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

Charles R. Lundelius

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FINANCIAL REPORTING FRAUD:

A Practical Guide to Detection and Internal Control

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Notice to Readers

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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.

ABOUT THE AUTHOR

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The opinions expressed in this book are those of the author and do not reflect the positions of FTI Consulting, Inc. or the NASDAQ Stock Market.

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INTRODUCTION

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 years. 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. Congress responded with the passage of the Sarbanes-Oxley Act of 2002 that restructured the accounting profession and placed supervision in the hands of a government-appointed entity.

Financial Reporting Fraud: A Practical Guide to Detection and Internal Control addresses the fraud issue from the practical perspective, using illustrations and examples of fraud concepts, in addition to references to research findings and authoritative literature. The text draws upon 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 hightened standards of corporate governance imposed on public companies by Sarbanes-Oxley and related regulations will greatly impact private companies as well.

For instance, it would be difficult to imagine, in today's environment, that a bank loan officer would present to a loan committee the application of a private company for a significant loan if that company's board of directors did not have an audit committee; should such a loan default due to accounting fraud in the absence of an audit committee, bank senior management and regulators would probably not be very forgiving. Therefore, many of the reporting standards and internal controls now being imposed or recommended for public companies will soon find their way to private companies as well.

For that reason, in addition to the discussions and illustrations of areas of financial reporting fraud, *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* provides in the appendixes some of the key Securities and Exchange Commission proposed rules and staff accounting bulletins that, while targeted at public companies, will likely become standards for private companies also. A CPA preparing for the world after Sarbanes-Oxley should be well-versed in these issues, regardless of the type of company involved.

PART A

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 unscrupulous 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. Fraudulent acts become less obvious, however, when cloaked in the mantle of accounting standards that are incorrectly applied. For example, the applicable accounting standards in the United States are generally accepted accounting principles (GAAP), and those principles may allow management some discretion about when to recognize revenue or expenses. 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 GAAP 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 GAAP. Less-than-honorable people, however, might make use of these gray areas to produce financial statements that mislead. This practice is found most often in concert with other misleading applications of GAAP.

Those who commit fraud almost always fail to discuss their misuse of GAAP principles in the notes to financial statements. Although the accounting for a certain transaction may appear to be supported by GAAP, failure to disclose so as not to make the financial statements misleading may take the reporting entity out of GAAP compliance. Without knowledge of the impact of GAAP gray-area judgments on the 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 while, in reality, there may be serious problems that the misuse of GAAP 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 GAAP produce financial statements intentionally designed (with scienter) to mislead the reader, those decisions cross the line into fraud.

Legal and Regulatory Guidance and Standards

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

SEC 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, which states the following:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce,

> or 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.

Publicly traded companies must conform to GAAP and to the rules and regulations promulgated by the SEC under U.S. securities laws. The SEC drew heavily on accounting literature when it addressed the issue of accounting gray areas for materiality and other issues. SEC standards that have their origin in GAAP 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 GAAP.

Key Fraud Laws and Definitions

In addition to SEC Rule 10b-5, there are several other important laws and accounting statements that 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 business and officials, went further and codified the requirement that all public companies maintain adequate internal controls. FCPA Section 102 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 (1) 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 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, addresses the steps a company may take to mitigate criminal penalties if it is ever found to have violated U.S. law. Those steps include establishing policies and procedures designed to implement an "effective program to prevent and detect violations of law." The sentencing guidelines require that a company exercise "due diligence" to implement an "effective program," and such "due diligence" requires, at a minimum, that a company must: (1) spell out its policies and procedures, (2) communicate them effectively with its employees, and (3) designate individuals who will be responsible for enforcing those standards. If there is a likelihood that certain activities of a company or certain of its personnel are known to be at risk of violating U.S. law, as may be demonstrated by prior conduct, the federal sentencing guidelines impose heightened requirements on management to take steps to discipline offenders and implement procedures to prevent and detect such conduct in the future. Furthermore, there must be a monitoring mechanism with:

> Systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution. (FCPA Sec. 8A1.3(k)(5)).

However, even though the monitoring requirements of the federal sentencing guidelines existed for many years, many companies had been slow to implement such a reporting system until enactment of the Sarbanes-Oxley Act of 2002 (see the discussion in the section titled "The Sarbanes-Oxley Act of 2002") and other post-Enron reforms. Only as recent legislation and regulations imposed greater requirements on corporate audit committees and boards of directors have companies rushed to install fraud-reporting hotlines and other reporting systems.

More important, however, is that if a company implements the federal sentencing guidelines, that company and its management can hold up these actions taken as evidence of intent to prevent fraud. When the CPA is looking at how serious an organization is about fighting fraud, whether or not the organization has implemented steps previously described is a clear indicator. Finally, failure to implement applicable government standards "weighs against a finding of an effective program to prevent and detect violations of law." In the case of financial reporting fraud, those standards are expressed in GAAP and SEC rules and regulations, among others.

Statement on Auditing Standards No. 53

In 1988, 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.* This Statement, since superseded, set out the basis for distinguishing the difference between fraud and honest error. Referring to accounting fraud as "irregularities," SAS No. 53 stated:

> The 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, then, 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, AU sec. 316), 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, since superseded, used the term *misstatement* to characterize fraud, and stated the following:

> 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 was 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 and financial stability characteristics

Examples of red flags included aggressive or unrealistic forecasts, ineffective communication and support of entity values or ethics, and domineering management behavior or attempts to influence audit 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 ("The Relative Importance of Management Fraud Risk Factors," *Behavioral Research in Accounting,* 1/1/2001) that evaluated the weight placed by 140 external and internal auditors on each of the three 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, then, clearly stood out among auditors as the most important indicators of potential fraud. Within that category, three red flags led the list: history of violations, compensation tied to accounting, and lack of interest in internal controls. 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) incentives and pressures on management to commit fraud, (2) opportunities to commit fraud, and (3) the attitudes and rationalizations found among those who commit fraud. See Table 1.

Table 1. *Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting*

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

A.2 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 or 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 or the board of directors' 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[1]
— Personal guarantees of debts of the entity

d. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

[1] 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.

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 board of directors or audit committee oversight over the financial reporting process and internal control

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 reportable conditions

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, 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:

- 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 reportable conditions 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 the board of directors or audit committee
  — 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

When looking for early warning indicators, the CPA should first focus attention on the *incentives and motives* for fraud. 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 who 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 Materiality Loophole

Qualitative Materiality

With the publication of SEC Staff Accounting Bulletin (SAB) No. 99 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.)

The SEC staff provided examples.

> 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
> - 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

For example, the following illustrates the first bullet point. 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, though, 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 the correct value was less than the firm's quantitative materiality threshold, say 5 percent of assets, then, applying just a quantitative standard, management was able to argue that no adjustment would be required. SAB No. 99, though, 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 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, but when examining financial statement accounts, in most cases detected fraudulent intentional misstatements would be deemed material according to SAB No. 99. 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 was effectively closed.

Quantitative Materiality

In addition to imposing qualitative standards for materiality, the SEC pursued other steps to lower the triggers for quantitative materiality. In the matter of *W. R. Grace* (SEC Accounting and Auditing Enforcement Release No. 1141, June 30, 1999), Grace 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 is done to show consistent growth over several reporting periods (the rationale for smoothing earnings is discussed in detail in Chapter 3). W. R. Grace's outside auditors knew about the reserve, recognized that it violated GAAP (see Chapter 12 for a discussion of reserve accounting), and proposed adjusting entries. Grace management refused to make the adjustments, though, 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 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 up 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 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 the *W. R. Grace* case. In the SEC's view, then, if management touts the performance of a specific subsidiary and then manages its earnings, *Grace* would apply quantitative materiality at the subsidiary level.

Sarbanes-Oxley Act of 2002

When accounting frauds were tied to the collapse of Enron Corp., Global Crossing Ltd., and WorldCom, Inc., all occurring within the few months from December 2001 to June 2002, Congress reacted rapidly by passing the Sarbanes-Oxley Act of 2002, which was signed by President Bush on July 30, 2002. The Act 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 auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers." (Sarbanes-Oxley, Sec. 101(c)(2).) 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, the Act 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
>   (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. (Sec. 103(a)(2)(A)(iii).)

Thus, with Sarbanes-Oxley, the record-keeping 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 generally accepted auditing standards, the requirements for these procedures now carry the force of federal law (and enhanced penalties under the Act).

In addition, Section 404 of the Act 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. (Sarbanes-Oxley, Sec. 404(a).)

In addition to the auditor's evaluation of internal controls under Section 103 of the Act described here, under Section 404(b), outside auditors are required to "attest to, and report on," *management's assessment* of company internal controls as well.

More noteworthy, though, are the requirements 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. (Sarbanes-Oxley, Sec. 2(a)(3).)

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. (Sec. 407(b).)

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

(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, the Act 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, then, wanted to encourage a frank discussion between 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, and in particular the proposed rules contained in Release Nos. 33-8098; 34-45907, which set out the SEC's criteria for determining critical accounting policies and estimates. This book examines those criteria in detail, building upon the actual examples used in the SEC's proposed rules.[1]

[1] These examples are expanded from examples contained in Securities and Exchange Commission (SEC) Releases No. 33-8098 and No. 34-45907, Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies 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 shown, reflect the opinions of the author and not the SEC. The reader is encouraged to read the SEC releases, which are included as an appendix to this book.

Clearly, Sarbanes-Oxley 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 before release of the financial statements of any judgment calls.

The Act, though, 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;
> (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. (Sec. 302(a).)

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 also discusses in detail the role of senior management in the act of and prevention of financial reporting fraud.

While Sarbanes-Oxley principally applies to public companies, the Act and related reform measures will likely 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 non-public sectors. Therefore, whether the CPA works with public or non-public entities, knowledge of all the relevant standards is essential.

Common Methods of Committing Fraud

Research carried out for the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, found that, when it came to executing financial reporting fraud, the most common kinds of fraud methods were the following:

1. Overstatement of earnings
2. Fictitious earnings
3. Understatement of expenses
4. Overstatement of assets
5. Understatement of allowances for receivables
6. Overstatement of the value of inventories by not writing down the value of obsolete goods
7. Overstatement of property values and creation of fictitious assets

These methods tend to fall into three broad categories:

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

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

[2] There is no distinction in accounting literature between earnings management and earnings manipulation. The author makes this distinction, however, for ease in explaining different concepts of financial reporting fraud affecting the income statement.

Conclusion

The following chapters in Part A cover the various kinds of financial reporting fraud for each of the three categories and corresponding motives for each kind. The early indicators of financial reporting fraud (both quantitative and qualitative) are discussed in Part B, and the means to detect some of the most difficult-to-find kinds of fraud are covered in Part C.

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 increases revenues. Conversely, capitalizing marketing costs as an asset, contrary to guidance in generally accepted accounting principles (GAAP), decreases current period expenses. Notice also that both examples affect the balance sheet as well: Recognizing fictitious sales inflates accounts receivable; deferring marketing expenses creates some type of amortizable asset. Because the primary intent of these manipulations is, however, to increase earnings rather than create assets, these practices are classified as earnings manipulation.

Though 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." Earnings management generally involves the manipulation of a *series* of earnings data to achieve a perception of profitability and/or growth in earnings, as illustrated in *W. R. Grace* (Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Release No. 1141, June 30, 1999), 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.

Recent research has shed much light on the motives for earnings manipulation. The Committee of Sponsoring Organizations of the Treadway Commission sponsored research published in 1999 (the COSO Report) that examined SEC enforcement actions for the period of 1987 through 1997 (see Chapter 7 for a more complete discussion of the findings). The COSO Report found that motives for 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 to 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.

A fourth motive, to cover up assets misappropriated for personal gain, does not involve earnings manipulation and is not discussed in this book.

Earnings Improvement

Secondary Securities Markets 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 that increases in value if senior managers can fraudulently increase reported earnings before selling their shares.

Stock Compensation

Over the last several decades, management consultants, compensation committees, and academicians have 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 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, however, 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.

For senior management, though, 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), there is tremendous incentive 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 translates into a much greater increase in stock price—on the order of 15 to 40 times as much, or more. When a senior executive is trying to liquidate large numbers of shares, such an increase is meaningful. If, though, 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 1990s' Internet boom market, then-SEC Chairman Arthur Levitt observed that companies missing street earnings per share (EPS) expectations by as little as one penny per share were hammered. 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, then, provides a powerful motivator for income statement manipulation and subsequent illegal insider trading. A manager who is heavily compensated in stock needs 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 from the perspective of personal net worth and from colleagues in similar situations to manipulate earnings. 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 requirements 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 urged compensation committees to make bonuses a significant part of total compensation. The end result was that managers certainly were motivated to increase reported earnings, but some managers, faced with the prospect of seeing their compensation fall significantly if they failed to hit their goals, succumbed to the temptation to manipulate earnings. For those managers, the increase in reported earnings was not necessarily an accurate reflection of their business performance. 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 statement 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 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 then begin trading that stock in the secondary markets after shares are issued. The primary markets, though, present yet another opportunity for financial statement fraud, especially for 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, there are other, seasoned, shares outstanding that 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, there are numerous fraud motives and methods. (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 (see Chapter 5). For public companies, however, 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 planned to go public, the expense sharing and revenue allocations among the related entities, done most likely for tax minimization, need 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 become 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. When management, which was essentially 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. That scheme would violate various provisions of the Internal Revenue Code (see Revenue Procedure 2002-18 for a discussion of IRS-imposed reallocations used to correct such schemes). 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, then, relying on those financial statements to value the shares, may underestimate future rent expense. The end result is financial statement fraud arising from tax fraud and an overvaluation of the IPO shares.

SEOs

Academic research over the last decade 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, about 3 percent, after a firm announced an SEO.[1] 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 make up for and eventually reverse any near-term dilution. Reviewing other research, however, Gombola, Lee, and Liu found that actual performance 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 percent. 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.[2]

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 aided by the fact that the fraud resulted in raising more capital that, in turn, could have been invested to produce earnings that cover up the fraud in later periods. The following example illustrates how.

Example Scenario. The Operating System Co., a 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 management believed that Data Mover's product would complement their own and that, since the target market for both products was the same—mainframe users—there was an opportu-

[1] "Evidence of Selling by Managers after Seasoned Equity Offering Announcements," *Financial Management,* September 22, 1997.

[2] Ibid.

nity 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/Data Mover customer instead of two.

Operating System's chief financial officer (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, though, the joint sales calls had so far resulted in fewer unhappy customers, so the acquisition reserves went largely untapped, though it was still too early to tell whether they would be needed.

The CFO concluded, then, 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 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 to 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. While this example deals with loss contingencies, as discussed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies,* and FASB Statement No. 141, *Business Combinations,* 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 GAAP; 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 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* standard discussed in Chapter 1, the SEC would likely assert that materiality should be judged against the increase in operating income caused by reclassing some of the payroll costs. From the perspective of qualitative materiality, relying on Staff Accounting Bulletin No. 99, the SEC would likely go further to assert that any knowing violation of GAAP, 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.

The NASDAQ Stock Market, for example, looks to income from continuing operations for several of its listing standards for both the NASDAQ National Market (NNM) and the NASDAQ SmallCap Market (SmallCap), as summarized in the accompanying tables at the end of this chapter. To become listed on NNM for the first time, a firm must meet at least one of three initial listing standards. The first NNM initial listing standard requires a firm that wishes to be listed to have reported pretax income before continuing operations of at least $1 million in either the last fiscal year or in two of the last three years. The second and third NNM initial listing standards do not have an income requirement but do require that the firm demonstrate certain levels of shareholders' equity or market value. To initially list on the SmallCap, a firm must have net income from continuing operations of at least $750,000 in either the latest fiscal year or in two of the last three years.

There is also a requirement that a firm traded on NNM or the SmallCap 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 so if an investor wishes to purchase some shares and there are, at that moment, no ready sellers in the market, the market maker is obligated under NASDAQ rules to sell a minimum number of shares from its inventory. 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 a bid 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 who 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.

Once a firm's stock meets the initial listing standards, it must meet the continued listing standards to remain listed, and those standards operate in a manner similar to the standards for initial listing. The only difference is that continued listing standards are more relaxed to allow for negative changes in income and stock price after the initial listing.

More important, though, all NASDAQ listing standards have set minimums for market value of publicly held shares (MVPHS) and bid price that are largely a function of reported revenues or earnings. For listing purposes, publicly held shares are those shares in the hands of investors who are not directors, officers or major (10 percent or more) shareholders. The bid price used for listing requirements is the bid at the close of market trading on a given day. MVPHS, then, is a function of shares outstanding times the price per share. Price per share, though, is a function of the P/E multiple applied to forecasted earnings per share, and analysts typically forecast earnings beginning with historical earnings. Substituting historical, basic earnings per share (EPS) in place of forecasted EPS for simplicity, the MVPHS equation becomes:

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

EPS is, of course, a function of earnings; therefore, from the equation, it is clear to see that reported earnings are an important driver in this listing standard. (During the Internet bubble, when some analysts did not give as much weight to traditional earnings measures, companies used another income statement item, sales revenues, as their metric; thus, even for Internet firms without positive earnings, the income statement still provided the key to setting value.)

Bid price is simply the last two terms of the previous equation:

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

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, to give three examples. However, over the long run, earnings 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 if delisted or unlisted firms can trade their shares on the Over the Counter Bulletin Board (OTCBB) market? The OTCBB is an electronic market, administered by NASDAQ, on which shares are traded between brokerage firms on behalf of their customers. However, unlike the NNM or the SmallCap, there is no requirement that a firm traded on OTCBB have a minimum number of market makers.

How much is liquidity worth? Valuation studies of shares issued by public companies that are restricted, that is, not allowed to be traded like the companies' publicly registered shares, find that the restrictions produce a 30 percent to 40 percent discount from the price of the publicly traded shares. After having served on the NASDAQ Listing Qualifications Panel for several years, the author believes that shares delisted from the NNM or the SmallCap to the OTCBB may incur a decline of 20 percent in price. This finding, while anecdotal, does make sense in the context of the valuation studies: Restricted shares may not be traded at all except under strict limits set by securities regulations (see SEC Rule 144); OTCBB shares remain freely tradable, but 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. Nevertheless, 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

The three primary motives for earnings manipulation cited in the COSO Research Report—earnings improvement, new issue 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, though, 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, then, 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.

