Deceptive Accounting Practices

(DAP4)

KAPLAN

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Overview

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- ☐ Identify and describe factual situations and examples leading to deceptive accounting practices associated with financial reporting

INTRODUCTION

The accounting profession and the financial markets have been plagued during the past 25 years with repeated cases of financial reporting problems. At times, reports of **earnings restatements, fraudulent financial reporting, audit failures, and increased regulatory actions** have become more commonplace. Examples include:

- Mining company Rio Tinto for inflating the value of coal assets acquired for $3.7 billion and sold a few years later for $50 million.
- PharMor's inappropriate quarter end journal entries to debit inventory and credit sales to achieve performance targets for the drug store chain.
- SEC enforcement actions against China-based Longtop Financial Technologies Limited and its auditor, Deloitte Touche Tohmatsu CPA Ltd.
- HP's allegations of pre-acquisition financial-reporting fraud by the software company Autonomy.
- Osiris Therapeutics overstating the company's performance by improperly recognizing revenue using artificially-inflated prices, backdating documents, and prematurely recognizing revenue for products shipped on consignment.

The financial reporting model and the role of auditors have been completely reexamined in recent years as a result of lessons learned from the numerous frauds, abuses, misrepresentations, and conflicts of interest situations in recent years.

In the SEC Division of Enforcement's January 2021 *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions,* it identified 531 stand-alone enforcement actions from January 1, 2014 through June 30, 2019. Of these enforcement actions, 204 addressed financial statement fraud. Of those, 82 addressed improper revenue recognition; 57 addressed improper accounting for reserves; 24 addressed inventory related issues; and 17 addressed impairment issues. For example, misconduct actions include:

- Revenue and expense recognition problems
- Faulty valuation and impairment decisions
- Missing or insufficient disclosures
- Misappropriation through accounting misrepresentations
- Inadequate internal controls
- Misconduct by financial reporting executives

Each individual case seems to reveal **“creative” accounting practices**, highlighting a basic disregard for the well-being of users, employees, customers, and regulators by management personnel in these entities. Many of these abuses of GAAP and the fraudulent practices used will be discussed today. It is important, however, to realize that this type of abuse is not exclusive to large, public companies. While the motives and methods may be different, the use of deceptive accounting practices by private companies cannot be ignored. In fact, **many fraud studies conclude that most fraud takes place in non-public entities due to the lack of basic internal controls and significant owner/management involvement.**

EXAMPLE

A privately held electronics distributor overstated inventory and sales in order to appear to be in compliance with terms of its line of credit agreement with a bank. The misstatements were accomplished through a complicated scheme involving fictitious sales and purchases with “shell” corporations that were not disclosed as related parties to the auditors. The magnitude of sham transactions was overshadowed only by the lies told to the auditors.

WHY HAS THIS ACTIVITY HAPPENED?

One columnist compared the accounting environment at times to the way that accountants apply the Tax Code, looking for loopholes, gray areas, or aggressive positions that are not specifically prohibited or that may be successfully challenged. But the two disciplines do not share common goals. The Code is not intended to produce meaningful information, and has no underlying “spirit” or “intent”; it is merely a complex set of rules designed to raise revenue. **The financial reporting process has been undermined by the motivation to increase stock value, obtain financing, raise equity capital, achieve incentive compensation goals, increase the sales price of a business, or meet analysts’ expectations.**

The “desired result” at times has prevailed over the realistic representation of **economic substance over form**.

As imperfect as GAAP may be, if bankers, regulators, or investors require GAAP, they should get it; not tax accounting or some unjustified variation of GAAP. The ability of the financial world to function in an orderly, predictable manner is dependent on a system of reporting that is clearly defined and consistent from entity to entity. Whenever GAAP is abandoned in favor of methods that are potentially misleading (e.g., to smooth earnings) or "simpler" (e.g., passing tax methods off as GAAP), there is a breakdown in the system we are ethically bound to uphold and a deterioration in the reliability of information relied upon by third parties.

When the economy slows down, it places many companies in a difficult financial position possibly leading to aggressive or fraudulent accounting practices taking place. We know that in past recessions, two to three years after the recessions ended, fraudulent accounting practices and audit failures were disclosed. In addition, as FASB moves more towards a fair value measurement base, the potential for financial statement abuse increases as more **estimates and judgments** are necessary to arrive at the financial statement outcomes.

This program is designed to review selected fraudulent or otherwise deceptive accounting practices with the goal of improving awareness by participants of the types of practices followed when fraud is performed. This awareness should enable participants to more clearly identify these types of fraudulent practices, develop audit strategies to detect fraud, if applicable, and develop meaningful internal controls and effective oversight to prevent or detect these types of practices. **Fraud is not an isolated instance; fraud is intentional and tends to occur over a period of time**. Understanding the motivations and deceptive practices utilized by fraudsters can help reduce the frequency of these types of activities.

Two examples are described below to illustrate the use of deceptive accounting practices and to further illustrate the characteristics that existed that allowed fraudulent practices to continue without being discovered in the normal course of business.

EXAMPLE 1

HealthSouth

In 2010, HealthSouth had $2 billion of revenue with 23,000 employees in the area of health care rehabilitation. In 2003, HealthSouth had $4.5 billion of revenue with 60,000 employees in 2,000 facilities throughout the country.

In 2003, the SEC accused HealthSouth of overstating earnings by at least $1.4 billion in order to meet or exceed earnings expectations established by Wall Street analysts. The SEC alleged that between 1999 and the second quarter of 2002 HealthSouth intentionally overstated its earnings identified as "Income before Income Taxes and Minority Interests" by at least $1.4 billion in reports filed with the SEC. The following table illustrates the details of the alleged fraud:

Income (Loss) before Income Taxes and Minority Interests (in $ millions)	1999 Form 10-K	2000 Form 10-K	2001 Form 10-K	For 6 months ended 6/30/02
Actual	$(191)	$194	$9	$157
Reported	$230	$559	$434	$340
Misstated Amount	$421	$365	$425	$183
Percentage	220%	188%	4,722%	119%

The accounting fraud itself consisted of reducing contra revenue accounts and/or decreasing expenses while correspondingly increasing property, plant, and equipment accounts. The contra revenue account estimated the differences between the gross amounts billed for patient services and the amounts that insurance companies and Medicare would pay for the specific treatment. HealthSouth management knew that its outside auditors (Ernst & Young) would only question additions to fixed assets, if the additions exceeded a certain dollar threshold. As a result, HealthSouth was careful not to exceed this threshold. HealthSouth also created false documents to support its fictitious accounting journal entries.

- Overstatement of earnings
- Meet earnings expectations
- Overstated earnings by $1.4 billion
- Use of reducing contra revenue accounts and decreasing expenses
- Increasing property, plant, and equipment accounts
- Materiality abuse

EXAMPLE 2

Tyco International Ltd

Tyco is a diversified manufacturing and service company involved in fire protection and safety systems, electronic security services, electrical and electrical components, medical products, and engineered products and services. Tyco has approximately 100,000 employees worldwide, working within three separate business units, with sales in 2011 of over $17 billion.

From 1996 through 2002, Tyco overstated and smoothed net income by over $1 billion. During these years, Tyco acquired hundreds of companies and utilized improper accounting practices by undervaluing acquired assets, overvaluing acquired liabilities, and establishing unnecessary reserves for future contingencies. In addition, Tyco overstated revenue from “connection fees” that lacked economic substance and did not meet the criteria for revenue recognition.

Understating acquired assets benefited Tyco’s earnings by decreasing depreciation expense in future periods for plant and equipment and increasing earnings. Overstating acquired liabilities allowed Tyco to maintain inflated reserves that Tyco reduced in future periods to inflate earnings.

A subsidiary of Tyco, ADT Security Services Inc., regularly purchased contracts from unrelated security alarm dealers to provide residential and commercial security systems. ADT implemented a $200 “connection fee” to be paid by the dealers to ADT for each contract purchased. This connection fee was recognized in full as revenue on the income statement. At the same time, ADT increased the price it paid to the dealers for the contracts by the same $200. This $200 was amortized over 10 years. Using this technique, Tyco inflated its revenue and net income by over $550 million. The “connection fee” was a sham transaction with $200 coming into Tyco and $200 going out of Tyco. The transaction had no economic substance.

On April 17, 2006, the SEC finalized a settlement over these actions that included financial statement restatements and civil penalties against Tyco.

Tyco was a heavily decentralized organization involved in an aggressive acquisition growth program (acquired over 100 companies in six years), with aggressive earnings targets, and aggressive incentive compensation programs. They also had a weak board of directors that permitted Dennis Kozlowski, then Chairman of the Board and CEO, to run the company without any effective oversight.

Tyco is a classic example of an organization that exhibited many of the characteristics of companies that participate in fraudulent financial reporting. The title of this program includes the phrase "recognizing the warning signs." We will identify and discuss many of these "warning signs" throughout the program.

Note: There were other irregularities at Tyco related to compensation, reimbursed personal expenses, and unpaid loans which were not accounting related and not part of the Tyco settlement.

Tyco supports an aggressive acquisition strategy:

- Overstated and smoothed net income
- Undervalued acquired assets
- Overvalued acquired liabilities
- Established unnecessary reserves for future contingencies
- Overstated connection fees

Tyco Characteristics:

- Decentralized organization
- Acquisition growth program
- Aggressive earnings targets
- Aggressive incentive compensation programs
- Weak board of directors
- Limited oversight

You may find the observations in the Association of Certified Fraud Examiners (ACFE) *2020 Report to the Nations on Occupational Fraud and Abuse*, interesting:

- The typical organization loses 5% of its revenue to fraud each year which approximates global fraud losses of nearly $4.5 trillion loss to fraud globally each year with an average loss per case being $1,509,000
- The frauds reported in the study lasted a median of 18 months before being detected
- The industries most commonly victimized were the banking and financial services, mining, energy, real estate, telecommunications, construction, manufacturing, and health care
- Fraudsters with higher levels of authority tend to cause significantly larger losses

- The longer a fraudster has worked for an organization, the higher the fraud losses tend to be
- Most fraudsters are first-time offenders with clean employment histories
- Approximately 77% of the frauds were committed by individuals working in one of seven departments: accounting, operations, sales, executive/upper management, customer service, purchasing and finance

You may also find it interesting that the 2020 *Report to the Nations* identified the most useful anti-fraud controls in reducing incidents of fraud:

- Code of conduct
- Job rotation/mandatory vacation
- Internal audit department
- Management certification of financial statements
- Management review of the financial statements
- External audit of the financial statements
- Surprise audits
- Proactive data monitoring/analysis of financial information
- Hotline
- Formal fraud risk assessments
- Fraud training for employees
- Fraud training for managers/executives

A 2007 study, *Predicting Material Accounting Misstatements*, by Dechow, Ge, Larson, and Sloan reviewed 680 companies with over 2,100 instances of fraudulent activities during the period 1982 through 2005. The study made the following summary observations:

- Multiple income statement line items were manipulated, which suggests multielement frauds are more likely
- Frauds were recurring, not isolated in only one period
- Highest recurrence of fraudulent activity occurred in the following:
  - Revenue – 55%
  - Inventory and costs of goods sold – 25%
  - Allowances, including allowance for doubtful accounts – 10%

- Industries most affected by fraudulent activity included:
  - Computers and computer services
  - Retail
  - Telecommunications and healthcare

Many of the examples used in this program are consistent with the results of these studies.

NOTES

Unit

2

Introduction to Fraud Theory

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- ☐ Define fraud in the context of financial statement fraud
- ☐ Describe management's and the auditor's responsibilities in the areas of fraud prevention and detection
- ☐ Describe the Fraud Triangle and its implications for financial statement fraud
- ☐ Recognize both soft and hard indicators of fraud

TYPES OF FRAUD

While this program is focused primarily on financial statement fraud, we should note that there are various types of fraud. Fraud can be broken out into management fraud and occupational fraud.

Management Fraud

Management fraud is created by those in management who have better access to company assets and are capable of overriding internal controls. Management fraud is normally of a greater dollar amount than occupational fraud. Management fraud examples include:

- Financial statement fraud
- Misappropriation of corporate assets
- Illegal acts
- Bribery, both paid and received

Management fraud can be designed to overstate business income or understate business income. For example, overstatement may be designed to meet earnings predictions or maintain the price of the company's shares. Management may want to understate earnings when they desire consistent earnings trends over time.

Occupational Fraud

Occupational fraud occurs when opportunities exist for employees to steal company assets due to poor internal controls or inadequate supervision. As we will see later in this seminar, corporate culture as developed by management or management practices often drive the behavior of employees to commit fraud. Occupational fraud examples include:

- Theft of cash, inventory, or other organization assets
- Bribery received, often in the form of kickbacks
- Overstating expense reimbursements

Some authors will include a third category of fraud—corruption. Corruption generally includes bribery, conflicts of interest, illegal acts, or even extortion by third parties. Since this program focuses primarily on financial statement fraud, we will use the two fraud classifications of fraud above—management fraud and occupational fraud.

INTRODUCTION TO FINANCIAL STATEMENT FRAUD

This program is focused primarily on financial statement fraud—types, causes, cases, and consequences. We will also broadly discuss asset misappropriations (customer and employee theft) due to their losses having a significant negative impact on financial reporting results.

Fraud is generally defined as:

> *A deliberate false intentional misstatement of a matter of fact – fraudulent financial reporting and misappropriation of assets – whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed, that deceives and is intended to deceive others so that the individual will act upon it to his or her advantage*

The key terms in this definition are deliberate false misstatement, intentional, misappropriation of assets, fraudulent financial reporting, and concealment. Let's look at each term:

- **Deliberate False Misstatement** – Fraud is deliberate, not a mistake, and it is designed to benefit one party while harming another party (company or individual).
- **Fraud is Intentional** – Fraud is planned and it does not happen by accident.
- **Fraudulent Financial Reporting** – Fraudulent financial reporting is preparing false or misleading financial statements. This is normally committed by upper

management. Examples include: fictitious revenues, timing differences, hidden liabilities and expenses, improper asset valuation, or impairment recognition.

- **Misappropriation of Assets** – Fraud can be a theft of assets (i.e., cash, inventory, equipment); and when internal controls are poor, theft can be concealed by manipulating the accounting records. Normally, misappropriation of assets can take place when there is a lack of segregation of duties and weak internal controls.

- **Concealment** – Concealment is deliberate, creating misleading information by using the confidence others have in him/her to hide the fraudulent actions taking place.

