// Insights

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COSO Study Provides Insights on Preventing and Detecting Fraudulent Financial Reporting

On May 20, 2010, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a study, "Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies". The study examined nearly 350 financial statement fraud allegations investigated by the SEC over a ten-year period. By examining key company and management characteristics for the companies involved in instances of financial statement fraud, this study provides insights related to preventing, deterring, and detecting fraudulent financial reporting.

Financial fraud affects companies of all sizes, with the median company having assets and revenues just under $100 million. The median fraud was $12.1 million, although more than 30 of the fraud cases each involved misstatements/misappropriations of $500 million or more. Although fraudulent financial reporting can occur in any industry, the study showed that the most frequent industries where fraud occurred included computer hardware and software and other manufacturing, healthcare/health products, retailers/wholesalers, other service providers, and telecommunications. Most of the frauds were committed at or directed from the companies' headquarters. The highest percentages of frauds involved companies headquartered in California and New York.

The financial health of some of the companies involved was generally close to a break-even position in the periods before the fraud. This finding warrants enhanced skepticism on the part of board members, auditors, and regulators when companies are experiencing financial stress. This financial stress clearly took its toll on CEOs and CFOs who were named for some level of involvement in nine out of ten cases. The most commonly cited motivations for fraud include the need to:

- Meet external or internal earnings expectations;
- Conceal the company's deteriorating financial condition;
- Increase the stock price;
- Bolster financial performance for pending equity or debt financing; or
- Increase management compensation based on financial results.

Although assets were misappropriated in some of the frauds, the intentional misstatement of financial statements was noted much more frequently and involved improper revenue recognition, asset overstatements, and/or understatement of expenses or liabilities. Improper revenue recognition accounted for more than 60 percent of the cases and transpired through a variety of tactics including recording fictitious or premature revenues through sham sales, conditional sales, round-tripping or recording loans as sales, bill-and-hold transactions, premature revenues before all terms of the sale were complete, improper sales cutoff, improper use of the percentage-of-completion method, unauthorized shipments and consignment sales. Financial statement frauds generally involved multiple fiscal periods. Fraud periods extended on average for 31 months.

Another interesting finding regarding fraudulent financial reporting is that fraud companies disclosed significantly more related-party transactions than non-fraud companies. The higher frequency of related-party transactions for fraud companies may suggest heightened fraud risk and require greater scrutiny of such transactions to determine if the nature of those transactions has broader implications on management's integrity, philosophy, and ethical culture.

"Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies" is available in full at http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf. COSO encourages those involved in financial reporting to carefully consider the results reported in this study and recommit their efforts to improve the prevention, deterrence, and detection of fraudulent financial reporting.

Accounting

Get Your Facts First!
Comments from McGladrey & Pullen National Director of Accounting, Jay Hanson

> "Get your facts first, and then you can distort them as much as you please."
> - Mark Twain

This famous Mark Twain quote contains simple advice for the accounting profession. It is also this simple advice (getting the facts first) that many times is not followed, leading to much inefficiency and sometimes errors. How often have we each assumed we know the facts of a situation, but not confirmed or verified them? The proper accounting for any transaction or situation can only be accomplished with the facts. There may be different ways to account for a transaction and legitimate interpretations of what the accounting standards require. There is, however, only one set of facts, so it is important that we get those facts and understand them.

How often have we seen a transaction that we just don't understand? As a national office consultant, I hesitate to provide any accounting advice for a transaction I don't understand. Mark Twain also said, "The more you explain it, the more I don't understand it." If you find yourself in this situation, there are probably more facts to be discovered. A simple audit step that we all know, but sometimes forget, is getting the agreement, making sure it is the final agreement, and reading it. If a transaction or arrangement has many provisions, but we don't think it is written, ask again. Oral agreements lead to misunderstandings. If an agreement truly is oral, all the parties may have different understandings, and the facts may only come from obtaining the understanding from each party.

More Accounting Changes Coming – June Update

Currently, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have at least a dozen joint projects in process. The goal of each project is to replace the existing FASB and IASB guidance on the topic with a common standard. Previously, McGladrey & Pullen's National Professional Standards Group published a summary discussing six of the projects that will have the biggest impact on virtually all companies, plus the planned changes to the guidance on how to measure fair value. These projects are:

- Financial statement presentation
- Revenue recognition
- Financial instruments
- Leases
- Financial instruments with characteristics of equity
- Consolidation
- Fair value measurements

An updated summary, More Accounting Changes Coming, was published on June 8 and is available at http://mcgladreypullen.com/Resource_Center/more_accounting_changes_coming.pdf.

