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What if ... management doesn't evaluate variable interest entities?

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

Consolidation issues continue to pose challenges for preparers of financial statements and practitioners performing attest engagements on the financial statements.

In the world of private company financial reporting, the guidance associated with whether reporting entities are considered to be primary beneficiaries of variable interest entities (VIEs) has proven to be particularly problematic in practice. The guidance is in the Financial Accounting Standards Board's Accounting Standards Codification (FASB ASC) Topic 810, *Consolidation*.

To address one area of concern, the staff of the American Institute of CPAs released new technical practice aid (TPA) guidance in April 2012. The particular issue addressed relates to the situation in which reporting entity management does not perform required assessments of affiliated entities to determine whether they are VIEs that need to be consolidated in the financial statements.

Primarily because of cost-related issues, management often does not engage practitioners to help with the required VIE assessments. Questions have bubbled up as to what management can expect in its compilation or review reports and how practitioners should handle this matter when they are compiling or reviewing financial statements. To that end, the TPA guidance should be helpful.

U.S. GAAP requirements. Using the provisions of FASB ASC 810, management of reporting entities with variable interests in VIEs needs to assess whether the reporting entity has a controlling interest in the VIEs and, therefore, is their primary beneficiary.

This requirement includes assessing characteristics of the reporting entity variable interests and other involvements in the VIEs, if any (including involvement of related parties and *de facto* agents), as well as involvement of other variable interest holders. Management assessments also need to consider the purpose and design of VIEs, including the risks that the VIEs were designed to create and pass through to their variable interest holders.

Compilation and review requirements. Practitioners who are engaged to compile or review financial statements may become aware of departures from U.S. generally accepted accounting principles (U.S. GAAP), including note disclosure deficiencies or omissions, that are material to the financial statements.

If reporting entity management does not revise the financial statements, practitioners will need to consider whether modification of their compilation reports would be adequate to disclose the departures.

Importantly, practitioners are not required to determine the effects of U.S. GAAP departures when management has not done so, as long as their reports include the stipulation that the effects of the departures on the financial statements have not been determined.

The TPA guidance. The TPA guidance should be helpful in resolving the above-noted practice issue. The conclusion in the guidance is that, because management is required to perform the assessments of affiliated entities to comply with U.S. GAAP requirements,

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Business owners play important fraud prevention role

Small businesses usually have limited resources when it comes to implementing fraud prevention controls.

A substantial number of them have a single owner and fewer than 25 employees. These businesses usually have been passed down from generation to generation and employ a couple of long-term, highly trusted employees – many times hired by an owner from the previous generation.

How can a small business, with a single owner and a small number of trusted employees, put fraud prevention controls in place without spending thousands of dollars?

The answer is simple. Owners must take a proactive role in preventing fraud in their businesses. After all, they're protecting their money. As the old Fram Oil Filter slogan said, "You can pay us now or you can pay them more later."

Small-business owners can personally implement inexpensive fraud deterrent measures, or they can risk the consequences of a major loss that can cripple their business significantly or even close their doors.

Owners must take a proactive role in preventing fraud in their businesses.

The important point of owner implementation of fraud-deterrent measures is appearance. The tone must be set at the top, and that starts and finishes with the owner.

If employees witness an owner demonstrating a carefree spending attitude or treating the employees as second-class citizens, a general feeling of resentment will build. The employees may feel that they're doing all the work while the owners are carelessly spending on themselves.

Owners should evaluate how their actions are perceived by their employees. The greater the resentment by employees or the more "they won't miss a little here and there" attitude takes hold, the greater the risk that fraud will eventually happen.

Owners must always give the appearance that all employees are being checked or that the owners are always looking over each employee's shoulder. Honest employees will have no problem with this and will even welcome the philosophy.

Implementing this one control could very well be the deterrent employees need when faced with pressure in life to abscond with a company's money. The feeling that there is a greater chance of being caught plays on the ego of employees who may have the potential for committing fraud – and the image of how they want peers, friends, family and the community to perceive them.

