customer. Although Company R may set a time period within which the customer must finalize the purchase, Company R does not require the customer to enter into an installment note or other fixed payment commitment or agreement when the initial deposit is received. The merchandise generally is not released to the customer until the customer pays the full purchase price. In the event that the customer fails to pay the remaining purchase price, the customer forfeits its cash deposit. In the event the merchandise is lost, damaged, or destroyed, Company R either must refund the cash deposit to the customer or provide replacement merchandise.

Question: In the staff's view, when may Company R recognize revenue for merchandise sold under its layaway program?

Interpretive Response: Provided that the other criteria for revenue recognition are met, the staff believes that Company R should recognize revenue from sales made under its layaway program upon delivery of the merchandise to the customer. Until then, the amount of cash received should be recognized as a liability entitled such as "deposits received from customers for layaway sales" or a similarly descriptive caption. Because Company R retains the risks of ownership of the merchandise, receives only a deposit from the customer, and does not have an enforceable right to the remainder of the purchase price, the staff would object to Company R recognizing any revenue upon receipt of the cash deposit. This is consistent with item two (2) in the Commission's criteria for bill-and-hold transactions which states "the customer must have made a fixed commitment to purchase the goods."

[35] SOP 00-2, paragraph 7.

f. Nonrefundable up-front fees

Question 1

Facts: Registrants may negotiate arrangements pursuant to which they may receive nonrefundable fees upon entering into arrangements or on certain specified dates. The fees may ostensibly be received for conveyance of a license or other intangible right or for delivery of particular products or services. Various business factors may influence how the registrant and customer structure the payment terms. For example, in exchange for a greater up-front fee for an intangible right, the registrant may be willing to receive lower unit prices for related products to be delivered in the future. In some circumstances, the right, product, or service conveyed in conjunction with the nonrefundable fee has no utility to the purchaser separate and independent of the registrant's performance of the other elements of the arrangement. Therefore, in the absence of the registrant's continuing involvement under the arrangement, the customer would not have paid the fee. Examples of this type of arrangement include the following:

- A registrant sells a lifetime membership in a health club. After paying a nonrefundable "initiation fee," the customer is permitted to use the health club indefinitely, so long as the customer also pays an additional usage fee each month. The monthly usage fees collected from all customers are adequate to cover the operating costs of the health club.

- A registrant in the biotechnology industry agrees to provide research and development activities for a customer for a specified term. The customer needs to use certain technology owned by the registrant for use in the research and development activities. The technology is not sold or licensed separately without the research and development activities. Under the terms of the arrangement, the customer is required to pay a nonrefundable "technology access fee" in addition to periodic payments for research and development activities over the term of the contract.

- A registrant requires a customer to pay a nonrefundable "activation fee" when entering into an arrangement to provide telecommunications services. The terms of the arrangement require the customer to pay a monthly usage fee that is adequate to recover the registrant's operating costs. The costs incurred to activate the telecommunications service are nominal.

- A registrant charges users a fee for non-exclusive access to its web site that contains proprietary databases. The fee allows access to the web site for a one-year period. After the customer is provided with an identification number and trained in the use of the database, there are no incremental costs that will be incurred in serving this customer.

- A registrant charges a fee to users for advertising a product for sale or auction on certain pages of its web site. The company agrees to maintain the listing for a period of time. The cost of maintaining the advertisement on the web site for the stated period is minimal.

- A registrant charges a fee for hosting another company's web site for one year. The arrangement does not involve exclusive use of any of the hosting company's servers or other equipment. Almost all of the projected costs to be incurred will be incurred in the initial loading of information on the host company's internet server and setting up appropriate links and network connections.

Question: Assuming these arrangements qualify as single units of accounting under EITF Issue 00-21[36], when should the revenue relating to nonrefundable, up-front fees in these types of arrangements be recognized?

Interpretive Response: The staff believes that registrants should consider the specific facts and circumstances to determine the appropriate accounting for nonrefundable, up-front fees. Unless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process,[37] the deferral of revenue is appropriate.

In the situations described above, the staff does not view the activities completed by the registrants (i.e., selling the membership, signing the contract, enrolling the customer, activating telecommunications services or providing initial set-up services) as discrete earnings events.[38] The terms, conditions, and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement, and the customer would ascribe a significantly lower, and perhaps no, value to elements ostensibly associated with the up-front fee in the absence of the registrant's performance of other contract elements. The fact that the registrants do not

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[36] The staff believes that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under EITF Issue 00-21, will rarely provide value to the customer on a standalone basis.

[37] See Concepts Statement 5, footnote 51, for a description of the "earning process."

[38] In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in Statement 91 that loan origination is not a separate revenue-producing activity of a lender, and therefore, those nonrefundable fees collected at the outset of the loan arrangement are not recognized as revenue upon receipt but are deferred and recognized over the life of the loan (paragraphs 5 and 37).

sell the initial rights, products, or services separately (i.e., without the registrants' continuing involvement) supports the staff's view. The staff believes that the customers are purchasing the on-going rights, products, or services being provided through the registrants' continuing involvement. Further, the staff believes that the earnings process is completed by performing under the terms of the arrangements, not simply by originating a revenue-generating arrangement.

While the incurrence of nominal up-front costs helps make it clear that there is not a separate earnings event in the telecommunications example above, incurrence of substantive costs, such as in the web hosting example above, does not necessarily indicate that there is a separate earnings event. Whether there is a separate earnings event should be evaluated on a case-by-case basis. Some have questioned whether revenue may be recognized in these transactions to the extent of the incremental direct costs incurred in the activation. Because there is no separable deliverable or earnings event, the staff would generally object to that approach, except where it is provided for in the authoritative literature (e.g., Statement 51).

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance[39] and generally should be deferred and recognized systematically over the periods that the fees are earned.[40]

Some propose that revenue should be recognized when the initial set-up is completed in cases where the on-going obligation involves minimal or no cost or effort and should, therefore, be considered perfunctory or inconsequential.

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[39] The revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee (e.g., if subsequent renewals are priced at a bargain to the initial up-front fee).

[40] A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

However, the staff believes that the substance of each of these transactions indicates that the purchaser is paying for a service that is delivered over time. Therefore, revenue recognition should occur over time, reflecting the provision of service.[41]

Question 2

Facts: Company A provides its customers with activity tracking or similar services (e.g., tracking of property tax payment activity, sending delinquency letters on overdue accounts, etc.) for a ten-year period. Company A requires customers to prepay for all the services for the term specified in the arrangement. The on-going services to be provided are generally automated after the initial customer set-up. At the outset of the arrangement, Company A performs set-up procedures to facilitate delivery of its on-going services to the customers. Such procedures consist primarily of establishing the necessary records and files in Company A's pre-existing computer systems in order to provide the services. Once the initial customer set-up activities are complete, Company A provides its services in accordance with the arrangement. Company A is not required to refund any portion of the fee if the customer terminates the services or does not utilize all of the services to which it is entitled. However, Company A is required to provide a refund if Company A terminates the arrangement early. Assume Company A's activities are not within the scope of Statement 91 and that this arrangement qualifies as a single unit of accounting under EITF Issue 00-21.[42]

Question: When should Company A recognize the service revenue?

