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2013 Max Block Awards Presented

Tax & Accounting Update

Book Review: *The Big Four and the Development of the Accounting Profession in China*

Understanding Financial Reporting: Views from Regulators and the Profession

Baruch College’s 13th Annual Financial Reporting Conference, hosted by the Robert Zicklin Center for Corporate Integrity on May 1, 2014, focused on recent developments in financial reporting. The speakers and panelists included regulators, standards setters, financial statement preparers, financial statement users, and auditors. The featured speakers were FASB Chair Russell G. Golden, former SEC Chief Accountant Paul A. Beswick, and PCAOB Chair James R. Doty.

The first panel covered recent developments at the SEC; the second panel discussed the new guidance on revenue recognition; the third panel addressed current developments in the private sector; and the fourth panel focused on reporting issues for preparers, auditors, audit committees, and users.
50 Accounting & Auditing
- Assurance Services
  Levels of Assurance under the SSAEs: A Quick Reference Guide
  By Joyce C. Lambert

54 Taxation
- Tax Planning
  Cost Recovery Issues Involving the Acquisition of Open-Air and Prefabricated Structures
  By Mark A. Segal and Bruce M. Bird

64 Finance
- Personal Financial Planning
  Social Security Benefit Strategies for Baby Boomers
  By Howard Davidoff

66 Management
- Practice Management
  Strategies to Minimize Self-Employment Tax on Service Partner Retirement Payments
  By James R. Hamill

70 Responsibilities & Leadership
- Ethics
  Erasing the Big Mistake: Sealing Records of Criminal Convictions for Licensed Professionals
  By Sharon P. Stiller and Joseph L. Indusi

72 Technology
- What to Bookmark
  Website of the Month: Standard & Poor’s Rating Services
  By Susan B. Anders

74 Classified Ads

79 Economic & Market Data

80 Editorial
  A Dialogue about Financial Reporting
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IRS Taxpayer Regulation Program Misses Its Target

According to the IRS, 60% of paid preparers filing tax returns each year do so with little or no oversight by the federal government. For an agency that collects more than $2.9 trillion per year, that’s a lot of good faith with little assurance. On its face, it might seem to make sense to require anyone who charges a fee to prepare more than a few tax returns every year to take competency testing and continuing education classes and be able to prove that they’ve done so. But taking a deeper dive into the IRS’s program to do just that reveals several flaws.

The IRS’s Initiative

When the IRS began rolling out the Tax Return Preparer Initiative in 2010, its approach received mixed reviews by the professional community, even though CPAs, attorneys, and enrolled agents are exempt from the program. One primary objection was that the agency did not have the statutory authority to implement the program. The courts agreed: on January 18, 2014, the U.S. District Court for the District of Columbia found that the agency had no statutory authority to enforce regulatory requirements for competency testing and continuing education. That decision was upheld this past February, when Loving v. IRS made its way to a federal appeals court.

The IRS is committed to this program, so much so that instead of working with the CPA community to implement a registration program the right way, it is about to take another misstep—making the program voluntary. While no one would be required to earn continuing education courses and take a test, they can still earn the certificate if they want to be included in a database of federally registered tax preparers.

The AICPA has come out strongly against the agency taking this route; in a June 24 letter, it implored IRS Commissioner John Koskinen to hold a public comment period on the program. Furthermore, the AICPA identified in the letter “significant legal problems” that would confuse the public, frustrate the IRS’s goals, and lead to lawsuits if implemented in its current form.

Two days after the AICPA issued its letter, Koskinen said in a statement posted on the IRS website that the agency will solicit feedback on the voluntary proposal, although it has already announced the program and the details of it on its website. In addition, the IRS has already stated that the program will be in effect for the 2015 filing season.

An Unintended Consequence

The IRS’s initiative sounds like one that would be easy to support: ensure that all preparers of individual income tax returns have a minimum level of competency and adhere to professional standards, with an overarching objective of better service to taxpayers and increased compliance. But any competency program that is badly implemented—without the profession’s feedback—can only lead to more confusion for the public. And any unscrupulous tax preparers will still commit tax fraud, blissfully unaware that any mandatory or voluntary program even exists.

The IRS has not yet given up on its mandatory registration program. The 2015 federal budget proposal includes a provision to authorize the IRS to regulate all tax return preparers. But the public will not benefit from a brass-plated program. The unintended consequence will be a loss of distinction between the gold-standard CPA profession and the unlicensed tax preparer.

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The Importance of Data Integrity

Told as a Hypothetical Fable

Thomas E. McKee

A staff auditor named Brandon queried Tom, the firm’s audit partner, for what seemed like the thousandth time that day: “Why is it necessary to validate the initiating location on a data transfer from an overseas branch?” Despite feeling a headache coming on, Tom replied, “Did you ever study any accounting or auditing history while in school?”

Brandon derisively responded, “No. Why would history be relevant to accounting and auditing as practiced today?” This question incited another flash of pain in Tom’s head. He replied, “Let me give you a brief lesson about how an audit partner knows when it’s time to retire.” Tom decided to tell Brandon a hypothetical fable concerning historical changes in data integrity over approximately 7,000 years in order to provide his staff auditor with an opportunity for critical thinking about innovation, change, and career planning in the accounting and auditing profession.

In the Beginning …

Prior to about 6000 B.C., accounting data was recorded by carving into stone tablets. Around that time, some bright accountant got the idea that recording accounting data on clay tablets was less labor-intensive, and he began doing so. Audit partner Theocles was upset by this change and commented, “Clay is easier to change than stone. You can easily scratch a new line into it—and this change is nearly impossible to detect. I think I should retire because I cannot deal with this increased risk.”

By around 4000 B.C., clay accounting records were routinely sealed in clay pots that bore the originator’s seal so that the clay records could not be easily accessed and changed. In 3000 B.C., another bright accountant got the idea that recording accounting data on papyrus scrolls was even less labor-intensive, and he began doing so. Audit partner Thoth was upset by this change and commented, “Papyrus is easier to change than clay. You can just get a pen and ink, enter a new word or squeeze in a new line, and it is almost impossible to detect! I think I should retire because I cannot deal with this increased risk.”

Around 1000 B.C., another bright accountant got the idea of cutting up a papyrus scroll into pages of uniform size and binding these pages as a book. This change sped up routine data access, as compared to having to unwind a long papyrus scroll; therefore, it was less labor intensive. Audit partner Thaddeus was upset by this change and commented, “We have lost control over the data structure. It is too easy to add or remove pages from books. At least papyrus scrolls did not easily allow for the removal of data or the insertion of significant new space for data. I think I should retire because I cannot deal with this increased risk.”

Around 1900 A.D., another bright accountant came up with the idea of recording accounting data on punched cards, where data is stored digitally by the presence or absence of holes in predefined positions. This was more efficient for processing the larger amounts of data that the companies of the industrial revolution were producing. Audit partner Theodore almost fainted when he heard that he was going to have to audit holes in a piece of paper and commented, “What is this language of holes? How do we control when holes are added? Don’t all holes look alike? I think I should retire because I can’t deal with this increased risk.”
Around 1950 A.D., another bright accountant got the idea of recording accounting data on magnetic tape, where data is stored by writing magnetic signals on the tape. This enabled faster data processing with larger amounts of data. Audit partner Timothy felt very stressed by this change and commented, “I can’t see the data or directly touch it. How do I deal with invisible data? How do I know what’s on the tape? How do I know that someone didn’t change it? I think I should retire because I can’t deal with this increased risk.”

Around 1960, another bright accountant got the idea of recording accounting data on magnetic hard disk platters called “disk packs.” This enabled larger amounts of data to be stored randomly in order to maximize quick retrieval. Audit partner Todd was extremely upset by this change and commented, “This means that a single transaction might be stored in several different places in the disk pack. How do I know that I have retrieved all aspects of the transaction? How do I know when I get to the end of all data on the disk pack? At least when I had a magnetic tape, the records were sequential and I could see when the tape had spun to the end! I think I should retire because I can’t deal with the increased risk.”

Around 1980, another bright accountant got the idea of recording accounting data for smaller companies on optical disk drives, where a laser reads and writes data onto the surface of the disk. This permitted many smaller companies to afford stand-alone computer systems because this storage was reasonably fast and significantly cheaper. Small versions of the optical disk drives could be carried in a shirt pocket. Audit partner Tyrone was extremely upset by this development and commented, “Oh, great! Now all my clients can afford computerized accounting systems. I’ll have to hire more auditors with advanced computer training, and that’s expensive. In addition, there is now no way to protect data; anyone can make a copy and carry it off. I think I should retire because I can’t deal with the increased cost and risk!”

Around 1990, another bright accountant got the idea of sending accounting data over the Internet using TCP/IP protocols. This meant that any company location could send or retrieve accounting data quickly and cheaply. It sped up financial reporting, improved the timeliness of managerial accounting reporting, and lowered costs. Companies could now cheaply receive data from any of their locations around the globe. Audit partner Taylor was extremely upset by this development and commented, “The Internet has no serious controls whatsoever! We cannot tell for sure who sent the data, which countries it has been through, and whether it has been altered en route! I think I should retire because I can’t deal with the increased risk.”

The Present Day

“Around 2000,” Tom continued, “another bright accountant got the idea of storing accounting data and software on the Internet in a ‘cloud’ and doing away with company servers altogether. This had the advantage of lowering fixed hardware and software acquisition costs and eliminating most software maintenance costs. Audit firms also adopted this concept by storing audit workpapers in the cloud via files that multiple auditors could access from different offices in locations around the world.”

Brandon interrupted, “Is that the event that will cause you to retire, Tom?”

“No,” replied Tom. “But it will let me leave you here working on the audit, while I check in on you electronically from my vacation home on the beach.”

Thomas E. McKee, PhD, CMA, CIA, CPA (active N.C., inactive Tenn., not practicing S.C.), is a professor in the department of healthcare leadership & management, Medical University of South Carolina, Charleston, S.C. The author would like to gratefully acknowledge helpful comments from Ted Mock, Miklos Vasarhelyi, Linda McKee, and Eric Byrnes.

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2013 Max Block Awards Presented

The winners of the 2013 Max Block Distinguished Article Awards were honored during The CPA Journal Editorial Board meeting on June 17, 2014. This award recognizes excellence in three categories that reflect the mission of The CPA Journal: Technical Analysis, Informed Comment, and Policy Analysis.

CPA Journal Editor-in-Chief Maria L. Murphy presented the awards to three authors—Robert S. Barnett, Elizabeth Forspan, and Mark S. Warshavsky—at the meeting. Because authors Brian Daugherty, Forspan, JD, is an associate, also at Capell Barnett Matalon and Schoenfeld LLP.

Informed Comment. “The Role of Forensic Accountants in Litigation Cases” by Mark S. Warshavsky, June 2013, won in the Informed Comment category. The article focuses on the litigation aspects of forensic accounting. In addition, it provides insight into noteworthy cases, the forensic accountant’s role, and the tools used during investigations.

Mark S. Warshavsky, CPA/ABV/CFF, CVA, CBA, ASA, CFE, MAFF, DABFA, MBA, is a partner-in-charge in the business valuation & litigation services group of Gettry Marcus CPA, P.C., New York, N.Y.

Policy Analysis. “The Question of Mandatory Rotation: Would Investors Benefit?” by Brian Daugherty, Denise Dickins, Julia Higgs, and Kay Tatum, January 2013, won the Max Block Award for Policy Analysis. In the article, the authors analyze whether mandating periodic rotation of the audit firms of publicly traded companies is improving financial reporting quality.

Brian Daugherty, PhD, CPA, is an assistant professor in the Sheldon B. Lubar School of Business at the University of Wisconsin–Milwaukee. Denise Dickins, PhD, CPA, CIA, is an associate professor in the college of business at East Carolina University, Greenville, N.C. Julia Higgs, PhD, CPA, is an associate professor in the school of accounting at Florida Atlantic University, Boca Raton, Fla. Kay Tatum, PhD, CPA, is an associate professor in the school of business administration at the University of Miami, Miami, Fla.

Determining the Winners

The Max Block Distinguished Article Award winners are selected 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 this year’s nominated articles.

About Max Block

Max Block (1902–1988) was a founding partner of Anchin, Block & Anchin LLP, and served as managing editor of the NYSSCPA’s Journal (now The CPA Journal) from 1958 to 1972. Many individuals who knew him have described him as a visionary whose ideas helped form the basis for many reporting and practice-management concepts used today.

Since 1975, The CPA Journal has recognized his contributions and achievements by bestowing the Max Block Distinguished Article Award on the most outstanding articles published in the past year. Although the judging and selection procedures continue to evolve, the criteria remain the same: “An innovative and stimulating article which is of current significance and which is likely to be of lasting value.”

Mark S. Warshavsky

Denise Dickins, Julia Higgs, and Kay Tatum were unable to attend in person, The CPA Journal editors accepted the awards on their behalf.

