By Stephen Barlas, Dennis Beresford, Gordie Brenne, Mike Osheroff, Kathy Williams

GOVERNMENT

Obama Budget Lowers Boom on Business

By Stephen Barlas, Editor

President Obama's proposed budget for fiscal year 2010 (starting October 1, 2009) lowers the boom on business taxes, and groups such as the National Association of Manufacturers (NAM) are ticked off about it. This budget imposes $353.5 billion of new business taxes (over 10 years, which is true of all dollar figures that follow). Some of those taxes would affect all companies, while other provisions are more focused, such as those that touch only oil and natural gas producers. About $210 billion of the total includes increases that Obama described broadly, without details, in the areas of international tax enforcement, general "tax reform," and elimination of the current deferral of taxes on profits made overseas. Given that huge haul of additional tax revenue, companies may not be totally assuaged by the fact that the President endorses a net operating loss (NOL) carryback proposal aimed at large corporations. That proposal had been part of the economic stimulus package, but there the House and Senate targeted it at companies with gross receipts in any year of less than $15 million. Obama would also make the research and development tax credit permanent.

Dorothy Coleman, vice president of tax and domestic economic policy for the NAM, says the $210 billion figure is "of extreme concern." She adds, "It looks to us like it will hit multinationals, and that is very disturbing." She also criticizes Obama's intention to eliminate Last-In, First Out (LIFO) accounting, forecast to raise $61 billion. While Coleman thinks the full NOL proposal is very positive, it doesn't come close to outweighing the negative aspects of the President's business tax proposal, she emphasizes.

GOVERNMENT

Taxing All Corporate Income

Here's an issue many corporate treasurers and accountants haven't heard about. Not only is Congress likely to increase taxes on the corporate income that the IRS is aware of, but there's a likelihood that Congress will also give the IRS a new tool with which to ensure that companies are reporting all income they receive. Look for a proposal this year to require small businesses who file 1099-MISC forms—reporting payments they have made to independent contractors and others—to also file 1099-MISCs for payments made to corporations. Those payments are currently exempt, but the Government Accountability Office (GAO) has reported over the years that it would be easier for the IRS to ensure corporations are paying their fair share of taxes if the IRS had 1099-MISCs for payments to corporations. The latest GAO report, hitting the same notes as previous ones, landed in the Senate Finance Committee in February. The Bush administration had asked Congress to require 1099-MISC reporting for payments to corporations as part of its fiscal 2008 and 2009 budget proposals, but it demurred then. Now facing a $1.5 trillion deficit, Congress may be much more amenable to helping the IRS identify unreported corporate income.

SFbulletin

CDS Bill Moves Forward

Last month I mentioned Congress's apparent determination to regulate credit default swaps (CDS), the most politically volatile derivative because of its role in the AIG debacle. Congressional regulation of CDS could have some significant impact on corporate sales of debt and company use of those swaps to protect themselves from defaulting suppliers. The House Agriculture Committee took the first step toward regulation on February 13 when it passed a bill (H.R. 977) that would require all CDS traded outside an exchange to be processed through a central clearinghouse regulated by the Commodity Futures Trading Commission (CFTC) or the Securities & Exchange Commission (SEC). The CFTC or SEC will also be able to suspend trading in CDS with the President's approval, but only in situations where the SEC has suspended short-selling in the underlying securities.

A Bad Accounting Rule

I think Curt Verschoor's January article ("Does the Fraud Triangle Apply to the Credit Crisis?") misses a key cause. Citi used FAS 140 to move $1.2 trillion in CDOs backed by mortgage securities off their balance sheet. Ironically, the FAS 140 rule was the product of a new standard-setting process under SOX.

As the saying goes, everything changes and everything stays the same. An earlier version of this standard had a 3% rule that was exploited to create Enron's Special Purpose Entities. The current FAS 140 has the Section 9(c) loophole, or 10% rule, that was aggressively exploited by Citi and other key players in the subprime crisis to move mortgage-backed securities off balance sheets after selling just 10% to outsiders. Citi did this right under the nose of their regulator, the Federal Reserve, and thereby avoided banking reserve requirements on this debt.

I suggest this is not ethics, but bad accounting policy. FYI, this lousy policy was the result of heavy lobbying by the financial industry, which said that a higher (say 51% is common sense) rule would inhibit capital formation. Guess we know the truth now. This was not bad ethics but a bad accounting standard.

