Fine-Tuning Financial Reporting

Views from Regulators and the Profession

Plus
• Options Under IFRS
• Audit Fees and Ethics
• Mandatory Partner Rotation
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Not insured by us? Give CAMICO a call, and we can start the conversation about lowering your risk — and easing your heartburn — today.

See a video of Ron Klein talking about how CPAs can best handle disengagements at www.camico.com/disengage
44 Accounting & Auditing
International Accounting
Accounting Policy Options in IFRS: Weighing the Choices Upon First-Time Adoption
By Eva K. Jermakowicz and Barry Jay Epstein

Accounting
Accounting for Stock Options: A Comparative Simulation for Straight-Line and Graded Vesting Attributions Methods
By David G. DeBoskey and Kevin M. Lightner

54 Taxation
Federal Taxation
Revenue Procedure 2010-13 Provides Guidance for Passive Activity Groupings
By Robert S. Barnett

56 Finance
Banking
Cultural Aspects of Credit Risk Management: A Lesson from the Microfinance Industry
By Rahnuma Ahsan

60 Management
Practice Management
Reducing the Potential Negative Effects of Mandatory Partner Rotation
By Brian Daugherty, Denise Dickins, and Julia Higgs

64 Responsibilities & Leadership
Ethics
Audit Fees and Engagement Profitability: An Approach to Strengthen Compliance with Standards of Ethical Behavior
By Raymond N. Johnson and Gaylen R. Hansen

68 Technology
The CPA & the Computer
By August A. Saibeni

What to Bookmark
Website of the Month: Global Corporate Governance Forum
By Susan B. Anders
Fine-Tuning Financial Reporting: Views from Regulators and the Profession

On May 5, 2011, Baruch College’s Robert Zicklin Center for Corporate Integrity held its 10th Annual Financial Reporting Conference, bringing together a collection of regulators, preparers, auditors, and users to discuss the state of financial reporting. Featured speakers were FASB Chairman Leslie Seidman, SEC Chief Accountant James Kroeker, and PCAOB Chairman James Doty. Four panel discussions covered the following: current issues at the SEC, accounting for financial instruments, developments impacting the private sector, and new models for revenue recognition and leases.
The CPA Journal welcomes the submission of articles on a wide variety of topics of interest to CPAs in public practice, industry, education, and government. Articles are evaluated on the basis of the clarity of ideas and writing, contribution to the profession, relevance, benefit to practitioners, and soundness of point of view. Manuscripts deemed to have potential for publication are reviewed by two referees prior to acceptance for publication. See www.cpaj.com/guidelines.htm for more detailed information.

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Profile of Jacob K. Lasser

New York CPA and a Famous Name in Tax Guides

By Dale L. Flesher and Tonya K. Flesher

Now entering its 71st year, J.K. Lasser’s Your Income Tax is America’s best-selling tax guide for the general population. The book was first written by Jacob Kay Lasser, whose legacy lives on today through his books, the tax institutes he founded, and the J.K. Lasser Institute. Lasser was more than just a writer of guidebooks; he was also a respected and honored professional CPA who was active in both the AICPA and the NYSSCPA.

History of a Classic

During the late 1930s, Simon & Schuster Inc. encouraged two business authors to write highly successful books: Dale Carnegie’s How to Win Friends and Influence People and J.K. Lasser’s Your Income Tax. When Lasser first published his handbook in 1939, it soon became a bestseller. That first volume sold 23,000 copies, which was a meaningful number during the closing days of the Great Depression when there was not yet the mass tax that originated during World War II. At that time, only about 6% of the American population even paid taxes. Lasser revised the volume annually for the remainder of his life. The 1946 edition, which followed the increase in the tax rolls brought about during World War II, sold 7 million copies, and Lasser became the best-known tax accountant in the country. A companion volume, Your Corporation Tax, was started in 1941. The timing of the publication of these volumes was ideal, because the World War II tax policy had changed the income tax from a “class tax” to a “mass tax,” and most Americans were now looking for legal methods of avoiding the highly progressive income tax. On January 11, 1943, Lasser addressed the NYSSCPA’s meeting on federal taxation at the Waldorf-Astoria Hotel and commented, “We have had a great many drastic changes in our tax laws. … Fundamentally, these changes look like the tax man’s paradise.” While these changes were a boon to tax preparers, they came at a time when the profession was ill-equipped to take on large volumes of additional work because of critical manpower shortages. The complexity brought about by frequent changes in the tax laws may have appeared to be “a tax man’s paradise” to Lasser, but it had turned into a nightmare for the average citizen and was approaching a level of complexity that even accounting experts could not tolerate. As a result, Lasser’s tax guides became bestsellers.

Lasser had long been viewed as a tax expert even before he became a household name. Prior to his 1946 bestseller, Lasser had been selected as the “expert” to write the tax materials for the very first continuing professional education (CPE) course published by the American Institute of Accountants—a volume designed to reacquaint returning soldiers to the profession that they had been away from for up to four years. That volume, Contemporary Accounting, was edited by Thomas W. Leland of Texas A&M University, with authors selected from the best-known experts in the country (John L. Carey, The Rise of the Accounting Profession to Responsibility and Authority: 1937–1969, AICPA, 1970).

In addition to his writing, Lasser’s speeches about taxes throughout the nation appeared with tax tips on early television programs. The State of Vermont even asked him to develop a simplified income tax law for that state.

(Profile of Jacob K. Lasser (Continues on page 8)
Twelve years ago, the NYSSCPA Board of Directors voted to support the Uniform Accountancy Act (UAA), model legislation that would update the New York State law that regulates the practice of public accountancy through multiple provisions that affect almost every aspect of the profession: CPE, peer review, prelicensure experience, substantial equivalency, and CPA firm ownership. At the time, the state law had not been significantly updated in more than 50 years.

With the passage of UAA section 23 mobility earlier this year by the New York State Legislature (as of press time, the governor has not yet signed the bill into law), and the passage of the accountancy reform law in 2008, almost every provision that the Society board voted to support at that meeting 12 years ago—albeit with some modifications to that position over time—will have been passed by the state legislature. The work may have been done piecemeal, but we accomplished what we set out to do. These legislative successes may not have been possible if not for another vote the board took at that same meeting—to endorse the formation of a political action committee (PAC), which would be known as CPAPAC, to participate in New York’s political process.

Some Society members may not be aware that the Society has a PAC or know what it does. That might be because the PAC is an organization separate from the NYSSCPA. While the NYSSCPA, as a 501(c)(6) organization, can lobby on its members’ behalf, a PAC cannot; however, it is one of the most important tools in our advocacy toolkit. The PAC has a separate set of bylaws and a board of trustees that includes a representative from each of the Society’s 15 chapters as well as the NYSSCPA president, president-elect, and immediate past president. The PAC has a sole purpose—to collect from members and CPA firms monetary donations that it will later distribute to the political campaign committees of New York elected officials or candidates who have been identified by the PAC trustees as supporters of the legislative goals of the NYSSCPA or who are in a position to promote the profession through legislation that protects the profession and the public trust. CPAPAC is truly nonpartisan. Contributions are never based on party affiliation; they are distributed only in places where the profession will ultimately benefit.

The Power of the PAC

In the past, I’ve spoken about the power of our collective voice as a CPA society. I have also asked you, our members, to think about what it means to be involved in your professional association. Contributing to CPAPAC is one of the ways to get involved. A single campaign contribution of $50 from a CPA to a political candidate does not make as much of an impact as a PAC that has a pool of $1.4 million to distribute to candidates, which is how much the PAC would have in its coffers if each of our 28,000 members donated $50 to it. Campaign contributions, including those to CPAPAC, are not tax deductible, but unlike individual donations to candidates, contributions that come directly from CPAPAC create a positive identification between NYSSCPA members and the candidate who receives that contribution. The strength of a PAC is directly related to its size. Imagine how strong we could be if we had just half of that $1.4 million in our PAC.

Unfortunately, contributions to CPAPAC dipped precipitously over the past several years, with donations down between 30% and 50% of previous levels. What will happen if donations to CPAPAC continue to decline? The answer is simple: Our influence in the political process in New York will wane. If you have contributed to CPAPAC in the past, have you done so this year?

While the current economic climate has led to a reduction in supplementary spending for many New Yorkers, a donation to CPAPAC should not be considered discretionary spending for Society members—it is essential to the empowerment of our profession in New York State. It is also important to know that a contribution to CPAPAC in no way duplicates any contributions to the AICPA’s PAC. While the Society may advocate for CPAs on a national level, CPAPAC contributions are put to work closer to home—the PAC’s focus is only on New York State legislators and statewide elected officers—governor, attorney general, and state comptroller. CPAPAC is clearly an important political tool—especially when paired with the Society’s other advocacy efforts—but only if we leverage the Society’s advocacy efforts with donations to the PAC. Make our voice heard in Albany: Donate to CPAPAC today via the contribution form available on the Society’s website at www.nysscpa.org/legislative/cpapacform.pdf. Your profession needs you.

Joanne S. Barry
Publisher, The CPA Journal
Executive Director, NYSSCPA
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(Continued from page 6)

which was subsequently adopted (J. K.
Lasser, “Tax Simplification in Vermont,”
62–66). These new Vermont tax laws more
closely conformed to federal income tax laws.

Personal Life

Lasser was born in Newark, New Jersey,
on October 7, 1896, the son of immigrants
from Austria-Hungary. While working as a
bookkeeper in a factory, he took night class-
ess in accounting at New York University
from 1915 to 1917. During World War I, he
served in the U.S. Navy on a submarine
chaser and then as petty officer who checked
war contracts. After the war, he enrolled at
Pennsylvania State University and earned an
undergraduate degree in mechanical engi-
neering in 1920 and a master’s degree in
industrial engineering in 1923. At his death
due to a heart attack at the age of 57, he was
survived by his wife, his mother, a son,
a daughter, and a sister (“J. K. Lasser
Dies: Expert on Taxes,” New York Times,
May 12, 1954).

Lasser was called “Yoc” by his friends,
and “his reading was prolific, and varied
beyond that of almost anyone I have known”
(Paul A. McGhee, “J. K. Lasser,
University’s 13th Annual Institute on Federal
Taxation, November 3, 1954). His work
for nonprofit groups is illustrated by his
efforts on behalf of many unrelated religious
organizations, including the American
Baptist Convention, the Board of Foreign
Missions of the Presbyterian Church, the
American Bible Society, the National
Council of the Churches of Christ in
America, and the Federation of Jewish
Philanthropies (McGhee 1954). He took a
special interest in colleges and universities,
giving advice about fund raising or helping
to establish a new program or educational
service. His volunteer service was extended
to the following schools, which were not his
clients: Bard College (as Trustee and
Treasurer), Berea College, Dartmouth,
Dickinson, Fairleigh-Dickinson, Loyola,
the University of Miami, the New School
for Social Research, NYU, Penn State, and
Pomona College (McGhee 1954).

Lasser was a pioneer in the development of the regional accounting firm
practice, and his firm developed a niche market with clientele from
New York’s publishing and printing industries.

Professional and Writing Career

Lasser had become a CPA in 1923
after having passed the examination in
1921 while on the staff of Touche, Niven
& Co. (now Deloitte) in New York.
Eventually, he was certified in New
York, New Jersey, Illinois, and California.
While working at Touche, Niven & Co.,
his tax knowledge was so widely recog-
nized that it was rumored that Lasser had
memorized the compendium of regulations
associated with the Revenue Act of 1916.
It was likely that this early exposure to
John Niven, the best-known tax expert in
the country and editor of the Journal of
Accountancy’s “Tax Clinic” column, was
what led Lasser into a career in taxation.

During a temporary leave from public
accounting, he started writing as a tax con-
sultant in 1922. It was during this period
that he became involved in a company’s
tax dispute with the Bureau of Internal
Revenue and further developed his tax
competencies (Paul J. Miranti and Leonard
Goodman. “Lasser, Jacob Kay,” American
National Biography, Oxford University
Press, 1999, p. 224). In 1923, Lasser
started his own firm at 1440 Broadway in
New York. Lasser was a pioneer in the
development of the regional accounting
firm practice, and his firm developed a
niche market with clientele from New
York’s publishing and printing industries
(Miranti and Goodman 1999).

When the NYSSCPA celebrated its 50th
anniversary in 1947, it was Lasser who was
asked to prepare an article on “The Growth
of Tax Accounting.” In the introduction,
Lasser noted that we have “a tax law
almost entirely based upon our account-
ing concepts; and a host of barnacles that
will always need attention.” The use of
the term “barnacles” is an apt description
of some of the differences between tax
accounting and GAAP. He concluded
that these differences provided “a lot of fun
for the strange breed in our group who burn
so much midnight oil with tax studies.”
The “barnacles” included such things as
prepaid rental income and other differences
with respect to treatment of accruals, many
of which had been previously outlined in
a Journal of Accountancy feature article
titled “Tax Accounting Incongruities”
(March 1947, pp. 221–228). As with
most of Lasser’s journal articles, the cen-
tennial piece was replete with lengthy
explanatory footnotes. Lasser was indeed
a scholar in the field, which he dubbed
“the science of taxation.” Lasser concluded his
anniversary article with a salute to some
of the tax researchers whom he admired:
And sheer fright (for fear of missing a
few) has prevented me from referring in
detail to the strange breed in our own
midst who devote nearly all their hours
to research in this field. For them I might
record that their labor has been enor-
maous. Their [contribution] to the public
welfare has been and is a continued
ornament to the profession.

Despite his “fear of missing a few,”
Lasser included a footnote wherein he did
pay tribute to those whose “perspiration
and intelligence in contributions to our
tax literature have added so much to our
professional standing.” The names he chose
to list included Robert H. Montgomery,
Joseph J. Klein, Walter A. Cooper,
Benjamin Harrow, Isidor Sack, Maurice
The man was a publishing machine, with taxation his primary field of endeavor. His annual tax volume is still published today through the auspices of the J. K. Lasser Institute.

Lasser had about 100 partners; Touche had annual domestic billings of an estimated $200 million and Lasser billed about $40 million annually. According to the Times, the merger “would catapult the firm from near the bottom of the list of the country’s largest accounting firms—known collectively as the Big Eight—to somewhere in the mid-
dle” (Rankin 1977). The merger moved Touche up to third place in size, behind Peat, Marwick, Mitchell & Co., and Arthur Andersen. The article called Touche Ross “one of the most aggressive and growth-oriented of the big accounting firms.” The merger was primarily designed to enable Touche Ross to grow and to become more involved in taxation; the two firms had offices primarily in the same cities. The merger resulted in no additional offices for Touche, except for one in Syracuse, N.Y. For its part, the managing partner of J. K. Lasser & Co., Herbert P. Stillman, indicated the reason for the merger was the cost pressures his firm faced in areas such as employee training, research and development, and insurance coverage. Stillman became a senior partner at Touche Ross and joined the combined firm’s board of directors and executive committee.

In addition to its strength in tax work, the Lasser firm was well respected in other areas of accounting as well. For example, executive office partner Arnold I. Levine was one of the seven members of the 1971–1972 Wheat Committee of the AICPA that recommended the creation of FASB. Levine was one of only three public accountants on the committee.

Critics from other firms quickly regarded the Touche acquisition as meaningless. One competitor, a managing partner at another Big Eight firm, stated, “The Lasser firm has been going downhill for years, and the competence of those people is very low. We wouldn’t touch them with a 10-foot pole” (Rankin 1978). There were also reportedly some objections to the merger within Touche Ross.

The Lasser firm was known for its strength in the field of tax services, despite the fact that it had no connection with the popular tax preparation book, J.K. Lasser’s Your Income Tax, taken over by the publishing house of John Wiley & Sons after Lasser’s death. The Lasser firm had in addition to its tax business also audited about 100 publicly held companies, including a large number in the media and communications field. This clientele provided Touche with a foothold in an industry wherein it was not already strong.

The long-term success of the Lasser merger with Touche Ross is subject to question. A 1984 New York Times article stated:

The last directory of Lasser partners published before the merger listed 158 partners, and 80 percent voted in favor of the merger, according to Public Accounting Report, an industry newsletter. A total of 144 were invited to join the combined firm and 130 accepted. By 1981 (four years later), only 44 remained. (Gary Klott, “Merger Moves in Accounting,” New York Times, October 3, 1984)

The above number of partners does not reconcile with the 1977 Times article that mentioned that Lasser had “about 100 partners”; however, it is presumed that the difference relates, at least partially, to foreign partners. Given the specificity of the 158 and 130 members mentioned in the 1984 article, it might be supposed that the later numbers are more accurate. The later article noted that partners in the second-tier acquired firms might not be enthusiastic about merging with a national firm, given the history of the Lasser merger into Touche Ross.

Touche Ross acquired the best-known name in the tax business, albeit without the signature annual tax preparation handbook, which was not included in the merger deal. Still, managing partner Russell Palmer and the Touche Ross executives got what they wanted—growth and a broadened scope of services.

Legacy

Perhaps the best summation of J. K. Lasser’s life was expressed in his eulogy given by McGhee:

His influence will continue to be upon all of us, on all members of his profession and the tax fraternity at large; on the laws and regulations under which we live and do business, and on humble people whom he never knew. Just last week an elevator operator at [NYU] said to me: ‘My wife told me she never understood anything about taxes until she heard Lasser on television. He made everything so clear and simple!’

The eulogist was correct in predicting that Lasser’s influence would continue as it has through the continuing publication of Your Income Tax and its many imitators and through the J.K. Lasser Institute. This assessment of Lasser’s work is contrary to Lasser’s own description of his writings. In a review of the 1951–1952 edition of Montgomery’s Federal Taxes, Lasser compared Montgomery’s books to tax literature of the type that consists of “daily, weekly, monthly letters and booklets giving reports, trends, advice, what to do, what not to do, when not to move— and when to get going in what you are thinking about.” This category of literature—“I do my share of it,” Lasser admitted—“shouts out the tale of what it sees, and hears. It is quickly forgotten” (Accounting Review, October 1952).

There is an element of truth in Lasser’s appraisal of tax publications that exist to impart knowledge and advice about the ever-changing tax laws. These writings become obsolete and are not often quoted. However, the measure of the service that these documents provide is perhaps incalculable. Lasser and his successors offered guidance through the maze of tax laws to help tax professionals and ordinary taxpayers remain in compliance with the laws and thereby generate revenue for the government. This is a legacy that deserves more respect and praise than Lasser was willing to acknowledge. In the tax guide publishing business, there is no more famous name than J.K. Lasser. But more than being an author of consumer tax guides, Lasser was a tax scholar and a contributor to the accounting profession. It was for his service to the profession that the NYSSCPA recognized Lasser in 1946, not for his best-known publication. He accumulated wealth through his tax publications, but at the same time he was also writing for his fellow professionals. He built a firm that became an integral part of one of today’s Big Four firms, but his legacy has remained through the J. K. Lasser Institute.

Dale L. Flesher, PhD, CPA, is the Arthur Andersen Alumni Professor and associate dean, and Tonya K. Flesher, PhD, CPA, is the Arthur Andersen Alumni Professor of Accountancy and former dean, both at the Patterson School of Accountancy at the University of Mississippi, University, Miss. 

10 AUGUST 2011 / THE CPA JOURNAL
The winners of the 2010 Max Block Distinguished Article Awards were honored during The CPA Journal Editorial Board meeting on June 20. The presentations were made by Editor-in-Chief Mary-Jo Kranacher. Two authors, Alan Reinstein and Vincent J. Love, were present at the meeting to accept their awards in person.

The Max Block Distinguished Article Award recognizes excellence in three categories that reflect the mission of The CPA Journal. The 2010 winners are as follows.

**Technical Analysis.** “Recent Developments in Fair Value Accounting,” by Avinash Arya and Alan Reinstein, August 2010.

This article analyzes three FASB Staff Positions (FSP) that provide additional application guidance to Statement of Financial Accounting Standards (SFAS) 157 and enhance disclosures regarding fair value measurement of assets and liabilities and impairments of debt securities.

Avinash Arya, PhD, MBA, is an associate professor of accounting at the Christos M. Cotsakos College of Business, William Patterson University, Wayne, N.J. Alan Reinstein, DBA, CPA, is the George R. Husband Professor of Accounting in the school of business administration at Wayne State University, Detroit, Mich.


This article makes the case that only a strict application of auditing principles—after compliance with rules—will provide all of the necessary safeguards to protect individuals and the profession.

Vincent J. Love, CPA, CFE, is a managing director of Finance Scholars Group, New York, N.Y., and a member of The CPA Journal Editorial Board.


This article compares operating cash flows and net income of companies in industries involved in subprime lending from 2003 to 2006. The authors’ analyses indicate that although fair value-based reported net income was substantially similar for all companies, operating cash flow differed significantly between companies that eventually experienced problems with subprime lending and companies that did not experience problems.

Benjamin P. Foster, CPA, CMA, is a professor of accountancy and Trimbak Shastri, CA, CMA, CIA, is an associate professor of accountancy, both in the College of Business at the University of Louisville, Ky.

The Max Block Distinguished Article Awards are determined by the members of The CPA Journal Editorial Board and Editorial Review Board, who rank a selection of articles from a list of nominees determined by the editorial staff. The editors thank all of the board members who judged the nominated articles for the Max Block Awards.

**About Max Block**

Max Block (1902–1988), a founding partner of Anchin, Block & Anchin LLP, is described by many who knew him as a visionary whose ideas have formed the basis for many reporting and practice-management concepts in use today. Block was managing editor of the NYSSCPA’s Journal (now The CPA Journal) from 1958 to 1972. Each year since 1975, The CPA Journal has recognized his contributions and achievements by bestowing the Max Block Distinguished Article Award on the most outstanding articles. Although the judging and selection procedures continue to evolve, the criteria remain: “An innovative and stimulating article which is of current significance and which is likely to be of lasting value.”

Max Block Award winner Alan Reinstein with Mary-Jo Kranacher.

Max Block Award winner Vincent J. Love with Mary-Jo Kranacher.
PCAOB Proposed Standards on the Auditor’s Reporting Model


James R. Doty, PCAOB chairman, gave the following comments about the concept release at the board meeting:

The proposed concept release on the auditor’s reporting model before the board today is an important step to enhance the relevance of audits to the investing public.

The recent financial crisis has prompted serious concerns about the role and value of audits. While auditors most certainly did not cause the financial crisis, some people have legitimately questioned whether audits adequately served investors’ needs in the months and years before and during the crisis.

For decades, the auditor’s report has identified the financial statements that were audited, described the general nature of the audit, and presented the auditor’s opinion as to whether, taken in their entirety, those statements present the company’s financial results and position fairly in all material respects.

Given the effort involved in an audit of a large company, and the complexity of many financial statements, investors want deeper insight from the auditor. This concept release explores several ways that audit reports could better serve investors.

The alternatives the release describes are not mutually exclusive. A revised auditor’s report could include one or a combination of these alternatives, or elements of these alternatives. Commenters may also suggest other alternatives to consider.

I commend the staff for bringing these alternatives forward. They are the result of several months’ of engagement with investors and others to identify concrete ways in which audit reports can be improved. This outreach was critical, since unlike most other standard setting projects, this project required us to understand user needs before we could develop means of meeting those needs.

In this regard, we have come a long way. In the early stage of the project, we faced generalized investor dissatisfaction with the pass-fail model, and generalized frustration with auditors who had issued unqualified opinions on the financial statements of banks that later failed. (This dissatisfaction was not new. It has been studied by various groups over many decades.)

The project thus began as an inquiry into the phenomenon called the “expectation gap.” Depending on where one sat, this meant either that investors expect too much from audits or that auditors do too little.

This concept release, however, carries the discussion well beyond any expectation gap. It’s not about deciding that investors should expect less than absolute assurance, or that auditors should do more to obtain reasonable assurance.

This project is about what investors want from audit reports in the future, and how audit reports can be more useful to society.

It’s about how audits can provide investors more insightful assessments of management stewardship.

I am mindful that culture does not change quickly. It would be naïve to think that merely changing the auditor’s report would trigger the culture change we need. This is why I have advocated a holistic approach aimed at enhancing the credibility and transparency of audits as well as their relevance.

Before I turn to my fellow board members for discussion, let me say a word about costs. Depending on the nature and extent of additional information to be communicated in the auditor’s report, new auditing requirements might be necessary or appropriate. Further, some alternatives might increase the scope of audit procedures to extend to disclosures beyond the financial statements.

These possibilities may prompt some commenters to point out that increasing scope will likely increase audit fees. To be sure, increasing procedures or scope involves cost, but so does investor doubt about the reliability of management’s statements. I will be interested in feedback on all of these kinds of costs.
Greed: Connecting the Dots

One of the valued traits of accountants and auditors has been their canny ability to decipher a plethora of data, analyze it, describe it, classify it, and make it transparent to readers of financial statements. Further investors, third parties, owners, and other interested stakeholders can make informed business decisions based on it. And through this logical rendition, the market and economy benefit.

Yet like so many people who lose the forest for the trees, the essential problem and issues are not seen or accounted for. This was so apparent in the three articles that appeared in June 2011 issue of The CPA Journal:

■ Mary-Jo Kranacher writes about how WaMu and Goldman Sachs deceived the public on securities they issued ("Financial Market Alchemy: Turning Junk into Gold").
■ R. Mithu Dey and Ashok Robin describe in depth the quest of second-tier auditing firms to be more recognized by large corporations, which would lead to more revenue and recognition ("Second-Tier Auditing Firms: Developments and Prospects").
■ Paul A. Ashcroft explains how accounting can attract new business in this troubled economic time ("Growth Potential in a Difficult Economy: Strategies for Expanding Client Services").

What was faulty in these three well-researched articles is that the authors were not seeing the big picture. It is like the old tale of multiple blind people feeling parts of the elephant, addressing parts but not seeing the whole animal. The issue all three authors missed was human behavior:

■ For WaMu and Goldman Sachs, their drive was not for excellence, but for old-fashioned greed.
■ In the analysis of first-tier and second-tier firms, the number of lawsuits that each firm must defend itself against was not analyzed. In this respect, are the first-tier and second-tier firms that much different? Are the second-tier firms free of lawsuits because they are somehow more ethical than the Big Four?
■ In seeking to attract new business, what strategy is the CPA going to look at? If it is a traditional analysis, its way is for the client to generate more wealth by finding loopholes in the law or weaknesses in the competition. If this is the approach, is there really anything new being said?

Hence, the issue is that as long as accountants do not examine human behavior, a complete understanding of business and its abuse cannot occur. And until people are willing to look at their behavior and intent within our current financial structure, the inevitable decline of the United States will continue.

Until accountants and society in general act in self-righteous rage at the waste of human potential in pursuit of profit, articles such as those above will continuously get published with no real answers.

Though society in the past may have benefited from maximizing profit at all costs, now this has a corrupting and corrosive effect on the fabric of society. The United States no longer controls world resources, so this endless spiral of ever-increasing profits and the pressure that comes with it will continue to result in articles that delude the reader into thinking, “As long as I play the game by these set rules, success will happen.”

We must, as a society, question the most fundamental values of the pursuit of profit at all cost, and question all thoughts and concepts from that perspective. Perhaps business would improve by true organic growth and not financial shenanigans. Perhaps when this logical paradigm—the increasing bottom line—is truly questioned and rejected for a more creative and more natural relationship for this planet and universe, the fraudulent behavior of the Goldman Sachs of the world will end, lawsuits against accounting firms for negligence will be reduced, and business will increase for CPAs based on intelligence, collaboration, and collegial spirit, as opposed to the whatever-you-can-get mentality. And when this day comes,
Editor’s Response

Stack’s observation that human nature is integral to understanding the dynamics of business, especially as it relates to fraud and abuse, is right on. Fortunately, a growing number of colleges and universities are recognizing this fact and including interdisciplinary course material in accounting and business curricula. Courses such as fraud examination, corporate governance, risk assessment, and business ethics have begun to address behavioral aspects of the business environment. Hopefully, this will serve to enlighten future accountants, auditors, and business leaders about why, and how, some individuals betray the trust of others for personal benefit.

My editorial was meant to educate The CPA Journal’s readers as to the findings of the Levin report regarding “how a culture of greed and deception managed to undermine our financial system and our economy” through financial shenanigans, not to provide answers to why some in our society prey on the trust of others. That, unfortunately, is a question that many others have been unable to answer. This is an area that is ripe for research but will necessitate a collaboration between a variety of antifraud experts in the fields of psychology, criminology, accounting, technology, and law. The Institute for Fraud Prevention (IFP), a coalition of researchers, businesses, and government, has taken on this challenge.

Credit Ratings and the Financial Crisis

I enjoyed the interview with Robert Herz in the February issue of The CPA Journal. One of Herz’s responses especially caught my attention: “And then, a global financial crisis came along!” I was hoping there would be follow-up questions dealing with the role of the accounting profession in the upside of the bubble and the shortcomings of mark-to-market (or fair value) in practice (as opposed to in theory). Some have said that the problem on the upside was bad loans, not bad accounting. This overlooks the basic fact that bad loans should not be accounted for as though they were good loans.

The inflated market values used on the upside were based, at least in part, by the AAA ratings given by the rating agencies. These ratings were apparently used without question, even though it was common knowledge that loan underwriting standards had declined significantly. We now know that the rating agencies bestowed their highest ratings without doing any meaningful analysis. Thus, fair values based on these rating were totally unreliable but nevertheless widely used.

However, it appears that no one took the time to investigate the rating agencies’ procedures. There was a good precedent in auditing history to require such a step, but it was either overlooked or ignored. I refer to the requirement in the early days of computer processing that the work of a service bureau had to be reviewed by an independent person before reports from the service bureau could be relied on. Based on reports in the financial press, the significant shortcomings of the rating agencies’ procedures would have been obvious almost immediately if an investigation had been made.

Then, presumably, the ensuing financial crisis would have been less severe, perhaps significantly. But it never happened.

The financial crisis will be studied for many years, and there were many causes in addition to that mentioned above that are beyond the scope of this letter. But, by applying the simple audit test described above, the accounting profession could have mitigated its impact.

Full disclosure: Herz and the author were colleagues in an accounting firm for many years and he succeeded the author as senior technical partner for financial accounting and reporting matters upon his retirement.