Technical Analysis. “Casualty Losses for Property Damaged by Hurricane Sandy: Maximizing Tax Benefits within the Rebuilding Process” by Robert S. Barnett and Elizabeth Forspan, February 2013, won in the Technical Analysis category. In the wake of Hurricane Sandy, many homeowners have unreimbursed losses, and this article reviews IRS rules regarding casualty loss deductions.

Robert S. Barnett, JD, MST, CPA, is a partner at Capell Barnett Matalon and Schoenfeld LLP, Jericho, N.Y. Elizabeth Forspan, JD, is an associate, also at Capell Barnett Matalon and Schoenfeld LLP.
### Tax & Accounting Update

**Tax & Accounting Update** is provided by Thomson Reuters and based on material published on Checkpoint, its online news and research platform. The Update is a quick-reference guide to the most pressing issues coming down the regulatory pipeline. Visit https://tax.thomsonreuters.com/daily-newsstand/ for further information and daily updates.

**Tax News**

- **IRS cautions against “dumping” employees on health insurance exchanges.** The IRS has published a Q&A on its website that addresses the consequences of an employer reimbursing its employees for the premiums they pay for health insurance, rather than establishing its own plan. The IRS’s guidance concluded that such arrangements are considered to be group health plans and subject to the Patient Protection and Affordable Care Act (ACA); therefore, employers will be subject to penalties—as high as $100 per day per employee excise tax—for failure to meet ACA provisions.

- **IRS okays midyear amendments to reflect DOMA.** In Notice 2014-37, the IRS has stated that 401(k) and 401(m) safe harbor plans will not be affected by a plan sponsor’s adoption of a midyear amendment pursuant to recent IRS guidance that required amendments to plans to reflect the Supreme Court’s striking down of Defense of Marriage Act (DOMA) provisions.

- **Final regulation outlines trust/estate expenses that escape 2% income floor.** The IRS has issued final regulations, under which costs incurred by estates and nongrantor trusts are subject to a 2% floor for miscellaneous itemized deductions. The final regulations largely follow, but also expand upon, proposed regulations issued in 2011. Among the notable clarifications is a limitation on tax preparation fees that are not subject to the 2% floor, including estate and generation-skipping transfer tax returns, fiduciary income tax returns, and a decedent’s final individual income tax returns.

**SEC News**

- **Regulatory agenda will turn to IFRS.** The SEC is ready to revive its debate about what to do with IFRS for the U.S. financial markets. SEC Chair Mary Jo White explained in a May 20 speech before the Financial Accounting Foundation: “Today, over 500 companies representing trillions of dollars in aggregate market capitalization report to us under IFRS with no reconciliation. And the SEC staff enforces those standards. By any measure, we have thus demonstrated a major commitment to the use of IFRS in our markets. But, the question remains—what about domestic issuers?” White indicated that considering whether to further incorporate IFRS into the U.S. financial reporting system continues to be a priority and that the SEC intends to make a statement on this issue in the near future.

- **Credit rating agency reforms revisited.** The SEC is returning to a three-year-old proposal to toughen regulation of credit rating agencies and would like to finish the rule by year-end. Before it does, the SEC will have to address concerns raised by rating agencies who say that the proposed rules impose too many restrictions and by investors who say that the rules don’t go far enough. The proposal would standardize the way rating agencies calculate and present information about changes to ratings and how often a rated company or product subsequently defaulted. To bring transparency to the process, the SEC would require boards of directors’ approval of rating agencies’ methods, publication of major changes to methods, and disclosure of the methods used for a particular rating.

**FASB News**

- **Top-line revenue calculations overhauled.** FASB and the IASB completed more than a decade of work with the publication of landmark guidance that will change how companies calculate and report their revenues. The new standards eliminate industry-specific guidance in U.S. GAAP; strengthen the principles in IFRS; and produce a single, principles-based way to report revenue. Companies need to comply starting in January 2017, but businesses reporting under IFRS may start using the new guidance right away.

- **Going concern standard approved.** FASB said it will add a requirement to U.S. GAAP that a company’s management will have to evaluate a business’s financial health every quarter and alert investors if there is “substantial doubt” about the company’s survival. The decision shifts the primary responsibility for the going concern assessment to management and away from the external auditor.

**Disclosure framework reviewed.** The board is continuing discussion on how to encourage businesses to write more streamlined, less redundant disclosures in notes to financial statements. FASB has said that it wants to focus on ways to encourage companies to use less boilerplate language in their note disclosures so that investors and analysts can better identify important information. The board has also made a tentative decision that note disclosures in annual financial statements would only be repeated in quarterly reports if there were new information that a “reasonable investor” would view as significantly altering the total mix of available information.

**PCAOB News**

- **Converged revenue standards in the crosshairs.** The PCAOB has been closely monitoring the latest developments on revenue recognition. “We are going to be asking lots of questions,” PCAOB board member Jay D. Hanson said on May 20. “Do we need to adjust our standards to accommodate the new revenue recognition models? Right now, [concerning] our audit standards on revenue, there is no one place you can look to see, ‘here’s how you test revenue.’ It’s really a risk assessment; it’s a lot of different things.” Hanson said the PCAOB hasn’t made any decisions about adding revenue recognition to its standards-setting agenda, but that could change.

**GASB News**

- **Financial statements standard outlined.** GASB issued Concepts Statement 6, Measurement of Elements of Financial Statements, intended to guide the board in establishing accounting and financial reporting standards regarding the measurement of assets and liabilities. The new statement augments the framework the board uses to promote consistency in setting accounting and financial reporting standards and is primarily intended for GASB’s use. But the new concepts might also benefit preparers and auditors when evaluating transactions for which no standards exist.
The Big Four and the Development of the Accounting Profession in China


Reviewed by Anthony S. Chan

Fueled by a program of economic reforms called the “Four Modernizations,” China has turned itself into an economic powerhouse and transformed its economy from a centrally planned system to “socialism with Chinese characteristics” in just 30 years. These economic reforms, coupled with the associated economic growth over the past few decades, have fundamentally changed the way that business is conducted in China, as well as affected how global accounting firms have established their presence in China.

Based on research conducted by Gillis for his doctoral thesis, this book documents the historical development of the accounting profession in China, with a focus on the role of the Big Four accounting firms—especially how they served as agents of change, how they changed their operating structure from representative office to joint venture to wholly foreign-owned enterprise (WFOE) and limited liability partnership (LLP) in order to respond to changes in the regulatory requirement, and how they localized their business in order to stay competitive in China.

Key Highlights

Although this book is written from the perspective of a Western practitioner who did not grow up or work in China as an accountant, it does contain a fair discussion of the key events and factors that have collectively shaped the Chinese accounting profession, including the following:

- The economic reforms that began in China in 1978
- The foreign direct investments that flowed into China as a result of these economic reforms
- The impact of recent accounting frauds and scandals involving companies with operations in China
- The securities regulation in the United States, PCAOB inspections, and their related impact on the Big Four firms, as they localized their business in China
- Local firm reforms and licensing of CPAs in China.

Who knows what the next 30 years will bring to the Chinese accounting profession?

A Useful Perspective

China is a unique case study, and Gillis has succeeded in outlining the critical factors that shape the Chinese accounting profession. Although not every reader might find this book helpful, I would recommend it to anyone who plans to do business in China—young CPAs, in particular—because it would help expand their understanding of the development of the global accounting profession. Readers who are pressed for time should go straight to chapters 7 and 8 and get the author’s perspective on 1) the development of local CPA firms and how they responded to competition from the Big Four and 2) how and why the Big Four came to dominate the accounting markets in China, and how the local firms tried to break their dominance.

Who knows what the next 30 years will bring to the Chinese accounting profession? What is certain is that Gillis has provided a great introduction to the new China in The Big Four and the Development of the Accounting Profession in China.

Anthony S. Chan, CPA, is the executive vice president and director of Sino-Global Shipping America, Ltd., and a member of The CPA Journal Editorial Board.
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UNDERSTANDING FINANCIAL REPORTING
Views from Regulators and the Profession

PricewaterhouseCoopers Partner
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PCAOB Chairman
James R. Doty
Recent developments in financial reporting were the subject of Baruch College’s 13th Annual Financial Reporting Conference, hosted by the Robert Zicklin Center for Corporate Integrity on May 1, 2014. The speakers and panelists included regulators, standards setters, financial statement preparers, financial statement users, and auditors. The featured speakers were FASB Chair Russell G. Golden, outgoing SEC Chief Accountant Paul Beswick, and PCAOB Chair James R. Doty.

The conference included four panel sessions with a variety of participants tackling current topics. The first panel covered recent developments at the SEC and featured Deputy Chief Accountant, Office of the Chief Accountant Daniel Murdock; Deputy Chief Accountant, Division of Corporate Finance Craig Olinger; and Deputy Chief Accountant, Division of Enforcement Michael Maloney. Revenue recognition was the subject of the second panel, featuring Golden, Murdock, GE Controller and Chief Accounting Officer Jan Hauser, Financial Reporting Advisors Managing Director Scott Taub, and PricewaterhouseCoopers Partner Dusty Stallings. The third panel focused on developments in the private sector and included FASB Technical Director Susan Cosper, Ernst & Young Partner Jackson Day, Microsoft Senior Director of Financial Accounting and Reporting Robert Laux, and Deloitte Partner Robert Uhl. Laux returned for the final panel, along with former FASB Chair Robert Herz, Moody’s Managing Director Mark LaMonte, NBCUniversal Controller Allan Cohen, and KPMG Partner Mark Bielstein, to discuss reporting issues for preparers.

The following are edited transcripts and summaries of the speeches and panel discussions from the conference. In all cases, the speakers’ comments represent their own views and are not necessarily those of their respective organizations.
Reducing Reporting Complexity and Strengthening Audit Oversight

UPDATES FROM FASB AND THE SEC

Reducing Reporting Complexity and Strengthening Audit Oversight
Russell G. Golden began serving as FASB chairman on July 1, 2013. Golden, who was first appointed to FASB in 2010, previously served for six years on the FASB staff in various roles, including technical director, director of technical application and implementation activities, and senior technical advisor. Before joining FASB, Golden was a partner at Deloitte & Touche LLP in the national office.

SEC Chief Accountant Paul A. Beswick left the agency in May 2014, shortly after these remarks were delivered, to return to the private sector. He served as the chief accountant since 2012, after joining the SEC staff in 2007 as a senior advisor to the chief accountant. He oversaw the SEC’s work with private-sector accounting organizations, such as FASB; he also participated as an observer to FASB’s Emerging Issues Task Force (EITF). He has also served in the role of deputy chief accountant at the SEC and as a FASB practice fellow from July 2005 to June 2007. Prior to joining the SEC, Beswick was a partner at Ernst & Young.

On May 1, 2014, Golden and Beswick presented the opening remarks at Baruch College’s 13th Annual Financial Reporting Conference, discussing recent developments at FASB and the SEC, respectively. The following is an edited transcript of their remarks.
Foundational Projects

FASB Chair

Russell G. Golden

A few weeks ago, FASB met and talked about its future agenda. We started to split our agenda into two types of projects. The first are foundational projects that will create a mechanism and an avenue for future boards to improve financial reporting. We also talked about projects to reduce complexity and promote simplification within our system. So you’ll see us assign resources between those foundational projects and those projects that reduce complexity and promote simplification.

Foundational Projects

Conceptual framework. The first of the foundational projects is the conceptual framework, a very important tool for board members and for you all in practice to have an idea of where the future might go. The goal of the conceptual framework is to ensure that, as the board evolves over time, we come out with consistent ideas. We try to have similar philosophies throughout. Recognizing the conceptual framework is a start, but it is not the end. Board members need to think first about its future agenda. We started to talk about projects to reduce complexity and promote simplification within our system. So you’ll see us assign resources between those foundational projects and those projects that reduce complexity and promote simplification.

Presentation is also not in the conceptual framework. And when you think about the use of non-GAAP measures that occur in our system today, when you think about the use of OCI [other comprehensive income], when you think about debates about operating income and recurring versus nonrecurring activities ... treatments vary because there isn’t enough foundational philosophy about presentation. We need to think about whether there could there be improvement in a performance statement, predominantly the income statement. Would it be better to classify the income statement between recurring and nonrecurring activities? Or between operating activities and nonoperating activities? I also think it’s very good to think about how to separate various components of what we have today into multiple line items.

I want you to think about pension accounting. Today, one of the heavy criticisms of pension accounting is that investors struggle with the understanding between components and service costs; actuarial gains and losses; changes to the fair value of an underlying asset; or other things, such as interest costs. If you were able to have more disaggregation on the performance statement, it might give investors a better understanding of what is a recurring item—that is, service costs versus nonrecurring or noncontrolling items, such as fair value changes.