Interpretive Response: The staff believes that, provided all other revenue recognition criteria are met, service revenue should be recognized on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed,[43] whichever is longer. In this case, the customer contracted for the on-going activity tracking service, not for the set-up activities. The staff notes that the customer could not, and would not, separately purchase the set-up services without the on-going services. The services specified in the arrangement are performed continuously over the contractual term of the arrangement (and any subsequent renewals). Therefore, the staff believes that Company A should recognize revenue on a straight-line basis, unless

[41] Concepts Statement 5, paragraph 84(d).
[42] See Note 36, supra.
[43] See Note 39, supra.

evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed, whichever is longer.

In this situation, the staff would object to Company A recognizing revenue in proportion to the costs incurred because the set-up costs incurred bear no direct relationship to the performance of services specified in the arrangement. The staff also believes that it is inappropriate to recognize the entire amount of the prepayment as revenue at the outset of the arrangement by accruing the remaining costs because the services required by the contract have not been performed.

Question 3

Facts: Assume the same facts as in Question 2 above.

Question: Are the initial customer set-up costs incurred by Company A within the scope of SOP 98-5?

Interpretive Response: Footnote 1 of SOP 98-5 states that "this SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Statement 60…and loan origination costs in Statement 91… The SOP addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public)." As such, the set-up costs incurred in this example are not within the scope of SOP 98-5.

The staff believes that the incremental direct costs (Statement 91 provides an analogous definition) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue, unless specifically provided for in the authoritative literature, may be either expensed as incurred or accounted for in accordance with paragraph 4 of Technical Bulletin 90-1 or paragraph 5 of Statement 91. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

Question 4

Facts: Assume the same facts as in Question 2 above.

Question: What is the staff's view of the pool of contract acquisition and origination costs that are eligible for capitalization?

Interpretive Response: As noted in Question 3 above, Statement 91 includes a definition of incremental direct costs in its glossary. Paragraph 6 of Statement 91 provides further guidance on the types of costs eligible for capitalization as customer acquisition costs indicating that only costs that result from successful loan origination efforts are capitalized. The FASB staff has published an Implementation Guide on Statement 91 that provides additional guidance on the costs that qualify for capitalization as customer acquisition costs. Further, Technical Bulletin 90-1 also requires capitalization of incremental direct customer acquisition costs and requires that those costs be "identified consistent with the guidance in paragraph 6 of Statement 91." Although the facts of a particular situation should be analyzed closely to capture those costs that are truly direct and incremental, the staff generally would not object to an accounting policy that results in the capitalization of costs in accordance with paragraph 6(a) and (b) of Statement 91 or Technical Bulletin 90-1. Registrants should disclose their policies for determining which costs to capitalize as contract acquisition and origination costs.

Question 5

Facts: Assume the same facts as in Question 2 above. Based on the guidance in Questions 2, 3 and 4 above, Company A has capitalized certain direct and incremental customer set-up costs associated with the deferred revenue.

Question: Over what period should Company A amortize these costs?

Interpretive Response: When both costs and revenue (in an amount equal to or greater than the costs) are deferred, the staff believes that the capitalized costs should be charged to expense proportionally and over the same period that deferred revenue is recognized as revenue.[44]

g. Deliverables within an arrangement

Question: If a company (the seller) has a patent to its intellectual property which it licenses to customers, the seller may represent and warrant to its licensees that it has a valid patent, and will defend and maintain that patent. Does that obligation to maintain and defend patent rights, in and of itself, constitute a deliverable to be evaluated under EITF Issue 00-21?

Interpretive Response: No. Provided the seller has legal and valid patents upon entering the license arrangement, existing GAAP on licenses of

[44] Technical Bulletin 90-1, paragraph 4.

intellectual property (e.g., SOP 97-2, SOP 00-2, and SFAS No. 50) does not indicate that an obligation to defend valid patents represents an additional deliverable to which a portion of an arrangement fee should be allocated in an arrangement that otherwise qualifies for sales-type accounting. While this clause may obligate the licenser to incur costs in the defense and maintenance of the patent, that obligation does not involve an additional deliverable to the customer. Defending the patent is generally consistent with the seller's representation in the license that such patent is legal and valid. Therefore, the staff would not consider a clause like this to represent an additional deliverable in the arrangement.[45]

4. Fixed or determinable sales price

a. Refundable fees for services

A company's contracts may include customer cancellation or termination clauses. Cancellation or termination provisions may be indicative of a demonstration period or an otherwise incomplete transaction. Examples of transactions that financial management and auditors should be aware of and where such provisions may exist include "side" agreements and significant transactions with unusual terms and conditions. These contractual provisions raise questions as to whether the sales price is fixed or determinable. The sales price in arrangements that are cancelable by the customer is neither fixed nor determinable until the cancellation privileges lapse.[46] If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term.[47] Short-term rights of return, such as thirty-day money-back guarantees, and other customary rights to return products are not considered to be cancellation privileges, but should be accounted for in accordance with Statement 48.[48]

Question 1

Facts: Company M is a discount retailer. It generates revenue from annual membership fees it charges customers to shop at its stores and from the sale of products at a discount price to those customers. The membership arrangements with retail customers require the customer to pay the entire membership fee (e.g., $35) at the outset of the arrangement. However, the

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[45] Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FIN 45, subject to a scope exception from the initial recognition and measurement provisions.
[46] SOP 97-2, paragraph 31.
[47] Ibid.
[48] Ibid.

customer has the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee. Based on historical data collected over time for a large number of homogeneous transactions, Company M estimates that approximately 40% of the customers will request a refund before the end of the membership contract term. Company M's data for the past five years indicates that significant variations between actual and estimated cancellations have not occurred, and Company M does not expect significant variations to occur in the foreseeable future.

<u>Question</u>: May Company M recognize in earnings the revenue for the membership fees and accrue the costs to provide membership services at the outset of the arrangement?

<u>Interpretive Response</u>: No. In the staff's view, it would be inappropriate for Company M to recognize the membership fees as earned revenue upon billing or receipt of the initial fee with a corresponding accrual for estimated costs to provide the membership services. This conclusion is based on Company M's remaining and unfulfilled contractual obligation to perform services (i.e., make available and offer products for sale at a discounted price) throughout the membership period. Therefore, the earnings process, irrespective of whether a cancellation clause exists, is not complete.

In addition, the ability of the member to receive a full refund of the membership fee up to the last day of the membership term raises an uncertainty as to whether the fee is fixed or determinable at any point before the end of the term. Generally, the staff believes that a sales price is not fixed or determinable when a customer has the unilateral right to terminate or cancel the contract and receive a cash refund. A sales price or fee that is variable until the occurrence of future events (other than product returns that are within the scope of Statement 48) generally is not fixed or determinable until the future event occurs. The revenue from such transactions should not be recognized in earnings until the sales price or fee becomes fixed or determinable. Moreover, revenue should not be recognized in earnings by assessing the probability that significant, but unfulfilled, terms of a contract will be fulfilled at some point in the future. Accordingly, the revenue from such transactions should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers (i.e., the $35 fee mentioned above) should be credited to a monetary liability account such as "customers' refundable fees."