NASDAQ Listing Standards

The following tables summarize the initial and continued listing standards of the National Association of Securities Dealers Automated Quotation (NASDAQ) markets. NASDAQ uses a two-tier market system that differentiates between more mature companies and smaller, usually younger, companies. The first table summarizes the listing standards for the NASDAQ National Market, the market for larger companies; the second table summarizes the listing standards for the SmallCap market. Among the various listing standards, the requirements for net income, shareholders' equity and market value of publicly held shares tend to be the principal, though not exclusive, targets of fraudsters using earnings manipulation. The standards for corporate governance that relate to audit committees are discussed in more detail in Chapter 7, "Research Findings on Fraudulent Accounting" and Chapter 8, "Role of the Audit Committee."

NASDAQ NATIONAL MARKET

FINANCIAL REQUIREMENTS

Companies that choose to list their securities on The NASDAQ Stock Market® must meet minimum initial and continued inclusion financial requirements.

A company must meet all of the requirements under at least one of three listing standards for initial listing on The NASDAQ National Market®. A company must continue to meet at least one continued listing standard to maintain its listing.

Requirements	Initial Listing			Continued Listing	
	Standard 1 Marketplace Rule 4420(a)	**Standard 2 Marketplace Rule 4420(b)**	**Standard 3 Marketplace Rule 4420(c)**	**Standard 1 Marketplace Rule 4450(a)**	**Standard 2 Marketplace Rule 4450(b)**
Stockholders' equity	$15 million	$30 million	N/A	$10 million	N/A
Market value of listed securities or Total assets and Total revenue	N/A	N/A	$75 million[1, 2] or $75 million and $75 million	N/A	$50 million or $50 million and $50 million
Income from continuing operations before income taxes (in latest fiscal year or 2 of last 3 fiscal years)	$1 million	N/A	N/A	N/A	N/A
Publicly held shares[3]	1.1 million	1.1 million	1.1 million	750,000	1.1 million
Market value of publicly held shares	$8 million	$18 million	$20 million	$5 million	$15 million
Minimum bid price	$5	$5	$5[2]	$1	$1
Shareholders (round lot holders)[4]	400	400	400	400	400
Market makers[5]	3	3	4	2	4
Operating history	N/A	2 years	N/A	N/A	N/A
Corporate governance[6]	Yes	Yes	Yes	Yes	Yes

1 For initial listing under Standard 3, a company must satisfy one of the following: the market value of listed securities requirement or the total assets and the total revenue requirement. Under Marketplace Rule 4200(a)(19), listed securities is defined as "securities quoted on NASDAQ or listed on a national securities exchange".

2 Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under the market value of listed securities requirement of Standard 3 must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.

3 Publicly held shares is defined as total shares outstanding less any shares held by officers, directors, or beneficial owners of 10 % or more.

4 Round lot holders are shareholders of 100 shares or more.

5 An Electronic Communications Network ("ECN") is not considered a market maker for the purpose of these rules.

6 Marketplace Rules 4350 and 4351.

NASDAQ SMALLCAP MARKET

FINANCIAL REQUIREMENTS

A company must meet minimum financial requirements for initial listing and continue to meet standards to maintain its listing on The NASDAQ SmallCap Market℠.

Requirements	Initial Listing	Continued Listing	Marketplace Rules*
Stockholders' equity[1] or Market value of listed securities[2] or Net income from continuing operations (in latest fiscal year or 2 of the last 3 fiscal years)	$5 million or $50 million or $750,000	$2.5 million or $35 million or $500,000	Rule 4310(c)(2)
Publicly held shares[3]	1 million	500,000	Rule 4310(c)(7)
Market value of publicly held shares[4]	$5 million	$1 million	Rule 4310(c)(7)
Minimum bid price[2]	$4	$1	Rule 4310(c)(4)
Shareholders (round lot holders)[4]	300	300	Rule 4310(c)(6)
Market makers[5]	3	2	Rule 4310(c)(1)
Operating history or Market value of listed securities[2]	1 year or $50 million	N/A	Rule 4310(c)(3)
Corporate governance	Yes	Yes	Rules 4350 & 4351

* Applies to domestic and Canadian securities. For non-Canadian foreign securities and American Depositary Receipts, see Marketplace Rule 4320.

1 For initial listing, a company must satisfy one of the following to be in compliance: the stockholders' equity requirement, the market value of listed securities requirement or the net income requirement. Under Marketplace Rule 4200(a)(19), listed securities is defined as "securities quoted on NASDAQ or listed on a national securities exchange".

2 Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under market value of listed securities requirement must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.

3 Publicly held shares is defined as total shares outstanding less any shares held by officers, directors or beneficial owners of 10% or more. In the case of ADRs/ADS, for initial inclusion only, at least 100,000 shall be issued.

4 Round lot holders are shareholders of 100 shares or more.

5 An Electronic Communications Network ("ECN") is not considered a market maker for the purpose of these rules.

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. The reasons fraudsters engage in earnings management go beyond simply trying to meet a forecast, though. 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 second type of firm, a forecast looking five years out could have a number of widely divergent outcomes. For example, five years of negative 15 percent per year change in earnings puts earnings in year five at 44 percent of the base year earnings, whereas five years of 25 percent annual growth produce year five earnings equal to over 300 percent of base. In contrast, the more predictable firm, after five years, will have earnings ranging from 122 percent to 134 percent of base year earnings. Clearly, the more predictable firm is easier to value.

There is more to predictability, though, 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.

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. The lower the cost of equity, the lower the rate 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 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 for Consistent is:

$$R_{\text{Consistent}} = R_{\text{f}} + \beta_{\text{m,Consistent}} (R_{\text{m}} - R_{\text{f}})$$

where:

$R_{\text{Consistent}}$ is the total return (dividends and price appreciation) of Consistent's 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)

$(R_{\text{m}} - R_{\text{f}})$ 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

$\beta_{m,Consistent}$, called by its Greek letter "beta," is a measure of the degree changes in excess returns of Consistent's stock mirror 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 going 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 percent. 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 stock has excess returns of 30 percent; however, if the market declines by 15 percent, Volatile stock declines by 30 percent, while Consistent stock declines by only 15 percent. Therefore, stocks with higher betas, like Volatile's, have greater volatility of returns.

The Price of Volatility

The market extracts a penalty, though, for volatility. Using the CAPM formula and the examples of Consistent and Volatile, assume the risk-free rate is 5 percent and the market excess return is 15 percent.

The return on Consistent stock will be:

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

The return on Volatile stock will be:

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

Volatile's cost of equity, then, 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, it is more volatile) relative to the overall market as Consistent's stock. Given that the cost of each firm's equity discounts its future cash flows to the present, the discount rate for Consistent's forecast dividends is 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, or $50.00. The value of a share of Volatile's stock is $15 divided by 35 percent, or $42.86. Therefore, even though Volatile's stock pays a dividend expected to be 150 percent 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.

Enhanced Share Value

The importance of steady growth does not affect just cost of equity, though. 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 the Single-Stage Gordon Growth Model to Determine Share Value

A rudimentary version of the Gordon Growth Model, the Single-Stage Gordon Growth Model, is used by securities analysts to determine share price. For example, assume Volatile, Inc. has no marketable debt. According to the single-stage model, the share price of Volatile's stock is determined as follows:

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

where:

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

D_{Volatile} is Volatile's current annual dividend
R_{Volatile} is the cost of equity capital (calculated above)
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 annual dividend remains at \$15 and cost of equity is 35 percent. The Gordon Growth Single-Stage Model calculates the price of Volatile's stock as:

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

Therefore, adding a 15 percent growth rate, Volatile's stock price rises from \$42.86, the value assuming no growth, to \$86.25, double its stock price. (The previous equation used to value Volatile stock without growth was actually the Gordon Growth Single-Stage Model with g set to zero.)

The Reward of Consistency and Growth: Price/Earnings Multiples

The end result is 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 Co. had a lower beta and cost of equity. If it managed to achieve growth of 15 percent, its share price would be:

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

Even though Consistent paid current dividends of only \$10 per share compared to Volatile's \$15, with the same growth rate of 15 percent, Consistent's share price is much higher than Volatile's 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 to \$50 (without growth), or more than \$7 over Volatile's (no-growth) price, even though Volatile paid a much larger dividend. Combined with growth, though, 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.

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). Earnings per share, then, would equal the annual dividend divided by the payout ratio; in the present case, EPS equals current dividend divided by 75 percent. To contrast consistency and growth, assume Consistent has both and Volatile has neither. As calculated above, when both earnings consistency and growth were included in Consistent's stock price, that price was $230. 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:

$$
\begin{aligned}
P/E_{\text{Consistent}} &= \$230.00/(\$10/75\%) \\
&= 17.25 \\
P/E_{\text{Volatile}} &= \$42.86/(\$15/75\%) \\
&= 2.14
\end{aligned}
$$

Though 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, then, 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. The motives for earnings management, however, are broader and 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 those shares at an earlier date. Examples of stock granting or sale restrictions and inducements include the following:

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 gain 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 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 chief executive officer the title of "miracle worker."

Not surprisingly, Acme's executives were well compensated. While 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. 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. 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. 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 stock bonuses each year (for each five-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, though, and if that ratio could be maintained and if the cash bonus earnings target could be met, Acme's chief financial officer (CFO) believed 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.

Early in the year, however, the satellite components manufacturing division began to experience problems. Commercial launches were postponed or canceled as satellite communications ventures failed to attract new customers and as traffic on existing satellites did not grow as expected. Several of Acme's contracts were terminated, idling some plant and 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.

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 a finance charge 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 funds but also would cause the securities analysts that 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 earnings, the CFO believed that reported earnings over the next several quarters would be key. Those earnings needed to come in on target with analyst 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, though, would be quite a challenge because demand for components in the aerospace industry is tied to contracts that have already been awarded and does 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 most of the plant and equipment that were idled initially were acquired in a purchase combination about one year ago, when the satellite division acquired the assets of Orbit Company. The controller recommended an adjustment of the purchase price to allow for a loss contingency for idled plant and equipment, which he believed was permitted under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141, *Business Combinations,* if done within 12 months of the transaction date. 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 reserve instead of an income statement account. The CFO thought this was "a brilliant solution." As 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, though, did not check with the aircraft components plant managers to see if they actually needed the equipment.

Turning, then, 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 contracts 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 and not 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 Statement No. 142, *Goodwill and Other Intangible Costs,* 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. Anyway, even if he did have to write down the Orbit goodwill, the CFO believed he could explain the impairment as a one-time 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. Furthermore, 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 chief executive officer 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 reserves (see Chapter 11), and the failure to make 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 their 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 all the 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 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 earnings per share might not be affected greatly 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 Gordon Growth 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 loss contingency reserves from a previous acquisition that would then absorb some of the write-offs. The second scheme would route the cost of idle equipment over to the defense division, where contracts could turn the extra expense into income. Both schemes violated generally accepted accounting principles (GAAP).

For the acquisitions reserves scheme, the controller's reference to FASB Statement No. 141 was only, at best, partially correct. FASB Statement No. 141 does provide guidance about the amount of time, the "allocation period," the buyer has to make adjustments to the purchase price of an acquisition:

> Although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination.[1]

Acme may have met the one-year guidance in FASB Statement No. 141, as the controller noted, but idle plant and equipment did not meet the FASB Statement No. 141 requirements to be included in the purchase price of Orbit. To adjust the purchase price, the idle capacity issue had to be identified before the acquisition to qualify as a "preacquisition contingency," defined as:

> A contingency of an entity that is acquired in a business combination that is in existence before the consummation

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[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141, *Business Combinations* (FASB, *Original Pronouncements,* vol. 2, FAS141), Appendix F, Glossary.

> of the combination. A preacquisition contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.[2]

The problems in the satellite industry that idled the Orbit assets did not arise until one year after the Orbit transaction; therefore, the idle plant and equipment was not a preacquisition contingency. Without being considered a part of Orbit's purchase price, the contingency could not create goodwill, as the controller did when he debited goodwill and credited a reserve 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. Here, the fraudsters actually violated a second GAAP principle in addition to failing to take an impairment charge. The example stated that early in the fiscal year, "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 estimated, a loss contingency under FASB Statement No. 5, *Accounting for Contingencies,* should have been established (with a charge to current net income) for that entire amount in the current quarter, not spread out over several 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 GAAP for precisely that reason: to alert financial statement readers.

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 necessary [that is, the asset impairments] in order to make the statements made [Acme's quarterly income statements], in the light of the circumstances under which they were made [problems the market noted in the satellite industry], not misleading."

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

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[2] Ibid.

The example contained some clues that could have signaled these frauds. Adjustments to purchase price late in the one-year allocation period discussed in FASB Statement No. 141 should be scrutinized carefully. Looking at the requirements to qualify as a preacquisition contingency, the contingency must have existed before the acquisition, and all that is left is to quantify the contingency. FASB Statement No. 141 provides guidance about how to determine the amount of the contingency (discussed in more detail in Chapter 11) and states that "the existence of a preacquisition contingency for which an asset, a liability, or an impairment of an asset cannot be estimated does not, of itself, extend the allocation period."[3]

Facts should generally emerge in the first few months that help narrow the range of possibilities of a preacquisition contingency and allow for a materially accurate estimate. Therefore, there should be a strong and convincing reason for why a contingency could not be resolved until nearly one year after acquisition, and a CPA should carefully review the rationale to be sure that the allocation period was not held open simply due to the existence of the preacquisition contingency.

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 least the estimated moving costs and down time may be needed for past or 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 CFO might be right about not getting caught on his FASB Statement No. 142 goodwill impairment analysis if auditors blindly apply a qualitative materiality standard when setting up their audit program. The FASB Statement No. 142 analysis was the CFO's Achilles' heel, though, because the controller's "brilliant idea" manufactured additional goodwill from the Orbit acquisition that might not withstand the FASB Statement No. 142 earnings test: The present value of future earnings from the Orbit assets, now in the hands of Acme, have to equal or exceed the assets' carrying value on Acme's books or Acme

[3] Ibid.

will have to take a write-down to earnings. Adding more goodwill for the idled plant and equipment increased the carrying value on Acme's books but decreased future earnings because the former Orbit assets would no longer be productive. An honest analysis of the higher carrying value might have resulted in a write-down, reversing all the CFO's efforts to cover up the problems in the satellite segment. The CFO might try to explain away the write-off as a one-time charge, but the analysis would likely open up to questioning about why goodwill was increased just before being written off. Therefore, a useful addition to audit procedures would be the review of activity in preacquisition reserves, especially any reserves set up or adjusted after the acquisition date.

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 GAAP, may be colored by the intent to show the company in the best possible light. Accrual, deferral, and allocation procedures designed to permit the relation of revenues and expenses, gains, and losses across periods also allow management considerable leeway about when to declare any monies as *earned*. When, within this process, does discretion become the intent to deceive? Within what limits should management be acting to permit investors to price the company's securities in the market? How much earnings *smoothing* actually misrepresents the trend of economic performance as opposed to 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":

> Flexibility 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, however, when 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, the managements of publicly traded companies, especially growth and high-tech companies, have for the last two decades been under tremendous pressure from both analysts and investors to perform. 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 performances that are good by historical standards can cause a price decline if they 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.

Four Types of Earnings Management

In his 1998 speech, Levitt focused on the following four main fraudulent practices used to enhance earnings.

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 reserves for shutting down operations or shifting operations to other areas. If the reserve estimates are too large and actual expenses do not consume all the reserves, 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."

In-Process Research and Development

After one company acquires another, research and development (R&D) work performed in one or both of the companies may be redundant because of a change in corporate direction under the new management. For that reason, companies may write off some in-process R&D projects that have yet to be expensed because they do not fit into the new corporate plans. A number of companies, however, have taken advantage of the opportunity to write off substantial amounts of in-process R&D, by applying a principle similar to the big bath restructuring charge. Management believes that the company can take a large, one-time hit to earnings without further hurting its stock price when the financial community is already expecting some write-offs because of the acquisition. By taking the write-off at the time of the acquisition, these R&D expenses will not weigh on future earnings.

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 a GAAP principle to manage the final earnings figure. In a calendar quarter in which a company expects to outperform market expectations, it might create 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 predicted it will not make enough income to meet market expectations, management can reverse out 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 reserves may appear unrelated to earnings expectations. GAAP provides for the booking of loss contingencies in FASB Statement No. 5, provided the loss contingencies are both quantifiable and probable. In reality, however, the possibility of losses on future contracts most likely existed before the establishment of the reserve and continued to exist after the reserve was reversed into income. The reserves then become an accounting artifice used by management to manage earnings to meet market expectations. Moreover, management violated GAAP, in this example, either by creating the reserve without justification or reversing the reserve without any change in the degree of risk that the loss would in fact occur. Such reserves 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 or not there is fraud.

The SEC decided to weigh in on this matter when it issued Staff Accounting Bulletin No. 99 (discussed initially in Chapter 1; the full text is included in Appendix B), 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 were 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 application of appropriate accounting standards has no basis in accounting literature (or in U.S. securities laws).

The FASB in 1980 issued Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* which addressed 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.[4]

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. Before the release of FASB Concepts Statement No. 2,

[4] FASB, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (FASB, *Original Pronouncements,* vol. 3, CON2), paragraph 132.

the U.S. Supreme Court, in reviewing a securities case (*TSC Industries v. Northway, Inc.*) involving materiality issues, 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." Therefore, both accounting literature and the U.S. 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. There is now more guidance in the form of SAB No. 99 and case decisions coming from the SEC, such as *W. R. Grace* (SEC Accounting and Auditing Enforcement Release No. 1141, June 30, 1999; see Chapter 1). The CPA's challenge is to keep up with the rapidly changing landscape of materiality issues.

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, though, balance sheet frauds have become more complex and the potential rewards much greater as the balance sheet has grown in importance and as 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. Under generally accepted accounting principles (GAAP), most assets on a balance sheet are recorded at their original historical cost and are not adjusted as their market values change. Through the urging of the Securities and Exchange Commission (SEC), though, accounting standard-setters over the last decade have moved closer to reflecting values for assets and liabilities at current prices, especially if the values of those assets and liabilities are volatile and subject to significant change over short periods of time. For example, financial and commodity derivatives are now marked to their market values under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.* Even presumably less volatile assets, such as plant and equipment, under certain circumstances, can be written down (though not up) to fair value under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Thus the balance sheet, with some justification, has gained more importance as it has become a more accurate reflection of current values of assets and liabilities. Lenders and investors, then, have come to rely on the balance sheet more. Indeed, numerous academic studies 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.

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. A typical bank revolving-loan covenant, for example, may set out one or more of the following requirements:

1. A minimum amount of shareholders' equity
2. A maximum debt-to-equity ratio
3. 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 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.

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 by 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 based on 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.