I don’t think we should try to strive to eliminate non-GAAP measures, but it might help to reduce some of them. Now, if we were to improve the income statement between operating and nonoperating, we might have to do some conforming changes to the statement of cash flows. Today, there isn’t any board member that wants to devote resources to creating a direct statement of cash flows. A lot of us think that it would be an improvement, but we just don’t think it would meet the cost-benefit test. But I do believe there may be some conforming changes to the existing statement of cash flows, if we were to align it with the improvements we might make on a performance statement. For example, if we were to conclude that interest expense should no longer be within operating, it wouldn’t seem consistent to put it in operating cash flow on the statement of cash flows.

Disclosure framework. We have an opportunity to make disclosures more effective and to get people to focus on communication. Today there is a lot of concern that companies don’t have the flexibility to make disclosures more effective. One of the reasons is because the board, historically, has said, ‘This is the objective, and in order to comply with the objective, thou shalt do the following 17 things.’ And I think if I was a preparer or an auditor, I’d do it.

We can do instead is say, ‘Thou shalt consider. Thou shalt use judgment to determine if your disclosures meet the objectives.’

We’re in the process of field testing—taking a few existing disclosure requirements and seeing if we can make this better. We’re trying to take two things that have been criticized as causing disclosure overload—fair value and pensions—and one, disclosures associated with income taxes, that has been criticized as having not enough disclosure. This is something we’ve asked the staff to think about: is there a better way that the standard can be written so you can have more effective disclosures?

About half of the board’s resources will be devoted, over the next three years, to these foundational projects: conceptual frameworks, financial statement presentation, and the disclosure framework. The other half is going to be devoted to reducing complexity and promoting simplification and education awareness.

Reducing Complexity

With respect to reducing complexity, the board will be focused on improving the accounting for liabilities and equities. Every year, Audit Analytics puts out a list of restatements, and every year liabilities and equities seems to be at the top of the list. You have slightly different economics that can have substantial changes in the measurement, whether there’s a beneficial conversion feature, whether you bifurcate the embedded derivative and convertible debt, and whether something is an equity instrument or a liability instrument. We have an idea of some targeted...
changes that could take some pressure out of the system, potentially align the concepts within convertible debt, and potentially reduce some of the issues around freestanding derivatives and whether the appropriate answer is related to any opportunity to get cash versus only other-than-temporary opportunities to get cash.

Now I don’t think this will be the end-all with respect to solving the debate about what is a liability and what is equity. That needs to be developed after we come to some conceptual conclusions about the definitions of liabilities and the definition of equity. That will take a lot longer than I’m willing to allow to reduce some of the complexities around liabilities and equities. I’m talking here about targeted changes to take out some of the pressures in the system around the confusion that I think exists.

Another issue is hedge accounting, which is very difficult to comply with. A lot of companies tell us that they don’t bother to comply with it because it’s too difficult, it’s not intuitive, and it’s very costly. The IASB recently put out a final document on hedge accounting, and we will look to see if that’s something that could work in the United States, or if there’s some other thing we can do to appropriately portray to investors when management is entering into a risk-mitigation strategy. Investors understand what the risk that’s been mitigated is and what the other risk that has been created is (which often happens in hedging strategy), so they can make their own decisions about whether the risk inherent in business has been mitigated or if it’s just been changed to something else.

We’ve asked a lot of you about other issues that you believe we could change to reduce complexity and promote simplification, but not impact decision-useful information to investors. One we’ve recently completed has to do with development-stage enterprises, where companies that did not start the revenue stream had to disclose their historical losses, and so companies were in the development stage for a very short period of time. But today, in the R&D [research and development] world that we’re in, there are development-stage enterprises, such as those in biotech, that can last for 10 or 20 years. It’s very difficult to track all of those accumulated losses. That was a place where we thought we could reduce the complexity and promote simplification, but we wanted to understand how it would impact decision-useful information to investors. We asked investors; unanimously, they said, “What’s a development-stage enterprise?” Which indicated that maybe we don’t need to label things ‘development-stage enterprises’ or have additional costs related to tracking all these accumulated losses because people don’t use it.

In the coming months, we’re going to start taking these types of projects to the board. We’ve got quite a few, so obviously we can’t take them all at once but we’re going to try to take three or four, issue them for public comment, get feedback, finalize them, and then take more.

Promoting Education

Education is very important. As we finish these substantial projects, it’s important that the board stand ready to help ensure that what is occurring in practice is what the board intended. We don’t solve every single debate out there because not every debate will matter to investors, but we should stand ready to solve those that will.

We’re creating a transition resource group (TRG) made up of U.S. and international participants, as well as those in the auditing community and those in the preparer community so that they can raise awareness of the issues that practice is struggling with. What are issues where practice is confused about the board’s intent? What are issues where there are legitimate debates between two firms, between companies and firms, or between the Chief Accountant’s Office and someone else?

We want to resolve the diversity in the issues before a standard’s effective date. We expect the group will meet a number of times between July and the actual effective date. Again, the goal is to bring awareness to these types of implementation questions and try to solve them in real time. The meetings will be public—we’ll produce minutes so that there can be transparency.

International Comparability

It’s very important that as we improve U.S. GAAP, we also promote comparability around the world. As we make these improvements, we’re going to look to what others in the system—whether it’s the IASB, the accounting standards board of Japan, or other accounting standards boards that have the authority to set GAAP in their countries—think about what we’re doing and what they have done in the past. There’s a lot of intellectual capital where people have seen these problems before, and they have an idea and a solution, so it’s important that we engage in a discussion with others to produce the best product that we can.

It’s also important that we continue to advise the IASB as they produce solutions to improve IFRS because the United States is a substantial user of IFRS. Foreign private issuers in our country have the opportunity to use it, and quite a few companies do choose to do so. Thus, it’s an important measure for our U.S. investors and it’s important to our capital markets that IFRS is a quality product. I participate on the Accounting Standards Advisory Forum of the IASB and I advise them on the U.S. perspective.

One of the forthcoming issues that is relevant to the United States has to do with rate regulation. We have a standard in the United States that works and that U.S. investors say gives them the information that they want. My job as the U.S. representative is to explain how the current U.S. GAAP model works, what investors say is good or not good, and what preparers say is costly or not costly, so that the IASB can make the most informed decision. They’re also working on a disclosure initiative similar to what we’re doing. Again, I bring the experience that we have to their process so that they can make better and informed decisions. The process is working well; we have a good, solid debate and we have a good, solid relationship.

It’s very important that as we improve U.S. GAAP, we also promote comparability around the world.
I want to focus on three areas: audit committees; internal controls; and disclosure effectiveness, which I know is all the rage right now.

**Audit Committees**

The Sarbanes-Oxley Act of 2002 (SOX) fundamentally changed the role of audit committees. It was a great game changer because it raised the prominence of audit committees in protecting investors. But how does that affect most of us? All of us are impacted by audit committees in one way or another. If you’re in this room, you probably are either on an audit committee, report to an audit committee, have an audit committee that oversees your financial reporting operations, or rely on an audit committee to make sure that you have transparent information when you’re making investment decisions. But SOX is more than 10 years old, so we’re making sure that SOX is still relevant and deciding whether we need to update the requirements. This is also a time for us to rethink what audit committees do.

I’d like to start by going through what the requirements are, because I think some people lose track of that. It’s also relevant because this is a global environment, and other jurisdictions are thinking about the roles of audit committees. If you look at what’s going on in Europe and other areas, they are rethinking what an audit committee should do. I’d like to read you a quote that was from about the time that SOX was passed about the commission’s views on an audit committee: ‘The audit committee, composed of the members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company’s financial reporting system.’ That is an incredibly broad and important remit. As we think about it, and as the commission has articulated, there are three primary responsibilities: 1) they have the responsibility over the financial reporting processes of a company, 2) they have the responsibility for the internal controls and the oversight of internal controls of a company, and 3) they have the responsibility for the relationship with the independent auditor.

**Oversight.** In fulfilling their responsibilities in overseeing the audit, what are some of the things that audit committees should be doing? One is making sure that they have a critical evaluation of the qualification and performance of the auditors. You want to make sure, as an audit committee member, that you don’t just rubber-stamp the auditor, but every year you think about whether the auditor is fulfilling the obligation to investors. Does the audit committee have regular, direct contact with the auditor, or does management serve as an intermediary? And finally, is the audit committee functioning as an advocate for management, or are they functioning as an advocate for shareholders?

When you think about the various committees, the audit committee has a very unique relationship—it’s the one committee that has more of a responsibility to the outside shareholders. I was told this great story about an audit committee member who was the chairman of a large public company’s audit committee. He was trying to understand what was going on with the business and said, ‘I want to meet the auditors.’ So management introduced him to the auditors—and then he turned to management and said, ‘Okay, you need to leave now and kicked management out. He said to the auditors, ‘I want to make one thing clear to you—you work for me.’ And the audit team thought that was great, because he, in that moment, made it very clear whom they report to. I think that message is very important and I would love it if more audit committee members took that tone with their auditors.

**Independence.** People typically think about the auditor having responsibility for being independent, but it’s really a shared responsibility, because the decisions that the auditor makes on independence can impact the company, and it’s really important that the audit committee be involved in that process. The audit committee is required to preapprove audit services; but what does it mean? The better audit committees are really taking the time to understand, when they get that schedule, what the auditor is really doing. In situations where enforcement has brought independence cases, one of the questions asked is always, ‘How involved was the audit committee in approving the services and what sort of due diligence did it do?’

I think that’s one thing audit committees could really do a better job of: making sure they understand what services the auditor is performing. Because one of the problems that we’ve seen in practice is that the service might have started out initially as being okay within the context of the independence rules, but as time has gone on, there’s been ‘scope creep,’ and it’s in that scope creep that the auditors sometimes get in trouble. So we think it’s really important for the audit committee to be involved in all stages.

**Fees.** I’m not here to say that audit committees have to do whatever auditors say, but you start to get a little concerned when you see audit fees at a company—when there’s been no change in the operations of the business—all of a sudden drop by 20% or 30% in one year. You wonder, ‘What’s the impact on quality going to be there?’ And what did the audit committee do to get comfortable that the auditor was going to do their job, especially in the context of a change in auditor?’

That’s one of the things that we’re constantly highlighting for audit committees when we talk to them: remember that you have a fiduciary responsibility and there are situations where you see ‘fee hunting,’ where audit committees are looking for the lowest fee and not spending a lot of time focusing on audit quality.

**Required communications.** This is one area where the rules from the exchanges and the commission lay out very basic requirements of what is to be communicated publicly and internally. Internally, between the auditor and the audit committee, you’re supposed to talk about critical accounting policies, alternative accounting treatments, and any written communications between the auditor and
management. The PCAOB recently passed Auditing Standard (AS) 16 [Communications with Audit Committees], and the auditor is supposed to communicate unusual transactions; difficult issues; and any inspections, including PCAOB inspections. From the Regulation S-X requirements, there is required to be an audit committee report made public as part of the proxy that has some very basic reporting requirements. The message that we’re trying to get across is that we view those as the floor, and what we’re seeing is some of the better audit committees expanding on those reporting requirements.

To give you an example, what we’ve noticed in some cases—these are voluntary—is expanding disclosures on the scope of the audit committee’s duties; factors in selecting or reapportioning the audit firm, talking about how they select the engagement partner; factors in determining auditor compensation; how the committee oversees the auditor; and how they evaluate the auditor. We think those are wonderful disclosures, and we’re continuing to try to highlight those in terms of best practices.

I think we’re all invested in audit committees and making sure that they function. In your various roles, you should always be challenging whether the audit committee is doing their job. If you’re an auditor, one of the things that you’re supposed to do is evaluate whether the audit committee is setting the tone at the top. It’s an integral part of protecting investors, so I would just encourage everyone to rethink their relationships with audit committees and take the next step.

Internal Controls over Financial Reporting

There are two aspects of this that I’d like to discuss. First, I’d just like to highlight that COSO [Committee of Sponsoring Organizations of the Treadway Commission] has a new framework out there. This is a great opportunity for people to get the new framework and read it. While the core definition and the five components are the same, COSO has explicitly incorporated 17 new principles and points of focus on the updated framework. We’ve been saying all along that we wouldn’t think that people would get a materially different answer on their evaluation of controls, but this is a wonderful opportunity to refresh your thinking on internal controls because, at least anecdotally, we’re seeing some things that would raise questions about whether people are continuing to perform a robust analysis on internal controls. If you look at the PCAOB inspection results, you’ll see an uptick in findings around internal controls. That would lead to a natural question: what is management doing, and are they finding similar things?

The other area of internal controls that we wonder about is: when we see a material weakness, it’s usually around the time a restatement is announced, but why aren’t there more material weaknesses when there’s not a restatement announced? You would expect there to be more material weaknesses prior to a restatement, but a controls error always seems to be found at just about the same time.

