Education Advisor

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SAS 99: Consideration of Fraud in a Financial Statement Audit And the Fraud Triangle

By Christopher P. Stenmon, CPA, MST

Happy Birthday SAS 99! This October, auditors all around the United States will be celebrating the 20th year since this statement was issued. Well, "celebrating" might be a slight stretch but I must admit that it makes me feel a little old knowing I have been doing this work at the same firm for more than twenty-five years. I remember attending seminars and working through our firm's training and implementation of this standard like it was just yesterday.

Since then, the following six items are required to be addressed and documented in our workpapers for all financial statement audits:

- How and when the brainstorming session occurred and what members of the audit team participated
- Which procedures were performed to obtain the information to identify and assess fraud risk (questionnaires, checklists, etc.)
- What specific risks of material misstatement occurred due to fraud and the auditor's response to those risks
- What were the results of the procedures performed to address the risk of management override of controls
- Which conditions and analytical procedures led to additional audit procedures
- What were the nature of communications about fraud made to management and others (for example Audit Committee or other Board members, etc.)

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FASB Lease Standard

By Steven J. Cohen, CPA, CGFM

Overview
Beginning for financial statements with year ends after December 15, 2021, the Financial Accounting Standards Board (FASB) will require not-for profit entities to implement the new lease standard (known as Accounting Standards Codification Topic 842, Leases). This translates to the year ending June 30, 2023 for June year ends and December 31, 2022 for calendar year ends.

Previous to the implementation of the new lease standard, capital leases are capitalized on the balance sheet, while operation leases are not capitalized on the balance sheet, but rather disclosed in the notes to the financial statements. Many users of financial statements believed that not having operating leases capitalized on the balance sheet makes financial statements analysis to be difficult.

In response to the concerns of those users of the financial statements, the new lease standard was established. The purpose of new lease standard is to increase transparency and comparability of financial information by recognizing virtually all leases on the balance sheet.

Definition of Lease
Under the new lease standard, the definition of a lease is "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

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SAS 99 *(continued)*

I believe that these audit procedures and audit processes have helped to keep some frauds from occurring. However, technology has changed over these twenty years and the sophistication of frauds have become difficult to uncover.

Some Frauds Still Can Occur Even With A Well Planned Audit and Good Internal Controls

Anyone reading this article has heard of the Bermuda Triangle and even though it may have been a long time ago, we learned about different types of triangles in high school geometry. But have you heard of the fraud triangle? From a very young age, we learned that triangles have three sides.

In the fraud triangle, the three sides represent the following:

- opportunity
- motivation
- rationalization.

As auditors, we understand that you cannot have a 100% accurate method for preventing fraud from occurring. However, your organization can work to minimize the risk on each side of the triangle which could significantly reduce the threat of fraud occurrence.

Opportunity can be greatly reduced by having good internal controls in place. I always remember the simplest way to explain this is by comparing it to securing one's own important possessions. Do you lock your door every night? Do you lock your car every night? If not, you are creating the opportunity for someone to commit a fraud.

Motivation is the pressure or incentive to commit fraud. When an individual feels motivated, they do things one would never think possible. Over the years, fraud cases I have read about involved pressures due to a family illness, drugs or alcohol, gambling, and foreclosure or eviction. These are the frauds that are more difficult for outsiders to find, but they are ones that are more likely discovered by your own employees.

What best practices can organizations have in place to help to reduce the motivation to commit fraud? From my experience, organizations that foster a healthy work environment, have good communication, which includes a strong "tone at the top", and pay their employees fairly are the most successful at minimizing motivations to commit fraud.

Rationalization is the ability for an individual to convince oneself that their wrongful actions are ok. Getting to this point at a company usually would take some time. When was that person was hired? Did they have an employee handbook that discussed the importance of honesty and high ethical standards? Does the company have a mission statement or company wide values that are shared at all levels? Do they have good internal controls to prevent an employee from "borrowing" from the petty cash drawer?

In May 2022, the inflation rate hit a forty-year high. Economists are predicting a recession. There is so much uncertainty in the world. With these factors in play, I predict individuals committing frauds will be on the rise. If you have any concerns about the internal controls within your organization, please contact our office.

FASB Lease Standard (continued)

FASB defines control of a leased asset when both of the following occurs:

- *The right to obtain substantially all of the economic benefit from use of the identified asset*
- *The right to direct the use of the identified asset*

An entity shall apply lease accounting for arrangements that meets the above definition unless it meets one the following exceptions.

- *Leases of intangible assets, minerals, oil, natural gas, biological assets, timber, inventory and assets under construction.*
- *Short-term leases – a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.*
- *A reasonable capitalization threshold – similar to fixed assets, management can determine that recognizing the lease would not be material to the entity's financial statements.*

Why it is important?