Other recent accounting-related publications available on the McGladrey & Pullen Web site include:

- Guidance on Fundamentals of Debt Modifications and Restructurings
- Quick Reference Guide to the FASB Codification
- Fair Value Disclosures for Business Combinations and Other Accounting Events
- Fundamentals of Fair Value Measurements and Disclosures
- Fundamentals of Debt Classification

Pervasive Changes to the Accounting for Financial Instruments Proposed

To provide a consistent, comprehensive financial reporting model for the recognition, measurement, and presentation of financial instruments, the Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update (ASU), Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815). If adopted as drafted, the proposed guidance will have a pervasive effect on existing accounting guidance for financial instruments. The guidance proposes changes to the number of categories and methods for measuring financial instruments; the model for testing impairment; and the qualifications for hedge accounting.

Existing U.S. generally accepted accounting principles permit different accounting treatments for similar financial instruments. For example, currently debt instruments may be measured at amortized cost (for example, loans held for investment or held-to-maturity debt securities), at lower of cost or fair value (for example, loans held for sale), or at fair value (for example, trading securities). Under this 218-page proposal, most financial instruments would be measured at fair value in the statement of financial position each reporting period.

Financial institutions and other entities that currently measure a large number of financial assets at amortized cost would be most affected. For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, the proposed guidance would require a reconciliation from amortized cost to fair value on the face of the statement of financial position. For such financial instruments, net income would remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period. With the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.

For some financial instruments, this proposed ASU represents no change for measurement. For example, for derivatives and financial instruments for which an entity's strategy is trading the instruments, fair value would continue to be required, with all changes in fair value recognized in net income each reporting period. Changes in the fair value of equity securities, certain hybrid instruments, and financial instruments that can be contractually prepaid in such a way that the holder would not recover substantially all of its investment also would be recognized in net income each reporting period regardless of an entity's business strategy with respect to those financial instruments. In addition, some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Also, short-term receivables and payables would continue to be measured at amortized cost (plus or minus fair value hedging adjustments). However, the proposed ASU does change the criteria to be met for an investor to use the equity method of accounting. The proposal requires the investor to have both the ability to exercise significant influence over the investee (same as the existing requirement) and the

operations of the investee must be considered related to the investor's operations (the new requirement). If both criteria are not met, the investor must account for its investment in the equity securities of the investee at fair value with changes in fair value recognized in net income.

Currently, there are different impairment rules depending on category and instrument type. The proposal includes a single credit impairment model for both loans and debt securities. Under the proposed ASU, only instruments in the held-for-collection/payment category will be tested for impairment. Also, currently a high threshold for recognition of credit impairments impedes timely recognition of losses. The proposed ASU would remove the existing "probable" threshold for recognizing credit losses on loans.

The proposed guidance also would replace highly complex, quantitative-based hedging requirements with more qualitative-based assessments that would make it easier to qualify for hedge accounting. An entity could continue to designate particular risks in financial items as the risks being hedged in a hedging relationship, with only the effects of the hedged risks reflected in net income each reporting period. Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires, is sold, terminated, or exercised.

The FASB will establish the effective date of the requirements when it issues the final amendments. Whatever that date (the Board has stated that an effective date of no earlier than January 1, 2013 should be expected), a nonpublic entity with less than $1 billion in total consolidated assets would be granted an additional four years to measure its loans and loan commitments at fair value and remeasure its core deposit liabilities that qualify for changes in fair value to be recognized in other comprehensive income. An entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date. Early adoption would be prohibited.

The proposed ASU is available for comment until September 30, 2010 at www.fasb.org. The FASB will host a live webcast on the financial instruments proposal on June 30, 2010, beginning at 2 p.m. EDT.

To register for the live or archived webcast, follow the audience URL at: http://event.on24.com/r.htm?e=217085&s=1&k=D099CC4CFDD333F0978A797582066D20.

Statement of Comprehensive Income Proposed

Current U.S. generally accepted accounting principles allow reporting entities several alternatives for displaying other comprehensive income and its components in financial statements. The Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update (ASU), Comprehensive Income (Topic 220) - Statement of Comprehensive Income, which, if finalized, would remove existing options that permit the components of net income and the components of other comprehensive income to be displayed in separate financial statements. The proposed ASU would require that all components of comprehensive income be reported in a continuous financial statement that displays the components of net income and the components of other comprehensive income within comprehensive income. An entity would be required to display a total for each part — net income and other comprehensive income. An entity that has no items of other comprehensive income in any period presented would not be required to report other comprehensive income or comprehensive income.