Disclosure Effectiveness

I just want to dispel some myths about what people can do today, without waiting for the commission to go through formal rulemaking.

There was a speech given recently by Keith F. Higgins, the division director of the SEC’s Division of Corporation Finance (DCF), and he laid out the process that they go through. But he also highlighted some things that people can do today, like do a better job of cross-referencing between the documents and avoiding duplication in what people say. The DCF recently pulled some critical accounting policies and compared it to the accounting policies listed in the notes of the financial statements. To give you an example, in one case, they found that it was 3,500 words—and the difference between what was in [the] MD&A [management’s discussion and analysis] and what was in the financial statements was one sentence. If people are talking about redundancies, this is a great place to deal with that. Instead of rearticulating what your policy is on revenue recognition in the MD&A section, … you could just say, ‘To understand our policy on revenue recognition, see the notes’—but then describe the critical estimates and judgments you made and avoid the duplication.

In terms of impediments to change, I think the number one thing that we hear is second-guessing by the auditors and the regulators. The auditors say, ‘We’ll second-guess you, but it’s the SEC that’s going to second-guess us, and so we want to make sure that we’re right.’ They’re more worried about the SEC and the PCAOB. I’m going to acknowledge that that fear exists, but the DCF staff and my office is working very hard to make sure that that doesn’t happen—that people can really take the time and reassess their disclosures, because disclosures are often put in the context of what’s going on in the current environment. That doesn’t mean that the DCF isn’t going to ask a question when reviewing the filing, but we’ve seen, time and time again: where they’ve asked a question and the company was able to articulate why it changed, the DCF said, ‘Your explanation made a lot of sense, and we have no more questions.’ We really want to encourage people to take that time and critically think about the disclosures.

One of the other things we frequently hear is that there are resource constraints; it takes more time to apply and defend the judgment every period. This is another area where, when we’ve done outreach, people have said, ‘Yes, up front it takes a little more time to do this.’ One of the practices we’ve seen is not to do the whole document at once, but to take it in sections. If you do it in smaller bites, and you spend the time up front, you’re actually going to get savings over the longer period.

I would just encourage everyone to rethink their disclosures in that context. What would make it easier for people to do this? Russ has talked about some of the things FASB is going to do, in terms of changing how they do disclosures, and I’m encouraged that they’re doing field testing in some areas. I think that’s a great change that FASB is orchestrating.

One of the things I hear is that we need assurances from the SEC and the PCAOB that we’re not going to require immaterial items be disclosed. This is something that we’re going to keep talking about. Hopefully, our actions will speak louder than words. When people do make a good-faith effort, we’ll respect those judgments.

The other thing we frequently hear is blaming the auditors and their checklists: ‘If it wasn’t for that checklist, I would have customized my disclosures.’ And I think those checklists get a little bit of a bad reputation. What the auditors are trying to do is make sure that you understand all the requirements. I never met an auditor who said that just because we have it on a checklist, you have to disclose it. I think everyone would say that the checklist is just a reminder—you still have to make an evaluation.
The first panel at Baruch College’s 13th Annual Financial Reporting Conference on May 1, 2014, featured three speakers from the SEC, representing the Office of the Chief Accountant (OCA), the Division of Corporation Finance (DCF), and the Division of Enforcement (DOE). The panelists discussed consultations, reporting and filing issues, and ongoing investigations.

Role of the SEC and the OCA

Daniel Murdock, deputy chief accountant in the OCA, began by providing an overview of the SEC and the OCA, which is the “principal advisor to the commission.” He noted that “three of the divisions have their own OCA—Enforcement, DCF, and Investment Management,” constituting his “primary customers.” He described one aspect of the OCA’s role as helping these divisions answer certain questions related to accounting and financial reporting. Another is to advise the SEC chair and other commissioners. “One half of what we do is to monitor standards setting,” Murdock explained. “The other half is to answer consultations or interpretive questions.”

“It is the commission’s authority to set the accounting standards,” he said. “We have looked to the private sector to set those accounting standards. In 2003, we provided the policy statement that recognized FASB as the single standards setter with respect to U.S. GAAP.” But what distinguishes the SEC from other regulatory bodies is its enforcement ability: “When a new ASU [Accounting Standards Update] comes out—there’s a new ASU [2014-08] on discontinued operations—we look at it and say, ‘What kind of questions would we ask if we were in DCF so that we can help the reviewers as they do their job’? … As the project is being done, we’ll provide thoughts and questions to FASB on what the SEC thinks and whether we can enforce it.” Furthermore, SEC staff members consider the technical concepts underpinning a standard. Nevertheless, the SEC does not typically get heavily involved in FASB’s standards-setting process.

With respect to international standards setting, the SEC reviews the IFRS filings of approximately 500 registrants and provides the IASB with thoughts and opinions on enforcement. The SEC
also participates in the International Organization of Securities Commissions and the IFRS Foundation Monitoring Board, among others.

Prefiling and Postfiling Consultations

The OCA’s role also extends to consultations, either on a prefiling or postfiling basis. Within the SEC, the DCF and the DOE sometimes consult with the OCA on questions that arise during document review, although registrants are not necessarily informed of this consultation. In addition, “the PCAOB does consult with us on accounting matters,” Murdock said, “and I can assure you that we would never object to a registrant’s accounting without engaging them in the discussion; however, we would conclude that the accounting was okay without alerting the registrant.”

“The consultations coming on a prefiling basis are down pretty significantly from 2012 to 2013, and that trend has not stopped,” Murdock noted. “It has flattened, but the drop-off is pretty significant, around 40%. But at the same time, DCF consultations are going up, so that’s not a good trend. It’d be better if we were getting more consultations up front and then not running into issues when we review a document.” Fewer prefiling consultations might be occurring because “there aren’t any new standards, so there aren’t really any implementation questions to ask.” Another theory is that “there are less transactions in the marketplace.” A third is that “people understand how to apply the standards that currently exist, so they don’t need to ask questions as much.”

Murdock noted, “Objections haven’t changed, in percentage terms; restatements haven’t changed,” although the mix of major and minor restatements has changed, “with big restatements going down and smaller restatements rising.” In addition, “several large accounting firms have also experienced declines in their accounting consultations.” Murdock speculated that “the pendulum has swung with respect to controls and I wonder whether any of this decline in prefiling consultations is associated with a lack of focus on accounting.”

On the topic of internal controls, Murdock said, “When we object to an accounting conclusion, we sometimes ask, ‘How did you evaluate internal controls?’ … Our perspective is a risk assessment that says no accountant can be an expert at everything. We honor good, reasoned judgments. … We are asking questions in that regard and trying to understand a little bit of a root-cause analysis with respect to the registrant’s internal controls. How did the company come to a conclusion that can cause a big restatement without a controls issue?”

Murdock also said that the SEC has seen an increase in consultations related to revenue recognition—specifically questions of “gross versus net.” He speculated that this “has to do with new industries and new products; people are applying it for the first time.” The SEC’s “objection percentage is relatively healthy in this area,” he said, but it will continue to monitor whether there’s an “acceptable amount of diversity and complexity” in this area.

Another frequent consultation topic is segments. Murdock mentioned a couple of historic issues in segments: “One is with respect to similar economic characteristics and the other is with respect to the identification of operating segments.” Regarding the latter, the SEC has utilized the “chief operating decision maker (CODM) package” to “ask questions when we saw something that was of interest”; however, Murdock expressed concern that the CODM package now presupposes the notion that “I can have any segment presentation I want, as long as I’ve titled the first sheet ‘CODM package’.” In response, the SEC is currently discussing using an organizational chart instead.

Role of the DCF

Next, DCF Deputy Chief Accountant Craig Olinger discussed the DCF OCA’s role: “We provide technical support to the review groups within the DCF. In GAAP matters, we do work closely with the OCA.” In addition, the DCF is responsible for updating the financial reporting manual (FRM) on the SEC’s website.

On reporting matters, the DCF OCA conducts a “preclearance” process: “If a company has a difficult reporting matter, it can write to us in advance. In some cases it’s to seek relief. It will of course very much depend upon the particular facts and circumstances, but we do at least entertain those. And then there are requests that are more or less just asking for guidance or help.” Olinger gave the example of a complicated reorganization of privately held entities to form an ini-
tial public offering (IPO) vehicle to sell to the public. In this case, the company might have significant questions about whose financial statements need to be in the filing and which is the predecessor entity that has to have the full registrant presentation, versus the other entities that may have a different status.

**FRM Updates**

Olinger reviewed significant recent updates to the FRM since last year’s conference. First he mentioned emerging growth companies (EGC), created under the Jumpstart Our Business Startups (JOBS) Act of 2010: “The JOBS Act created this whole new category of filer, with a whole new bunch of twists and turns in the statute that have not been baked into the rules yet because rulemaking is a formal, lengthy process, but we do have guidance that helps people navigate the EGC area.”

Olinger next discussed revised SEC guidance under FRM section 9520 that is intended to streamline IPO stock compensation disclosures: “That revised section now essentially says to cut it back to just those things that really hone in on the stock compensation valuation. It also says we still will continue to take a hard look at the accounting. In other words, is the valuation appropriate in the first place?”

Olinger next talked about oil and gas property acquisitions with respect to Rule 3-05 and FRM section 2065. “The revised section clarifies the distinction between when you need the full carveout financial statements under SAB [Staff Accounting Bulletin] Topic 1B,” he explained, “versus when it would be appropriate to have something more abbreviated or truncated, such as when you acquire a small product line within a very large entity.”

**Disclosures and Regulation S-X**

Olinger next turned to the notion of “disclosure effectiveness”—that is, considering situations where disclosures are redundant or unnecessary and can be reduced, as well as circumstances where additional disclosure would actually be useful to investors. “It’s going to be more of a two-way street” rather than disclosure overload, Olinger said. The project began following the JOBS Act study on Regulation S-K, after SEC Chair Mary Jo White requested that the DCF develop specific recommendations for updating the related requirements and industry guides.

“We’ve got teams looking at the various pieces of Regulation S-K,” Olinger said. “This is really the guts of your basic disclosure documents—10-Ks, 10-Qs, 8-Ks—looking at items that underlie those filings. … It’s looking at whether things are outdated.” For example, he referenced the earnings-to-fixed charge ratio associated with a debt filing or certain off-balance sheet items disclosed in the MD&A. “Regulation S-X has been brought into this as well,” Olinger continued. “We’re going to take a look at the financial statements for nonissuer entities. … If you go to the FRM, you’ll find over 100 pages of guidance on things like just applying the nonissuer entity rules. You’ll find there are different tests, different thresholds, different presentation requirements, different audit requirements, different ways they are treated in interim reports; there are literally dozens of buckets, and it gets very complicated. So we’re going to look at whether that can be simplified.” Olinger noted that the division would perform outreach to determine what investors really use the statements for.

Olinger concluded by echoing SEC Chief Accountant Paul Beswick’s comments about what companies can do to make disclosures less repetitive, more focused, and less outdated: “The way we’ve reviewed things historically has probably led people to keep things in that maybe they don’t really need any longer, so we are shifting that mindset to say, ‘If something really doesn’t need to be there, it doesn’t need to be there.’

**DOE Efforts and Trends**

Michael F. Maloney, the new chief accountant of the DOE, provided an overview of the office and then discussed auditing and accounting actions brought over the past 12 months and several trends he has observed.

“We work very closely with those investigating trial teams, advising on the cases as they go through the very lengthy process of investigation and leading to resolution,” Maloney described. “My office also coordinates with the PCAOB enforcement group. We talk about cases and trends that we’re seeing on the auditing side.”

Maloney highlighted several recent DOE trends in accounting and auditing violations. For the year ended 2013, he noted that there were 138 parties named in 68 accounting and auditing violations. Of these parties, there were 93 named in-
Recent Enforcement Cases

Maloney then reviewed accounting and auditing cases brought by the DOE in the past 12 months, consisting of these major categories: “cross-border/China-related matters; banking and investment matters; core accounting and financial reporting matters, which were accounting and auditing issues other than the China- and banking-related matters; matters related to the Foreign Corrupt Practices Act of 1977 (FCPA); and strictly auditor-related matters.”

Maloney began by summarizing the China issues: “There’s still a fair amount of activity in this area, primarily in three categories. The first relates to improper cash transfers and related parties. A lot of these cases involve offering proceeds that came in and then were diverted to related parties.” For example, in the Universal Travel Group case, proceeds were diverted to several unknown companies and there were alleged false business disclosures about subsidiaries that had been transferred to other related parties; in addition, there were allegations of revenue and profits being overstated.

The second China-related category concerned false or overstated disclosures about businesses, revenues, and assets. Maloney mentioned the case of American-owned Subaye, Inc., which reported in one quarter roughly $39 million of revenue for a business segment—cloud computing—that did not exist. There were also allegations of lying to the auditors.