Ronald J. Murray, CPA (retired)
Stamford, Conn.
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On May 5, 2011, Baruch College’s Robert Zicklin Center for Corporate Integrity held its 10th Annual Financial Reporting Conference in New York, N.Y. The event brought together a collection of regulators, financial statement preparers and users, auditors, and others in the private sector to discuss recent developments in the field. The featured speakers were Leslie Seidman, chairman of FASB; James Kroeker, chief accountant of the SEC; and James Doty, chairman of the Public Company Accounting Oversight Board (PCAOB).

The conference also featured four panel sessions that presented a wide variety of viewpoints. The first panel explored current issues at the SEC, including its efforts at better communication, improved enforcement, and gradual transition to global accounting standards. The second panel looked at the complex standards regarding financial instruments and how FASB and the International Accounting Standards Board (IASB) are endeavoring to find common ground on the topic. An afternoon panel examined a variety of standards-setting developments affecting the private sector. The final panel focused on FASB and the IASB’s progress in creating new models for the controversial topics of revenue recognition and accounting for leases.

Following are edited transcripts and write-ups of the speakers and panel discussions from the conference. The speakers’ comments represent their own views and are not necessarily those of their respective organizations. All photos by Rob Horne.
Leslie Seidman has been a board member of the Financial Accounting Standards Board (FASB) since 2003. She was appointed FASB chairman in December 2010 when former chairman Robert Herz retired. Seidman began her career in public accounting at Arthur Young & Co. (now Ernst & Young), and she later set accounting policies for J.P. Morgan & Co. (now JPMorgan Chase).

James Kroeker, SEC chief accountant, serves as the principal advisor to the SEC on accounting and auditing matters. Before joining the SEC, Kroeker was an audit partner at Deloitte & Touche and served as a practice fellow at FASB. On May 5, 2011, Seidman and Kroeker kicked off Baruch College’s 10th Annual Financial Reporting Conference, hosted by the Robert Zicklin Center for Corporate Integrity, speaking on recent developments at FASB and the SEC.

Leslie Seidman
FASB Chair

There are quite a lot of new things going on at the FASB, and I thought I’d start out on a very positive note, going through some of the changes that have occurred over the recent months and years. Before I move forward with describing those changes, I really should give credit to Bob Herz for starting a lot of these positive developments. It really is an honor to step into the big shoes that he left. He really had done a terrific job as chairman over the eight years that he served.

The first thing that I want to focus on is the new people that we have at the FASB. Our trustees decided to add two board members to our ranks, to restore the size of the board back to seven members. We have a new board member who primarily spent his career in the private-company, small-business area—Daryl Buck—and another new board member—Harold Schroeder—who has spent his most recent professional years as an investor. Before that, he was a CFO and also an auditor. It’s terrific to have more board members at the table, because the more perspectives we have during those initial discussions, the better opportunity we have to have a robust discussion. We also have a new technical director, Susan Cosper, who will be speaking later. She has really hit the ground running, having served as a fellow for us a few years ago, and she’s doing a terrific job at the beginning of her service. I have very high hopes for the rest of the time she spends with us. It’s great to have new people involved in the process.

Current FASB Projects

We also have a number of new projects. Recently, we at the FASB and the FAF [Financial Accounting Foundation] undertook the responsibility for developing the XBRL—or extensible business reporting language—taxonomy, which is the code or definitions that we use when we’re attributing labels to the databases that communicate financial information. We have an opportunity to standardize those codes so that when investors are extracting information through those means, they have some indication that everybody is doing it the same way. We’ve built that function into our process; as we’re developing new guidance, the team of people working on XBRL are working side by side to develop the right codes for people to use as they implement these new standards.

We have also started working on our disclosure framework project in earnest in recent months. The purpose of that project, which I’m very excited about, is to develop a framework for the board to use as we’re approaching disclosure requirements in future standards, so that we have a more disciplined approach to identifying the key elements that users of financial statements want to see with regard to a particular type of item or with regard to the financial statements taken as a whole. It really offers an opportunity for us to take a fresh look at how we approach the full set of information in a set of financial statements.

I would say the most common concern that I hear among business professionals, investors, and preparers of financial statements is that the disclosure package is too detailed and cumbersome, to the degree that it’s not an effective communication tool. Once we have that framework developed, we can take a step back and evaluate which current disclosures are getting the job done. We will do some housekeeping to go through and clean up the requirements so that we have a more useful package. There’s obviously an overlap...
between the GAAP requirements and the SEC and other disclosure regulatory requirements. At some point down the road, we will need to work collaboratively with the SEC, and the SEC staff has certainly indicated a willingness to do that. I think it’s a real opportunity for a win-win in terms of preparers being able to communicate more effectively, and investors being able to see the messages more clearly and not having to parse through all of the detailed disclosures that currently exist.

We’re also working collaboratively with the EFRAG [European Financial Reporting Advisory Group]—it advises the European Commission on whether to adopt an accounting standard—and we recently started working with the U.K. Accounting Standards Board and the French Accounting Standards Authority [Autorité des Normes Comptables; ANC] because we realized we were all trying to pursue a similar initiative. We also have a new advisory group: We formed a group primarily of nonprofit professionals, preparers, donor groups, and auditors in that area of practice, to help us take a fresh look at the accounting standards that apply to nonprofit organizations. Those standards have been in effect for over 20 years, and we were starting to hear concerns that there was a need to review whether those standards are providing useful information to the nonprofit community. We had our first meeting recently and identified three working groups to work on particular aspects of nonprofit accounting, and we’re hoping that those subcommittees can advise the board on where to prioritize in order to move those efforts forward on a timely basis.

Process Developments

We have new processes at the FASB. Our oversight organization, the Financial Accounting Foundation, realized through recommendations that had been made by the SEC’s committee on complexity, or the CIFIR [Committee on Improvements to Financial Reporting] committee, that there was a strong desire to take a look back at standards that have been in effect for a period of time and see whether they are accomplishing the board’s intended objective. Our trustees have set up a function within the foundation—and that’s an important point; it is not a function within the board itself—to take a post-implementation review of existing standards. The objective is to make sure the standard is functioning as the board intended and also to identify opportunities to improve the process that we use to go through the setting of our standards. A team of people has been established within the foundation that has been working on a process that it is currently beta-testing. My understanding is that they will be doing public communication about the process and the standards that they may select for review, and you’ll have more information from the foundation about that in the near future. But I wanted to highlight it as an important positive development in oversight that will ask: Is everything going according to plan and are there opportunities for improvement there?

Another important development is the establishment of a Financial Reporting Series by the SEC. The FASB will be participating in it as another opportunity to have feelers out there in the community to identify emerging practice issues on a timely basis, and I’m very supportive of that effort.

Technological Advancements

We have some new technology at the FASB. We recently began videocasting our board meetings so that you can sit in the comfort of your own office and watch our board meetings, either live or on an archived basis. An important process change that we made was also to videocast the education sessions that we have leading up to a board meeting. So, if you choose to, you can watch the process from soup to nuts, because every meeting of the board is conducted in public, and now we’ve made it even easier for you to observe and share your views with us without having to come to Norwalk or go to London. For some time now, we have been conducting webinars that include training about our standards and our exposure drafts. We’ve tried to step up those activities recently, to make it easier for people to stay in step with us in terms of accounting developments.

But a very positive important development is that we’re planning to offer CPE credits for those webinars, particularly the ones that relate to technical matters. I want to encourage people to stay current with standards and not wait for annual or semi-annual conferences held by others, but rather to go to the source. We’ll take ownership of that and give you credit for participating in the process.

Another important technological development that we have just introduced is an experiment with an online way to provide comments on proposals. In connection with a proposal having to do with goodwill impairment, we are demoing an opportunity for constituents to fill out a few questions to give us an indication of how they’re generally viewing this proposal. Of course, if you would like to go into more detail, you can do it right on the website or send us a letter. The reason we’re doing that is to make it easier for people to participate without having to go through the process of developing a comment letter, which some people find very challenging and time-consuming. We’re hopeful that people find this a more accessible, easy way to participate in the process.

All of these changes are designed to encourage people to stay up-to-date on the developments at the FASB with respect to the proposals and the final standards, and encourage them to share their points of view with us on a timely basis so that we can work those considerations into the proposals before they go final.

Private Company Reporting

One of the heightened areas of focus at the FASB recently is our focus on private company issues. A special Blue Ribbon Panel was formed to address and study concerns that have been expressed about the way that the FASB and other participants in the system are handling the unique concerns of private companies. There were
Concerns about relevance: Were the standards relevant for private companies and the users of their financial statements? Are they overly complex for those particular types of stakeholders?

There was a set of recommendations issued by the Blue Ribbon Panel. One of the major recommendations is a proposed structural change so that a separate board would be formed to develop accounting standards for private companies. There were other, more short-term, recommendations, a number of them aimed at changes in the process that the FASB goes through to set standards. I strongly support those short-term recommendations having to do with process changes. In fact, we had already begun to implement them or are continuing to implement most or all of those changes.

Let me just pause for a second to speak about that more major recommendation having to do with the structural change. That recommendation has gone to the foundation, and the trustees are undertaking a process to evaluate the recommendation and discuss it with a wide range of stakeholders. They will then form a view on how to resolve the concern that has been raised and also any appropriate response to it. It is not something that the FASB itself will be undertaking as a project, but something that the foundation is giving serious consideration to.

Regardless of the outcome of that structural recommendation, the FASB is moving forward with a number of specific process changes that are all designed to be more responsive to our private company stakeholders, to get a better handle on the unique needs of preparers and users of private company financial statements, and to see if we have some common ground that we can use to move forward and better address those concerns. For example, we have a number of staff members whose sole focus is to understand the concerns that are being expressed by private companies and the users of their financial statements, and make sure those views are brought to the board on a real-time basis for us to consider as we make decisions about various technical matters. We’ve also held a number of roundtables designed specifically to get at the views of private companies and the users of their financial statements; we’re trying to hold those around the country to make sure that it’s easy for people to participate. We have standing advisory committees: a Small Business Advisory Committee [SBAC], as well as a Private Company Financial Reporting Committee [PCFRC].

We’re also making sure that at each of those meetings, we have a separate discussion about each major project that’s going on, to give them another opportunity to express their views directly to us and have a discussion about what the issues are and how we might be able to best address them.

A very important development is that our staff is developing a white paper that will ask: What are the unique needs of private companies and the users of their financial statements? We’re calling that a “differential framework” to see if there are differences, what are they, and why should they exist. My strong belief is that unless we have a common understanding on that key issue (whether it’s the FASB that moves forward with this responsibility—which I strongly hope is the case—or a new board is established to conduct this activity), without a common understanding of when differences should exist and why, I think any effort is doomed to fail because there will be an ongoing expectation gap between all the parties involved. Our staff is well under way with the development of a differential framework that is based on discussions with private companies and the practitioners in that area, and it reflects what we’ve heard. We have formed a special resource group to work with us on these issues, and they are in the process of going through that initial draft to see whether it resonates, whether it is complete, and whether they can add any value to the development of the white paper before we start discussing it with others. Ultimately, I think we’re going to need to expose this document for public comment, so that everybody has an opportunity to look at it and share their views on it.

I hope that those improvements that I’ve described show a strong commitment on behalf of the FASB to respond to the concerns that have been expressed in a very constructive, positive way. Despite all these changes, let me emphasize one thing that has stayed the same at the FASB, and that is our strong commitment to the development of high-quality accounting standards so that the users of financial statements can make informed decisions about how best to deploy their capital.

Convergence

Our recent focus has been on our convergence projects with the IASB [International Accounting Standards Board]. I thought I’d give you a general overview of the status of the Memorandum of Understanding, or MOU, that we have with the IASB. We have made some significant progress on the MOU this year and other joint projects with the IASB. We issued two chapters of the Conceptual Framework that were jointly developed and that relate to the objectives and qualitative characteristics of financial information. We are also about to issue two new standards that are converged, one on fair value measurement, so we now have a standard that is the same between U.S. GAAP and IFRS [International Financial Reporting Standards] on how to measure fair value when another standard requires or permits the use of fair value. We are about to issue a standard on the presentation of other comprehensive income [OCI], so that anywhere around the world, OCI will be presented either as part of a single statement of comprehensive income or in a statement that immediately follows the statement of net income. So there will no longer be a practice of presenting other comprehensive income in the statement of changes in stockholder’s equity, which is the major way that that item is presented in U.S. GAAP today.

At about this time last year, we announced a prioritization of the remaining projects on the MOU and we did defer work on several of the projects in order to focus on what we viewed as the most important projects: to make progress on and improvements in U.S. GAAP and in IFRS, and also to give our constituents an opportunity to focus on fewer matters so that we could encourage active participation among everybody on that smaller group of projects. Those projects are the revenue recognition project, the leasing project, financial instruments, and then, as we say, “our friend, insurance,” because
it’s not technically on the MOU but it’s certainly viewed as a very important project. I believe that the strategy of winnowing down the list was effective, if I use the number of comment letters that we received as an indicator of people’s willingness and ability to participate. We did receive very high volumes of comment letters on these projects, and I’m very grateful for the time and effort people spent, because I know there’s a lot else going on in the world and it takes a significant amount of effort to understand the proposals and share your views. So thank you for that.

We also really stepped up our outreach activities and went out to meet with people who we knew would be affected by the proposals to make it easier for people to share their views with us. One particular group that we were focusing on in those efforts was investors, because we have found historically that investors are less likely to share their views with us in writing.

Generally speaking, all of those priority MOU projects that I mentioned are in active redeliberations. A number of issues were raised about each of the projects, and we are carefully working through all of those issues. A common theme among the proposals was that there was a level of complexity that did not seem warranted, and we’re taking that particular concern to heart and trying to find ways to provide useful information without making the proposals unnecessarily difficult to understand or to apply. We want to do this without compromising the quality of the information that will ultimately be provided to investors. To try and get that balance just right, what we’re doing is conducting targeted research outreach with investors, preparers, and auditors to immediately cross-check whether we’re getting that balance right. I should say that we do so on a “targeted basis,” meaning it has to be a pretty central issue in the project and something that we think people cared about deeply in their comments to us.

Another important change with respect to the convergence project is that, at our April meeting with the IASB in London, we determined—after looking at the remaining issues that needed to be addressed and important steps in the process that we felt needed to be conducted—that we were going to need a little more time before we feel we’ve done what we need to do to issue a high-quality standard on these matters. The purpose for the extension of the timetable is entirely to ensure that the standards are of the level of quality that we think is important. There is no desire here to indefinitely delay these projects or to lose momentum on them, but we felt it was extremely important to proceed at a pace that allowed people to continue to participate actively, and then allow time for us to evaluate the proposals as a whole and determine what other steps might be necessary from a quality control standpoint to make sure the standards were ready to be issued and implemented by people widely around the world.

Each of the projects has unique considerations, but what we’re hoping to do is have the major decisions made on each of these projects, with insurance being an exception, on or about a June time frame. For those of you who follow us very closely, I am not saying that we’re going to be done or that we’re going to have a draft of some kind done—I’m just saying that we’re hoping to complete the board meetings around that time frame. Then we have an extensive process to draft the basis for conclusions and move forward with publishing a document.

Before we publish anything, we will take a look at the decisions as a whole and determine whether we need to re-expose the document or not. The way we determine that is to evaluate the changes that we’ve made relative, first, to current GAAP and, second, to what we’ve already exposed. Depending on the nature of the changes, we will have a basis to evaluate whether we think we need more commentary on this proposal or not. Regardless of whether we decide to expose the documents, what we’re planning to do jointly with the IASB is, when we’re finished with the standards, to draft them and post them on our websites for a period of time, to give people an opportunity to look at the standards as a whole and provide any additional commentary that they have about whether we’ve missed something, whether there’s a fatal flaw in the proposal. There will be a pause built into the process to give people another chance to take a look at the document.

We have, importantly, not decided yet on any effective dates for the standards. We issued a special document to solicit comments on whether these standards should be implemented as a group or sequentially, released over time. We got mixed feedback on that discussion paper, geographically as well as within the various communities of constituents. We had very few responses from investors, and so what we have done recently is posted a survey on our website and done a little prodding to get people to participate to give us a little bit more information, especially now that we’ve made some changes to the proposals in our redeliberations. In my mind, those are interrelated. Sometimes people will tell you they need more time to implement a standard or they want to implement in a certain way, because of the nature of the accounting change. We’re going to regroup and get a little more input on that before we determine the effective date or the manner of transition on any of these individual standards. But the clear signal I want to send is that we do plan to provide ample time for people to understand the proposals and then transition to the new requirements in an orderly matter. This is not going to be a case where we release something and make it effective this year-end or next year-end. We’re looking at a couple of years at a minimum before we would move forward.

As you can see, we have made a lot of progress within the organization. You have all been a major contributor to that process and that progress, and I want to thank you very much for that.
JAMES L. KROEKER
SEC Chief Accountant

Last year at this conference, you heard about a comprehensive assessment of the staff work plan on IFRS that we were beginning to develop and execute. Since then, we’ve issued a progress report, and I expect to issue updates of our work progress as it continues. The SEC is dedicating several resources to the work in preparing the commission to make a fully informed decision about IFRS, a decision that must be in the best interest of U.S. investors and the U.S. capital markets.

Financial Reporting Series

Today I’d really like to focus on several other accounting and auditing developments that are on our agenda for 2011. As part of our oversight of the financial reporting system, we’re instituting a series of roundtables that we’re aptly— I think, at least— referring to as the “Financial Reporting Series.” The idea is to facilitate a robust and balanced discussion of existing and emerging risks, trends, issues, and pressures on financial reporting. The Financial Reporting Series will help us at the SEC in our job— and also at the PCAOB [Public Company Accounting Oversight Board] and the FASB—in early identification of risks related to, as well as other areas for potential improvement in, the reliability and usefulness of reported financial results. The approach will be one of inviting a cross section of auditors, preparers, investors, and other individuals to express their views. The purpose of the roundtable is to gather a spectrum of views and to foster informed discussion and dialogue on some of the most difficult and challenging financial reporting topics. The idea is not to create some type of “blue ribbon” committee that would offer up a set of recommendations.

More particularly, I expect that the series would provide the commission staff, as well as the FASB and the PCAOB, with useful information about emerging issues and challenges in the business environment that affect each of our respective roles and responsibilities. In addition to observers from the FASB and the PCAOB, we expect to invite others. For example, if the issue relates to an area that is important to bank regulation, we would invite bank regulators or other commission staff from other offices or divisions.

I anticipate that we would have around three sessions of this Financial Reporting Series each year, depending on the nature and the number of issues that are encountered. We’ll be looking for participants who are knowledgeable about the issues at hand, and, consistent with the commission’s other roundtable activities, the sessions will be open to the public. They’ll be webcast and archived. I encourage you to watch for a public announcement about these sessions in advance through a press release or through a devoted webpage to the Financial Reporting Series that will be available on the commission’s website. I expect—or at least I hope—that our first session could be held later this summer and that it would focus on a topic such as addressing disclosure uncertainty and the role of uncertain measures in financial reporting. It’s a pretty big topic to bite off.

Converging Standards

Another item on our agenda is convergence of accounting standards. The FASB and the IASB are committed to enhancing and converging financial reporting standards and have been doing so for a number of years. They’re nearing completion on a number of priority projects and are considering how best to transition from existing accounting standards to the ones that will be finalized. I’m pleased that the boards are working on these important financial reporting issues and that they’re making progress toward resolution. To me, the boards’ issuing of high-quality standards is of the utmost importance. High-quality standards provide investors with relevant, reliable financial information to guide investment decisions. High-quality standards can be understood and implemented in a consistent way by preparers and audited by auditors. I’m also pleased that the boards are committed to following rigorous due-process procedures, including preimplementation testing and outreach so that they’re able to achieve this high-quality desired result. While performing research and field testing are important elements of the process, they also take time. I support the continued reprioritization of their agendas and the time to achieve high-quality converged standards.

I believe it’s crucial, particularly as it relates to the MOU projects, that the boards take all reasonable steps to maximize the prospect of really converged...
solutions. For example, currently the boards are not aligned as it relates to their approaches to consideration of hedge accounting in their financial instruments project. Numerous conceptual, operational, and practical questions have been raised about proposals issued to date that I believe should be considered jointly by both boards. I believe that in the long run, a measure of added time to provide for joint redeliberations on a project as critical and as complex as hedge accounting will prove to be far more productive than any gains that are perceived by finalizing deliberations individually. In achieving high-quality converged standards, the boards inevitably will be faced with difficult choices about how to proceed. I continue to encourage the boards to reconcile their differences in their proposed standards, and to work to reach converged and approved solutions. My focus tends to be on ensuring that there is an appropriate balance between the conceptual underpinnings of the project and a degree of pragmatism in the standards so that they can be consistently applied and audited.

I’ve also spent time understanding the report and the recommendations put forward by the Blue Ribbon Panel on private companies. My focus has been to consider the nature and the impact of any recommendations for private companies to apply accounting standards that may differ from those of public companies. It’s prudent, in my view, to carefully consider the impact placed on the capital formation process if private companies have to adopt a more stringent set of accounting policies in connection with preparing for a filing to raise capital. It’s important to understand why one might suggest a different standard for private companies. I support the approach taken by the FAF to carefully consider the advice from this panel as they strategically assess the financial reporting system for private companies. I believe additional research, study, and outreach, particularly to investors, will be warranted in a number of areas prior to implementing any significant structural change.

**Improving Auditing**

With that, let me turn to auditing. We have a number of auditing issues on our agenda, several of which arise from or are at least highlighted by lessons learned as our nation emerges from the financial crisis. Let me start with just our work on [Sarbanes-Oxley] section 404(b). As many of you know, coming out of the Dodd-Frank legislation, the commission was directed to study how to reduce the burden of complying with the auditor-attestation requirement. This is what people often refer to as section 404(b), or the auditor’s opinion, particularly as it relates to companies that are on the smaller end of the spectrum, companies with market capitalizations between $75 million and $250 million. [We were directed] to study that, but also study how to reduce that burden and, at the same time, maintain the investor protection for such issuers that is a result of section 404(b).

Let me provide you with an update in this area. We’ve issued our study, which is available on the commission’s website, and in performing this study we considered the number of actions that had been taken since the implementation of 404(b) in 2003. First, when 404(b) was implemented, it was done on a phased basis. There were several extensions to the compliance date. The commission already put in place relief for those companies that are entering into initial public offerings, both for the period of the offering as well as the next annual period. Further, the commission issued interpretive guidance to management and the PCAOB revised its auditing standard from AS 2 to AS 5 at the same time, and then in 2009, the commission released a study on 404 and the costs and benefits of its implementation that forms much of the basis for the commission’s recently issued study.

The information that we compiled in the context of the study provided us with a fairly clear understanding of a number of points. First, the cost of complying with the auditor-attestation requirement of 404(b) has declined since the commission first implemented those requirements in 2003. Investors generally view the auditor’s report, required under section 404(b), as beneficial, and financial reporting as a whole as more reliable when the auditor is involved in the internal control of a financial reporting process. Finally, the evidence that we looked at in the study does not suggest that 404(b) alone is affecting listing decisions in the study. After gathering this information, we concluded with the two recommendations. First, the commission should maintain the investor protections of 404(b) for accelerated filers, that is, those that were the subject of the study. There’s strong evidence that the auditor’s role in auditing the effectiveness of internal controls improves financial reporting, and I would note that the Dodd-Frank Act exempted approximately 60% of reporting issuers from section 404 when it exempted companies below $75 million. Therefore, as recommendation one, we don’t suggest any further exemption. The second recommendation was that the commission staff encourage activities that have the potential to improve the efficiency and effectiveness of section 404(b).

That sounds pretty abstract, so I’ll just give you one example. The staff has recommended that the PCAOB, through its inspection process, monitor the results and publish its observations beyond the observations that they already published in 2009 on the performance of audits. The objective in publishing these observations would be to provide auditors with the benefits and lessons learned that the PCAOB sees in their process.

Let me now just turn to the role of the auditor in mitigating financial reporting risks. We’re also considering what lessons can be learned from the financial crisis about the role of the auditor more broadly than you think about it today. In exercising their vital function in our capital markets, auditors play a key role with respect to a particular type of risk, that is,
the risk of a material misstatement in reported financial results. In looking specifically at the role of the auditor, it’s critical to distinguish between financial reporting risk and other types of risk, such as business risk or operational risk, that may affect the company’s results and impact investment decisions. While auditors must understand these risks, to the extent that they impact financial reporting risks, the auditor’s procedures and communications are not designed specifically to address risks other than financial reporting risks, or to make judgments about the merits of a company’s business strategy or management’s decisions in implementing that strategy. An audit is not designed, nor can it or should it be designed, to take all risk out of investing. An audit is instead designed to add to the credibility of financial information reported to investors, so that investors can rely on that information in making their own informed investment decisions.

Focusing, then, on financial reporting risk, we’re taking the opportunity to consider how the role of the auditor could be improved. I’d like to underscore what I believe to be a good opportunity for a renewed focus on the auditor’s reporting model. I believe the PCAOB project relating to the auditor’s reporting model is a particularly important initiative in understanding whether there is information that investors are currently not getting from auditors. Of course, there are fundamental questions that I think have to be answered—questions such as: What information is needed for investors, or what additional information might be useful? Who should provide that information? In what form or in what manner should the information be provided? I look forward to the PCAOB’s continued work on this project. Of course, we at the SEC will provide our perspective to the PCAOB on the details of the project, including questions such as whether the auditor should have a role in auditing presented MD&A [management discussion and analysis] information or other aspects of reported results that might rest outside of the financial statements.

While there might be an opportunity for new standards, I hasten to mention that there are existing requirements for disclosure of risks and uncertainties. To the extent that poorly performed audits have failed to report substantial doubt about an entity’s ability to continue as a going concern, or where audit standards have other opinions based almost entirely on the work performed by other auditors outside of the U.S. This is significant for a number of reasons, not the least of which is that the PCAOB has been unable to inspect audits in a number of countries. While the vast majority of these registrations via a reverse merger may be legiti-

“I believe the PCAOB project relating to the auditor’s reporting model is a particularly important initiative in understanding whether there is information that investors are currently not getting from auditors.”

mate businesses, some of them seem to have significant accounting deficiencies—even to the point of being frauds. We have recently seen an uptick in resignations associated with these types of issuers. In looking at the 8Ks for resignation, the disclosed reasons have included troubling information about auditors being unable to do things like confirm cash and receivables, and in some instances [there have been] allegations of falsified documents. We’re looking at these situations very closely, and I’d encourage each of you who has a role in auditing overseas and in these types of listings to be vigilant as well. Staff in my office, as well as across the commission, have been working collaboratively with the PCAOB and others to investigate concerns about financial reporting deficiencies or frauds at U.S.-listed foreign companies, with a particular emphasis on companies engaging in reverse mergers to achieve registration.

We all have an important stake in the accounting and auditing topics that we’ve discussed so far and that we will continue to discuss today, with the goal of maintaining the trust that investors have—that bedrock of our financial system upon which much of our capital market system rests.
In Focus

Current Developments at the SEC
Enforcement, Red Flags, and the IFRS Work Plan

Panelists, from left to right: Wayne Carnall, Howard Scheck, and Paul Beswick

The first panel at Baruch College’s 10th Annual Financial Reporting Conference on May 5, 2011, featured speakers discussing current developments at the SEC, including financial reporting issues, SEC audit investigations, and the Commission’s progress on adopting global standards.

Communication Efforts
Wayne Carnall, the chief accountant of the Division of Corporate Finance at the SEC, began by speaking about the commission’s efforts to improve communications with corporations, accountants, and the public. He pointed to the SEC’s “Dear CFO Letters” program as an example. Through this project, the SEC puts actual letters it has issued to companies on its website to provide guidance to others. For example, an October 2010 letter dealt with the topic of foreclosures (www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm). Carnall also stated that the SEC teams up with the Public Company Accounting Oversight Board (PCAOB) to present seminars around the country for auditors of smaller businesses to help address issues unique to them. This information can also be found on the SEC’s website, where Carnall said there are “50 pages of detailed information of unique issues that we have addressed for smaller reporting companies.” The SEC has also been making strides in communicating with small, community banks.
developing guidance documents that are available on the website.

Working with the SEC

Saying that if people don’t work with the SEC staff on a frequent basis, they can seem like “a mysterious group of people,” Carnall pointed to an online document that will help filers learn how to interact successfully with the staff. “Best Practices for Working with SEC Staff” (www.sec.gov/news/speech/2009/spch120609ac-ms.pdf) outlines when to ask questions, whom to call, and how to perform research on the SEC website.

Another tool that Carnall recommended is the SEC’s Financial Reporting Manual, which is updated quarterly (sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf). “It doesn’t address accounting guidance; it addresses financial reporting in terms of the SEC’s rules and how you comply with them,” Carnall said. “It has a lot of valuable information.” He said updates to the manual in the past year have included guidance on calculating “significance” for acquired businesses, goodwill impairment, what types of disclosures should be included in the management discussion and analysis (MD&A), and stock compensation in an IPO.

Carnall also highlighted the importance of Compliance and Disclosure Interpretations, which primarily address legal issues but can be, he said, “very relevant to an accountant.” They are updated regularly on the SEC’s website (www.sec.gov/divisions/corpfin/cfdisclosure.shtml). One recent item for which the SEC provided additional guidance was a filer’s change of accountants; the guidance addressed the interim period between auditors during the change, going-concern opinions that might have been issued, and the deregistration of auditors by the PCAOB. Carnall said that especially in the latter case, such a situation should be disclosed in the 8K, because “that is a fact that investors should know.”

Carnall then offered advice on how to handle issues that may arise with the SEC. Most significantly, he recounted a story about an issuing company that provided only a one-page response to the SEC’s questions about its financials—before coming up with a 35-page submission, once pressed. Carnall advised: “Don’t try to submit something to us to see if we go away. Make it your best effort, your most complete response. It makes the process more efficient and effective for all of us.”

Issues of Focus for the SEC

Carnall pointed out two other areas on which the SEC is focusing: contingencies and reasonably possible losses. On the former, he said: “If we see a company has had a large settlement, we look at prior filings to see if there’s any disclosure about that or see how they have accrued for it.” He said one of the concerns the SEC has is that companies sometimes take a charge and accrue it over a long period of time—several quarters; the SEC will want to know the basis for when a company booked the charge and how they supported the charge when that event took place. “We don’t allow companies to smooth charges in this regard,” Carnall said.