The amendments in the proposed ASU would not change:

- The items that must be reported in other comprehensive income
- When an item of other comprehensive income must be reclassified to net income
- The option for an entity to show components of other comprehensive income gross or net of the effect

of income taxes in the statement of comprehensive income as long as the tax effect for each component is disclosed in the notes to the financial statements or is displayed parenthetically on the statement of comprehensive income

- How earnings per share are calculated or reported

The amendments in the proposed ASU would be applied on a fully retrospective basis. Early adoption would be permitted. The FASB plans to align the proposed effective date of the amendments in this proposed ASU with the effective date of the amendments in the recently proposed ASU on financial instruments. See "Pervasive Changes to the Accounting for Financial Instruments Proposed" above.

The proposed ASU, Comprehensive Income (Topic 220) - Statement of Comprehensive Income, is available for comment until September 30, 2010 at www.fasb.org. Also, since this proposed ASU is a joint project undertaken with the International Accounting Standards Board (IASB), the IASB has separately issued a similar document. See "IASB Proposes Continuous Statement of Profit or Loss and Other Comprehensive Income" in the International section below.

Valuation Resource Group Meets

In 2007, the Valuation Resource Group (VRG) was formed by the Financial Accounting Standards Board (FASB) to provide advice to the FASB staff on implementation issues and valuation issues regarding fair value measurements. The VRG's members include representatives from financial statement preparers and users, auditors, and valuation experts. The VRG does not reach authoritative conclusions during its meetings, as it has no standard-setting authority. McGladrey & Pullen is represented on the VRG by Richard Stuart, a partner in our firm's National Professional Services Group. The VRG recently met on April 12, and discussed the following topics within the Group and with members of the FASB.

FASB/IASB Joint Project

The FASB and International Accounting Standards Board (IASB) staffs discussed the decisions to date on the joint fair value measurement project with the VRG members. The two Boards have completed deliberations on the project and an Exposure Draft is expected in the second quarter of 2010. VRG members expressed concern that the proposed guidance on market participants might lead to an increase in use of prices from related-party transactions as fair value. A question also was raised as to whether the proposed guidance was inconsistent with existing guidance on related parties. The FASB stated that their intent had been to convey that one could not simply conclude that a transaction price was not at fair value solely because the parties to the transaction were related.

VRG members also discussed the relationship between the proposed guidance on (a) valuation premise and (b) highest and best use. The proposed guidance would require that the objective of a fair value measurement of an individual asset is to determine the price for a sale of that asset by itself, not for sale as a part of a group of assets or a business. However, when the highest and best use of an asset is to be used as a part of a group, the fair value measurement presumes that the sale is to a market participant that has, or can obtain, the complementary assets. The VRG pointed out that this notion is not consistent with a premise of continued use. The FASB staff noted that the intent was to exclude entity-specific synergies from the fair value measurement, and will make the necessary changes.

The VRG also discussed the issue of premiums and discounts in a fair value measurement, including the notion of "blockage". The FASB and IASB had concluded that they would clarify what a blockage factor is, and describe how it differs from other types of adjustments. The proposed guidance discussed lack of marketability as a possible adjustment. VRG members discussed that lack of marketability is not relevant in a fair value measurement, which

is attempting to value the item as if it were sold at the measurement date. Consequently, any marketability restrictions would be deemed to have expired as of the measurement date.

Fair Value of Leased Investment Properties

The FASB recently added a project to its agenda to determine whether entities should be permitted to measure investment properties at fair value. This issue addresses the question of whether, if investment properties are permitted (or required) to be measured at fair value, should the reporting entity recognize any "off-market" leases only in business combinations, or should the reporting entity recognize any such off-market lease? The VRG expressed a view that the recognition of off-market leases should not be limited to business combination situations.

Measurement of Reacquired Rights in a Business Combination

The VRG discussed an example of a reacquired franchise right and expressed a view that the reacquired right should be measured based on a valuation technique that considers the franchisee's cash flows after paying an at-market royalty rate to the franchisor/acquirer.

Fair Value Measurement of Accounts Receivable, Accounts Payable, and Other Accrued Liabilities

The FASB staff requested input on the appropriate approach to measure the fair value of accounts receivable, accounts payable, and accrued liabilities. The VRG informed the FASB staff that this question did not arise very often.

For more detail on the fair value measurement project, visit the FASB Web site at www.fasb.org. Additionally, the fair value measurement project is one of several FASB projects summarized in More Accounting Changes Coming, a publication of McGladrey & Pullen.

Auditing

Tackle Those Spreadsheets!

Generally accepted accounting principles (GAAP) may require that an asset or liability be valued based on a prescribed method such as cost or fair value. GAAP also may require additional disclosures about the value or specify how an asset or liability should be recognized or released through the income statement.