The third category was “gatekeepers.” In the ongoing case of L&L Energy, there was a signed Sarbanes-Oxley certification by a person who was not actually the CFO. “The CEO and chairman was recently arrested,” Maloney said. “What’s interesting about that case is that the audit committee chairman was charged with some allegations that he knew about this problem. That’s a pretty big wake-up call in terms of the responsibilities of the audit committee.”

On banking and investment matters, Maloney focused on two cases. The first, Fifth Third Bancorp, involved allegations related to nonperforming loans that the company had taken steps to sell. The allegations concerned whether those loans were moved on a timely basis to the held-for-sale category, which would have resulted in an alleged $169 million dollar impairment. The case alleged that moving the loans “didn’t happen on a timely enough basis, inconsistent with the actions the company was taking to actually sell the non-performing loans.” The second, JPMorgan Chase, relates to the ongoing case against two former traders and the steps they might have taken to avoid mark-to-market accounting adjustments and mismarking. In addition, an internal control case was brought against the company and settled for its failure to maintain effective internal controls over financial reporting, as well as disclosure controls and procedures.

In the core accounting and financial reporting area, Maloney noted that “there were a lot of problems similar to past years.” He began with the case of Hansen Medical Inc., in which the allegations related to accelerated revenue recognition. “It was alleged that certain equipment was installed on a temporary basis and that customer acceptance signatures for the equipment were forged,” Maloney said. “In fact, then the equipment was deconstructed and put in storage until the customer actually needed it, and so that resulted in accelerated revenue recognition.”

Another recent case in this area, Diamond Foods Inc., concerned the underreporting of expenses related to fairly significant payments due to vendors. Payments were made, but were mischaracterized as prepaid assets rather than cost of sales. There were also allegations that one of the executives misled the auditors, according to Maloney. He also discussed the case of CVS Caremark Corporation, which related to a lack of disclosure of some significant contracts related to lost pharmacy business. “Ultimately, when those disclosures were made, the stock of the company dropped by 20%,” Maloney said.

Maloney next spoke about two other accounting/auditing cases. The first, Paccar Inc, was a settled matter related to ineffective internal controls over segment reporting. It was alleged that two business lines met all the criteria to be reported separately as segments, but they were not. “The after-market parts business had over $500 million of profits in the time period that was being looked at,” Maloney explained. “The trucks business had a significant loss, a little under $500 million. When those weren’t split
out separately, it looked like there was profitability of $68 million. That was misleading.” The second case was that of Dewey & LeBoeuf, which focused on “a criminal action against the law firm in terms of allegations of false revenues, understated expenses, mischaracterized liabilities, and some other issues to support a bond offering.”

In terms of the FCPA, Maloney said that the SEC is “bringing cases that involve alleged violations of the antibribery provisions, as well as the books and records and internal controls provisions of the securities laws. … Disgorgement continues to be a part of these enforcement actions. There are some fairly significant disgorgement numbers, and working through those calculations and getting a number that works is something that a lot of time is spent doing.”

Maloney discussed auditor-related matters in two categories: independence and improper professional conduct under Rule 102(e). “Independence continues to be a significant area of focus for the division,” he said. Maloney referred to a KPMG independence case that related to violations for three different clients. On improper professional conduct, he said that “we continue to be very active in looking at the conduct of auditors.”

Maloney then reviewed notable topics of cases currently in the pipeline, which concern revenue recognition; asset impairment and reserves, especially in the banking arena; income tax accounting; sales incentives, which is “an area with a lot of judgment and a lot of estimation”; and variable interest entities and off-balance sheet arrangements, as well as the decision on whether to consolidate.

New Initiatives

Lastly, Maloney discussed two new initiatives, beginning with the Financial Reporting and Audit (FRAud) task force formed last fall: “Twelve of the commission’s best accountants and attorneys are involved. There’s a lot of activity.” Part of the task force’s efforts focus on analytical approaches and tools that can help detect and remedy potential violations. “But that is not the only thing the FRAud task force is doing,” Maloney said. “They’re really digging in to try to understand the root causes of fraud. They’re collaborating across the commission with the different groups to understand what they’re seeing and learn from that. They’re collaborating with the academic community to understand where fraud is occurring and likely to occur.” The task force, Maloney added, is looking at areas that might have greater potential for violations and digging into specific cases in those areas. “The initial thoughts are that it has been very successful and it’s reinforcing the division’s renewed focus on accounting- and auditing-related cases,” he said.

The second initiative was Operation Broken Gate, “an ongoing initiative to look at auditors of public companies. A lot of that focus was on firms that were auditing a significant number of small issuers simultaneously. There have been five actions already brought against auditors, including Rule 102(e) bars and, in one case, disgorgement of audit-related fees.”
How to Recognize Revenue

Exploring the New Standard’s Goals, Effects, and Transition

Panelists: Russell G. Golden, Daniel Murdock, Jan Hauser, Scott Taub, and Dusty Stallings
The second panel at Baruch College’s 13th Annual Financial Reporting Conference on May 1, 2014, focused on one of FASB and the IASB’s primary convergence projects: revenue recognition. Panelists representing preparers, regulators, users, and auditors discussed the final standard and how to apply it in practice. Norman Strauss, the Ernst & Young Professor-in-Residence at Baruch College, moderated the panel.

A Successful Project

FASB Chair Russell G. Golden commenced the discussion on the final revenue recognition standard by noting it had been cleared by all board members. (Editor’s Note: Following the conference, ASU 2014-09 and IFRS 15 were issued on May 28.)

In terms of convergence, Golden described the project as “an absolute success story. … Now there are really only two differences—one has to do with interim disclosures, the other has to do with a threshold for collectability. But it is a grand achievement and is going to make a lot of improvement throughout the world. Investors can better understand how companies are recognizing revenue.”

Daniel Murdock, deputy chief accountant in the SEC’s Office of the Chief Accountant, described the project as “an absolute success story. … Now there are really only two differences—one has to do with interim disclosures, the other has to do with a threshold for collectability. But it is a grand achievement and is going to make a lot of improvement throughout the world. Investors can better understand how companies are recognizing revenue.”

 Goals and Scope

PricewaterhouseCoopers Partner Dusty Stallings summarized the core principle of the new standard: “You recognize revenue at the amount that you’re entitled to as you satisfy the promises that you made in your contract.” Although Stallings described this as a “good, sound principle,” challenges could arise when trying to determine “the amount that you’re entitled to, when you are satisfying those promises that you’ve made, and what those promises that you’ve made are.”

“We spent a lot of time analyzing the standard and working with FASB and the IASB,” said Jan Hauser, controller and chief accounting officer of General Electric. “What’s scoped in are the entity’s ordinary activities. Most things that have been covered by
Revenue recognition in the past will be covered by this guidance in the future. Some things are scoped out—leases, insurance, and financial instruments.

“A very unsatisfying consultation for us is when we see a registrant that is applying an appropriate revenue recognition pattern but might have cited the wrong piece of literature,” Murdock commented on his experience. “The ability to dispel that sort of tension in the system under the new standard is going to be fantastic.”

Strauss raised the issue of collaborative arrangements (i.e., when two companies work together to develop a product), which have been scoped out of the new standard. In response, Scott Taub, managing director of Financial Reporting Advisors LLC, replied, “It’s going to be an issue. These contracts are already very difficult to account for, but there is a little bit of guidance in the literature today with regard to the milestone method, which often applies to them. That guidance is going away. … The pharmaceutical industry, for example, is already putting together a task force to try and develop some practices, which presumably they will run past the revenue implementation group.”

Five Steps of Revenue Recognition

**Step 1: Identify the contract.** “You need to understand what rights and obligations are created by the arrangement,” Golden explained. “I suspect that in some cases, it’s going to be very easy to understand; in other cases, it’s going to be a little more difficult. The real issue is not so much identifying the contract as the rights and obligations embedded within the contract.”

The five criteria for a contract, according to Strauss, are as follows: 1) it is a substantive agreement, 2) each party’s rights are identifiable, 3) the payment terms are identifiable, 4) the parties to the contract plan to enforce their rights, and 5) collectability is probable.

“This was a very controversial topic between members of FASB and the IASB,” Golden said. “It’s not good enough just to have a contract. You have to believe that both parties will act. The institution providing the good or the service has the obligation to provide it, but the counter-party has the ability and the willingness to pay for the consideration. That’s why we put the ‘probable’ notion in the standard.”

“The rest of the criteria for a contract are generally encompassed in the persuasive evidence of an arrangement criteria that we’re all somewhat familiar with,” Taub said. “I don’t suspect that this will be a big change, except at the margins.”

One of the areas in which he expects to see improvement is modifications: “We didn’t previously have any guidance on contract modifications in most industries. … Now we’ll actually have some guidance that’s applicable across industries, and the boards have done a good job of simplifying the original proposal. Basically, the way this is going to work is, if the modification is just to add more things to the contract with a reasonable amount of additional payment to compensate for those things, you just treat the additions as if they’re a separate agreement and they don’t affect the accounting for the original contract. If that’s not the case, then from the point of the modification forward, you look at what is still left to do and the amount of revenue that is still left to recognize. Looking at those, you determine whether the group of things you still have left to do is distinct. If it is distinct from everything that went on before, then you just account for the remaining performance obligations in the now-modified contract as if that were a new contract. … And if the remaining performance obligations are not distinct—for example, if you’re halfway through a service—then you have to reevaluate the whole modified contract and book a catch-up adjustment.” Although there are certain contracts that will be complicated, Taub said the guidance overall “will be a big improvement.”

**Step 2: Identify performance obligations.** “The good news is when it comes to identifying performance obligations, this is fairly familiar territory,” Stallings said. “It’s kind of a new name for what today would be called a deliverable or a component or an element of an arrangement. In short, it is just those promises that you’ve made in your contract. One challenge is making sure that you’ve identified all of those promises. … But I think the bigger challenge will be whether those performance obligations are distinct.”

Hauser summarized the criteria for a performance obligation to be considered distinct: “The customer can benefit from the good or service; that’s very much like the stand-alone value. Secondly, the promise to transfer a good or service is separately identifiable from other promises in the contract. This one is a bit harder to describe, but it was born out of the need to deal with contracts that have a number of interrelated goods and services in order to ultimately provide what the customer is looking for. So it’s whether the ultimate output is distinct within the contract. … Where the new evaluation is going to end up are the questions of what is similar to stand-alone and what you can bundle under the second criterion as interrelated.”

Hauser next reviewed an example from the standard, in which three goods or services—A, B, and C—are all combined in one contract and the customer can buy any one or all of them, but the choice is not...
affected by which they select; in that case, each of the three is considered distinct and can be separately accounted for, rather than bundled. In the case of bundling, however, Stallings noted: “If you need to account for two things together, the timing might be different than if you were accounting for those two things separately.” With distinct services, “you would take part of your revenue immediately, and part of your revenue as you’re doing that second thing; however, if you have to look at them together, you’re probably going to recognize it all as you do that second thing, as opposed to taking some of that revenue up front.”

Although the notion of a distinct good or service was not contested, Golden said that interpretations of a good (a point in time) versus a service (over time) did become controversial, especially for transactions that have the appearance of both. He offered licenses as an example: “When you’re licensing a software product, are you really getting a service, because you’re getting access over time, or are you getting a good? That’s where we had to try to clarify the criteria.”

**Step 3: determine the price.** “This is another area where the new standard is set to give us guidance that we previously didn’t have—or, at least, we only had piecemeal,” Taub said. The price is the amount the entity expects to be entitled to. The current rules regarding uncertain pricing, which don’t allow the recognition of revenue for a price that is not fixed or determinable, will be replaced with unified guidance on how to estimate variable consideration in order to record the most likely amount or expected value.

“That best estimate might be a single best estimate,” Taub noted. “If you’ve got binary outcomes, if you think it’s likely you’re going to earn the whole bonus, then you take into account the whole bonus. Or it can be an expected value; if you have a large number of transactions and you believe you’ll get the bonus about 70% of the time, then you take into account 70% of the bonus.” The one constraint he noted is that you should not recognize revenue if there is a reasonable chance that it will be reversed.

Although FASB says that this estimate must be “probable” and the IASB says that it must be “highly probable,” those terms actually refer to the same threshold, Taub explained. “In U.S. GAAP, ‘probable’ means ‘70%–80% likely to occur.’ Under IFRS, probable means ‘more likely than not.’ So for the IASB to get to the same thing that we mean by probable, they have to say ‘highly probable.’ Do not perceive this as a failure of convergence.”

In terms of auditing, Stallings noted, “There are a lot of judgments and a lot of estimates to be made in this process. Most industries are not familiar with having to make these estimates and judgments, so the constraint is helpful. But with that level of estimate and that level of judgment, this is going to be challenge for both preparers and auditors, especially early on.”

On the preparer side, Hauser said that implementation issues could depend upon the type of customer contracts that a company uses: “For those that have been in long-term contracts, they’re used to making estimates. … I don’t see it as a significant implementation issue. I do see it in terms of just the way practice is going to evolve.”