Carnall pointed to three ways to comply with the disclosure requirements for reasonably possible losses: Disclose the amount or the range of possible reasonable losses, disclose that any additional amount would not be material, or disclose that the amount cannot be estimated. “If a company makes that assertion, though, they need to be able to support it,” he said.

On the topic of disaggregated information, Carnall said, “Obviously consolidated financial statements are critically important, but sometimes you have to pierce those items to understand what’s behind them and to understand the company’s financial statements.” He used segments as an example of the type of information the SEC might be skeptical about. Another area that the SEC has been asking questions about is income tax disclosures from companies that have many offshore operations. He said the SEC sometimes sees companies assert that their profits are permanently invested overseas and they do not provide taxes on repatriation, even as these companies have lots of cash and short-term investments. When that occurs, he said, “We will suggest that they segregate in their MD&A the amount of cash in short-term investments that are overseas and that they are not planning on repatriating.”

Lastly, Carnall touched on the area of reverse acquisitions and non-U.S. companies. He said that when the SEC sees a company with all its operations overseas using U.S. GAAP, “We will basically ask a very simple question: Who is preparing the financial statements and what are their qualifications? Are they a U.S.-trained CPA? Do they have any U.S. GAAP experience?” As a result, he said that the SEC has seen some registrants elect to deregister and basically delist from the United States; some acknowledge that they don’t have the capability and indicate that it’s a material weakness, while others hire people to fulfill that role. The third option, Carnall said, is the SEC’s long-term objective: “We want companies to have the capability to be able to prepare financial statements that comply with U.S. GAAP.”

How SEC Enforcement Works

Howard Scheck, chief accountant in the SEC’s Division of Enforcement, spoke next. He explained that his division helps the enforcement attorneys who are investigating accounting cases with all aspects of their day-to-day activities, including “advising on accounting and auditing issues, deciding what documents to request from companies and auditors, reviewing the documents when they come in, taking and participating in testimony, evaluating all the evidence, and making recommendations to the Commission as to whether an enforcement action should be made.”

Scheck said his general view is that the vast majority of accountants and other practitioners are doing the right thing and are fulfilling their role in detecting and deterring fraud. “But we all know that there are frauds that still occur,” he said. “And it usually is the CFOs, the controllers, and the audit partners who are involved in those frauds, so we all have to remain vigilant.”

He then highlighted the federal securities laws that apply in the cases his division investigates. “We’re always going to be evaluating intent—if there’s an accounting error, why did it happen, how did it happen, who was involved,” he said. “We’re going to try
to look behind whether it’s just a GAAP error and why it happened.”

Scheck also pointed out the “nonfraud violations that we have in our arsenal from enforcement.” He specifically wanted audience members to be aware of reporting violations (section 13(a) of the Securities Exchange Act of 1934), books and records violations (section 13(b)(2)(A)), and internal controls violations (sections 13(b)(2)(B) and 13(b)(5)). “Those are all nonfraud violations in the sense that the Commission doesn’t have to prove fraudulent intent to bring those violations,” he said.

Enforcement Areas of Focus

He also outlined the accounting areas of focus for the enforcement division, which include reverse mergers, disclosure, revenue recognition, loan losses, valuations, impairments, expense recognition, and related-party transactions. He said reverse mergers is an area where the SEC has become increasingly proactive in the past year. “In the last couple of months alone, there have been over two dozen companies that have filed a case that disclosed auditor resignations or accounting issues, and the SEC has recently suspended trading in various reverse merger companies,” he said.

As for red flags, Scheck said the SEC is not seeing any significant new items. He said it continues to examine aggressive accounting policies, changes to accounting policies, or methods of applying those policies without disclosure. He added: “That’s one of my particular pet peeves, when changes are being made and there might be a material impact but there’s no disclosure to investors.”

He said the SEC continues to focus on gatekeepers and other relevant individuals, such as audit committee members, CEOs, CFOs and controllers, and transaction personnel. In addition, he explained, “we’re always going to be getting the audit workpapers, to see what the auditors did, to evaluate whether they were lied to or misled, or whether there was some sort of audit failure, and we’re going to be looking at what the lawyers were recommending regarding disclosure and what the counterparties did.”

Scheck gave some advice as to how those involved in auditing should conduct themselves. “When you’re on the private side, if you’re involved in an audit or an investigation, you have to ask yourself: How is this going to look?” he said. “What are the facts and circumstances going to look like? What is the analysis going to look like if the enforcement division looks at it?”

He said that, in assessing audit board conduct, the biggest issue is what happens when the board finds something: What did they do to resolve it, and what did they do to ensure that the financial reporting was right? He said that questions his division would ask might include: “Was there an investigation being done? Who conducted the investigation? Did they use inside counsel? Did they use outside counsel? Did they use the internal audit folks? What is the scope of the investigation?” Scheck said the SEC would use similar queries in assessing independent auditors; in assessing third parties, it would look at counterparties to determine whether they provided any substantial assistance in causing a violation. He added that the Dodd-Frank Act has clarified that recklessness is, in fact, sufficient as far as aiding and abetting.

Scheck ended by stating that section 106 of the Sarbanes-Oxley Act, which deals with the ability of the SEC and PCAOB to obtain foreign audit workpapers, was updated in the Dodd-Frank Act. He anticipates that the SEC will “be using 106 going forward.”

SEC Work Plan Update

Paul Beswick, SEC deputy chief accountant, spoke last on the panel, focusing on the topic of the SEC’s work plan regarding conversion to or convergence with IFRS, which was issued in February 2010 (“Commission Statement in Support of Convergence and Global Accounting Standards”). He said the goal of the work plan is to provide information to the SEC so it can make the most informed decision possible. A progress report was issued in October 2010; Beswick said that, as of the May 2011 conference, the SEC was still in the process of gathering information and not yet “trying to understand what that information means.”

Areas of Focus on IFRS

Beswick said there are three areas of focus on which the SEC might release staff reports: the potential incorporation framework, a comparison of U.S. GAAP and IFRS, and a review of financial statements prepared under IFRS. With regard to a framework for the incorporation of global standards, he said that the SEC has learned in its outreach that “people initially thought that going to IFRS was a binary decision—we either had to go or we didn’t go.” But he said the SEC saw that there were other ways that countries had incorporated IFRS into their financial reporting system, including a model of endorsement: The International Accounting Standards Board (IASB) would issue a standard, and then the local standards setters would endorse that standard into the national GAAP. “One of the key questions, though, if you’re going to do an endorsement model, is what is the threshold for endorsement?” he said. “I’m not sure if we ever want to have a mechanism where we have a perfunctory endorsement.”

He added that another area to consider is what to do with existing national standards. “If you go to a scenario where someone would endorse new standards, what would you do with existing GAAP?” he asked. “One of the things we’re trying to flesh out in that paper is: What would be a good model for dealing with existing differences?”

In order to make progress on that question, Beswick said the SEC is preparing a staff report that would compare U.S. GAAP and IFRS. “We started with identifying every difference possible, down to
almost the comma,” he said. “Now, we’re trying to take those differences and make it in a format that’s more understandable for people.” In doing so, the SEC is trying to focus on where there is a difference in the objective, as compared to the application guidance. He said that, so far, the SEC has highlighted different objectives in the areas of “LIFO [last-in, first out inventory method], contingencies, R&D, and rate-regulated assets.”

The last area of focus for a potential staff report is reviewing financial statements prepared under IFRS. He said the Division of Corporation Finance selected a sample of around 200 SEC registrants and reviewed their financial statements in order to understand what companies are really doing with standards. The SEC is currently in the process of summarizing the results of that review.

SEC Decision on IFRS
Last year, the SEC stated that it would make a determination in 2011 on whether to require companies to report using IFRS. Beswick said this decision has generated a lot of interest from the accounting and investing communities, but the SEC is still gathering the information it needs to make a decision. He said that if the SEC does decide to incorporate international standards, “some of the various ways they can do that are IFRS as issued by the IASB, convergence, or an endorsement mechanism”; the SEC is making sure that it has considered each of these options carefully and determined whether there are others.

He outlined the key questions for consideration, including the role of the SEC in accounting oversight and the role of FASB in standards setting. “I can’t imagine we have a scenario where the FASB doesn’t have a very substantive role,” he said. “I think it would be very important for FASB to be the representative of U.S. interests in the global accounting standards setting.” Some of the other key considerations are oversight of the IASB and the IFRS Foundation, funding of the IASB, and options for U.S. issuers.

Beswick ended with a list of things the profession can do to build investor confidence, the most important being to remember that no issue is worth risking a personal reputation over. “You can’t get it back. Once you lose it, it’s almost impossible to rebuild,” he said. “So you just really need to try to operate and conduct yourself with as much personal integrity as you can.”

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The second morning panel at Baruch College’s 10th Annual Financial Reporting Conference on May 5, 2011, focused on the topic of financial instruments, and brought together regulators, preparers, and users to discuss recent and proposed changes in the field, as well as the progress of the ongoing convergence project between FASB and the International Accounting Standards Board (IASB). Norman Strauss, Ernst & Young Professor-in-Residence at Baruch, moderated the panel.

Converging Standards

Leslie Seidman, FASB chairman, began by explaining why FASB and the IASB are working on the project to converge standards. “Current U.S. standards for financial instruments have been set over time on an ad hoc basis, as a problem became clear for a particular instrument or a particular activity,” she said. “So what we have is a piecemeal accumulation of standards that sometimes account for similar things differently. And that has caused a great deal of confusion.”

Greg Jonas, managing director in Morgan Stanley’s equity group, stated that, from a user’s perspective, changes in this area are necessary. “We’ve long argued that the current model is, in certain respects, broken,” he said. “It’s too complex. The same instrument can be accounted for in five different ways. It’s not intuitive.”

Enrique Tejerina, a partner in KPMG’s department of professional practice and a member of FASB’s Derivatives Implementation Group, explained how FASB’s initial proposal was intended to
improve the accounting for financial instruments. “FASB issued one comprehensive exposure draft, covering classification and measurement, impairment, and hedge accounting. In addition, that exposure draft addressed all financial assets and liabilities,” he said. “The accounting would be the same for all instruments, as opposed to having different accounting for debt securities, loans, and other things.”

**Classification and Measurements**

Tejerina then delved into more specifics, starting with classifications and measurements, which, he said, FASB is in the process of redeliberating. “One significant change is that for financial assets, the exposure draft had fair value on the balance sheet and then changes in either net income or OCI [other comprehensive income],” he said. He described that, in the current proposal, “instead of two buckets, we have three buckets.” The new third bucket, added to fair value through OCI and fair value through net income, would be amortized cost, limited to “plain vanilla” borrowings.

Strauss asked Seidman what it was that gave rise to FASB’s thinking to allow for more historical cost. She said: “It did seem as though people cared very much which of those measurement attributes was going to form the basis for the footings in the balance sheet. In other words, people cared whether loan deposits and your own debt were going to be carried at cost on the balance sheet or at fair value.”

Seidman continued: “There was general agreement that the impairment model is too complicated, too diverse, and didn’t serve us well during the financial crisis—therefore, we should move forward with an improvement that would cause more timely recognition of losses on debt instruments.”

She added: “There was widespread support for reporting plain-vanilla debt instruments—loans, deposits, and your own debt—that are plain vanilla at cost in the balance sheet with a more robust impairment approach and more extensive disclosures than what we have today.”

Robert Laux, director of financial reporting at Microsoft, gave his thoughts on these changes from a preparer standpoint. “I think the preparer community is generally supportive of the changes, and I actually think there’s a very strong argument for certain securities being held at amortized cost if their purpose is collecting cash,” he said.

Laux added: “I don’t believe preparers think fair value information is all-relevant, and most are supportive of disclosing the information, but when it comes to giving an indication of future cash flows for a security that’s going to be held to maturity, the best predictor of that future cash flow is, in my opinion, amortized cost.”

Jonas said the three-bucket approach will feel familiar to users and that the approach is simpler than current practice. He added, however: “On the potentially negative side, I think this loan participation issue is going to be a problem. … Banks get all worked up about not having loans at amortized cost, and I think they’d be equally worked up at not having loan participations at amortized cost.”

Jonas continued: “I think a lot of users would say, ‘Gee, I don’t see a big difference between a loan that I originate and a loan participation that I have, so why do I have radically different accounting for those two?’”

Strauss asked Laux if he thought that preparers would find these new classifications objective enough to be able to tell what a company’s business strategy is. “I think it is functional,” Laux said. “It may be difficult to audit, and we need to be forthright in our application of it, but it’s the way we run the businesses, and I don’t see a difficult problem in actually incorporating that into our processes.”

Jonas said the business strategy notion is superior to management intent. “Nothing is worse than management intent, not because management is evil, but because accounting and audit differ based on underlying economics,” he said. “Management intent not only seems to me to be very difficult or impossible to audit, but it makes differences in accounting happen, which is problematic.”

Paul Beswick, deputy chief accountant at the SEC, said he thinks the SEC “can absolutely get behind the notion of a business model.” He added: “I think some of it is going to put a little pressure on how FASB articulates what a business model is and what the principle is. We are—at least I think I am—perfectly comfortable accepting preparers and auditors making good judgments in terms of application of GAAP.”

**Recognizing Impairment: A Compromise**

Tejerina then spoke about another aspect of the financial instrument project—how to recognize impairment, principally, the impact on financial institutions with long-term loans like mortgages. He characterized the issue as “too little too late.” He explained the background of the proposed compromise between FASB and the IASB, saying that “FASB proposed a model where you would get rid of the probability, so you would recognize a loss on day one, based on current and past events. … On the other hand, the IASB’s proposal was that you have the same expected loss model; however, on day one, you look at the expected loss on that particular asset over its life, and you would amortize it, or put that into the yield of the asset and recognize it over the life of the asset.”

Tejerina said the boards have started to redeliberate together and have issued a discussion document that is clearly a compromise, in other words, not necessarily what either board would have liked. He mentioned that one aspect of the compromise is a “combination of the IASB’s view of amortizing a loss and the FASB’s view of taking a loss when you actually think you have an expected loss.”

Seidman explained the thinking behind the compromise proposal. “There’s a philosophical divide here,” she said. “I would say that FASB and most U.S. constituents … see this as an asset impairment issue. In other words: What should these loans and debt securities be reported at when you don’t expect to see all the cash flows? The IASB believes that when you make a loan or invest in an asset, there is a certain amount of uncollectibility that you can foresee or that you price into the loan.”

She added: “The world wants us to come to a converged solution here.”

Laux said most preparers probably do not support this proposal. “What I think
most preparers in the U.S. take exception to is just how complex these two thought processes are, and I am skeptical it can work, from a practicality standpoint.”

Jonas said users might not be happy with the solution, either. “We basically took a guns approach and combined it with a butter approach—and we ended up with a gutter approach,” he said. “I was a big fan of the

“Hedging Needs Fixing

Strauss said FASB and the IASB are also working on the issue of hedging and derivatives. “Everybody seems to agree that [SFAS] 133 is too hard, too many companies do it incorrectly, and it needs some fixing,” he said.

Seidman said FASB reviewed its hedging standard because of the practice issues that were emerging with compliance in interpretive matters. “In the meantime, the IASB moved forward with a fundamental reconsideration of hedge accounting, even though the standard they were starting with is quite similar to [SFAS] 133,” she said. “And so we have gotten out of step.”

She said FASB took the IASB’s exposure draft and issued it for comment in the United States in order to see if it was a “superior starting point for us to develop a converged standard.” She added that the comment period had just closed, and FASB was beginning to look at the comment letters.

Laux agreed that preparers think hedge accounting needs fixing, “not just to make it easier, but to make it so it’s more representative of an entity’s risk management for these changes in value.”

Jonas said users have struggled, not so much with the U.S. accounting model for derivatives and hedging, but rather, with the company’s story about “What risks exist? Which of those risks do we try to hedge? How do we go about economically hedging them? And how do we account for those activities?”

Tejerina pointed out some of the changes to hedge accounting in the exposure draft. “Right now, we have to conclude that you can have a hedge because it’s ‘highly effective.’ … The exposure draft would change that to a ‘reasonably effective’ threshold,” he said.

Another change, he said is, “today, you have to have very detailed calculations of your assessment of effectiveness at inception and on an ongoing basis. The exposure draft would allow a qualitative assessment to be performed, both at inception and going forward. And it would only require actual reassessment if there was evidence that the relationship wasn’t going to function the way that you thought when you set it up.”

Tejerina said one big issue that people disagreed with was that the exposure draft proposed that hedges could not be de-designated once established if they continued to qualify as hedges. “In other words, once you set it up you have to keep it,” he said “There was some ability to terminate the hedge by buying an offsetting derivative, but it got convoluted. Bottom line, it’s going to be very difficult to de-designate a hedge, which people didn’t necessarily appreciate.”

In comparing the exposure draft that FASB issued with the IASB’s exposure draft, there are also major changes, Tejerina said. “Number one, the IASB is suggesting that hedge accounting be aligned with an entity’s risk-management activities.” Other changes he outlined include: The assessment of effectiveness would be much more qualitative, the IASB would allow nonderivative financial instruments carried at fair value through net income to actually be hedging instruments, and hedged items could be combined into a portfolio.

Beswick said the SEC would be working with both the IASB and FASB on this topic. “I think both boards need to meet and come up with, ‘What are we really going to do here?’” he said. “Are we going to try to make some small changes to improve the ability of preparers to comply with the standards, or are we going to holistically rethink how we’re doing hedging?”

Seidman said that this is what she intends to see happen. “My personal preference would be for us to try and complete our discussions on classification and measurement and impairment, pause, sit down with the IASB and say, ‘What are the remaining differences?’” she said. “Let’s get in the room again and figure out how we want to move forward with a converged standard here. I would have hedging follow that discussion.”

“IAASB’s approach, of the yield adjustment approach, and I thought I could understand it. I thought I could explain it. Then I became a fan of the FASB’s approach. There are big negatives any way we go.”

Jonas suggested, “Maybe we go back to an incurred loss framework—but on steroids. Let’s go back to thinking about incurred loss but encourage companies to record losses earlier than we do today, which has been a key problem with users. And we could do it in two ways: One is we could lower the threshold for loss recognition from ‘probable’ to something less, like ‘more likely than not.’ Or, we could emphasize incurred but not reported consideration and demonstrate techniques to do that in a more robust way.”

Seidman said the boards are considering alternative approaches. “We are determined to work this one to the ground and come forward with an improvement over what we exposed, because it was not well received, and we will end up with an improved impairment model that is the same around the world.”
The Reliability, Role, and Relevance of the Audit: A Turning Point

Keynote Address: James R. Doty

John A. Elliott, dean of Baruch’s Zicklin School of Business: It’s my pleasure to introduce James Doty. He was appointed PCAOB [Public Company Accounting Oversight Board] chairman in January of this year and he took that responsibility over on February 1, 2011. He was born and raised in Texas and began his education at Rice University, where he earned a BA in history. Subsequently, he served as a Rhodes Scholar at Oxford University in England. He then moved to an MA in history at Harvard, followed by an LLB from Yale Law School. His education is extraordinary, and it launched him on a career in the law firm of Baker Botts LLP. He joined that firm in 1969 and served with distinction most of the rest of his career. He was mostly an attorney but he did spend a two-year stint at the SEC as general counsel, and that experience gave him significant insight into the process of drafting regulations—insight that will, no doubt, be very helpful in his new role as chair of the PCAOB.
One of the legal cases that he successfully brought to a conclusion was *Free Enterprise Fund vs. PCAOB*. They were attacking the constitutionality of the PCAOB, and he successfully defended that claim, since the organization continues with him at its helm. That background positions him extraordinarily well to serve the organization. He has a strong relationship with Mary Schapiro, and that relationship will help support interaction with the SEC in the years to come, while the PCAOB’s agenda will provide him many opportunities to bring that background to work. I found the following quote from Chairman Doty in an article about his role at the PCAOB: “I’ve had a very satisfactory, interesting legal career, but I’m not in a position where I need to be thinking about what my next job will be. This is my last job, and I want to do it justice.”

**A Turning Point**

*James R. Doty, PCAOB chairman:*

Accounting and auditing are more important to American society than ever. Auditors may look back on this time as the moment when they turned to seize the future. This may seem odd, given the extent to which they have been questioned since the financial crisis. I am thankful for the opportunity to explain.

I intend to focus my remarks today on auditing. There are obviously important accounting issues to discuss and debate as well. But since February 1, when I became chairman of the PCAOB, auditing has preoccupied me. The public policy questions relating to the role of the auditor and the societal value of the audit deserve ample attention. I do have to say that the ideas I express today are my own and should not be attributed to the PCAOB as a whole or to any other members or staff.

**Background**

As was the case nine years ago, before the PCAOB was created, auditors find themselves at a point where their role and relevance are being debated. Reliable financial and economic data are one of the fundamental assumptions of American society that set us apart. We value a culture of honest representation and must continue to do so to promote our economic success.

Our system of capital formation relies upon the confidence of millions of savers to invest in companies they trust. The auditor’s opinion is critical to that trust. There are, of course, formidable forces that work against that trust.

First, the payment model: The auditor is hired and fired by the company itself. The Sarbanes-Oxley Act’s reform to shift hiring and oversight of the auditor from management to the audit committee may, in practice, have proved insufficient to counteract that conflict and others facing auditors. As with management, audit committees may see their job as negotiating the lowest audit fee, not championing auditor objectivity and independence from management.

In this environment, not surprisingly, the scope of the audit has not grown, even if society’s expectations have. As the guardian of a cultural value, the audit is arguably as important as electricity or water. But if it is to retain that lofty status, auditors and the PCAOB need to do their best to make sure the audit is useful.

This is not a new challenge. The late Sandy Burton was a respected SEC chief accountant, thereafter deputy mayor of New York City brought in to fix the city’s finances when it was on the verge of bankruptcy, and dean of Columbia Business School. In his time, Sandy put the same challenge to the profession. Burton was an effective advocate for using accounting and auditing to promote the public interest. He challenged auditors to do more for the public, but as he lamented in a characteristic op-ed piece in April 1980, auditors devote “[a] great deal of effort … to limiting responsibility rather than enlarging it.” His advice was clear: “The concept of audit” had to be expanded, and the auditor “must see his role as encompassing the evaluation of effectiveness in meeting goals and efficiency in operations as well as simply expressing an opinion on financial statements” [“Where Are the Angry Young CPAs?” *New York Times*, April 13, 1980].

Second, to protect the investing public, all public companies are required by law to obtain an audit. This statutory franchise protects the profession as a whole from the risk of obsolescence, thereby reducing auditors’ need to adapt to investor needs. As a result, auditors don’t have a natural incentive to evolve their reports into what investors want.

Third, there are other external conflicts of interest for the audit to overcome. Conflicts are rife in the fundamental issues auditors face in evaluating whether a company’s going-concern assumption is valid. They inhere in the judgments of people who prepare and market valuations while actively trading. Conflicts also emerge in audit committees compensated substantially in stock.

These forces—the payment model, the statutory franchise, and the incentives of others in the environment auditors operate in—constitute formidable discouragement. They deter the profession itself from innovating the audit to meet public expectations the way, say, a technology company or a properly incentivized service company would.

There is no silver bullet to address these challenges. There are as many or more problems with structural alternatives, such as a third-party payer or insurance-based system, and, in a dispersed ownership society, eliminating the audit requirement would be impractical and outright reckless. Therefore, our initiatives should go to reducing risks that follow from these conflicts and challenging incentives that weaken investor protection by applying a counterweight.

Public expectations demonstrate that the audit embodies a core societal value and relevance. But we obviously need to work on resolving the debate over the role auditors should be expected to play. In this, we will continue to benefit from the thoughtful involvement and support...
of Chairman Schapiro, her fellow commissioners and staff, and especially Chief Accountant Jim Kroeker.

**The Regulatory Interest in the Audit**

We are not alone in our reevaluation of the role and relevance of the audit, in light of lessons learned from the financial crisis. The cacophony of ideas currently in play makes for an exciting—but at times confusing—debate. Making sense of the debate requires careful consideration of the relationship between potential reforms and the goals we want to achieve.

European policy makers have contributed substantially to the debate. Many of the problems they have identified are the same that we experienced in the United States. But they attribute the cause of the problems, in large part, to market concentration. The reforms they propose would go to reducing market concentration—the paucity of choice among global audit firms.

Thus, for example, the European Commission has sought “views on whether the consolidation of the past decades should be reversed” by breaking up the Big Four (green paper on Audit Policy: Lessons from the Crisis, October 13, 2010, p. 17). The Financial Reporting Council (FRC) in the United Kingdom has championed “living wills” to plan for the contingency that a large firm will fail and thus concentrate the audit market even further (Response to Green Paper on Audit Policy: Lessons from the Crisis, December 2010). In the same vein, it supports initiatives to “reduce the level of concentration.” The FRC also proposes encouraging banks and other systemically important institutions to use non–Big Four firms and prohibiting the use of “Big Four only” clauses in banking and loan covenants.

In a rather unprecedented measure, the United Kingdom’s House of Lords’ Select Committee on Economic Affairs has also weighed in on these issues. The Lords focused on the ramifications, during the financial crisis, of the “narrowness of the assurance” auditors gave on systemically important financial institutions, and auditors’ “failure to give warning of trouble in the run-up to the financial crash.” But they went on to conclude that “There is inevitably a connection between the assessment of the Big Four’s performance and the question … of market concentration” (Auditors: Market Concentration and Their Role, HL Paper 119-1, March 30, 2011).

I question how directly these proposals advance the public’s call for more relevant information, including “early warnings,” from auditors. I do not believe that the global audit firm networks themselves pose systemic risk to our economy. But initiatives to shrink the global firms would likely further weaken their ability to audit the large, multinational companies that may themselves be systemically important.

The global audit firm is not too big to fail: It is too important to leave unregulated. To protect investors, governments should regulate such firms, not cripple them.

There’s no reason to think that if there were more major firms, they’d be more likely to stand up to their clients. Audit firms today compete fiercely on the basis of price and client service. They don’t compete on the basis of investor protection, and they question whether their corporate clients value audit quality.

This position offers no support for anti-competitive, price-fixing practices. But competition issues are the bailiwick of competition authorities. And I would be concerned about measures to promote competition that would—proposed in the name of audit reform and expressed in the rhetoric of market transparency—have a negative effect on audit quality in application.

**PCAOB Protections**

Turning away from reforms aimed at competition, there is still much to be done to meet the public’s demand for more and better information from auditors. The PCAOB is engaged in a broad dialogue with investors, auditors, audit committees, preparers, and others to consider how the auditor’s report can be changed to provide more useful, relevant, and timely information. The central questions emerging in our dialogue are: What should auditors’ responsibilities to the investing public be? What can auditors be expected to do? And how do we close the expectation gap in a meaningful way?

We expect to issue a concept release in the early summer summarizing and analyzing the input we’ve received. That concept release may result in the first substantial changes to the reporting model in more than half a century. The release will explore various possibilities and seek specific feedback.

We are also engaged in efforts to hold auditors to the high standards necessary to protect investors. The financial crisis revealed weaknesses in auditor practices, and we are pursuing them.

**Confidentiality and process.** Both our investigations and any contested disciplinary proceedings we bring are, by law under Sarbanes-Oxley, nonpublic, unless the respondents consent to publication of our complaints and decisions. We have asked Congress to change this.

In the years since Sarbanes-Oxley passed, the PCAOB has built an active enforcement program, but unfortunately for investors, audit committees, and the audit profession itself, it takes place largely behind the scenes. For example, in the last 18 months, the division has handled three disciplinary hearings against partners of large accounting firms for audit failures, in addition to a caseload of other litigated matters. If, after investigation, the board determines to file a complaint, it will not be public. Nor will any decision by the hearing officer or the board to impose a sanction, until any appeal to the SEC is exhausted.

The confidentiality of the enforcement process erodes public confidence in our oversight. Moreover, the public is denied any benefit from the deterrent effect that the filing of public complaints would have on other auditors. And other auditors and their counsel are denied the benefit of timely access to the board’s precedents.

**Current initiatives.** Public proceedings are important for public trust. But they are by no means the salve for all of the risks to investor protection that were revealed in the financial crisis. The PCAOB has important initiatives underway relating to improving audits of fair value measurements, improving communications among affiliated firms in global networks engaged in multination-
al audits as well as related global quality controls, and improving auditors’ communications with audit committees. Our improvements in standards are not intended to be traps or trip wires for auditors. We write standards so that expectations are clear.

We are also looking for ways to make our own oversight more effective and relevant. Our inspection process is a key early warning tool. I’m therefore troubled about reports that some auditors have downplayed the significance of our findings to their clients. Audit committees should be skeptical of auditors’ efforts to do so.

Many aspects of inspection findings are, by law, confidential other than to the inspected firm. But we are looking for ways to improve audit committee awareness of the risk of accepting overly rosy characterizations of our reports, as well as to discourage firms from making them.

I am also concerned about possible disparities between firms’ routine representations—in public responses to PCAOB inspection reports—that they have complied with applicable standards on addressing deficiencies, and the inspection staff’s view that that is frequently not the case (see AU 390, “Consideration of Omitted Procedures After the Report Date,” and AU 561, “Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report”). We intend to increase our scrutiny of firms’ follow-up efforts to correct deficiencies and will consider enforcement actions where appropriate.

Oversight of Multinational Audits

I’ve touched on the global networks a couple of times today. While I don’t think they are too big, let me talk about what does concern me.

My first concern is investor and public awareness. I have been surprised to encounter many savvy businesspeople and senior policy makers who are unaware of the fact that an audit report that is signed by a large U.S. firm may be based, in large part, on the work of affiliated firms that are completely separate legal entities in other countries. For many large, multinational companies, a significant portion of the audit may be conducted abroad—even half of the total audit hours. In theory, when a networked firm signs the opinion, the audit is supposed to be seamless and of consistently high quality. In practice, that is often not the case.