Small-business owners should never instill too much trust in any one employee or group of employees, no matter how long the employees have been with the company. Time and time again, an employee that everyone thinks would be the last person to commit fraud is the one who commits the fraud.

Many times owners and co-workers have no idea about the financial or emotional pressures a perpetrator has been facing in private life until it's too late. When a person is overtaken with hopelessness, all moral boundaries can be erased, making it easier to do things that are normally out of character, including fraud.

An owner should always check employees' work. Never take anything for granted or make blind assumptions – even about family members employed by a small business.

Five years ago, an owner's son initiated a $360,000 embezzlement. The son was having an affair with the company's bookkeeper. When confronted with the evidence, the owner was in shock, refusing to believe that his own son would steal from him and the company the son had a minority interest in.

What can you as a small-business owner do to prevent or reduce the risk of fraud? Here are a few things to do regularly, involving very little time and cost:

✓ Make a point of taking each month's unopened bank statements out of the mail and reviewing them in private. Ideally, the statements should be sent to your personal residence for review.

✓ Make sure employees see you hand the opened bank statement to the bookkeeper or controller every month – giving the appearance of a review. It also gives you a chance to review the checks cashed during the previous month, spot any unusual items and investigate them independently.

✓ Avoid using a check stamp with your signature. Personally sign each check issued after reviewing the invoice package accompanying the check. You will have a better understanding of the business and be better equipped to detect an unusual vendor or company expense.

✓ On an irregular basis, send out balance confirmations to customers to independently check accounts receivable balances. You don't have to wait until the year-end audit. Also, make sure your employees know this procedure is performed at no predetermined time.

✓ Keep unused check stock in your possession. Sign an authorization each time a supply is used by an employee who processes the checks. All numbers should be sequentially ordered and accounted for.

✓ Pay to get the copies of both sides of the checks returned with monthly bank statements. You'll save large bank charges you would have to pay to obtain copies of the endorser's signature side if you later detect fraud. You'll also have the information available to determine whether an employee is depositing any company checks in a personal bank account.

✓ Try to have employees bonded – at a minimum, those handling cash-sensitive transactions and involved directly with cash.

✓ Perform extensive background checks, and always phone a potential employee's references.

✓ Make it known that your door is open. You might offer small loans to employees that they can repay through payroll

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Nonprofit expenses: Correct coding prevents problems

By guest columnist Cesar Mejia, CPA, with Sol Schwartz & Associates, P.C., a CPAmerica International member firm

Failing to categorize or allocate expenses properly is a common accounting mistake some nonprofits make.

A nonprofit organization's expenses can be broadly categorized as expenses for program services and for supporting services. Expenses can also be classified by a natural or a functional classification.

Natural and functional classification of expenses

Expenses classified by their natural classification provide information about the type of expense incurred, such as salaries, rent, supplies, etc. Conversely, expenses classified by their function provide information about the purpose of the expenses.

The primary functional classifications are program services and supporting services. Basically, a functional expense tells us why money was spent instead of what it was spent on.

Program service expenses

Program service expenses include costs of activities related to the purpose of the organization. For example, a nonprofit whose purpose is to feed the homeless would include food and food preparation costs under program service expenses.

Supporting services expenses

Supporting services expenses are costs for activities not directly related to the purpose of the organization. Using the previous example of the nonprofit whose purpose is to feed the homeless, supporting expenses may include costs for the governing board or accounting fees.

Supporting service expenses are broadly categorized as:

Management and general – relates to the overall direction of the nonprofit organization

Fundraising – relates to costs associated with requests for monetary funding

Membership development – relates to membership dues, solicitation of new members and similar expenses

Cost allocation between functions

While some costs can be identified to a specific program, others cannot. Expenses that relate to more than one function should be allocated between the pertinent functions.