The staff believes that if a customer has the unilateral right to receive both (1) the seller's substantial performance under an arrangement (<u>e.g.</u>, providing services or delivering product) and (2) a cash refund of prepaid fees, then the prepaid fees should be accounted for as a monetary liability. In consideration of whether the monetary liability can be derecognized, Statement 140 provides that liabilities may be derecognized only if (1) the debtor pays the creditor and is relieved of its obligation for the liability (paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities) or (2) the debtor is legally released from being the primary obligor under the liability.[49] If a customer has the unilateral right to receive both (1) the seller's substantial performance under the arrangement and (2) a cash refund of prepaid fees, then the refund obligation is not relieved upon performance of the service or delivery of the products. Rather, the seller's refund obligation is relieved only upon refunding the cash or expiration of the refund privilege.

Some have argued that there may be a limited exception to the general rule that revenue from membership or other service transaction fees should not be recognized in earnings prior to the refund privileges expiring. Despite the fact that Statement 48 expressly does not apply to the accounting for service revenue if part or all of the service fee is refundable under cancellation privileges granted to the buyer,[50] they believe that in certain circumstances a potential refund of a membership fee may be seen as being similar to a right of return of products under Statement 48. They argue that revenue from membership fees, net of estimated refunds, may be recognized ratably over the period the services are performed whenever pertinent conditions of Statement 48 are met, namely, there is a large population of transactions that grant customers the same unilateral termination or cancellation rights and reasonable estimates can be made of how many customers likely will exercise those rights.

The staff believes that, because service arrangements are specifically excluded from the scope of Statement 48, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is Statement 140. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, Statement 140 indicates that the liability would not be extinguished (and therefore no revenue would be recognized in earnings) until the cancellation or termination and related refund privileges expire. Nonetheless, the staff recognizes that over the years the accounting for membership refunds evolved based on analogy to Statement 48 and that

[49] Statement 140, paragraph 16.
[50] Statement 48, paragraph 4.

practice did not change when Statement 140 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature.

Pending further action in this area by the FASB, the staff will not object to the recognition of refundable membership fees, net of estimated refunds, as earned revenue over the membership term in the limited circumstances where all of the following criteria have been met:[51]

- The estimates of terminations or cancellations and refunded revenues are being made for a large pool of homogeneous items (e.g., membership or other service transactions with the same characteristics such as terms, periods, class of customers, nature of service, etc.).
- Reliable estimates of the expected refunds can be made on a timely basis.[52] Either of the following two items would be considered indicative of an inability to make reliable estimates: (1) recurring, significant differences between actual experience and estimated cancellation or termination rates (e.g., an actual cancellation rate of 40% versus an estimated rate of 25%) even if the impact of the difference on the amount of estimated refunds is not material to the consolidated financial statements[53] or (2) recurring variances between the actual and estimated amount of refunds that are material to either revenue or net income in quarterly or annual financial statements. In addition, the staff believes that an estimate, for purposes of meeting this criterion, would not be reliable unless it is remote[54] that material adjustments (both individually and in the aggregate) to previously recognized revenue would be required. The staff presumes that reliable estimates cannot be made if the customer's termination or cancellation and refund privileges exceed one year.

[51] The staff will question further analogies to the guidance in Statement 48 for transactions expressly excluded from its scope.
[52] Reliability is defined in Concepts Statement 2 as "the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Paragraph 63 of Concepts Statement 5 reiterates the definition of reliability, requiring that "the information is representationally faithful, verifiable, and neutral."
[53] For example, if an estimate of the expected cancellation rate varies from the actual cancellation rate by 100% but the dollar amount of the error is immaterial to the consolidated financial statements, some would argue that the estimate could still be viewed as reliable. The staff disagrees with that argument.
[54] The term "remote" is used here with the same definition as used in Statement 5.

- There is a sufficient company-specific historical basis upon which to estimate the refunds,[55] and the company believes that such historical experience is predictive of future events. In assessing these items, the staff believes that estimates of future refunds should take into consideration, among other things, such factors as historical experience by service type and class of customer, changing trends in historical experience and the basis thereof (e.g., economic conditions), the impact or introduction of competing services or products, and changes in the customer's "accessibility" to the refund (i.e., how easy it is for customers to obtain the refund).
- The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund.

If Company M does not meet all of the foregoing criteria, the staff believes that Company M should not recognize in earnings any revenue for the membership fee until the cancellation privileges and refund rights expire.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the initial amounts received from customer or subscribers (i.e., the $35 fee mentioned above) should be allocated to two liability accounts. The amount of the fee representing estimated refunds should be credited to a monetary liability account, such as "customers' refundable fees," and the remaining amount of the fee representing unearned revenue should be credited to a nonmonetary liability account, such as "unearned revenues." For each income statement presented, registrants should disclose in the footnotes to the financial statements the amounts of (1) the unearned revenue and (2) refund obligations as of the beginning of each period, the amount of cash received from customers, the amount of revenue recognized in earnings, the amount of refunds paid, other adjustments (with an explanation thereof), and the ending balance of (1) unearned revenue and (2) refund obligations.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the staff believes that adjustments for changes in estimated refunds should be recorded using a retrospective approach

[55] Paragraph 8 of Statement 48 notes various factors that may impair the ability to make a reasonable estimate of returns, including the lack of sufficient historical experience. The staff typically expects that the historical experience be based on the particular registrant's historical experience for a service and/or class of customer. In general, the staff typically expects a start-up company, a company introducing new services, or a company introducing services to a new class of customer to have at least two years of experience to be able to make reasonable and reliable estimates.

whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue.[56]

Companies offering memberships often distribute membership packets describing and discussing the terms, conditions, and benefits of membership. Packets may include vouchers, for example, that provide new members with discounts or other benefits from third parties. The costs associated with the vouchers should be expensed when distributed. Advertising costs to solicit members should be accounted for in accordance with SOP 93-7. Incremental direct costs incurred in connection with enrolling customers (e.g., commissions paid to agents) should be accounted for as follows: (1) if revenue is deferred until the cancellation or termination privileges expire, incremental direct costs should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the earlier of termination or cancellation or refund; or (2) if revenue, net of estimated refunds, is recognized in earnings over the membership period, a like percentage of incremental direct costs should be deferred and recognized in earnings in the same pattern as revenue is recognized, and the remaining portion should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the refund occurs.[57] All costs other than incremental direct costs (e.g., indirect costs) should be expensed as incurred.

[56] The staff believes deferred costs being amortized on a basis consistent with the deferred revenue should be similarly adjusted. Such an approach is generally consistent with the amortization methodology in Statement 91, paragraph 19.

[57] Statement 91, paragraph 5 and Technical Bulletin 90-1, paragraph 4 both provide for the deferral of incremental direct costs associated with acquiring a revenue-producing contract. Even though the revenue discussed in this example is refundable, if a registrant meets the aforementioned criteria for revenue recognition over the membership period, the staff would analogize to this guidance. However, if neither a nonrefundable contract nor a reliable basis for estimating net cash inflows under refundable contracts exists to provide a basis for recovery of incremental direct costs, the staff believes that such costs should be expensed as incurred. See SAB Topic 13.A.3.f. Question 3.