This gets to my second concern. Based on our inspections, I can say that the challenges of managing a multinational audit are great. As our international inspections program matures, we have begun to evaluate the various pieces of the audit performed by different registered firms in multiple jurisdictions. Our inspectors often see more than the principal auditor or signing firm does. In many cases, principal auditors rely on high-level reports from subsidiary auditors. They often don’t review the workpapers of the other auditors. Our inspectors do. And they often find problems in that work. (It is worth noting that the European Commission’s green paper Audit Policy: Lessons from the Crisis expressed the view that “Group auditors should have access to the reports and other documentation of all auditors reviewing sub-entities of the group. Group auditors should be involved in and have a clear overview of the complete audit process to be able to support and defend the group audit opinion.”)

Inspectors have found obvious errors that could have—and should have—been picked up by the principal auditor if communication between the two auditors had been more robust. Inspectors have found unresolved audit issues between affiliates. One inspection team found a situation where the affiliate’s audit team perversely failed to perform audit procedures, unbeknownst to the principal auditor until we conducted our review. Once the problem came to light, the firm arranged for the team to be removed. But it fell to the PCAOB to find the problem. In several cases, inspectors discovered that an affiliate had failed to appropriately audit revenue, even though the affiliate reported to the principal auditor that it had. There’s more, but you get the picture.

We intend to enhance our scrutiny of how principal auditors react to deficiencies in the work they refer to other auditors. Findings like those I’ve described should drive auditors to improve their communications with the affiliates they use, as well as improve preventative global quality controls.

These findings demonstrate why it’s so important that we look at the parts of the audit not performed by the principal auditor, whether the principal auditor was in the United States or elsewhere. (Indeed, some of these examples were in situations where the principal auditor was outside the United States, but the subsidiary auditor was in the United States.) This month, we are commencing joint inspections with U.K. and Swiss authorities. In addition to the work we perform to protect U.S. investors both here and in those jurisdictions, as appropriate, we will share any relevant information we obtain on the U.S. portion of multinational audits of importance to those authorities.

We are working diligently to reach similar arrangements with other European authorities. In addition, the PCAOB continues to be engaged in discussions with the Chinese authorities and hopes that—over the course of the next several months—significant progress will be made. This is especially important given the growth in the number and size of Chinese companies seeking access to capital in U.S. securities markets.

I believe Chinese authorities understand that they have a real interest in solving our impasse. For those who argue that the big Chinese companies don’t find the U.S. markets attractive, think again. The Chinese Internet social networking giant, Renren—sometimes referred to as the “Facebook of China”—went public earlier this week, raising in excess of $700 million in its IPO. It has an estimated market value of approximately $7 billion.
U.S. markets continue to be attractive for companies that have their major operations in China. It is critical that investors in these companies are afforded the investor protections that attach to U.S. markets. But as long as we are unable to inspect a registered firm’s work, investors are deprived of the benefits of our identifying or correcting audit problems like those I’ve described. In the case of multinational U.S. companies, investors may even mistakenly assume their interests have been protected by an audit inspection. This undermines a key component of our investor protection system.

Our markets are the strongest in the world. They provide for the formation of capital, and ownership by U.S. and non-U.S. companies and investors alike. I know my predecessors have pointed this out before, but let me reiterate: Investors are willing to pay a premium for shares purchased in U.S. markets and protected by strong securities regulation and enforcement. Foreign companies can even get a premium in their home market if they are also listed in the United States (see Rene M. Stulz, Craig Doidge, and Andrew Karolyi, “Why Do Countries Matter So Much for Corporate Governance?,” Journal of Financial Economics, vol. 86, no. 1, October 2007, pp. 1–39; and Luzi Hail and Christian Leuz, “Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings.” Journal of Financial Economics, vol. 93, no. 3, August 2009, p. 428–454).

The premium will only survive, though, if investors believe U.S. investor protections are actually enforced. The laws on the books, including oversight of auditors, won’t continue to make a difference for non-U.S. companies if they don’t comply.

As painful as the recent past has been for investors and financial markets, and as complicated and expensive as the future appears, we in the United States can take heart in the fact that the future, even if uncertain, is not as complicated and expensive as the future appears, we in the United States can take heart in the fact that the future, even if uncertain, is not as complicated and expensive as the future appears to be.

Investors are deprived of the benefits of our identifying or correcting audit problems. As long as we are unable to inspect a registered firm’s work, investors are deprived of the benefits of our identifying or correcting audit problems.

**Questions from the Audience**

**Audience member:** How does that supervisory-driven inspection meet the Sarbanes-Oxley Act of 2002, which says that oversight is to determine compliance? It continues to be a supervisory-driven inspection, and the inspection report says you can’t make any judgment about the rest of this company and there’s no way to compare this year’s with last year’s, or all of them as a group in a given year, because they’re doing different things at each inspection. Does this supervisory approach meet the compliance implication? I have never been able to get an answer to this question.

**Doty:** You have touched on one of my favorite subjects in this area; it’s a good question. I believe that the entire discussion over supervisory roles has been a confusion over nomenclature. We are not the Federal Reserve; we do not have money to hand out. We do not perform a support role. We are inspectors. We are there to promulgate standards that add clarity and effectiveness to the performance of the audit. We inspect to determine whether those standards are being met in the audits that we inspect and insist on remediation where we think they are not. If a firm is not cooperating in our process of inspection, or our investigation of audit deficiencies, or our remediation, we bring complaints. Those are the functions that we have.

I think supervisory roles add confusion to what is a straightforward regulatory role. We administer statutes—we are required to promulgate audit standards, to improve audit standards where they need to be improved. Some of the ones I’ve mentioned today, such as the supervision of the work of a foreign audit firm, a non-U.S. audit firm, a participating audit firm, are areas where we think the standards will be improved and should be improved. But to the extent we demand or ask for remediation and then determine whether remediation has occurred, we do that under statutory mandate. I don’t think it’s useful to lump all of that into a term like “supervisory” and assume that it means something other than what the statute and the regulatory system calls for.

**Audience member:** Are the board members sufficiently skilled for the responsibilities that they undertake? And a second question: Many board members have multiple board obligations. When you get to four, five, six memberships for a single individual, what impact do you think that has, and what is your view on the commitment level?

**Doty:** First of all, let me say I don’t think the chairman of the PCAOB has any particular standing on this question. I think I have standing based on 35 years of law practice and having seen boards of all kinds. I will tell you that I am firmly of the opinion that the quality of directors varies a great deal, has generally improved in the course of my time as a practicing lawyer, and still has a way to go in some areas.

Second, I think the bar—and the efforts of a lot of people, such as the ones in this room—has done a great deal to focus directors on the problems of being on too many boards. And I do think that’s one of the areas where I, a practicing lawyer, have seen much more self-consciousness.

I don’t think directors think that they can be on six, eight boards anymore. I hear a lot of the people I regard as the better directors saying that you can’t handle more than three, that if you’re on an audit committee or a compensation committee, one of the high-work, skills-based committees, that cuts down the number of boards that you should undertake. This is an area where, if I may say so, I think that lawyers have actually elevated the level of consciousness and awareness. The standards that were enacted in Sarbanes-Oxley, min-
imum standards of independence of committees and boards, and that were embodied in the New York Stock Exchange rules—these all became best practices by the time they became part of law. So I think that board quality, board skill, and board acumen is something that directors have to continue to work on.

Our standard on communications with audit committees will have that governance focus. It will be intended to make sure that we have enhanced the awareness of a board of directors or an audit committee about the nature of the audit and the adequacy of the audit practice and the audit function. There’s a governance role for the PCAOB there, and it’s broader.

Norman N. Strauss, Ernst & Young Executive Professor-in-Residence, Baruch College: May I ask a quick question about what you had said about the possibility of changing the auditor’s report to a qualitative report introducing a lot of subjective information? I imagine auditors who are used to having the standard language for all these decades might be a bit reluctant to get into this new, possibly subjective direction. Do you expect that type of feedback from the auditing profession?

Doty: We’re getting it. We’ve had it. The concept release will recite concerns by the audit profession that, first, they shouldn’t be preparers of financial information. The responsibility for preparing the information that’s in a financial document should stay clearly with management; to the extent that the auditor expands some of these areas that are covered, there’s a danger of that. Auditors are keenly aware of the fact that there are some things that can be audited and some things that can’t. The concept release offers a wide range of areas in which the audit report could be modified to make it more meaningful and relevant. We hope that when we’re through with this, we will have had a lot of comments from the audit profession and the investor constituencies that will enable us to focus on those changes of the best ones. There is, for example, a view that we should have an “auditor’s discussion and analysis” in which they do address some of the non-financial statement items in the report of an issuer—there’s a practical question which the profession raises as to how you get control of that. As a major firm with 20,000 to 30,000 people out there preparing a year-end audit, how do you avoid free riding, which results in no control by the firm?

You asked what the audit profession is concerned about, and I’ve summarized that. There’s an equally wide range of concerns by investors and by users of financial statements that somehow we avoid a simple binary formulation, which gives an investor little sense of how far the audit has gone, how searching some of the processes have been, and whether they’ve done their work, for example, in determining anything about the adequacy of management’s estimates. There’s a big menu in that concept release that will attract a lot of interest.

Audience member: I respect your support for the idea that important actions by the PCAOB should be public during the proceedings. What would be the line of demarcation according to which some issues should be made public?

Doty: It’s when the division of enforcement has brought to the board a proposed complaint with charges and the division of inspection tells the board that they are prepared to prove these charges so that it achieves the specificity of a filed complaint. This is very important in my thinking. In other words, I think we want to avoid speculation and rumor about what enforcement authorities are doing with respect to any particular highly public issuer failure, issuer problem, and it seems to me that one of the advantages is that if that which is publicized is a filed complaint which has crisp, clear, concrete allegations in it which we approve and prepare to have tested in the appellate process, that’s what should be made public. Not the negotiations, not the rest of the process of the investigation. Investigations at the SEC are confidential, as you know, and it’s appropriate that they be highly confidential.

Audience member: Thinking about Parmalat and Satyam, if you ask for more control of international affiliates, are you going to be increasing the accounting firm’s liability?

Doty: We have a basis on which much of our activities proceed in which we think it is important for us not to proceed with a view to increasing liability or increasing the risk of private civil litigation. We want to make sure that what we’re doing has a regulatory basis, a regulatory purpose. With the SEC rules, one of the examples I use is that I’m not aware of a single major accounting firm that has been brought down by civil private litigation that resulted from an SEC civil enforcement action. Arthur Andersen failed because of a criminal indictment which, in retrospect, was very questionable. There are firms that have had their troubles with the SEC, but, in general, the administrative process has proved to be a very flexible tool for dealing with these issues. There are civil complaints filed on Satyam now, and I assume that as long as the plaintiff’s bar is working on these issues, there will be complaints filed and these come out of civil enforcement actions. But we should not be doing what we’re doing, or refraining from what we’re doing, based on the issue of what private civil litigants may do.

“There are firms that have had their troubles with the SEC, but, in general, the administrative process has proved to be a very flexible tool for dealing with these issues.”
The first panel of the afternoon session at Baruch College’s 10th Annual Financial Reporting Conference on May 5, 2011, dealt with standards-setting developments in the private sector. The panelists provided updates on standards-setting efforts by a number of bodies, including the FASB, as well as the Emerging Issues Task Force (EITF) and Financial Reporting Executive Committee (FinREC).

**FASB’s Agenda**

FASB Technical Director Susan Cosper, a former PricewaterhouseCoopers partner, began the session by addressing a variety of less controversial issues (i.e., revenue recognition, leasing, and financial instruments) recently covered by the board or topics on its agenda.

“If you have a troubled debt restructuring, there’s a lot of additional disclosure and a different impairment model that one needs to follow. We undertook this project to clarify the notion of concession and financial difficulty,” Cosper said. The guidance in ASU 2011-12 clarifies when a restructuring occurs and when a debtor is actually experiencing financial difficulties. In practice, Cosper said, “there will probably be more troubled debt restructurings than in the past.”

Cosper then briefly discussed the recently completed ASU 2011-03 (Topic 860). The guidance recommends that an entity look at whether effective control exists when determining if a repurchase agreement should be classified as a sale or a secured borrowing.

“The credit crisis highlighted the need for additional disclosures, particularly as it relates to financing receivables,” Cosper said. The objective of ASU 2010-20 is
“greater transparency to users of the financial statements to understand the changes that have occurred with respect to allowances and the evaluation that management has performed.” The disclosures “put a little bit more pressure to have companies consistently identify troubled debt restructurings,” according to Cosper. “The initial feedback is that users have seen a lot more consistency among disclosures and among companies in this regard,” she added.

Cosper then turned to active projects on FASB’s agenda, starting with multi-employer plans. “The premise behind the project was to increase the transparency associated with an employer’s involvement,” Cosper said. What began as a disclosure-only project resulted in a controversial proposal that would require employers to estimate their proportion of the unfunded status of the plan. Because of the overwhelmingly negative response the proposal received, FASB is “going back to the drawing board,” and “exploring ideas with respect to the information that’s already available,” Cosper said.

**Debate over Goodwill Impairment**

Cosper said that feedback from private companies led to the current project on goodwill impairment. “Is there a way,” she asked, “that we can achieve the same outcome but reduce the cost for private companies?” The proposal would introduce a qualitative screen in which accountants would “look at a number of factors to see if there’s a more-likely-than-not determination of whether the fair value of the reporting unit is less than the carrying amount. If it’s more likely than not that it is, then you proceed—but if it isn’t, then you stop.”

“We’re still looking at it and actually struggling with going on record of being opposed to a simplification,” responded Robert Laux, senior director of financial accounting and reporting at Microsoft. He said that there are huge assumptions that go into determining the fair value of a reporting unit, notably its terminal value and the weighted average cost of capital. “I don’t know personally if this is the way to go,” he said. “For the auditing community it seems like: How do you make that qualitative assessment unless it’s not even close? But if it is close, it seems like you want to see some numbers. It just seemed like a low threshold to me.”

“I think you’re also hitting on a couple of important issues, which is some of the subjective nature of the inputs into a fair value measurement,” added Richard Paul, partner at Deloitte & Touche LLP. “When is that point where the fair value measurement from some period in the past is no longer a good piece of information on which to make this assertion?” He added, “The user community has typically responded negatively to optional accounting treatment … from a comparability standpoint.”

“From a user’s standpoint, I’m not sure that this is going to be a huge deal,” said Carlo Pippolo, partner at Ernst & Young LLP. “From an auditor’s standpoint, the more subjectivity you have in a test, the more discomfort we have. It’s probably not going to help a lot on close calls, but the ones that we wouldn’t have been concerned about before, will be easier to put behind us.”

**FASB Proposals**

Cosper then turned to the proposed guidance on consolidation, notably the agent-principal classification. The proposed guidance would eliminate the deferral of SFAS 167 for interests in certain entities and align the variable interest model more with the voting interest model. Another consolidation issue that FASB is working on involves investment companies. “The tentative decision is that, if you’re an investment company, you measure all your investments at fair value.” This guidance is expected to be released alongside similar guidance for investment properties. The project was added to the agenda to “fill a void” in FASB’s guidance as compared to International Financial Reporting Standards (IFRS), brought to light by tentative decisions reached in the leasing project.

Cosper also noted forthcoming guidance in fair value measurement, clarifications of “highest and best use,” that should not be significant for U.S. GAAP filers. Finally, minor changes to the presentation of other comprehensive income are also forthcoming.

Norman Strauss, the Ernst & Young Executive Professor in Residence at Baruch College and panel moderator, followed up with a question: “Right now, there isn’t any real concept for what goes into OCI [other comprehensive income]; it’s basically whatever the board selected in different standards. … When a reader picks up the income statement and sees a major adjustment for changes in exchange rates from the translation adjustment, will there be some potential for that to detract from the ability to read the old-fashioned income statement as a stand-alone statement?”

“I think it will have some favorable reactions from users,” Cosper replied, “and it may cause a little consternation to some preparers; but I think the information was previously there, but perhaps not as prominent.”

**The EITF’s Efforts**

“The SEC and Dodd-Frank and everything else going on, I have some good news for you: The EITF has absolutely slacked off over the last year,” Pippolo, a member of the EITF, began his presentation on the group’s recent efforts. Pippolo attributed the EITF’s lack of recent pronouncements to FASB’s own full agenda. The EITF’s recent projects have tended to be industry-specific.

“Hospitals are required to disclose how much charity care they provide,” noted Pippolo. “The only problem is, there’s no guidance about how to calculate that number. Some entities were using revenue, some were using stated revenues, some price lists, some reduced prices, some cost. So the EITF decided, let’s make it cost” (EITF Update 2010-23). In another healthcare industry issue, Pippolo said the EITF decided that “when you have a contingent liability, like a malpractice liability, and
you have a probable insurance recovery, rather than netting those on the balance sheet, those have to be grossed up” (EITF Update 2010-24).

With regard to reporting loans to participants in defined benefit plans, the EITF clarified a problem in the literature by advising entities to account for them at amortized cost (EITF Update 2010-25).

A more controversial decision (EITF Update 2010-26) involved the costs associated with acquiring life insurance contracts. “A lot of life insurers were basically capitalizing the loss incurred by underwriters whether or not they successfully issued an insurance contract. And that’s something that really caught the attention of some people,” Pippolo said. The resulting guidance, a significant change in GAAP, “narrows practice considerably with respect to deferred acquisition costs in the insurance industry.” The guidance is also stricter than that from the International Accounting Standards Board (IASB), so Cosper said it will come up for further discussion.

EITF Update 2010-27 deals with the fees that pharmaceutical companies have to pay to the government, starting this year under the Affordable Care Act (ACA). “Even though it’s based on prior year revenues, this is simply a tax,” Pippolo summarized the decision. “We kind of twisted the interim reporting rules to get to an answer that allowed for amortization of that liability over the course of the year.”

“Goodwill rears its ugly head again,” noted Pippolo in discussing EITF Update 2010-28, “When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.” In situations where an entity had negative carrying value, “entities appeared to skate through the goodwill impairment test, even though there were situations where goodwill was looked impaired.” Although the EITF passed on the issue of whether units should be measured under an equity premise or an enterprise premise, it did say that the impairment test shouldn’t stop just because book value is negative. “Look at the qualitative indicators that were already in the guidance around goodwill impairments and see if it looks like it’s more likely than not that you have a goodwill impairment,” Pippolo said. “If so, proceed to step two [of the impairment test].”

The final pronouncement discussed by Pippolo, EITF Update 2010-29, made accounting rules consistent with SEC rules. “You effectively had this purchase accounting adjustment amortization coming through twice in two different years,” explained Pippolo. The guidance called for users to “prepare your disclosures as if a business combination occurred at the beginning of the preceding year, not as if it occurred in two different periods.”

The EITF Agenda

Pippolo then discussed pending projects on the EITF’s agenda. Issue 09-H deals with the netting of patient service revenues and the associated allowances for bad debt, a widespread issue given healthcare institutions’ obligations to provide care in many situations where patients’ ability to pay might be in doubt. The consensus out for exposure would start with revenues, classify bad debt expense as contra revenues, and effectively reach a net revenue amount.

“Issue 10-E [Accounting for Deconsolidation of a Subsidiary that Is In-Substance Real Estate] is one of those issues where we have different models that have different recognition, or derecognition, cuts,” Pippolo said. “You wind up getting different answers depending on which piece of literature you apply.” The EITF was unable to reach a consensus, so further attention from FASB is expected. Finally, Pippolo noted a consensus out for exposure on fees that will be assessed on healthcare institutions under the ACA starting in 2014, a similar issue to the one facing pharmaceutical companies.

“Is there any concern that there’s a lag of practice issues that are substantive that are not getting to the EITF?” Laux asked Pippolo. He responded that more issues are not being dealt with behind the scenes: “Now that we have to go through essentially the same type of due process that the FASB does … the EITF process isn’t so quick anymore.” He also thought convergence issues might be pushing other issues into the background.

FinREC Update

Paul reviewed recent developments at the Financial Reporting Executive Committee (FinREC; formerly the Accounting Standards Executive Committee, AcSEC), which he chairs.

“There’s an evolution of accounting standards,” Paul said. “A lot of industry guidance is getting removed and Revenue Recognition [the joint FASB-IASB project] is the perfect example.” He said FinREC tries to “provide some examples, but not cross the line and provide guidance.”

Paul described FinREC’s accounting guides as more robust than the guidance in the Accounting Standards Codification. “There’s a lot more discussion about the regulatory environment, about state and local laws, about some typical types of transactions that are relevant to that particular industry, and there’s a lot more examples. … It’s intended to be a document that you can pick up and read cover to cover, and you could be knowledgeable about the particular industry.”

Paul described FinREC’s practice aids as “intended to provide examples, to provide some valuation techniques that go beyond what the accounting literature says and align that with some of the accounting guidance so that you could really get a full flavor for what’s going on with a particular industry.” He mentioned that the group recently finished a draft practice aid on valuing the equity securities of a privately held company and is working on another about impairment testing for goodwill, intangible assets, and other long-lived assets.

Paul concluded by discussing a pending guide on in-process research and development. Laux, who is working on the guide, described the challenges presented by a literal reading of the existing guidance. “All intangible assets acquired in a business combination to be used in research and development activities should have an indefinite life,” he said. “The problem is that some of the intangible assets you acquire could be patents and to put an indefinite life on a patent that has a finite life just does not make sense, so we’re trying to step around the literal reading and interpret it.”
The final panel at Baruch College’s 10th Annual Financial Reporting Conference on May 5, 2011, was a free-flowing discussion about revenue recognition and leases. These two major projects are nearing completion and the panelists, representing a wide range of perspectives, debated the pros and cons of the approach being deliberated by FASB and the International Accounting Standards Board (IASB).

Simplifying Revenue Recognition

Norman Strauss, the Ernst & Young Executive Professor-in-Residence at Baruch College, opened the discussion by asking why FASB and the IASB decided that a new model for revenue recognition was needed.

He was answered by FASB Technical Director Susan Cosper. “There are a lot of rules that are industry-specific and a lot of concerns around economically similar transactions that perhaps aren’t being recognized in the same way,” she said. “Simplification is needed, and a principles-based model that spans across all industries is needed.”

James Barge, Viacom CFO, said, “I don’t think it’s the number of standards, whether it’s one or 180. I think it’s the ability to implement standards and the reasonableness of the standards.” Though he likes the concept of one standard, Barge said it is difficult to craft guidance that can be applied across different industries with different business models.

Greg Jonas, managing director at Morgan Stanley, added, “The concerns of the current status quo are that there are too many models, inconsistent models, insufficient disclosure about revenue streams, and problems with revenues that seem to be back-ended. In other words, you find the good news up front and then as con-
tracts wear on, the bad news comes out.” He thinks a single, integrated standard could lead to better understanding by investor users. “The two big risks of an integrated project is it introduces a lot of judgment—or could—into the process, and it opens the door for potential aggressive behavior by removing conservative industry accounting that frankly was put in place over the years because of abuse.”

Jan Hauser, a partner at PricewaterhouseCoopers, said that although simplification would make things simpler for users and auditors, the devil would be in the details. “There were a number of things in the original exposure draft that will create a lot of judgments and estimates that need to be used by preparers and then audited,” she said.

SEC Chief Accountant James L. Kroeker said the guidance should address the recognition issues raised in Staff Accounting Bulletin (SAB) 104. “A good exercise would be … to go through SAB 104 and say, ‘How would the model they’re developing address the particular question?’ That doesn’t mean the outcome has to be the same as SAB 104, but if the question isn’t addressed, then you wonder: Do we still need some incremental guidance?”

**Satisfying Performance Obligations**

Cosper said that the overall premise of the proposal is to develop a core principle that can overlay all industries: A company would recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer who thus obtains control. “The challenge of that principle is all of the steps that you need to go through,” she said, “such as identifying and separating performance obligations, which are sort of similar to what we used to called deliverables, determining what your transaction price is, determining how it’s allocated, and so on.”

Hauser said, “Even though there will be changes in the terminology, I think in many respects a lot of revenue recognition is not going to change.” She noted that the focus now is on the performance obligation and what assets and liabilities are created as a result. “I think many of the same types of things that drive the economics will continue to drive the accounting,” she said.

Strauss asked, if companies credit the performance obligation instead of deferred revenue, would it be clearer to users that it represents a liability rather than a deferred item? Jonas thought it would: “There are many places in the literature over the years where the board has requested the discipline of every balance sheet date, taking stock, literally, of where you’re at. Some people have referred to that as a balance sheet focus. I don’t think that’s what it is. I think it just adds discipline in thinking about defining flows in terms of changes in stocks over time.”

Hauser admitted: “When you think about control and transfer of controls as it relates to services, it’s not exactly an intuitive concept.” She said the boards are still developing the details for the final standard, coming up with relevant criteria that would address services provided continuously over time. She said the boards are also talking about the impact on this continuous recognition of revenue if the service is stopped midstream and if valuable services are provided prior to an ultimate deliverable.

**Variable Consideration**

“The boards have tentatively made a decision that there are two approaches one can use to determine how much variable consideration should be included in the overall transaction price,” Cosper said. “The overall objective is to estimate the total amount of consideration that the company expects to receive or what they predict that they might be entitled to.” The two approaches are referred to as probability-weighted and best-estimate.

Strauss walked through how he thought the probability-weighted approach would be applied in a hypothetical situation, but Barge disagreed with the outcome. “To me, this should be relegated to a theoretical textbook. It doesn’t work in practice,” he said. He favored the best-estimate approach: “I think real life is far too complex to be going down a probability-type measure across all points. It’s very difficult in practice, and I would simply remove it from the standard.”

Barge continued: “I think there’s still some work to be done on what ‘reasonably assured’ means, to prevent front-end revenue recognition that doesn’t serve anybody well.” He expressed some concern that one could still find examples that would lead to very different accounting treatments depending upon the approach and parameters used.

Hauser admitted that several questions remain about the “reasonably assured” benchmark. “I think the industry input on this variable consideration is definitely going to be key,” she said. “The board certainly doesn’t want to end up with unintended consequences.”

Kroeker added, “I’m not sure how reasonably assured and probability-weighted work together. I’m certainly troubled by the idea that you could choose to do either probability-weighted or best-estimate. … I happen to be more of a fan of a best-estimate, with some higher threshold, if we’re going to get into recognizing contingent revenue.”

**Collectibility**

Cosper said that feedback to the initial proposal led FASB to reconsider its stance on customer credit risk, so that now it is not considered in the overall transaction price. Hauser preferred the approach ultimately chosen, because the proposal would have been “very complex in order to bake the collectibility into the transaction price.”

“We want to see all the bad debt and we don’t care whether we see it upstairs as a separate line item under revenue or whether we see it downstairs as an expense,” said Jonas, noting that the board ultimately didn’t allow companies to bury bad debts in revenues. “I commend the board for being responsive to what they heard.”

Barge disagreed that a separate line item was necessary. “I think it’s tough when you take something that could be small in a lot of cases and dictate it as a separate line item on the income statement.”

**Other Revenue Issues**

Hauser said that the board revised the “onerous test” for contract losses in response to comments, but noted that the issue might be revisited.
Cosper explained: “There are two types of warranties—warranties for latent defects … and a second warranty that perhaps you purchase for fault down the line. Under the current proposal, the notion of latent defects wouldn’t necessarily rise to a separate performance obligation; you’d largely account for it the same way you account for warranties today. But to the extent you actually do purchase that separate warranty … that would likely give rise to a separate performance obligation.”

“I think the model that the FASB proposed certainly sounded, on its face, not all that difficult,” Hauser commented. “But it became much more complex in terms of implementation.”

Cosper said the implementation of the guidance will likely be retrospective, perhaps with a limited alternative. When it comes to reconstructing past numbers, Barge advocated some flexibility, given the time and costs that will be involved in the transition. “We should be prepared to make further changes to the standards, because I think when we start running two years parallel before we’ve adopted, that’s where all of the flaws, unintended as they are, will start to surface.”

Strauss asked the panel if they thought the revenue recognition was ready to be finalized or needed to be reexposed. “I think that there’s some potential fatal flaws in the document as it is now, which has moved considerably in a very good direction,” responded Barge. “I think it’s worthy of a reexposure to go to that second level … to make what would be another set of hopefully good corrective efforts.”

Leases

Strauss turned the discussion to the proposed accounting for leases. In explaining the reasoning behind the changes, Hauser said that “the focus was certainly to treat leases consistently and get them on balance sheet, recognizing that there is an element of an asset.” She noted that the focus of this project has been on lessee accounting.

“I think the model that the FASB proposed certainly sounded, on its face, not all that difficult,” Hauser commented. “But it became much more complex in terms of implementation.”

Jonas opined: “It turns out that users are of two camps on this whole issue. In the one camp, we have those who think it’s an operating activity, and for them this is not about finance. [The leases of those in this first camp] are operating activities, and lease liabilities are not debt-like, they are operating-like liabilities. … As such, that liability is not very likely to alter users’ impressions of company value.” He considers himself in the second camp, which “view leasing as fundamentally a financing activity. And we see lease-relat ed debt on the balance sheet.” According to Jonas, the two camps see leases differently on the income statement and balance sheet, and the camps have been giving the boards very different counsel on how to proceed. “Everybody agrees there’s a liability, but we treat that liability very differently, depending on your camp.”

From the lessor’s perspective, Hauser said there are “two different models, depending upon whether or not the lessor retains exposure to a significant portion of the risks or benefit.” If the lessor retains exposure to significant risks and benefits, it would use the performance obligation approach: “The asset would stay on the balance sheet and then you would account for the receivable and then have the offsetting performance obligation.” Otherwise, it would use a derecognition approach, where “you would effectively have the right to use an asset removed from your balance sheet and have different accounting, but not a performance obligation.” According to Cosper, factors to be considered in determining whether the lessor has retained exposure to the risks and benefits include the asset’s useful life, its value, and how that value may have declined over the lease term.

Strauss asked how leases, now that they were on the balance sheet, would be removed. Cosper said that the issues are still being deliberated, but a finance lease could be amortized based on a pattern of consumption, whereas other leases could use a straight-line method. This led to a discussion about the new guidance that would distinguish between the two leases, analogous to those formerly termed capital and operating, respectively.

“Once we have the guidance, we’ll know how easy or difficult it will be to implement,” Barge said. He discussed an example that would look like a finance lease under the proposed guidance and considered the implications on his cash flow and balance sheet.