In a similar manner, the Association of Certified Fraud Examiners defines fraud as:

> *Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent on the application of threat of violence or of physical force. Frauds are perpetrated by individuals and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage*

Also, the AICPA's Auditing Standards Board in AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*, defines fraud as:

> *An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement of financial statements that are the subject of an audit*

Fraudulent red flags are often present when financial statement fraud occurs. Examples of financial statement fraud red flags include the following:

- Incentive compensation plans linked to performance

- Management dominated by a single individual or a small group

- Management sets unrealistic or aggressive financial goals

- Past history of fraudulent activity or illegal activity

- Unusual, one-time transactions recorded during an accounting period

Examples of **fraudulent financial reporting** (potential fraud risks) include:

- Shipping product to a company owned/controlled warehouse – obtain third party shipping documents and create a false bill

- Overstating revenue and income by creating false journal entries that debit assets (inventory or PP&E) and credit revenue

- Use of side agreements between customers or related parties designed to overstate revenues and income
- Understatement of accounts receivable reserves (allowance for credit losses) when customers delay payments
- Establishing unnecessary reserves and reducing these unneeded reserves in later periods through income
- Understating liabilities and expenses to increase reported income
- Manipulation of compliance with debt covenants
- Unrecognized inventory impairments
- Deliberately misapplying accounting principles used to measure and recognize operational activities
- Transferring uncollectible receivables to unconsolidated off-balance-sheet entities and not recognizing the losses
- Source documentation supporting transaction activity for customer payments is altered to appear to have come from the customer
- Borrowing monies from third parties and record the borrowings as sales or customer payments
- Use false or improper inputs for significant estimates or fair values
- Misleading plans to remain a going concern

EXAMPLE

Cardinal Health, Inc. is a "Fortune 500" pharmaceutical distribution company. The SEC accused the company of defrauding investors by materially overstating operating revenue, earnings, and growth trends in earnings releases and SEC filings from September 2000 through March 2004.

According to the SEC's complaint, Cardinal Health:

- Fraudulently manipulated certain balance sheet reserve accounts in an attempt to manage the Company's reported earnings.
- Made other adjustments to certain reserve accounts that were not in accordance with GAAP.

Specifically, Cardinal Health made at least 73 different period-end adjustments in 60 different reserve accounts, resulting in an overstatement of the Company's net earnings of approximately $65 million.

Cardinal Health's abuses appear to have been systematically executed by management.

- Reserve balances or excesses were reported to Cardinal's corporate management on a quarterly basis.
- Corporate management then analyzed the reserve balances and sometimes directed business unit employees to use release reserves in order to help Cardinal Health meet its earnings goals.

- In virtually every quarter, Cardinal Health analyzed various reserve adjustments to show the effect those adjustments would have on the Company's earnings per share (EPS).

In many instances, Cardinal Health internally identified a reserve (or portion thereof) as an "available item not used," indicating that the reserve should have been reversed at that time but was maintained and available to help the Company meet its earnings goals in a future quarter.

Also, in at least one instance, Cardinal Health improperly created and built up a general contingency reserve eventually totaling $2 million, in the absence of a specific liability that was reasonably estimable. Cardinal later adjusted this reserve downward to boost reported earnings. In a December 2002 email exchange, two members of the Company's corporate management discussed reversing the $2 million general reserve "to help make the quarter" and noted that "we built it for a rainy day… and it looks like it is pouring!"

Cardinal Health was also accused by the SEC of other wrongdoing with regard to the company's financial reporting.

The SEC asserted that Cardinal Health deliberately presented a false picture of its operating results to the financial community and the investing public in order to match the company's publicly disseminated earnings guidance and analysts' expectations rather than to reflect its true economic performance. Without admitting or denying the allegations, Cardinal Health agreed to pay $35 million to settle with the SEC.

RESPONSIBILITY FOR FRAUD PREVENTION AND DETECTION

The Center for Audit Quality of the AICPA indicates that the responsibility for mitigating the risk of financial reporting fraud sits with four primary parties as described as the financial reporting supply chain:

1. **Board of directors and audit committ**ee – responsible for corporate governance and oversight. In this role, they should establish a tone at the top reducing fraud risks and driving antifraud behavior. The board and audit committee is responsible for ensuring that management effectively assumes and carries out its fraud risk management program and sets the appropriate culture for management and employee behavior.

2. **Internal audit** in its capacity of being independent of management – it should create an objective assurance that fraud risks are mitigated. Internal audit should also be the first line of defense if fraudulent activity is suspected and their access to the board of directors and the audit committee should assure effective communications within the organization. Internal audit should never report to management but always to the board or audit committee.

3. **External audit** in its role of providing external independent assurance – that fraud risks are mitigated and internal controls are effective. External audit, while not providing 100 percent assurance that fraud has not occurred, does provide a high level of assurance that the financial statements are fairly presented and that obvious material errors do not exist.

4. **Management –** having the primary responsibility for the financial reporting process, reinforces the tone at the top and is responsible for implementing an effective fraud risk management program. For example, management is responsible for the day-to-day operations of the business and has the authority over systems,

controls, data, and employees. Management must create a culture where fraud is not tolerated by identifying fraud risks and taking action when fraud risks increase or fraud is suspected.

If management's responsibility is to prevent and detect fraudulent activity, then management must establish the appropriate **tone at the top** as to what expected behavior is among management and employees. Tone at the top refers to the environment that is developed at the organization by the organization's leadership. This requires leading by example. This tone at the top creates a culture that is unique to the organization and drives management and employee behavior. The tone at the top would include the incentives and disincentives that are in place to drive the appropriate management and employee behavior to insure that management and employees behave in a manner consistent with the organization's goals and objectives.

Each of these parties must apply an appropriate amount of **skepticism** to effectively perform their responsibilities. *The Fraud-Resistant Organization* (published by the Anti-Fraud Collaboration) states that, "Skepticism throughout the financial reporting supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted."

EXAMPLE

Colonial Bank Fraud

Colonial Bank was a bank holding company located in Alabama with $26 billion of assets. For over 15 years a fraud was occurring as Colonial's largest customer, a mortgage originator, colluded with a number of Colonial employees. As part of this fraud, the mortgage originator continued to overdraw his bank account to a cumulative amount of $120 million but these overdrafts were never reported internally at the bank by its employees causing an overstatement of the bank's cash balance.

The mortgage originator also sold Colonial Bank worthless mortgages that had already been sold once. In effect, cash was paid to the mortgage originator for mortgage assets that had no value. These mortgage assets grew on the balance sheet over time. The total amount of both these fraudulent activities grew to about $1.5 billion by 2017.

As indicated in the federal court decisions related to this case in 2017 and 2018, a number of Colonial executives colluded with the mortgage originator to hide these fraudulent transactions. They falsified data, forged documents, hid the impaired mortgages, hid any fraud related communications, and lied to the auditors (PWC).

This fraud is a classic example of the corporate culture (tone at the top) at Colonial Bank permitting its employees and its largest customer to commit a massive fraud because they decided that these types of fraudulent activities were acceptable as long as each individual and the bank benefitted.

The Committee of Sponsoring Organizations (COSO) has created in COSO Principle 8 the need for companies to develop internal fraud controls based around the **COSO Framework**, which includes the following:

- Control environment

- Risk assessment
- Control activities
- Information and communication
- Monitoring activities

This COSO Framework is the responsibility of management to create and maintain, but it is the board and audit committee's responsibility to provide oversight of management in this area and it is internal and external audits' responsibility to assess whether this COSO model is operating sufficiently to prevent or detect fraudulent activity.

The COSO Framework identifies **fraudulent reporting** as one of four types:

1. Fraudulent financial reporting
2. Fraudulent non-financial reporting
3. Misappropriation of assets
4. Illegal acts

The COSO Framework also identified **risk assessment considerations** reporting entities should build into their strategies for preventing and detecting fraudulent activity. These risk assessment considerations include:

- Management bias; for instance, when selecting or applying accounting principles
- Degree of estimates and judgments used in financial reporting
- Fraud schemes and scenarios common to the industry and markets in which the company operates
- Geographic regions when the company does business
- Company incentives that may motivate fraudulent behavior
- Nature of the company's technology and management's ability to manipulate information
- Unusual or complex transactions subject to significant management influence
- Vulnerability to management's override and potential schemes to circumvent existing internal controls

FRAUD THEORY

Fraud Theory – what is it? To understand fraud, we must understand the conditions that can lead someone to commit fraud. These conditions can be described as either fraud motivators or as the fraud triangle. We look at both below.

Fraud Motivators

To prevent or detect fraud, companies must be able to identify employee or corporate **fraud motivators**. This requires training and monitoring of activities. **Employee fraud motivators** can be characterized as follows:

- *Greed* – Employee never satisfied with compensation or recognition – always wants more
- *Need* – Employee cannot meet personal financial obligations. Sometimes caused by gambling, lifestyle, or an addiction
- *Entitled* – Employee believes he/she has earned a right (promotion, for example) or benefit (bonus, for example) and has been unfairly denied the right or benefit
- *Abused* – Employee believes the company (management or other employees) are unfairly treating the employee

All of these employee fraud motivators are fraud risks that must be identified and monitored by management. Let's look at the following example.

EXAMPLE

Mary was employed in the human resources department of a company. At her annual review, she expected to be given an excellent performance evaluation and, as a result, receive a 10% increase in her base pay. Unfortunately, her manager did not see her performance in the same way and gave her a "needs improvement" review in a number of areas resulting in only a 3% increase in base pay.

Mary was incensed with her performance review and salary increase and felt entitled to the 10% increase. She believed that she was unfairly treated by her manager and vowed to obtain the 10% increase even if she had to steal the difference.

Mary worked in human resources and had access to all employee payroll data, including her own. Mary went into the payroll system and gave herself a base salary increase of 7%. When added to the 3% salary increase provided by her manager, Mary had her 10% increase.

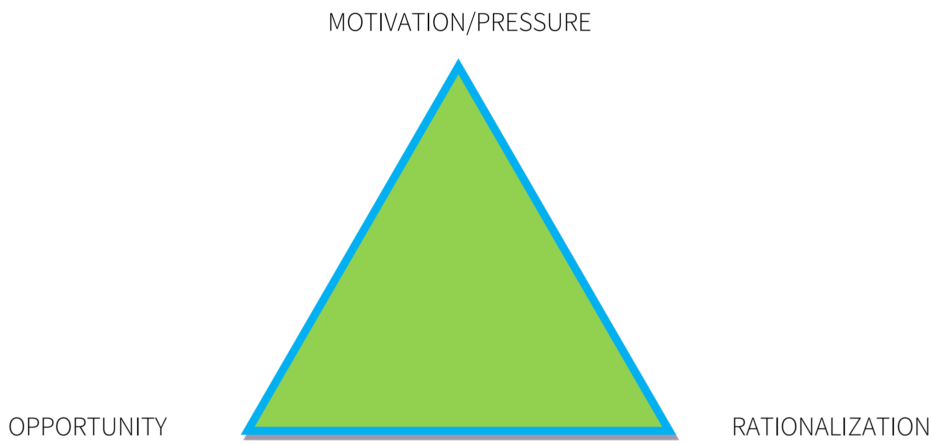
While clearly internal controls were not adequate in this company, the driving conditions for Mary's behavior were the employee fraud motivators of entitled and feeling abused.

Corporate fraud motivators may be influenced by employee fraud motivators, but they are normally expressed with corporate or company characteristics:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Comply with debt covenants
- Conceal the company's deteriorating financial condition

- Maintain or increase the company’s stock price
- Improve the company’s financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

Corporate fraud motivators often are more associated with preventing embarrassment, losing a job, helping to maintain a reputation, or achieving incentive compensation.



Fraud Triangle

The Association of Certified Fraud Examiners (ASFE) has developed the Fraud Triangle to explain the factors that cause someone to commit fraud. The Fraud Triangle consists of the following three components:

- **Motivation/Pressure** – Motivation/pressure can be performance-based, due to personal financial difficulty, or as a result of personality conflicts with someone at the company. There is normally a desire for personal or professional gain or causing injury and/or embarrassment for someone else.
- **Opportunity –** Access to assets and/or financial information, made possible by weak internal controls or a perpetrator’s senior position within the company.
- **Attitude/Rationalization** – The actions taken are consistent with some greater good – either the company’s good or the individual’s good. Individuals rationalize, for example, that improper revenue recognition is appropriate because of the benefits that accrue to them, even if others are damaged.

The following provides a few examples of each of the components of the Fraud Triangle. These components, as well as their related fraud risk factors when considering Fraud Risk Assessments, will be discussed in more detail later in this course.

Motivation/Pressure

- Meeting corporate performance goals
- Pressure of the job or position
- Financial obligations – misuse of credit cards

Opportunity

- Ineffective internal controls
- Poor segregation of duties
- Inadequate supervision

Attitudes/Rationalization

- Perceived poor treatment by someone
- It is in the best interest of the shareholders
- Can always correct it at a later time
- Will only do it once

SOFT AND HARD INDICATORS OF FRAUD

Indicators of fraud can be described as “soft” or “hard.” Soft indicators are indirect activities or circumstances that suggest something else may be taking place that is being concealed and that an investigation should take place. Hard indicators are specific or direct activities or circumstances that suggest fraudulent activity has taken place. Companies need to be alert for both soft and hard indicators of fraud in their fraud risk management programs.

Below are lists of soft and hard indicators of fraud.

Soft Indicators of Fraud

- Risk taker
- Likes to “beat the system”
- Refusal to take time off

- Coming in early/staying late
- Drug/alcohol abuse
- Lavish lifestyle
- Personal financial problems
- Divorce/family problems
- Self-control issues

Hard Indicators of Fraud

- Discrepancies in accounting records
- Conflicting or missing documentation
- Frequent changes in accounting estimates
- Frequent resignations of accounting or finance personnel
- Transactions not completed in a complete or timely manner
- Unsupported or unauthorized balances or transactions
- Last minute adjustments that significantly affect accounting results
- Evidence of management override
- Unexplained differences between subledgers and control accounts
- Missing inventory or other physical assets
- Financial reporting results significantly different from competitors in the same industry

WHO COMMITS FRAUD?

Again, referencing *The Fraud-Resistant Organization*, we have the following information:

- Age of fraudster – between 36 and 55
- Overwhelmingly male
- Generally, a member of management
- The fraudster works in finance or operations/sales and is frequently the CEO

- Time with the organization – 33% over 10 years; 56% between 3 and 10 years
- Fraud was committed in collusion with others 69% of the time
- Internal controls were overridden in 74% of the cases

A major factor that often directly causes organizations to become victims of fraud is the **trust factor**. The more trust a company has in an employee, the more risk exists that fraud will take place. Cases have demonstrated that many employees exploit this trust factor to commit fraud against their employers. Trusted employees with long-time work experience are at most risk of committing fraud. Combined with pressure, opportunity, and rationalization, these trusted employees represent high fraud risk. Suggested solutions to minimize this fraud risk include rotation of job duties, mandatory vacation, close supervision, and more project assignments instead of recurring responsibilities.