Question 2

Question: Will the staff accept an analogy to Statement 48 for service transactions subject to customer cancellation privileges other than those specifically addressed in the previous question?

Interpretive Response: The staff has accepted the analogy in limited circumstances due to the existence of a large pool of homogeneous transactions and satisfaction of the criteria in the previous question. Examples of other arrangements involving customer cancellation privileges and refundable service fees that the staff has addressed include the following:

- a leasing broker whose commission from the lessor upon a commercial tenant's signing of a lease agreement is refundable (or in some cases, is not due) under lessor cancellation privileges if the tenant fails to move into the leased premises by a specified date.

- a talent agent whose fee receivable from its principal (i.e., a celebrity) for arranging a celebrity endorsement for a five-year term is cancelable by the celebrity if the celebrity breaches the endorsement contract with its customer.

- an insurance agent whose commission received from the insurer upon selling an insurance policy is refundable in whole for the 30-day period that state law permits the consumer to repudiate the contract and then refundable on a declining pro rata basis until the consumer has made six monthly payments.

In the first two of these cases, the staff advised the registrants that the portion of revenue subject to customer cancellation and refund must be deferred until no longer subject to that contingency because the registrants did not have an ability to make reliable estimates of customer cancellations due to the lack of a large pool of homogeneous transactions. In the case of the insurance agent, however, the particular registrant demonstrated that it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations and satisfy all the criteria specified in the previous question. Accordingly, the staff did not object to that registrant's policy of recognizing its sales commission as revenue when its performance was complete, with an appropriate allowance for estimated cancellations.

Question 3

Question: Must a registrant analogize to Statement 48, or may it choose to defer all revenue until the refund period lapses as suggested by Statement 140 even if the criteria above for analogy to Statement 48 are met?

Interpretive Response: The analogy to Statement 48 is presented as an alternative that would be acceptable to the staff when the listed conditions are met. However, a registrant may choose to defer all revenue until the refund period lapses. The policy chosen should be disclosed and applied consistently.

Question 4

Question: May a registrant that meets the above criteria for reliable estimates of cancellations choose at some point in the future to change from the Statement 48 method to the Statement 140 method of accounting for these refundable fees? May a registrant change from the Statement 140 method to the Statement 48 method?

Interpretive Response: The staff believes that Statement 140 provides a preferable accounting model for service transactions subject to potential refunds. Therefore, the staff would not object to a change from the Statement 48 method to the Statement 140 method. However, if a registrant had previously chosen the Statement 140 method, the staff would object to a change to the Statement 48 method.

Question 5

Question: Is there a minimum level of customers that must be projected not to cancel before use of Statement 48 type accounting is appropriate?

Interpretive Response: Statement 48 does not include any such minimum. Therefore, the staff does not believe that a minimum must apply in service transactions either. However, as the refund rate increases, it may be increasingly difficult to make reasonable and reliable estimates of cancellation rates.

Question 6

Question: When a registrant first determines that reliable estimates of cancellations of service contracts can be made (e.g., two years of historical evidence becomes available), how should the change from the complete deferral method to the method of recognizing revenue, net of estimated cancellations, over time be reflected?

Interpretive Response: Changes in the ability to meet the criteria set forth above should be accounted for in the manner described in paragraph 6 of Statement 48, which addresses the accounting when a company experiences a change in the ability to make reasonable estimates of future product returns.

b. Estimates and changes in estimates

Accounting for revenues and costs of revenues requires estimates in many cases; those estimates sometimes change. Registrants should ensure that they have appropriate internal controls and adequate books and records that will result in timely identification of necessary changes in estimates that should be reflected in the financial statements and notes thereto.

Question 1

Facts: Paragraph 8 of Statement 48 lists a number of factors that may impair the ability to make a reasonable estimate of product returns in sales transactions when a right of return exists.[58] The paragraph concludes by stating "other factors may preclude a reasonable estimate."

Question: What "other factors," in addition to those listed in paragraph 8 of Statement 48, has the staff identified that may preclude a registrant from making a reasonable and reliable estimate of product returns?

Interpretive Response: The staff believes that the following additional factors, among others, may affect or preclude the ability to make reasonable and reliable estimates of product returns: (1) significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as "channel stuffing"), (2) lack of "visibility" into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end users, (3) expected introductions of new products that may result in the technological obsolescence of and larger than expected returns of current products, (4) the significance of a particular distributor to the registrant's (or a reporting segment's) business, sales and marketing, (5) the

[58] These factors include "a) the susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand, b) relatively long periods in which a particular product may be returned, c) absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies and relationships with its customers, and d) absence of a large volume of relatively homogeneous transactions."

newness of a product, (6) the introduction of competitors' products with superior technology or greater expected market acceptance, and (7) other factors that affect market demand and changing trends in that demand for the registrant's products. Registrants and their auditors should carefully analyze all factors, including trends in historical data, which may affect registrants' ability to make reasonable and reliable estimates of product returns.

The staff reminds registrants that if a transaction fails to meet all of the conditions of paragraphs 6 and 8 in Statement 48, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first.[59] Simply deferring recognition of the gross margin on the transaction is not appropriate.

Question 2

Question: Is the requirement cited in the previous question for "reliable" estimates meant to imply a new, higher requirement than the "reasonable" estimates discussed in Statement 48?

Interpretive Response: No. "Reliability" of financial information is one of the qualities of accounting information discussed in Concepts Statement 2. The staff's expectation that estimates be reliable does not change the existing requirement of Statement 48. If management cannot develop an estimate that is sufficiently reliable for use by investors, the staff believes it cannot make a reasonable estimate meeting the requirements of that standard.

Question 3

Question: Does the staff expect registrants to apply the guidance in Question 1 of Topic 13.A.4(a) above to sales of tangible goods and other transactions specifically within the scope of Statement 48?

Interpretive Response: The specific guidance above does not apply to transactions within the scope of Statement 48. The views set forth in Question 1 of Topic 13.A.4(a) are applicable to the service transactions discussed in that Question. Service transactions are explicitly outside the scope of Statement 48.

Question 4

Question: Question 1 of Topic 13.A.4(a) above states that the staff would expect a two-year history of selling a new service in order to be able to make

[59] Statement 48, paragraph 6.

reliable estimates of cancellations. How long a history does the staff believe is necessary to estimate returns in a product sale transaction that is within the scope of Statement 48?

Interpretive Response: The staff does not believe there is any specific length of time necessary in a product transaction. However, Statement 48 states that returns must be subject to reasonable estimation. Preparers and auditors should be skeptical of estimates of product returns when little history with a particular product line exists, when there is inadequate verifiable evidence of historical experience, or when there are inadequate internal controls that ensure the reliability and timeliness of the reporting of the appropriate historical information. Start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns.

Question 5

Question: If a company selling products subject to a right of return concludes that it cannot reasonably estimate the actual return rate due to its limited history, but it can conservatively estimate the maximum possible returns, does the staff believe that the company may recognize revenue for the portion of the sales that exceeds the maximum estimated return rate?