“I can promise you we’ve seen our last finance lease,” declared Jonas. He harkened back to the two camps of users: Those who think leases are an operating item are applauding the proposed guidance, but those who think every lease is a financing activity are disappointed. “We think there’s no such thing as lease expense,” he said. “We see amortization of an acquired asset in interest.” He credited the boards for listening to users, but criticized them for listening only to those users in the first camp.
“I think we need to resolve: Is there a financing component to leases or not?” Kroeker added. “I think they’re financing and we ought to recognize them as financing. We’re making added complexity by trying to split them. If it’s financing, put the asset on the books and recognize it.” Cosper noted that the boards are still deliberating this contested issue, and thus the details are still to be determined.

Renewals and Contingent Rents

The issue of lease renewal was also controversial. “Today, people in camp one are not adjusting financial statements for leasing. Camp two are the ones who are adjusting financial statements for leasing,” Jonas said. “We think that lease renewals that are likely ought to be factored into the thinking. We think contingent rent ought to be factored into the thinking. We’re getting numbers … that are much larger than the board is going to give us capitalizing minimum rent.” Jonas questioned the usefulness of the approach: “The risk here is the board’s going to hand us a number we’re going to look at and say, ‘Well, that number isn’t helpful,’ and we’re going to adjust these statements on the back of the napkin just like we always have.” He added that those in camp one would just disregard the number.

“In the original proposal, contingent rents would be included based upon a probability-weighted assessment,” Hauser said. “Once again, that proposal was very controversial.” She said that “the boards listened and effectively scaled that back dramatically,” such that contingent rents would not be included unless they were effectively disguised fixed payments.

Making Progress and Making Judgments

“We believe that the revenue project and the leasing project have progressed at a faster pace than the financial instruments project,” Cosper said. “I think the teams have consistently endeavored to reach out on all of the decisions that are being made as they go along, as well as to try and solicit feedback after we finish deliberations on the overall models.”

In response to a question from the audience about how auditors are going to be able to support the revenue recognition decisions made by management, Cosper noted that such judgments are already being made today. “As we gain experience with this, I think we will be able to make those judgments,” she said. “I do think the results, in many occasions, are going to be a better economic representation of the revenue stream.”

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Accounting Policy Options in IFRS

Weighing the Choices Upon First-Time Adoption

By Eva K. Jermakowicz and Barry Jay Epstein

As the SEC continues working on its final road map to transition U.S. publicly traded companies to International Financial Reporting Standards (IFRS), advance planning is the best way for companies to prepare for this seemingly inevitable change. It also presents companies with a unique opportunity to comprehensively reassess their financial reporting policies. Doing so may provide management with the occasion to reconsider whether their accounting policies reflect mainstream practices in their respective industries, provide users with the clearest understanding of the underlying economics of the business, and convey the desired degree of management prudence and transparency in financial reporting.

Key steps in adopting IFRS include the selection of accounting policies based on IFRS in effect at the end of the first IFRS reporting period, and the preparation of at least two years’ worth of financial statements and the opening balance sheet (statement of financial position) at the date of transition to IFRS, using those selected accounting policies.

Selecting and Applying IFRS Accounting Policies

In accordance with International Accounting Standard (IAS) 8, Accounting Policies, Changes in Accounting Estimates and Errors, accounting policies are “specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements.” Accounting policies include principles for recognizing and measuring assets, liabilities, income, and expenses, as well as the principles and practices for presenting these items in the financial statements. Entities presenting their financial statements in accordance with IFRS must follow accounting policies addressed in the standards issued by the International Accounting Standards Board (IASB).

IFRS, which are accounting standards adopted or issued by the IASB, consists of the following:

- IFRS, issued by the IASB;
- IAS, issued by the predecessor International Accounting Standards Committee (IASC), as amended; and
Interpretations developed by the IFRS Interpretations Committee, formerly called the IFRIC (International Financial Reporting Interpretations Committee), or its predecessor, the Standing Interpretations Committee.

IASB standards and interpretations often have guidance designed to assist entities in applying IFRS. Such guidance is mandatory only if it clearly states that it is an integral part of IFRS. Guidance that is not an integral part of IFRS does not provide requirements for financial statements.

If an IFRS specifically addresses a transaction, other event, or condition, an entity must generally follow the prescribed accounting. An entity may choose to not follow a specific requirement addressed in IFRS, however, if the effect of not doing so would be immaterial. IAS 8 explains that omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users based on the financial statements. Nevertheless, it is inappropriate to make—or leave uncorrected—immaterial departures from IFRS to achieve a particular financial statement presentation.

Under IAS 8, when there is not a specific IFRS that applies to a particular transaction, other event, or condition, an entity’s management must use its judgment in developing and applying an accounting policy. This should result in information that is both of the following:

- Relevant to the decision-making needs of users; and
- Reliable, meaning that the information—
  - represents faithfully the financial position, financial performance, and cash flows of the entity;
  - reflects the economic substance of transactions, other events, and conditions, and not merely their legal form;
  - is neutral (i.e., free from bias);
  - has been prudently developed and presented; and
  - is complete in all material respects.

In making such judgments, management should first attempt to directly apply the requirements in IFRS dealing with similar and related issues, and secondarily, as needed, make reference to the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses set out in the IFRS Conceptual Framework for Financial Reporting.

Furthermore, when making its judgments, an entity’s management may also consider the most recent pronouncements of other standards-setting bodies that employ a conceptual structure similar to the Framework to develop accounting standards, other accounting literature, and accepted industry practices, to the extent that these do not conflict with IFRS standards, interpretations, and the Framework.

An entity adopting IFRS for the first time may have a choice among accounting policies as a result of options within accounting standards (newly issued IFRS), options among alternate accounting policies that are set forth within accounting standards, and exemptions in IFRS 1, First-time Adoption of International Financial Reporting Standards.

Retrospective Application of IFRS

Guidance regarding initial implementation of IFRS is found in IFRS 1, which stipulates that an entity should apply the most current version of IFRS throughout all periods presented in its first set of IFRS financial statements, and also in its opening IFRS statement of financial position. Therefore, the standard requires retrospective application of each IFRS effective at the reporting date of an entity’s first set of IFRS-compliant financial statements.

For example, if a U.S. entity decides to adopt IFRS in 2012 and to present comparative information for one year only, the entity has to prepare the financial statements for 2012 and 2011 based on IFRS in effect at December 31, 2012, its first IFRS reporting date. In addition, the opening statement of financial position, prepared at the date of transition to IFRS (January 1, 2011, the beginning of the earliest comparative period) must also comply with IFRS in effect at December 31, 2012. Exhibit 1 illustrates these dates.

If a new IFRS has been issued prior to the first IFRS reporting date, but application is not yet mandatory, and if reporting entities have been allowed to apply it before the effective date, the first-time adopter is permitted, but not required, to apply the new standard as well. In such instances, retrospective application to the comparative and transition date financial statements, as described above, would also be necessary. An entity must apply all IFRSs that are relevant.

IFRS 1 contains five mandatory exceptions to the general rule of retrospective application, in recognition of the fact that the effect of the change in accounting policies for those items cannot be measured with sufficient reliability (e.g., retrospective application would require judgments about the past, and the outcome would be known on first-time adoption). These exceptions include accounting estimates, derecognition of nonderivative financial assets and nonderivative financial liabilities, hedge accounting, measurement of noncontrolling interests, and classification and measurement of financial assets.

In addition, the standard provides a number of optional exemptions from some requirements of other IFRSs in areas where the costs of applying IFRS retrospectively may exceed the benefits to financial statement users, or where retrospective application may be impracticable. An entity will thus have a number of choices between different options of accounting policies within IFRS 1, as well as within other accounting standards that need to be resolved in preparing its first IFRS financial statements.

Accounting Policy Options Dictated by Circumstances

The first—and most important—step in making the transition to IFRS is the selection of accounting policies. Many accounting policy options will, in fact, simply be dictated by an entity’s specific circumstances, for example, the method of accounting for long-term construction
projects or the method of accounting for development costs. Exhibit 2 presents examples of accounting policy options that are dictated by an entity’s specific circumstances. These options are discussed in more detail below.

**Inventory methods (IAS 2).** The specific identification method is used to cost items that are segregated for a specific project and not ordinarily interchangeable. It typically is only feasible when there are a relatively small number of items, having relatively high unit values, where the added effort of maintaining individual item records can be justified. In circumstances in which this is not required, a choice between first-in, first-out (FIFO) and average costing will be available. If the objective is to have inventory costing be roughly congruent with the physical flow of goods (which is not a required goal for financial reporting), then the choice of method may be dictated or suggested by the movement of product. For example, for companies that attempt to sell the oldest goods in inventory first for some of their products (e.g., perishable or fashion-sensitive goods), the FIFO method would best mirror the actual physical flow.

**Events after the reporting period (IAS 10).** The nature of information obtained after the reporting date (i.e., the date of the latest statement of financial position) will, typically, dictate how that information is to be reported—that is, as an adjustment to the financial statements themselves, or as mere disclosures. IFRS 1 requires an entity to treat information received after the transition date that relates to estimates made under previous GAAP as nonadjusting events. In contrast, significant nonadjusting events that are indicative of conditions that arose after the reporting period should be disclosed.

**Construction contracts (IAS 11).** In addition to all other IFRS requirements, construction contracts where the outcome can be estimated reliably, both parties have enforceable rights, and the stage of completion can be reliably estimated, necessitate the use of percentage-of-completion accounting. If all requirements are not met, revenue is recognized only to the extent of contract costs incurred that are probable to be recovered, and contract costs are recognized as an expense in the period in which they are incurred. An expected loss would be recognized immediately.

**Depreciation methods (IAS 16).** An entity should select a depreciation method that reflects the pattern in which it expects to consume the asset’s future economic benefits. In some cases, the benefits are evenly consumed and a straight-line method is most appropriate, whereas in others, a declining pattern of utility over time reflects economic reality, inasmuch as many types of equipment do become less productive with age. A “components” accounting is required for the depreciation of an asset with differing patterns of benefits.

**Leases (IAS 17).** Whether a lease is recognized as a finance lease or an operating lease depends on the substance of the transaction rather than the form. At the inception of the lease, the lease is classified as a finance lease if it transfers substantially all the risks and rewards accompanying ownership to the lessee. Careful and objective analysis of the substance of lease arrangements should reveal which method of accounting is appropriate.

**Governmental grants (IAS 20).** A grant that imposes specified future performance conditions on the recipient is recognized as income only when there is reasonable assurance that the entity will comply with such conditions and that the grant will be received. Grants received before the recognition criteria are met are recognized as a liability.

**Functional currency (IAS 21).** Several factors, such as the currency in which most operating proceeds are maintained, must be considered when determining the functional currency of a foreign operation, as well as whether its functional currency is the same as that of the reporting entity.

**Development costs (IAS 38).** Internal development costs are recognized as assets if an entity can demonstrate technical and economic feasibility of a project in accordance with specific criteria. The criteria include demonstrating technical feasibility, an intent to complete the asset, the ability to use or sell the asset in the future, how the intangible asset will generate future economic benefits, the availability of resources to complete the asset, and the ability to reliably measure the development expenditure.

### Other Accounting Policy Options

A number of IFRSs—as is also the case with U.S. GAAP standards—provide for a choice among alternative acceptable accounting policies that do not depend solely on circumstances but, instead, reflect IFRS flexibility (i.e., free choices). The optional accounting policy choices available upon first-time adoption of IFRS are discussed below.

**Optional exemptions (IFRS 1).** IFRS 1 provides for optional exemptions from some requirements upon first-time adoption of IFRS. Those optional exemptions are discussed in the next section.

**Noncontrolling interests (IFRS 3).** An entity has a choice of two methods to measure a noncontrolling interest in the acquiree: measure at fair value, or measure at the noncontrolling interest’s share of the acquiree’s identifiable net assets, recognized in accordance with IFRS 3. The method selected affects the amount recognized as goodwill. The first method will

### EXHIBIT 2
Examples of Accounting Policy Options Dictated by Circumstances

<table>
<thead>
<tr>
<th>IFRS</th>
<th>Accounting Policy Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 2</td>
<td>Specific identification or FIFO inventory methods</td>
</tr>
<tr>
<td>IAS 10</td>
<td>Adjustments for events after the reporting period</td>
</tr>
<tr>
<td>IAS 11</td>
<td>Percentage-of-completion versus completed-contract method</td>
</tr>
<tr>
<td>IAS 16</td>
<td>Choice of depreciation methods (e.g., components accounting)</td>
</tr>
<tr>
<td>IAS 17</td>
<td>Finance lease versus operating lease</td>
</tr>
<tr>
<td>IAS 20</td>
<td>Government grants</td>
</tr>
<tr>
<td>IAS 21</td>
<td>Selection of functional currency for translation</td>
</tr>
<tr>
<td>IAS 38</td>
<td>Internal development costs capitalization versus expensing</td>
</tr>
</tbody>
</table>
result in recognizing all of the goodwill of the acquired business (allocating implies goodwill to the noncontrolling interest), while the second method will result in recognizing goodwill associated with only the percentage of ownership acquired by the controlling interest.

Insurance liabilities (IFRS 4). If an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as measured at fair value. An insuring entity is permitted, although not required, to change its accounting policies such that it remeasures designated insurance liabilities to reflect current market interest rates, and recognizes changes in those liabilities in current-period earnings. It may also adopt accounting policies that require other current estimates and assumptions for the designated liabilities.

Presentation of financial statements (IAS 1). Two approaches to the presentation of the statement of comprehensive income are allowed. Under the single-statement approach, all items of income (revenues, gains) and expense recognized during the period are presented in one statement that encompasses all components of “profit or loss” and of “other comprehensive income.” Under the two-statement approach, the income statement and statement of comprehensive income are presented separately.

Inventories (IAS 2). The cost of inventories should be assigned by using the first-in, first-out (FIFO) or weighted average cost formula (the last-in, first-out [LIFO] method is prohibited under IFRS). As noted, there is no requirement that this track the physical flow of goods. In addition, certain inventories such as agricultural produce, minerals, and commodities are measured at net realizable value (versus cost) at certain stages of production.

Statement of cash flows (IAS 7). Operating cash flows can be presented in the statement of cash flows using the direct or indirect method. In addition, interest and dividends received can be presented as either operating or investing cash flows, and interest paid may be presented as either an operating or financing cash flow.

Property, plant, and equipment (IAS 16). Items of property, plant, and equipment may be measured using the cost-depreciation-impairment model or the revaluation-through-equity model. Using the revaluation model, those items are measured at fair value as of the date of revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Government grants (IAS 20). Various approaches to accounting for government grants are available under IFRS; the choice is partially dictated by the circumstances (e.g., for government grants related to biological assets) and partially elective. For example, if government grants made in the form of nonmonetary assets, the asset and grant are to be consistently recognized, either at the fair value of the nonmonetary asset or at a nominal amount.

Investments in subsidiaries, associates, and joint ventures (IAS 27). In separate financial statements (i.e., not in the consolidated financial statements of the parent, investor, or joint venturer), an entity is required to account for investments in subsidiaries, associates, and joint ventures at cost or in accordance with IFRS 9.

Intangible assets (IAS 38). The cost model or the revaluation model can be applied to intangible assets for which an active market exists.

Financial instruments (IFRS 9/IAS 39). A number of options exist pertaining to the accounting for financial instruments. Under certain circumstances, an entity can elect to use hedge accounting if the instruments had been designated as hedges under the reporting entity’s predecessor financial reporting regime; it may also designate financial assets and liabilities to be measured at fair value through profit and loss; reassessments of accounting for embedded derivatives, permitted before IFRS 9, will no longer be allowed upon initial adoption of IFRS. In addition, in a cash flow hedge of a forecasted transaction that subsequently results in the recognition of a nonfinancial asset or a nonfinancial liability, or that becomes a firm commitment for which fair value hedge accounting is applied, the carrying amount of a nonfinancial hedged item can be adjusted for gains and losses on the hedging instruments that are determined to be an effective hedge. Trade date versus settlement date accounting can also be applied.

Investment property (IAS 40). The cost model or the fair value model can be used to account for investment property. Also, land use rights can be classified as investment property.

Exhibit 3 presents examples of accounting policy options that do not depend upon circumstances.

The IASB’s policy is to exclude options in accounting treatments from accounting standards whenever possible. In implementing this policy, recently a choice in accounting treatment for joint ventures was eliminated with the issuance of IFRS 11, Joint Arrangements (the equity method is now required for all investments in joint ventures), and the corridor approach for deferred recognition of certain benefit plan gains and losses was eliminated with the issuance of amended IAS 19, Employee Benefits. It is reasonable to assume that a further narrowing of options currently available to issuers of financial statements may occur, both as a by-product of the IASB-FASB convergence efforts, and as IFRS continues to evolve.

IFRS 1 Exemptions

In general, IFRS 1 requires a first-time adopter to comply with each standard effective at the end of its first IFRS reporting period. But IFRS allows limited exemptions for first-time adopting entities related to the following areas:

Share-based payment (IFRS 2). Under certain circumstances, entities are encouraged, but not required, to apply IFRS 2 to 1) equity instruments that were granted on or before November 7, 2002; 2) equity instruments that were granted after November 7, 2002 and vested before the later of the date of transition to IFRS or January 1, 2005; and 3) liabilities arising from share-based payment transactions that were settled before the date of transition to IFRS or settled before January 1, 2005.

Business combinations (IFRS 3). Entities may elect not to apply IFRS 3 retrospectively to business combinations that occurred before the date of transition to IFRS. If one business combination is restated to comply with IFRS 3, however, then all business combinations occurring after that date must be restated.

Insurance contracts (IFRS 4). Entities may apply the transitional provisions in IFRS 4, which restrict changes in accounting policies for insurance contracts, including those made by a first-time adopter.
**Deemed cost (IASs 16, 38, and 40).** At transition date, first-time adopters may elect to measure an item of property, plant, and equipment either at its historical cost or at its deemed cost. The deemed cost may be its fair value at the date of transition to IFRS, provided certain criteria are met; or a previous GAAP revaluation, provided certain criteria are met; or an event-driven fair value measurement. This option is also available for investment property measured under the cost model and for intangible assets that meet certain criteria.

**Leases (IAS 17).** Entities may determine whether an arrangement existing at the date of transition to IFRS contains a lease on the basis of facts and circumstances existing at that date (IFRIC 4).

**Employee benefits (IAS 19).** IFRS 1 allows an entity using the corridor approach to recognize all previously unrecognized cumulative actuarial gains and losses at the date of transition to IFRS, even if it uses the corridor approach prospectively. If an entity uses the defined benefit plan exemption, it must be applied to all defined benefit plans.

**Cumulative translation differences (IAS 21).** Entities may set the cumulative translation adjustment for all foreign subsidiaries to zero at the date of transition to IFRS.

**Investments in subsidiaries, jointly controlled entities, and associates (IAS 27).** An entity electing deemed cost to account for investments in subsidiaries, jointly controlled entities, and associates in its separate financial statements may choose either the fair value—determined in accordance with IFRS 9—at the entity’s date of transition to IFRS, or the carrying amount under previous GAAP at that date.

**Assets and liabilities of subsidiaries, associates, and joint ventures.** If a first-time adopter reports earlier than its subsidiary (or associate or joint venture), the subsidiary can, in its (stand-alone) financial statements, measure its assets and liabilities at either 1) the amounts that would be included in its parent’s consolidated financial statements based on its parent’s date of transition to IFRS (except for consolidation adjustments), or 2) the carrying amounts required by IFRS 1, based on the subsidiary’s date of transition to IFRS.

For entities adopting IFRS 1 in consolidated financial statements later than its subsidiary (or associate or joint venture), assets and liabilities of the subsidiary are measured at the same carrying amounts as in its stand-alone financial statements (except for consolidation adjustments).

**Compound financial instruments (IAS 32).** Entities that have issued a compound financial instrument need not separate two portions of equity (the original equity component and the cumulative interest accreted on the liability component), if the liability component is no longer outstanding at the date of transition to IFRS.

**Designation of previously recognized financial instruments (IAS 39).** Despite IAS 39 permitting a financial asset to be designated as a financial asset or financial liability at fair value through profit or loss upon initial recognition, a first-time adopter is permitted to make such designation at the date of transition to IFRS.

**Fair value measurement of financial assets or financial liabilities at initial recognition (IAS 39).** Entities may apply the requirements of IAS 39 regarding the best evidence of the fair value of a financial instrument at initial recognition and the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses, either prospectively to transactions entered into after October 25, 2002, or prospectively to transactions entered into after January 1, 2004.

**Decommissioning liabilities included in the cost of property, plant, and equipment...**

---

**EXHIBIT 3**

**Accounting Policy Options That Do Not Depend Upon Circumstances**

<table>
<thead>
<tr>
<th>IFRS</th>
<th>Accounting Policy Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 1</td>
<td>Apply optional exemptions from some requirements of IFRS</td>
</tr>
<tr>
<td>IFRS 3</td>
<td>Measure noncontrolling interest at fair value versus proportionate share of the acquiree’s identifiable net assets</td>
</tr>
<tr>
<td>IFRS 4</td>
<td>Remeasure insurance liabilities to fair value during each accounting period</td>
</tr>
<tr>
<td>IAS 1</td>
<td>Present the statement of comprehensive income under the single-statement approach versus the two-statement approach; present expenses by nature versus by function</td>
</tr>
<tr>
<td>IAS 2</td>
<td>Measure inventories at FIFO versus the weighted average method (LIFO is prohibited)</td>
</tr>
<tr>
<td>IAS 7</td>
<td>Present operating cash flows using the direct or indirect method; classify interest and dividends as operating, investing, or financing</td>
</tr>
<tr>
<td>IAS 16</td>
<td>Measure property, plant, and equipment using the cost model versus the revaluation model</td>
</tr>
<tr>
<td>IAS 20</td>
<td>Use various approaches to accounting for government grants</td>
</tr>
<tr>
<td>IAS 27</td>
<td>Account at cost or in accordance with IFRS 9 for investments in subsidiaries, associates, and joint ventures in separate financial statements</td>
</tr>
<tr>
<td>IAS 38</td>
<td>Apply the cost model versus the revaluation model for intangible assets in an active market</td>
</tr>
<tr>
<td>IFRS 9/IAS 39</td>
<td>Use optional hedge accounting; designate individual financial assets and financial liabilities to be measured at fair value through profit and loss (FVTPL); adjust the carrying amount of a hedged item for gains and losses on the hedging instrument; apply trade date versus settlement date accounting.</td>
</tr>
<tr>
<td>IAS 40</td>
<td>Use the cost model versus the fair value model for investment property; classify a property interest held by a lessee under an operating lease as investment property under certain circumstances</td>
</tr>
</tbody>
</table>
(IASs 16 and 37). Entities need not comply with IFRIC 1 for changes in such liabilities that occurred before the transition to IFRS. They can use a simplified procedure.

**Financial assets or intangible assets accounted for in accordance with IFRIC 12.** Entities may apply the transitional provisions of IFRIC 12.

**Borrowing costs (IAS 23).** Entities may apply the transitional provisions included in IAS 23 (as revised in 2007). The effective date in IAS 23 should be interpreted as the later of July 1, 2009, or the date of transition to IFRS.

**Transfers of assets from customers.** Transitional provisions provided in IFRIC 18 (paragraph 22) may be applied, and the effective date should be interpreted as the later of July 1, 2009, or the date of transition to IFRS. Entities may also designate any date before the transition date for the purposes of accounting under IFRIC 18 for all transfers of assets from customers received on or after that date.

**Extinguishing financial liabilities with equity instruments.** Transitional provisions in IFRIC 19 may be applied upon first-time adoption of IFRS.

**Severe hyperinflation.** If, before the transition to IFRS, an entity used to be subject to a severe hyperinflation, it can measure assets and liabilities at fair value on the date of transition to IFRS at their deemed cost. Under severe hyperinflation, a reliable general price index for all entities and exchangeability with a relatively stable currency are not available.

Transition to IFRS is a moving target. Although recent changes to IFRS have been incorporated in this article, as other standards continue to change, those contemplating first-time adoption should update their understanding of transition options before making decisions.

**Selecting Initial IFRS Accounting Policies.**

Upon first-time adoption of IFRS, entities determine the accounting policies that will be used in preparing their financial statements, and establish the benchmark against which their performance will be evaluated in the future. Selecting accounting policies should, ideally, meaningfully reflect such matters as asset valuation, cost allocation, and revenue realization by the reporting entity. First-time adopters must select initial IFRS accounting policies based on relevance and reliability, inasmuch as these choices will affect the company’s financial reporting for years to come.

Applying the requirements in IFRS to transactions and events often requires judgment. In some cases, management must make significant judgments in selecting its accounting policies. For example, in certain circumstances, management must make judgments in determining the degree of influence the entity exerts over another or whether certain properties should be accounted for as investment property, inventory, or property, plant, and equipment. Entities should disclose the judgments made in selecting and applying accounting policies expected to have the most significant effect on the amounts presented in the financial statements.

The effect on prior periods of the mandatory exceptions and optional exemptions from some IFRS requirements (other than IFRS 1) at the time of first-time IFRS adoption is recognized in equity, generally in retained earnings. Equity is a key determinant of entity value and is used in the computation of several key financial ratios. Consequently, the selection of accounting policies can have significant financial and strategic implications, regarding both the equity balance to be reported at the transition date and also through the effect on periodic net income to be reported thereafter.

Research based on the experiences of European companies has revealed that entities that reported mandatory adjustments that increased equity and that had higher book values and higher earnings multiples are more likely to select optional exemptions that have a negative impact on equity at the date of transition to IFRS. In addition, entities with higher leverage are less likely to elect exemptions that decrease equity.

For example, IFRS 1 allows recognition in equity at the transition date of all previously unrecognized cumulative translation adjustment for all foreign subsidiaries. This may benefit entities with unrecognized translation losses, because they can avoid future decreases in profits. In contrast, the revaluation model adopted for items of property, plant, and equipment and intangible assets typically increases transition date equity and reduces future profits.

**Advance Planning.**

The next several years will bring major changes to U.S. financial reporting, and the effect on U.S. businesses will be considerable. Upon first-time IFRS adoption, entities are given a fresh start and are required to redetermine their accounting policies, fully restating past comparative information. The limited voluntary exemptions also present some opportunities for entities to determine optimal outcomes. Once an accounting policy is adopted, opportunities to change may be restricted to justifiable situations where the change would result in a more appropriate presentation.

Advising planning is recommended in order to most effectively prepare for implementing IFRS and to take advantage of the opportunity to comprehensively reassess financial reporting policies and processes. Compared to U.S. GAAP, IFRS has several more areas where entities have a choice of accounting policies that may be implemented. Companies need to be cognizant that the accounting policies they elect could have a significant impact on an entity’s future reported results of operations and financial position and, thus, could have significant financial and strategic implications.

Some may be tempted to choose the path of least resistance—or least effort—by continuing to employ accounting policies utilized under predecessor financial reporting regimes, assuming those are optionally acceptable under IFRS. But because the first-time adoption rules provide a unique opportunity to optimize an entity’s accounting policies, it is strongly recommended that this default option be avoided. The attention paid to the selection of accounting principles will pay handsome dividends in terms of more meaningful, transparent, decision-relevant financial statements if this process is given the consideration it deserves.

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**Eva K. Jermakowicz, PhD, CPA,** is a professor and head of the department of accounting and business law in the college of business, Tennessee State University, Nashville, Tenn. **Barry Jay Epstein, PhD, CPA,** is a partner with RNCO Financial Litigation Advisors, Russell Novak & Company LLP, Chicago, Ill.
Accounting for Stock Options

A Comparative Simulation for Straight-Line and Graded Vesting Attributions Methods

By David G. DeBoskey and Kevin M. Lightner

Stock options with graded vesting attributes create interesting choices for corporate accounting personnel to consider. Moreover, these choices vary depending on whether the company’s reporting is based on U.S. GAAP or International Financial Reporting Standards (IFRS).

Under U.S. GAAP (ASC Topic 718-20-35-8), an entity shall make a policy decision about whether to recognize compensation cost for an award with service conditions only that has a graded vesting schedule in either of the following ways: 1) on a straight-line basis over the requisite service period for each of the award’s separately vesting portions as if the award was, in substance, multiple awards; or 2) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

Conversely, under IFRS 2, straight-line amortization is not permitted; instead, accelerated amortization must be applied. This means each individual vesting portion of an award—known as a tranche—is expensed on a straight-line basis (i.e., graded vesting attribution, where each award tranche has a separately determined fair value). This differs from ASC Topic 718, in which “service only” awards can be expensed on a straight-line basis over the entire grant, and fair value can be determined at either the tranche level or the grant level. These differences can result in significant variations in interperiod compensation expense for firms preparing their financial statements under different accounting standards. This may require a company to modify the way it approaches areas such as valuation, tax accounting, and stock administration processes.

The purpose of this article is to highlight the different approaches for determining compensation expense under both ASC Topic 718 and IFRS 2 for awards with graded vesting attributes. We provide a

EXHIBIT 1
Differences Between ASC 718 and IFRS 2

<table>
<thead>
<tr>
<th>Category Comparison</th>
<th>ASC 718 (GAAP)</th>
<th>IFRS 2</th>
<th>Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation</td>
<td>Black-Scholes, Lattice, or Binomial</td>
<td>Black-Scholes, Lattice, or Binomial</td>
<td>Under IFRS, country-specific valuations of share-based payments are required.</td>
</tr>
<tr>
<td>Expense amortization</td>
<td>Straight-line amortization or accelerated amortization can be applied.</td>
<td>Only accelerated amortization can be applied.</td>
<td>Under IFRS, straight-line amortization is not allowed.</td>
</tr>
</tbody>
</table>

EXHIBIT 2
Simulation 1, Step 1

<table>
<thead>
<tr>
<th>Tranche</th>
<th>No. of Options</th>
<th>Expected Life in Months of Each Vesting Segment</th>
<th>Options × Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20% × 80,000 = 16,000</td>
<td>15</td>
<td>240,000</td>
</tr>
<tr>
<td>2</td>
<td>35% × 80,000 = 28,000</td>
<td>27</td>
<td>756,000</td>
</tr>
<tr>
<td>3</td>
<td>15% × 80,000 = 12,000</td>
<td>39</td>
<td>468,000</td>
</tr>
<tr>
<td>4</td>
<td>30% × 80,000 = 24,000</td>
<td>51</td>
<td>1,224,000</td>
</tr>
<tr>
<td>Total</td>
<td>80,000</td>
<td></td>
<td>2,688,000</td>
</tr>
</tbody>
</table>

Result: Weighted average life in years = 2,688,000 / 80,000 / 12 = 2.8 years
summary of the major differences between ASC Topic 718 and IFRS 2 with regard to valuation and expense amortization under share-based compensation arrangements. To better grasp the differences between straight-line and graded vesting attribution methods, we outline two step-by-step simulations that can be followed in determining compensation expense under either ASC 718 (straight-line or graded vesting attribution) or IFRS 2 (graded vesting attribution only). (See Exhibit 1.)