—Gordie Brenne, CMA

No More Cheap Shots

The "SF bulletin" in the February issue quotes an anonymous "Washington insider" making some very disparaging comments about Conrad Hewitt, former Chief Accountant of the SEC. Mr. Hewitt recently completed over two years of service as Chief Accountant during which the Commission oversaw a significant refinement of the internal control reporting rules per Sarbanes-Oxley Section 404, undertook and completed a major study to improve financial reporting, adopted required XBRL reporting, developed a proposed roadmap for the adoption of international accounting standards, and dealt with the accounting for many aspects of one of the most disruptive economic periods in history. In short, Mr. Hewitt served with great distinction in the position that is arguably the most important accounting job in the world.

Discrediting his excellent performance with such cheap shots from unnamed sources is the worst kind of muckraking journalism. I would have hoped that these kinds of comments would be reserved for weekly gossip magazines or the like and not a professional journal like *Strategic Finance*.

—Dennis R. Beresford, CMA, CFM, CPA
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(Editor's Note: Thanks for pointing this out, and we will definitely be more careful in the future.)

We welcome all opinions on articles and departments published in *Strategic Finance*.
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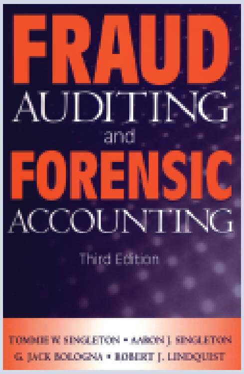
BOOKS

The Fraud Auditor

In *Fraud Auditing and Forensic Accounting*, authors Tommie G. Singleton, Aaron J. Singleton, G. Jack Bologna, and Robert J. Lindquist look at the expanded scope that fraud and other white collar crimes have taken on in the business landscape, attributed in part to the pervasiveness of computerized accounting systems, the World Wide Web, the occurrence of large-scale frauds such as Enron and WorldCom, and the Sarbanes-Oxley Act (SOX), which requires financial accountants to provide a new level of assertion as to the veracity of a company's financial records. As the authors point out, fraud cost the economy $684 billion in 2004 alone, 20 times more than the losses caused by street crime. They go on to describe the role of fraud auditors and forensic accountants, including how the job differs from a typical accountant's role. For example, while a financial accountant certifies that financial statements conform to Generally Accepted Accounting Principles (GAAP), the fraud auditor and forensic accountant ensure that employees and managers account for assets and liabilities properly (and provide physical evidence thereof) and that appropriate accounting procedures are followed.

A key theme is how fraud auditors deal heavily with certifying the use of internal controls. Firms subject to SOX requirements must provide proof of the existence of internal controls, and top management must sign off on the financial auditor's verification, but the existence of a set of internal controls doesn't mean that these controls are followed 100% of the time. Indeed, while a financial auditor may not examine a particular transaction due to immaterial limitations, sampling methods, or infrequent occurrence, a fraud auditor may have a field day discovering impropriety in the accounting treatment.



A fraud auditor often finds deviations from a good internal control system by examining the audit trail of random transactions or, thanks to computerization, all such transactions made. The fraud auditor must be part accountant, part detective, part lawyer, and entirely professional. Successful prosecution of fraud requires the fraud accountant to prove the approximate amount of the loss and identify those responsible. Consequently, the fraud auditor must have accounting and investigative skills.

The authors devote much of their book to describing a framework for fraud auditing and forensic accounting that relies on the extensive use of tables of methodology largely based on information about the various transactions that flow through a firm. The reason they go to such length to develop the methodology is because prosecution of fraudulent activity must be presented to a jury of nonaccountants. It requires a structured examination in lay terms and is subject to cross-examination by a defendant's lawyer, who also has accounting experts to call on. The fraud auditor's job is to show beyond a reasonable doubt that fraud occurred, how much, and by whom. Any missing or flawed piece of evidence or poorly presented technique of investigation can result in a mistrial or acquittal.

SOX Section 404 may have made top management ultimately responsible for ensuring the existence of adequate internal controls, but fraud auditing and forensic accounting guarantee their application. The fraud auditor and forensic accountant must not only have good accounting skills to navigate a client's accounting system, but they also must have investigative skills to understand an employee's motivation to commit fraud in the daily course of handling business transactions. To a degree only touched on in the book, every accountant should exercise fraud auditing and forensic accounting skills in his/her daily work. It's far easier to discover employee or other stakeholder fraud while it's happening than after the fact, when the loss may indeed be material and the perpetrator long gone from the firm.—*Mike Osheroff*, osheroff@wa-net.com