Direct balance sheet manipulation does not necessarily take place in a vacuum, though. 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, then, 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, then, the factor, in the short-run at least, is led to believe that the firm expects to receive more 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:

1. Fraudsters may wish to bolster the assets of another entity.
2. Fraudsters may wish to keep asset values at unsustainably high levels to hide management mistakes by failing to record impairments and write-downs.
3. Fraudsters may wish to hide liabilities to avoid difficult questions from lenders, current investors, potential investors, and regulators.
4. 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, called Betascott (a name taken from an SEC proposed rule release),[1] is shown as a publicly traded company to cover some issues that

[1] This example is expanded from examples contained in Securities and Exchange Commission (SEC) Releases No. 33-8098 and No. 34-45907, Disclosure in Management's Discussion and

arise due to public disclosure requirements, but the fraud and motives illustrated can be found in nonpublic companies as well.

Example Scenario. Betascott Company manufactures and sells data storage devices, principally computer hard drives. 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 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 and Pocketdrive 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

Analysis about the Application of Critical Accounting Policies 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 shown, reflect the opinions of the author and not the SEC. The reader is encouraged to read the SEC releases, which are included as an appendix to this book.

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, though, 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, presents a plan to Pocketdrive management to "clean up" the accounts payable. The controller's plan is essentially to reverse any unbilled payables outstanding for more than 90 days. "If our vendors have not sent us a bill within three 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 asks which vendors have failed to send a bill, and the controller names some unaffiliated suppliers that have overlooked a few shipments. The vice president then asks how much the "clean-up" will contribute to their problem with the current ratio, and the controller responds that the ratio should climb to 2.5:1 by year end. The vice president approves the plan, suspecting that most of the improvement in the ratio is attributable to write-offs of intercompany payables owed to Megadrive. The vice president, though, does conveniently forget to tell Betascott management about the "clean-up" plan, and Pocketdrive's controller reports to the bank that Pocketdrive is 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. While the scheme was originated to avoid problems with an outside lender, many motives were 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 while 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. Pocketdrive's margins were being squeezed by competition, so 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, then, 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 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. The root of the problem, however, was grounded in the visibility of Pocketdrive, purposely engineered by Betascott management. Whenever management focuses attention in such a specific manner, the pressure on that operating segment is enormous. 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 *W. R. Grace* (SEC Accounting and Auditing Enforcement Release No. 1141, June 30, 1999), 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, though, by pointing out that Grace management had trumpeted the division's earnings growth and prospects, thereby moving the materiality test down from the corporate 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.

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 $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 FASB Statement No, 144, *Accounting for the Impairment of Long-Lived Assets.* 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 asset is not recoverable and the company must recognize an impairment.
2. If there is an impairment as determined in the first step, the amount of impairment to be recognized is the excess of the reported value of the assets over the fair value of those assets.

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

The assistant consulted several industry forecasts, including one study commissioned by Betascott last year, most predicting 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 cash flows, no matter which industry forecast she used, was under the reported value of the PP&E, indicating that the assets were impaired.

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 three years, producing an operating loss last year. To predict a turnaround, then, 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. Using that discount rate, she discounted her forecasted cash flows to the present and determined that the PP&E had a fair value of $170 million. Megadrive, then, 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. While the vice president thought she might be successful in shopping around for a valuation 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 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.

The vice president, though, 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, though, 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, though, 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 to $220 million, mostly due to the marketing department's hope that future sales of the Stored line would achieve 40 percent market share within three years. Therefore, using the inflated sales data, the first step of the FASB Statement No. 144 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, 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 someone 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 management's 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 since there is little historical data on that line, the auditors may conclude that the forecast is reasonable under the circumstances. FASB Statement No. 144 allows for a wide interpretation of forecasting techniques for future cash flows, and using a probability-weighted forecast, for instance, auditors may conclude that Megadrive's estimate was appropriate.

But the auditors can go further. If there is an audit committee (which is required for public companies), Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380), as amended, states that "[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." Therefore, the auditor is required to inform the audit committee of the reasonableness of "sensitive accounting estimates." It may help the audit committee, though, if the auditor also spelled out the range of possibilities for those accounting estimates that are most critical and subject to material change. If, in the example of Betascott, the auditors could point out that, while 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.

The SEC has proposed rules that would require disclosure of "critical accounting policies," such as the range of possible outcomes for material accounting estimates, in the MD&A section of filings for public companies. Such disclosure, though, would be helpful to readers of financial statements of private companies as well. Assuming that the estimated sales for the Stored line is defensible, the following is a suggested disclosure for Betascott, taken from the SEC's 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.

We reviewed our hard drive-related PP&E in our Megadrive subsidiary for impairment, as of yearend, 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 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 yearend, 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 yearend 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. (SEC Release No. 33-8098 and No. 34-45907, Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies)

Such a disclosure may appear to be too bitter a pill for private companies to swallow, especially if, as in the above example, management believes that disclosure will open the possibility of more problems. Frankly, though, the lenders in the example have probably already made some assessment about the value of Megadrive's assets, and disclosure of a well-reasoned valuation may actually serve to head off any further action by the lenders.

However, at the very least, a private company's senior management or auditors could provide such a statement similar to this proposed disclosure to the company's audit committee. Then, the audit committee would clearly be on notice, not only that there was 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, there is no audit trail.

The motives of balance sheet manipulation include the following:

- Pressure from management to avoid write-downs so 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 through 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: 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, though, typically come from creditors (and regulators in regulated industries) that use balance sheet accounts as measures of financial security (also see the section in Chapter 1 titled "Examples of Fraud Risk Factors").

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 investigated thoroughly. Outside auditors can also play an important role by identifying critical accounting policies 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.

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 relating to the fraud. Second, the Securities and Exchange Commission (SEC), with jurisdiction over public companies, has been in the forefront of both setting standards by which fraudulent actions are judged and, working in concert with the Justice Department and other agencies, the prosecution of fraud in publicly traded companies. Closely held private companies, however, 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, outside shareholders, bankers, and venture capitalists 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, there is a motive for earnings manipulation 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, 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 reconcile: one for investors and bankers and one for the tax authorities. 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 may not reconcile to the financial reporting books through legal reconciling entries. For example, revenues parked off-shore in a tax haven or through the use of related entities is able to shift costs from low-tax rate to high-tax rate affiliates.

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 as to force the company to go to venture capitalists (see the section of this chapter titled "The Pressure to Go Public for the Venture Capitalists"), the founders and key managers can retain control as they sell shares to outsiders.

The minority outsiders, though 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 the Banker 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 foreclose 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, then, 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 watch carefully 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—say, past 90-days—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 From Venture Capitalists to Go Public

If the private firm is funded by venture capital, pressure to perform can be enormous. For instance, venture capitalists (VCs) in high technology ventures generally look to cash out of their investments within three to five 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 about 100 percent or more to make up for the losses sustained in firms that did not succeed.

The Small Initial Public Offering Window

The exit plan for most venture capitalists is usually an initial public offering (IPO) of stock to be publicly traded. Part of the shares offered to the investing public consists 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. The IPO market, though, 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.

Securities Law

Consequently, the period leading up to going public is a time of intense pressure and negotiation. For this reason, the Securities Act of 1933 (1933 Act) sets stricter liability standards for firms going public than the standards under the Securities Exchange Act of 1934 (1934 Act), which 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 1933 Act 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 1934 Act, 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. Due to the strict liability standards imposed by the 1933 Act, if management were to attempt to manipulate financial data, the manipulation would be most carefully hidden. In all likelihood, any manipulation would come by the indirect methods described in previous chapters and make full use of accounting gray areas. In particular, 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'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 three 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 VC.

Link management had aggressively pushed the development of JIT over the years, focusing principally on adding features demanded by customers. As Link added features 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. Each change, no matter how large or small, was given a new version number (such as 1.0, 2.0, 3.0).

JIT was *commercially feasible,* as the term is used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs,* with the launch of its first version. Since management and the VC were interested only in the monthly cash burn rate, though, neither paid much attention to the financial statements. Link's chief financial officer (CFO), then, simply expensed the development costs because she felt that trying to separate capitalizable costs under FASB Standard No. 2 would be too much trouble, and it did not appear that anyone cared anyway.

Then Link's CFO, a 28-year-old who had previously worked at Link's auditing firm before coming to Link, 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.

The VC director, though, 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 VC was bailing from a bad investment and leaving the IPO investors with "a dog." The director said that his investment banker said 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 of development costs to achieve a "20 percent reduction in development costs," and he wanted the adjustments made quickly because he did not know when the IPO window would close.

Link's CFO concluded that since 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 reclass.

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 the other members of the management team, even though they may not have known about the fraud.

Other members of Link's accounting staff would have to be involved, though, to make the reclasses. 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 reclasses. Since 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. This misleading rise in earnings could induce an appraiser or stock valuations specialist to assign a higher growth rate to projected earnings. It is just as likely, however, that the appearance of consistently rising earnings could suggest the use of a lower firm-specific risk premium to calculate the present value of that projected earnings stream because earnings would appear to be less volatile. The end result of earnings management in a closely held company is thus similar to the effect of earnings management on the price/earnings (P/E) multiple of publicly traded companies (see Chapter 3).

Generally Accepted Accounting Principles-Basis Standard

Generally accepted accounting principles (GAAP) are the standard of accounting for companies that are publicly traded and listed on U.S. stock exchanges because those firms must file financial statements with the SEC, and the SEC requires those statements to conform to GAAP. Private companies, though, may use other accounting methods, 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 financials presented to the board of directors and to outsiders be in conformity with GAAP. 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 three tax years (Internal Revenue Code (IRC) Sec. 448).

Accrual-basis accounting looks to economic events to determine whether a debt is incurred or whether revenue is earned; the time of the occurrence of those events may be quite different from when cash is paid or received. What limits the possibility for fraud in accrual-basis accounting is the reduced opportunity to hide a debt or record unearned revenue since the standards of recognition are more explicit than those for cash-basis accounting.

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 GAAP-basis 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 (IRC Sec. 453(c)). Under GAAP, 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 (IRC Sec. 56(c)(1) and 56(g)) 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 net income. Gains from installment sales, for instance, are recognized in the year of sale under ACE, just as they are under GAAP.

To achieve income minimization as a tax reduction strategy, then, 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 carryforwards (NOLs) for tax purposes may be willing to absorb income from other related parties. For example, assume two firms are under common ownership, and one firm, a manufacturer, makes products used by the second firm, its customer. The manufacturer, though, 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, then, has the effect of increasing the customer's inventory cost that, eventually, reduces its income and its taxes, while not causing the manufacturer to pay any current period tax. Aside from being subject to penalties and other measures for tax fraud (under IRC Sec. 6663), the manufacturer's and the customer's GAAP-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 Between Company Size and Fraud

Additional fraud reduction measures include the implementation of internal controls and promoting an ethical environment (see Chapter 7). For middle-market firms (as the term is used by banks and venture capitalists), meaning, those with annual revenues of $10 million to $100 million, the findings of the Committee of Sponsoring Organizations (COSO) (see

Chapter 7) are especially applicable since research conducted for the COSO found that smaller companies 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, middle-market 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 should implement reviews of internal controls at least once a 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 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 the capital markets 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 venture capitalists 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. A firm looking at venture capital financing will come under different, and perhaps unexpected, pressures 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 GAAP.

To adequately detect and prevent against fraud in closely held companies, then, 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, "The Role of the Audit Committee," for more detail.

CHAPTER 6

Not-for-Profit and Government Entities

It may come as a surprise to some, but management in not-for-profit organizations (NPOs) 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 NPOs 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.

NPOs: 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 NPOs, but the terms are somewhat different. In a desire to secure or retain bank financing, for instance, the NPO may wish to show itself to be fiscally responsible by showing a positive reported change in net assets on the NPO'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.

There are other similarities with closely held companies as well. Issues that a company has with outside shareholders are akin to those NPO management encounters with the board or trustees empowered with overseeing NPO activities. If management wishes to secure a pay raise, showing improved financial results (a positive change in net assets) would help support the request. For that matter, NPO management may have incentive compensation plans as well, and all the motives for manipulating financial statements discussed in previous chapters would apply here as well.

There are differences, however, that set NPOs apart.

Reputation Over Compensation

The one key difference between NPOs and for-profit firms is that management compensation may not be quite as strong a motivator. Instead, NPOs 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 NPO that is facing financial problems may hope to cover up the issues so the reputations of management and the NPO are not tarnished. The desire to protect reputations, then, can be as strong an inducement for NPO management to manipulate financial data as any contingent bonus.

Revenue Recognition

Unlike in closely held companies, recognizing revenue may be difficult for the NPO 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 NPO are revenue: The NPO may be acting as an agent or transferor for other beneficiaries.

Restricted Funds

When an NPO receives donations, the revenue may be restricted as to how it can be spent or invested (and the earnings from the investments may be restricted also). In addition to purpose restrictions, restrictions may be time-limited (that is, temporary) or exist in perpetuity (that is, permanent). Within these categories are other categories required by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*:

> 14. Information about the nature and amounts of different types of permanent restrictions or temporary restrictions shall be provided either by reporting their amounts on the face of the statement or by including relevant details in notes to financial statements. Separate line items may be reported within permanently restricted net assets or in notes to financial statements to distinguish between permanent restrictions for holdings of

> (a) assets, such as land or works of art, donated with stipulations that they be used for a specified purpose, be preserved, and not be sold or (b) assets donated with stipulations that they be invested to provide a permanent source of income. The latter result from gifts and bequests that create permanent endowment funds.
>
> 15. Similarly, separate line items may be reported within temporarily restricted net assets or in notes to financial statements to distinguish between temporary restrictions for (a) support of particular operating activities, (b) investment for a specified term, (c) use in a specified future period, or (d) acquisition of long-lived assets. Donors' temporary restrictions may require that resources be used in a later period or after a specified date (time restrictions), or that resources be used for a specified purpose (purpose restrictions), or both. For example, gifts of cash and other assets with stipulations that they be invested to provide a source of income for a specified term and that the income be used for a specified purpose are both time and purpose restricted. Those gifts often are called term endowments.[1]

These various types of restrictions present significant classification, reporting, and documentation challenges that require significant attention to detail. Given that NPOs try to limit administrative costs (see the next section), it is frequently the case that an NPO's accounting personnel are strained to keep up, either because the NPO 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 NPOs 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 Statement No. 117. An example of a measure used to assess the relative amount spent on nonprogram costs could be the ratio of support expenses as a percentage of total revenues. Such expense ratios

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[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations* (FASB, *Original Pronouncements,* vol. 2, FAS117), paragraphs 14 and 15.

are typically compared to other NPOs in the same field to determine which are more efficient. There is a strong incentive, then, to classify as much in expense away from support to program activities as possible to minimize the ratio.

FASB Statement No. 117 gives some guidance about definitions:

> 27. 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 organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health or family services, research, disaster relief, and public education, among others.
>
> 28. Supporting activities are all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund-raising, and membership-development activities. Management and general activities include oversight, business management, general recordkeeping, budgeting, financing, and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Fund-raising activities include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities.[2]

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

Example Scenario. The Snail Darter Foundation is a not-for-profit 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 come from solicited, tax-deductible contributions from individuals. Snail Darter also receives

[2] FASB Statement No. 117, paragraphs 27 and 28.

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 50 and 60 people in various functions, and the current year budgeted revenues are $3,000,000.

The executive director had been rather successful in raising funds, including grants from EPA, in past years and asked that his compensation package include a cash bonus contingent upon Snail Darter achieving certain revenue targets. The trustees, anxious to expand the organization's programs by attracting more revenues, accepted the executive director's proposed compensation plan and implemented the plan for the current year that just started. Under the plan, the executive director would receive a significant bonus if revenues increased by 20 percent over current-year budgeted levels. The bonus would scale down to zero if revenues failed to increase.

In January of the current year, though, a new administration took office in Washington, and the EPA severely cut back on funding for research conducted by nongovernmental organizations, such as Snail Darter. While 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.

The executive director had projected that fundraising from individuals would increase in the current year, but he counted on that increase to qualify him for his bonus. Now, with the loss of government research funds, he stood to lose the entire bonus that he previously thought was easily in reach. Just as important to the executive director, though, was that the standing of his organization among fellow environmentalists may fall: A decline in Snail Darter's revenues would be seen as a loss of political influence.

The executive director's first step 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 thinly spread already. The end result would be the likely increase in Snail Darter's supporting expenses as a percentage of revenues. That increase, though, 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, in the event that he could not replace the lost grant revenues in the current year, to protect Snail Darter's historically low expense ratio.

Making up for the revenue shortfall would prove more challenging. The executive director had previously been approached by the Trees Unlimited Foundation, an NPO that was just starting up, 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, but it gave the executive director—he thought—a way to recognize the contributions as income to Snail Darter that would count toward his bonus and 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 small fee for staff time.

While the donor list was tapped out for contributions to Snail Darter, the Trees Unlimited appeal struck a responsive chord, and donors came up with several hundred thousand dollars of contributions. But that was not enough. 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 pro-labor candidates for public office; because of past legal problems and a pending criminal investigation, however, 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 since 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 a substantial bonus. 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 to 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 expense was arbitrary and unsupportable under generally accepted accounting principles (GAAP). Perhaps after a position-by-position analysis, some functions could be deemed to be "activities that result in goods and services being distributed to beneficiaries" that would qualify under FASB Statement No. 117 as program activities, but it is difficult to see how any portion of, say, the fund-raising staff included in administrative costs provides those services. 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 percent due to loss of government grants. The result was precisely the "insurance" the executive director mentioned: protection for the NPO'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 demands placed on NPO staff.

The Trees Unlimited funds create a more subtle complication. Appropriate GAAP guidance is found in FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*:

> 11. Except as described in [other paragraphs] of this Statement, a recipient organization 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.[3]

Therefore, unless an exception applies, funds that simply flow through an NPO on their way to another beneficiary must be recorded as a liability to the NPO, not as revenue when received or program expense when disbursed. The only exception potentially relevant in this case is found in FASB Statement No. 137, paragraph 12, which states that the contributions can be booked as revenues "if the donor explicitly grants the recipient organization variance power—that is, the unilateral power to redirect the use of the transferred assets to another beneficiary." For the example, there is no specific mention of variance power one way or the other. 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—but not impossible. This example of the flow-through charitable contributions, then, illustrates a key area CPAs should examine in the context of potential financial statement fraud at NPOs.

The case of the political contributions is clearer and has more grave repercussions. Setting aside whether running the union contributions through the NPO 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 NPO'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, then, would not increase revenues. More important, though, loss of 501(c)(3) status may severely hamper the NPO's ability to raise funds in the future because those contributions may no longer be tax deductible.