Unit

3

Revenue Recognition

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- ☐ Identify and describe examples of improper revenue recognition
- ☐ Anticipate revenue recognition challenges associated with Topic 606, *Revenue from Contracts with Customers*

INTRODUCTION

Among the various types of deceptive financial reporting practices, improper revenue recognition has probably been the most prevalent. The market implications of frequent revenue overstatement (potential losses by lenders, suppliers, and investors) have had a detrimental effect upon the credibility and integrity of the financial reporting process and the accounting profession. In response to these concerns, the SEC, COSO, and the AICPA have published guidance on revenue recognition in an attempt to clarify and identify the appropriate measurement and recognition standards. A few of these publications are:

1. SAB 104: *Revenue Recognition in Financial Statements* – SEC, 2003
2. *Fraudulent Financial Reporting: 1998-2007*, An Analysis of U.S. Public Companies – COSO, 2010
3. Fraud Risk Management Guide – COSO 2016
4. ASU 2014-09, Revenue from Contracts with Customers (Topic 606) - FASB
5. *Auditing Revenue in Certain Industries* – AICPA, 2012 – Note this guide has been replaced by *Revenue Recognition – Audit and Accounting Guide* published in 2018 reflecting the new revenue guidance found in Topic 606, *Revenue from Contracts with Customers*
6. *Mitigating the Risk of Common Fraud Schemes: Insights from the SEC Enforcement Actions* – January 2021, SEC

Further, in 2014, FASB issued ASU 2014-09 (Topic 606), *Revenue from Contracts with Customers*. While the ASU was issued to achieve a number of objectives, one of the objectives was to reduce the amount of fraud associated with revenue recognition due to the perceived complexity of prior revenue GAAP, Topic 605.

In addition, in December 2002, the AICPA's Auditing Standards Board issued SAS 99 (now AU-C Section 240), *Consideration of Fraud in a Financial Statement Audit*. SAS 99 (AU-C 240) presumes that improper revenue recognition is a fraud risk and provides guidance to auditors related to identifying revenue recognition fraud. **A majority of improper revenue recognition cases have involved at least one of the following: premature revenue recognition, fictitious sales, or improper "grossing up" of revenues and costs to inflate sales or simply making a fictitious journal entry to debit an asset and credit sales.**

REVENUE RECOGNITION CONSIDERATIONS BASED ON TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

Introduction

ASU 2014-09, *Revenue from Contracts with Customers,* was effective for public companies for fiscal years beginning after December 15, 2017 and for all other reporting entities for annual reporting periods beginning after December 15, 2019.

In general, the revenue guidance would apply to **any entity that enters into contracts with customers**, excluding contracts that are within the scope of other standards. In this context:

- A "contract" is any agreement (written, verbal, or implied) between two or more parties that creates enforceable rights and obligations.
- A "customer" is "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities."

EXAMPLE

Company A is developing a product and has contracted with Company B who will participate in the development of the product and share in the assets, benefits, and rewards. Because both parties share the benefits and rewards instead of one or the other obtaining an output of the other's ordinary activities, this would not constitute a revenue contract under Topic 606.

THE SIX-STEP PROCEDURE

The core principle of Topic 606 is that a reporting entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the reporting entity expects to be entitled in exchange for those goods or services.

A reporting entity recognizes revenue in accordance with the core principle by applying the following six steps to the revenue recognition process (606-10-05-4):

1. Identify the **contract(s)** with a customer including combining contracts and contract modifications.

2. Identify the performance obligation(s) in the contract – a contract includes promises to transfer goods or services to a customer. If these goods or services are **distinct**, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the reporting entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

3. Determine the transaction price – the **transaction price** is the amount of consideration in a contract to which a reporting entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include **variable consideration** or consideration in a form other than cash.

4. Allocate the transaction price to the performance obligations in the contract – a reporting entity typically allocates the transaction price to each performance obligation on the basis of the relative **standalone selling prices** of each distinct good or service promised in the contract.

5. Recognize revenue when (or as) the reporting entity satisfies a performance obligation – a reporting entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains **control** of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation.

6. Topic 606 also includes a cohesive set of **disclosure requirements** that would result in a reporting entity providing users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the reporting entity's contracts with customers

In summary, Topic 606 requires a reporting entity to provide disclosure information about:

- Revenue recognized from contracts with customers, including the disaggregation of revenue into relevant categories

- Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities

- Performance obligations, including when the reporting entity typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract

- Significant judgments, and changes in judgments, made in applying the requirements to those contracts

The application of these steps differs significantly from the application of revenue criteria in the legacy guidance. In that guidance, revenue was recognized when all the criteria were met, regardless of the order of meeting such criteria. In Topic 606, the six steps are evaluated in sequence and one does not move on to the next step until the current step is completed.

Challenges companies and their auditors should consider as they are monitoring their compliance with Topic 606 include the following:

- How their business and accounting processes (procedures) have changed and are they being consistently applied?
- How effective are the systems that have been developed or changed to accumulate the needed revenue data from the above processes?
- How effective are the preventive and detective internal controls designed to manage and monitor revenue transactions based on Topic 606?
- Are revenue processes and internal controls adequate to address revenue estimates as Topic 606 is more of a principle-based standard than Topic 605?
- Do all of the above provide sufficient data to develop revenue disclosures both qualitative and quantitative?

The significance of these challenges will increase the risk of material misstatement whether due to error or fraud. Implementation and ongoing monitoring of Topic 606 will be particularly important when assessing the **risk of fraudulent material misstatement** in the following areas:

- Determining if revenue is recognized in compliance with the six-step model (risk is that revenue may be recognized even though the customer has not taken control of the good or service)
- Determining if a contract exists between the company and customers (lacking a contract, the company would recognize revenue only as cash is received)
- Determining if contract modifications are being accounted for properly and consistently (certain modifications could result in additional distinct performance obligations being created)
- Determining how performance obligations are identified and satisfied and whether the conclusions as to whether they are “distinct” or stand-alone or not appropriate (risk is that companies may aggregate performance obligations to accelerate revenue)
- Determining if any variable consideration exists in the contract and it has been accounted for in the proper time period and in the correct amount (risk is that variable consideration will be recognized prematurely or recognized when it should be deferred until it is probable of occurring)
- Determining the transaction price based on stand-alone selling prices and allocating it correctly to the performance obligations (risk is that allocations will occur that accelerates the recognition of revenue)

- Identifying evidence supporting recognizing revenue over time – transfer of control (risk is that the evidence developed may not agree to the contract terms)

It will be interesting to see how companies attempt to manipulate Topic 606's revenue guidance in the future given the number of estimates required to comply with Topic 606. It is expected by many that companies will attempt to accelerate revenue recognition by overstating the numerous estimates required in the five-step model such that premature revenue recognition will occur even though the customer has not taken control of the good or service.

There are many issues that arise in the area of revenue recognition. Deceptive revenue and cases above can be categorized broadly as dealing with:

- **Timing** – When does the customer take control of the good or service? Is revenue a discrete event or a prolonged process? Have estimates been manipulated to accelerate revenue recognition?

- **Fictitious** – Has a bona fide order even been placed? Were shipments actually sales to a third party? Do customers actually exist?

- **Gross vs. Net** – Do the nature of the seller's involvement and the terms of the transaction support recording revenues and expenses "gross"? Are all revenues that impact overall pricing policy reflected as such?

- **Topic 606** – Will the frequency of estimates applied to comply with Topic 606 add additional fraud risk to revenue recognition?

As fast as the profession tries to respond, companies devise new ways to create revenue (e.g., advertising bartering, bandwidth swaps) as well as new ways to fabricate revenue. In those cases where revenue is genuine, the goal must be to examine each case in view of the basic building blocks of revenue recognition:

1. Identify the contract(s)

2. Identify the performance obligation(s) in the contract

3. Determine the transaction price

4. Allocate the transaction price to the performance obligations in the contract

5. Recognize revenue when (or as) the entity satisfies a performance obligation **(transfer of control)**

6. Prepare revenue recognition disclosures

When the revenue process is manipulated or – worse yet – fabricated, the question becomes one of ethical issues and the responsibility of outside accountants to detect the abuse. It remains to be seen whether new regulatory activity and major changes to the performance of audits will change this disturbing economic trend.

IMPROPER REVENUE RECOGNITION

Improper revenue recognition can be attributable to the timing and valuation of revenue including fictitious revenues and pattern of revenue recognition for long-term contracts. Many of the examples that follow are based on Topic 605, *Revenue Recognition,* superseded by Topic 606, *Revenue from Contracts with Customers*. The fraudulent revenue practices though are just as applicable to Topic 606 as they are to Topic 605.

EXAMPLE

Examples of Improper Revenue Recognition Practices

Leap Wireless International provides wireless services to a diverse customer base around the world. During 2004 through early 2007, the Company recognized one additional month of revenue for customers that had disconnected their service the prior month. Leap's restatements for this practice reduced sales and earnings by $20 million during these periods. Leap's related press release states, "The restatements are the result of an internal review of the Company's service revenue activity and forecasting process that was initiated by management in September, 2007, and are not attributable to any misconduct by company employees."

Tesco Plc, the world's second largest retailer after Wal-Mart Stores Inc., reported in 2015 that it overstated profits by recognizing revenue prematurely in its 2013/14 fiscal year financial statements. The amount of the overstatement is expected to exceed $400 million. PWC, in its most recent audit report, warned that the Company's commercial revenue was at risk of manipulation due to weaknesses in the Company's internal controls. The primary issue centers around Tesco recognizing vendor rebates from suppliers in different periods than when they were earned.

Qwest Communications International was a telecommunications carrier that operated mainly in the western United States. In 2004, the SEC alleged that "between 1999 and 2002, Qwest fraudulently recognized over $3.8 billion in revenue … as part of a multifaceted fraudulent scheme to meet optimistic and unsupportable revenue and earnings projections." Among other charges, the SEC accused Qwest of:

- Artificially inflating its revenue by selling certain assets that had been held for use only to buy or lease back the same (or nearly identical) assets from the companies that had purchased them.
- Mischaracterizing the proceeds from those sales as recurring revenue.
- Employing "fraudulent devices" such as backdated contracts and secret side agreements to conceal the company's violations of GAAP in accounting for those transactions.
- Fraudulently concealing the fact that based on a series of accounting errors, the company improperly recognized $112 million of revenue between 2000 and 2002 from its Wireless division.

Under Qwest's settlement with the SEC, the company agreed to pay a $250 million civil penalty without admitting or denying guilt.

iGo made and sold universal power adapters for portable computers and mobile electronic devices. In 2005, the SEC alleged that from 1999 through March 2001, iGo materially overstated its revenues by millions of dollars. One of iGo's alleged schemes was to ship products to a third-party warehouse and invoice a sham company operated by a relative of iGo's Senior Vice President of Sales; the products were eventually returned to iGo's inventory. Officers of iGo settled with the SEC, paying civil penalties without admitting or denying guilt.

Note: Deceptive accounting usually involves improper revenue recognition for good reason. For a number of industries, revenue growth is a primary driver of perceived value. In retailing, revenue growth is often cited before earnings performance as a key financial indicator. Valuations for technology companies and start-up companies are often based (for obvious reasons) primarily on revenue growth or multiples. A company can understate expenses as a way to increase profit, but there is a limit to how low you can go. When you choose to overstate revenue – the sky is the limit!

Due to market pressures, management incentives, potential debt covenant violations, reduced sales, or any number of other factors that can negatively impact a company, improper revenue recognition has become an increasing problem for the accounting profession. Too often, managers believe they must achieve certain revenue and/or profit targets even if it involves improper revenue recognition techniques to achieve those targets.

Improper revenue recognition practices identified in the SEC's *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions,* include:

- Falsifying customers or their contracts
- Accelerating revenue in a current period even though all recognition criteria were not met
- Recognizing revenue when inventory was shipped on consignment
- Failing to account for extended terms, concessions, or discount side-agreements
- Improperly applying percentage of completion to long-term contracts
- Engaging in channel stuffing – sending customers more goods than they can be expected to sell to inflate sales figures and failing to properly account for returns

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EXAMPLE

OCZ Technology Group was charged by the SEC of materially inflating revenues and gross margins. The SEC alleged that OCZ's CEO mischaracterized sales discounts as marketing expenses and ordered the creation of false documents to conceal the fraud; shipped more goods to its largest customer knowing that the customer would not be able to resell these goods; and withheld information on significant product returns from OCZ's finance department and auditor so that they were not recorded on the company's books.

Other alleged violations included:

- Improperly classifying costs of goods sold as research and development expenses
- Not capitalizing labor and overhead costs in inventory costs
- Recognizing revenues when products were shipped rather than when they were delivered
- Understating accruals for product returns

OCZ subsequently issued a financial statement restatement decreasing OCZ's previously reported revenues by more than $100 million resulting in a significant reduction in previously reported revenues and gross profits. The company subsequently filed for bankruptcy protection, liquidated assets, and ceased operations.

In 2010, COSO released *Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies*. Among other objectives, this report attempted to identify management characteristics that existed in these companies where financial statement fraud took place.

The following summarizes selected key findings of the report:

- The companies in the study had median sales of approximately $72 million and median company income approximating $875,000.
- In 72% of the cases, the CEO was involved in the frauds and the CFO was involved in 65% of the cases.
- Most frauds were not isolated in a single period but impacted at least two consecutive periods.
- Majority of the fraudulent activity took place close to or as of the end of the fiscal year.
- 60% of the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Examples of improper revenue recognition practices included:
  - **Sham sales** by falsifying inventory records, shipping documents, and invoices. Shipping goods to another company location was a frequently used technique to overstate revenue.
  - **Premature revenues before all the terms of the sale were completed**. This consisted of recording sales after the goods or services were ordered but before the goods were shipped or the services performed.
  - **Conditional sales**. Sales recognized had unresolved contingencies or the terms of the sale were amended by side agreements that changed the seller's performance obligations.
  - **Improper cutoff of sales**. Accounting records were held open beyond the Balance Sheet date to record sales of the subsequent period in the current period.
  - **Improper use of the percentage-of-completion method**. Revenues were overstated by accelerating the estimated percentage of completion for projects in process.
  - **Unauthorized shipments**. Revenues were overstated by shipping inventory never ordered or by shipping defective inventory and recording revenues at full, rather that discounted prices.

  - **Consignment sales**. Revenues were recorded for consignment shipments or for shipments of inventory for customers to consider on a trial basis.