In Simulation 1, we examine the specific steps required to apply the straight-line attribution method for an option grant with graded vesting. This method is allowed by U.S. GAAP, but not allowed by IFRS for options with graded vesting. In Simulation 2, we examine the specific steps to apply the graded vesting attribution method. This method is allowed under U.S. GAAP and IFRS. The simulations proceed through the main procedures that a manager would follow in determining the correct compensation expense to recognize.

**EXHIBIT 3**
Simulation 1, Step 2

<table>
<thead>
<tr>
<th>Black-Scholes Variable Inputs:</th>
<th>Mr. Avery’s Option Award</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Price at Grant Date</td>
<td>$22.50</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>$22.50</td>
</tr>
<tr>
<td>Expected Life</td>
<td>2.8</td>
</tr>
<tr>
<td>Risk-Free Interest Rate</td>
<td>4.50%</td>
</tr>
<tr>
<td>Volatility</td>
<td>40%</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>0</td>
</tr>
<tr>
<td>Black-Scholes Model Output:</td>
<td></td>
</tr>
<tr>
<td>Market Value per Option¹</td>
<td>$6.9747</td>
</tr>
<tr>
<td>Number of Options Granted</td>
<td>80,000</td>
</tr>
<tr>
<td>Market Value of Options¹</td>
<td>$557,978</td>
</tr>
</tbody>
</table>

1. The Black-Scholes variable inputs are required in order to determine the market value per option. The market value per option is multiplied by the number of options granted to derive the aggregate market value of the options granted.

**EXHIBIT 4**
Simulation 1, Step 3

2010. Take the higher of the straight-line (SL) calculation or the amount based on cumulative vesting to date.

<table>
<thead>
<tr>
<th>SL Fraction</th>
<th>Balance of Deferred Compensation</th>
<th>Compensation Expense</th>
<th>Compare compensation: Take higher amount</th>
<th>Portion of Award Vested to Date</th>
<th>Grant Date Market Value</th>
<th>Expense to Date</th>
<th>Expense Previously Recognized</th>
<th>Compensation Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4</td>
<td>$557,978</td>
<td>$139,495</td>
<td></td>
<td>20%</td>
<td>$557,978</td>
<td>$111,596</td>
<td>0</td>
<td>$111,596</td>
</tr>
</tbody>
</table>

2011. Take the higher of the SL calculation or the amount based on cumulative vesting to date.

<table>
<thead>
<tr>
<th>SL Fraction</th>
<th>Balance of Deferred Compensation</th>
<th>Compensation Expense</th>
<th>Compare compensation: Take higher amount</th>
<th>Portion of Award Vested to Date</th>
<th>Grant Date Market Value</th>
<th>Expense to Date</th>
<th>Expense Previously Recognized</th>
<th>Compensation Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/3</td>
<td>$418,483</td>
<td>$139,495</td>
<td></td>
<td>55%</td>
<td>$557,978</td>
<td>$306,888</td>
<td>$139,495</td>
<td>$167,393</td>
</tr>
</tbody>
</table>

2012. Take the higher of the SL calculation or the amount based on cumulative vesting to date.

<table>
<thead>
<tr>
<th>SL Fraction</th>
<th>Balance of Deferred Compensation</th>
<th>Compensation Expense</th>
<th>Compare compensation: Take higher amount</th>
<th>Portion of Award Vested to Date</th>
<th>Grant Date Market Value</th>
<th>Expense to Date</th>
<th>Expense Previously Recognized</th>
<th>Compensation Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2</td>
<td>$251,090</td>
<td>$125,545</td>
<td></td>
<td>70%</td>
<td>$557,978</td>
<td>$306,888</td>
<td>$139,495</td>
<td>$167,393</td>
</tr>
</tbody>
</table>

2013. Take the higher of the SL calculation or the amount based on cumulative vesting to date.

<table>
<thead>
<tr>
<th>SL Fraction</th>
<th>Balance of Deferred Compensation</th>
<th>Compensation Expense</th>
<th>Compare compensation: Take higher amount</th>
<th>Portion of Award Vested to Date</th>
<th>Grant Date Market Value</th>
<th>Expense to Date</th>
<th>Expense Previously Recognized</th>
<th>Compensation Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1</td>
<td>$125,545</td>
<td>$125,545</td>
<td></td>
<td>100%</td>
<td>$557,978</td>
<td>$557,978</td>
<td>$139,495</td>
<td>$125,545</td>
</tr>
</tbody>
</table>
Simulation 1

Stock options with graded vesting using straight-line attribution simulation.

Simulation problem: On January 1, 2010, when its stock price is $22.50 per share, CSinc. Corporation grants Mr. Avery, the company CEO, 80,000 stock options with an exercise price of $22.50. The options vest over four years and have a contractual life of six years. After one year 20% vest, followed by 35% after two years, 15% after three, and 30% in the last year. Each year during the four-year vesting, the company’s risk-free interest rate is 4.5%, and its estimated volatility is 40%. From the company’s experience, options are expected to be exercised three months past each vesting. The company has no plans to issue dividends. The Black-Scholes Option Pricing Model is used by the company to determine the fair value of options.

Using the data above, what is the compensation expense for 2010, 2011, 2012, and 2013?

Step 1: weighted-average expected life.

Compute the weighted-average expected life for Mr. Avery’s 2010 option award, assuming the expected exercise date is three months past the vesting date. Each vesting portion of the award is referred to as a tranche. (See Exhibit 2.) The result is that the weighted-average life in years = 2,688,000 / 80,000 / 12 = 2.8 years.

We note, however, that if all option awards issued to all executives in 2010 had been used to calculate a weighted-average number of months, this figure would then be converted to a weighted-average number of months.

### Exhibit 2

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Number of Options</th>
<th>Expected Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20% x 80,000 = 16,000</td>
<td>(12 + 3) / 12 = 1.25</td>
</tr>
<tr>
<td>2</td>
<td>35% x 80,000 = 28,000</td>
<td>(24 + 3) / 12 = 2.25</td>
</tr>
<tr>
<td>3</td>
<td>15% x 80,000 = 12,000</td>
<td>(36 + 3) / 12 = 3.25</td>
</tr>
<tr>
<td>4</td>
<td>30% x 80,000 = 24,000</td>
<td>(48 + 3) / 12 = 4.25</td>
</tr>
</tbody>
</table>

1. According to the simulation problem, options are expected to be exercised three months past each vesting, as follows:

   1 year 2 year 3 year 4 year 5 year
   16,000 28,000 12,000 24,000

### Exhibit 3

<table>
<thead>
<tr>
<th>Tranche</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Black-Scholes Variable Inputs:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Price at Grant Date</td>
<td>$22.50</td>
<td>$22.50</td>
<td>$22.50</td>
<td>$22.50</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>$22.50</td>
<td>$22.50</td>
<td>$22.50</td>
<td>$22.50</td>
</tr>
<tr>
<td>Expected Life (from Step 1)</td>
<td>1.25</td>
<td>2.25</td>
<td>3.25</td>
<td>4.25</td>
</tr>
<tr>
<td>Risk-Free Interest Rate</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Volatility</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Black-Scholes Model Output:</td>
<td>$4.5176</td>
<td>$6.2034</td>
<td>$7.5506</td>
<td>$8.6949</td>
</tr>
<tr>
<td>Market Value per Option</td>
<td>$4,5176</td>
<td>$6,2034</td>
<td>$7,5506</td>
<td>$8,6949</td>
</tr>
<tr>
<td>Number of Options (from Step 1)</td>
<td>16,000</td>
<td>28,000</td>
<td>12,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Market Value of Options</td>
<td>$72,282</td>
<td>$173,695</td>
<td>$90,607</td>
<td>$208,678</td>
</tr>
</tbody>
</table>

1. The Black-Scholes variable inputs are required in order to determine the market value per option. The market value per option is multiplied by the number options granted to derive the aggregate market value of the options granted.

### Exhibit 4

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Compensation Expense (IFRS 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>1</td>
<td>72,282</td>
</tr>
<tr>
<td>2</td>
<td>$173,695</td>
</tr>
<tr>
<td>3</td>
<td>$90,607</td>
</tr>
<tr>
<td>4</td>
<td>$208,678</td>
</tr>
<tr>
<td></td>
<td>$545,262</td>
</tr>
</tbody>
</table>

Simulation 2

Market Value Vesting (from Step 2) Compensation Expense (IFRS 2)

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Step 1: weighted-average expected life.

Compute the weighted-average expected life for Mr. Avery’s 2010 option award, assuming the expected exercise date is three months past the vesting date. Each vesting portion of the award is referred to as a tranche. (See Exhibit 2.) The result is that the weighted-average life in years = 2,688,000 / 80,000 / 12 = 2.8 years.

We note, however, that if all option awards issued to all executives in 2010 had been used to calculate a weighted-average life, the option-months for each award would be included in the total option-months to get a weighted-average number of months. This figure would then be converted to a weighted-average number of months.
number of years by dividing by 12. In other words, the procedure for computing weighted-average life is the same, regardless whether there is a single award or multiple awards. This aggregate weighted-average life is the number reported in a company’s 10K.

Step 2: fair market value. Compute the fair market value of Mr. Avery’s 2010 option award using the Black-Scholes Option Pricing Model with the weighted-average expected life from Step 1. (See Exhibit 3.)

Step 3: compensation expense. Using the fair market value calculated in Step 2, determine the compensation expense to be reported in fiscal years 2010, 2011, 2012, and 2013 for Mr. Avery’s 2010 stock option award.

In Exhibit 4, we calculate the amount of compensation expense in each year as the higher of either 1) straight-line over the remaining period until fully vested, or 2) based on the portion of the award vested to date, less any previously recognized expense. ASC Topic 718-20-35-8 requires that compensation cost recognized at any date must be at least equal to the amount attributable to options that are vested at that date. This is not required under IFRS 2 because straight-line attribution is not allowed.

Simulation 2

Stock options with graded vesting using graded vesting attribution. This method is allowed by both U.S. GAAP (ASC 718) and IFRS 2. This method treats each vesting portion of the award as a separate award. Simulation problem: Use the same problem as in Simulation 1.

Step 1: expected life. Determine the expected life and number of options for each vesting portion of the award as if each portion was a separate award. Each vesting portion is referred to as a tranche. (See Exhibit 5.)

Step 2: fair market value. Compute the fair-market value for each tranche using the Black-Scholes Option Pricing Model, the weight-average expected lives from Step 1, the number of options from Step 1, and the other Black-Scholes input variables given in the problem. (See Exhibit 6.)

Step 3: compensation expense. Calculate the compensation expense for each year. (See Exhibit 7.)

Key Differences

The simulations offered here highlight the major differences between graded vesting and straight-line attribution methods when applied to a stock option award with a graded vesting schedule. (For a summary, see Exhibit 8.) IFRS 2 allows only graded-vesting attribution, while ACS 718 allows either straight-line or graded-vesting attribution. Graded-vesting attribution, however, provides a conceptually better choice because the accelerated compensation expense created by overlapping tranches best relates to the accelerated pattern of vesting (or pattern of service). The overlapping of tranches in the earlier years causes accelerated compensation expense similar to what we observe with accelerated depreciation, versus straight-line depreciation. In the early years of the option grant, compensation expense is higher than the straight-line attribution method, but in later years straight-line catches up with the graded vested attribution method. However, over the vesting period, total compensation expense is similar between both straight-line and graded attribution methods. Compensation expense will differ because the fair value for accelerated attribution is based on the sum of fair values for each tranche, whereas for GAAP—utilizing straight-line attribution—the fair value is based on the total award.

These differences have implications for interperiod financial statement analysis, as profitability analysis such as return on investment and return on equity ratios is potentially understated for firms’ using graded vested attribution over those firms using straight-line attribution, especially in the earlier years of the vesting schedule. Moreover, cash flows and deferred taxes are impacted as well. It behooves managers to carefully consider the impact that choosing one method over the other has for financial reporting and disclosure purposes.

It behooves managers to carefully consider the impact that choosing one method over the other has for financial reporting and disclosure purposes.

David G. DeBoskey, PhD, CPA, is an assistant professor and the KPMG Faculty Fellow, and Kevin M. Lightner, PhD, is a professor emeritus, both at the Charles W. Lamden School of Accountancy at San Diego State University, San Diego, Calif.

<table>
<thead>
<tr>
<th>Compensation Expense Comparison</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 2 (Graded Vesting Attribution Method)</td>
<td>$241,502</td>
<td>$169,220</td>
<td>$82,372</td>
<td>$52,170</td>
<td>$545,262</td>
</tr>
<tr>
<td>ASC 718 (Straight-Line Attribution Method)</td>
<td>$139,745</td>
<td>$167,393</td>
<td>$125,545</td>
<td>$125,545</td>
<td>$557,978</td>
</tr>
<tr>
<td>Difference1</td>
<td>$101,757</td>
<td>$1,827</td>
<td>$(43,173)</td>
<td>$(73,575)</td>
<td>$(12,716)</td>
</tr>
</tbody>
</table>

1. A positive (negative) number indicates compensation expense is higher (lower) under IFRS 2 application.
Losses and credits attributable to passive activities are limited under Internal Revenue Code (IRC) section 469. Such losses and credits are limited to the income associated with the passive activities, and any excess losses are suspended and carried forward to subsequent years (IRC section 469[a][1][b]). A passive activity is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. Material participation requires regular, continuous, and substantial involvement in the operations of the activity (IRC section 469[h][1]).

These suspended losses can be utilized to offset other passive income. In addition, they may offset non-passive income if a taxpayer disposes of the entire passive activity during the tax year in a taxable transaction (IRC section 469[g]). The loss is then treated as one that does not result from a passive activity. Therefore, determining what constitutes the entire passive activity is extremely important; if the taxpayer disposes of less than the entire activity, the losses remain suspended and passive.

**Background**

Treasury Regulations section 1.469-4 provides rules for grouping activities for the purpose of applying the passive activity loss rules. These rules provide that “one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss purposes” (section 1.469-4[c][1]). Treasury Regulations section 1.469-4(c)(2) provides guidelines for determining when a taxpayer can group activities together as a single unit. The regulations adopt a “facts and circumstances” approach to determine appropriate combinations. Such circumstances include business similarity, common control, location, business interaction, and customers.

A partnership, C corporation, or S corporation that is subject to these rules must independently group its activities. The shareholder or partner may then group those activities with each other or with other activities conducted directly by the shareholder or partner. The group’s losses may offset related income and gains; however, such benefits of a grouping may be lost if a member disposes of less than the entire group because suspended losses will not be realized.

Once a taxpayer has grouped activities, the taxpayer generally may not regroup in subsequent years. But if it is later determined that the taxpayer’s original grouping is “clearly inappropriate,” or if there is a material change in the facts and circumstances that makes the original
grouping clearly inappropriate, the taxpayer must regroup, and comply with the disclosure requirements (Treasury Regulations section 1.469-4[e][2]). The IRS may similarly regroup a taxpayer’s activities in order to prevent tax avoidance (Treasury Regulation section 1.469-4[f]).

New Guidance

A recently issued IRS pronouncement, Revenue Procedure 2010-13, requires taxpayers to report groupings that occur during taxable years beginning on or after January 29, 2010. Taxpayers must file a written statement with their income tax return for the first taxable year in which they group two or more activities as a single activity (or make new additions to existing groupings). The taxpayer must reveal names, addresses and employer identification numbers, as well as declare that the grouped activities “constitute an appropriate economic unit for the measurement of gain or loss for purposes of [IRC] section 469” (Revenue Procedure 2010-13, part 4). Similar requirements apply for regroupings due to inappropriate groupings or material changes. Partnerships and S corporations must report groupings on Schedule K-1. Reporting is generally not required for previously reported groupings (Revenue Procedure 2010-13, sections .04, .05).

Perhaps the most important part of the new procedure is the section describing prior failures to report. Many taxpayers are involved in multiple rental or business activities, but have failed to group them with related activities. As a result, each activity is treated separately for purposes of applying the passive activity loss utilization rules described above; this may result in extreme hardship for some taxpayers. Revenue Procedure 2010-13 (part 4, section 07) contains a safety feature for some taxpayers that states: “A timely disclosure shall be deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.” But if the IRS first discovers the failure, the taxpayer must show reasonable cause for the failure to disclose. Because Revenue Procedure 2010-13 provides relief provisions, relief is not available under the provisions in Treasury Regulations section 301.9100-1(d)(2).

Implications for Real Estate Professionals

It is worth noting that the safety feature for a late election for real estate professionals, as described in IRC section 469(c)(7), is currently not available. Those individuals must still apply for a late election by means of a private letter ruling.

Each activity is treated separately for purposes of applying the passive activity loss utilization rules described above; this may result in extreme hardship for some taxpayers.

This distinction is extremely important because rental activities are generally considered passive regardless of the participation threshold. IRC section 469(i) provides a $25,000 exception within limited income limits if the taxpayer materially participates in the real estate rental activity. Qualifying real estate professionals, however, are permitted to treat rental real estate losses as non-passive (IRC section 469(c)(7)). This allows such a taxpayer’s passive losses to offset active income. Real estate professionals must meet the following tests:

- More than half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates.
- Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or business in which the taxpayer materially participates.

Such real property trades or businesses include development and construction, acquisition and conversion, rental and leasing, management, and brokerage. It is important to note that unless a taxpayer makes an election to group all rental real estate as a single activity, the material participation requirement must be independently met with respect to each interest in rental real estate. This may require that the taxpayer prove at least 500 hours of participation in each rental activity.

The IRS places a heavy burden of proof upon taxpayers claiming such status. A taxpayer with several rental activities may find it impossible to meet this hurdle. A recent case, Anjum Shiekh v. Comm’r (TCM 2010-126), confirms that merely including such activities on Schedule E of Form 1040 is not sufficient. The taxpayer must file the activity grouping election as a statement with the income tax return initially claiming such benefits. Such election may be stated as follows: “Taxpayer X, SSN 123-45-6789, is a qualifying taxpayer and hereby elects pursuant to IRC section 469(c)(7)(A) to treat all interest in rental real estate as one activity.” Qualified real estate professionals who fail to make the grouping election may not currently rely on the safe harbor reporting provision of Revenue Procedure 2010-13. Such taxpayers must apply by means of a private revenue ruling request. Private Letter Ruling 2010271018, issued on July 9, 2010, indicates that the IRS is willing to grant positive acceptance with respect to prior returns that omitted the required election statement. The taxpayer must promptly request such ruling in good faith, and the grant of such relief must not prejudice the government’s interest. Reasonable reliance on a tax professional employed by the taxpayer who failed to either make or provide advice with respect to the election will generally be sufficient for this purpose.

But a private letter ruling request is time consuming and expensive. The author has had informal discussions with a member of the IRS’s Chief Counsel’s Office, who indicated that there are thoughts of expanding the late disclosure provisions of the notice to include real estate professionals, which would be a welcome change.
Cultural Aspects of Credit Risk Management

A Lesson from the Microfinance Industry

By Rahnuma Ahsan

With a 9.2% unemployment rate and increasing default rates, credit risk management has become more difficult than ever. In October 2009, Bloomberg reported that the number of U.S. lenders with a 20% default rate is at an 18-year high. For commercial real estate mortgages, the default rate during the first quarter of 2010 (4.17%) was at its highest level since 1992, and this figure does not include bank-held mortgages on apartment buildings. In February 2009, the Obama administration launched a Home Affordable Modification Program (HAMP) to assist defaulting real estate borrowers. In June 2010, the Wall Street Journal reported that the redefault rate within one year under HAMP, predicted by Fitch Ratings Ltd., would be 65% to 75%. These disparate perspectives of the credit crisis draw a challenging picture for overall credit risk management.

In contrast, Grameen America, a non-profit microfinance institute and affiliate of Bangladeshi microfinance institute Grameen Bank, reported a 99% loan repayment rate from 2008 to 2010. The difference in the repayment rate of Grameen America compared to other lenders may be attributed to Grameen’s lending methods, as well as the size and types of loans. Grameen America lends to high-risk borrowers who generally earn less than $11,000 annually, do not have any collateral, do not have a prior credit history, and have been ignored by commercial and retail banks.

Grameen America’s high repayment record with these borrowers has been attributed to its group-lending or peer-lending methodology. Peer lending is one of the major contributions of the original Grameen Bank model, which was designed after trial and error in the villages of Bangladesh in the 1970s. Under the initial Grameen model, which was used until 2001, borrowers formed their own groups (social collateral), elected a group leader, and were responsible for each group member’s loan amount (joint and individual liability). In case of default by one borrower, each member of the group was responsible for repayment. After the full loan was repaid on time, the group could apply for a higher amount (repayment incentives). If one member of the group defaulted, none of the group members could apply for any future loans (lowers strategic default). Since 2001, Grameen has implemented a modified peer-lending model whereby the borrowers still form their own groups and must continue to support each other’s projects, but are no longer jointly liable for each other’s payments. As the borrowers receive the loan as a group, however, this modified peer-lending approach still enforces and establishes social collateral conditions. Under this model, Grameen Bank has reported a 95% to 99% loan repayment rate since 1976.

Peer Lending in the United States

During the 1980s and 1990s, the peer-lending model was replicated in the United States with mixed results. According to a 1999 report by Michael Conlin, the default rate for these projects ranged from 3% to 40%, and some of the projects were unsustainable and failed to reach their goals completely (“Peer Group Micro-Lending Programs in Canada and the United States,” Journal of Development Economics, vol. 60, no. 1, October 1999, pp. 249–269). For instance, the Good Faith Fund of Southern Development Bancorporation in Arkansas had a 40% default rate in the first two years and after modification of its lending method, the default rate decreased to 3% in the third year. The Women’s Self Employment Project (WESP), a nonprofit affiliate of South Shore Bank in Chicago, had a loan default rate of 5% but spent more on overhead and administrative costs than it loaned. The Women’s Economic Development Company (WEDCo) in Minneapolis, Minnesota, and the South Madison
Neighborhood Housing Service in Madison, Wisconsin, terminated their programs within a few years due to limited success.

In 2008, Grameen Bank opened the non-profit entity Grameen America in Queens, N.Y. Unlike the previous experience of other U.S. peer-lending models, Grameen America has thrived since its beginning. By August 2010, Grameen America had 4,048 borrowers, disbursed $9.1 million in loans, opened three new branches, and had plans to open branches in seven other states. The suitability of the Grameen peer-lending model in the United States has engendered much debate. The Grameen America website states, “Grameen micro-credit programs have succeeded all over the world, demonstrating that the concept of credit as a basic human right transfers easily across cultures. We have not changed the Grameen group-lending model at all; the only difference is the average loan size.”

History of Grameen

Grameen Bank started its journey in 1976 when the founder, Muhammad Yunus, then a professor at the University of Chittagong, Bangladesh, loaned $27 from his own pocket to 42 people in the tiny Bangladeshi village of Jobra. The first group of borrowers repaid the small loans promptly and inspired Yunus to establish the Grameen Bank Project. Gradually, this project evolved into a bank and spread among 81,000 villages in Bangladesh, reaching 8.1 million borrowers within 34 years. Yunus crafted and perfected the peer-lending model over time. In retrospect, the cultural characteristics embedded in Bangladeshi society might have paved the way for peer-lending methodology. Bangladeshi culture values collective decision making and has similar acceptance of inequality within their societies. Because of these cultural similarities, the methods that have been successful in Bangladesh have also been successful in similar cultures. Among other factors, cultural orientation and teaching can shape how an individual manages his personal finances and how he interacts within a group setting. A lending system designed around the distinct cultural elements of the borrowers might help achieve two things: First, the familiar aspects of the methodology would make the borrower comfortable with the system, and second, it would help the credit manager manage the loan portfolio better in terms of reducing the credit default rate.

Value Dimensions

Dutch social psychologist Geert Hofstede, who conducted a pioneering study of cultures, classified the values that distinguish countries from one another into four clusters: individualism (IDV, the relationship of the individual with his primary group), power distance index (PDI, ways of coping with inequality), uncertainty avoidance (UA), and masculinity (MAS).

**EXHIBIT 1**

Hofstede’s Cultural Value Dimensions for Bangladesh and the United States

<table>
<thead>
<tr>
<th>IDV</th>
<th>PDI</th>
<th>MAS</th>
<th>UAI</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>91</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>80</td>
<td>62</td>
<td>55</td>
</tr>
<tr>
<td>60</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: www.geert-hofstede.com/geert_hofstede_resources.shtml

**EXHIBIT 2**

Hofstede’s Individualism Dimension Score for Latin American Countries, Bangladesh, and the United States

<table>
<thead>
<tr>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venezuela</td>
<td>12</td>
</tr>
<tr>
<td>Peru</td>
<td>16</td>
</tr>
<tr>
<td>Panama</td>
<td>11</td>
</tr>
<tr>
<td>Mexico</td>
<td>30</td>
</tr>
<tr>
<td>Guatemala</td>
<td>6</td>
</tr>
<tr>
<td>El Salvador</td>
<td>19</td>
</tr>
<tr>
<td>Ecuador</td>
<td>8</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>15</td>
</tr>
<tr>
<td>Colombia</td>
<td>13</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>20</td>
</tr>
<tr>
<td>U.S.</td>
<td>91</td>
</tr>
</tbody>
</table>

Source: www.geert-hofstede.com/geert_hofstede_resources.shtml
tainty avoidance (UAI, ways of coping with uncertainty), and masculinity (MAS, the emotional implications of gender). Subsequently, two other value dimensions were added—long-term orientation and indulgence versus restraint—and these value dimensions were replicated in six international studies. In the past three decades, Hofstede’s value dimensions have been extensively applied in business and market research.

According to Hofstede’s value dimensions, Bangladesh scores low in individualism—20 out of 100. This reflects the collective behavior of Bangladeshis in decision making: Decisions are made as a group and group improvement is emphasized over individual self-actualization. The peer-lending model, where all borrowers are responsible for each other’s repayment, is a natural fit for Bangladeshi culture. A high sense of collectivism that is ingrained in this culture ensures joint responsibility, promotes social collateral, and results in a high repayment rate.

Conversely, the individualism score for the United States is high—91 out of 100—where individual decision making is emphasized. A significant difference is present in the power distance value score as well—the United States scores 40, Bangladesh scores 80. These differences show that by bringing the Grameen peer-lending model from Bangladesh to the United States, Grameen has imported the model from a highly collective, high-power-distance culture to a highly individualist, low-power-distance culture. These cultural differences might be the reasons for the dismal results of the earlier peer-lending efforts in the United States. In a country where individuality is nurtured, making borrowers responsible for each other’s loan repayment might create more problems than solutions. Interestingly, there isn’t much difference in UAI or MAS scores between these two cultures (Exhibit 1).

If we compare the cultural value dimensions of Bangladesh with those of some Latin American countries (i.e., the culture of Grameen America borrowers), a pattern emerges (Exhibit 2). All the Latin American countries have individualism scores of less than 31, with the highest score of 30 for Mexico and lowest score of 6 for Guatemala. The average of the individualism score for Latin American countries is 14.44, whereas Bangladesh’s score is 20. This high collectivism (low individualism) means that people in these societies are integrated into strong, cohesive groups, which continue to protect them in exchange for unquestioning loyalty. Collectivism (the opposite of individualism) is a fundamental social value, which forms individual values, norms, and behavior, and eventually can evoke and ensure group loyalty in the peer-lending model.

We see a similar pattern in the power distance dimension score of the borrowers’ cultures and Bangladeshi culture (Exhibit 3). The PDI scores range from a low of 35 for Costa Rica to a high of 95 for Guatemala and Panama. The average PDI score for these Latin American countries is 73.5, whereas Bangladesh scores 80 and the United States scores 40. In a group of borrowers with a hierarchical structure, a high power-distance rating ensures high social collateral, which generally leads to a high repayment rate. The similarity in power distance scores for Latin American countries and Bangladesh might have worked as another thrust for successfully applying the same peer-lending model across cultures.

In essence, Grameen has brought the original peer-lending model from Bangladesh to the United States and then successfully identified the target group that
would be able to best adapt to its model. In the end, this strategic fit of the model’s structure with its client’s culture has helped Grameen America achieve its 99% repayment rate. Grameen America’s continued success with its repayment rate using the peer-lending method is proof of the importance of understanding and appreciating cultural differences and utilizing the cultural components to design lending methods and practices.

In addition to the United States, Grameen has replicated its microfinance model in 37 countries with or without local partners. It replicated its model through Grameen Trust’s Replication program, and the projects are categorized into Build, Operate, and Transfer (BOT) and Build, Operate, and Own (BOO) groups. Grameen projects have continued to show the same high results for repayment—98% to 100%. The individualism and power-distance value dimensions of the countries where Grameen has its BOT or BOO projects show familiar patterns. The countries with Grameen projects (Exhibit 4) have relatively low individualism scores and relatively high power-distance scores. The individualism scores range from 6 for Guatemala to 48 for India, with an average of 23.33. For the power-distance dimensions, other than Costa Rica’s score of 35, the score for others range from 64 for Zambia to 95 for Guatemala. The peer-lending model’s strategic fit with the low individualism, high-power-distance cultural components might be the propelling force behind Grameen’s worldwide success.

Lessons to Be Learned
Credit managers working with multicultural clientele have much to learn from Grameen’s experience. Grameen’s story suggests that for low individualism, high-power-distance cultures, the peer-lending model can successfully garner a high repayment rate. More importantly, Grameen has done what U.S. commercial and retail banks have failed to do: During the worst economic crisis in decades, Grameen America has extended loans to high-risk customers in America and managed to achieve and maintain a high repayment record by focusing on those clients whose cultural orientation best fits its model.