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[3] FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133* (FASB, *Original Pronouncements,* vol. 2, FAS137), paragraph 11.

The motives for the executive director, in this example, were not all monetary. His bonus was a key driver, but his and his organization's status was just as important. Therefore, the CPA, when looking for motives, may find nonmonetary motives playing a larger role with NPOs.

The lack of internal controls is evident but, unfortunately, not that uncommon. If an NPO 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 NPO is a matter of priorities competing with the NPO programs. The CPA, then, must carry the argument for strong controls and spell out the consequences if controls fail. Those consequences may include irreparable harm to the NPO's reputation, loss of tax-exempt status, and damage to reputation may be fatal for many NPOs dependent on public donations.

Government Entities

As with NPOs, governments have motives to publish misleading financial statements, and those motives are quite similar to those for NPOs. 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 NPOs are also found in government.

The Dangers in Greater Disclosure

New reporting standards may also provide incentive for fraud. As Government Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* is implemented at various levels of government through 2003, the format for financial reporting by governmental entities will become more like the reporting by publicly traded companies. In fact, GASB Statement No. 34 mandates 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 (SEC). The Summary for GASB Statement No. 34 explains:

> 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.

With the additional MD&A disclosures, though, come motives for fraud. If a governmental fund, for instance, 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. Under GASB Statement No. 34, though, governments are 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 there are a plethora of different types of funds used in government:

- Governmental funds
- Proprietary funds
- Fiduciary funds
- Special purpose government funds
- Enterprise 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.

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, according to GASB Statement No. 34, "the net assets of a government should be reported in three categories—invested in capital assets net of related debt, restricted, and unrestricted." Therefore, just as with NPOs, governments must properly determine how revenues create net assets in each of those categories.

There are often ambiguities, though, 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, though 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 count the excess toward the general fund's assets. One method to accomplish recording the assets in a different fund would be to reclass the revenues in excess of special purpose needs as those revenues are received, hoping that the multiple small reclasses will go unnoticed.

Another, perhaps 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.

Conclusion

Financial statement fraud at NPOs and governmental units have common motivators in compensation and reputation, with both playing equal roles. This slight shift away from the dominant role compensation plays in for-profit company financial statement frauds will require CPAs to approach suspected fraud in NPOs 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 NPO or government unit, however, 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 NPOs 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 NPO and governmental accounting.

PART B

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 by the National Commission on Fraudulent Financial Reporting, chaired by James C. Treadway, Jr., then executive vice president and general counsel of Paine Webber, Incorporated, and the commission came to be known as the Treadway Commission.

In October 1987, the Treadway Commission published the 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 to 1997 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.

The 1987 and 1999 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 important from the CPA's viewpoint. One key area in all 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:

- 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.

- Nonaudit services to audit clients have been the focus of extensive discussions between the SEC and major accounting firms over the last few years and 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 a decade after the Treadway Report, in 1998. He referred to them as "big bath restructuring charges" (see Chapter 3). The write-offs were addressed in Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges* (see Chapter 12).
- The accountant's responsibility for the detection of fraud has been a long-standing, ongoing issue and was specifically addressed in both Statement on Auditing Standards (SAS) No. 82 and 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 through 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, as opposed to 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; these controls, however, were overridden by management.
- The SEC cited a member of upper-level corporate management (chief executive officer, president, or chief financial officer) 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 Research Report as well. As to the methods used by fraudsters, the findings gave early warnings of revenue recognition and asset overstatement problems that would continue into the next decade. In the 1990s, accounting standard-setters attempted to address those issues. Concerning revenue recognition problems, the SEC issued in December 1999 Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (see Chapter 12). Overstatement problems were addressed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* issued in March 1995.

Many of the findings and statistics of the 1987 Treadway Report did not change when the 1999 Research Report looked at the same issues, with one notable exception. Regional and local accounting firms were singled out in the last bullet point as being the source of 74 percent of the actions brought against accountants. Ten years later, that percentage had decreased.

The 1999 Research Report

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 study researchers surveyed SEC Accounting and Auditing Enforcement Releases (AAERs) issued over the period of 1987 to 1997 to identify about 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.

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 findings in each area.

Operating and Financial Condition

Size

The typical company cited in an AAER was small, with median assets of $15.7 million and median revenues of $13 million. Though there were a few very large companies, at least three-quarters of the firms cited had less than $100 million in either assets or annual revenues.

Trends

Earnings reported in the years preceding the fraud gave the researchers information about earnings trends. For 99 of the 204 companies in the sample, the researchers were able to obtain clean financial statements for the years before frauds identified in the AAERs. With data from those companies, the researchers performed the following procedures:

> We also analyzed income statements for the last two years before the year of the last clean financial statements. Net income increased in the one-year period from the year before the last clean financial statements to the year of the last clean financial statements for 49 of the 99 companies. Of these 49 companies, net income for 30 companies increased for two years in a row. Net income decreased in the one-year period from the year before the last clean financial statements to the year of the last clean financial statements for 43 of the 99 companies.

> Of these 43 companies, net income for 22 companies decreased two years in a row. We were unable to observe any trends for seven of 99 companies because they were in their first year of operations or represented development stage companies with no meaningful income statement results.
>
> To summarize, it appears that 22 companies experienced a downward trend in net income preceding the first year of the fraud, while 30 companies experienced an upward trend. This suggests that the subsequent frauds may have been designed to reverse downward spirals for some companies and to preserve upward trends for other companies.

The findings on earnings trends were important because little research had examined the company operating results before they attempted to manipulate financial data. Moreover, these findings established the importance of trends in earnings as a motivator of financial statement fraud. It was no surprise that firms with negative trends attempted to reverse those downward trends. It was more interesting that firms with positive trends attempted to maintain those upward trends at the risk of detection by the SEC (in another section of their report, the researchers described the results of fraud detection for the management of these companies, which was catastrophic). Why was maintaining a positive earnings trend so important to those 30 companies? One answer is the market rewarded consistent or predictable earnings increases, as discussed in Chapter 3. The role of earnings trends, then, was a path-breaking discovery.

Quality of Internal Controls

Just as the 1987 Treadway Report found, top management was heavily involved in fraudulent activity, only the percentages were worse in the 1999 Research Report. 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, they found that 72 percent were chief executive officers and 43 percent were chief financial officers; in 83 percent of the cases, the CEO or the CFO, or both, were involved. The 1987 Treadway Report placed the percentage of senior level involvement at 66 percent. Thus, the trend in fraud was more senior management involvement, and the "tone at the top" of an organization became 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 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 study also found problems with audit committees. First, audit committees of AAER companies met only once a year or were nonexistent. Furthermore, about 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 "gray directors." In addition, about 40 percent of the AAER companies had family relationships between officers and/or directors. Thanks to these findings, though, the national stock markets have implemented requirements, as part of their listing rules, that address these issues. The NASDAQ, for example, sets a standard that requires three independent directors for most listed companies, at least one of which must be financially literate:

> Marketplace Rule 4350(d)(2) Audit Committee Composition
>
> (A) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that 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 4200(a), the NASDAQ defines an *independent director* by describing relationships that could interfere with the exercise of independent judgment:

> (14) "Independent director" means a person other than an officer or employee of the company or its subsidiaries 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 judgement in carrying out the responsibilities of a director. The following persons shall not be considered independent:
>
> (A) a director who is employed by the corporation or any of its affiliates for the current year or any of the past three years;
>
> (B) a director who accepts any compensation from the corporation or any of its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation;
>
> (C) a director who is a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation or any of its affiliates as an executive officer. Immediate family includes a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, and anyone who resides in such person's home;
>
> (D) a director who is a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments (other than those arising solely from investments in the corporation's securities) that exceed 5% of the corporation's or business organization's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the past three years;
>
> (E) a director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

There is an exception to the requirement that all audit committee directors be independent if there is one (and no more than one) individual who, due to exceptional skills or knowledge, would be suitable for the audit committee but would not pass all the above requirements. However, this person could not be a current officer or related to a current officer.

There is also an exception for small business firms that qualify as filers under SEC Regulation S-B. Their audit committees may consist of only two members if both are independent. If an S-B company's audit committee has more than two members, some nonindependent members are allowed as long as the majority is independent. According to SEC Rule 405, the term *small business issuer* means an entity that meets the following criteria:

> 1. [The entity] has revenues of less than $25,000,000;
> 2. [The entity] is a U.S. or Canadian issuer;
> 3. [The entity] is not an investment company; and
> 4. If a majority owned subsidiary, the parent corporation is also a small business issuer,
>
> Provided however, that an entity is not a small business issuer if it has a public float (the aggregate market value of the outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more.

Therefore, there is a carve-out for a special individual who, in the opinion of the board of directors, would be a valuable asset to the audit committee but who lacks all the elements of independence. There is also a relaxed exception for small companies.

Even though it is worthwhile to see how the securities markets addressed the issue of audit committee quality in wake of the findings of the 1999 Research Report, 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. A private company, then, that is serious about demonstrating its commitment to high business ethics will adopt an audit committee structure similar to those used by the nation's markets.

Nature and Duration of Fraud

The size of financial reporting frauds relative to the size of the AAER companies was large. The median asset misstatement was $4.9 million, compared to median total assets for an AAER company of $15.7 million. The median revenue misstatement was $4.4 million, compared to median total revenues of $13 million.

Regarding how fraud was committed, the number of companies split evenly between improper revenue recognition and asset overstatement. Fictitious revenues and premature recognition of revenues dominated the revenue recognition category; overstating existing assets, as opposed to creating new fictitious assets, stood out in the asset overstatement category. The following table, taken from the 1999 Research Report, summarizes the findings.

Common Financial Statement Fraud Techniques*

Methods Used to Misstate Financial Statements	***Percentage of the 204 Sample Companies Using a Fraud Method***
Improper revenue recognition:[a]	50%
Recording fictitious revenues—26%	
Recording revenues prematurely—24%	
No description/"overstated"—16%	
Overstatement of assets (excluding accounts receivable overstatements due to revenue fraud):[a]	50%
Overstating existing assets—37%	
Recording fictitious assets or assets not owned—12%	
Capitalizing items that should be expensed—6%	
Understatement of expenses/liabilities:	18%
Misappropriation of assets:	12%
Inappropriate disclosure (with no financial statement line-item effects):	8%
Other miscellaneous techniques:	20%

[a]Note: 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.
*From *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies.*

Fictitious revenues included:

- Sham sales to nonexistent customers
- Unauthorized shipments of products to existing customers who did not order them

Premature revenue recognition occurred due to:

- Failure to complete the terms of the sale
- Use of side letters that imposed additional significant (and usually secret) conditions
- Improper sales cutoffs that brought sales from a subsequent period into a previous period
- Improper use of percentage of completion method by incorrectly accelerating estimates of completion
- Recognizing revenue from consignment sales

These issues were addressed by the SEC in SAB No. 101 (see Chapter 12) in December 1999.

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

Asset Accounts Frequently Misstated

Asset Accounts Typically Overstated	*Number of Sample Companies Involved*
Inventory	24
Accounts receivable (other than revenue fraud)	21
Property, plant, and equipment	15
Loans/notes receivable	11
Cash	7
Investments	7
Patents	7
Oil, gas, and mineral reserves	7

Looking forward, the change in accounting treatment of goodwill, implemented after the date of this study, may change the composition of the previous list. Due to the promulgation of FASB Statement No. 142, *Goodwill and Other Intangibles,* which ended the amortization of goodwill and subjected goodwill to periodic testing, CPAs would do well to watch this asset class closely to be sure it is not overstated (see Chapter 12 for a discussion of how acquisition reserves can be used to inflate goodwill).

Also, while understatement of expenses and liabilities came in a distant third place on the survey that ended in 1997, a more recent survey may yield a different result. A survey that picks up the post-1990s market boom companies that both went into bankruptcy and were the targets of financial statement fraud investigations may produce a different finding. Some of those companies went into bankruptcy because they allegedly hid expenses or debts. After the investigations of those companies are complete and the nature of fraud, if any, is determined, the expenses/liabilities category may rank higher on the list in a future survey. The bottom line is that the CPA needs to be as cognizant of expense/liability fraud as of improper revenue recognition and asset misstatements.

Duration

The median fraud extended 21 months, covering several quarterly filings as well as at least one year-end filing. This finding led the researchers to conclude that the fraud began small and grew as it went undetected:

> From our readings of the AAERs, we observed that many frauds allegedly were initiated in a quarterly Form 10-Q, with the first manipulation sometimes at relatively small amounts. After observing that the fraud was undetected in initial attempts, the fraud scheme was repeated in subsequently issued quarterly or annual financial statements, with the fraud amount often increasing over time and generally stretching over two fiscal years.

This finding tells CPAs to watch for the warning signs at the early stages of fraud. For instance, a regional manager engaging in improper revenue recognition may brag at a firm-sponsored conference that she was able to meet sales goals when most other regions had great difficulty. If not investigated early and stopped, her practices may spread to other regions as other managers see revenue manipulation as the only way to keep up and rationalize that because another region got away with it, they can as well.

Internal Control Report

Clearly, the 1987 Treadway Report and the 1999 Research Report pointed to internal control failures that gave rise to the frauds. Between the publication of the two reports, 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 controls. 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: effectiveness and efficiency of operations, reliability of financial reporting, 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 go in 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 important, it must implement a process that addresses "risks associated with change."

- *Control activities.* The organization must implement the policies and procedures that effect 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 model for determining the adequacy of internal controls. When fraud materializes that went undetected for a period of time, 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" (*Internal Auditor,* December 1999), described Boeing's warning signs for each step:

- Control environment
  —*Hard controls [specific procedures]* are missing or inadequate.
  —There are verified instances of breakdowns or *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 risks mitigation strategy is not adequately reflected within control activities.
- Information and communication
  —Key metrics are not identified, collected, and communicated.
  —Employees' misunderstanding of their control responsibilities 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. 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, though, CPAs should not hesitate to bring all observed weaknesses to management's attention because such weaknesses may provide what 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 statement fraud through its studies, and its findings helped shape the development of a significant amount of accounting literature. 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. 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
THE 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 composed of 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 (see Chapter 7 for audit committee member requirements).

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 chief financial officer, the corporate controller, and the corporate treasurer, among others. If there is an internal audit function within a company, the chief audit executive 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 to maintain separation of duties, a fundamental internal control concept. Firms implement separation 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 him or her in as well. If collusion works initially, so 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, however, circumvent the internal control protections, such as separation 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 is a principal component 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, though 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. They must be selective, though, 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 Committees

If internal auditors or others within a corporation do discover an accounting irregularity, though, 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. A committee of the board of directors 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, the securities markets have limited the membership of audit committees, in most cases, to outside directors who have few ties, if any, 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 outside auditors and communicating with those auditors on important accounting judgments and internal control issues.

Outside Auditors

Outside auditors perform more functions than just the annual audit. 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 discussions frequently over the course of the year relating to accounting issues and controls. In particular, the auditors, in accordance with Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380.08), as amended, "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." Therefore, the auditors provide an objective opinion on accounting positions taken by management over the course of the year.

If outside 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 to report that fraud directly to the audit committee. 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) of the Securities Exchange Act of 1934 provides explicit instructions:

> 2. Response to failure to take remedial action.—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 accountant in the course of the audit of such accountant, the independent public accountant 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 independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors.

3. Notice to commission; response to failure to notify.—An issuer whose board of directors receives a report under paragraph (2) 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 independent public accountant making such report with a copy of the notice furnished to the Commission. If the independent public accountant fails to receive a copy of the notice before the expiration of the required 1 business day period, the independent public accountant 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.

Therefore, if the audit committee fails to act appropriately when fraud is reported, the outside auditor 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 next day the outside auditor must inform the SEC.

The provisions of Section 10A, then, place significant responsibilities upon the audit committee and the outside auditor to take corrective action in the event material fraud is detected.

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 4350 spells out the requirements of a charter:

> (1) Audit Committee Charter
>
> Each Issuer 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 the following:
>
> (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, consistent with Independence Standards Board Standard 1, 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 outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Paragraph c implements another Blue Ribbon Committee recommendation, that outside auditors are ultimately accountable to the board and the audit committee who nominate, hire, and fire the auditor. Thus the reporting lines are clearly established from the audit committee (or board) directly to the outside 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 outside auditors defer to management when seeking explanations for potential irregularities without bringing those irregularities to the attention of the audit committee (or other appropriate personnel), that behavior infers that management has indeed moved into the reporting chain where it should not be: between the audit committee and the outside auditors. Management was kept out of that chain precisely so it could not filter 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:

> The 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 therefore resistant to raising accounting and reporting issues with the audit committee. The CPA, then should observe that the chief audit executive have frequent and, if necessary, private meetings with the audit committee. Also, those meetings should occur even if the chief audit executive 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. 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 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, SAS No. 61 required that auditors discuss with the audit committee the "process used by management in formulating particularly sensitive accounting estimates" and "the basis for the auditor's conclusions regarding the reasonableness of those estimates." SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316.20 and .22), added affirmative obligations for the auditor to inquire of management about whether there was knowledge of fraud or suspected fraud and for the auditor to make similar inquiries of the audit committee.

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 account-

> ing 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 new regulations that would implement this suggestion by requiring company management to identify a limited number, perhaps three to five, of critical accounting policies (CAPs). A 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 the 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 are. 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, the CPA (who is not the auditor) may be able to perform a special service as consultant to the audit committee to help the committee evaluate management's CAP submissions.

Audit Committee Overload

After having reviewed the issues relating to audit committees, it is easy to see that tremendous responsibility rests upon committee members. While 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 the following list in 1999 of 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.

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 relating to "critical accounting policies," the list has since expanded and will most likely continue to expand. If Olson's list were contained in a single audit committee charter, the committee may be spread too thin, and that is a dangerous condition that CPAs should try to identify.

With knowledge of the proper functions, 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 the 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 chief audit executive, who should have board-level input. Reviewing expense reports and potential conflict of interest situations can also be assigned to management or 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 its review of financial reports, internal controls and legal requirements if the demands of the workload or additional expertise so require.

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, for public companies, that the audit committee approve all audit services, and private firms would be well-served to follow this requirement as well. Generally accepted auditing standards require outside auditors to both confer with the audit committee and to 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 (required under Sarbanes-Oxley for public companies) of critical accounting policies. 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 in Part C of this book will examine some of the more difficult fraud issues and how the audit committee, working in concert with internal and outside 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? The answer according to empirical studies 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 additional warning signs to the CPA in addition to the qualitative warning signs discussed in the preceding chapters.

COSO Research

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) funded research in the area of financial reporting frauds and published it under the title, *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (the 1999 Research Report). Chapter 7 covered several key aspects of that research dealing with the nature of the frauds committed by the survey companies. The 1999 Research Report had more information that would be of use to CPAs, though.