The motivations often found in these fraudulent cases include the following:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Conceal the entity's deteriorating financial position
- Maintain or increase the stock price
- Improve financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

Indicators of Improper Revenue Recognition

- Aggressive accounting policies or practices leading to questionable results
- Statements by senior management to increase revenues and earnings
- Existence of executive incentive programs based on revenue or earnings
- Lack of involvement by accounting personnel in revenue transactions or in the monitoring of transactions with customers
- Existence of sales transactions in conflict with company's normal revenue recognition policies
- Significant sales activity at the end of the fiscal year
- Increasing transactions with related parties
- Existence of side agreements on sales transactions
- Unusual level of inventory returns after year-end for sales recorded in the prior period

Improper Revenue Recognition Practices

- Recognizing revenue when products shipped have a right of return provision without appropriately estimating the expected returns
- Recording refunds or credits (purchase returns) from suppliers as revenue
- Establishing restructuring reserves in excess of future requirements and taking these reserves back into income as needed to achieve earnings targets

- Recognizing revenue before the transfer of control to the customer has taken place
- Reinvoicing past due receivables to become current rather than writing off uncollectible amounts
- Understating estimates of sales returns, sales discounts, warranty reserves, and uncollectible receivables
- Front loading costs when using percentage-of-completion accounting to increase degree of completion
- Overstating percent-complete when using contract accounting
- Leaving the books open at the end of an accounting period and recognizing the next period sales in the prior period
- Creating fictitious customers and fictitious revenue transactions
- Selling undervalued assets and classifying the gain as recurring revenue
- Shipments of inventory or recording sales prior to receiving customer purchase orders
- Prebilling customers prior to the inventory being shipped (bill and hold transactions)
- Recording sales for inventory shipped on consignment
- Shipments made after year-end recorded as sales of the prior period
- Recording sales, a second time based on previously-filled customer orders
- Recording sales for shipments made to company warehouses

SEC Staff Accounting Bulletin No. 104 – *Revenue Recognition*

Staff Accounting Bulletin No. 104 has served as the primary guidance associated with revenue recognition for public companies. While SEC publications are authoritative only for SEC registrants, this bulletin provides valuable guidance in applying GAAP in specialized situations. Its conclusions are based on interpretations of FASB Concepts Statement No. 5 and other GAAP standards. While ASU 2014-09, *Revenue from Contracts with Customers,* was issued subsequent to SAB 104, SAB 104's revenue guidance is generally still applicable to common situations.

The SAB applies the elements of revenue to a number of sales scenarios that complicate revenue recognition.

1. **Side agreements** that may result in cancellation or termination of revenue arrangements or introduce sales return clauses can be indicators that the original agreement was not final and revenue recognition may not be appropriate.

EXAMPLE

Netopia, Inc. provides broadband and wireless products or services. During 2002 and 2003, Netopia improperly reported revenue on two software transactions with a thinly capitalized customer who did not have the legal obligation to pay for the software. Netopia entered into a side agreement with the customer whereby the customer would purchase products from Netopia, resulting in revenue being recognized, but the customer was not obligated to pay for the purchases until such time as another end user purchased the product from the customer. If the customer could not resell the products, they could be returned to Netopia.

2. Risk and rewards of ownership (now control) have not been transferred to the buyer, including:

   - A right of return where payment by the buyer is contingent upon resale, consumption, or use, where seller retains risk of physical loss or damage to the product, where the buyer lacks separate economic substance from the seller, or where the seller is obliged to directly bring about resale by the buyer.

   - SAB 104 incorporates Topic 605's guidance, *Revenue Recognition When Right of Return Exists*. Topic 605 requires that if a buyer has the right of return, then revenue can only be recognized at the point of sale if **all** of the following conditions are met:

     – Price is **fixed or determinable** at the date of sale

     – Buyer has paid the seller, or buyer is obligated to pay the seller and the liability is **not contingent on the resale of the product**

     – **Buyer's liability would not be changed** because of the theft, physical destruction or damage of the product

     – Buyer has its **own economic substance** apart from the seller

     – Seller **does not have future performance obligations** associated with the product

     – The amount of any **future returns can be reasonably estimated**

3. 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 adjusted only for finance and holding costs of the buyer (so-called "product financing arrangements").

4. The product is delivered for **demonstration purposes**.

EXAMPLE

In August of 2009, General Electric settled an SEC complaint related to revenue recognition accounting fraud by paying $50 million to settle the SEC's charges. The SEC alleged that GE used improper accounting methods to increase revenues and earnings to avoid reporting negative financial results.

These improper accounting methods included:

In the fourth quarters of 2002 and 2003, GE improperly accelerated revenue of $223 million and $158 million, respectively for train engines sold to bank intermediaries (referred to as "bridge financing" by GE) with the understanding that the banks would resell the train engines to GE's railroad customers in the first quarters of the subsequent fiscal years (2003 and 2004).

Note: The train engines were never delivered to the bank intermediaries. In these cases, GE maintained significant performance obligations, including not transferring the risks and rewards of ownership to their customers. These performance obligations should have precluded GE from recognizing revenue.

In 2002, GE changed its accounting for sales of commercial aircraft engine spare parts that improperly increased GE's 2002 net income by $585 million. GE had previously overstated revenue, starting in 1992, by recognizing future revenue for sales of spare parts at the same time aircraft engines were sold. By 2002, the amount of future revenue recognized by GE that had not yet been earned by GE amounted to $1 billion. This $1 billion was accounted for as a deferred asset on the balance sheet. GE management became concerned about the size of the deferred asset in 2002 and improperly changed its accounting for the sale of aircraft engine spare parts in two ways:

1) GE removed sales of spare parts from the accounting model used to account for sales of aircraft engines that resulted in an immediate charge to net income of $844 million.

2) To offset this $844 million charge and to avoid disclosure of its original improper accounting, GE simultaneously made a second change to the revenue recognition model of another business unit, effectively transferring future revenue (including improper pricing increases) from the sales of spare parts to that business unit. The effect of both of these accounting changes allowed GE to overstate 2002 consolidated net income by $585 million.

- Scheme to increase sales and earnings
- Train engines – Bridge Financing
- Sales of commercial airplane engines spare parts

5. **Bill and holds** qualify for revenue recognition only if the following criteria are met to support the transfer of title and risks and rewards of ownership to the buyer (i.e., "delivery"):

   - The **risks of ownership** must have passed to the buyer.
   - The customer must have made a **fixed commitment** to purchase the goods, preferably in written documentation.
   - **The buyer, not the seller, must request that the transaction be on a bill and hold basis, preferably in written documentation**.

- The **buyer must have a substantial business purpose** for ordering goods on a bill and hold basis.
- There must be a **fixed schedule for the delivery of goods** based on what is customary in the buyer's business.
- The **seller must not have retained any specific performance obligations** such that the earnings process is not complete.
- The ordered goods must have been **segregated from the seller's inventory** and not subject to being used to fill other customer orders; and
- The products must be **complete and ready for shipment**.

The following factors should also be considered:

- The date by which the seller expects payment and whether the seller has modified its normal billing and credit terms for this buyer.
- The seller's past experience with and pattern of bill and holds transactions.
- Whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods.
- Whether the seller's custodial risks are insurable and insured.
- 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.
- The delivered item or items have value to the customer on a stand-alone basis. The item(s) have value on a stand-alone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a stand-alone basis and
- If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in control of the vendor.

When the deliverables are considered separate performance obligations (Topic 606), each deliverable's transaction price must be established at the inception of the arrangement by evaluating the deliverable's stand-alone selling price.

EXAMPLE

Chisum Liquor Distributors is required by state law to sell its liquor products at the same prices to all customers. Consequently, a distributor cannot reward large volume customers with lower prices. State law does allow monthly special discounts, but they must be offered to all customers equally.

To get around state law, Chisum performs bill and hold transactions at the end of each month for specially priced items to its best customers so they can continue to get discounted prices on prior month (expired) specials shipped at a later date.

This situation not only violates most of the conditions stated in the SEC release but also appears to be an illegal act.

EXAMPLE

Raytheon Company is an industry leader in defense, government electronics, space technology, and business and special mission aircraft. Between 1997 and 2001, Raytheon used improper accounting practices related to bill and hold arrangements designed to hide declining operating results and deteriorating business at Raytheon Aircraft Company (RAC), a subsidiary of Raytheon.

To meet quarterly and year-end financial targets, RAC identified unfinished airplanes still in the production process and considered them complete for accounting purposes. This practice overstated net sales by over $200 million. Once these planes were identified, the buyers were given significant incentives in order to induce them to accept a sale before quarter or year-end. It was inappropriate to recognize revenue on these planes because the aircraft were not complete and ready for shipment and RAC, not the buyer, had requested the bill and hold arrangement.

6. When **delivery is made to 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.
7. When **uncertainty exists about customer product acceptance** (product testing, service commitments, additional work), revenue should not be recognized until acceptance occurs or the acceptance provisions lapse.
8. Sellers should **substantially complete or fulfill the terms** specified in the sales or purchase agreement in order for the earnings process to be complete (per Topic 605 – Topic 606 requires the transfer of control) and revenue recognized. Any additional obligations should be minor and inconsequential.

EXAMPLE

Home Solutions of America (HSOA) – On November 30, 2009, the SEC alleged that senior executives at HSOA (a hurricane restoration company) engaged in a series of revenue inflation schemes booking in excess of $40 million of bogus revenue by invoicing and recording receivables in 2004 through 2007 that had never occurred. Home Solutions improperly recognized revenue on hurricane restoration projects after Hurricane Katrina that HSOA had not been contracted to perform. Home Solutions also recorded $9 million of revenue from another company as its own.

9. Agreements requiring the **delivery or performance of multiple deliverables** should not be recognized as revenue until all deliverables essential to the functionality of the product(s) have been delivered or performed.

EXAMPLE

Bally Total Fitness Holding Corporation – In addition to separately selling health club services, personal training services, and nutritional products, Bally also sold packages that included a combination of all three. Under U.S. GAAP, the packages did not meet the criteria to be treated as multiple separate elements for revenue recognition purposes. Therefore, revenues from the packages should have been treated as a single element and recognized on a deferred basis. However, Bally treated the sales of such packages as separate elements, which led to Bally prematurely recognizing over $100 million of revenue for some of the elements in the years up to and including 2003.

10. In **licensing agreements**, delivery does not occur for revenue recognition purposes until the license term begins, even if the licensed product or technology is physically delivered to the customer at an earlier date.

11. **Layaway transactions** should not be recognized as sales until the product is delivered to the customer. Any cash received by the seller prior to delivery of the product should be recognized as a liability until such time as the product is delivered to the customer.

12. **Non-refundable or up-front fees** are often charged for membership purposes, contract signing, or enrolling or activating telecommunications services. The SAB indicates that these fees are normally negotiated in conjunction with the pricing of all elements of the agreement and that the earnings process is completed by performing under the terms of the agreement, not simply by originating a revenue generating arrangement. Therefore, non-refundable or up-front fees should be deferred and recognized systematically over the periods that the fees are earned.

EXAMPLE

Bally Total Fitness Holding Corporation – Part of the price of a health club membership was a one-time initiation fee. Under U.S. GAAP the initiation fees should have initially been capitalized (as a liability) and amortized (as revenue) over the expected total duration of the membership, including both the initial period of membership as well as the expected period of renewal beyond the initial period. In contrast, Bally prematurely recognized its members' initiation fee revenue over a period that was shorter than the estimated total membership life, and in most instances even shorter than the initial period of membership.

13. **Service revenue** associated with long-term agreements should be recognized on a straight-line basis, unless evidence suggests the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the agreement or the expected period during which those specified services will be performed. Any up-front payments should be spread over the contract period and revenues should not be recognized on a basis proportional to costs incurred because any initial set-up costs incurred bear no direct relationship to the performance of services specified in the agreement.

EXAMPLE

Bally Total Fitness Holding Corporation – When a health club member elected to renew his or her membership for an additional period of time after completing the initial membership contract term, the renewing member could elect to prepay his or her monthly dues for the renewal period. Under U.S. GAAP, prepaid dues should have initially been capitalized (as a liability) and a portion recognized monthly as revenue as health club services were provided over the period for which the member had prepaid. In contrast, Bally prematurely recognized the entire amount of prepaid dues as revenue in the month prepayment was received.

14. **Contingent revenue contracts**. Contingent revenue should not be recognized by sellers/lessors until the contingent element has been achieved.

CASE – XEROX CORPORATION

DECEPTIVE ACCOUNTING FOR LEASE REVENUE

Note: This case is based on legacy GAAP from Topic 840, *Leases,* but its application is identical to the new lease guidance in Topic 842, *Leases*.

From the lessor's point of view, a sales-type lease is preferable to an operating lease because the income is recognized upon delivery rather than over the lease term.

Since the 1980s, Xerox has offered long-term equipment leases to its customers. These leases, usually referred to as "bundled leases", include equipment, service, supplies, and financing in the monthly lease payment. During the 1990s, these leases were the largest component of Xerox's sales revenue.

During the late 1990s, Xerox was facing financial difficulties due to competitive pressures and poor business decisions. During the period 1997 through early 2000, Xerox improperly accelerated lease revenue by over $3 billion, increasing earnings by approximately $1.5 billion. This was accomplished by preparing fraudulent documentation that modified existing lease terms for thousands of customers such that these leases would be accounted for as sales-type leases not operating leases.

The fraud was discovered when a disgruntled employee notified the SEC of the fraudulent activity. On April 11, 2002, the SEC filed a civil complaint against Xerox, claiming that the company defrauded investors by disguising its true operating performance through undisclosed accounting maneuvers.

Note to Participants: In 2008, Xerox and KPMG settled a shareholder suit related to the fraudulent activity. Under the proposed settlement, Xerox made cash payments of $670 million and KPMG paid $80 million to a shareholder settlement fund.

When considering the Fraud Triangle, the following fraud risk factors existed at Xerox:

Motivation:

- The financial stability or profitability of the company was threatened by economic, industry, or the company's operating conditions.

Opportunity:

- Internal control components were deficient.

Rationalization:

- Excessive interest by management in maintaining or increasing the company's stock price or earnings trends.

Discussion Question

Clearly, this fraud was an example of management override. In your experience, what preventive controls can be utilized by an entity to prevent or minimize management override?

CASE – AXESSTEL, INC.

DECEPTIVE ACCOUNTING FOR REVENUE RECOGNITION

Note: This case is based on legacy GAAP from Topic 605, *Revenue,* but its application is identical to the new revenue guidance in Topic 606, *Revenue from Contracts with Customers*.

Axesstel, Inc. is a California-based telecommunications equipment manufacturer. The SEC accused Axesstel of inflating reported revenues in the company's Middle East, Africa, and Europe regions in the fourth quarter of 2012 by $10.5 million and the first quarter of 2013 by $3.9 million.