In response to a question about royalties, Stallings said, “There was a lot of contention around accounting for licenses in general. Should it be point in time, or over time? One of the areas that kept coming up was if I have a royalty-based payment, how do I know how many people are going to come see my movie or buy my drug? After a good bit of discussion back and forth … they decided to leave the exception that says if consideration is based on either sales or usage of intellectual property by a customer—and only if it’s a license—then you do not record those royalties until they actually occur. But it has to be intellectual property, and it has to be royalties that are either sales or usage based. So it’s a fairly narrow exception.”

With respect to discounting, which is required if the contract has a significant financial component, Taub said, “If it’s less than a year between payment and performance or performance and payment, depending upon which goes first, you don’t have to worry about the financing element. … But if there’s financing baked into the contract, you need to account for it. There will be some judgment involved here.”

“I think it’s fair to say while people tend to think about considering the time-value of money for payments made over a number of years, it’s less prevalent that people think about needing to consider payments made in advance, so this is an area that people need to focus on,” Stallings later added.

In terms of collectability, Taub said it has gotten simpler: “If we really think collectability is not probable, we don’t have a contract in the first place and we don’t have revenue to recognize. … We have clarified that all noncollectability losses are now an expense. They do not come off revenue. They’re all going to be in one line item and you won’t have to decide which are revenue reductions and which are sales losses.”

“This is an issue where both FASB and the IASB have used the same word—that is, ‘probable’—for collectability, but it will get different outcomes because of the definition of probable versus highly probable,” noted Golden. “So the threshold that one needs to meet under IFRS will
Companies that make money through an annuity could have changes in timing related to revenue if the reason they did not allocate all of the stand-alone selling price of a delivered item was because payment depended upon future undelivered items.”

Step 4: allocate the transaction price. The allocation of amounts expected for each separate performance obligation, based on relative stand-alone selling prices, is similar to multiple-element allocations under EITF [Emerging Issues Task Force] Issue 08-01. Golden explained, “Those that had a change going from EITF 00-21 to 08-01 will have a limited change here. Those that are dealing with software and needed vendor-specific objective evidence—that’s no longer a requirement.”

Taub discussed an example of recognizing revenue for a burglar alarm system and the five-year monitoring performed by the system. “Just because the contract refers to them separately doesn’t mean they’re distinct,” he said. Once an analysis concludes they are distinct, “We need to recognize revenue on the system when we install it and then the monitoring service over the period, so we need to allocate the selling price between the two. … The hard part, the judgmental part, might be, depending upon the situation, coming up with these best estimates of stand-alone selling prices.”

“One issue I wanted to highlight: there is a constraint embedded in U.S. GAAP today that says if the cash payment for the delivered item is dependent upon performance of the undelivered, you don’t get ahead of cash,” Golden said. “We’ve taken that away. Companies that make money through an

Step 5: recognize revenue as performance obligations are satisfied. “Once you’ve determined the point in time or the pattern over which you’ll recognize revenue, the previous four steps already told you what amount of revenue to recognize, you have already allocated it to the appropriate performance obligations, and as you satisfy those obligations, you’ll make the necessary entry,” Taub explained. “You may have gotten paid in advance, in which case you’ll have deferred revenue sitting on the books—which the standard calls ‘a contract liability,’ but I think we all know what is deferred revenue—and if that is the case, you’ll start bringing in revenue. If you need to recognize a receivable because you’re getting paid later, that’s fine too.”

“Today we put a lot of weight on whether the risks and rewards have passed, but there’s less weight on that under the new standard,” Taub continued. “It’s really looking at control. For example, there are things today that we account for essentially as consignments, even though they actually aren’t. Title has passed and the customer does have control but because we’re uncertain about their ability to sell it if they’re a reseller, we sometimes say we’ll go to the sell-through method. We won’t recognize our revenue until our distributor sells it on. That won’t be the case anymore. … You have to use the sell-in method and then make your necessary estimates of returns.”

Hauser explained how to recognize revenue over time: “There are three different criteria here. The first one is the service contract; generally, there’s no asset created and the customer is consuming the services. One of the things that you’d need to think about, in terms of whether over time would be appropriate, is if another entity would need to come in and reperform the work already done if they needed to fulfill the remaining obligation. The next one is whether your performance creates or enhances an asset that the customer controls. … The last one is probably the more judgmental area, where it’s not necessarily clear whether the customer controls the asset, but the creation of the asset is such that there really is no alternative future use. … As we’re thinking about some of our contracts, some clearly could be recognized over time, but may not be under the new arrangement. This is an area where we’re thinking about the judgments that we’re going to have to put in place.”

In the case of journal entries for sales returns, Taub said, “It’s pretty much like
Disclosures

Strauss shifted the discussion to disclosures under the new standard. “We were able to take some of the disclosure requirements away and focus on what is very important to the investor, which is the qualitative and quantitative amounts of the estimates that go into revenue, the disaggregation associated with revenue, whether it’s a product or service, reconciliations of performance obligations,” began Golden. “A new thing that the board has been working on is ensuring that disclosures are relevant for nonpublic companies and recognizing that investors have more access to nonpublic companies and they might not need as much disclosure. … The other critical decision—this was a narrow vote—the majority felt that disclosures needed to be done on an interim basis, because revenue is such an important metric.”

From the preparer perspective, Hauser said that it still “feels like a lot” of disclosure. As for interim disclosures, Hauser noted that “the time frame is very condensed, and trying to gather the information and make sure it’s right is quite a task.”

Transition

The effective date for the revenue recognition standard is annual reporting periods beginning January 1, 2017, beginning with the first quarter of 2017, for public companies, and annual reporting periods beginning January 1, 2018, for nonpublic companies without quarterly filing requirements. Early application is not permitted by FASB for public companies, but the IASB does permit early adoption. Companies using IFRS could adopt it as early as this year. “I think we’re going to need potentially more time than what we’re being allotted,” Hauser later said. “It’s a huge undertaking.”

Stallings described the two transition methods available: “First, you can do a full retrospective application. You just cast back for all periods presented, as if this standard had been the guidance in place all along. For a company that decides to go down this route, there are some practical expediency provided. … The alternative is that you will present year 2017 using the new guidance, while previous periods will be under the old guidance. In order to help someone understand the trends that are taking place, there is some additional disclosure that’s required: all of the line items that changed because of the new standard and what they would have been under the old guidance.” She noted that this goes beyond just revenue, gross margin, and net income—to all of the financial statement line items that might be affected. Stallings advised that the transition decision not be made in a vacuum: “You want to understand what your investors and your analysts are expecting.”

With respect to implementation guidance, Golden noted, “Just because the board has issued a final document, FASB is not done. We need to monitor the questions that come in. We are forming what we call the Joint Transition Resource Group for Revenue Recognition [TRG].” Although this group is not designed to answer every single question, it will invite subject-matter experts to talk with FASB about their issues; the board will then decide whether it needs to provide more information, release an interpretive question, or produce a technical amendment to the standard. [Editors’ Note: This group was announced on June 3.] “I expect have some change,” Hauser added. “One of the most dangerous positions to be in is if you think you’re going to have no change. You probably need to allot some time to grab that document and read through it in detail, because chances are that there will be some level of change—it’s just a question of how much.”
Keynote Address
by James R. Doty

Enhancing the Audit
James R. Doty has been chairman of the PCAOB since January 2011. Prior to that, he served as general counsel of the SEC and as a partner at the law firm of Baker Botts LLP. The following is an edited version of the keynote speech Doty presented at Baruch College’s 13th Annual Financial Reporting Conference on May 1, 2014.

Preserving the American Dream

We credit the Frenchman, Alexis de Tocqueville, with being the first to recognize the American Dream, based on his travels in America in the early 1830s to conduct research for a book on the American penal system. … What we best remember of his journey is not what he set out to find, but what he discovered along the way. He lived in one of the most educated and advanced societies in the world at the time. Yet it was fraught with rebellion. When his patron king was exiled, he lost his paid commission.

He found in America the peaceful influence of free enterprise. He marveled in his book, Democracy in America, ‘I know of nothing more opposite to revolutionary attitudes than commercial ones. Commerce is naturally adverse to all the violent passions.’ Alexis de Tocqueville wrote for a French audience, but in doing so he offered Americans a broad vision of themselves, founded on fairness and opportunity. Where he found fairness and opportunity, we thrived; where he did not—most importantly in the institution of slavery—we too trod the path to social upheaval.

On this moral foundation of fairness and opportunity, the American accounting profession was built. The presiding individualism that de Tocqueville recognized in early America created the perfect breeding ground for that most American of institutions—voluntarily funded private enterprise made possible not by the crown, but by 1) marshaling capital from numerous, dispersed individuals; 2) hiring professional, trained management; and 3) monitoring management’s stewardship with the watchful and expert eye of the public accountant.

But private financing, small or grand, flows most freely when investors believe they have access to good evidence of a company’s performance. By allowing the investing public—and not just the privileged classes—to make informed investment decisions, that transparency disciplines management and fuels competition for capital based on the achievement of real success. It is the essence of American economic success.

In our growing and increasingly complex economy, the amount and complexity of information relevant to informed investment decisions is greater than ever. Accounting and auditing are, thus, more important to American society than ever.

The Challenge to Innovate to Meet Investor Needs

As chairman of the PCAOB, I spend most of my time listening. People talk to me about the value of the audit; about whether auditors are happy; whether auditors have the right skills or perform the right procedures; how important missed procedures are; whether skepticism matters and how you observe it; and whether auditors should second-guess management and, if so, how far they should go.

I hear much from preparers—management and members of boards of directors—and auditors themselves. Their views are often aligned, although not always so. I also hear from investors. Their voices are quite naturally as dispersed and diverse as they are. They are often not in harmony. Some value the audit and argue for more; others discount the audit as a commodity.

I believe the nub of this commoditization is that it is difficult to observe the full benefit of a good audit. We can’t tell which companies would or might have collapsed under management misreporting, but for the auditor’s watchful eye. All the public knows comes after an issuer has collapsed, or had to restate materially misstated financial statements, and then the audit is judged a failure.

Let me say a word about that, because there has been some discussion in the press about the term “audit failure.” Audit failures are, of course, of great concern to the PCAOB, whether or not the financial statements are misstated, and they are emphasized in PCAOB inspection reports for that reason.

Some have expressed concern that audit failure could be understood to mean that PCAOB inspectors have determined that the financial statements were incorrect—that is, that the audit must have failed to detect a material misstatement. This is not necessarily the case, and inspection reports have appropriately made this point clear.

Before the audit inspection regime established by the Sarbanes-Oxley Act of 2002 (SOX), an audit failure could only be discovered if there were a restatement or other problem in the financial statements. Independent audit oversight and inspections, however, have allowed for new, independent insight into the performance of all audits. In that environment, it is both appropriate and useful to distinguish between a financial reporting failure and an audit failure.

In my view, most people can understand that distinction in this new environment. But I also think that a debate over a label needlessly distracts from a critically important substantive point, about which there must be
no confusion: the auditor has issued an opinion without satisfying the fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement.

Whether it is associated with a disclosed financial reporting misstatement, an auditor’s failure to obtain this reasonable assurance is a serious matter. It is a failure to accomplish the essential purpose of the audit. It means that, based on the audit work performed, the audit opinion should not have been issued, and more work consistent with applicable audit standards was necessary for the opinion to stand.

But the profession needs to do more than just address particularized problems that arise today. The economic crisis that emerged in 2008 has eroded public confidence in the audit’s relevance. If audits are meaningful, how could such a crisis occur without the auditors sounding an alarm? The investing public calls for a stronger basis to trust the audit and a more relevant audit report. The auditing profession must devote attention to these needs in order to maintain its importance to capital markets for the future.

There are also conflicts of interest for the audit to overcome. Regulations have addressed the more obvious ones, such as personal financial interests and business relationships between an audit firm and an audit client. The regulations have also affected the business model by limiting the scope for audit firms’ escalation of commitment to an audit client with dependence on nonaudit service fees from that client.

But in some cases, and to some auditors, the audit fee alone represents a significant income stream that anyone would find hard to put in jeopardy. Auditors who blow the whistle are more likely to lose that account. Research shows that 50% of whistleblowing auditors lose the client shortly after the fraud revelation; in contrast, only 14% to 15% of audit firms lose their client when they are not the one to uncover or reveal the fraud (Alexander Dyck, Adair Morse, and Luigi Zingales, “Who Blows the Whistle on Corporate Fraud?,” Journal of Finance, vol. 65, no. 6, December 2010, pp. 2213–2253).