The 1999 Research Report was compiled from companies that were the subject of SEC Accounting and Auditing Enforcement Releases (AAER companies) during the years of 1987 through 1997. The financial and other characteristics of companies that fell into that group, then, would provide some hints at potential warning signs to look for in other companies.

Size

To gain an understanding of the size of the AAER companies, the researchers grouped companies by total assets and net income using the financial statements published immediately before the period when fraud began according to the SEC (see Table 1).

Table 1. *Financial Profile of Sample Companies (n = 99 companies) Last Financial Statements Before the Beginning of Fraud Period*

(in 000s)

	Assets	*Revenues*	*Net Income (Loss)*	*Stockholders' Equity (Deficit)*
Mean	$532,766	$232,727	8,573	$86,107
Median	$15,681	$13,043	$175	$5,012
Minimum value	$0	$0	($37,286)	($4,516)
1st quartile	$2,598	$1,567	($448)	$1,236
3rd quartile	$73,879	$53,442	$2,164	$17,037
Maximum value	$17,880,000	$11,090,000	$329,000	$2,772,000

The data indicate that while most of the companies were rather small, with 50 percent of the companies having revenues ranging from $1.6 million to $53.4 million, there were some very large companies in the sample, with revenues that ranged up to $11 billion. As a result, the mean size of an AAER company was markedly less than the median size.

Not many companies reported large losses in the last, prefraud period. The largest net loss was $37 million, but ranking the firms by net loss and then net income, the 25th firm up the list had a net loss of only $448,000. Reaching the 50th firm, net income is positive. Therefore, losses incurred in a single given year are not necessarily an indicator of or precursor to fraud. However, there was evidence of some companies trying to protect a positive trend in earnings or reverse a negative trend (see Chapter 7).

Amount of Misstatements

The quantity of misstatements classified by income or balance sheet item provides some useful insights (see Table 2).

The mean numbers are larger than the medians because the means are influenced by the very large companies in the sample, but this leads

Table 2. ***Amount of $ Misstatements by Fraud Type***

Misstatement Type	*Number of Sample Companies*	*Mean Cumulative Misstatement (in millions)*	*Median Cumulative Misstatement (in millions)*
Asset misstatements	38	$39.4	$4.9
Revenue or gain misstatements	32	$9.6	$4.4
Net income misstatements	31	$16.5	$2.3
Pretax income Misstatements	30	$9.2	$5.4
Misappropriation of assets	12	$77.5	$2.0

Note: See Table 1 for the typical size of the companies involved.

to some interesting observations. When ranked by means, which reflects the weighting of larger companies in the sample, asset misstatements clearly dominate among the financial statement fraud categories (all but misappropriations of assets). When looking at medians, which reduce the impact of the very large firms, no one category stands out markedly from the rest. Therefore, larger companies contributed significantly to the size of asset misstatements, indicating to CPAs that, when dealing with very large companies, the balance sheet is a key area of concern.

Stock Market Listing and Industry

AAER companies tended to congregate on the NASDAQ stock market (see Table 3).

Table 3. ***Sample Companies' National Stock Exchange Listing***

National Stock Exchange	*Number of Companies*	*Percentage of Companies*
New York Stock Exchange	20	15%
American Stock Exchange	10	7%
Over-the-counter markets	104	78%
Number of sample companies with available stock exchange information	134	100%

For that reason, the citations in this book for issues concerning stock market listing requirements and the composition and charter of audit committees are to the NASDAQ Marketplace Rules. The researchers did not distinguish among the over-the-counter (OTC) markets, but it is likely that many of the AAER companies were traded on the Bulletin Board, which during the survey period had few financial and disclosure requirements. After the survey period end in 1997, though, NASDAQ took some important fraud-fighting measures, such as tightened listing requirements on all markets, including the Bulletin Board, and opening a Listing Investigations Group to examine potential fraud in listed companies. A future tabulation of AAER companies, then, may find the percentage to be less.

The industry classifications also provide some useful information (see Table 4).

Table 4. ***Primary Industries of Sample Companies***

Industry Classification	*Number of Fraud Companies in Industry*	*Percentage of Fraud Companies*
Computer hardware/software	25	15%
Other manufacturers	25	15%
Financial service providers	23	14%
Healthcare and health products	19	11%
Retailers/wholesalers	14	8%
Other service providers	14	8%
Mining/oil and gas	13	8%
Telecommunication companies	10	6%
Insurance	6	4%
Real estate	5	3%
Miscellaneous	14	8%
Number of sample companies with available information on industry	168	100%

While almost no industry was immune from financial statement fraud, the top three industries did stand out from the rest, accounting among themselves for 44 percent of all AAER companies. Those industries were computer hardware and software, manufacturers (other than computers), and financial services. The examples in this book draw heavily from those industries. Certain fraud techniques tend to be associated with each industry, such as improper revenue recognition with software developers, asset overvaluation with manufacturers, and hidden debts with financial services. The healthcare industry also made a strong showing in Table 4 and so should not be overlooked. CPAs, therefore, should be aware that financial statement fraud did tend to concentrate in certain industries and they should exercise additional caution when working in those industries.

Audit Committees

The 1999 Research Report had some interesting findings on the composition and operation of audit committees (see Table 5).

Table 5. ***Audit Committee Profile***

Item	*Number of Companies With Information*	*Result*
Existence of audit committee	96	75% had audit committee
Number of audit committee members	71	Mean = 3.0
Type of audit committee member:	71	
Insider		Mean = 11%
Gray		Mean = 21%
Audit committees with no insiders	71	69%
Audit committees composed entirely of outside directors	71	38%
Number of audit committee meetings per year	66	Mean = 1.8 Median = 1.0
Audit committees meeting at least twice per year	66	44%
Percentage of audit committee members with accounting or finance expertise	71	Mean = 35%
Audit committee disclosures provide evidence of an internal audit function	63	19% mentioned internal audit function

First, most AAER companies had audit committees, even though stock market listing requirements did not always require them. Second, the audit committees were relatively free of insiders, though a good number had "gray directors," defined by the researchers as:

> Former officers or employees of the company, a subsidiary, or an affiliate; relatives of management; professional advisors to the company; officers or owners of significant suppliers or customers of the company; interlocking directors; officers or employees of other companies controlled by the CEO or the company's majority owner; owners of an affiliate company; those who are creditors of the company.

Nevertheless, 38 percent of audit committees of AAER companies had no gray or inside directors.

That said, though, the most telling statistic in Table 5 is that the mean number of audit committee meetings per year was just under two and the median number was just one. If the number of meetings indicates the level of involvement of audit committee members, which is a logical assumption when the number of meetings is so low, one can conclude that, for the most part, audit committees of AAER companies were for show only and had no substance. The lesson for the CPA is that, given the importance of the role and tasks of audit committees, it is very difficult to see how any committee can fulfill its obligations by meeting only once or twice per year.

Academic Research

Independent research continued after the COSO studies were published that examined financial statement fraud. One important study published in 1999, "The Detection of Earnings Manipulation," was performed by Messod D. Beneish of Indiana University.[1] Beneish asked whether, just by examining publicly available financial statements, one could predict financial fraud. 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 AAERs and published reports of restated financials to identify 74 companies as earnings manipulators from 1987 to 1993. In terms of timeframe for the companies studied, Beneish's work paralleled, to some extent, the 1999 Research Report.

Characteristics of Sample and Control Companies

Like the 1999 Research Report, the Prediction Study found that most manipulators were found in the manufacturing and services industries. The only industry identified by the 1999 Research Report that did not have as many manipulating companies in the Prediction Study was the computer software industry. In total, Beneish identified 74 manipulator companies and then matched those companies by two-digit Standard Industrial Classification (SIC) 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

[1] Messod D. Beneish, "The Detection of Earnings Manipulation," *Financial Analysts Journal*, September/October, 1999.

manipulation occurred (similar to the methodology used in the 1999 Research Report) and compared that company's data to its nonmanipulator peers' financial statements for the same period. As with the 1999 Research Report, the Prediction Study reported that, in each manipulator/nonmanipulator category, there were many small companies and 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 recording fictitious revenues or inventory, unearned or uncertain revenues, or capitalizing costs improperly.

Ratio and Index Analysis

The Prediction Study hypothesized, based on prior academic research, 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 $t - 1$ subscript. The change in account balances from one year end to the next year end is denoted by Δ.[2]

[2] The formulas were adapted from Messod D. Beneish, "The Detection of Earnings Manipulation," *Financial Analysts Journal,* September/October, 1999, p. 27.

Days' Sales in Receivables Index

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

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, there is the possibility 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 one if receivables as a percentage of sales do not change from year to year. If, however, receivables are beginning to become large in relation to sales and the index jumps to, say, 1.2:1 or more, 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

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

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 one, gross margins have weakened. Statistically, this index was one of the stronger predictors, so a GMI significantly greater than one 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

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

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 Prediction 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, then, 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 poor-quality noncurrent, non-PP&E assets to the prior year's percentage. An AQI greater than one 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 turns out to be the strongest indicator of manipulation in the Prediction Study, with manipulators showing 60 percent one-year growth compared to 10 percent growth for nonmanipulators. Any dramatic increase in the SGI on the order found in the study, which for manipulators ranged from 34 percent to 58 percent, should alert the CPA to possible problems.

Total Accruals to Total Assets

Total Accruals to Total Assets

$$= \frac{\begin{array}{c}\Delta\text{Working Capital}_t - \Delta\text{Cash}_t \\ - \Delta\text{Current Taxes Payable}_t - \Delta\text{Current portion of LTD}_t \\ - \Delta\text{Accumulated depreciation and amortization}_t\end{array}}{\text{Total Assets}_t}$$

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 to a firm with 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, then, will have a higher TATA measure. The study found that TATA for nonmanipulators was .018; the measure for manipulators was .031, or about 72 percent higher. A TATA measure in excess of .03, then, 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 any of the characteristic measures in this magnitude 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 historical earnings.

As a result of the high price paid, MPS management was under pressure from Great Drug to at least maintain, if not grow, it earnings. A decline in earnings so soon after the acquisition, while not very significant to Great Drug overall, would make Great Drug 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, though, 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. The MPS unit, in its monthly reports to Great Drug senior management, 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 preliminary MPS income statements and balance sheets for the prior year and current year just ended (see Table 6).

Table 6. ***MPS Income Statements and Balance Sheets***

Income Statements	***Year 1 (in thousands)***	***Year 2 (in thousands)***
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

(continued)

Balance Sheets, as of the last day of	***Year 1***	***Year 2***
Less: accumulated depreciation	(1,200)	(1,300)
Intangibles	500	800
Total assets	2,300	3,000
Current payables	200	400
Long-term debt (all non-current)	600	1,000
Equity	1,500	1,600
Total liabilities and equity	2,300	3,000

While 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 pre-tax 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:

$$\text{DSRI} = (700/1{,}500)/(300/1{,}000) = 1.56$$

$$\text{GMI} = [(1{,}000 - 600)/1{,}000]/[(1{,}500 - 1{,}200)/1{,}500] = 2.00$$

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

$$\text{SGI} = 1{,}500/1{,}000 = 1.5$$

$$\begin{aligned}\Delta\text{Working capital} &= (200 + 700 + 500 - 400) \\ &\quad - (400 + 300 + 300 - 200) \\ &= 200\end{aligned}$$

$$\Delta(\text{Cash} = (200 - 400) = -200$$

$$\Delta\text{Accm depreciation} = 1{,}300 - 1{,}200 = 100$$

Current maturities of LTD and income taxes payable are assumed to be zero.

$$\text{TATA} = [200 - (-200) - 100]/3{,}000 = 0.10$$

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 so 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 pay. Inflated sales could be one explanation for how profits were maintained.
- Looking further, the CAE observed that the total accruals to total assets 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 $400,000 in interest-only loans to MPS over the course of Year 2. The question that ran through the CAE's mind was, Where did the money go? She saw $200,000 probably provided for increased inventory, but that left another $200,000 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 $300,000 over Year 2. Her investigation later revealed that $100,000 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 "long-term impact" on future sales. Because this marketing effort was performed with existing personnel, the effect of the capitalization was to shift $100,000 from selling, general, and administrative expenses to the balance sheet. The CAE then noted that the shift helped MPS make up for a $100,000 decline in gross profit and thereby maintain its pretax profit.

- There was more to the intangible assets analysis, though. Spending $200,000 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 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 revenue manipulation.

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 funds to allow examination of every financial statement account. Indeed, generally accepted auditing standards require the auditor to assess at an early stage the probability of financial statement fraud to perform the audit efficiently and effectively.

Furthermore, the analytical procedures described in this chapter can guide outside auditors in the additional procedures required in Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec.

316), when there are specifically identified risks of material misstatement due to fraud. SAS No. 99 (AU sec. 316.52) 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, then, 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 SAS No. 99 responsibilities.

PART C

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. Generally accepted accounting principles (GAAP) require 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 there are some useful warning signs that may appear and lead the CPA to an unrecorded liability.

Loss Contingencies

A loss contingency is defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies,* as:

> An existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. (footnote omitted)[1]

FASB Statement No. 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, though, 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 Statement No. 5 lists examples of loss contingencies, which include the following:

- 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

A firm is required to accrue a loss contingency when that contingency is both *probable* and *able to be estimated.* FASB Statement No. 5 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 prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. 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.[2]

A future event is probable if it is "likely to occur." The following discussion principally focuses on failure to accrue a probable loss contin-

[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FASB, *Original Pronouncements,* vol. 1, FAS5), paragraph 1.

[2] FASB Statement No. 5, paragraph 8.

gency. However, violations of 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 Statement No. 5, but fails to make the required disclosure of that contingency in its financial statements. FASB Statement No. 5 states that a contingency is reasonably possible if the "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 focuses on warranty and product claims because the issues surrounding those claims are complex and occur with ever-greater frequency. Collectibility 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, under product tort law, or under 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 of 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 Statement No. 5 would require the booking of a loss contingency if the future claims were likely to occur. If, however, 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 FASB Statement No. 5 reserve should be accrued with a charge to current earnings. Actually, FASB Statement No. 5 requires the assessment of contingencies arising from "information available *prior to issuance* of the financial statements" (emphasis added). 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. An alert CPA, however, 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 include the following:

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 and/or the shipment of replacement product
7. Shifting of production schedules to manufacture replacement product
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 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, then, 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. In the course of examining internal correspondence between department heads and within departments, however, 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,[3] illustrates the complexities involved.

> ***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 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 three 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 chief financial officer 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 five 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

[3] This example is expanded from examples contained in Securities and Exchange Commission (SEC) Releases No. 33-8098 and No. 34-45907, Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies 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 shown, reflect the opinions of the author and not the SEC. The reader is encouraged to read the SEC releases, which are included as an appendix to this book.

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 whatever the going price may be. In each of the last three 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 to 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 one 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 chief financial officer (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 about 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 secondary offering of stock to pay down the debt. The CFO believed an increase in analysts' ratings would increase the price of shares already outstanding as well as of the new shares to be sold through the secondary offering. A rise in warranty costs relative to sales, though, would likely kill any chance of an upgrade from analysts, making any secondary offering more expensive in terms of the number of shares Alphabetical would need to offer to raise the needed capital.

In addition, the CFO and 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 time of issue). Finally, with the increase on 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 chief executive officer (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 to 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 stock, the copper pricing model would show a significant increase. The CFO, then, 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 five years instead of the 10-year look-back currently used in the model. By truncating historical data at five years, the CFO knew the model would not pick up the 72 percent price increase of eight 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 to 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, GAAP would give him some support. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes,* states:

> 10. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, warranty costs, periods benefited by a deferred cost, and recoverable mineral reserves. Future events and their effects cannot be perceived with certainty; estimating, therefore, requires the exercise of judgment. Thus accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

The change in methodology for warranty costs, then, could fall under this definition. As to footnote disclosure, APB Opinion No. 20 states:

> 33. Disclosure. The effect on income before extraordinary items, net income and related per share amounts of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts 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 recommended if the effect of a change in the estimate is material.

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 doubtful accounts works essentially the same way and yet is considered by APB Opinion No. 20 to be made "each period in the ordinary course of accounting," which does *not* require disclosure, though disclosure is *recommended* if the item is material. Again, the CFO has a defensible argument on this point as well because disclosure would just be recommended and not required under APB Opinion No. 20.

The CFO, though, may violate 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, then, will be income statements for at least the previous two years. Then, when comparative financial statements are presented to be comparable, according to Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins,* 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. That said, however, APB Opinion No. 20 amended ARB 43 to defer to the APB in matters involving "accounting changes," so the CFO still has an argument if he can bring the discussion back to APB 20. Therefore, the issue of whether an undisclosed change in estimation methodology violates GAAP is very much open to debate.

From the perspective of securities fraud, though, the provisions of Rule 10b-5 are clearer. 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:

> It 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 these facts as presented in this example because the omission led analysts to think gross margins were consistently presented with prior years' margins and comparable. Also, in light of the pending secondary offering of stock, the strict liability provisions of Section 11 of the Securities Act of 1933 may apply, and so 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 how much of that correction was due to the fraudulent misrepresentation. 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, generally accepted auditing standards (GAAS) 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 above (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's 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, 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, . . . 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, then, it would be more likely that (1) the change in methodology would be uncovered and (2) the rationale for the change would be questioned. While 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

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, however, 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 Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* 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.[4]

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[4] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FASB, *Original Pronouncements,* vol. 2, FAS144), paragraph 8.

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 Statement No. 144 states that 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 for an asset group if it is not possible to forecast cash flows for a single asset. Under FASB Statement No. 144, 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, then, is the key to halting asset impairment fraud. Most management information systems measure profitability by product line or by 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. In either case, however, 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. 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 AICPA *Guide for Prospective Financial Statements*). If that forecast, however, 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. If, however, 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.

Debt and Equity Instruments

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. If the security held is stock and there have been substantial historical operating losses with little hope of future profitability (meaning, the decline in value is other than temporary), that stock may be impaired according to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Likewise, FASB Statement No. 115 states that for debt (footnotes omitted):

> 16. . . . if it is possible that the investor will be unable to collect all amounts due according to the contractual terms of a debt

> security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in fair value [*of any security*] is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss).[5]

Without recent prices for the sale of stock and debt in a private company, 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). That data would likely include results of operations that would give historical profitability. For future profit estimates, one should look to company forecasts and assess the validity of those forecasts based on known relationships, if any, between the management of the investor and investee. If there exists common representation within management or on the boards of both companies, further inquiry may be necessary to determine the validity of any forecast. Losses over several past years may be sufficient to establish impairment.