According to the SEC's complaint, Axesstel's CFO, CEO, and sales director inflated the company's revenues by prematurely recognizing revenue on sales and by improperly recognizing revenue despite entering into undisclosed side agreements with two customers that relieved these customers of their payment obligations. In addition, Axesstel inflated unit selling prices of products to hit revenue targets with the agreement that Axesstel would subsequently repay the inflated amounts to customers' as marketing development fees. These deceptive practices were achieved by Axesstel who circumvented internal accounting controls and falsified its books and records through management override.

To further conceal these frauds and to justify the revenue being recognized, Axesstel prepared fake purchase orders (POs) and presented these fake purchase orders to Axesstel's auditor, even though customers had not actually agreed to the terms in the POs. Axesstel executives also asked one customer to deceive Axesstel's auditor by falsely acknowledging an outstanding accounts receivable balance that Axesstel had secretly agreed the customer did not actually owe. In addition, Axesstel's CFO and CEO signed quarterly management representation letters to Axesstel's auditor that failed to disclose the true facts and circumstances concerning these deceptive accounting practices.

The fraud was identified after an 8k filing took place which indicated that the financial statements would be restated due to "errors related to the recognition of revenue from sales to two customers in the first quarter of 2013." The Chair of the Audit Committee ordered an investigation into these alleged errors.

Note to Participants: In 2018, the CFO, CEO, and director of sales agreed to settle the charges without admitting or denying the allegations and consented to an entry of final judgment that permanently enjoins them from future violations of securities laws and fined each of them personally. The CEO is barred from serving as an officer or director of a public company and the CFO is barred from serving as an officer or director of a public company for five years.

When considering the Fraud Triangle, the following fraud risk factors existed at Axesstel:

Motivation:

- The financial stability or profitability of the company is threatened by economic, industry, or the company's operating conditions.

Opportunity:

- The monitoring of management is not effective and internal control components are deficient

Rationalization:

- Excessive interest by management in increasing the entity's stock price or earnings trends

Discussion Question

Clearly, this fraud was an example of management override. In your experience, what preventive controls can be utilized by an entity to prevent or minimize management override?

OTHER DECEPTIVE REVENUE RECOGNITION PRACTICES

An alarming number of revenue misstatements have been accomplished in the past by **recording totally fictitious revenue, or by liberally grossing up revenues**. Still other companies have engaged in practices that, while permitted under GAAP, can result in misleading financial results.

Fictitious Revenue

The number and variety of schemes to create fictitious revenue seem limitless. A sampling of a number of infamous cases follows:

EXAMPLE

Centennial Technologies was a Massachusetts manufacturer of computer hardware and software that went public in 1996. In 1997, it restated 1994-1996 earnings by about $40 million. A portion of the restatement related to fictitious sales.

- The company reported $1.16 million in sales for a nonexistent product called "Flash 98." The "sales" were made to a company owned by a friend of CEO Emanuel Pinez. Funds were then funneled through intermediate companies by Pinez to create the appearance that the sales were collected.
- Fictitious sales of $2 million for PC cards were recorded to another company owned by a friend of Pinez. Centennial later provided funds, converted them to treasurer's checks to "pay" for the PC cards and created false documentation for the sales.

EXAMPLE

Cisco Systems was named in a class action suit alleging falsified earnings during the period 8/10/99 to 2/6/01. Issues involving fictitious revenue include:

- Recording sales for shipments to its own warehouses (this ploy is a perennial favorite).
- Recording sales for shipments to customers who had not placed orders; knowing the product would be returned.
- Recording sales before goods ordered had been manufactured. Customers were given "loaners" to use until delivery.
- Inflating fourth quarter 1999 sales by filling an order to Worldwide Web in Miami. Since the product wasn't completed, Cisco shipped 14 empty switch shells – allegedly on purpose. When World Web installed the switches, no lights came on. Cisco replaced the "defective" switches in a later quarter.
- Recording sales using a "yellow line" scheme. If additional revenue was needed to meet quarterly targets, product was moved across a yellow line on the warehouse floor and a sale was booked.

EXAMPLE

Mini-Scribe was a Denver based manufacturer of computer disk drives in the 1980s. It grossly overstated earnings during 1986 to 1988 by:

- Packaging bricks in disk-drive cartons. The cartons were counted and included in inventory and were then shipped to other warehouse companies and recorded as sales.
- Recording sales for shipments to its own warehouses (bill and hold transactions).
- Shipping and reshipping defective goods.
- Shipping excess goods near year-end and recording the returns in the subsequent quarter.

EXAMPLE

ZZZZ Best, perhaps one of the most notorious fraud cases, reported revenues that were 85% fictitious. CEO Barry Minkow and CFO Mark Morze fabricated false restoration projects and forged 20,000 documents to deceive the outside accountants. The bogus restoration projects were as large as $7 million when the largest such project that ever existed previously was $2.4 million.

The "Gross vs. Net" Issue (Principal vs. Agent)

Recognizing revenue at "gross" or "net" has been an accounting issue as far back as the late 1990s as can be seen in the Priceline example below. Under Topic 606, a principal's performance obligations would be different from an agent's performance obligations:

- A principal controls the goods or services before they are transferred to customers. Consequently, the principal's performance obligation would be to transfer those goods or services to the customer. A principal recognizes revenue on a gross basis.

- An agent does not control the goods or services before they are transferred to customers. The agent facilitates the sale of goods or services between a principal and the customer. Therefore, an agent's performance obligation would be to arrange for another party to provide the goods or services to the customer. An agent recognizes revenue on a net basis, reflecting the commission to arrange for another party (principal) to provide the goods or services to the customer.

To be a principal and recognize revenue gross, the following should be considered:

- Does the company have **inventory risk**? Would the company suffer a loss if the goods or services could not be sold?

- Does the company have discretion in establishing prices?

- Does the company have **performance risk**? Does the company have the primary responsibility for fulfilling the promise to provide the good or service?

When a company recognized revenue on a gross basis even though they are acting only as an agent, the company is attempting to overstate revenue for purposes of incentive compensation, revenue growth targets, planning an IPO, or support for additional borrowing or equity investments. The two examples below illustrate these situations.

EXAMPLE

Priceline.com

Priceline.com is a web-based intermediary for airline tickets, home financing, hotel rooms, new cars, rental cars, and telephone long distance. Priceline developed the "name your own price" concept, which enables customers to bid on specific tickets or packages, and if accepted, Priceline will deliver the tickets or packages purchased.

At inception, Priceline recognized revenue "gross" rather than "net" as traditional travel agents have done. For example, if a customer bids $500 for two airline tickets and they cost $450 to be acquired from an airline, Priceline recognized sales for $500 rather than the $50 commission it is entitled to. Since Priceline did not have the tickets prior to the sales taking place, net recognition would be more appropriate. Priceline argued that its practice was in compliance with Topic 605 because it temporarily holds the tickets in inventory before issuance to the customer.

Priceline recognized revenue at gross because its employees had significant employee stock options, and if Priceline could demonstrate revenue growth, these stock options would be more valuable to the employees.

What is also interesting about this revenue recognition practice was Priceline's footnote in its S-1 filing which states, "In collecting payment for Priceline tickets, Priceline will act as the agent of airlines." If Priceline is acting as an agent, then they are not assuming the risk of ownership of the inventory and should not be recognizing gross bookings based on the total selling price of the tickets or packages.

In other words, Priceline did not have:

- Inventory risk

- Collection risk, or
- Performance risk as a principal would have in order to recognize revenue at the gross amount.

EXAMPLE

Groupon, INC.

Groupon, Inc. is a local ecommerce marketplace that connects merchants to consumers by offering goods and services at a discount. Traditionally, local merchants have tried to reach consumers and generate sales through a variety of methods, including the yellow pages, direct mail, newspaper, radio, television and online advertisements, promotions and the occasional guy dancing on a street corner in a gorilla suit. By bringing the brick and mortar world of local commerce onto the internet, Groupon is creating a new way for local merchants to attract customers and sell goods and services. Groupon planned an initial IPO in 2012.

Groupon apparently did not learn the lesson of Priceline relating to being a principal or agent in a transaction. Groupon reported revenue significantly higher than it should have. Groupon recognized the price it received from customers at gross amounts rather than the net amount it earned after remitting payments to the retailers providing the coupons. Groupon did not have inventory risk, collection risk, or performance risk that would have permitted it to recognize revenue at the gross amounts of the transaction. Instead, Groupon should have recognized revenue at the net amounts after payments to the retailers.

In September 2011, Groupon was forced to restate their financial statements in 2010 from reported revenue of $713,365,000 to the restated amount of $312,941,000. While the restatement had no bottom line impact, its revenue per customer ($79 to $35) and revenue per coupon ($24 to $10) was significantly less making Groupon's IPO less attractive than it would have been.

Channel Stuffing or Trade Loading

There are numerous cases where companies have pumped up sales at the end of a reporting period by convincing customers to buy in quantities that far exceed their needs. Often, this is accomplished by offering deep discounts, extended payment terms, or similar incentives that do <u>not</u> preclude revenue recognition under GAAP.

Obviously, this practice provides only a temporary benefit at the expense of future periods; however, it has been used in diverse industries. Back in the 1980s, tobacco companies were accused of exaggerating profits by $600 million through trade loading. In 1993, Bausch and Lomb offered deep discounts on contact lenses and extended payment terms to induce customers to buy up to two years' supply in a period of two weeks. Software companies and toy companies have been cited for this practice, as well.

EXAMPLE

Channel Stuffing at Bristol-Myers Squibb

On October 25, 2002, the Wall Street Journal reported "Bristol-Myers Squibb, after insisting for months that its accounting of excess sales to wholesalers was proper, said that it would restate sales and earnings for at least the past two years."

The correction resulted from an investigation by the SEC and the U.S. Attorney in New Jersey into whether the company had improperly inflated sales and profits by offering discounts to customers who then purchased drugs far in excess of patient needs during 2000 and 2001. Auditors PricewaterhouseCoopers had also recommended the restatement.

The problem came to light when Bristol-Myers Squibb reported disappointing first quarter results in April, the result of a plunge in sales to wholesalers who had overpurchased in earlier periods.

As the story unfolded, the company's management first predicted a $1 billion restatement, which later grew to $1.5 billion, then $2 billion.

This case is interesting in that sales and profits from channel stuffing, while often regarded as distorting earnings, is not generally considered a departure from GAAP as long as the earnings process is complete. Note, however, **if GAAP is misleading, it is no longer appropriate.**

All in all, 2002 was a dismal year for this pharmaceutical giant. In midyear, attorney generals in 29 states and other jurisdictions sued it for illegally delaying generic competition for its popular cancer drug, Taxol. Reserves in the hundreds of millions resulted. Later, the company announced an additional $367 million writedown of its investment in ImClone Systems, Inc., to reduce an original investment of $1.34 billion to a revised estimated fair value of only $98 million.

In 2004, Bristol-Meyers Squibb paid $150 million to the SEC to settle charges of accounting fraud for this event.

- Excess sales to wholesalers
- Discounts offered to customers
- Declining future sales
- $2 billion restatement

EXAMPLE

Channel Stuffing at McAfee, Inc.

McAfee, Inc. is a manufacturer and worldwide supplier of computer programs and hardware focusing on network security, antivirus, and network management products. One of many revenue overstatement practices developed by McAfee between 1998 and 2000 was to aggressively oversell its products to distributors in amounts that far exceeded the distributors' demand for these products.

As part of this channel stuffing practice, McAfee offered its distributors significant sales incentives that included deep price discounts and rebates in an effort to persuade the distributors to continue to buy McAfee products. In addition, McAfee paid distributors millions of dollars to hold the excess inventory, rather than return it to McAfee for a refund and reduction in revenue. McAfee also created a wholly-owned subsidiary (Net Tools) to repurchase inventory at a profit from McAfee's distributors. Through Net Tools, McAfee avoided direct returns of inventory by the distributors and the consequent reduction in McAfee's revenue.

Through channel stuffing and other improper revenue recognition activities, McAfee overstated revenue by $622 million between 1998 and 2000. It is interesting to note, that by the fourth quarter of 2000, after eleven quarters of McAfee's distribution channel stuffing, its distributors held such huge inventories of McAfee products that they refused to buy any additional product.

On January 4, 2006, the SEC finalized a settlement over these actions that included financial statement restatements and civil penalties against McAfee.

- Oversold its products to distributors in amounts that far exceeded the distributor's demand for these products
- Establishment of Net Tools for inventory returns
- Did not consolidate Net Tools

Back (or Forward) Dating Sales

Many past financial frauds involved backdating contracts to accelerate revenues to earlier periods:

EXAMPLE

Qwest Communications International recognized $85.5 million of revenue in the third quarter of 2001 from a sale contract that bore a false signature date of September 30, 2001 but that was not actually executed by the parties until October 1, 2001.

EXAMPLE

Donnkenny, a women's apparel company, backdated sales to create the illusion that each quarter's revenues and earnings met or exceeded forecasted levels. In addition, Donnkenny anticipated future sales and recognized revenue without shipping products to customers (an example of a bill and hold transaction).

EXAMPLE

Sensormatic Electronics, Inc., a manufacturer of theft-deterrent products, backdated legitimate contracts that provided for delivery of its surveillance and theft-prevention systems in the subsequent period. It then asked the carrier to delay delivery or stored "sold" goods in warehouses until the desired delivery date. (Sensormatic also frequently shipped products to its own warehouses and recognized sales based on the shipment.)

In these cases, the companies were recording valid sales in the wrong period. This is in contrast to the numerous abuses where goods not even ordered were shipped before year-end to create the appearance of a sale.

This type of manipulation can arise with small companies where management is less inclined to use complex GAAP issues or side agreements to misstate earnings. For example, a tax-motivated owner manager could understate revenues by "forward dating" year-end sales to the subsequent period. In general, closely-helds are more likely to manipulate cutoff of sales (and purchases) then to fabricate or omit transactions.

This is in stark contrast to the willingness to leave inventory off the books.

EXAMPLE

A manufacturer in the jewelry industry stamps product from sheets or coils of brass. The amount of scrap can be significant. The same vendor that supplies raw material takes back the scrap and pays the manufacturer based on the going price per pound, reduced for the cost to convert the material to salable form.

At year-end, the manufacturer stockpiles scrap and assigns a zero value to it. Soon after year-end, the brass is picked up by the vendor and the manufacturer is paid. The intent here is to defer the taxable income to the next period by expensing the full purchase price without accruing the scrap revenue.