Culture is a dynamic process. Does this mean Grameen will become irrelevant in an increasingly individualist society? Grameen must have thought about this shift, because since 2002 Grameen has tested and implemented a more flexible lending method in Bangladesh. Under Grameen II, the newer model, a borrower’s capacity to borrow in the future would depend on her individual repayment record, not on the group repayment history. Perhaps Grameen is getting ready to address the more individualist sections of society and extend its reach to other markets.

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Reducing the Potential Negative Effects of Mandatory Partner Rotation

By Brian Daugherty, Denise Dickins, and Julia Higgs

The Sarbanes-Oxley Act of 2002 (SOX) shortened the maximum allowable period an audit partner may serve on a U.S. publicly traded company’s audit engagement from seven years to five years and lengthened the minimal allowable cooling-off period from two years to five years. Since adoption of the revisions, concerns have been raised about the potential erosion of client-specific and industry knowledge resulting from mandatory audit partner rotation and the resulting potential negative impact on audit quality and financial reporting quality (U.S. Department of the Treasury, Advisory Committee on the Auditing Profession [ACAP], February 4, 2008 meeting). These concerns are potentially due to audit engagement partners requiring two to three years to fully familiarize themselves with client-specific issues, processes, and controls on newly assigned audit engagements (Brian Daugherty, Denise Dickins, and Julia Higgs, “Mandatory Audit Partner Rotation: Partners’ Perceptions of Impacts on Quality of Life and Audit Quality,” working paper presented at the American Accounting Association’s annual meeting, August 2010).

In this article, the authors report the results of a survey of audit partners subject to the rotation rules. Their views about the impact of rotation on audit quality and mechanisms they have adopted to compensate for the potential negative impact of rotation on audit quality are summarized. In doing so, possible unintended consequences of audit partner rotation are identified, as well as practices that may partially negate the spirit of SOX mandates.

Mandatory Audit Partner Rotation

SOX requires that auditors serve as lead engagement partner or concurring/control partner of an audit of a publicly traded company for no more than five consecutive years. Once rotating off, partners must observe a minimum five-year cooling-off period before returning to the audit engagement. Technical, national, or other specialty partners serving audits of publicly traded companies are exempt from these rotation requirements. Prior to SOX, the AICPA’s Securities and Exchange Commission Practice Section required only the lead audit partner to rotate off audits of publicly traded companies after seven consecutive years of service, and required only a two-year cooling-off period before the partner could be reassigned to the audit engagement (AICPA, “Comments on SEC’s Proposed Rules to Enhance Independence of Accounting Profession,” 2003; SEC, “Strengthening the Commission’s Requirements Regarding Auditor Independence,” 2003).

Benefits of rotation include the opportunity for a “fresh look” at audit issues and engagement risk, and the possibility of enhanced auditor independence (in fact and in appearance). Auditing firms likely recognize the benefits of periodic engagement personnel rotation, evidenced by the policies of some to require engagement partner rotation even for audits of privately held companies. However, the benefits of rotation must be balanced against the potential negative impact of the loss of client-specific engagement knowledge on audit quality.

It is likely auditors have taken steps to mitigate these potential negative effects, protect their reputations, and minimize associated economic damages by implementing mechanisms that facilitate audit partner rotation. To gather information about these mechanisms, the authors distributed surveys to 370 practicing audit partners from 14 audit firms, representing approximately 40 distinct practice office locations.
locations of varying size. Of the surveys distributed, 170 (46% response rate) were returned. All participants had public company audit experience with audit firms subject to mandatory partner rotation. Exhibit 1 provides demographic data of the partners participating in the survey.

Participants averaged 47 years of age and have been audit partners for approximately 11 years. Approximately 22% are employed by Big Four accounting firms, and 73% are employed by the eight largest (Big Four and the next four) U.S. accounting firms. Participants conduct their work in offices averaging 11 partners.

**Perceptions of Mandatory Rotation**

Below, we report partner participants’ beliefs about the impact of rotation on audit quality and the audit firm, and mechanisms employed to reduce the potential negative effects of rotation and successor audit partners’ client familiarization period. Responses relevant to perceptions about the impact of mandatory partner rotation on audit quality are presented in Exhibit 2.

Measured on a 7-point scale where 1 = strongly disagree, 4 = neutral, and 7 = strongly agree, surveyed partners, in general, are neutral in their perceptions regarding the impact of mandatory rotation on audit quality. However, they believe the SOX-mandated rotation changes placed additional burdens on the audit firm. Interestingly, examining differences based on firm size, the perceived negative impact of rotation on audit quality and audit firm burdens (including SOX changes) increases with audit firm size and varies significantly between the largest (Big Four) and smallest (Other) firms.

That is, audit partners of larger firms are more likely to believe rotation negatively impacts audit quality and is more of a burden than do audit partners of smaller firms. Results do not vary significantly based on office size. It may be that smaller firms have fewer clients subject to the rotation rules as a percentage of their entire (firmwide or officewide) practice and, therefore, do not perceive the rules as being as burdensome as larger firms do. It is also possible that some smaller firms may focus on niche industries, so that the potential successor partners have desired industry expertise.

Written comments from surveyed partners are expressive of their concerns about the burdens of rotation. For example, one partner commented that the initial year of rotation is most difficult, diminishes as the partner learns the client’s unique characteristics, and is offset to a degree by consulting with the prior partner for their perspectives prior to transition. Another commented that the rotation cooling-off period puts more strain on quality review partners than engagement partners, as they serve more clients.

Somewhat in contrast, and indicative that some auditing firms (particularly, but not solely, the Big Four) perceive value in periodic rotation, 22.5% of survey participants reported their firms have rotation requirements for audits of privately held companies, even though these companies are not covered in the rotation mandate. On average, auditing firms imposing these requirements have adopted a nine-year rotation policy.

**Minimizing the Impact**

Survey statements and participants’ responses describing certain mechanisms designed to minimize the impact of mandatory rotation are presented in Exhibit 3.

**EXHIBIT 1**

Demographic Data of Surveyed Audit Partners

<table>
<thead>
<tr>
<th>Big Four (n = 37)</th>
<th>Midsize (n = 86)</th>
<th>Other (n = 47)</th>
<th>Total (n = 170)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mean</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Age, Expertise, and Experience</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age in years (n = 167)</td>
<td>44.6</td>
<td>47.8</td>
<td>46.3</td>
</tr>
<tr>
<td>Years as an audit partner (n = 167)</td>
<td>9.4</td>
<td>11.9</td>
<td>10.2</td>
</tr>
<tr>
<td>Calculated age at partner (n = 167)</td>
<td>35.2</td>
<td>35.9</td>
<td>36.1</td>
</tr>
<tr>
<td># of expert industries (n = 166)</td>
<td>2.1</td>
<td>2.8</td>
<td>2.5</td>
</tr>
<tr>
<td># of lead partner public-company audits last year (n = 166)</td>
<td>2.1</td>
<td>2.1</td>
<td>0.64</td>
</tr>
<tr>
<td># of concurrent partner public-company audits last year (n = 166)</td>
<td>1.5</td>
<td>2.5</td>
<td>0.73</td>
</tr>
<tr>
<td># of audit partners locally (n = 165)</td>
<td>21.2</td>
<td>8.1</td>
<td>8.4</td>
</tr>
<tr>
<td><strong>Percentage</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm type (n = 170)</td>
<td>21.8%</td>
<td>50.6%</td>
<td>27.6%</td>
</tr>
<tr>
<td>Response rate (n = 170)</td>
<td>56.1%</td>
<td>45.7%</td>
<td>40.5%</td>
</tr>
<tr>
<td>Gender (n = 166)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>20.0%</td>
<td>80.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Male</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. BDO Seidman, Crowe Horwath, Grant Thornton, and McGladrey & Pullen.
b. All other firms, primarily the top 25 firms not categorized as Big Four or Midsize.
A partner may serve to minimize the amount of lost client experience, it also circumvents the spirit of the SOX rotation mandate, and may negate the newly assigned lead engagement partner’s ability to take a fresh look at audit risks and engagement issues.

Since it is likely these rotation-facilitating mechanisms were in place prior to SOX, the real benefit of SOX changes may have been in extending the cooling-off period. Recall that prior to SOX, lead engagement partners could serve on an audit engagement for up to seven years and were required to cool off two years, suggesting that the primary lead engagement partner’s involvement and influence may have been substantial throughout the pre-SOX cooling-off period.

One partner was particularly descriptive of his audit firms’ processes, stating that planning for rotation to find the right partners begins about three years before the rotation and includes having the client interview possible candidates. Partners are required to educate themselves about new industries and clients, and all rotation partners have to be approved by his firm’s regional technical partners. Another partner wrote that partners who will be rotating onto audit engagements are usually kept aware of issues and significant audit and accounting judgments, and participate in significant meetings with the client and audit committee to build relationships. This partner emphasized manager/senior manager retention through partner transition to the extent possible.

Measured on a 7-point scale where 1 = strongly disagree, 4 = neutral, and 7 = strongly agree, surveyed partners believe audit quality is higher when the engagement partner and quality review partner rotations are staggered. Partners nearly unanimously reported a mechanism key to maintaining audit quality during engagement partner rotation was not having a concurrent quality review partner change. Example comments included that the concurring partner doesn’t change in the year of partner rotation, and that concurring partners are generally rotated one or two years before the lead partner changes to provide continuity. Sometimes, the concurring partner then becomes the lead partner, while in other circumstances, the concurring partner remains in the concurring partner role for the remainder of the five years. It should be noted that years served both as lead or concurring partner count toward the five-year tenure limit imposed by SOX. Like other rotation-facilitating mechanisms, while these practices reduce the likelihood of lost client-specific engagement knowledge, they also reduce the benefits associated with a fresh look, and may not be in the spirit of the SOX rotation mandate.

Coordinating skill sets of engagement and concurring partners was also emphasized. As one partner wrote, lead and concurring partners are tracked by engagement and region, with a focus on engagements requiring specialized industry expertise. These findings are consistent with the Center for Audit Quality’s (CAQ)
observation that concurring/quality control partners bring deep industry expertise to an audit engagement and play an important role in the overall quality of public company audits (“Discussion Outline for Consideration by the Advisory Committee on the Auditing Profession,” 2008).

Although results of prior research suggest client experience and industry expertise are two of the most important audit partner characteristics contributing to audit quality (J. V. Carcello, D. R. Hermanson, and N. T. McGrath, “Audit Quality Attributes: The Perceptions of Audit Partners, Preparers, and Financial Statement Users,” Auditing: A Journal of Practice & Theory, 1992, vol. 11, no. 1), more than one-half of surveyed partners report having to learn a new industry to satisfy an audit partner rotation requirement (not tabulated). Further, audit partners in the smaller firms surveyed were significantly more likely to have to learn a new industry. This finding is consistent with those of other studies that suggest smaller auditing firms may have been disproportionately negatively impacted by SOX mandates in general. For example, more triennially inspected auditors (smaller auditing firms) resign from their publicly traded clients or cease to be registered with the PCAOB following receipt of PCAOB inspection deficiencies (Brian Daugherty, Denise Dickins, and Wayne Tervo, “Negative PCAOB Inspections of Triennially Inspected Auditors and Involuntary Client Losses,” Journal of International Auditing, vol. 15, no. 2, 2011).

Implications

Results of the authors’ survey suggest that audit partners share the concerns expressed during testimony heard by the ACAP about the potential negative effects of the accelerated rotation and extended cooling-off periods mandated by SOX. Results also indicate mechanisms are employed to minimize the negative impacts of rotation to the extent possible. Specifically, auditors recognize the importance of detailed tracking of rotation requirements by partner and client, avoiding concurrent engagement partner and quality review partner changes, preplanning engagement partner changes well in advance of rotation, and minimizing changes of other engagement team members in the year of rotation. One partner summarized this process saying, “Coordination of outgoing, incoming partners is critical and time-consuming and ultimately, is in the hands of those two partners.” Somewhat ironically, and against the spirit of the rotation mandate, certain of these mechanisms may act to reduce the intended benefits of rotation as they extend the influence lead engagement partners have over newly assigned engagement partners.

Consistent with the results of other studies that suggest certain SOX mandates may have had a disproportionately negative impact on smaller audit firms, accelerated rotation may have more negative impacts on smaller firms with fewer resources. These disproportionate impacts may result in an even greater concentration of audit services for publicly traded companies. Currently, only auditing firms with fewer than five partners are exempt from mandatory audit partner rotation.

Regulators may want to consider changes to the current rotation requirements in order to address these issues. These changes may include allowing an audit committee to justify extended partner tenures to shareholders, which would provide companies flexibility, when it is necessary or desirable to have a partner on the engagement longer than five years, further extending the cooling-off period to reduce the likelihood that a single engagement partner will continue to exert influence over an audit engagement, and increasing the auditing firm size exemption in order to reduce the possibility of disproportionate effects of rotation.

**AUGUST 2011 / THE CPA JOURNAL**

**EXHIBIT 3**

Audit Firm Mechanisms to Minimize Impact of Rotation

<table>
<thead>
<tr>
<th>Question</th>
<th>Scale</th>
<th>Percentage Selecting at Least Two Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. How far in advance is the transition of audit engagement partners (required to comply with the mandatory rotation requirements) planned internally by your firm?</td>
<td>Less than One Year to Five Years</td>
<td>1.64 (0.92)</td>
</tr>
<tr>
<td>2. How far in advance is the transition of audit engagement partners (required to comply with the mandatory rotation requirements) coordinated with clients?</td>
<td>Less than One Year to Five Years</td>
<td>1.15 (0.75)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement</th>
<th>Endpoints, Midpoint</th>
<th>Mean (std. dev.)</th>
<th>Difference from Neutrala</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Audit quality is higher when the audit engagement partner and quality review (concurring) partner rotations are staggered.</td>
<td>1 = Strongly Disagree 4 = Neutral 7 = Strongly Agree</td>
<td>5.64 (1.29)</td>
<td>1.64b</td>
</tr>
</tbody>
</table>

a. Difference from neutral value of 4.  
b. Denotes significance at p < 0.001 (two-tailed).  
Note: The number of responses for the individual statements may be less than the overall number of partners responding (n = 170) due to responses left blank.
Professional life would be so much simpler if ethical issues were clear-cut. Professional life is not so simple, however. Ethical and other professional problems often present themselves in unstructured and unfamiliar settings. The ability to recognize an ethical issue is as important as the problem-solving process that one engages in once an ethical issue is raised. This article explores the benefits of a threats-and-safeguards approach to ethical issues. It then illustrates how this approach might be applied to the ethical challenges of performing audits below cost.

Threats-and-Safeguards Approach to Ethics

The AICPA Professional Ethics Executive Committee (PEEC) adopted a threats-and-safeguards approach as part of its Conceptual Framework for AICPA Independence Standards. In addition, the PEEC has approved a similar nonauthoritative “Guide for Complying with Rules 102-505,” which includes substantially all AICPA ethics rules other than independence. The AICPA threats-and-safeguards approach has been patterned after standards developed by the International Ethics Standards Board for Accountants (IESBA).

The broad-based threats-and-safeguards concept can be helpful in resolving a variety of ethical issues not explicitly covered in codes of conduct. In an era that puts a premium on professional judgment, it is impossible to define every possible ethical threat. The public interest is well served when practitioners recognize significant ethical risks and put appropriate safeguards in place to ensure that ethical behavior and professional judgment are not compromised.

When applying the threats-and-safeguards approach, practitioners should view potential ethical issues from the perspective of a reasonable and prudent person who possesses both knowledge and experience. It is important for practitioners to not just view a situation from their own personal perspective. Rather, they should consider how a potential ethical threat would be viewed by a reasonable and prudent member of the public.

It is important for practitioners to 1) recognize threats to fundamental ethical principles, 2) evaluate the significance of those threats, and 3) determine the appropriate safeguards that might be put in place.
to reduce the threat to an acceptable level. If no safeguards are available to eliminate a threat or reduce it to an acceptable level, the CPA should not take the action that raises the ethical threat. The Conceptual Framework approach assists professional accountants in complying with the ethical requirements and meeting their responsibility to act in the public interest.

Audit Fees and Profitability

Does a significant ethical threat arise when an audit firm conducts an audit for a very low fee or performs an audit at a loss, or when an audit firm, office, or partner is financially dependent on an individual client? This issue is a common discussion topic among CPAs, who are under pressure not only to comply with the increasing requirements of the public but also to compete with other firms for work. Accusations of lowballing and their adverse impact on the public and the profession have long been the “elephant in the room” in discussions among practitioners, regulators, and private-sector standards setters wary of antitrust ramifications. Regardless of the reluctance, the time to deal with this issue has come.

Practitioners often cite business reasons for bidding audits at a loss. For example, some firms will bid audits at a loss to—

■ keep audit staff busy during slow periods,
■ gain entrance into an industry where the firm has not performed audits,
■ gain entrance to a geographic market where the firm has not performed audits,
■ obtain access to members of an entity’s board of directors in hopes of gaining additional and more profitable work, or
■ provide work for a not-for-profit organization as a charitable contribution.

In addition, a firm may absorb a loss in an initial audit with the hope that the engagement will become profitable in the long run.

Perhaps this issue is so difficult because it involves significant professional judgment. What happens, for example, when an audit firm bids an audit for what it believes is a reasonable fee but then encounters unexpected problems, and the cost of additional work cannot be recovered from the audit client? If the firm follows professional standards, it may encounter a loss. Where does this fit into the discussion? And how do audit firms balance the public interest in high-quality audits, when there is the private benefit to a CPA firm in performing an audit below the firm’s cost?

Further, it is easy for accountants to get sidetracked by debating the merits of different methods of measuring the profitability of an engagement. Most audit firms have their own methods of tracking engagement profitability. While some of these measures may differ, the nuances of such a debate regarding how to measure engagement profitability are lost on a public that relies on reliable audited financial statements. When viewed through the lens of the public, the key issues are whether a firm identifies a very low-fee or below-cost audit as an ethical threat, whether it considers appropriate safeguards, and whether it takes appropriate action.

The remainder of this article focuses on three specific threats and the appropriate safeguards that might be put in place to ensure that ethical principles are met. These are the threats that arise when—

■ fees are too low to reasonably perform an engagement and comply with standards;
■ inadequate fees pose a threat to the subordination of judgment, independence, integrity, and objectivity; and
■ a firm, office, or partner is financially dependent on an individual client.

Engaging in these fee-related activities is not by itself a violation of ethics; however, appropriate safeguards need to be put in place to ensure that ethical principles are not compromised.

When Low Fees Jeopardize Standards

As noted above, there may be valid reasons why firms may choose to bid a very low fee on an audit or attest engagement. But performing an engagement for fees inherently too low to allow the firm to reasonably comply with standards is a significant threat to due professional care and compliance with professional standards. A recent National Association of State Boards of Accountancy (NASBA) discussion paper noted that board members have cited low fees as a common denominator involving inadequate audit work (Gaylen Hansen, “Audit Fees and Engagement Profitability: A Threats and Safeguards Approach to Strengthen Compliance with Standards of Ethical Behavior,” 2010, www.nasba.org/nasbaweb/NASBAWeb.nsf/PS/8AA249A4EF682AB8862577F20057F232?OpenDocument). In addition, if audit managers are evaluated or compensated wholly or partially based upon engagement realization, and fees are quoted at a very low level, an audit manager may be put in a position where it is difficult or impossible to perform the work required by professional standards and at the same time realize earnings aspirations. When fees are unreasonably low, some auditors assert that they actually performed the work but did not document it, leading to a failure to comply with professional standards.

When engaging in a discussion about engagement profitability, a number of auditors have expressed concern over audits appearing to be profitable at the outset, only to subsequently discover more work than expected needed to be done, that is, an engagement expected to be profitable turns into a loss. This is a vivid example of where a firm must recognize the risks and put compliance with ethical standards above engagement profitability. Whether the firm realized it or not, the threat was identified and appropriate safeguards were applied.

It is important that an audit firm recognize the threat to due professional care and compliance with professional standards at the outset of an engagement and put appropriate safeguards in place to ensure the firm’s responsibility to the public. Such safeguards might include—

■ instituting an adequate system of quality control, including approval of acceptance and continuance of engagements by those responsible for managing the auditing firm, preferably those who otherwise have no participation in the audit;
■ requiring adequate supervision and review;
■ allocating a reasonable amount of time to complete the engagement; and
■ assigning qualified staff to the engagement team.

Many auditors might argue that these safeguards are normally instituted in their audits. That may be true. Many auditors recognize that when fees are not sufficient to cover the costs of performing an audit, they need to communicate different expectations about the realization of the engagement by allocating an appropriate amount of time and staff to the engagement.
Unfortunately, this is not always the case. The disciplinary records of many state boards of accountancy include instances where one or more of the safeguards suggested above were not performed.

Another safeguard suggested by the IESBA’s Code of Ethics for Professional Accountants is requiring disclosure to those charged with governance of the client. In the context of low audit fees, the auditor should disclose to an audit committee 1) that the fee is so low that a loss is anticipated in order to reasonably comply with standards, and 2) that the safeguards will be applied in order to reduce the threat of noncompliance with professional standards. This approach informs the client’s audit committee of the fact that the audit fee is unreasonably low and forces the audit committee to be informed about such matters and to take some responsibility for the implications of an unreasonably low audit fee. This is particularly important in an era where management is asking for—and obtaining—significant reductions in audit fees. Perhaps it is time for the AICPA and state boards of accountancy to add a discussion of this safeguard to relevant codes of professional conduct in the United States.

Performing an audit for a fee that is too low to reasonably comply with professional standards is not, by itself, a violation of professional ethics. Further, this threat to due professional care can be overcome by applying appropriate safeguards to ensure that the public is protected.

In general, when fees are significantly low, there is a presumption by the public and regulators that performing an audit for a very low fee, or performing an audit at a loss, is a significant threat to due professional care and compliance with professional standards. Indeed, virtually all firms, when addressing client acceptance or continuance, ask the question, “Does the prospective fee justify pursuing the engagement, in light of the anticipated cost of obtaining and conducting the engagement?” This question is focused on the threat of very low fees, which can be mitigated by appropriate safeguards to ensure that due professional care is exercised and that the audit or attest engagement complies with professional standards.

**Independence, Integrity, and Objectivity**

Not only may low fees pose a threat to due professional care, but they may also threaten independence, integrity, and objectivity. For example, an auditor might subordinate judgment to the client rather than devote additional time to investigating an audit issue. The NASBA discussion paper addresses a situation brought to a state board involving a low fee audit, where a material issue arose at the end of the engagement. Rather than taking the time to fully investigate a problem, the auditors subordinated their judgment to that of the client. It was later determined that the subordination of judgment resulted in a material misstatement in the financial statements. While this situation involved an element of failure to use due professional care, it also was a result of a firm’s failure to act with integrity, objectivity, and, arguably, independence.

Further, just as a firm may have overdue fees bearing on independence, performing services below cost may indicate underlying financial considerations that impair independence. There are times when auditors openly talk about “investing in a client” when they perform an audit at a loss. A threat exists that the audit firm may subordinate judgment in order to make the “investment” pay off. If the auditor needs to keep the client satisfied in order to get other work (e.g., from the client or from a board member), the auditor may not have an independent attitude.

The accounting profession has witnessed these problems with public company audits. Stephen A. Zeff documents a 30-year span where some auditors shifted from making professional judgments in the interest and well-being of the shareholder, to making those judgments in the interest of management (“How the U.S. Accounting Profession Got Where It Is Today: Part I,” *Accounting Horizons*, September 2003, pp. 189–205, and “How the U.S. Accounting Profession Got Where It Is Today: Part II,” *Accounting Horizons*, December 2003, pp. 267–286). This trend is also clearly discussed by C. Richard Baker in a *CPA Journal* article (“The Varying Concept of Auditor Independence: Shifting with the Prevailing Environment,” August 2005, pp. 22–28). There is well-documented evidence that some of this shift was associated with using the audit as a “loss leader” to obtain more lucrative consulting services, which caused some auditors to subordinate their judgment and lose their independence.

This problem has been addressed for public companies because the Sarbanes-Oxley Act of 2002 prohibits performing certain nonattest services for audit clients. For private company reporting, the issue of using the audit as a loss leader to obtain more lucrative services is less rigorous but is addressed by the AICPA in Interpretation 101-3, *Performance of Nonattest Services*. However, the risk of subordinating judgment in order to gain more profitable work still exists.

The accounting profession recently witnessed a variation of the threat that inadequate fees pose to the subordination of judgment in the purported audit of Bernard L. Madoff Investment Securities LLC (BMIS) by Friehling & Horowitz, CPAs, P.C. A glaring red flag existed when Madoff’s multi-billion-dollar fund paid Friehling & Horowitz only $186,000 for its 2008 audit. While the fee was sufficiently low to raise a question of whether an audit could be performed and comply with professional standards, the engagement may have been profitable for Friehling & Horowitz. The SEC contended that Friehling merely “pretended” to conduct minimal audit procedures of certain accounts to make it appear it was conducting an audit. Friehling subsequently pleaded guilty to fraud charges associated with the audit of BMIS. (For more on the Friehling & Horowitz audit of BMIS, see www.sec.gov/litigation/litreleases/2009/lr21274.htm.) In the Friehling & Horowitz case, the issue is not whether the attest engagement was profitable. The issue was a fee so low that the auditor resorted to the subordination of judgment and did not perform reasonably expected audit work.

When an attest engagement is performed for a very low fee or at a loss, there is a real threat to independence, integrity, and objectivity. But appropriate safeguards can be put in place to reduce the threat to the point where professional judgment is not compromised. Such safeguards might include—

- consultation with technical specialists on issues of significant professional judgment;
- requiring engagement quality reviews (e.g., concurring, post- or preissuance reviews); and
- discussion of safeguards against subordination of judgment with those charged with governance of the entity.

The focus of attention here is to establish a way to ensure that professional judgment is not subordinated to that of the client. If an audit firm is sufficiently small,
such as a sole practitioner, it may be prudent to engage another auditor to perform some level of preissuance peer review to ensure that judgment has not been subordinated to that of the client, even if it may increase the risk of a loss for the audit firm.

Financial Dependence on an Individual Client

When the fees from an attest engagement represent a large proportion of total firm fees, the dependence on a client and concern about losing the work create an inherent self-interest or intimidation threat to independence, integrity, and objectivity. A similar threat arises when the fees from a client represent a large proportion of the revenue from an individual partner’s book of business or a large proportion of the revenue of an individual office of the firm. This was the case in the Enron audit failure for both the engagement partner and the performing office. There also may be circumstances when fees are accepted in excess of those required—solely as an inappropriate response for the auditor to report what the client may want and to compensate the auditor for not being independent.

Both the PEEC and the IESBA recognize that an ethical threat exists when a large proportion of fees come from a single client. The Conceptual Framework recognizes that a financial self-interest threat to independence exists when there is “excessive reliance on the revenue from a single client” (AICPA Code of Professional Conduct, ET section 100.01.18[c]). The IESBA has recently adopted a rule requiring application of the threats-and-safeguards approach when the amount of fees from an individual client deemed to be a “public interest entity” exceeds 15% of total firm fees (International Federation of Accountants, Code of Ethics for Professional Accountants, section 290.220–222).

In general, when total fees from any audit client represent a large proportion of the total firm fees, the IESBA recommends the following safeguards:

- Reducing the dependence on the client;
- Instituting internal or external quality control reviews of the engagement; and
- Consulting an independent third party on key audit judgments.

When fees from a public interest entity audit client exceed 15% of total firm fees, the IESBA recommends that the firm address the following issues with those charged with governance of the client:

- Disclose that total fees represent more than 15% of the total fees of the firm.
- Discuss the safeguards the firm will apply to reduce the threat to an acceptable level (e.g., preissuance or postissuance engagement quality control reviews).

When a CPA firm commences its attest practice, there will likely be a time in which the audit firm is dependent on a few clients. This is not an ethical violation per se; however, the firm should apply the safeguards discussed above. The client should be aware that the audit firm is dependent on the client’s fees, and the auditor should discuss the safeguards that have been put in place. It would be quite appropriate, for example, to engage another audit firm for some level of preissuance review.

Other General Safeguards

In addition to the safeguards discussed above, there are a number of general safeguards to help recognize threats to ethical behavior. A firm’s senior leadership might, for example—

- Stress the importance of ethical behavior and an expectation that members of attest engagement teams act in the public interest;
- Implement training and timely communication of policies and procedures for identifying ethical threats associated with very low fees or fees representing a significant proportion of firm revenues; and
- Document policies regarding the identification of ethical threats, the evaluation of the significance of those threats, and the application of safeguards.

Antitrust Considerations

Whenever the profession discusses ethics and fees in the same sentence, antitrust considerations are raised. A threats-and-safeguards approach is raised as well. Antitrust considerations are not considered as an effort to stifle competition. This approach recognizes the professional judgment involved in pricing an engagement and attempts to find a balance between a firm’s interest in pricing an audit engagement with the public’s interest in high-quality audits. It is sometimes appropriate for a firm to quote a low fee, a fixed fee, or even fees insufficient to cover the cost of performing an audit, as long as the related threats are identified and appropriate safeguards are applied and documented.

Time for a Comprehensive Look

The time has come for the auditing profession in the United States to move forward with a more comprehensive look at adopting a threats-and-safeguards approach to ethical issues. It is also time to recognize that low fees and low engagement profitability are an ethical issue. It is not an issue that demands a prohibition on performing audits for a low fee or at a loss; however, the threats to due professional care and potential subordination of judgment are real.

Some of the safeguards suggested above are already addressed in Generally Accepted Auditing Standards (GAAS) and in the AICPA Code of Professional Conduct. However, it is suggested that firms take the additional safeguards described above, such as discussing the low-fee threat and the safeguards applied with those responsible for the governance of the client. When a firm, office, or partner is financially dependent on an audit client, it is also appropriate to implement some form of preissuance internal or external quality review and to implement consultation with an objective third party on matters of significant professional judgment.

The benefit of a threats-and-safeguards approach is that it recognizes that auditors work in a complex environment that requires the exercise of professional judgment. When a firm has a strong tone at the top, it will take steps to help its auditors recognize potential threats of all sorts and then take steps to ensure compliance with both the spirit as well as the letter of ethical standards of professional conduct.