Conclusion

Detection of fraud in loss contingencies and asset impairments is difficult because it is a search for a transaction that was not booked. Successful detection requires drilling down within an organization to obtain information from either or both of the following:

1. 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
2. Personnel in other departments, such as sales and legal, who may know relevant facts but not be aware of any attempt to hide those facts.

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

Estimates play a significant role in both loss contingencies and asset impairments and are subject to manipulation. Detecting that manipulation requires an internal control process that challenges the estimation assumptions.

[5] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Original Pronouncements,* vol. 2, FAS115), paragraph 16.

An audit committee that is aware of the sensitive areas most subject to unrecorded loss contingencies and asset impairments 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 internal and outside auditors that point to these issues.

CHAPTER 11

Manipulation of Preacquisition Reserves

If one company acquires another using the purchase method of accounting for the transaction as required under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141, *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 identifiable assets acquired is booked as goodwill.

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 increase the amount paid. If the asset portion of the purchase price covers the fair value of identifiable assets acquired, liabilities assumed over and above the assets conveyed increase goodwill.

One type of liability managers of an acquiring company may wish to set up is preacquisition loss contingencies as provided under FASB Statement No. 141, presumably for potential problems inherited when the target company is acquired. These loss contingencies or reserves, as they are more commonly known, typically increase the goodwill paid for the acquired company: The entry establishing the loss contingency is a credit to a reserve liability and a debit to goodwill. Under FASB Statement No. 142, *Goodwill and Other Intangible Assets,* the goodwill remains on the books at its unamortized carrying value unless it is impaired. The reserve on the balance sheet, however, with its credit balance, serves to absorb debits from expenses in future years; that is, the expenses never get to the income statement. This makes the preacquisition contingency a particularly useful tool for fraudsters who want to hide expenses.

FASB Rationale for Allowing Preacquisition Contingencies

The FASB's purpose for recognizing preacquisition expenses was to allow adjustments to the purchase price for contingencies that require more time to be quantified. FASB No. 141 defines a preacquisition contingency as a "contingency of an entity that is acquired in a business combination that is in existence before the consummation of the combination," and allows for contingent assets as well as liabilities.

It is not necessary that the contingency be known before the acquisition, but, once discovered, it must have existed before the acquisition. Not all contingencies that result from a business combination give rise to a preacquisition contingency, though. Reserves established by the purchaser for anticipated problems resulting from the acquisition, such as reserves for possible early contract cancellations, write-offs of accounts receivable, and product discounts as illustrated in the example scenario in Chapter 2, most likely will not qualify as preacquisition reserves because those contingencies arose after the transaction.

Loss Contingencies: FASB No. 141 Versus FASB No. 5

Contingencies not governed by FASB Statement No. 141 would fall under FASB Statement No. 5, *Accounting for Contingencies,* but fraudsters will attempt to blur the difference. A FASB Statement No. 5 reserve is set up by taking a debit charge to current period earnings; a FASB Statement No. 141 preacquisition reserve is established by debiting an asset, usually goodwill. The fraudster who wants to divert current period expenses away from the income statement will try to characterize postacquisition contingencies as if they were preacquisition to avoid FASB Statement No. 5 treatment.

Allocation Period

Fraudsters do not have unlimited time in which to manufacture preacquisition contingencies, but unfortunately generally accepted accounting principles (GAAP) do give them enough time to cause mischief. There is a period of time, called the "allocation period," which is designed, according to FASB Statement No. 141:

> B 175. . . . for discovery and quantification of preacquisition contingencies. . . . [After the allocation period,] subsequent adjustments of the amounts recorded as a part of the purchase allocation [will] be included in the determination of net income in the period in which the adjustments are determined. In contrast to the amounts deemed paid for the asset or liability,

> those subsequent adjustments are gains or losses that result from the uncertainties and related risks assumed in the purchase.[1]

Therefore, GAAP requires that all acquisition-related loss contingencies be identified during the allocation period to set up preacquisition loss contingency reserves. After the allocation period ends, any adjustments to the purchase price are put through the income statement.

The rationale for the allocation period is to allow time to adequately value the components of a transaction. The FASB determined that the allocation period should not continue for long after the transaction closes, and in most cases not more than one year, when it defined the allocation period as the:

> F1. . . . period that is required to identify and measure the fair value of the assets acquired and the liabilities assumed in a business combination. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Thus, the existence of a preacquisition contingency for which an asset, a liability, or an impairment of an asset cannot be estimated does not, of itself, extend the allocation period. Although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination.[2]

Time Limits

The FASB gave the following examples and explained its rationale for forcing the allocation period to a close:

> B 183. . . . [A]ppraisals might be required to determine replacement cost of plant and equipment acquired, a discovery period may be needed to identify and value intangible assets acquired, and an actuarial determination may be required to determine the pension liability to be accrued.
>
> . . . The Board concluded that it should relate the recording of preacquisition contingencies in the purchase allocation to the nature and process of the allocation, rather than to an arbitrary time limit. However, to indicate the Board's intent that the defined "allocation period" should not be unreasonably extended, paragraph [F1] notes that the existence of a preacquisition contingency for which an amount cannot be

[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141, *Business Combinations* (FASB, *Original Pronouncements,* vol. 2, FAS141), paragraph .B175.

[2] FASB Statement No. 141, paragraph F1.

> estimated does not, of itself, extend the "allocation period." For example, the existence of litigation for which no estimate can be made in advance of the disposition by a court does not extend the "allocation period." That paragraph also notes that the "allocation period" should usually not exceed one year from the consummation date.[3]

Simply because an estimate may be difficult to obtain, then, is no excuse to hold the allocation period open. Also, the allocation period is not necessarily one year and may well be much less. Fraudsters, though, may try to use the whole year to go shopping for postacquisition expenses that they can mischaracterize as preacquisition contingencies.

Amount of the Contingency

FASB Statement No. 141 provides a two-pronged test for determining the value of a preacquisition contingency and sets out the following conditions for recognizing the contingency:

> 40. A preacquisition contingency . . . shall be included in the purchase price allocation based on an amount determined as follows:
>
> a. If the fair value of the preacquisition contingency can be determined during the allocation period, that preacquisition contingency shall be included in the allocation of the purchase price based on that fair value.
>
> b. If the fair value of the preacquisition contingency cannot be determined during the allocation period, that preacquisition contingency shall be included in the allocation of the purchase price based on an amount determined in accordance with the following criteria:
>
> (1) Information available prior to the end of the allocation period indicates that it is probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination. It is implicit in this condition that it must be probable that one or more future events will occur confirming the existence of the asset, liability, or impairment.
>
> (2) The amount of the asset or liability can be reasonably estimated.
>
> The criteria of this subparagraph shall be applied using the guidance provided in FASB Statement No. 5, Accounting for Contingencies, and related FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, for application of the similar criteria of paragraph 8 of Statement 5. [*Footnotes omitted*][4]

[3] FASB Statement No. 141, paragraph B183.
[4] FASB Statement No. 141, paragraph 40.

Therefore, FASB Statement No. 141 provides that the amount of the contingency can be determined using fair value (the value set by a willing buyer and a willing seller) or it can be estimated, if the contingency is probable, using methods established by FASB Statement No. 5. Fraudsters, though, rarely concern themselves with these fine distinctions. Their goal is to create as large a preacquisition reserve as possible. And why not? If the reserve is created by debiting goodwill, there is no income statement charge to set it up. If the fraudster can convince others that the goodwill is not impaired, no charge reaches the income statement in following periods. However, in those following periods, if costs arise that the fraudster wishes to hide, he or she can debit the reserve and keep those costs off the income statement as well. In the end, preacquisition reserves appear to be a fraudster's paradise, except when confronted with a CPA who is wise to his or her ways.

Preacquisition Reserve Example

Fraud using reserves may seem easy at first look, but if used to hide significant quantities of costs, this type of fraud can be quite difficult to pull off. The following example illustrates the balancing act required for a fraudster to successfully employ preacquisition reserves to commit financial statement fraud.

Example Scenario. Great Strength Life and Health Insurance Company, a publicly traded stock insurance company, specialized 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 financials prepared according to regulatory accounting practices (RAP) to be filed with 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. Great Strength's chief executive officer, a former insurance salesman who rose through the ranks, paid no attention to the warnings from his chief financial officer (CFO), though, 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. In the fourth quarter, though, 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, then, came a large increase in the claims reserve in the fourth quarter. For each quarterly filing with the Securities and Exchange Commission (SEC), the CFO had been able to cover up some of Great Strength's problems with an inadequate 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. By the fourth quarter, however, 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.

Stymied, the CFO asked the controller to "reassess" the preacquisition reserves set up when Great Strength acquired another insurance carrier, named Old Life and Heath Insurance Company, late in the previous year. When the controller pointed out that FASB Statement No. 141's allocation period usually ended after one year, the CFO responded that since 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, though 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 preacquisition 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, so there already was a goodwill account from the transaction. The CFO, then, asked the controller to make the following entry to record a retroactive increase in the claims reserve for Old Life policies:

Goodwill—Old Life	$XXX	
Claims reserve		$XXX

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. If the FASB Statement No. 142 impairment test results 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 preacquisition entry above was recorded. FASB Statement No. 142 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. If the fair value of the reporting unit turned out to be less than the carrying amount of all the assets, all the non-goodwill 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 now 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 preacquisition contingency adjustment, a write-down was almost certain.

The CFO was not going to give up, however. Out of the CFO's fertile mind sprang more ideas. Like Great Strength, Old Life was an underwriter of whole life insurance policies. Old Life's policyholders, though, 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 were very profitable. The CFO did some quick calculations and decided that the high-risk products combined would show a healthy profit, healthy enough to carry the newly enlarged amount of goodwill. So he asked the controller to prepare a FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* asset group impairment test for the high-risk products that would be a part of a larger impairment test of all assets.

In performing the FASB Statement No. 144 impairment test for the high-risk products, the CFO knew the controller would include the carrying value of Old Life goodwill (both original and additional) in the test. The controller scheduled out the net cash flows for the asset group and added the undiscounted cash flows to determine if there was an impairment, in accordance with FASB Statement No. 144. The sum of the undiscounted net cash flows easily exceeded the combined carrying value of the high-risk products asset group. However, the CFO asked the controller to take the additional step of calculating the fair value of the asset group, as if the asset group were impaired, using discounted net cash flows. When the controller asked why she should run the second calculation when the asset group passed the first FASB

Statement No. 144 impairment test, the CFO explained that he wished to show the analysis to the audit committee "to help the committee better understand the impact, if any, of a potential write-down." The CFO went on to explain that the SEC had proposed changes to its filing requirements that would require companies to explain their "critical accounting estimates," and he simply wished to show the committee that "Great Strength had nothing to worry about."

The controller prepared the discounted net cash flow analysis as instructed. The sum of the discounted cash flows for the high-risk asset group exceeded the carrying value, thanks to the inclusion of the Great Strength policies. The CFO was quite pleased when she gave him the analysis. The CFO took the spreadsheet, in electronic format, and changed the title from "FASB Statement No. 144 Impairment Analysis" to "FASB Statement No. 142 Impairment Analysis" and inserted "Old Life Acquisition" in the title.

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 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 "FASB Statement No. 142 Impairment Analysis," the audit manager was satisfied and did not pursue any other issues regarding the booking of the preacquisition contingency.

By diverting the unanticipated additional claims cost to the goodwill account, the CFO kept reported claims expense within budget, and Great Strength hit its EPS 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 Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* though, 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.

The simple cost-shifting scheme does not solve the entire problem of higher claims, though, so the CFO has to employ other schemes. The CFO devises a plan to use preacquisition contingency reserves relating to the Old Life acquisition, but the plan calls for a doubling of the 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 the goodwill is tested for impairment.

So the CFO creates cover by fabricating a "FASB Statement No. 142 Impairment Analysis" from a "FASB Statement No. 144 Impairment Analysis," which includes more profitable policies from Great Strength's book of business. (In a more realistic scenario, the CFO would probably have asked the controller to prepare a FASB Statement No. 60 "premium deficiency" analysis that would have followed some of the same steps, but for illustrative reasons and to make the example more broadly applicable, FASB Statement No. 144 is demonstrated here.) The fabricated analysis is successful, though, only if the inclusion of Great Strength policies goes undetected. To hide this deception, the CFO initiates the 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 "FASB Statement No. 142 Impairment Analysis" conformed with the quantity of policies originally acquired.

The auditors stopped short of asking the more important question regarding the propriety of the entire preacquisition contingency, however. The auditors, and the controller, appeared to accept the concept that there is generally a one-year allocation period to identify and book preacquisition contingencies. In this case, though, Great Strength hired outside actuaries to assess the adequacy of claims reserves, and, according to paragraph B183 of FASB Statement No. 141, previously cited, the rendering of the actuaries' opinion should have fulfilled the requirements for closing the allocation period. Any change to reserves subsequent to closing the allocation period should have been recognized in the income statement as gain or loss on the transaction. Therefore, by not following up on the rationale for the preacquisition reserve, the audit manager lets the fraud slip by.

Conclusion

Use of preacquisition reserves 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 preacquisition reserve, fraudsters can hide or divert significant quantities of current expenses, such as higher claims costs in the example, to create or maintain the appearance of profitability.

Without restrictions on the booking of reserves after an acquisition, the management of an acquiring company could constantly (and conveniently) create reserves to absorb current losses from an acquired company. At some point, however, current management must take responsibility for current period results. CPAs should carefully review the allocation period cutoff, as provided in FASB Statement No. 141, to make sure that it is not abused. Management crosses the line into fraud when its only justification for extending the allocation period is to cook up unmerited reserves.

CHAPTER 12
COST AND DEBT SHIFTING

Chapter 11 discusses the methods fraudsters use to move costs from the income statement to preacquisition contingency accounts on the balance sheet. This chapter explores the techniques used to move both 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 to allocate costs that should be sourced to other ventures or to 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.

Cost Shifting at Livent

The entertainment industry also provides an example of cost shifting in the *Livent, Inc.* case (Securities and Exchange Commission (SEC)

Accounting and Auditing Enforcement Release (AAER) No. 1095, January 13, 1999). Livent, Inc. 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 through 1998. It inflated net income over that period by Cdn$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.

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 information technology (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 so 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 and 1997, Livent sold the rights to various North American locations for the shows 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, though, were side letters that allowed Pace to recoup its fees and earn additional profit as the shows were performed. From a financial perspective, then, 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. However, 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. After Livent management told Pace that the auditors had the side letters, Pace responded without raising any red flags. Therefore, to catch such a scheme, CPAs in the future will have to go further than simply asking whether any side letters exist. 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. More often, though, 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," for one, 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.

Where 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 first as debits and then transferred the expenses out with offsetting credits. It is not safe, however, to assume that the subsidiary incurring the expense initially recorded it as such. There may be a special reserve 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, there is likely to be some correspondence spelling out the procedures, especially if the initial debit is to an unusual account, such as a liability reserve.

With Livent, though, internal controls that were compromised by extensive collusion made detection of the amortization roll difficult because shifted expenses had the appearance of 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. But 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 the Special Purpose Entities

The collapse of Enron Corp. in 2001 brought extensive attention to the role of off-balance sheet entities 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. This discussion does not include an analysis of Enron SPEs specifically but covers general methods used by fraudsters to improperly move debts off the balance sheet.

Enron was not the first company to use SPEs. SPEs had long been in use to own buildings and other real estate that companies wanted to sell and lease back to themselves. In addition, financial institutions had for many years used SPEs 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 for creditworthiness. The bank would then set up an SPE with a small amount of capital provided by outsiders. The SPE would then issue bonds in sufficient quantity to purchase the loan portfolio, and because the bonds were rated, those bonds would be marketable to institutional investors. With the proceeds of the bond sale, the SPE would purchase the loans from the bank. After the transaction, then, the bank had additional capital with which to go out and make more loans. Indeed, many Americans today have SPEs to thank for providing a mechanism for banks to extend them credit.

Were the bonds issued by the SPE and used to acquire the loans "hidden" from the bank's balance sheet? The SPE holds the debt, along with the loan assets the bank transferred. As long as the SPE is not required to be consolidated with the bank for financial reporting purposes, generally accepted accounting principles (GAAP) do not require the bank to show the bonds on its balance sheet. Consolidation, then, is the key GAAP criterion that determines whether debts are to be shown on or off the balance sheet. Fraudsters trying to "hide debt" will attempt to obviate the consolidation requirements such that an SPE that should be consolidated is shown as a stand-alone entity.

GAAP Standards for SPEs

There are essentially two broad categories of SPEs:

1. Qualifying SPEs, defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* that hold primarily financial assets

2. Nonqualifying SPEs, defined in various Emerging Issues Task Force (EITF) Issue Statements and FASB Statements, which hold a wide range of assets

Tests used to determine whether an SPE will be consolidated with the firm (the transferor) that transfers assets and liabilities to the SPE vary depending on the category of the SPE.

Qualifying SPEs

Continuing the example of the transferor-bank discussed above, under the provisions of FASB Statement No. 140, the bank would recognize gain or loss on the transfer of financial assets to the qualifying SPE under the following conditions:

> 9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
> b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
> c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call. (references omitted)[1]

The requirements for a "qualifying special purpose entity" are very precise and complex. FASB Statement No. 140 spells out the elements:

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[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Original Pronouncements,* vol. 1, FAS140), paragraph 9.

35. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraph 36).
b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents.
c. It may hold only:
   (1) Financial assets transferred to it that are passive in nature
   (2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents
   (3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE
   (4) Servicing rights related to financial assets that it holds
   (5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds
   (6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).
d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
   (1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them
   (2) Exercise by a [Beneficial Interest Holder] (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE

> (3) Exercise by the transferor of a call or [removal-of accounts provision] specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds
> (4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception. (references omitted)[2]

Therefore, there are significant and highly restrictive legal and financial requirements to set up and operate qualifying SPEs.

However, a key feature is requirement (a) above that says that the qualifying SPE must be "demonstrably distinct from the transferor." To be able to keep SPE assets and debts off the transferor's balance sheet, that requirement is met by making sure that an outside party holds at least 10 percent ownership in the qualifying SPE or an outside party has given a "substantive guarantee" (in the words of FASB Statement No. 140, paragraph 182) of the debt in the form of a "guaranteed mortgage securitization":

> 36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization.[3]

The substantive involvement of an outside party, either as a holder of interests in the qualifying SPE or as a guarantor of the debt, is a critical element that allows a qualifying SPE to stand on its own and not be consolidated.