Unit

4

Estimates – Reserves, Asset Impairments, and Accruals

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- ☐ Identify and describe deceptive accounting practices in the area of reserves, asset impairments, and accruals
- ☐ Describe estimate deceptive accounting techniques used by Cendant and Rite Aid

INTRODUCTION

One way that earnings can be manipulated is through **estimates** that either reduce the carrying value of assets for impairments or reflect anticipated costs or losses. Such estimates range from reserves for uncollectible loans or accounts receivable, inventory writedowns and other asset impairments including loans, fair value estimates, to accruals for contingent losses, exit or restructuring activities, and pre-acquisition contingencies in business combinations. Depending on the motivation, these estimates can be abused in various ways, the most common being:

1. Failure to record adequate amounts to avoid the negative impact on earnings.

EXAMPLE

Ikon Office Solutions reported a "one-time" pretax charge of $94 million during 1998, due to "increased reserves for customer defaults," calling into question their methodology for estimating bad debts in previous periods.

Cisco Systems, after several periods when inventory growth outpaced sales growth, took a $2.5 billion "hit" in 2001 for excess inventory. In their defense, there had been an abrupt decline in the industry with the bubble bursting for dot.coms and telecommunications. But the case illustrates the difficulty in distinguishing a large change in estimate due to a significant change in circumstances from an inappropriate delay in recording the impact of poor business decisions (e.g., should management have seen this coming?)

Rite Aid was accused by the SEC of intentionally omitting a writedown of $8.8 million for inventory shrinkage during 1999, and reducing – without justification – its estimate of shrinkage for 2,000 stores not scheduled for inventory counts by another $5 million.

In 2013, Hertz Global Holdings announced that it is restating three years of financial statements due to various accounting issues all related to estimates. Hertz's 8-k filing identified the following accounting errors inflating net income by $87 million for the period 2011 through 2013:

- Capitalizing certain expenses that should have been expensed to operations
- Understating the needed allowance for doubtful accountants in its Brazilian operations
- Understating its allowance for uncollectable accounts related to receivables for renter obligations to repair damaged vehicles
- Understating the costs of restoration obligations at the end of facility leases

In February 2019, the Hertz Global Holdings Inc. agreed to pay $16 million to settle fraud and other charges brought by the SEC. According to the SEC, from February 2012 through March 2014, Hertz's public filings materially misstated (overstated) pretax income because of accounting errors made in a number of business units over multiple reporting periods. In July 2015, Hertz restated its financial results for prior periods, identifying $235 million in previously-reported pretax income based on treatment of items that was not consistent with U.S. GAAP. The SEC concluded that the inaccurate reporting occurred in a pressured corporate environment that placed improper emphasis on meeting internal budgets, business plans, and earnings estimates.

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2. Recording excess reserves up front to provide a "rainy day" fund for the future. There are several variations in this category:

   - **One-time charges for restructuring**. While GAAP permits these charges, some companies have intentionally overstated them to improve results in future periods.

   - **Excess reserves recorded in business combinations**. Established primarily to provide for pre-acquisition contingencies and/or costs that arise belatedly in connection with an acquisition, these accounts have been used by some companies to absorb just about any debit you can imagine.

EXAMPLE

Cendant was probably the most incredible abuser of acquisition reserves, to the point where its CUC division sought out acquisition opportunities primarily for the purpose of establishing reserves to absorb its own operating expenses and losses. (More on this case later.)

One of the many charges against Sunbeam was that it included amounts representing future operating expenses in restructuring reserves to artificially inflate earnings going forward.

- Routine "cookie jar" accounting schemes, which will now be explored in depth.

“Cookie Jar” Accounting Schemes in General

"Cookie jar accounting” refers to any of a variety of accounting practices that involve deliberately under-reporting earnings in an earlier period ("filling the cookie jar") in anticipation of opportunities and incentives to overreport earnings in a later period ("taking cookies from the jar"), all without detection. To execute a cookie jar accounting scheme, a company:

- Fills the cookie jar when it can (i.e., deliberately understates reported income for the period);
- Withdraws from the cookie jar when it must (i.e., deliberately overstates reported income for the period); and
- Without arousing the suspicions of auditors (external and internal) or securities analysts.

Cookie jar accounting schemes may be undertaken for any of a variety of reasons:

- **To reduce period-to-period volatility in reported earnings.** This reduces investors' perception of risk, and therefore enhances the entity's share price for a given average level of periodic earnings. Managers often have economic and other incentives to maximize the entity's share price.
- **To portray a pattern of steady earnings growth.** This increases investors' expectations of future cash flows, and therefore enhances the entity's present share price. Again, managers often have economic and other incentives to maximize the entity's share price.
- **To ensure the awarding of performance-based compensation to management even in periods of low performance.** By "storing" earnings that exceed bonus criteria in high-performance periods, the "stored" earnings can be used to enhance reported earnings in low-performance periods when bonus criteria would otherwise not be met.
- **To ensure that managers consistently "make their budget numbers."** Adverse career consequences – not necessarily economic in nature – may await managers who fail to do so.

Some people contend that cookie jar accounting is not wrong because:

- It enhances share prices and therefore shareholder wealth
- It does not create or destroy earnings; it just moves them around to better reflect long-term performance

However, for accounting professionals, cookie jar accounting *is* **considered wrong** because it:

- Obscures true period-to-period earnings volatility and therefore masks the actual risks that investors bear

- Encourages a culture of deception in financial reporting
- Manipulates multiple accounting periods

There are at least three distinct types of cookie jar accounting schemes.

1. Under the first type:
   - When "excess" earnings are available, the reporting entity **fabricates accounting events/transactions** that result in:
     - Debits to an income-statement account
     - Credits to a balance-sheet account (these credits are thus "stored" for future use)
   - During periods with lower-than-desired earnings, the entity fabricates accounting events/transactions that result in:
     - Debits to the previously-credited balance-sheet account (i.e., draw upon the "stored" credits)
     - Credits to an income-statement account
2. Similar to the first type of cookie jar accounting scheme, a second type works as follows:
   - When "excess" earnings are available, the reporting entity artificially increases the amounts recorded for accounting events/transactions that result in:
     - Debits to an income-statement account
     - Credits to a balance-sheet account (the excess credits are thus "stored" for future use)
   - During periods with lower-than-desired earnings, the entity "trues up" balance-sheet account balances by:
     - Debiting the previously-credited balance-sheet account (i.e., draw upon the "stored" credits)
     - Crediting an income-statement account
3. Here is a third type of cookie jar accounting scheme:
   - When "excess" earnings are available, the reporting entity **neglects to record events/transactions** that would result in:
     - Debits to a previously-credited balance-sheet account
     - Credits to an income-statement account

- **During periods with lower-than-desired earnings, the entity records the previously unrecorded accounting events/transactions.**

EXAMPLE

In July 2009, the SEC charged a former chief accounting officer of Beazer Homes USA, Inc. with conducting a multiyear fraudulent earnings-management scheme and misleading Beazer's outside auditors and internal Beazer accountants in order to conceal his wrongdoing.

The SEC alleged that Beazer’s former chief accounting officer:

- Fraudulently decreased Beazer's reported net income by recording improper accounting reserves during certain periods between 2000 and 2005
- Began reversing these improper reserves beginning in the first quarter of fiscal year 2006 in order to offset Beazer's declining financial performance
- Took affirmative steps to conceal the fraud from Beazer's outside auditors and internal Beazer accountants

As part of its homebuilding and marketing operations, Beazer purchased parcels of land upon which it constructed houses to form subdivisions. Beazer recorded the acquired land, along with costs for the common development of the parcels (e.g., installation of sewer systems, street paving) as an asset on Beazer's balance sheet in "Land Inventory" accounts. As subdivisions were built, Beazer allocated the costs accumulated in the Land Inventory accounts to individual home lots, which were then offered for sale. When the home sale was recorded in Beazer's books, all associated homebuilding costs, including allocated costs recorded in the Land Inventory accounts, were expensed as a cost of the sale, with a corresponding reduction in the Land Inventory account (debit Cost of Sales Expense, credit Land Inventory).

Because Beazer sold houses within a subdivision as the development of that subdivision progressed, the credit to Land Inventory recorded for any particular house sale was necessarily an estimate. The setting of the credits was done by each division based on estimates of costs to acquire, develop, and complete subdivisions plus an added amount for contingencies. As additional houses in a subdivision were sold, the Land Inventory account's debit balance continued to be decreased (i.e., credited) by amounts representing the land acquisition and development costs allocated to each individual house. If costs had been allocated properly, then shortly after the final house in a development had been sold, the balance in the Land Inventory account should have been at or near zero.

The SEC alleged that Beazer’s former chief accounting officer manipulated the credits recorded in the Land Inventory accounts by overallocating land inventory costs to individual house sales in material amounts. For example, in order to reduce the Company’s first quarter fiscal 2002 earnings, which had exceeded analysts' earnings per share (EPS) expectations, he allegedly increased the land inventory credit recorded for homes sold during the quarter (a scheme of the second type, as explained above). Beazer recorded approximately $1.8 million in excess cost of sales expense for that quarter, or approximately 8% of its reported net income. In this manner, the SEC alleged that the chief accounting officer caused Beazer to understate its net income by a total of $56 million (approximately 5% of reported net income) between fiscal years 2000 and 2005. Then, beginning in the first quarter of 2006, he began to reverse the reserves existing in the Land Inventory accounts, which increased then-current period earnings. The credit balances in Land Inventory accounts were debited (i.e., zeroed out) and a cost of sales expense credited (i.e., reduced). These reversals improperly reduced expenses and increased Beazer's earnings. During 2006, Beazer overstated its net income by approximately $16 million by "zeroing out" credit balances in its land inventory accounts.

The former chief accounting officer also worked additional, different schemes. Under its accounting policies, Beazer recorded revenue and profit on the sale of a house after the close of the sale of that house to a homebuyer. In the journal entries to record the sale, Beazer typically reserved a portion of its profit earned on the house. This reserve, called a "house cost-to-complete" reserve, was established to cover any unknown expenses that Beazer might incur on the sold house after the close, such as minor repairs or final cosmetic touchups.

Beazer's policy was to reverse any unused portion of the house cost-to-complete reserve within four to nine months after the close, taking any unused portion into income at that time. Although creation of such a house cost-to-complete reserve is proper, the former chief accounting officer fraudulently utilized these reserves to manage Beazer's earnings. Specifically, in various quarters between 2000 and 2005, he overreserved house cost-to-complete expenses in order to defer profit to future periods (another scheme of the second type, as explained above). He then took steps to maintain these reserves beyond the typical four to nine months and until increased earnings were required in future periods (a scheme of the third type).

Beginning in 2006, Beazer, requiring additional income, manipulated its house cost-to-complete reserve to increase its profits. During the first quarter of 2006, Beazer began reversing some of the excess cost-to-complete reserves that it had previously recorded. As a result, Beazer reduced its cost of sales expense by approximately $1.5 million by reducing the cost-to-complete reserve to zero on a number of houses.

For Crooks Only: How to Minimize the Risk of Detection

Are there any lessons to draw from cookie jar accounting schemes? Certainly there are for individuals who would seek to defraud users of financial statements without getting caught:

1. Don't create a new line item on the income statement or balance sheet; bury debits/credits in an existing item and keep them relatively small in comparison to the balance of that item.

2. Use a balance sheet account with many subaccounts; spread "stored" credits over some, but not all of the subaccounts.

3. Use a balance sheet account for which journal entries are frequently based on estimates. Current period anomalies can be attributed to inaccurate estimates. "Truing up" in later periods often goes unquestioned.

4. Have a good excuse for the balance-sheet credits and subsequent debits. This is especially important when drawing from the cookie jar; building up the cookie jar is easier to justify as anything that depresses income and the balance sheet will usually be perceived as "conservative" and therefore OK.

5. Avoid using journal entries for which the debits and credits fall in different cash-flow-statement categories.

6. It helps if there are many other unusual but legitimate accounting events/transactions to distract from the scheme, especially those in the same "direction" as the scheme in the same period.

Your key takeaway should be that these lessons are equally useful to accounting professionals who seek to defeat fraudsters' attempts to perpetrate cookie jar accounting schemes.

GAAP FOR RESERVES, ACCRUALS, WRITEDOWNS, AND ASSET IMPAIRMENTS

Reserves manipulation practices identified in the SEC's *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions,* include:

- Manipulating cost of goods sold by moving costs out of cost of goods sold to inflate margins
- Improper reduction or manipulation of reserves, including accounts receivables and rebates
- Increasing inventory amounts on the balance sheet to manage financial metrics or overall results by including overcapitalizing costs into inventory thereby inflating its value; the timing of inventory reserves and failing to record losses when cost exceeds market value
- Deferring the recognition of loan impairments by creditors

EXAMPLE

Diamond Foods

Due to price increases in certain commodity products causing a decrease in net income, Diamond Foods delayed the recognition of certain related expenses thereby reducing reported expenses causing increases in net income. Diamond Foods overstated net income by $10.5 million and $23.6 million for two consecutive years.

Due to the number of accounts and GAAP issues involved in this category of troublesome accounting, the following discussion is organized by account, and related GAAP standards are summarized.

Accounts and Loans Receivable

Under Topic 310, *Receivables*, (prior guidance for credit losses now in Topic 326, *Financial Instruments: Credit Losses)* receivables are to be stated at outstanding principal amounts, adjusted for:

- Charge offs
- Allowance for uncollectible accounts
- Deferred fees or costs
- Unamortized discounts or premiums

Topic 310 requires that receivables be stated at the amount of cash estimated as realizable. Consequently, allowances are needed for those amounts that can ultimately reduce the net amount realized as revenue, including estimates of discounts, allowances, and returns. (Some of these issues were involved in the revenue recognition cases discussed earlier; for example, the failure to reflect a right of return to overstate revenue will also overstate receivables.)

Loans receivable are impaired when the lender determines that principal and interest payments will not all be received as provided for in the loan agreement. This can mean that payments will be less, or will be delayed. Topic 310 require that the carrying value of impaired loans be reduced to an amount not greater than the present value of expected payments, discounted at the original stated interest rate on the loan. Topic 310 permits flexibility as to whether an allowance (rather than direct write off) is used and how interest income is recognized going forward. Basically, any method is permitted so long as the carrying value never exceeds the present value of expected repayments.

EXAMPLE

When Baptist Foundation of Arizona sold real estate at inflated values to related entities in exchange for IOUs, these receivables were identified as impaired by Arthur Andersen (AA), the auditors. But AA still signed clean opinions for at least two more years without any reserve against the IOUs.

There is no justifiable reason to exclude related party loans from these standards.