Interpretive Response: No. If a reasonable estimate of future returns cannot be made, Statement 48 requires that revenue not be recognized until the return period lapses or a reasonable estimate can be made.[60] Deferring revenue recognition based on the upper end of a wide range of potential return rates is inconsistent with the provisions of Statement 48.

c. Contingent rental income

Facts: Company A owns and leases retail space to retailers. Company A (lessor) renews a lease with a customer (lessee) that is classified as an operating lease. The lease term is one year and provides that the lease payments are $1.2 million, payable in equal monthly installments on the first day of each month, plus one percent of the lessee's net sales in excess of $25 million if the net sales exceed $25 million during the lease term (i.e., contingent rental). The lessee has historically experienced annual net sales in excess of $25 million in the particular space being leased, and it is probable that the lessee will generate in excess of $25 million net sales during the term of the lease.

[60] Statement 48, paragraph 6(f).

Question: In the staff's view, should the lessor recognize any rental income attributable to the one percent of the lessee's net sales exceeding $25 million before the lessee actually achieves the $25 million net sales threshold?

Interpretive Response: No. The staff believes that contingent rental income "accrues" (i.e., it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur.[61]

Statement 13 paragraph 19(b) states that lessors should account for operating leases as follows: "Rent shall be reported in income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used."

Statement 29 amended Statement 13 and clarifies that "lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue." [Summary] Paragraph 17 of Statement 29 provides the following example of determining contingent rentals:

> A lease agreement for retail store space could stipulate a monthly base rental of $200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of $25,000 for the past 2 years, minimum lease payments would include only the $200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at the inception of the lease, and future rentals would be limited to $200 per month if the store were subsequently closed and no sales were made thereafter.

Technical Bulletin 85-3 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in Statement 13, paragraph 19(b). Paragraph 2 of Technical Bulletin 85-3 states "using factors such as the time value of money,

[61] Lessees should follow the guidance established in EITF Issue 98-9.

anticipated inflation, or expected future revenues [emphasis added] to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29." In developing the basis for why scheduled rent increases should be recognized on a straight-line basis, the FASB distinguishes the accounting for scheduled rent increases from contingent rentals. Paragraph 13 states "There is an important substantive difference between lease rentals that are contingent upon some specified future event and scheduled rent increases that are unaffected by future events; the accounting under Statement 13 reflects that difference. If the lessor and lessee eliminate the risk of variable payments by agreeing to scheduled rent increases, the accounting should reflect those different circumstances."

The example provided in Statement 29 implies that contingent rental income in leases classified as sales-type or direct-financing leases becomes "accruable" when the changes in the factors on which the contingent lease payments are based actually occur. Technical Bulletin 85-3 indicates that contingent rental income in operating leases should not be recognized in a manner consistent with scheduled rent increases (i.e., on a straight-line basis over the lease term or another systematic and rational allocation basis if it is more representative of the time pattern in which the leased property is physically employed) because the risk of variable payments inherent in contingent rentals is substantively different than scheduled rent increases. The staff believes that the reasoning in Technical Bulletin 85-3 supports the conclusion that the risks inherent in variable payments associated with contingent rentals should be reflected in financial statements on a basis different than rental payments that adjust on a scheduled basis and, therefore, operating lease income associated with contingent rents would not be recognized as time passes or as the leased property is physically employed. Furthermore, prior to the lessee's achievement of the target upon which contingent rentals are based, the lessor has no legal claims on the contingent amounts. Consequently, the staff believes that it is inappropriate to anticipate changes in the factors on which contingent rental income in operating leases is based and recognize rental income prior to the resolution of the lease contingencies.

Because Company A's contingent rental income is based upon whether the customer achieves net sales of $25 million, the contingent rentals, which may not materialize, should not be recognized until the customer's net sales actually exceed $25 million. Once the $25 million threshold is met, Company A would recognize the contingent rental income as it becomes accruable, in this case, as the customer recognizes net sales. The staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. The contingent revenue should be recorded in the period in which the contingency is resolved.

d. Claims processing and billing services

Facts: Company M performs claims processing and medical billing services for healthcare providers. In this role, Company M is responsible for preparing and submitting claims to third-party payers, tracking outstanding billings, and collecting amounts billed. Company M's fee is a fixed percentage (e.g., five percent) of the amount collected. If no collections are made, no fee is due to Company M. Company M has historical evidence indicating that the third-party payers pay 85 percent of the billings submitted with no further effort by Company M. Company M has determined that the services performed under the arrangement are a single unit of accounting.

Question: May Company M recognize as revenue its five percent fee on 85 percent of the gross billings at the time it prepares and submits billings, or should it wait until collections occur to recognize any revenue?

Interpretive Response: The staff believes that Company M must wait until collections occur before recognizing revenue. Before the third-party payer has remitted payment to Company M's customers for the services billed, Company M is not entitled to any revenue. That is, its revenue is not yet realized or realizable.[62] Until Company M's customers collect on the billings, Company M has not performed the requisite activity under its contract to be entitled to a fee.[63] Further, no amount of the fee is fixed or determinable or collectible until Company Ms' customers collect on the billings.

[62] Concepts Statement 5, paragraph 83(a).
[63] Concepts Statement 5, paragraph 83(b).

B. Disclosures

Question 1

Question: What disclosures are required with respect to the recognition of revenue?

Interpretive Response: A registrant should disclose its accounting policy for the recognition of revenue pursuant to Opinion 22. Paragraph 12 thereof states that "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue . . .." Because revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should be disclosed. If sales transactions have multiple units of accounting, such as a product and service, the accounting policy should clearly state the accounting policy for each unit of accounting as well as how units of accounting are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with Statement 48 should be disclosed, if material (e.g., a change in estimate from two percent of sales to one percent of sales).

Regulation S-X requires that revenue from the sales of products, services, and other products each be separately disclosed on the face of the income statement.[64] The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.[65] This includes unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in FRR 36 that MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective

[64] See Regulation S-X, Article 5-03(b)(1) and (2).
[65] See Regulation S-K, Article 303 and FRR 36.

analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."[66] Examples of such revenue transactions or events that the staff has asked to be disclosed and discussed in accordance with FRR 36 are:

- Shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period.
- Granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations, and the effect on liquidity and capital resources. (The fair value of trade receivables should be disclosed in the footnotes to the financial statements when the fair value does not approximate the carrying amount.)[67]
- Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.
- An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users. Also, increasing service revenue that has a higher profit margin than product sales.
- Seasonal trends or variations in sales.
- A gain or loss from the sale of an asset(s).[68]

<u>Question 2</u>

<u>Question</u>: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

<u>Interpretive Response</u>: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with Opinion 20 and Statement 3 no later than the fourth fiscal

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[66] FRR 36, also see In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).
[67] Statement 107.
[68] Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S-X, Article 5-03(b)(6). Any material item should be stated separately.

quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in SAB Topic 11.M should be provided.

However, if registrants have not previously complied with GAAP, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill-and-hold guidance, those registrants should apply the guidance in Opinion 20 for the correction of an error.[69] In addition, registrants should be aware that the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.

Question 3

Question: The previous question indicates that the staff will not object to cumulative effect-type transition so long as the prior accounting does not represent an error. Could a company whose prior accounting does not represent an error voluntarily adopt a new method consistent with this SAB Topic by restatement of prior periods, rather than through a cumulative catch-up adjustment?