Non-Qualifying SPEs

A Nonqualifying SPE may hold a wide range of assets and has more flexibility in its capital structure. EITF Topic D-14 sets out the requirements with regard to nonconsolidation:

> Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks

[2] FASB Statement No. 140, paragraph 35.
[3] FASB Statement No. 140, paragraph 36.

> and rewards of ownership of the assets of the SPE (including residuals).

What constitutes a "substantive capital investment" is not very clear, though. In an exchange of questions and answers between the EITF and the SEC in 1990 and published in EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions,* the SEC described the minimum capital investment necessary for SPEs that own and lease assets such as buildings:

> The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with [EITF] Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

The SEC went on to say that "the conditions set forth in [EITF] 90-15 may be useful in evaluating other transactions involving SPEs." Therefore, for SPE leasing transactions, the SEC accepted an initial minimum capital requirement of 3 percent of SPE assets when the assets are first transferred to the SPE. If conditions require, the SEC would expect the capital to exceed 3 percent to reflect increased risk. Outside of leasing transactions, though, the SEC's guidance is merely suggested in that it "may be useful" to determine if the capital invested is "comparable to that expected for a substantive business" engaged in similar transactions. The FASB pronouncements issued after 1990 do not provide much additional guidance in this area. Therefore, with the exception of leasing transactions, GAAP is not clear as to the minimum capital required.

SPE Fraud

Substantive Ownership

That said, a qualifying or nonqualifying SPE can be manipulated by fraudsters to make it appear to be substantively owned by outsiders when, in fact, it is not. Substantive ownership is tested differently depending on the type of SPE:

1. For qualifying SPEs, the test is a minimum of 10 percent ownership or "substantive guarantees" of debt by third parties.
2. For nonqualifying SPEs, the test is a third party capital investment "comparable to that expected for a substantive business," which for leasing transactions is defined as a minimum of 3 percent of assets.

Substantive ownership is important because it provides the GAAP-authorized means by which assets and debts are moved off, or "derecognized" from, the balance sheet of the original owner and moved on to the balance sheet of the SPE, as explained in FASB Statement No. 140:

> After a transfer of financial assets [to an SPE by an entity], an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished.[4]

A lack of substantive ownership means the SPE is consolidated with the original owner for financial reporting purposes, bringing the assets and liabilities back onto the original owner's balance sheet and thereby obviating one of the principal objectives of the SPE.

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, though, the bonds used by the SPE to finance the purchase of the loan assets could be called the "hidden debt" of the bank since the bonds did not show up on the bank's balance sheet. What critics of SPEs fail to clearly state is that there are "hidden assets," the loans in this example, that move off the balance sheet as well. Implied in their criticism of SPEs, then, is the idea that the assets are not worth the amount of the debt issued against them. The quality of those assets, then, becomes another issue in assessing the legitimacy of an SPE.

Fraud Methodology

Asset quality and substantive ownership are related. Fraudsters manipulate both when they use the SPE vehicle 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 financial instruments,

[4] FASB Statement No. 140, paragraph 35.

real estate, or other assets that are not publicly traded, to place in the SPE at inflated values. Fictitious assets, such as illusory accounts receivable, also work if fraudsters can manufacture them.

2. By inflating the value of these non-publicly traded assets, the fraudsters can then move large quantities of debt equal to the inflated asset values from the company balance sheet to the SPE.
3. Fraudsters then attempt to avoid having to place capital at risk in the SPE because, with overvalued assets, the capital will be wiped out when the debts come due.

If an SPE has substantive capital at risk invested by an independent third party, that investor is likely to make sure the assets placed in the SPE are worth at least the amount of the SPE's debt, otherwise the third-party investor stands to lose its capital. A fraudster who wants to truly "hide debt," however, will attempt to move bogus or overvalued assets into an SPE loaded with debt, where there is little or no outside investment to avoid analysis and scrutiny.

Fraudulent Funding Schemes

Clearly, though, if there is no outside capital in the SPE, the assets and liabilities must be consolidated with the transferor firm that set up the SPE. 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 equity.

The fraudster, then, tries to create the appearance of a substantive outside investment in the SPE containing assets of dubious value. The schemes used to manufacture outside investment may closely resemble the schemes 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 needed to complete the purchase. An SPE fraud may work the same way, with funds coming from the firm that is trying to unload the assets and debts transferred to the SPE. The firm simply needs intermediaries to cover the movement of firm funds to the straw-man outside investor.

The source of the capital invested in the SPE, then, is a key element in uncovering SPE fraud. If real outside capital is at risk, the investor generally makes sure that other components of the SPE, as may be required under the provisions of EITF Issue No. 90-15, FASB Statement No. 140, or other areas of GAAP, are in place. In addition, a provider of outside capital may also insist on other safeguards, such as independent appraisals of assets placed in the SPE.

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, there is the potential for fraudsters to move costs from one project to another. Similarly, should fraudsters attempt to hide debts using an SPE, if the prospective outside SPE investor did not insist on an appraisal of hard-to-value assets sold to the SPE 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, then, 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

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. In 1999, 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 to 1997 were attributable to overstating revenue. Of those companies overstating revenue, the 1999 Research Report found that recording fictitious revenues and recording revenues prematurely were the primary causes of the fraud. Revenue recognition issues have occupied the accounting profession for many years as well. In 1984, the Financial Accounting Standards Board (FASB) issued FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.* That statement set out the following two basic requirements for recognizing revenue:

> a. *Realized or realizable.* Revenues and gains generally are not recognized until realized or realizable. 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 produc-

> ing 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. . . . (footnotes omitted)[1]

In Staff Accounting Bulletin (SAB) No. 101, the Securities and Exchange (SEC) staff identified a long list of additional accounting pronouncements that address revenue recognition, including the following:

- FASB Statement of Financial Accounting Standards No. 13, *Accounting for Leases*
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements*
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 51, *Financial Reporting by Cable Television Companies*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*
- Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*
- Accounting Research Bulletin (ARB) Nos. 43 and 45, *Long-Term Construction-Type Contracts*
- AICPA Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316)
- AICPA Statement of Position (SOP) No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*
- SOP No. 97-2, *Software Revenue Recognition*
- Emerging Issues Task Force (EITF) Issue No. 88-18, *Sales of Future Revenues*
- EITF Issue No. 91-9, *Revenue and Expense Recognition for Freight Services in Process*
- EITF Issue No. 95-1, *Revenue Recognition on Sales with a Guaranteed Minimum Resale Value*

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[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (FASB, *Original Pronouncements,* vol. 3, CON5), paragraph 83.

- EITF Issue No. 95-4, *Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease*

One could also add FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* to the list above. In addition, Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316), discusses procedures specific to a presumption of improper revenue recognition.

Also in SAB No. 101, the SEC staff set out its interpretation of the literature listed and concluded the following:

> The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:
>
> a. Persuasive evidence of an arrangement exists
> b. Delivery has occurred or services have been rendered
> c. The seller's price to the buyer is fixed or determinable
> d. Collectibility is reasonably assured. (footnotes omitted)

With regard to a fixed or determinable selling price, the SEC staff amplified its position by looking to SOP 97-2, which defines a *fixed fee* as a "fee required to be paid at a set amount that is not subject to refund or adjustment." Even though SOP 97-2 addressed software revenue recognition, the staff thought that the requirement of not being subject to refund or adjustment was applicable to all transactions. If the buyer retains a right to a refund of the purchase price, collectibility *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 were 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.

Standards of 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. Assume, for example, that Company A's salesperson has obtained verbal approval from Company B's customer management about the terms of a sale. Further assume that customer management must obtain approval of the sale's term from Company B'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, Company A's salesperson may represent (perhaps accurately) that Company B's purchasing decision maker has signed off on the sale but misrepresent that all conditions for revenue recognition are met. With the requirement for a signed contract, however, recognition of the sale would not occur at quarter end and for good reason: Company B has not agreed to the terms until legal department review is complete. Such a policy is put in place to ensure the company conforms to generally accepted accounting principles (GAAP). Violating that policy causes a GAAP violation if, in 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. 101. 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 as revenue sales lacking written agreements, 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 cut-off 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. For a document fabrication scheme to succeed over several quarters or years, however, 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 revenue recognition 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, though, may occur over the Internet at near instantaneous speed with no or lagging paper documentation. 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. 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 about why. 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 product after many others are experiencing sales declines, the CPA should attempt to understand why that reseller's channels of distribution are clear while others are blocked.

No Fixed Price

A price may not be fixed due to design or due to deceit. A price 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 they become fixed and determinable. Such a price 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. Minimum royalties, however, may be booked when they become due. Fraud occurs when royalties are recognized on fictitious or anticipated ultimate sales. Such royalty arrangements, however, 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 most likely candidates for this type of 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, side letters are the result of some type of internal control failure when the divisional manager is able to effect economic outcomes and alter accounting records.

These 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 must come to the surface if the buyer exercises his or her rights under the agreement. A more senior member of management is usually involved to cover up the refund with a fabricated reason or another transaction. Nevertheless, there is usually some documentation of the refund 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.

The CPA, however, 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, about 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.

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 side letters, which also affect collectibility, 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 a 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, though, 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."[2] It illustrates the issues involved in revenue recognition, set in foreign countries.

Example Scenario. MQB Corp., based in San Diego, California, is a developer and marketer of desktop publishing software. MQB's customers consist of third-party distributors, resellers, and retailers, and, collectively, they constitute MQB's channels of distribution. 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 product to MQB should a competitor's product or weakened economic conditions affect sales.

MQB recognized revenues under SOP 97-2, *Software Revenue Recognition.* MQB recognizes revenue upon shipment of its software products, provided that payment collection 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 by 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 three 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 earlier, he had 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 American and requires a completely different approach." That autonomy extended to financial as well as marketing operations management in Europe, but the European controller had a "dotted line" or secondary reporting

[2] This example is expanded from examples in Securities and Exchange Commission (SEC) Releases No. 33-8098 and No. 34-45907, Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, 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 shown, reflect the opinions of the author and not the SEC. The reader is encouraged to read the SEC releases in their entirety, which are included as an appendix to this book.

requirement to the corporate controller in the United States. The European division head hired all personnel, drawing upon French colleagues he had worked with while 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.

While 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. The company, overall, 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 had initiated a three-prong strategy that targeted:

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 target operating income was, in euros, €3,200,000 (or about US$3.1 million).

The marketing efforts were moving slowly and, toward the end of the current quarter, the division was behind its sales goal with only €1,700,000 booked and was headed toward reporting another operating loss. Sales to major accounts had been slow because a weakened European economy had stalled corporate buyers. Sales to resellers were also disappointing because they were more difficult to identify and reach than previously thought, and retailers reported that their inventory stocks were high and 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, Computer-Werken AG in Dusseldorf 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 and chip manufacturer, to see if that firm could proceed with its purchase.

All the last-minute efforts met with apparent success as large purchase orders were faxed in to the Paris office. The German retailers had ordered about €500,000 each and the French distributor ordered €700,000. 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 a larger-than-expected operating income for the quarter of €3,400,000.

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; 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 product 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 with these two orders because the quantities were so much larger than the others."

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 €102,000), 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. As the orders from each of the German firms were about €500,000, which translated to about US$490,000, audited statements were not required. Because Compagnie des Machines Française was publicly traded, it did have audited financial statements, prepared in accordance with International Accounting Standards (IAS). The IAS financial statements satisfied the credit requirements for the French distributor's €700,000 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 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.

As for the sale to the French firm, the corporate controller had only one question about a condition in the sales agreement referencing to "*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 is publicly held and traded on the Paris Bourse; its just that the government is the largest 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 €408,000 for the quarter 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, while the large firms' balances owed to MQB grew, intermittent payments were also being recorded. However, full payment never came within the 120-day period.

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 her time verifying receivables and tying those receivables to cash remittances. She 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. 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, ComputerWerken and UberComputer, were both experiencing financial difficulty and collectibility of the balances outstanding 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 five between the two firms. The U.S. internal auditor did not address this issue because, at the time of her 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, Compagnie des Machines Française, 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 there were French alternatives 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, 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 she examined the wire records, she was not able to trace them beyond the originating bank. Figuring that other customers would complain if the payments had been misapplied, she passed on attempting to source the wire transfers further.

- When asked why more licenses and product were sold to Compagnie des Machines Française 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. The corporate controller spent the day on the phone explaining to the chief financial officer 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 that 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, then, firms that are chartered in known tax havens should merit extra scrutiny.

In this case, the retail store chains were probably related, and while definitively determining common ownership could have been quite difficult given Dutch legal constraints, 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 requirements.

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?"

The financial statements of the German firms had red flags as well. The corporate controller noticed large quantities of goodwill on the firms' balance sheets. She did not understand, though, that, under German GAAP, in some cases goodwill is amortized to equity and not as an expense, and impairment testing will not become mandated, if ever, until IAS is implemented more widely. By failing to gain a better understanding of the principles that governed financial statement preparation, that controller was easily misled about the profitability of the German firms because amortization of significant quantities of goodwill was omitted from the income statement.

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. At the very least, assuming the controller were able to make a convincing argument for recognizing revenue on the date of the transaction, the returns allowance should have been increased significantly.

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 she had talked with them, they may have told her that they thought it odd that after a major corporate account 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, though, 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, and 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 that 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, 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 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, then, 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 soft-

> ware 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 failed to perform such an analysis for the European operations. The audit committee, though, could have used this statement as the benchmark by which to judge the adequacy of the methodology used to estimate the European returns allowance.

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 will allow them to charge off the phony sales they booked earlier without anyone noticing or minding. If future sales do not improve, though, the fraud schemes become more difficult to cover up. Customers who did not order product begin to complain, deadbeats who will not pay come to light, and buyers with side agreements begin to exercise their right to return product. These developments usually reveal the fraud scheme.

The best chance the CPA has to catch this kind of fraud 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.

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 *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 in this MD&A.*

In estimating future sales, we use our internal budgets. We develop our budgets based on 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.

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 2001 has resulted in a 0.5% increase in market share over the last five months of 2001, 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, following the 1999 restructuring of the hard drive division (which is described in the note 2 to the financial statements).

In each of the last two years, we have tested the hard drive-related 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 2001 sales were lower than those in 2000 and 1999, 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 2000 and 1999 impairment tests, respectively.

As of December 31, 2001, 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 the hard drive-related 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 the hard drive-related PP&E. A $30 million impairment loss would have reduced PP&E and Total Assets as of December 31, 2001 by 10% and 3%, respectively. That impairment loss also would have increased Net Loss Before Taxes, for the year ended December 31, 2001, by 100%.

If we had been required to recognize an impairment loss on our hard-drive related 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 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.*]

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

For Further Information Contact: W. Scott Bayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant (202-942-4400), or David R. Fredrickson, Office of General Counsel (202-942-0900), Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103; electronic addresses: BaylessWS@sec.gov; BurnsR@sec.gov; FredricksonD@sec.gov.

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. 101—Revenue Recognition in Financial Statements*

[**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.*]

SEC Staff Accounting Bulletin: No. 101—Revenue Recognition in Financial Statements

Securities and Exchange Commission
17 CFR Part 211

[Release No. SAB 101]

Staff Accounting Bulletin No. 101

Agency: Securities and Exchange Commission

Action: Publication of Staff Accounting Bulletin

*Source: SAB No. 101 is available at http://www.sec.gov/interps/account/sab101.htm.

Summary: This staff accounting bulletin summarizes certain of the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. The staff is providing this guidance due, in part, to the large number of revenue recognition issues that registrants encounter. For example, a March 1999 report entitled *Fraudulent Financial Reporting: 1987–1997 An Analysis of U. S. Public Companies,* sponsored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, indicated that over half of financial reporting frauds in the study involved overstating revenue.

Date: December 3, 1999

For Further Information Contact: Richard Rodgers, Scott Taub, or Eric Jacobsen, Professional Accounting Fellows (202/942-4400) or Robert Bayless, Division of Corporation Finance (202/942-2960), Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549; electronic addresses: RodgersR@sec.gov; TaubS@sec.gov; JacobsenE@sec.gov; BaylessR@sec.gov.

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: December 3, 1999

Part 211–(AMEND)
Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 101 to the table found in Subpart B.

Staff Accounting Bulletin No. 101

The staff hereby adds new major Topic 13, ''Revenue Recognition,'' and Topic 13-A, ''Views on Selected Revenue Recognition Issues,'' to the Staff Accounting Bulletin Series. Topic 13-A provides the staff's views in applying generally accepted accounting principles to selected revenue recognition issues. In addition, the staff hereby revises Topic 8-A to conform to FASB Statement No. 13, *Accounting for Leases.*

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. Examples of existing literature on revenue recognition include Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases,* No. 45, *Accounting for Franchise Fee Revenue,* No. 48, *Revenue Recognition When Right of Return Exists,* No. 49, *Accounting for Product Financing Arrangements,* No. 50, *Financial Reporting in the Record and Music Industry,* No. 51, *Financial Reporting by Cable Television Companies,* and No. 66, *Accounting for Sales of Real Estate*; Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*; Accounting Research Bulletin (ARB) Nos. 43 (Chapter 1a) and 45, *Long-Term Construction-Type Contracts*; American Institute of Certified Public Accountants (AICPA) Statements of Position (SOP) No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* and No. 97-2, *Software Revenue Recognition*; Emerging Issues Task Force (EITF) Issue No. 88-18, *Sales of Future Revenues,* No. 91-9, *Revenue and Expense Recognition for Freight Services in Process,* No. 95-1, *Revenue Recognition on Sales with a Guaranteed Minimum Resale Value,* and No. 95-4, *Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease*; and FASB Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.*[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 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] SFAC No. 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]
- The seller's price to the buyer is fixed or determinable,[5]

  and

- Collectibility is reasonably assured.[6]

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?

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.[7] 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 generally accepted accounting principles 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.

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,[8]
   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,[9]
   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,[10]
   d) the buyer acquiring the product for resale does not have economic substance apart from that provided by the seller,[11] or
   e) the seller has significant obligations for future performance to directly bring about resale of the product by the buyer.[12]
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,[13] 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).[14] 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 No. 95-1, *Revenue Recognition on Sales with a Guaranteed Minimum Resale Value,* and does not qualify for sales-type lease accounting.
4. The product is delivered for demonstration purposes.[15]

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.

3. Delivery and Performance

Question 3

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.

Questions: 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.[16] 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;
3. The buyer, not the seller, must request that the transaction be on a bill and hold basis.[17] 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 which 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:[18]

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;[19]

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).

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.[20]

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.[21] 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.

A seller should substantially complete or fulfill the terms specified in the arrangement in order for delivery or performance to have occurred.[22] 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 arrangement, all remaining costs of performance or delivery should be accrued.