NOTE: ASU 2016-13, *Financial Instruments-Credit Losses* (Topic 326), created a current expected current loss model (CECL) for the recognition of credit losses applicable to loans receivables as well as other financial instruments. Topic 326 requires that reporting entities recognize credit losses when a loan is originated based on an estimate of lifetime credit losses. For subsequent measurement, the reporting entity should record an allowance for credit losses on impaired loans. The reporting entity should report in net income (as a current loss expense or a reversal of credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on impaired loans. The estimates required by this ASU will likely create new fraud opportunities associated with accounting for credit losses.

Prior to the issuance of ASU 2016-13, the FASB guidance was an incurred loss model that required a probability assessment of losses based on past and current experiences. It was concluded by FASB that this incurred loss model delayed the recognition of credit losses because of the probability threshold and because the incurred loss model did not consider future expected cash flows. The CECL model corrects this prior guidance.

In the SEC's *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions,* the SEC identifies loan impairment fraud schemes whereby creditors failed to recognize loan impairments and their associated reserve allowances (credit losses) or improperly reclassified loans to specific categories that do not require review for impairment. One example from the report is Santander.

EXAMPLE

Santander

The SEC alleged that Santander did not properly calculate and report its credit loss allowance for three years. The company purchased and securitized retail installment contracts associated with car loans. Most of these installment contracts were subprime, so they carried a higher credit risk and a greater likelihood of default than do loans issued to borrowers with higher credit scores.

The SEC alleged that the company grouped troubled debt restructuring loans with other loan assets and evaluated the whole group for impairment in violation of GAAP, which requires that troubled debt restructuring loans be evaluated separately using a discounted cash flow. The SEC also alleged that the company used an incorrect discount rate and incorrectly calculated its accretion. As a result, the company understated its credit loss allowance and did not appropriately recognize related credit losses.

Inventory

Inventories are stated at the lower of cost or net realizable value (FIFO and average) or market (LIFO) under Topic 330, *Inventory*. (Inventory under a fair value hedge using derivatives is carried at fair value, however.)

Cost can be determined using various acceptable methods (LIFO, FIFO, etc.) that incorporate a full absorption approach; the resulting cost is compared to market, which in turn is usually based on replacement cost for materials or goods purchased for resale and net realizable value for work in process and finished goods. Lower of cost or market can be applied item by item or in the aggregate.

The potential need for a writedown of inventory usually arises from either obsolescence or overstocks. The amount (if any) that is ultimately recorded is subject to a high degree of judgment, leaving room for abuse. For example, is inventory totally obsolete and worth no more than its scrap value, or merely outdated, suggesting the need for markdowns that may or may not result in a loss upon sale? Writedowns for excess inventory can be even more subjective.

EXAMPLE

Often, discussions about reserves for excess inventory are heated. One company made parts for automotive instruments such as tachometers, and another sold electrical supplies. Significant portions of inventory were very old. Management at both companies maintained that they enjoyed a reputation for stocking hard-to-find items and that the goods would eventually be sold at prices above cost. Is a writedown required by GAAP in these cases?

Internal control weaknesses have been identified in the PCAOB firm’s inspection process causing inventory overstatements and inventory understatements in some instances.

EXAMPLE

VeriFone Holdings Inc., an industry leader in e-billing services, (countertop hardware, wireless technologies, and self-service software) also sells peripheral devices, including PIN pads and contactless card readers.

VeriFone restated its results due to double counting in-transit inventory. This internal control weakness resulted in a reduction in cost of sales expense and therefore an overstatement of gross profit and net income. VeriFone lost 46% of its share value when the restatements were announced. Gross revenues were decreased by over $900 million.

EXAMPLE

Stein Mart, did not properly take price discounts or markdowns into account when valuing inventory. Stein Mart improperly valued the inventory by writing down the inventory values when the products were sold rather than when the markdown was taken, thereby overstating inventory balances.

Vendor Rebates

Topic 606, *Revenue from Contracts with Customers,* requires that vendor rebates be evaluated as variable consideration when determining the transaction price. The misuse of vendor rebates in the past can be illustrated by the following examples:

EXAMPLE

Rite Aid and Royal Ahold NV both prematurely recognized vendor rebates they had not earned and recognized these vendor rebates as sales. Motivation for recognizing vendor rebates as sales were to maintain the price of the shares and earn incentive bonuses for management.

EXAMPLE

More recently, Office Depot settled SEC charges related to improperly accounting for vendor rebates. Office Depot during the third quarter of 2006 through the second quarter of 2007 recognized vendor rebates in those quarters that should have been deferred into later accounting periods. In Office Depot's press release announcing these restatements it stated, "Our investigation revealed errors in timing of vendor program recognition and included evidence that some individuals within the Company's merchandising organization failed to provide Office Depot's accounting staff with complete or accurate documentation of future purchase or performance conditions in certain vendor programs that would have required recognition of the related vendor funds to be deferred into future periods."

EXAMPLE

In a related matter, Saks, Inc., during the years 1996 through 2003, intentionally understated to vendors the sales performance of their products and collected millions of dollars in vendor allowances they were not entitled to. According to the SEC, Saks and its vendors entered into risk sharing arrangements if the vendor's products could not be sold at full price. The SEC said in its complaint, "The more Saks had to mark down the vendor's merchandise in order for it to sell, the more the vendor was expected to compensate Saks in additional vendor allowances."

Other Reserves

As documented in Topic 450, *Contingencies*, U.S. GAAP requires a reserve to be created, and a charge to income to be taken, if it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Conversely, to the extent a liability is no longer probable and reasonably estimable, a reserve should be removed from the books or decreased and income should be increased. In addition, Topic 450 specifically prohibits the accrual of "reserves for general contingencies" or for "general or unspecified business risks." ASU 2016-13, *Financial Instruments-Credit Losses,* introduced new credit loss reserves and over the last couple of years reversing these reserves has significantly boosted bank earnings.

EXAMPLE

Cardinal Health, Inc. is a "Fortune 500" pharmaceutical distribution company. In July 2007, the SEC accused the company of defrauding investors by materially overstating operating revenue, earnings, and growth trends in earnings releases and SEC filings from September 2000 through March 2004.

According to the SEC's complaint, Cardinal Health:

- Fraudulently manipulated certain balance sheet reserve accounts in an attempt to manage the Company's reported earnings.
- Made other adjustments to certain reserve accounts that were not in accordance with GAAP.

Specifically, Cardinal Health made at least 73 different period-end adjustments in 60 different reserve accounts, resulting in an overstatement of the Company's net earnings of approximately $65 million.

Cardinal Health's abuses appear to have been systematically executed by management.

- Reserve balances or excesses were reported to Cardinal's corporate management on a quarterly basis.
- Corporate management then analyzed the reserve balances and sometimes directed business unit employees to use release reserves in order to help Cardinal Health meet its earnings goals.
- In virtually every quarter, Cardinal Health analyzed various reserve adjustments to show the effect those adjustments would have on the Company's earnings per share (EPS).

In many instances, Cardinal Health internally identified a reserve (or portion thereof) as an "available item not used," indicating that the reserve should have been reversed at that time but was maintained and available to help the Company meet its earnings goals in a future quarter.

Also, in at least one instance, Cardinal Health improperly created and built up a general contingency reserve eventually totaling $2 million, in the absence of a specific liability that was reasonably estimable. Cardinal later adjusted this reserve downward to boost reported earnings. In a December 2002 email exchange, two members of the Company's corporate management discussed reversing the $2 million general reserve "to help make the quarter" and noted that "we built it for a rainy day… and it looks like it is pouring!"

Cardinal Health was also accused by the SEC of other wrongdoing with regard to the company's financial reporting.

The SEC asserted that Cardinal Health deliberately presented a false picture of its operating results to the financial community and the investing public in order to match the company's publicly disseminated earnings guidance and analysts' expectations rather than to reflect its true economic performance. Without admitting or denying the allegations, Cardinal Health agreed to pay $35 million to settle with the SEC.

Restructuring Reserves

Of all the issues in this category, restructuring charges have probably been the most controversial and abused. In fact, the "one-time charges" often mentioned in companies' earnings reports are often some variation of this type of charge. Recently, the SEC issued a Staff Accounting Bulletin on this topic in an effort to address creative accounting by registrants. Topic 420, *Exit or Disposal Cost Obligations,* further restricts recognition and classification of costs as one-time restructuring charges.

There are many terms used for **restructuring charges – reengineering, reorganization, resizing, etc.** Their appeal is that they **package bad news** in a way that is perceived positively by financial statement users, taking losses for past bad decisions and presenting it as a positive sign for the future. In recent years, companies seeking to pursue new opportunities have also tended to classify such "reengineering" costs as **one-time charges**. This trend has been fueled by observed *increases* in stock prices when these losses are reported, based on a perception that the future holds more promise than the past. (This is a testament to stock values incorporating future expectations as well as past performance. Ponder that for a moment—I can manipulate share price not only by manipulating reported results, but by manipulating expectations.)

As the amounts and types of costs included in these charges are highly subjective, some companies have inappropriately included future operating costs and/or the effects of very tentative plans to ensure a positive effect on future earnings. In short, a management record exaggerated charges today and gets a boost in share price. Then they report inflated earnings going forward to sustain the share price.

Topic 420 defines exit or disposal costs as:

1. Involuntary termination benefits under an arrangement that did not exist previously and does not constitute a deferred compensation arrangement

2. Costs to terminate contracts other than leases (Topic 842, *Leases*)

3. Costs to consolidate facilities or relocate employees

4. Costs associated with a disposal activity

5. Costs associated with an exit activity, including exit activities associated with an entity newly acquired in a business combination

This scope is somewhat narrower than that which has been – and still is – categorized under the umbrella of "restructuring charges" by many companies. For example, disclosures in recent annual reports explain that such charges included:

- “Special” warranty and repossession accruals
- Inventory writedowns
- Asset writedowns
- Impaired investments
- Idled or closed facilities

The **recognition and measurement rules** for costs included in the scope of Topic 420 are:

1. Recognition of the liability and expense when the liability is incurred (i.e., when there is “a probable future sacrifice of economic benefits arising from present obligations…to transfer assets or provide services…in the future as a result of past transactions or events.”) Mere *commitment* to an exit or disposal plan does not fit this definition.

2. The liability should be recorded at fair value, which may need to be adjusted going forward. Any adjustment should be recorded immediately, not spread over some remaining time period.

3. Costs to terminate operating leases or other contracts have two components: (a) termination fees, and (b) costs that continue with no economic benefit to the entity (such as paying rent on an abandoned facility). The obligation for a terminated operating lease does *not* include rents that are – or could be – offset with sublease rental income.

4. An obligation for one-time termination benefits should be recorded only when management has not only committed to the plan, but the employees involved are identified, benefits are determinable, significant changes are unlikely, and the employees have been notified. The date when these are all met is called the **communication date**.

5. The obligation is recorded on the communication date unless employees are required to provide service for more than a minimum retention period to receive the benefit (i.e., legal notification period or 60 days if no legal period). If employees are required to stay beyond this minimum period, the liability is systematically accrued over the required period of service so that, upon termination, the present value of the benefits has been recorded.

EXAMPLE

In connection with Printek Corporation’s downsizing, it will terminate 200 factory workers in 12 months. Each will receive $6,000 six months after the termination only if he/she stays with Printek for the 12 months. Management estimates that 30 employees will not stick around. At the communications date:

The obligation = 170 × \$6,000 = \$1,020,000 to be paid six months after termination

PV obligation at termination date (6% interest) = \$989,928

Accrue \$989,928 ÷ 12 = \$82,494 per month for the next 12 months.

Note that the present value only enters into the calculation at the termination date, not the accruals up to that date.

6. Other exit and disposal activity costs to consolidate or close facilities and relocate employees are recorded at fair value when the liability is incurred.

   Incidentally, the interest factor built into the liability is again termed "accretion" expense, similar to Topic 410.

The following two examples illustrate the use of reserves to manipulate reported earnings.

EXAMPLE

Cendant Corporation

Cendant was created in December 1997 through the merger of HFS, Inc. and CUC International, Inc. CUC's business included membership-based and internet-based consumer services such as auto, dining, shopping, and travel "clubs." Members were marketed through its Comp-u-Card division. HFS controlled franchise operations for several well-known hotel, real estate brokerage, car rental, and tax preparation businesses.

The merger was accounted for as a pooling of interests (now prohibited), which combines the previous carrying values of the merging entities. It was the operations of CUC that were later found to be fraudulent.

The SEC's enforcement action alleged a "massive fraudulent reporting scheme" spanning more than 12 years before it was exposed in 1998, the purpose being to inflate earnings to meet analysts' expectations.

Each year, senior management at CUC would identify so-called "opportunities," a term for methods available to inflate earnings. There were four major categories of "opportunities."

- Manipulating (i.e., accelerating) recognition of membership sales revenue
- Understating or eliminating liability accounts relating to membership commissions payable and cancellations
- Overstating merger and purchase reserves and then reversing them as revenue or a reduction of expenses
- Recording asset writedowns – some totally fictitious – and booking them against the excess merger reserves so that future depreciation expense would be reduced. In some cases, proper writedowns were shifted to the wrong periods.

The impact on earnings during the fiscal years ended January 31, 1996, January 31, 1997, and December 31, 1997 (change in year-end) totaled over \$500 million, of which more than half was in the year ended December 31, 1997.

The scheme, led by CUC's senior management, went at least as far back as 1988. To inflate interim quarterly results, "top-side" adjustments were simply inserted in spreadsheets used at corporate to prepare consolidated financial statements. As a result, quarterly financial statements reflected bogus entries never even recorded on CUC's books. In one three-year period, these entries overstated earnings by $294 million.

At year-end, the bogus amounts had to be recorded on the books to avoid detection by the outside auditors. Initially, this was accomplished by improperly accelerating membership revenue and deferring or ignoring related liabilities for commissions and cancellations. Over time, in order to conceal the debits needed to balance the inflated profits, CUC began to rely more and more on inflated merger-related reserves established from a series of acquisitions. CUC essentially had a "feeding frenzy," acquiring companies to create reserves that could be used to conceal expenses and losses of CUC. The SEC noted that, in devising the amount of bogus reserves to record, managers sometimes simply doubled the amounts that had been calculated as CUC's true costs. In other cases, divisional managers were simply told what to book as reserves without being consulted on what actual costs were.

The scheme was made harder to trace by funneling much of the manipulation through intercompany accounts at smaller divisions that were not fully audited. Eventually, only massive reserves could sustain the scheme, propelling CUC to reopen merger talks with HFS. The merger was accomplished just before year-end in 1997. The excess reserve recorded on the merger was used, among other purposes, to conceal a $75 million asset writedown of goodwill, receivables, and other assets of CUC at December 31, 1997.