Interpretive Response: In most instances, no. Opinion 20 does not permit restatement of financial statements for a change in accounting principle that does not represent correction of an error, except in very rare circumstances.[70] An exception is a company that is filing publicly for the first time. As stated in paragraph 29 of Opinion 20, those companies are permitted to reflect the adoption of the new policy via a restatement, and the staff believes that approach is usually necessary to avoid confusing investors in an initial public offering.

Question 4

Question: Should a registrant reporting a change in accounting principle as a result of this SAB Topic file a preferability letter?

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[69] Opinion 20, paragraph 13 and paragraphs 36-37 describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements. Because the term "error" as used in Opinion 20 includes "oversight or misuse of facts that existed at the time that the financial statements were prepared," that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in SAS 99.

[70] See, for example, Opinion 20, paragraph 27.

Interpretive Response: No preferability letter is required if an accounting change is made in response to a newly issued Staff Accounting Bulletin.

Question 5

Question: If a company had not previously adjusted sales revenues, but deferred recognition of the gross margin of estimated returns for a transaction subject to Statement 48, how should it present a current change in accounting to reduce revenue and cost of sales for estimated returns?

Interpretive Response: Paragraph 7 of Statement 48 states that "sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns." Statement 48 does not provide for recognition of sales and costs of sales while deferring gross margin under any circumstance. This SAB Topic provides no new guidance on this point. If a registrant has failed to comply with GAAP, the registrant should retroactively revise prior financial statements in the manner set forth in Opinion 20 and Statement 16.

APPENDIX D

Financial Reporting Fraud Supplemental Checklist

[**Author's Note:** *The following checklist addresses internal controls issues, taken from the discussion in this book, specific to suspected financial reporting fraud. The checklist is intended to be a* ***supplement*** *to other commonly used internal control checklists and procedures. For auditing purposes, this checklist is recommended (though not required) when fraud is suspected. If the nature of the suspected fraud can be limited to specific areas, only portions of the checklist need be used*.]