**Auditing Is a Declining Portion of Firms’ Business**

To be sure, audit firms are innovating, but not in the area of the audit. Audit fees have become a decreasing portion of audit firms’ revenues. Audit practices have shrunk in comparison to audit firms’ other client service lines—not all of which depend on the fundamental exercise of skepticism. SOX put the audit committee in charge of retaining the company’s auditor, and yet the audit committee has limited information on which to judge audit quality; thus, the primary battleground for market share becomes price.

Let me give you some statistics. From 2006 through 2011, 418 companies in the Russell 3000 index changed auditors. The median change in audit fee reported by these companies in their filings with the SEC was a decrease of 11.5%. A clear majority of the companies that changed auditor (62%) reported a decline in fees for the first year of the new engagement. (For additional details and graphic representations, see http://pcaobus.org/News/Speech/PublishingImages/05012014_Doty_Baruch/Baruch_Figure1.JPG and http://pcaobus.org/News/Speech/PublishingImages/05012014_Doty_Baruch/Baruch_Figure2.JPG.)

Among the 418 that changed auditors, the decline in audit fees was even more pronounced for large engagements—those with audit fees of $3 million or more. Of those companies, 83% reported lower audit fees in the auditor’s first year, with a median decrease of 15.7%.

In comparison, the year-over-year change in audit fees among the full Russell 3000 was essentially flat, with about half reporting increases and half reporting decreases.

Not surprisingly, the fight for market share becomes the fight for incumbency. The annual rate of auditor changes declined each year from 2006 to 2011. Among companies in the 2010 index, only 1.88% changed auditors in 2011, compared to 3.72% in the 2006 index (see http://pcaobus.org/News/Speech/PublishingImages/05012014_Doty_Baruch/Baruch_Figure3.JPG). By no means is it the role of the PCAOB to regulate audit fees; nevertheless, the facts are concerning.

It is not the custom for companies’ statements to explain the rationale for why a new auditor charges a lower fee than the previous auditor. Is the new auditor more efficient? Did the new auditor reduce the scope of the audit? Did the fee for the new audit cover the full cost of conducting the audit in the first year?

Whatever the answers are in particular cases, the emerging reality for all of us is the need to understand the effect of these trends and pressures on audit quality.

**Enhancing the Relevance and Reliability of the Audit**

The PCAOB is engaged in several initiatives to enhance the relevance and reliability of the audit and refocus market participants on the importance of the quality of the audit, as opposed to merely the price.

**Performance standards.** First, we have improved and are closely monitoring compliance with several fundamental performance standards to make audits more
reliable. We have recently commenced the 2014 inspection cycle, which includes evaluating compliance with our standards on the use of risk assessment throughout the audit, from planning through the gathering and evaluation of evidence. We have also recently issued a report on compliance with our standard on engagement quality review, which replaced the profession’s concurring partner requirement. The point of an engagement quality review is to catch deficiencies in the audit, much as our inspectors do, except before the report is issued—and thus before investors can be harmed by an unreliable audit opinion. The report, “Observations Related to the Implementation of the Auditing Standard on Engagement Quality Review,” discusses common inspection findings to promote better execution.

PCAOB inspectors will soon begin evaluating compliance with the PCAOB’s new standard to enhance auditors’ communications with audit committees, with a view to developing a similar report on compliance trends.

We are also engaged in several new standards-setting projects. I expect soon to ask the board to vote on a staff recommendation to improve the standard on auditing related-party transactions. This is based on two rounds of thoughtful public comment.

The PCAOB is also considering potential changes to the auditing standards on fair value and estimates, use of the work of other auditors and specialists, and quality control, among other topics.

**Auditor transparency.** We are also working on measures to address the problem that, today, many people see the audit as a commodity that can be produced equally well by any team from any firm with a recognized name. But to do so, we’ve got to provide markets with more information about the audit. The PCAOB has proposed that engagement partners and other firms involved in an audit be identified in the audit report. Other countries already have such disclosure. It allows the market to reward audit committees that choose audit partners with a demonstrated record of reliability and to give others an incentive to establish one.

Knowing the name of the engagement partner on an audit and the various other firms that participate in a global audit is just a start. But it might help the audit committee conduct appropriate vetting, based on objective benchmarking across firms. We are also developing other indicators of audit quality, both at the engagement and firm level. Expect to see a concept release seeking public comment on potential measures later this year.

The proposal to require disclosure of engagement partner names has generated considerable debate. Auditors in Europe have long signed their audit reports, to no apparent harm to the auditors involved, even when those audit reports have also been filed here in the United States with the SEC. But some here have argued that engagement partners are already held accountable to multiple parties, including their firms, audit committees, and even investors, and that firm-wide quality controls already provide for consistent performance across engagements.

While inspectors do find outstanding quality in some cases, they also routinely find situations where firms’ quality controls do not ensure consistently high performance, particularly in areas that have a pervasive effect on quality, such as professional skepticism. Some quality control concerns can be particularly challenging to remediate, especially in very large firms with thousands of professionals—lack of professional skepticism appears to be one of them. Inspectors have also found situations where engagement partners who presided over deficient audits were not held accountable and were even assigned more challenging engagements.

If this were transparent, the market would be able to provide a discipline on partner selection, as it has in other countries. On a personal level, I can understand the resistance to releasing information. Yet such transparency is common and effectively used in many settings and professions, including directors and senior management charged with corporate governance at audit clients.

**The auditor’s reporting model.** Last year, the board also proposed the first significant changes to the auditor’s reporting model in more than 70 years, based on investors’ calls for more informative, insightful, and relevant audit reports.

The proposal is based on more than a year of outreach to investors, auditors, preparers, academicians, and others on what kind of changes would be most useful and achievable. The outreach suggested a range of possibilities, from a new, stand-alone auditor’s discussion and analysis of the financial statements, all the way to some relatively small, but helpful, clarifications to the standard auditor’s report.

The PCAOB proposed a middle-ground approach. It builds on the pass-fail report but would provide more insight about the
audit in order to help the public understand where the audit was most challenging, and thus provided the most value.

The proposal provides a framework to report critical audit matters, which keeps the auditors in their area of expertise—the audit. The proposal would also require auditors to report on their evaluation of certain other information besides the financial statements, such as the company’s annual report and management’s discussion and analysis.

We are fortunate to be able to observe changes occurring across the ocean. The United Kingdom began requiring expanded audit reports earlier this year for companies that apply the United Kingdom Corporate Governance Code, which includes the FTSE 350 companies. Early experience has drawn praise from investors, auditors, and issuers.

Based on review of the first 64 FTSE 350 companies that filed the expanded audit opinions, there is no evidence that the additional auditor discussions have had a negative impact on the audit process. The auditors did not require additional time to issue an audit opinion. The new audit opinions were issued on average in 57 days for the observable group, compared to an average of 58 days for their prior year’s opinion. Preliminary data does not seem to indicate a significant increase in fees either.

Moreover, I was encouraged to see that the discussion in the new auditor reports appears to be meaningful, not boilerplate. U.K. auditors are now required to discuss in the audit report the assessed risks of material misstatement that had the greatest effect on the overall audit strategy, on the allocation of resources in the audit, and on directing the efforts of the engagement team. Among the 64 audit reports, there was variation in the risks discussed and how they affected the audit. The number of risk topics discussed in the audit reports ranged from one to eight, with an average of four (see http://pcaobus.org/News/Speech/PublishingImages/05012014_Doty_Baruch/Baruch_Figure4.JPG and http://pcaobus.org/News/Speech/PublishingImages/05012014_Doty_Baruch/Baruch_Figure5.JPG).

Last month, the PCAOB held a public meeting on our own proposal, and invited U.K. investors, auditors, and issuer representatives to speak to that experience. (Transcripts, witness statements and public comments are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx; podcasts are available at http://pcaobus.org/News/Webcasts/Pages/04022014_PublicMeeting.aspx.)

To give you a sense of the enthusiasm for expanded reporting, let me read to you what Tony Cates, head of audit at KPMG U.K., reported:

In 20-odd years of auditing, I’ve never had so much … interest from investors in what I’m doing and … emails out of the blue from people saying this is a really positive thing. And much more engagement with investors as a whole. Not on specific companies, but as a whole. And I can only see that as a real positive. (Auditor’s Reporting Model: A Public Meeting Before the PCAOB, Apr. 3, 2014)

The same week as our public meeting, coincidentally, the European Parliament voted to adopt a broad package of audit reforms for EU companies, including expanded audit reports. This is an engaging debate of the first order, with important implications for audits, corporate reporting, and capital markets. Anyone interested in the public policy of financial markets will find in the record of that April meeting something of interest.

Striving to Improve

This is a critical time to protect and champion the audit, and by doing so renew the compact of this generation with the next, as your mentors and forbears did for you. Many in the profession have come forward with ideas for the future and an open spirit. Others still tarry: caution dominates, expressed as concerns for cost, and concerns for vague impressions that expanding the audit could expand liability as well. Our liability system has never brought our markets to their knees. Inadequate warnings to investors have—time and time again. As Sandy Burton, the SEC’s one-time chief accountant and later dean of Columbia Business School once said—

Both currently and historically, the accounting profession has exhibited a comfortable, conservative commitment to the status quo in the absence of an external stimulus for change (John C. Burton, “The SEC and Financial Reporting: The Sand in the Oyster,” Journal of Accountancy, June 1982).

He held ‘that all changes seem several times more significant and more threatening when viewed in prospect than in retrospect.’ That is, ‘once the reality is faced, it is generally neither so monumentally different nor so threatening as it originally appeared’ (Ray Garrett Jr., “Address at the AICPA Second National Conference: The Need for Change in Accounting Policies,” Jan. 6, 1975).

Let us go back to Alexis de Tocqueville, who observed that we are a people ‘perpetually striving, in a thousand ways, to improve.’ If the audit is to prosper, this maxim must be its animating force.
In Focus

Current Developments in the Private Sector

Recent and Ongoing Projects on the FASB, PCC, and EITF Agendas

Panelists: Susan Cosper, Jackson Day, Robert Laux, and Robert Uhl
FASB Technical Director Susan Cosper began by talking about FASB’s project on leases: “We wrapped up the comment letter process and our ED [exposure draft] last fall, and we did a lot of outreach in terms of users and preparers and auditors.” Under the new model, a lease is “a right to use an asset for a period of time in exchange for consideration.” Cosper then reviewed the model’s classification of leases: “The difference between a Type A and a Type B lease was really around the pattern of income statement recognition, as well as cash flows. Real estate was generally Type B, which would be a straight-line expense recognition, whereas Type A was generally a financing-type.”

“We got perspectives from all types of investors and users—buy side, sell side, accounting analysts,” Cosper continued. “We essentially heard that leases do create assets and liabilities, and there was broad support for the balance-sheet recognition in our proposal. There was an overwhelming response that disclosures under our lease accounting standards today are insufficient. But because investors have different strategies, they certainly have different perspectives on how leases should be recognized. Preparers had mixed views. We had some that supported the recognition of assets and liabilities, and some that didn’t. We heard, pretty overwhelmingly, a concern about cost and complexity. … We also heard that the lessor accounting model is not broken.”

Despite arguments that the short-term lease exception—leases less than 12 months don’t have to be recognized on the balance sheet—would cause leases to be structured differently, FASB did not hear concerns about this during outreach. “We heard that they would still look at the economics of leasing and why they were entering into a lease arrangement, as opposed to just trying to manage the balance sheet,” Cosper said. Although the IASB decided to scope out small-ticket leases, she noted, FASB decided to do more research to better understand the potential consequences of allowing such an exception.

“We are a proponent of Type B, which is straight-line accounting on the income statement, for all leases,” commented Robert
Laux, senior director of financial accounting and reporting at Microsoft. “We also believe that leases should be on the balance sheet. … When FASB came up with the concept of the right to use, I believe they stretched the conceptual framework, because a lease is an executory contract at any point in time, and such a framework of definitions of assets and liabilities would not put one of those on the balance sheet. But I think it actually was the right thing to do.”

“There really is no consensus around the world as to the economics of a lease,” added Deloitte Partner Robert Uhl. “FASB’s job is to determine what the economics are and what the best way to faithfully represent the transaction is. If you talk to different people, you will get different answers on what is a lease. Some believe it is an executory contract; some look at it as an executed contract. … It’s that kind of dilemma that has really made this difficult.”

Cosper resumed her explanation of Type A and Type B leases: “The question here is really … where should the line be between Type A and Type B? We’ve spent the last six months or so trying to figure that out. … The IASB decided that all leases should be considered financing, so all leases would be recognized as Type A and appear on the balance sheet. … FASB kept the line between Type A and Type B very similar to today, albeit they made the bright-line test that we have in lease accounting today more principles-based.”

“I’m quite troubled by what I’m seeing as differences between U.S. GAAP and international accounting standards. With financial instruments, this will be a case where there’s definitely going to be divergence. In my mind, it’s a problem,” Laux said.