It is interesting to note that the excess reserves in this case related to mergers and acquisitions accounted for as poolings. Since no goodwill was recorded, the offset to the reserve hits earnings, as the SEC's Enforcement Release states, "The charges for a reserve so established in connection with a business combination accounted for as a pooling of interests appear in the entity's income statement as a separate expense item designated as unusual or transaction-related charges, to distinguish them from the entity's usual operating expenses…" For example, in CUC's report on Form 10-K for its fiscal year ended January 31, 1997, this line item was designated "merger, integration, restructuring, and litigation charges associated with business combinations," while one year later on Cendant's postmerger financial statements, it was called "merger-related costs and other unusual charges."

EXAMPLE

Rite Aid

Rite Aid Corporation is one of the largest drug store chains, operating 3,500 stores in 28 states. It was cited in June 2002 for overstating its income for fiscal 1998 and 1999, and the first quarter of 2000. Management used a smorgasbord of accounting devices, including manipulation of reserves.

At times, Rite Aid improperly recorded gains from the sale of stores as reserves instead of income, and then charged current or future operating expenses against the reserves. This served to "bury" one-time gains and instead report higher income from recurring operations. The most extreme example was during 1997, when 189 stores were sold to another company for a gain of $90 million. The gain was recorded as a reserve and then used to absorb a corresponding amount of operating expenses, creating the appearance that earnings were achieved through effective control over operating costs – when in reality, targets were achieved only because of the $90 million gain. This misclassification represented 34% of the company's 1997 reported pretax earnings. The 10-K disclosure for that same period stated, "Gains from drugstore closings and dispositions were not significant."

ASSET IMPAIRMENTS FOR LONG-LIVED ASSETS THAT ARE DEPRECIATED OR AMORTIZED

Topic 360, *Property, Plant, and Equipment,* along with Topic 820, *Fair Value Measurement,* identify and provide guidance for the GAAP treatment of impairment losses involving:

- Long-term assets held and used, primarily property and amortizable intangibles
- Long-term assets held for sale, including those associated with discontinued operations

Assets Held and Used – For assets held and used, an impairment test is "triggered" by events that suggest possible impairment, such as changes in industry or economic conditions, cost overruns on constructed assets, known market declines, changes in how the entity will use the assets, or significant reductions in previously determined useful lives. Potential **triggering events** include:

- A significant decrease in the market price of a long-lived asset (asset group)
- 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
- 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
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- 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)
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

EXAMPLE

In 2004, DirectTV Group took a $1.47 billion writedown after deciding to use several new satellites for high definition TV broadcasting rather than for their original intended use in an internet service. This change in use resulted in the impairment loss.

Once triggered, the test compares the carrying value of the assets to the expected cash flows associated with them. The cash flows used in this calculation are not present valued and do not include interest payments if the assets are financed with debt, but they do include anticipated sales proceeds, if the assets will be sold at the end of their useful lives.

The specific assets identified as potentially impaired may not generate identifiable cash flows by themselves. In such cases, they should be grouped together with other assets at the "lowest level" for which cash flows can be identified.

EXAMPLE

An expensive machine turned out to be much less productive than anticipated; leading management to believe it may be impaired. However, this one machine does not generate its own cash flows. To perform an impairment test, it and other assets would be considered "as a group," but the fewest assets possible would be in the group. This might be all the equipment used to produce a particular product line, if that is the lowest level for which cash flows can be identified.

Impairment Test "Triggered" by Events Suggesting Potential Impairment

- Step 1 – Compare carrying value to undiscounted cash flows. If CV > cash flows.
- Step 2 – Compare carrying value to fair value. Writedown to FV, if lower.

The assets are impaired only if the carrying value exceeds the total undiscounted future cash flows. In these cases, the assets are written down to fair value. Fair value is often determined by quoted market prices in an active market, expected cash flow present value methodologies and traditional present value approaches. The writedown is **permanent**, and depreciation continues on the new, lower carrying value. Topic 360 provides additional guidance for:

- Using the "expected" cash flow approach, which uses probability-weighted cash flows as described in FASB Concepts Statement No. 7.
- The useful lives to use for cash flow calculations when assets grouped together have varying lives, which should be based on a "primary asset" in the group.
- Allocating an impairment loss among grouped assets. This is accomplished on a pro rata basis, although no individual asset should be written down below its fair value.

Assets Held for Sale – Assets held for sale are carried at the lower of carrying value or fair value less direct costs to sell. A loss should be recognized for any initial adjustment of the long-lived asset's carrying amount to its "fair value less cost to sell" in the period the "held for sale" criteria are met. They are segregated on the balance sheet and not depreciated.

Topic 360 made this classification *very* restrictive to limit cases where assets might be improperly included to avoid depreciation expense. In particular, *as of the balance sheet* date, a plan for sale must be in place and the sale must be probable within one year.

GOODWILL AND OTHER INDEFINITE-LIVED INTANGIBLE ASSETS

Under Topic 350, *Intangibles – Goodwill and Other,* is not amortized. Instead, it is reviewed for impairment at least annually. Other intangible assets with indefinite lives (i.e., those that contribute to cash flows directly or indirectly for an indefinite period) fall under essentially the same rules as goodwill.

Note, non-public entities have the option of amortizing goodwill based on the guidance in ASU 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill.*

The goodwill impairment test can be performed any time during the year but may have to be performed again if a change in circumstances before the next scheduled annual test indicates a potential problem.

The impairment testing process for goodwill starts by "matching up" goodwill with the reporting unit to which it relates. A reporting unit is an operating segment, or one level below an operating segment, for which discrete financial information is available and is regularly reviewed by management.

The reporting entity has the option to:

- Assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, **OR**
- Bypass the qualitative assessment and proceed directly to a quantitative assessment by comparing the fair value of the reporting unit to its carrying value, and if the fair value is less than the carrying value, reduce goodwill by the difference limited by the recorded goodwill amount.

If a reporting entity opts to assess qualitative factors and determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the entity is required to perform quantitative assessment. Otherwise, goodwill is presumed to not be impaired.

Note: All other assets in a reporting unit are tested for impairment before goodwill is. This includes any writedown of receivables, inventory, investments, etc., as well as long-lived assets tested under Topic 360.

Note: Topic 805, *Business Combinations,* calculates goodwill as the excess of the consideration transferred (fair value) plus the fair value of any non-controlling interest in the acquiree over the fair value of the net assets accrued.

If the acquisition is a step acquisition (achieved in stages), the consideration transferred includes the acquisition date fair value of the acquirer's previously held equity interest in the acquiree.

The following example not only illustrates the mechanics of Topic 350, but also some of the opportunities for abuse.

EXAMPLE

Some years ago, KB Industries acquired Weaver, Inc. for $3,500,000. The fair value of net identifiable assets acquired was $2,900,000, resulting in goodwill of $600,000. When KB recently tested the goodwill for impairment, opting to perform the quantitative test, the following information was assembled.

Carrying value of assets & liabilities with goodwill	$3,300,000
Fair value of reporting unit, with goodwill	3,100,000
Goodwill impairment loss	$(200,000)

QUESTIONS FOR DISCUSSION – KB INDUSTRIES

Refer to the immediately preceding example for KB Industries.

1. Does writing other assets down before goodwill make goodwill impairment losses more or less likely? Evaluate this result in relation to the interests of companies likely to be impacted most by the changes.

2. This example illustrates a writedown scenario upon initial application of Topic 350, *Intangibles – Goodwill and Other*. Why might companies take an unduly conservative approach toward valuing goodwill when Topic 350 is first applied? How does the state of our economy at this time factor into your answer?

ACCRUALS

Like reserves, accruals may be unrecorded or understated to avoid lower earnings, or overstated now to give the appearance of better performance going forward.

While GAAP for routine accruals (and related expenses) are often straightforward, i.e., "as incurred," companies have been known to improperly reverse, fail to record, or understate them.

EXAMPLE

Livent, Inc. (later acquired by SFX Entertainment) was a producer and promoter of concerts, touring Broadway shows, and motor sports. One of a number of ways Livent caused profits to be overstated was to simply remove certain expenses and related accruals from the books at the end of a quarter. The amounts would be put back on the books in the subsequent quarter as original entries. The amounts were tracked internally as the "Expense Roll."

Smaller, private companies can manipulate accruals in a similar manner by either holding the books open or closing them prematurely. This can serve to reduce income (when tax liabilities are the issue) or increase it (when "looking good" for lenders or valuation purposes is the issue).

The following areas are among those that can present special challenges.

Accrued Benefits – Generally, GAAP requires benefits to be systematically accrued during an employee's years of active service so that when they terminate or retire, the present value of the benefits has been recorded. If the amount of the benefit cannot be estimated, the expense is recorded as soon as an estimate can be made and payment is probable. Different types of benefits are addressed in separate GAAP subtopics, but all adhere to this basic premise, including:

- Topic 710: *Compensation – General* – Subtopic: Compensated Absences
- Topic 712: *Compensation – Nonretirement Postemployment Benefits* – Subtopic*:* Non-Retirement Post-Employment Benefits
- Topic 715: *Compensation – Retirement Benefits* – Subtopic: Defined Benefit Pension Plans
- Topic 715: *Compensation – Retirement Benefits* – Subtopic: Special or Contractual Termination Benefits
- Topic 715: *Compensation – Retirement Benefits* – Subtopic: Post-Retirement Benefits
- Topic 715: *Compensation – Retirement Benefits* – Subtopic: Employers' Accounting for Defined Benefit Pension and Other Post-Retirement Plans
- Topic 420: *Exit or Disposal Cost Obligations* – Subtopic*:* Termination Benefits Associated with Exit or Disposal Activities

These accruals involve varying degrees of estimation, depending on the time period involved and the number and type of variables that affect the amounts paid. For example, accrued vacation is subject to much less estimation and judgment than post-retirement benefits for health insurance. And, as soon as "estimation" and "judgment" enter the picture, there can be problems (especially if benefits are associated with a restructuring, discussed later). For some companies, these obligations can have a significant impact on operations.

EXAMPLE

The January 13, 2003, New York Times reported that large companies with long-established defined benefit pension plans were being forced to contribute much greater amounts to these plans. Not only had market performance caused plan assets to fall far short of levels using assumed rates of return, but current low interest rates had affected the present value calculations for benefit obligations required to be funded. Both of these factors were built into funding formulas and annual reported expense.

During the years 2004 and 2005, many companies saw their real pension liabilities grow significantly faster than their plan assets related to these liabilities. At the same time, many companies had overstated the value of their plan assets due to income smoothing assumptions contained in Topic 715, *Compensation – Retirement Benefits*. In other words, companies had assumed greater historical average rates of returns for their plan assets than the market was currently providing. The higher rates of return appeared to reduce the real unfunded pension liability recorded in companies' financial statements.

Subsequent amendments to Topic 715 improved the reporting of employers' obligations for pensions and other post-retirement benefits by recognizing the overfunded or underfunded status of these plans as an asset or a liability in the balance sheet. This means that a sponsoring company will recognize all previously unrecognized items (such as unrecognized actuarial gains and losses) even when the plan is fully funded. Separate assets and separate liabilities are required to be recognized for overfunded and underfunded plans.

Companies impacted by Topic 715 included General Motors, Ford Motor, Boeing, IBM, Pfizer, and DuPont. For example, it is estimated that in real dollars, GM's pension plan is underfunded by approximately $41 billion. If GM were required to record this liability, its current stockholders' equity would be reduced below zero. GM, Ford and Chrysler reached agreements with their union (UAW) to transfer the responsibilities and related liabilities to the union effective in 2009.

EXAMPLE

One example applicable to smaller companies might be called "ignorance is bliss." Here, management may be unaware of accounting requirements and inadvertently fail to accrue benefits required by GAAP. (GAAP departures usually violate debt covenants.) Because there is no clear indication of this omission in the company's accounts, the failure to accrue can be missed. For example, assume a company has an informal policy of continuing to pay medical insurance premiums for retirees. The cost is buried in the monthly premiums being expensed on a "pay-as-you-go" basis, when they should be accrued as post-retirement benefits under Topic 715, *Compensation – Retirement Benefits*. Or, a company may informally allow vacation and sick days to vest or accumulate, even if their "official" policy is "use it or lose it." Owner/managers (not to mention their accountants) are especially loath to book these accruals because they are not deductible for income tax purposes.

FAIR VALUE ESTIMATES (MEASUREMENTS)

Many recent FASB statements have required that the fair value of accounts be **measured, recognized, or disclosed** in the financial statements. Fair values are often the result of predicting future cash flow expectations and are frequently very subjective. This subjectivity can lead to fair value estimates that may bear little relationship to the economic reality of the valuation. The following example illustrates the type of abuse that can take place.

EXAMPLE

The Federal National Mortgage Association (Fannie Mae) is a publicly held, for-profit corporation, legislated into existence by Congress and operating with a congressional charter to help lower- and middle-income Americans buy residential housing. Fannie Mae does not originate mortgages, but instead guarantees mortgage payments or buys mortgages outright. They receive a fee for guaranteeing the payments on mortgages and mortgages they buy. They traditionally resell to investors in the form of mortgage-backed securities.

As Fannie Mae grew, it chose to hold many of the mortgage-backed securities on its own, which dramatically increased earnings. The increase in earnings resulted from the spread between the lower cost of the individual mortgages and the higher market value of diversified mortgage portfolios. To protect its exposure to interest rate changes, Fannie Mae began investing in derivatives to hedge its downside exposure. Unfortunately, its management of its derivatives risk was poor, and it generated billions of dollars of fair value losses. Fannie Mae left these losses on the balance sheet as assets and did not reclassify the fair value losses as a reduction of earnings on the income statement.

The overstatement has reached $11 billion.

Note: Topic 820, *Fair Value Measurement,* creates consistent fair value applications throughout GAAP and provides a framework for future fair value measurements.

SUMMARY

Accruals, reserves, writedowns, and asset impairments can be misrepresented by:

- Failing to record them at all
- Recording them at understated amounts
- Recording them in the wrong period
- Over-accruing them (e.g., as a “one-time” charge or an amount associated with a business combination), or creating a “cookie jar” reserve or “rainy day” fund.

The first three offenses overstate earnings *now*, while the last sets the stage to overstate earnings *later*.

The degree of subjectivity and judgment in measuring and reporting these amounts complicates the situation further. Not only are the amounts highly dependent on future events, but their *existence* can be elusive, and their classification (as “one time” versus “operating” expenses or losses) can be debatable.

Further, the realities of business in today’s economy have placed this category of GAAP and related potential abuses in the limelight. For example, the competitive environment and the poor performance of financial markets in recent years has affected fair value determinations, interest rate factors, merger and acquisition activity, the prevalence of restructuring programs, and (last but not least) the motivational factors involved in measuring and reporting all types of accruals, reserves, and impairments.

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