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
1. Incentives/Pressures				
A yes *answer to any of the questions in this section indicates a greater likelihood of potential financial reporting fraud.*				
a. Is there a perception among management of the company or individual operating units that there is extraordinary pressure (over and above the pressures typically associated with this industry) to achieve a higher level of reported earnings?	•	•	•	____
b. Do management compensation agreements tie compensation or bonuses to higher levels of reported earnings?	•	•	•	____
c. Is there extraordinary pressure from outside shareholders or other outsiders to improve the value of company stock?	•	•	•	____
d. With regard to shares held by management or major shareholders, could the existence of any of the following provide an incentive to maintain or increase reported earnings, especially in the near term?	•	•	•	____
• Vesting provisions in employee stock ownership plans that postpone ownership	•	•	•	____
• Stock option exercise restrictions that prevent managers from acquiring shares until specified dates or the occurrence of specific events	•	•	•	____
• Rule 144A restrictions that limit the number of shares that can be sold on U. S. securities exchanges on a given trading day	•	•	•	____
• Income tax provisions that afford more favorable treatment to capital gains in shares held for a sufficient period of time to qualify as long-term capital gains (the restriction being that the government would receive more of the sale proceeds if the share sales were classified as short-term capital gains)	•	•	•	____
• Corporate control requirements that necessitate holding significant blocks of stock past some event, such as the record date of an annual shareholders meeting, before they can be sold	•	•	•	____
e. Is the company in danger of losing its listing on a major stock exchange, or is it attempting to obtain a new listing?	•	•	•	____
f. Is there extraordinary pressure, whether explicit or implicit, to continue to report a rising trend in earnings and/or revenues?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
g. Is the company operating close to or in violation of the limits of financial covenants, such as minimum shareholders' equity, maximum debt-to-equity ratios, or minimum current ratios, contained in bank credit facility agreements or other debt instruments?	•	•	•	____
h. For firms doing business in regulated industries, is the company operating close to or in violation of the financial restrictions set by regulators or by statute?	•	•	•	____
2. Quantitative Characteristics				
A yes *answer to any of the questions in this section indicates a greater likelihood of potential financial reporting fraud.*				
a. When calculating the following indexes for the previous and the current year, do any of the indexes show a year-over-year increase greater than 10 percent (meaning, an index greater than 1.1)?	•	•	•	____
• Days' Sales in Receivables Index	•	•	•	____
• Gross Margin Index	•	•	•	____
• Asset Quality Margin Index	•	•	•	____
• Sales Growth Index	•	•	•	____
b. When calculating the following indexes for the previous and the current year, do any of the indexes show a year-over-year increase greater than 10 percent more than increases for similar indexes of peer (same industry) companies?	•	•	•	____
• Days' Sales in Receivables Index	•	•	•	____
• Gross Margin Index	•	•	•	____
• Asset Quality Index	•	•	•	____
• Sale's Growth Index	•	•	•	____
c. Is the change in working capital over the past year (excluding cash changes) relative to total assets at the end of the period more than 20 percent greater than similar calculations for peer companies?	•	•	•	____
3. Qualitative Predictors: The Audit Committee				
A yes *answer to any of the questions in this section indicates a need to take action to improve the integrity and effectiveness of the Audit Committee.*				
a. Has the board of directors failed to designate an audit committee or failed to approve a charter for an audit committee?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
b. If there is an audit committee, do any of the following conditions exist with regard to members of that committee?	•	•	•	____
• A director being employed by the corporation or any of its affiliates for the current year or any of the past five years	•	•	•	____
• A director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan	•	•	•	____
• A director being a member of the immediate family of an individual who is or has been in any of the past five years employed by the corporation or any of its affiliates as an executive officer	•	•	•	____
• A director being a partner in or a controlling shareholder, or to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years	•	•	•	____
• A director being employed as an executive of another company while any of the corporation's executives serves on that company's compensation committee	•	•	•	____
c. Are there less than three audit committee members with at least some financial accounting experience?	•	•	•	____
d. Is it not clear or not the case that the audit committee—				
• Should be responsible for selecting the outside auditors?	•	•	•	____
• Has a formal written statement from the outside auditors describing all relationships between the auditors and the company?	•	•	•	____
• Regularly discusses with the outside auditors all aspects of the propriety or lack thereof of the company's accounting practices?	•	•	•	____
• Receives all reports of internal control deficiencies in a timely manner from both internal and outside auditors?	•	•	•	____
4. Other Qualitative Predictors				
A yes *answer to any of the questions in this section indicates a greater likelihood of potential financial reporting fraud.*				
a. Has the company had a history of internal control problems, whether those problems resulted in the detection of financial reporting or any other type of fraud?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
b. Does the company chief executive officer engage in micro-management or other practices that could unduly influence accounting decision-makers with regard to financial reporting reporting?	•	•	•	____
c. Are outside auditors unaware of any interim or quarterly financial reports or financial statements prepared for selected outside parties such as banks or investors?	•	•	•	____
d. In establishing and reviewing internal controls, has management failed to establish adequately the key metrics or guidelines to determine the extent and frequency of internal auditor review?	•	•	•	____
e. Is there a lack of evidence that management has properly communicated the internal control guidelines and procedures to appropriate personnel?	•	•	•	____
f. Does it appear that management does not assess the quality of its internal controls over time?	•	•	•	____
g. Have any audit tests detected significant risks not previously known to management?	•	•	•	____
h. Is there a history of using a quantitative standard for materiality, such as a percentage of earnings or assets, to excuse failure to correct known accounting errors or irregularities?	•	•	•	____
5. Special Areas				
A yes *answer to any of the questions in this section should generate further inquiry to determine if specific internal controls need to be improved.*				
Failure to Record Loss Contingencies				
a. Given the nature of the company's business, is it likely that any of the following issues could be relevant?	•	•	•	____
• Collectibility of receivables	•	•	•	____
• Obligations related to product warranties and product defects	•	•	•	____
• Risk of loss or damage of enterprise property	•	•	•	____
• Threat of expropriation of assets	•	•	•	____
• Pending or threatened litigation	•	•	•	____
• Actual or possible claims and assessments	•	•	•	____
• Guarantees of indebtedness of others	•	•	•	____
• Agreements to repurchase receivables (or repurchase related property) that have been sold	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
b. With regard to possible contingencies, do any of the following exist?	•	•	•	____
• The incidence of claims prior to the date of financial statements	•	•	•	____
• Correspondence with (and bills from) outside legal counsel	•	•	•	____
• Internal correspondence within production and research staffs as to the need to address a critical problem with a product already on the market	•	•	•	____
• Internal correspondence among department heads of production, R&D, general counsel, and senior management about postproduction problems and product claims	•	•	•	____
• External correspondence between the manufacturer and its customers about a given product concerning special price concessions or special return privileges	•	•	•	____
• The incidence of special or over-budget freight charges to accommodate returns and/or the shipment of replacement product	•	•	•	____
• Shifting of production schedules to manufacture replacement product	•	•	•	____
• Halting manufacture of the product in question	•	•	•	____
• Shifting of R&D staff away from planned research projects to applications engineering relating to redesign of existing products	•	•	•	____
• Payments in sometimes seemingly immaterial amounts to customers on a regular basis over a period of weeks or months that indicate some arrangement to compensate for product defects	•	•	•	____
c. If there is a suspected contingency, does correspondence between departments or within departments indicate a problem?	•	•	•	____
d. If a contingency is likely to exist, has management used an inadequate or inappropriate standard for quantifying the potential claim?	•	•	•	____
Failure to Record Asset Writeoffs				
a. Has the company's industry experienced rapid changes in engineering or materials applications that may lead to asset writeoffs due to obsolescence?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
b. Is the industry in which the company operates very cost competitive?	•	•	•	____
c. Has the company experienced any of the following?	•	•	•	____
• Significant changes in customer demand	•	•	•	____
• Significant loss of business to a competitor	•	•	•	____
• A need to obtain or retain a customer relationship by bidding below cost	•	•	•	____
d. When reviewing fixed asset schedules with production or divisional personnel, have any of the following occurred?				
• A significant decrease in the market value of an asset	•	•	•	____
• A significant change in the extent or manner in which an asset is used or a significant physical change in an asset	•	•	•	____
• A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator	•	•	•	____
• An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset	•	•	•	____
• A current period operating or cash-flow loss combined with a history of operating or cash-flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue	•	•	•	____
e. Is there evidence of significant changes in production or product demand?	•	•	•	____
f. From the review of moving expenses and discussion with production personnel, does it appear that any equipment has been moved off the shop floor into storage?	•	•	•	____
g. Does the company fail to maintain profitability analyses by product line or by customer?	•	•	•	____
h. Upon reviewing profitability analyses, does it appear that certain products have not been historically profitable?	•	•	•	____
i. For historically unprofitable product lines, to justify not writing down assets for impairment, has management used any of the following?	•	•	•	____
• Overly optimistic forecasts of future profitability	•	•	•	____
• Out-of-date forecasts	•	•	•	____
• Forecasts not prepared or reviewed by personnel with line responsibility for production	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
j. If written narratives accompany the forecasts, do they discuss downside possibilities that management has not adequately taken into account?	•	•	•	____
k. Are there any facts now known that would invalidate assumptions contained in the forecast?	•	•	•	____
l. For investments in non-publicly traded securities, have any of the following occurred?	•	•	•	____
• Does the company have financial data adequate to determine historical profitability of the investee?	•	•	•	____
• If the investee has not been historically profitable, has management failed to write down the investment based upon an overly optimistic forecast?	•	•	•	____
• If the investee has not been historically profitable, has management failed to write down the investment based upon a forecast prepared by management with business or family ties to the investor company?	•	•	•	____
Acquisition Contingencies and Cookie Jar Reserves				
a. Were contingencies established without a clear purpose or justification?	•	•	•	____
b. If contingencies were established by a current period charge to income, were earnings excluding the charge in excess of management or outside expectations?	•	•	•	____
c. Were contingencies established at or near the close of a reporting period?	•	•	•	____
d. Were contingencies established without adequate review by senior management?	•	•	•	____
e. Upon review of charges to a given contingency, are there charges for expenses that are not appropriate to the stated purpose of the contingency?	•	•	•	____
f. Was the timing of the takedown of contingencies coincident with achieving certain financial targets set by management or outsiders?	•	•	•	____
g. Was the amount of the takedown of contingencies for a given period necessary to achieve certain financial targets set by management or outsiders?	•	•	•	____
h. Has any of the following occurred with regard to acquisition contingencies?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
• Were contingencies established after twelve months from the date of the acquisition?	•	•	•	____
• Were contingencies set up for items not related to the acquisition?	•	•	•	____
• Does the quantity of costs allocated to the contingency in a given period cause earnings to reach certain financial targets set by management or outsiders?	•	•	•	____
Cost Shifting				
a. Has management made a recent change in policy with regard to capitalizing previously expensed costs?	•	•	•	____
b. Has a change in policy with regard to capitalizing previously expensed costs not been disclosed in company financial statements?	•	•	•	____
c. Has management proposed to capitalize a new category of expenditure that customarily is expensed on peer-group firm financial statements?	•	•	•	____
d. Does the timing of changes in policy with regard to capitalizing expenses coincide with any of the following?	•	•	•	____
• Implementation of a management bonus plan or calculation of bonuses under that plan	•	•	•	____
• Commencement of the sale of stock or the search for an equity partner	•	•	•	____
• Implementation of a new credit facility or recent problems in maintaining financial covenants under an existing facility	•	•	•	____
e. But for the capitalization of certain expenses, would any of the following occur?	•	•	•	____
• Management would not receive certain bonuses or other benefits under a management compensation plan.	•	•	•	____
• In the opinion of securities analysts, appraisers, or underwriters, the company's share price would be significantly lower.	•	•	•	____
• The company would be in violation of loan or debt covenants.	•	•	•	____
f. Does the capitalization of expenses cause the firm's Asset Quality Index to increase significantly in excess of increases (if any) for its industry peers?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
g. If company management provides segment or subsidiary financial data, especially if management or outsiders tend to point to performance of that segment or subsidiary in their discussions of company performance, has either of the following occurred?	•	•	•	____
• Have expenses been incurred by the parent that relates to the segment or subsidiary?	•	•	•	____
• Have other segments or subsidiaries incurred expenses that should be allocated to the segment or subsidiary in question?	•	•	•	____
h. Has senior management failed to establish proper procedures for allocating or apportioning costs among affiliates or, if there is a policy, is there evidence that adherence is lax or that there have been documented lapses?	•	•	•	____
i. Is there correspondence among heads of affiliates concerning disputes over expense allocations or apportionment that has not come to the attention of the audit committee?	•	•	•	____
j. Were contingencies established at the parent company for expenses anticipated for subsidiaries?	•	•	•	____
k. Are there debit entries in subsidiary expense or liability accounts that could reflect cost transfers to the parent or another subsidiary?	•	•	•	____
l. Are there debit entries in subsidiary expense or liability accounts that could reflect cost transfers to contingencies established at the parent level or in another subsidiary?	•	•	•	____
m. Is there any correspondence between accounting personnel at the parent and subsidiary levels that describe special procedures for certain costs that are incurred by the subsidiary but not charged to earnings of that subsidiary?	•	•	•	____
Recording Fictitious Revenues				
a. If the company requires signed agreements from customers before revenue is recognized, have sales personnel indicated or stated any of the following?	•	•	•	____
• Their managers have approved as income sales contracts that were not signed as of the period end.	•	•	•	____
• Unsigned contracts were recorded as revenue under the premise that key buyer personnel had given verbal approvals.	•	•	•	____
• Unsigned contracts were recorded as revenue under the premise that key buyer personnel had signed the contract but the contract was held up for other reasons.	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
b. Have there been prior internal control failures with sales cutoff?	•	•	•	____
c. If fabricated contracts are suspected, have the sales cutoff tests performed by internal or outside auditors failed to look for the fabrication and substitution of contracts?	•	•	•	____
d. Have sales cutoff tests failed to examine the history of sales returns and reversals over time?	•	•	•	____
e. With regard to the requirement for timely delivery, has any of the following occurred?				
• Are there lapses in documentation of delivery?	•	•	•	____
• Have customers complained about receiving deliveries too early?	•	•	•	____
• Have returns from a certain customer or reseller been abnormally high?	•	•	•	____
f. Is there evidence that certain customers or resellers are receiving unusually generous sales terms for returns or refunds?	•	•	•	____
g. Is there evidence that certain customers or resellers are receiving unusually low prices or above-average discounts?	•	•	•	____
h. Is the price for component products sold by the company dependent, at least in part, upon the price of the final product sold by another company?	•	•	•	____
i. Have royalties been accrued to income prior to receipt of confirmation from the payor that royalties are owed?	•	•	•	____
j. Do department heads have the authority to both approve sales and the recognition of related revenue in the financial statements?	•	•	•	____
k. Is there a lack of review of sales revenue recognition at the senior management level?	•	•	•	____
l. Is there a history of revenue being recognized improperly?	•	•	•	____
m. Have department heads approved significant refunds or returns that are out of the ordinary or appear to violate company policies?	•	•	•	____
n. Have refunds or returns been historically high for a certain department?	•	•	•	____
o. Have the reasons for refunds and returns not been documented or, if documented, have the reasons given been insufficient?	•	•	•	____