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Semi-Markov Process and Microsoft Excel

Using Mathematical Tools to Improve Operations

By August A. Saibeni

Several years ago, the author was responsible for the operations of a new skilled nursing division of a regional medical center. In addition to operations, part of the responsibilities included facility acquisitions. While reviewing acquisition possibilities, the author noticed that many skilled nursing facility (SNF) residents or patients had Medi-Cal (California’s version of Medicaid) as the payment source. On average, Medi-Cal residents constituted approximately 80% of the residents of area SNFs. Since Medi-Cal pays SNFs far less than private-pay residents, it is imperative that operators try to increase the number of private-pay residents if a facility is to remain solvent. Increasing the private-pay census is a goal of most SNFs, however, making this a difficult goal to achieve. The common sense reason for the high Medi-Cal census among facilities is that many residents do not have the resources to fund more than a brief stay before exhausting their own funds and thus defaulting to Medi-Cal as the source of payment.

Semi-Markov Process
In addition to the common sense reason for a high Medi-Cal census, the author wondered if there might be some type of mathematical model that could describe the transition of patient or resident payment sources (financial classes) from one category to another. After considerable searching, the author found a probability process that helps model the various changes of financial classes among residents. The process is called a semi-Markov process (see Sheldon M. Ross, *Introduction to Probability Models*, 5th ed., Academic Press Inc., 1993, pp. 331–333). A semi-Markov process is a process that can be in any of $N$ states (financial classes for our example) $1, 2, \ldots, N$. Each time the process enters a state $i$, it stays there for a random amount of time with a mean time of $\mu_i$. The process then transitions to the next state $j$, with a probability of $P_{ij}$ (Ross, p. 331).

In order to have a valid semi-Markov model, two assumptions must be met: the Markov assumption and the assumption of stationary transition probabilities from one state to another. The Markov assumption requires that each change of state be independent of any previous transition. The stationary transition assumption requires that the transition probabilities remain constant over time. Although in practice the transition probabil-

<table>
<thead>
<tr>
<th>Bed Pay Type</th>
<th>Mean Days in State</th>
<th>Transition to</th>
<th>Probability of Transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Pay</td>
<td>120</td>
<td>Private</td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicare</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medi-Cal</td>
<td>0.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>HMO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vacant</td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>sum = 1</td>
</tr>
<tr>
<td>Medicare</td>
<td>90</td>
<td>Private</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicare</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medi-Cal</td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>HMO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vacant</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>sum = 1</td>
</tr>
<tr>
<td>Medi-Cal</td>
<td>540</td>
<td>Private</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicare</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medi-Cal</td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>HMO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vacant</td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>sum = 1</td>
</tr>
<tr>
<td>HMO</td>
<td>12</td>
<td>Private</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicare</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medi-Cal</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>HMO</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vacant</td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>sum = 1</td>
</tr>
<tr>
<td>Vacant</td>
<td>10</td>
<td>Private</td>
<td>0.25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicare</td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medi-Cal</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>HMO</td>
<td>0.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vacant</td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>sum = 1</td>
</tr>
</tbody>
</table>
ties may change a bit over time, as long as fairly current data are used, forecasts will most likely be accurate enough for planning purposes for an operating cycle.

To explain a semi-Markov process, Ross uses an example involving a machine being in one of three states: good condition, fair condition, or broken down. The question for Ross is what proportion of time is the machine in each state of good condition, fair condition, or broken down.

The problem above was to find the average time the payment source of residents in an SNF would be in each of the following states: private payment, Medicare, Medi-Cal, or HMO/insurance. In addition, the state of a bed being vacant—analogous to the state of “broken” in Ross’s example—had to be considered. Results of the model could then be used for budgeting or forecasting.

### Constructing a Scenario

Consider the SNF financial class example: If, for a given SNF, the mean time for...

---

#### EXHIBIT 2

**Census Forecast**

<table>
<thead>
<tr>
<th>Financial Class</th>
<th>Percent of Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private</td>
<td>11.1%</td>
</tr>
<tr>
<td>Medicare</td>
<td>1.7%</td>
</tr>
<tr>
<td>Medi-Cal</td>
<td>85.8%</td>
</tr>
<tr>
<td>HMO</td>
<td>0.1%</td>
</tr>
<tr>
<td>Vacant</td>
<td>1.3%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

#### EXHIBIT 3

**Calculating Long-Run Time in Each State**

\[
P_i = \frac{\pi_i \mu_i}{\sum_{j=1}^{5} \pi_j \mu_j}, \quad i = 1, 2, 3, 4, 5
\]

\[
P_1 = 11.1%
\]

\[
P_2 = 1.7%
\]

\[
P_3 = 85.8%
\]

\[
P_4 = 0.1%
\]

\[
P_5 = 1.3%
\]

---

#### EXHIBIT 4

**Comparison of Planning Strategies**

<table>
<thead>
<tr>
<th>Financial Class</th>
<th>Mean Days in State</th>
<th>% of Admissions</th>
<th>% Financial Class Mix</th>
<th>Net Revenue per Patient Day</th>
<th>Net Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Pay</td>
<td>120</td>
<td>33%</td>
<td>11.1%</td>
<td>$140</td>
<td>$567,536</td>
</tr>
<tr>
<td>Medicare</td>
<td>90</td>
<td>7%</td>
<td>1.7%</td>
<td>$ 50</td>
<td>$ 30,745</td>
</tr>
<tr>
<td>Medi-Cal</td>
<td>540</td>
<td>57%</td>
<td>85.8%</td>
<td>$ 45</td>
<td>$156,545</td>
</tr>
<tr>
<td>HMO/Insurance</td>
<td>12</td>
<td>3%</td>
<td>0.1%</td>
<td>$ 0</td>
<td>$ 1,640</td>
</tr>
<tr>
<td>Vacant</td>
<td>10</td>
<td></td>
<td>1.3%</td>
<td></td>
<td>$ 0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>100%</strong></td>
<td></td>
<td><strong>$756,466</strong></td>
<td></td>
</tr>
</tbody>
</table>

| **Case 2**         |                    |                 |                       |                             |             |
| Private Pay        | 120                | 33%             | 11.2%                 | $140                        | $571,338    |
| Medicare           | 90                 | 7%              | 1.7%                  | $ 50                        | $ 30,951    |
| Medi-Cal           | 540                | 57%             | 86.4%                 | $ 45                        | $157,594    |
| HMO/Insurance      | 12                 | 3%              | 0.1%                  | $ 0                         | $ 1,651     |
| Vacant             | 5                  |                 | 0.7%                  |                             | $ 0         |
| **Total**          | **100%**           | **100%**        |                       | **$761,534**                |             |

| **Case 3**         |                    |                 |                       |                             |             |
| Private Pay        | 150                | 33%             | 13.5%                 | $140                        | $690,254    |
| Medicare           | 90                 | 7%              | 1.6%                  | $ 50                        | $ 29,915    |
| Medi-Cal           | 540                | 57%             | 83.5%                 | $ 45                        | $152,316    |
| HMO/Insurance      | 12                 | 3%              | 0.1%                  | $ 0                         | $ 1,595     |
| Vacant             | 10                 |                 | 1.3%                  |                             | $ 0         |
| **Total**          | **100%**           | **100%**        |                       | **$874,080**                |             |

| **Case 4**         |                    |                 |                       |                             |             |
| Private Pay        | 120                | 38%             | 13.0%                 | $140                        | $666,791    |
| Medicare           | 90                 | 6%              | 1.7%                  | $ 50                        | $ 30,618    |
| Medi-Cal           | 540                | 53%             | 83.2%                 | $ 45                        | $151,814    |
| HMO/Insurance      | 12                 | 3%              | 0.1%                  | $ 0                         | $ 1,633     |
| Vacant             | 15                 |                 | 2.0%                  |                             | $ 0         |
| **Total**          | **100%**           | **100%**        |                       | **$850,856**                |             |
each financial class “visit” and the transition probabilities are as shown in Exhibit 1, one can use Microsoft Excel to calculate the long-run mean time a patient has in each financial class payment category. With the assumed input shown in Exhibit 1, one can calculate that, in the long run, Medi-Cal patients or residents will represent about 86% of the facility’s census, which is close to what the author observed when investigating facilities for purchase. Exhibit 2 shows the long-run mean time a bed serves a given financial class or becomes vacant.

In order to calculate the long-run proportion of time that a patient is in each state shown in Exhibit 2, first calculate the long-run proportion of transitions between each state (see the Appendix for these calculations).

The long-run average time a patient remains in each state is the weighted average of the transition probabilities calculated in the Appendix and the average amount of time the patient spends in each state (Ross, pp. 331, 333). For example if a patient spends on average 120 days in state 1, 90 days in state 2, 540 days in state 3, and 12 days in state 4, with the bed vacant on average 10 days (state 5), each respective state visit—the long-run amount of time a patient is in each state—is calculated as shown in Exhibit 3 (Ross, p. 333).

The model is useful to forecast a percentage mix of financial classes based upon an input of transition probabilities and the mean time stay in each financial class, as well as for other planning purposes. For example, an operator could compare the impact of marketing efforts to reduce the vacancy rate compared to other planning strategies. Exhibit 4 shows a comparison of four planning strategies. Case 1 represents the base scenario. Case 2 assumes that the number of days that a bed is allowed to remain vacant for 15 days instead of 10 days, with the assumed increase of a transition probability for a vacant bed with a private-pay patient increasing to 30% of the vacant transitions, compared to the prior assumption of 25%, with a similar reduction in Medi-Cal transition probability, from 20% to 15%. The result would increase private-pay admissions from 33% to 38% and reduce Medi-Cal admissions from 57% to 53%. This increases net patient revenue from $756,466 to $874,080. Finally, Case 4 assumes that a bed is allowed to remain vacant for 15 days instead of 10 days, with the assumed increase of a transition probability for a vacant bed with a private-pay patient increasing to 30% of the vacant transitions, compared to the prior assumption of 25%, with a similar reduction in Medi-Cal transition probability, from 20% to 15%. The result would increase private-pay admissions from 33% to 38% and reduce Medi-Cal admissions from 57% to 53%. This increases net patient revenue from $756,466 to $850,856.

Due to the complex interplay of variables, including average length of stay by financial class, transitions among various financial classes, financial class admission ratios, and net patient revenue for each financial class, it is very difficult and time-consuming to try to develop scenarios similar to these examples without the use of a semi-Markov process. The changes between Case 1 and Cases 2, 3, and 4 have been minimized in order to isolate the impact of the changes. Using Microsoft Excel and a semi-Markov process, however, it is very easy to analyze numerous scenarios in a brief period of time. Of great benefit is the ability to make explicit assumptions for each input variable and see how the changes affect the census mix and net patient revenue.

Semi-Markov processes seem to have application to many situations, as evidenced by a significant number of published academic articles. One fairly recent article requiring advanced mathematics related to revenue planning for the airline industry as applied to discount tickets (see Shelby Brumelle and Darius Walczak, “Dynamic Airline Revenue Management with Multiple Semi-Markov Demand,” Operations Research, vol. 51, no. 1, January/February 2003, pp. 137–148). The goal was to create a strategy to optimize passenger revenue between full-charge tickets and discount tickets, while the SNF model is interested in optimizing patient or resident revenue.

Other Tools

To enhance forecasts of resident arrivals, an operator may also consider the use of a Poisson probability model. Although a full discussion of the Poisson and exponential distributions are beyond the scope of this article, it could be helpful for operators to consider them when planning for financial class admissions.

Case 1 of the SNF example above assumes that approximately 36 private pay patients will be admitted each year; this translates to approximately three patients per month, or approximately 0.1 per day. A Poisson distribution can be used to compute the probability of various arrivals per day, week, or month. An operator’s fear of vacancy would be reinforced, given that the Poisson distribution (Ross, p. 30), using the assumed data above, would forecast that the probability of zero private pay patients arriving each day is about 90%, with about one private patient arriving every 10 days. In addition, the exponential distribution (Ross, p. 214) would calculate that there is still a 37% and 22% chance that a private-pay patient would not arrive within 10 days or 15 days respectively. Exhibit 5 shows the probability calculations for the 10-day case.

Looking for an Edge

Given the difficulty of surviving and thriving in the current business environment, SNF and many other industry operators need any edge they can find. Using the power of a semi-Markov process and Microsoft Excel may be “just what the doctor ordered” for SNF operators, as well as operators in other industries.

EXHIBIT 5

<table>
<thead>
<tr>
<th>Exhibit 5</th>
<th>Poisson: Probability of Zero Private-Pay Patient Arrivals in One Day</th>
</tr>
</thead>
<tbody>
<tr>
<td>Let:</td>
<td>λ = Poisson parameter = 0.10</td>
</tr>
<tr>
<td>x</td>
<td>number of private patient arrivals</td>
</tr>
<tr>
<td>e</td>
<td>base of natural logarithms</td>
</tr>
<tr>
<td>P(x = 0)</td>
<td>$\frac{e^x}{x!}$</td>
</tr>
<tr>
<td>e(0.10)</td>
<td>0.10 e^0 = 0.10 e^-0 = 90%</td>
</tr>
<tr>
<td>Exponential: Probability that a private-pay arrival exceeds 10 days</td>
<td>P(time &gt; 10 days) = e^-10(0.10) = 37%</td>
</tr>
</tbody>
</table>

August A. Saibeni, CPA (inactive), is an adjunct professor of accounting at Cosumnes River College, Sacramento, Calif. The author thanks James J. Solberg, PhD, for his generous review of the manuscript and his expert recommendations.
Letting the states be 1, 2, 3, 4, 5, the proportion of transitions \( \pi_1, \pi_2, \pi_3, \pi_4, \pi_5 \) into each state must satisfy the following equations:

1. \( \pi_1 + \pi_2 + \pi_3 + \pi_4 + \pi_5 = 1 \)
2. \( \pi_1 = 0.6\pi_1 + 0.2\pi_2 + 0\pi_3 + 0\pi_4 + 0.25\pi_5 \)
3. \( \pi_2 = 0\pi_1 + 0.2\pi_2 + 0\pi_3 + 0.2\pi_4 + 0.1\pi_5 \)
4. \( \pi_3 = 0.3\pi_1 + 0.4\pi_2 + 0.6\pi_3 + 0.2\pi_4 + 0.2\pi_5 \)
5. \( \pi_4 = 0\pi_1 + 0\pi_2 + 0\pi_3 + 0.2\pi_4 + 0.05\pi_5 \)
6. \( \pi_5 = 0.1\pi_1 + 0.2\pi_2 + 0.4\pi_3 + 0.4\pi_4 + 0.4\pi_5 \)

State 1 is private pay, state 2 is Medicare, state 3 is Medi-Cal, state 4 is HMO, and state 5 is vacant. Equation (1) says that the sum of the transition proportions must equal one. Equation (2) says that 60% of the time, a private-pay patient retains this financial class, 20% of the time a Medicare patient transitions to private pay, zero percent of the time a Medi-Cal transitions to private pay, zero percent of the time an HMO patient transitions to private pay, and 25% of the time a vacant bed transitions to private-pay status. Similar interpretations can be made for equations 3 through 6.

The solution to these equations can be found by either manually manipulating the equations or by using Excel’s matrix manipulation functions. The equations can be arranged in a transition matrix (A) that describes how a patient moves through the financial class states, as shown in Appendix Exhibit. Matrix (A) is then transposed (using Excel’s Transpose function), resulting in the transpose matrix (B), which rearranges the rows and columns of the transition matrix in order to put the matrix into a proper linear algebra format needed to solve for the values of \( \pi_i \). Another needed step that results from combining equation 1 with each of the other equations is to adjust the transpose matrix (B) by adding ones to each entry, except for the diagonals, to which zero is added. For an excellent discussion of semi-Markov processes, see James J. Solberg, Modeling Random Processes for Engineers and Managers, Wiley, 2009. For a more detailed and a more advanced spreadsheet solution to the above matrix manipulations, see Solberg, pp. 90–91.

### Appendix Exhibit

<table>
<thead>
<tr>
<th>To State</th>
<th>(A) Transition Matrix</th>
<th>Appendix Exhibit</th>
<th>(B) Transpose Matrix</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.60 1.20 1.00 1.00 1.25</td>
<td>0.60 0.20 0.00 0.00 0.25</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>1.00 0.20 1.00 1.20 1.10</td>
<td>0.00 0.20 0.00 0.20 0.10</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>1.30 1.40 0.60 1.20 1.20 ×</td>
<td>0.30 0.15 −1.05 0.50 0.48</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>1.00 1.00 1.00 0.20 1.05</td>
<td>0.29 0.27 0.25 −0.99 0.20</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>1.10 1.20 1.40 1.40 0.40</td>
<td>0.62 0.37 0.02 0.11 −0.79</td>
<td></td>
</tr>
</tbody>
</table>

### (C) Adjusted Transpose Matrix

<table>
<thead>
<tr>
<th>(C) Adjusted Transpose Matrix</th>
<th>(C)(^{-1}) Inverse of Matrix (C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \pi_1 ) = 0.2249</td>
<td>( n_1 ) = 0.2249</td>
</tr>
<tr>
<td>( n_2 ) = 0.0455</td>
<td></td>
</tr>
<tr>
<td>( n_3 ) = 0.3860</td>
<td></td>
</tr>
<tr>
<td>( n_4 ) = 0.0202</td>
<td></td>
</tr>
<tr>
<td>( n_5 ) = 0.3234</td>
<td></td>
</tr>
</tbody>
</table>

Note: Except for solution, matrices show maximum of three digits.
The Global Corporate Governance Forum promotes corporate governance in developing countries and emerging markets. Its mission is to present incentives for corporations to operate efficiently and responsibly, promote economic growth from the private sector, and reduce market susceptibility to crisis. Founded by the World Bank and the Organization for Economic Cooperation and Development (OECD) in 1999, the forum operates as a subsidiary of the International Finance Corporation (IFC).

The forum’s website, www.gcgf.org, provides free access to forum-created resources dedicated to practical solutions, information, and training on corporate governance issues in emerging markets, as well as in developed nations. The website is organized around its main functional resource categories: “about us” pages that provide background information, focus areas related to the forum’s professional activities, and a variety of publications ranging from newsletters to case studies. Visitors can use the main index—found on the left side of all webpages—to navigate the website. The homepage highlights some of the website’s resources, such as reports, presentations, videos, and newsletters. The home and main pages provide selected materials, toolkits, publications, and events. Most articles open in a separate window and longer reports are generally available for download by section.

**Toolkits and Manuals**

The forum offers toolkits and manuals containing practical guidelines and training materials for developing best practice codes, resolving corporate governance disputes, and building director training organizations. Visitors who complete the forum’s corporate governance board leadership training program can receive a training kit on providing leadership resources to board members; they can also download toolkits in their entirety or by individual chapters. Each toolkit has a separate user guide that explains the purpose, targeted user groups, and topical content of the kit. The user guide includes a country index, allowing readers to focus on U.S. practices or those of other countries. The user guide is a useful feature; it is much shorter than the complete toolkit and makes it easier to determine whether the toolkit meets a user’s needs.

The “Developing Corporate Governance Codes of Best Practice” toolkit provides a step-by-step approach to creating and using corporate governance codes. Volume 1 discusses the importance and usefulness of corporate governance, highlights laws that affect corporate directors, provides examples of best practices, presents a German “scorecard” approach and a summary of General Motors’ board guidelines, and offers a comparison of selected corporate governance codes. Volume 2 covers practical suggestions on creating, implementing, and monitoring a code. The appendix contains a wealth of examples, such as a sample consultant engagement letter and sample telephone interview letter. A summary of OECD principles on corporate governance includes controlling executive and director remuneration, abuse in consolidated groups, self-dealing by insiders, improved financial market integrity, improved enforcement, and more effective shareholder participation.

The “Resolving Corporate Governance Disputes” toolkit addresses alternatives to help prevent, reduce, and resolve disputes, as well as to improve corporate governance practices. The toolkit identifies...
common types of disputes and offers strategies for resolving issues. These disputes can be internal within the boardroom or external, involving shareholders and other stakeholders. Volume 1 discusses the causes of disputes and a variety of resolution techniques. The appendix includes sample board structures and related potential for disputes to arise; an index of dispute categories; and a table comparison of negotiation, litigation, and mediation alternatives. Volume 2 demonstrates applications of dispute resolution methods. Its appendix outlines important components of shareholder agreements, sample mediation and dispute resolution clauses, sample board and director self-evaluation questionnaires, and a table of international mediation laws. Volume 3 covers skills and training for corporate governance dispute resolution. The appendix offers role-playing examples.

The “Building Director Training Organizations” toolkit focuses on creating organizations to train corporate directors. It provides a sample charter, code of ethics, and code of conduct for the training entity. One module offers sample curriculum, case study methods, and a reading list.

The forum’s website provides access to individual country corporate governance codes through the European Corporate Governance Institute. There are currently more than 70 country codes available, including Australia, Canada, New Zealand, the United Kingdom, and the United States, as well as other African, Asian, European, Latin American, and Middle Eastern countries. Visitors interested in information on corporate governance outside of the United States, especially in emerging markets, will find a large number of practical and easy-to-read resources on this website.

Publications

The “focus publications” area of the website offers access to case studies and discussion papers. The most recent case studies are generally 60 to 90 pages in length, while the earlier discussion papers are 25 to 50 pages. The earliest focus paper is “Corporate Governance and Development,” a policy study that defines corporate governance and explores its importance. The author, Stijn Claessens, finds a positive relationship between a good corporate governance framework and better access to financing, a lower cost of capital, and greater performance. Interestingly, market mechanisms cannot overcome weak country corporate governance policies.

“Enforcement and Corporate Governance: Three Views” presents a collection of three articles about enforcement’s role in improving markets. The first article provides an overview of practical approaches for strengthening corporate governance in the private sector. The second addresses corporate governance activities in India, as well as the importance of ethics in business. The third examines both public and private entity enforcement in developing countries. The appendix contains a matrix of points of intervention for a variety of issues.

“The Moral Compass of Companies: Business Ethics and Corporate Governance as Anti-Corruption Tools” provides background definitions on corruption, corporate governance, and ethics. The study examines corporate governance and ethics leadership as tools to combat corruption. The paper includes several useful tables and a lengthy list of Internet resources for business ethics and other related topics, with hyperlinks to the original source. "Mediating Corporate Governance Conflicts and Disputes" reviews such conflicts, examines the main characteristics of—and obstacles to—mediation, and offers specific recommendations on the use of mediation. The appendix provides a glossary of alternatives to mediation.

The most recent focus paper is “Shareholder Engagement and the Board: Integrating Best Governance Practices,” which develops support for stakeholder involvement to help companies identify and manage changes in the global environment. The paper includes best practices and practical examples, as well as a list of Internet resources on accountability and sustainability.

“Private sector opinion publications” is a collection of 10- to 12-page monographs written by members of the Private Sector Advisory Group (PSAG). The papers address topics such as noncontrolling shareholders, auditors and independence, whistleblowing, board performance evaluation, and board diversity. For example, “Corporate Governance: A North American Perspective” addresses the shift in power from the shareholders to corporate management, and more recently to management and the board. “Governance Scorecards as Tools for Breakthrough Results” discusses basic requirements for a corporate governance system and how the scorecard provides a useful tool to meet the demands.

The Global Corporate Governance Forum offers three newsletters: “Progress Report,” “Network Bulletin,” and the new “Emerging Markets Corporation Governance Research Network.” “Progress Report” is published bimannually and is available on the website. Issues often contain 20 pages, covering initiatives developed by the forum and its members. Its recent thought leadership section highlights publication additions to the website and the research updates section covers new academic research available through the Social Science Research Network. The Winter 2010 issue includes an excellent article, “High Profile Failures Demonstrate Necessity of Succession Planning,” that discusses one board’s role in providing for CEO succession. “Network Bulletin,” issued several times each year, is available by e-mail subscription or archived on the forum’s website. It provides brief descriptions and links to new publications, events, and news items. Visitors can access the new “Emerging Markets Corporation Governance Research Network” newsletter in webpage format. It provides summaries of, as well as links to, recently published articles from the Journal of Corporate Finance, the National Bureau of Economic Research, and the Social Science Research Network.

The Guidelines, Reviews, and Case Studies section presents practical guidance and research prepared by the forum and related entities. The IFC Family Business Governance Handbook is a 66-page guidebook covering a variety of issues such as the role of family members in governance, the board of directors, senior management, and going public. A four-page brochure, also prepared by the IFC, details 10 facts about corporate governance in the European Union. “The EU Approach to Corporate Governance” is a 20-page booklet that addresses boards, disclosures, shareholder rights, and other issues.

Susan B. Anders, PhD, CPA, is a professor of accounting at St. Bonaventure University, St. Bonaventure, N.Y.
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<th>Page#</th>
<th>INTERNET ADDRESS</th>
<th>AD INDEX</th>
<th>Page#</th>
<th>INTERNET ADDRESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearl Insurance</td>
<td>05</td>
<td><a href="http://www.nysscpainsurance.com">www.nysscpainsurance.com</a></td>
<td>ADP Business Services</td>
<td>C4</td>
<td><a href="http://www.adp.com">www.adp.com</a></td>
</tr>
<tr>
<td>Audimation Services, Inc.</td>
<td>13</td>
<td><a href="http://www.audimation.com">www.audimation.com</a></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounting Transition Advisors</td>
<td>74</td>
<td><a href="http://www.transitionAdvisors.com">www.transitionAdvisors.com</a></td>
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15-Year Mortgage 3.73% 3.77%
30-Year Mortgage 4.57% 4.55%
1-Year ARM 3.17% 2.94%
3-Month Treasury Bill 0.01% 0.06%
5-Year Treasury Note 1.77% 1.70%
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10-Year Inflation Indexed Treas. 0.75% 0.80%

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Price-to-Book Value 2.76 2.79
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Price/Earnings (12-Mth Trailing as Rpt) 15.19 15.47
Price/Earnings (2010 EPS Est as Rpt) 13.42 13.72

Key Economic Statistics

National
Producer Price Index (monthly chg) 0.20% 0.80%
Consumer Price Index (monthly chg) 0.20% 0.40%
Unemployment Rate 9.20% 9.10%
ISM Manufacturing Index 55.30 53.50
ISM Services Index 53.30 54.60
Change in Non-Farm Payroll Emp. 18,000 54,000

New York State
Consumer Price Index - NY, NJ, CT 0.60% 0.50%
Unemployment Rate 7.90% 7.90%
NYS Index of Coincident Indicators 1.60% 6.80%

Chart of the Month
Price of Crude Oil

Commentary on Significant Economic Data This Month

Oil prices fell in June 2011 after the International Energy Agency said it would release 60 million barrels of oil to compensate for the loss of Libyan exports, which account for around 2% of the world’s exports of oil. Thirty million barrels will come from the United States, while the United Kingdom will contribute about 3 million barrels. The decision to release barrels from the emergency stocks comes on the heels of the OPEC cartel’s refusal to increase production of oil to help ease rising global prices.

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The Audit Reporting Process

An Opportunity for Fundamental Change

T he standard audit report was adopted during the 1940s to provide uniform language in an effort to ensure comparability and consistency. Since then, little has been done to address the inadequacies of this cookie-cutter approach for auditors’ communication with users of this report, despite the growing complexities in the financial and business environments today.

Because many CPA Journal readers have heard the hype before regarding expected changes to the audit report, only to be disappointed, skepticism is understandable. This time, however, may be different. As a new PCAOB concept release notes, “Though the auditor’s reporting model has been studied by many groups that have provided recommendations over time, they were not in a position to effect change as they did not have standards-setting authority.” The PCAOB has an opportunity to oversee real, fundamental changes that could help to protect investors’ interests—and now that opportunity is knocking, let’s answer the door.

Possibilities

On June 21, the board issued PCAOB Release 2011-003, “Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements” (pcaobus.org/Rules/Rule making/Docket034/Concept_Release.pdf). Some of the possible changes suggested in the concept release include the following:

- Auditor’s discussion and analysis,
- Required and expanded use of emphasis paragraphs,
- Auditor assurance on other information outside the financial statements, and
- Clarification of language in the standard auditor’s report.

The document makes clear that these are just some of the possibilities under consideration. Perhaps they also can tackle the timeless question of how auditors can truly represent investors’ interests when the company being audited (the “client”) hires, fires, and pays the auditor. Even though SOX shifted hiring and oversight responsibilities to the audit committee, in practice, the auditors depend on the support of management to recommend their continued engagement. Does anyone else sense an inherent conflict of interest here? Yet there is still resistance to the idea of inserting a third-party intermediary between the auditor and the auditee. There isn’t an easy answer—but that doesn’t justify ignoring this key issue. After all, it goes to the heart of auditor independence, which is a main premise of the Code of Professional Conduct of both the AICPA and the NYSSCPA. Simply stated, it requires that the CPA must be independent “in fact” and “in appearance” from the client when providing auditing or other attestation services. The time has come again to have a dialogue about “who” engages the auditor. Appropriately structuring the relationships among the involved parties is critical to improving the credibility of the audit.

In an effort to reduce liability, auditors have devoted much time and resources to limiting their responsibility, particularly in the area of detecting financial statement fraud. This has simply opened the audit process to questions regarding its relevance. But in the current “pass/fail” audit report model, auditors don’t have the breadth of options they need to adequately assess the risk of material misstatement in the financial statements. A pass/fail system generally promotes mediocrity and increases the risk related to marginal passing grades. A more detailed ranking of the auditee’s operational environment and controls could help to better identify risks and alert investors and others of potential problems. The audit profession can take a page from a growing trend in academe on this matter and expand the choices to include the following: excellent, pass, low pass, and fail.

Share Your Ideas

There is no doubt that communication between the auditor and users of the audit report leaves room for improvement. Enhancements to the integrity, clarity, and comprehensiveness of the auditors’ work and communications thereof are long overdue. CPAs have a historic opportunity to participate in this important discussion and help the PCAOB shape the audit reporting process of the future.

Those interested in submitting comments to the board on this concept release should send them in writing to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803, or by e-mail to comments@pcaobus.org or through the board’s website at www.pcaobus.org by 5:00 p.m. EDT on September 30, 2011. Refer to PCAOB Rulemaking Docket Matter 34.

As always, I welcome your comments, and, in this case, so does the PCAOB.

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