While performing robust audit procedures directed at determining the appropriateness of management's determination of fair value and associated accounting is critical, the most embarrassing audit "mistakes" often result from failing to execute basic "blocking and tackling" audit procedures. "Blocking and tackling" audit procedures that should not be overlooked include testing the underlying data and computations used to establish values, whether provided by management or a specialist, to determine if the data used to value the asset or liability is accurate, complete, and relevant. Often these calculations reside in spreadsheets where it is critical that the formulas embedded in the spreadsheet are tested for appropriateness. Failing to execute on basics such as testing spreadsheet formulas and the data used in the calculation potentially leads to material misstatement not only in the current-period financial statements, but also embarrassing and unnecessary misstatements carrying over into future financial statements.

Proposed Standard Regarding Nonissuer Financial Statements in Registration Statements

In conjunction with its efforts to clarify generally accepted auditing standards for audits of nonpublic companies and to converge such standards with International Standards on Auditing, the Auditing Standards Board of the American Institute of Certified Public Accountants recently issued a proposed Statement on Auditing Standards (SAS), Filings with the U.S. Securities and Exchange Commission under The Securities Act of 1933, which, if finalized, would supersede SAS No. 37, Filings Under Federal Securities Statutes. The proposed SAS does not change or expand SAS No. 37 in any significant respect; however, to reflect a more principles-based approach to standard setting, certain requirements that are duplicative of broader requirements have been moved to application and other explanatory material.

The proposed SAS addresses the auditor's responsibilities in connection with financial statements of a nonissuer included in a registration statement filed with the SEC under The Securities Act of 1933, as amended. If finalized, the proposed SAS would be effective for audits of financial statements for periods ending on or after December 15, 2012.

The proposed SAS is available for comment until August 2, 2010 at http://www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/DownloadableDocuments/20100601a_ED_Filings_With_the_SEC_Under_the_1933_Act.pdf.

Compilations and Reviews

Reporting on Compiled Prospective Financial Statements when Independence Is Impaired

Currently, AT Section 301, Financial Forecasts and Projections, prohibits a practitioner from disclosing the reasons for an independence impairment in his or her compilation report on compiled prospective financial statements. Consequently, users who want to understand the reasons for an independence impairment need to contact the client or the accountant for more information. Because of this interest on the part of users and to improve the overall transparency in the compilation report on historical financial statements, the AICPA Accounting and Review Services Committee has issued a proposed Statement on Standards for Attestation Engagements (SSAE) to allow the practitioner, if he or she chooses, to disclose the reasons for an independence impairment in the compilation report on compiled prospective financial information.

The proposed SSAE, Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired, would be effective for compilations of prospective financial statements for periods ending on or after December 15, 2010, with early implementation permitted.

The proposed SSAE is available for comment until September 10, 2010 at http://www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/DownloadableDocuments/20100603a_ED_Practitioner_Independence.pdf.

Public Sector

Not-For-Profit Entities Industry Audit Risk Alert Released

The American Institute of Certified Public Accountants (AICPA) recently issued an Audit Risk Alert, Not-For-Profit Entities Industry Developments - 2010. This Audit Risk Alert is intended to provide auditors of financial statements of not-for-profit entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits they perform.

AICPA Audit Risk Alerts are available in the Auditing section of Accounting Research Manager.

International

IASB Proposes Continuous Statement of Profit or Loss and Other Comprehensive Income

International Accounting Standard 1, Presentation of Financial Statements, currently requires that an entity present all items of income and expense recognized in a period either (a) in a single statement of comprehensive income, or (b) in two statements: a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income). The International Accounting Standards Board (IASB) recently issued an Exposure Draft, Presentation of Items of Other Comprehensive Income (proposed amendments to IAS 1), which, if finalized, would remove existing options that permit the components of profit or loss and the components of other comprehensive income to be displayed in separate financial statements. The exposure draft would require a single statement of profit or loss and other comprehensive income containing two distinct sections — profit or loss and items of other comprehensive income.

The exposure draft does not address which items are to be presented in other comprehensive income. However, the IASB is proposing to group items in other comprehensive income on the basis of whether they will eventually be "recycled" into the profit or loss section of the income statement. In addition, the exposure draft proposes to change the title of the statement of comprehensive income to "statement of profit or loss and other comprehensive income" while continuing to permit the use of other titles for this statement, such as "statement of comprehensive income". Entities also are allowed to present additional line items, headings and subtotals in the statement when it is relevant to an understanding of the entity's financial performance. The provisions of the exposure draft are to be applied retrospectively.

The IASB's exposure draft has been jointly developed with the Financial Accounting Standards Board, which is proposing a similar change in the display of comprehensive income. See "Statement of Comprehensive Income Proposed" in the Accounting section above.

The IASB's exposure draft is available for comment until September 30, 2010, at http://www.iasb.org/NR/rdonlyres/58DEA5EA-8CFC-45A7-910E-A55F9B7EA04F/0/ED_OCI_May10.pdf

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