When allocating expenses between functions, the organization should apply a reasonable method. It's important that the basis for allocating expenses between functions be consistent from period to period to ensure comparability, but changes can be made to the basis for allocation if needed.

The use of estimates is permitted when allocating expenses. The method used to allocate expenses may vary depending on the actual expense being allocated. For example, occupancy expenses – such as rent and depreciation – can be allocated based on the square footage of space occupied by each program and supporting service.

Another example would be employees who spend half their time on strictly administrative functions and the other half on the purpose of the organization. Those employees' salaries and benefits should be split evenly between program services and management and general functions.

Functional expense reporting

Accounting literature requires all nonprofit organizations to provide information about expenses reported by their functional classification. The information may be presented either in the notes to the financial statements or on the statement of activities.

Accounting literature also requires all voluntary health and welfare organizations to include a Statement of Functional Expenses in their financial statements. While the Statement of Functional Expenses is not required for other nonprofit organizations, it is recommended. Functional expenses are also reported on an organization's IRS Form 990.

Common accounting mistakes to avoid

All money coming in and out of your organization must be assigned to the appropriate category. Proper assignment is particularly important if you accept donations that may be earmarked for certain projects or programs.

The following are common allocation errors that organizations make:

- ✓ Classifying all expenses as program expenses
- ✓ Failing to allocate personnel or occupancy expenses between the appropriate functions
- ✓ Reporting significant contribution revenue but little or no fundraising expenses

Outside reliance on functional expense reporting

Many nonprofits rely on outside contributions and grants. In deciding which nonprofit to donate their money to, some benefactors place reliance on financial indicators, many of which are based on reported functional expenses.

Two commonly used financial indicators are:

Program-spending ratio – total program expenses divided by total expenses

Fundraising-efficiency ratio – fundraising costs divided by total contributions

Providing inaccurate financial information to grantors and donors may hinder an organization's possibilities of receiving the financial support requested. ▮

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deduction. If they are in financial distress, this option can reduce the pressure and rationalization to commit fraud.

✓ Require employees to sign an annually updated fraud policy statement. It should emphasize that fraud will not be tolerated and will be prosecuted to the fullest extent of the law.

✓ State that any fraudulent act witnessed by another employee should be reported immediately. Build a culture in which an employee who is aware of unreported fraud will be viewed in the same light as the person who committed the fraud.

These and other actions can prevent or, at the very minimum, significantly reduce your business's fraud risk. ▮

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failure to perform the required management assessments – along with management instructions to practitioners not to perform the assessments– results in financial statements that include a departure from U.S. GAAP requirements.

This conclusion is significant: Practitioners do not need to consider the failure by management to perform the required assessments to fall under the umbrella of refusing to provide information to practitioners or a scope limitation, either of which would result in the default requirement for practitioners to withdraw from either compilation or review engagements.

With the conclusion, practitioners should consider whether modification of their compilation or review reports would be adequate to disclose the departures, as discussed earlier.

The TPA guidance includes illustrative report wording that should be helpful to practitioners. It addresses the frequently encountered issue in which management does not perform the required assessments needed to determine whether VIEs need to be consolidated.

Management of reporting entities can expect report wording similar to the following:

> *Accounting principles generally accepted in the United States of America require management to assess whether the Corporation has a controlling interest in any entities in which the Corporation has a variable interest in order to determine if those entities should be consolidated. Management has not performed the required assessment and, therefore, if there are variable interest entities for which the Corporation is the primary beneficiary, has not consolidated those entities. Although the effects on the financial statements of the failure to perform the required assessment have not been determined, many elements in the financial statements would have been materially affected had management determined that the Corporation is the primary beneficiary of any variable interest entities.*

Practitioners need to understand their obligations in this reporting arena when they compile or review financial statements. And, the hope is that the management of reporting entities will benefit from understanding this issue by knowing how reports received from practitioners will be written. ∎

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