- *Recognizing the new lease standard properly will be important to earn a clean audit opinion under generally accepted accounting principles.*
- *The change to lease accounting can affect key financial ratios, such as the current ratio and debt service coverage ratio, that could be tied to loan covenants.*
- *The new lease standard will have an effect on the financial responsibility supplemental information required by the Department of Education.*

Financing vs. Operating Leases

The new lease standard creates two different types of leases: financing leases and operating leases.

Finance leases – to be considered a finance lease, at least one criterion must be met at the lease commencement date:

- *The leased asset is transferred to the lessee on or before the end of the lease term*
- *The lessee has an option to purchase the leased asset, and it is reasonably certain that the option will be exercised*
- *The lease term is for the major part of the remaining economic life of the underlying asset*
- *The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the leased asset*
- *The leased asset is of such specialized nature that there is no alternative use to the lessor after the lease is completed*

Operating leases – an operating lease is any lease that is not a finance lease.

Lessee Accounting
Lessees will recognize a right of use (ROU) asset and a corresponding lease liability. The liability will initially be measured at the present value of the remaining lease payments (including the exercise price of an option to purchase the leased asset if it reasonably certain for this event to occur) using a proper discount rate. The discount rate should be the rate implicit in the lease arrangement. If the discount rate is not known, the Company can use their incremental borrowing rate or the risk-free rate.

The initial ROU asset is the lease liability, lease payments made to the lessor before the lease's commencement date, direct costs that the lessee incurred, and lease incentives made by the lessor.

Lessor Accounting
The initial accounting for lessors is more complicated.
If the lease is operating, the entity will continue to recognize the leased asset. Lease income will generally be recognized on a straight-line basis over the lease term.

If the lease is financing, the lessor will de-recognize the leased asset and recognize the net investment in the lease. The corresponding credit will be recognizing a portion to interest income and an implied selling profit that will either be recognized immediately or over the lease depending on several factors.

Recommendations

- *Assign a team leader to be responsible for implementation*
  - *The leader should define the issues related to implementation, resources needed to complete the lease review, and timeline for completion*
- *Determine capitalization thresholds*
  - *Consideration of quantitative and non-quantitative factors*
  - *Should be evaluated on the gross lease asset and liability, rather than the net of those two figures*
- *Identification of possible leases*
  - *Discussion with personnel from other departments*
  - *Review of frequent disbursements to the same vendor as this may indicate a lease*
- *Document your lease conclusions for each arrangement*
  - *Why the arrangement is or is not a lease*
  - *Key variables in the lease determination such as lease term, payments, discount rate, incentives, renewals and option to purchase the asset*
- *Discussion with your financial institutions since lease implementation could have an impact on debt covenants*
- *Calculation of needed information*
  - *Purchase of lease software*
  - *Excel spreadsheet*

This discussion is a summary of a very difficult standard to implement. Please contact your O'Connor & Drew representative or me with additional guidance.

Onboarding in a Hybrid World

By Michelle Anderson, PHR, SHRM-CP

The week leading up to an employee's first day can set the tone for the employment relationship. This leads to a number of questions that need to be answered to ensure a smooth transition to their new company. Have they received a link to all their new hire documents? Do they know the agenda for their first day? What time should they arrive, and will they have the correct I-9 documentation? Should they bring a lunch, or will they be taken out by members of their new team? Starting a new job can be stressful and full of unknowns, but if you take the time to address those simple but important questions, the new employee will see that you are already putting the work into making them feel comfortable.

In the new hybrid or remote world, half the team is only in the office a couple of days per week, if at all. What happens when half the new team is remote or the employee lives three hours away? We have found that having an employee come in for their first day does make for a positive experience for everyone. They have a desk with a name plate among their coworkers, which immediately makes them feel like a part of the company, even if they only come in one day a week. When we gather a small group of people to take them to lunch and get to know them, it makes it easier for them to come into the office and learn where to find certain people.

Being a remote employee does not mean that you are going to become increasingly disconnected from the rest of the company. Some people thrive in a remote environment and have no problem meeting everyone virtually. I have several employees I've never met in-person and actually find it easier to just call them through Teams whenever needed, because that's the relationship we have. I am not going to wait until they are in the office tomorrow just to have a face-to-face conversation with them when I can have a virtual conversation right now! With secure technology, onboarding employees is not much different virtually than in-person. You can share screens, view a presentation and pre-record training so it's both standardized and customized for each new employee. Technology allows for a more efficient use of time for all involved.

The most important thing you want to accomplish in your onboarding is making sure the employees know where to get their questions answered. Make sure they have met with a member from key departments, such as IT and HR, as well as members of their own department. I find it's helpful to have a point person who they know they can reach out to anytime. We understand they can't be expected to remember everything they were told during their first couple of weeks. Having this designated point person allows them to always know where to go.

At one point or another, whether it was a first job or a recent change within a long and successful career, we've all been the new person in a company. We all know it can be difficult finding your place within an established firm, so the next time someone knocks on your door or sends you an email with a simple question, please think twice before brushing them aside because you have too many things on your plate. The few minutes you take can make a lasting impression on a new employee and send them off with a positive message that they just may wind up passing along to someone else on the future.