Recognizing the Red Flags of a Ponzi Scheme

Plus
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Recognizing the Red Flags of a Ponzi Scheme: Will You Be Blamed for Not Heeding the Warning Signs?

By Sandra S. Benson

Even after Bernard L. Madoff pleaded guilty to operating a $65 billion Ponzi scheme, the fallout continues to spread, not only to direct investors but also to the auditors of funds that invested with Madoff. Investors in numerous funds were "fed" to Madoff, in some cases allegedly without the knowledge that Madoff was going to manage much or all of the funds. Now, investors are looking to the auditors of these funds for answers—in the form of class-action lawsuits. This should serve as a wake-up call to the profession. What can accountants do to protect themselves and their clients from the far-reaching effects of Ponzi schemes in the future?
The Human Side of IFRS

By G. Stevenson Smith and C. W. Von Bergen

The ongoing-convergence of U.S. GAAP with International Financial Reporting Standards (IFRS) will have a profound effect on the accounting profession. The upcoming changes will require more probing and extensive inquiries to reduce ambiguity and uncertainty in financial statement audits where the number of "bright-line" rules has been reduced. Highly valued accounting character traits that have worked well in a regulated environment—such as attention to detail and adherence to clear rules—may need to be reevaluated as changes are made from the rules-based U.S. GAAP to the principles-based IFRS.

U.S. Move to IFRS

The continued globalization of the world's economy has resulted in the adoption of IFRS by nearly 100 countries, including five G-8 countries, with plans for adoption by a number of others. IFRS is being considered for adoption in the United States by 2014.

In formulating IFRS, the International Accounting Standards Board (IASB) chose not to use the detailed rules-based approach found in U.S. GAAP. For example, U.S. GAAP requires that a capital lease be recognized when the lease term is equal to or greater than 75% of the asset's economic life (SFAS 13, Accounting for Leases), while IFRS guidelines only require such treatment when the lease term is a "major part" of the asset's economic life [International Accounting Standard (IAS) 17, Leases]. Under IASB standards, management may argue that the lease is not a capital lease, but instead an operating lease, even when the lease term is more than 75% of the asset's life due to contractual asset renewals and replacements. The meaning of "major part" is decided by the auditor. In IAS 17, there is no "90% rule" with regard to the present value of the minimum lease payments as found in SFAS 13. Under IAS 17, the auditor must interpret "substantially all" with regard to the present value of the minimum lease payments. Such differences create the need for increased background information to eliminate ambiguity in deciding whether a lease is an operating lease or capital lease. In order to make such a decision, the economic effects of a lease on company operations are examined, rather than a specific percentage cutoff being used. These economic effects can only be evaluated with more disclosures about business activities that would not have been as important under rules-based standards.

Additionally, deferred taxes under U.S. GAAP are recognized in full (SFAS 109, Accounting for Income Taxes), whereas
under IFRS guidelines, they are recognized when it is "more likely than not" that they will be realized (IAS 12, *Income Taxes*). This criterion requires more judgment from the auditor than simply recognizing all deferred taxes. Thus, the auditor’s judgment of the economic conditions facing the company becomes more important under IFRS. Effective auditor decision making requires the company to provide more information to meet the IFRS’s "more likely than not" criteria.

The transition to IFRS will require accounting firms to deal with adapting human resources to this new work environment. Such changes may be more daunting than other recent changes the profession has faced.

**What Is the Origin of the Rules-Based Accounting System?**

Rules-based approaches slowly developed over the decades by accounting and auditing standards-setting bodies. The result is a detailed set of rules that are used to cover almost every recognized or developing accounting problem and transaction. This approach was not always practiced. At one time, it was believed the subjective nature of accounting made the judgment of the accountant superior to a set of detailed rules for recording complex transactions. George May, a leading accounting practitioner during the first half of the 20th century, believed that the substance of the accounts often varied with the reason they were established. May stated that "no amount of standardization will either a) make an understanding of the nature of accounting process less necessary to a proper interpretation of such determinations; or b) convert those determinations into findings of fact." May’s arguments were not successful in influencing the direction taken by the accounting profession, and the application of U.S. GAAP and GAAS changed from a principles-based approach relying on the judgment of the accountant into a set of detailed prescriptions.