(continued)

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
p. Has senior management failed to review or been lax in reviewing significant sales refunds and returns?	•	•	•	____
q. If side letters are suspected, has either of the following occurred?	•	•	•	____
• Engineers, technicians, or others involved with the installation of the products indicated that certain customers made additional demands before agreeing to buy.	•	•	•	____
• There are notes or letters in sales files indicating that customer demands had been made to allow for returns or refunds.	•	•	•	____
r. Are sales approved before obtaining credit checks for new customers or for existing customers that are experiencing financial difficulties?	•	•	•	____
s. Is there an unusual concentration of orders from small or distressed customers occurring near the end of a reporting period or sales contest?	•	•	•	____

6. Critical Accounting Policies and Estimates (CAPE)

A yes answer to any of the questions in this section should prompt a re-evaluation of internal controls and communications between senior management, internal and outside auditors and the audit committee of the board of directors. A yes answer may also prompt disclosures to and discussions with the audit committee.

a. Management's assessment of the range of potential issues that could rise to the level of becoming a CAPE appears:
   i. To ignore significant issues identified in notes to the financial statements,
   ii. To ignore significant issues identified in management letters and other communications from outside auditors, including SAS 114 meetings,
   iii. To ignore significant issues identified by internal auditors,
   iv. To be constructed either hastily or simply in an effort to provide a list that appears to comport with reporting requirements, or
   v. To be a mere recitation of general accounting policies without any substantive analysis of risks from alternative accounting interpretations or estimates.

b. Having discovered a deficiency in the list of potential issues that could rise to the level of becoming a CAPE, neither management nor the board of directors have taken corrective action, which may include retaining forensic accountants.

c. Of the range of potential issues that could rise to the level of becoming a CAPE,
   i. Management's analysis of accounting policies appears to be incomplete in that significant alternative treatments were ignored,
   ii. Management's analysis of accounting policies appears to be inaccurate in that alternative accounting policies were incorrectly interpreted,

   iii. Management's analysis of accounting estimates failed to account for reasonably likely potential negative changes in cash flows, or
   iv. Management's analysis of accounting estimates ignored information that significantly increased the likelihood of a previously assessed potential negative change in cash flows.

d. For critical accounting policies presented to the audit committee, management's analysis of alternative accounting treatments appears to be biased against those policies because
   i. Management has misstated the scope or applicability of alternative accounting treatments,
   ii. Management has mischaracterized the nature of alternative accounting treatments,
   iii. Management has omitted relevant alternative accounting treatments, or
   iv. Management incorrectly assessed the materiality of alternative accounting treatments.
e. For critical accounting policies presented to the audit committee, management's analysis of alternative accounting treatments appears to be biased in favor of management's recommended policy because
   i. Management has misstated the scope or applicability of management's recommended policy,
   ii. Management has mischaracterized the nature of management's recommended policy, or
   iii. Management incorrectly assessed the materiality of management's recommended policy.
f. For critical accounting estimates presented to the audit committee, management's analysis
   i. Fails to account for the full range of reasonably likely cash flows under different circumstances,
   ii. Fails to account for known data relating to quoted markets or comparable asset values, or
   iii. Incorrectly applies valuation models or methodology.
g. Management fails to update its analyses of CAPE and/or fails to notify the audit committee in a timely manner should there be a change in facts known to management.
h. Management fails to update its analyses of CAPE and/or fails to notify the audit committee in a timely manner should there be a change in accounting policy (due to action of accounting standard setters or due to firm management's decision to change).
i. Management has not discussed with firm outside auditors either management's analysis of CAPE or changes to the analysis of CAPE.
j. Management has not consulted with firm internal auditors regarding management's analysis of CAPE or changes to the analysis of CAPE.
k. Disagreements by and between management and internal auditors have not been shared with the audit committee.
l. For those meetings of the audit committee in which management presents CAPE or changes to CAPE, the minutes do not indicate any substantive review or discussion.
m. For those meetings of the audit committee in which management presents CAPE or changes to CAPE, the minutes do not indicate that corrective action was taken when needed.