If an arrangement (*i.e.,* outside the scope of SOP 81-1) requires the delivery or performance of multiple deliverables, or ''elements,'' the delivery of an individual element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element because the customer does not have the full use of the delivered element.[23]

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 until the license term begins.[24] 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.

Question 4

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 that ''the customer must have made a fixed commitment to purchase the goods.''

Question 5

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.

Question: 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,[25] 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, or enrolling the customer or activating telecommunications services) as discrete earnings events.[26] 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 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.

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[27] and generally should be deferred and recognized systematically over the periods that the fees are earned.[28]

Question 6

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.[29] 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 SFAS No. 91.

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,[30] 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 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.

4. Fixed or Determinable Sales Price

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 are neither fixed nor determinable until the cancellation privileges lapse.[31] If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term.[32] 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 SFAS No. 48.[33]

Question 7

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 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.

Question: 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?

Interpretive Response: 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 SFAS No. 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 (*e.g.,* 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 accordance with SFAS No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* paragraph 16. SFAS No. 125 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.[34] 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 SFAS No. 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,[35] 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 SFAS No. 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 SFAS No. 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 SFAS No. 48, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is SFAS No. 125. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, SFAS No. 125 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 SFAS No. 48 and that practice did not change when SFAS No. 125 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature. For the staff to prohibit such accounting in this SAB may result in significant change in practice that, in these particular circumstances, may be more appropriately addressed in a formal rulemaking or standards-setting project.

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:[36]

- 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.[37] 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[38] 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[39] 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.

- There is a sufficient company-specific historical basis upon which to estimate the refunds,[40] 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 whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue.

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. 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, *Reporting on Advertising Costs*. 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.[41] All costs other than incremental direct costs (*e.g.,* indirect costs) should be expensed as incurred.

Question 8

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.

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.[42]

SFAS No. 13, *Accounting for Leases,* 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.''

SFAS No. 29, *Determining Contingent Rentals,* amended SFAS No. 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 SFAS No. 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.

FASB Technical Bulletin (FTB) 85-3, *Accounting for Operating Leases with Scheduled Rent Increases,* addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in SFAS No. 13, paragraph 19(b). Paragraph 2 of FTB 85-3 states ''using factors such as the time value of money, 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 SFAS No. 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. FTB 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 FTB 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.

Question 9

Facts: Paragraph 8 of SFAS No. 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.[43] 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 SFAS No. 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 newness of a product, (6) the introduction of competitors' products with superior technology or greater expected market acceptance, and 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, that 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 SFAS No. 48, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first.[44] Simply deferring recognition of the gross margin on the transaction is not appropriate.

5. Income Statement Presentation

Question 10

Facts: Company A operates an internet site from which it will sell Company T's products. Customers place their orders for the product by making a product selection directly from the internet site and providing a credit card number for the payment. Company A receives the order and authorization from the credit card company, and passes the order on to Company T. Company T ships the product directly to the customer. Company A does not take title to the product and has no risk of loss or other responsibility for the product. Company T is responsible for all product returns, defects, and disputed credit card charges. The product is typically sold for $175 of which

Company A receives $25. In the event a credit card transaction is rejected, Company A loses its margin on the sale (*i.e.,* the $25).

Question: In the staff's view, should Company A report revenue on a gross basis as $175 along with costs of sales of $150 or on a net basis as $25, similar to a commission?

Interpretive Response: Company A should report the revenue from the product on a net basis. In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the staff considers whether the registrant:

1. acts as principal in the transaction,
2. takes title to the products,
3. has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
4. acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.[45]

If the company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, sales should be reported on a net basis.

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 APB Opinion No. 22, *Disclosure of Accounting Policies*. 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 elements, such as a product and service, the accounting policy should clearly state the accounting policy for each element as well as how multiple elements are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with SFAS No. 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.[46] The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

Management's Discussion and Analysis (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.[47] 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 Financial Reporting Release (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 analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future.''[48] 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.)[49]
- 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).[50]

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: 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 APB Opinion No. 20, *Accounting Changes,* no later than the first fiscal 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 Staff Accounting Bulletin Topic 11-M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Adopted in a Future Period,* should be provided. With regard to question 10 of Topic 13-A and Topic 8-A regarding income statement presentation, the staff would normally expect retroactive application to all periods presented unless the effect of applying the guidance herein is immaterial.

However, if registrants have not previously complied with generally accepted accounting principles, 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 APB Opinion No. 20 for the correction of an error.[51] 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.

Topic 8: Retail Companies

A. Sales of Leased or Licensed Departments

Facts: Department stores and other retailers customarily include the sales of leased or licensed departments in the amount reported as ‘‘total revenues.’’

Question: Does the staff have any objection to this practice?

Interpretive Response: In November 1975 the staff issued staff accounting bulletin number 1 that addressed this issue. In that bulletin the staff did not object to retailers presenting sales of leased or licensed departments in the amount reported as ''total revenues'' because of industry practice. Subsequently, in November 1976 the FASB issued SFAS No. 13. In June 1995, the AICPA staff amended its Technical Practice Aid (TPA) section 5100.16, *Rental Revenue Based on Percentage of Sales,* based upon an interpretation of SFAS No. 13 that leases of departments within a retail establishment are leases of tangible assets within the scope of SFAS No. 13.[52] Consistent with the interpretation in TPA section 5100.16, the staff believes that SFAS No. 13 requires department stores and other retailers that lease or license store space to account for rental income from leased departments in accordance with SFAS No. 13. Accordingly, it would be inappropriate for a department store or other retailer to include in its revenue the sales of the leased or licensed departments. Rather, the department store or other retailer should include the rental income as part of its gross revenue. The staff would not object to disclosure in the footnotes to the financial statements of the amount of the lessee's sales from leased departments. If the arrangement is not a lease but rather a service arrangement that provides for payment of a fee or commission, the retailer should recognize the fee or commission as revenue when earned. If the retailer assumes the risk of bad debts associated with the lessee's merchandise sales, the retailer generally should present bad debt expense in accordance with Regulation S-X article 5-03 (b)(5).

B. * * * * *

This Staff Accounting Bulletin is not intended to change current guidance in the accounting literature. For this reason, adherence to the principles described in this Staff Accounting Bulletin should not raise the costs associated with record-keeping or with audits of financial statements.

[1] In February 1999, the AICPA published a booklet entitled ''Audit Issues in Revenue Recognition.'' This booklet provides an overview of the current authoritative accounting literature and auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

[2] SFAC No. 5, ¶83-84; ARB No. 43, Chapter 1A, ¶1; APB Opinion No. 10, ¶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] SFAC No. 2, *Qualitative Characteristics of Accounting Information,* ¶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, ¶8. The use of the term ''arrangement'' in this Staff Accounting Bulletin is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.

[4] SFAC No. 5, ¶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.

[5] SFAC No. 5, ¶83(a); SFAS No. 48, ¶6(a); SOP 97-2, ¶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 No. 43, Chapter 1A, ¶1 and APB Opinion No. 10, ¶12. See also SFAC No. 5, ¶84(g) and SOP 97-2, ¶8.

[7] AICPA, Codification of Statements on Auditing Standards (AU) §560.05, *Subsequent Events*.

[8] SFAS No. 48, ¶6(b) and 22.

[9] SFAS No. 48, ¶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.

[10] SFAS No. 48, ¶6(c).

[11] SFAS No. 48, ¶6(d).

[12] SFAS No. 48, ¶6(e).

[13] SFAS No. 49, ¶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.

[14] SFAS No. 49, ¶5(b).

[15] See SOP 97-2, ¶25.

[16] See In the Matter of Stewart Parness, Accounting and Auditing Enforcement (AAER) Release No. 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., et al, Lit. Rel. No. 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER No. 971 (September 30, 1997); In the Matter of Cypress Bioscience Inc., AAER No. 817 (September 19, 1996). Also see SFAC No. 5, ¶84(a). and SOP 97-2, ¶22.

[17] Such requests typically should be set forth in writing by the buyer.

[18] See Note 16, supra.

[19] Such individuals should consider whether APB Opinion No. 21, *Interest on Receivables and Payables,* pertaining to the need for discounting the related receivable, is applicable. APB Opinion No. 21, ¶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).

[20] SOP 97-2, ¶22.

[21] SOP 97-2, ¶20. Also, SFAC No. 5, ¶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.

[22] SFAC No. 5, ¶83(b) states that ''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.''

[23] SOP 97-2, ¶13, and 68-70.

[24] SFAS No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films,* ¶6. The FASB has issued an Exposure Draft to rescind SFAS No. 53. The AICPA's Accounting Standards Executive Committee intends to issue a new SOP that would replace SFAS No. 53 and provide authoritative guidance on accounting for motion pictures. The Exposure Draft of the proposed new SOP contains a similar criterion for revenue recognition of a licensed film (*i.e.,* the license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale).
[25] See SFAC No. 5, footnote 51, for a description of the ''earning process.''
[26] In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* 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).
[27] 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).
[28] 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.
[29] Footnote 1 of SOP 98-5, *Reporting on the Costs of Start-Up Activities,* states that ''this SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Financial Accounting Standards Board (FASB) Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* and loan origination costs in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* 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 (SFAS No. 91 provides an analogous definition) incurred related to the acquisition or origination of a customer contract, unless specifically provided for in the authoritative literature, should be accounted for in accordance with paragraph 4 of FASB Technical Bulletin (FTB) 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* or paragraph 5 of SFAS No. 91.
[30] See Note 27, supra.
[31] SOP 97-2, ¶31.
[32] Ibid.
[33] Ibid.
[34] SFAS No. 125, ¶16.
[35] SFAS No. 48, ¶4.
[36] The staff will question further analogies to the guidance in SFAS No. 48 for transactions expressly excluded from its scope.
[37] Reliability is defined in SFAC No. 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 SFAC No. 5 reiterates the definition of reliability, requiring that ''the information is representationally faithful, verifiable, and neutral.''
[38] 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.
[39] The term ''remote'' is used here with the same definition as used in SFAS No. 5, *Accounting for Contingencies.*
[40] Paragraph 8 of SFAS No. 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.

[41] SFAS No. 91, paragraph 5 and FTB 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 Note 29, supra.

[42] Lessees should follow the guidance established in EITF Issue No. 98-9, *Accounting for Contingent Rent.*

[43] 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.''

[44] SFAS No. 48, ¶6.

[45] See, for example, ARB 43, Chapter 11A, ¶20; SOP 81-1, ¶58-60; and SFAS No. 45, ¶16.

[46] See Regulation S-X, Article 5-03 (b) (1) and (2).

[47] See Regulation S-K, Article 303 and Financial Reporting Release No. 36.

[48] FRR 36, also see In the Matter of Caterpillar Inc., AAER No. 363 (March 31, 1992).

[49] SFAS No. 107, *Disclosures about Fair Values of Financial Instruments.*

[50] 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.

[51] APB Opinion No. 20, ¶13 and ¶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 APB Opinion No. 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 Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit.*

[52] SFAS No. 13, ¶1 defines a lease as ''the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time.''

SEC Staff Accounting Bulletin: No. 101A—Amendment: Revenue Recognition in Financial Statements**

Securities and Exchange Commission

17 CFR Part 211

[Release No. SAB 101A]

Staff Accounting Bulletin No. 101A

Agency: Securities and Exchange Commission

Action: Publication of Staff Accounting Bulletin

Summary: Staff Accounting Bulletin No. 101 (''SAB 101'') was released on December 3, 1999 (64FR68936 December 9, 1999) and provides the staff's views in applying generally accepted accounting principles to selected revenue recognition issues. Since the issuance of SAB 101, the staff received requests from a number of groups asking for additional time to study the guidance. Many registrants have calendar year-ends and may need more time to perform a detailed review of the SAB since its issuance on December 3, 1999. This staff accounting bulletin delays the implementation date of SAB 101 for registrants with fiscal years that begin between December 16, 1999 and March 15, 2000.

Date: March 24, 2000

For Further Information Contact: Richard Rodgers, Scott Taub, or Eric Jacobsen, Professional Accounting Fellows, Office of the Chief Accountant (202/942-4400) or Robert Bayless, Division of Corporation Finance (202/942-2960), Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549; electronic addresses: RodgersR@sec.gov; TaubS@sec.gov; JacobsenE@sec.gov; or BaylessR@sec.gov.

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

**Source SAB No. 101A is available at http://www.sec.gov/interps/account/sab101a1.htm.

of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz

Secretary

Date: March 24, 2000

Part 211–(AMEND)
Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 101A to the table found in Subpart B.

Staff Accounting Bulletin No. 101A

The staff hereby amends Question 2 of Section B of Topic 13 of the Staff Accounting Bulletin Series.

Topic 13: Revenue Recognition

* * * * *

B. Disclosures
Question 1

* * * * *

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: 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 APB Opinion No. 20, *Accounting Changes,* no later than the first fiscal quarter of the fiscal year beginning after December 15, 1999, except that registrants with fiscal years that begin between December 16, 1999 and March 15, 2000 may report a change in accounting principle no later than their second fiscal quarter of the fiscal year beginning after December 15, 1999 in accordance with FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements.* 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 Staff Accounting Bulletin Topic 11-M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Adopted in a Future Period,* should be provided. With regard to question 10 of Topic 13-A and Topic 8-A regarding income statement presentation, the staff would normally expect retroactive application to all periods presented unless the effect of applying the guidance herein is immaterial.

However, if registrants have not previously complied with generally accepted accounting principles, 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 APB Opinion No. 20 for the correction of an error.[1] 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.

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[1] APB Opinion No. 20, ¶13 and ¶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 APB Opinion No. 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 Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit.*

SEC Staff Accounting Bulletin: No. 101B—Second Amendment: Revenue Recognition in Financial Statements***

Securities and Exchange Commission

17 CFR Part 211

[Release No. SAB 101B]

Staff Accounting Bulletin No. 101B

Agency: Securities and Exchange Commission

Action: Publication of Staff Accounting Bulletin

Summary: Staff Accounting Bulletin No. 101 (''SAB 101'') was released on December 3, 1999 (64 FR 68936 December 9, 1999) and provides the staff's views in applying generally accepted accounting principles to selected revenue recognition issues. SAB 101A was released on March 24, 2000 (65 FR 16811 March 30, 2000) and delayed for one fiscal quarter the implementation date of SAB 101 for registrants with fiscal years beginning between December 16, 1999 and March 15, 2000. Since the issuance of SAB 101 and SAB 101A, the staff has continued to receive requests from a number of groups asking for additional time to determine the effect, if any, on registrant's revenue recognition practices. This staff accounting bulletin delays the implementation date of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999.

Date: June 26, 2000

For Further Information Contact: Richard Rodgers, Scott Taub, or Eric Jacobsen, Professional Accounting Fellows, Office of the Chief Accountant (202/942-4400) or Robert Bayless, Division of Corporation Finance (202/942-2960), Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549; electronic addresses: RodgersR@sec.gov; TaubS-@sec.gov; JacobsenE@sec.gov; or BaylessR@sec.gov.

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

*** Source: SAB 101B is available at http://www.sec.gov/interps/account/sab101b1.htm.

of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz

Secretary

Date: June 26, 2000

Part 211–(AMEND)
Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 101B to the table found in Subpart B.

Staff Accounting Bulletin No. 101B

The staff hereby amends Question 2 of Section B of Topic 13 of the Staff Accounting Bulletin Series.

Topic 13: Revenue Recognition

* * * * *

B. Disclosures

Question 1

* * * * *

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: 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 APB Opinion No. 20, *Accounting Changes,* and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements,* no later than the fourth fiscal 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 Staff Accounting Bulletin Topic 11-M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Adopted in a Future Period,* should be provided. With regard to question 10 of Topic 13-A and Topic 8-A regarding income statement presentation, the staff would normally expect retroactive application to all periods presented unless the effect of applying the guidance herein is immaterial.

However, if registrants have not previously complied with generally accepted accounting principles, 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 APB Opinion No. 20 for the correction of an error.[1] 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.

[1] APB Opinion No. 20, ¶13 and ¶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 APB Opinion No. 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 Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit.*

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?	____	____	____	____

* This checklist is adapted with permission from the ''Financial Statement Fraud Checklist,'' in chapter 10, ''Reducing the Risk of Financial Statement Fraud,'' of *The CPA's Guide to Fraud and Commercial Crime Prevention* by Tedd Avey, Ted Baskerville, and Alan Brill, published by the AICPA.

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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 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?	_____	_____	_____	_____
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?	_____	_____	_____	_____

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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?	_____	_____	_____	_____

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?	____	____	____	____

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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?	____	____	____	____
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?	____	____	____	____
c. Are outside auditors unaware of any interim or quarterly financial reportings 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 fail 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.*				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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	_____	_____	_____	_____
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	_____	_____	_____	_____

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
• 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?	_____	_____	_____	_____
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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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 not 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	____	____	____	____
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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
prepared by management with business or family ties to the investor company?	_____	_____	_____	_____
Acquisition and Cookie Jar Reserves				
a. Were reserves established without a clear purpose or justification?	_____	_____	_____	_____
b. If reserves were established by a current period charge to income, were earnings prior to the charge in excess of management or outside expectations?	_____	_____	_____	_____
c. Were reserves established at or near the close of a reporting period?	_____	_____	_____	_____
d. Were reserves established without adequate review by senior management?	_____	_____	_____	_____
e. Upon review of charges to a given reserve, are there charges for expenses that are not appropriate to the stated purpose of the reserve?	_____	_____	_____	_____
f. Was the timing of the takedown of reserves coincident with achieving certain financial targets set by management or outsiders?	_____	_____	_____	_____
g. Was the amount of the takedown of reserves 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 reserves?	_____	_____	_____	_____
• Were reserves established after twelve months from the date of the acquisition?	_____	_____	_____	_____
• Were reserves set up for items not related to the acquisition?	_____	_____	_____	_____
• Does the quantity of costs allocated to the reserve 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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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?	_____	_____	_____	_____
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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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 reserves 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 reserves 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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
personnel had signed the contract but the contract was held up for other reasons.	_____	_____	_____	_____
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?	_____	_____	_____	_____

Financial Reporting Fraud Supplemental Checklist	**Yes**	**No**	**NA**	**Ref**
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?	_____	_____	_____	_____
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:				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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 61 meetings,	_____	_____	_____	_____
iii. To be constructed either hastily or simply in an effort to provide a list that appears to comport with reporting requirements, or	_____	_____	_____	_____
iv. 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:				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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				

Financial Reporting Fraud Supplemental Checklist	Yes	No	NA	Ref
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.	_____	_____	_____	_____

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