**Approaches to Client Interactions**

For decades, auditors have had to face clients who try to structure transactions to specifically meet U.S. GAAP rules regardless of the underlying substance of the transaction. Soon, attempts at transaction structuring to meet technical rule criteria will be replaced by an evaluation of the underlying economic nature of a business transaction. A business will not be able to use a rule as leverage against the auditor’s judgment. Under U.S. GAAP, management could claim, “the transaction meets the rule’s criteria, so what are you worried about?” Without the detailed rules found in U.S. GAAP, the level of uncertainty attached to properly recording a transaction is likely to increase, and the chances of auditor-client disagreements may also increase as less defined standards are applied. Such disagreements may arise from the need for more extensive disclosures of corporate activities that allow auditors to apply their judgment regarding the true nature of economic events. In following a rule, such supplemental disclosures about future business events and private contractual relationships may not have been as critical in making a determination about a transaction.

Accounting choices will be directly tied to the economic impact of the business transaction rather than the rule. Instead of tactically applying a rule, it will be...
necessary to adopt strategic financial perspectives and apply an in-depth understanding of relationships between accounting concepts and economic issues.

**Value-Added Personality Attributes**

According to the FASB, the main differences between IFRS-based accounting standards and principles-based standards are that principles are broad and there is less guidance on implementation. Such differences suggest that personal attributes that were once highly sought after in accountants may no longer be as important.

If a work environment remains relatively unchanged, it is likely that new employees similar to current employees will be hired and become successful. In a more dynamic work setting, such as the one presented by the move from rules-based to principles-based accounting systems, employers may reconsider which attributes are desirable in new hires. Although intellectual and cognitive skills will remain important, certain other personal traits will need to be reevaluated for their importance in a principles-based environment.

**EXHIBIT 2**

**Logical Application of Broad Standards**

Employees should receive training in IFRS and learn how to use the principles in specific situations. This is essentially a deductive learning approach following the principles advocated here. Particular emphasis should be placed on the application of broad standards to specific accounting and auditing events. The importance of judgment and the use of personality traits that lead to logical decision making in a principles-based environment should be illustrated.

**Using a New Approach**

Accountants should be trained in how to persuasively respond to clients who aggressively say: "Show me in the rules where it says I can’t do that," or "Why do you need that information?" With fewer rules and more judgment required, accountants, especially junior-level professionals, must be able to competently and vigorously respond to such statements without alienating a client.

**Follow More than Rules**

Accounting personnel must recognize the meaning of truthful presentation. Training should emphasize that fair presentation, in all economic respects, is to be certified, not fair presentation with U.S. GAAP in all material respects. This is clearly a requirement to do more than follow rules. It is the beginning of a fundamental attitude shift.

**Training should highlight the enhancement of personality traits that may have remained unused in traditional rules-based accounting environment**

**Value-Added Training**

In addition to addressing new hiring criteria, employers that effectively adjust to these changes must implement training programs that give workers guidance on how to successfully operate in the new environment. Such training goes beyond the technical training needed to understand new accounting standards.

Training for a principles-based work environment should include learning how to apply strategic judgment to identify the substance of economic events without the guidance of bright-line accounting standards. In order to apply longer-ranged perspectives, information acquisition techniques need to be redirected to investigations of corporate economic risks. This is a much broader perspective than one narrowly focused on specific accounting rules.

Training should highlight the enhancement of personality traits that may have remained unused in a traditional rules-based accounting environment, such as the ability to deal with restructured client arguments for recording business events. Training and development programs should focus on the attributes outlined in Exhibit 2.

**The Role of Accounting Education**

Without question, a university accounting education has a significant role to play in preparing a new cadre of accounting graduates. Although accounting educators have explored ways in which the curriculum should cover IFRS guidelines, few accounting programs have actually incorporated IFRS material; according to recent surveys. Even fewer accounting educators have considered that the presentation of IFRS material will need to take a stonger critical-thinking approach than is practiced today, when the FASB's bright-line rules are studied in the classroom. To deal with these changes, teaching methodologies may require the use of case studies that provide for real uncertainty in finding solutions. The problems of how to adjust presentations and how to incorporate IFRS and FASB materials into an already crowded curriculum have yet to be solved.

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