“I think we had the opportunity of a lifetime,” he said with respect to convergence. “I personally think it has passed us and we’ve missed it. … I would encourage the standards setters: you don’t have to think of convergence first and foremost, but it had better be pretty high on your list because the farther we go down this road, the worse it’s going to get.”

“I’m really struggling with how we’re going to come up with a definition of a small-ticket item.”

Next, Cosper discussed lessor accounting: “In terms of the balance sheet, for Type A, you have a lease receivable and a residual asset, whereas for Type B you have the underlying asset that remains on the balance sheet. From an income statement perspective, on Type A you have profit that’s recognized on the asset that’s been derecognized and then interest income on the receivable. In terms of Type B, you have lease income that’s recognized on a straight-line basis, with the cash flow statement being the same between the two.” FASB has tried to soften the existing bright lines and make them more principles-based, Cosper said. In addition, the board has tried to align the standard with revenue recognition. Laux agreed that this was important.

Remaining FASB deliberations include the definition of a lease, separating lease
and nonlease components, incentives and direct costs, residual value guarantees, sub-leases, sale and leaseback transactions, disclosures, effective date, and transition.

Financial Instruments

Cosper first discussed impairment: “Today, some would say we have an incurred loss model, others would say we have an incurred-plus loss model. But the objective is to utilize more forward-looking information and to reduce complexity. In response to that, FASB decided to stick with the current expected credit loss model [CECL]. The IASB developed their three-bucket approach, and we each exposed our respective models last summer.”

Under the CECL model, “you measure the expected credit losses by looking at past events and taking into account current conditions, and reasonable and supportable forecasts that reflect the time-value of money,” Cosper explained, adding that there would be enhanced disclosures. Users strongly supported the model, whereas preparers generally did not. They expressed “concerns around operationality and determining the measurement attribute and looking at the life of a loan,” she said. “They were also concerned about a disconnect with how they priced the loan and the economics of lending. There was strong support for the purchase credit impaired [PCI] model.”

Uhl agreed that this was consistent with what he heard from preparers. “I get the CECL model and having the full lifetime losses from the balance-sheet perspective,” he said. “But from the income statement or the performance statement, I struggle with recognizing all those losses on day one when I know that’s not really how those losses are going to occur.”

After discussing the model with the IASB and looking at various other approaches, FASB decided to stick with the CECL model. “There are some operational concerns about understanding how you make this measurement in terms of forward-looking information,” Cosper admitted. “We realize you’re not going to be able to look out seven years. So you look at your historical information and you make adjustments based on your current conditions, and then maybe you make adjustments to that based on what you expect in the next couple of years, and then perhaps you revert to the mean. The board is also looking at this whole notion of day one loss and trying to identify whether there are certain circumstances where you shouldn’t have a day one loss. … In terms of financial assets at amortized cost, CECL should apply to loans and debt securities. For financial assets that are held at fair value [with changes in] OCI [other comprehensive income], if fair value exceeds amortized cost, then there’s no loss. If fair value is less than amortized cost, then the loss is limited to the difference. There were some accommodations made for debt securities. … They’re trying to identify situations where perhaps CECL doesn’t work perfectly and make some accommodations for that.”

“The financial crisis occurred in 2008. It’s 2014 now,” Laux noted. “There’s going to be implementation that will take at least three more years, so we’re talking about eight to ten years after the biggest financial event in our lifetimes. … I share great respect for FASB and the EITF. I don’t think that’s where the problem really is, but there’s something wrong in the system. It will probably be 10 years after the financial crisis before there will actually be a standard on impairment of securities. That’s pretty sad, in my opinion.”

Cosper replied, “As we think about the IASB’s impairment model, one of the things that we asked is whether it would make an improvement in the United States. What we found when we analyzed the IASB’s model is that, from our perspective, it didn’t look like much of an improvement. That’s why we’re not converging with the IASB on this.”

“You’re going to have to pay attention to the details and you’re going to have to really understand what’s underneath in order to implement them properly.” Day commented. “It’s the same thing for revenue recognition. There’s going to be a lot of details that we’re going to have to work through.”

Classification and Measurement

Cosper next discussed FASB’s classification and measurement of financial instruments project. The model exposed by the board, which was also exposed by the IASB, “was premised on looking at the characteristics of cash flows, whether payments were solely payments of principal and interest, and then focused on looking at what the entity’s business model was to determine whether you have a classification based on amortized cost, fair value of OCI or fair value of net income.”

The boards received negative feedback about the complexity of the proposal and the lack of benefits. As a result, FASB decided to keep the current model and focus on making modest improvements. “I do think it would have been changing one type of complexity—complexity that we know today and that we’ve dealt with—for some unknown complexity,” Day said.

“I want to give a different point of view,” Laux said. “We’re talking about the recognition and measurement of securities, but much of the discussion gets dominated by debt securities. At Microsoft, we actually have a significant portfolio of equity securities; in the exposure draft the outcome was the change in market value of equity secu-
rities would be marked to market through the income statement, not as a component of OCI. We went to FASB and showed them one quarter where our net income would have been $1 billion different, recognizing financial equity securities in the income statement versus OCI. … The real issue is: are you looking at these things holistically or is something else going on?"

Cosper admitted that the board has received mixed feedback on its latest affirmation related to equity investments. She noted, “There’s a practicability election in terms of nonmarketable equities that the board will redeliberate in the coming months, and the board also retained the fair value option.”

The board intends to look at other related topics and hopes to have a standard later this year.

Disclosure Framework

“Essentially what we’re trying to do here is figure out how we can make disclosures more effective,” Cosper said about the next topic on the agenda, FASB’s disclosure framework. “We’ve been thinking about that in terms of two initiatives. One is the board’s process for determining the disclosures that are needed, and the other is half of the companies used discretion in terms of materiality and the other half looked at relevance. Cosper summed up the results: “Those companies that applied the materiality field test reduced their disclosures on average by 8%. The ones that used relevance … decreased their disclosure notes by 24%. … We had one company that took it a step further and did its interim financial statements, and in that instance it was able to reduce its notes by 50%. As a result, the board has decided to take on looking at interim disclosures as well.”

Cosper described FASB’s next steps related to disclosures: “The board asked the staff to look at three areas of disclosure—fair value measurements, pensions, and income taxes … Our hope is that looking at effectiveness, there’s a natural reduction in disclosure.”

Laux noted that there is a discrepancy between what CEOs think is important, according to the PricewaterhouseCoopers 2014 global CEO survey, and what accountants think is important. “I would actually like for us to get into the 21st century,” he said. “While these projects are good and we have a lot of discussion about duplication of disclosure and MD&A [management’s discussion and analysis] and footnotes, we’re not even close to [the goals] we’re talking about in terms of financial reporting or transparency. Something needs to change.”

Private Company Standards

Cosper next discussed FASB’s activities in conjunction with the Private Company Council (PCC). In December 2013, the board released a decision-making framework that would act as a guide to determine when separate standards should be established for private companies. In January 2014, FASB issued two standards related to PCC initiatives: goodwill and interest rate swaps. The first, Cosper explained, “allowed for amortization of goodwill as an alternative for private com-
panies for a period not to exceed 10 years. It also allowed for a trigger-based impairment test with an election to do it either at the entity level or at the reporting unit level. It also simplified that impairment test as a single-step test comparing the fair value versus the carrying value.” The interest rate swaps standard, she continued, simplified hedge accounting for plain vanilla interest rate swaps. “It’s a little more forgiving version of the short-cut method. It allowed the option to measure the swap at settlement value and it also provided relief in terms of timing of hedge documentation.”

In March, FASB issued an alternative for applying the variable interest entity (VIE) consolidation guidance for private companies if they have certain commonly controlled leasing transactions. “You still have to apply the voting interest guidance,” Cosper said. “You don’t have to apply the VIE guidance, but you provide some disclosure.”

Lastly, FASB is working on a project related to identifiable intangible assets, specifically customer relationship intangibles, and has preagenda work related to stock compensation for equity awards and their valuation, Cosper noted.

Strauss asked whether this divergence between public and private entities has been working well. Cosper replied: “In some instances, it is a user-relevance issue. In other instances, it’s a cost-benefit issue. If there are ways to do things in a more cost-beneficial way, why wouldn’t you extend that to public companies too, if you have the same outcome? We got a little out of sync when we started the activities of the PCC. They set their own agenda, but at the same time, if it’s an issue that relates to both public and private companies, it’s an issue that should be flushed out for both at the same time in order to foster the ability to get the same solution. If it’s an issue for just private companies only, maybe it warrants the difference.” She noted as an example that the board is looking at whether goodwill impairment should be simplified for public companies.

Cosper brought up other initiatives on which the PCC is advising the board, such as going concern: “This one has been a bit of a boomerang. … We started the project to lift the going concern information that’s in the audit literature into the accounting literature, and so the board decided to define substantial doubt. They decided to define it at a higher level, a probable level. They decided that the assessment period should be one year from the date of the financial statements being issued, which is a little controversial, and they also decided on enhanced disclosures. I think the assessment period is something that we’re going to have to continue to discuss.”

Finally, FASB has conducted outreach on other areas that need to be simplified, including the presentation of cash flows.

The EITF’s Role

Cosper turned the discussion over to Day, who provided a recap on the EITF’s role: “We now are an advisory committee to FASB. … We make recommendations that the board decides whether to ratify, which they then expose and put through their normal process.”

Recent projects. Day touched on several recent EITF projects, including service concessions and unrecognized tax benefits.

Day then discussed in depth ASU 2014-04, which addresses when a creditor is considered to have taken physical possession of a residential real estate asset: “There was diversity in practice of what to do, and the EITF said that it is when you actually have a change in legal title, or a deed in lieu of legal title.”

Another issue addressed by the EITF was accounting for investments in qualified affordable housing projects [ASU 2014-01]. Day explained: “The idea is that what you’re really buying is an investment in the income tax benefits. … There was a method that we used called the effective yield to make it smooth over time; now we’ve changed that to proportional amortization. Most importantly, we’ve changed the criteria so they should apply to a much broader group.”

A third issue related to whether the federal funds rates can be a benchmark interest rate for hedge accounting [ASU 2013-10]. In the wake of the Dodd–Frank Act, “a lot of the swap market is now clearing on the federal funds rate,” Day noted, so another exception to facilitate hedge accounting was needed in the form of the federal funds rate.

Projects on the agenda. One current EITF project relates to consolidated collateralized financial entities. Another project concerns accounting for share-based payments when the award terms provide that a performance target could be achieved after the service period. Day explained: “There used to be three methods that were generally accepted in practice, and people had different views on the acceptability of all three of those methods, and we needed to get everybody on the same page. So we said we’ll account for this as a performance target.”

“We’re talking a little bit about how to account for guarantees from the government. We said that those are assets and we ought to account for them,” Day said. “Finally, push-down accounting … 1) it’s now going to be fully optional; … 2) the scope of who can push down accounting is going to be broadened; and 3) we’re going to get rid of a lot of details.”
Financial Reporting Issues for Preparers | Relationships with Auditors, Audit Committees, and Users

Panelists: Robert Laux, Robert Herz, Mark LaMonte, Allan Cohen, and Mark Bielstein
The final panel of Baruch College’s 13th Annual Financial Reporting Conference on May 1, 2014, focused on financial reporting issues commonly faced by preparers, as well as their relationships with auditors, audit committees, and users. Norman Strauss, the Ernst & Young Professor-in-Residence at Baruch College, moderated the panel.

Complexity in Financial Reporting

Strauss first asked the two panelists representing preparers—Allan Cohen, controller at NBCUniversal Media LLC, and Robert Laux, senior director of financial accounting and reporting at Microsoft Inc.—what they believe the big issues are in preparing financial statements.

“It’s really hard to define complexity in a couple of words,” Cohen replied. “We live in a very complex world, and the financial statements are trying to communicate that complexity to investors, but hopefully in a very simple and plain-English manner. Our financial pronouncements are very complex. At times, they’re probably too complex.”

“Things are complicated,” Laux agreed, “but we’re smart people. We get paid well. We can figure them out. Standards can be improved but I don’t think it’s as bad as some make it out to be.”

Speaking for users, Managing Director and Chief Credit Officer of Moody’s Mark LaMonte said, “We always want more information, but I do recognize a problem with financial statements expanding in length. What happens is that you have a lot of boilerplate information. In a set of financial statements, there might be one or two key nuggets of information that are really going to drive the decisions around an investment. With all the volume, those can get lost.”

Robert Herz, former FASB chairman and current audit committee chairman of Morgan Stanley, spoke about improving the complicated language often found in the standards: “In part, it got better because the IASB staff members were foreign and English wasn’t their first language. They seemed to take a lot more care sometimes in constructing their standards—the way they wrote—to make it understandable. I
“There’s a broader issue about the relevance and usefulness of the financial statements and the type of information that goes in there,” said KPMG partner Mark Bielstein. “There are content issues in our financial statements or the financial reporting package or the corporate reporting package, and there are also delivery and usability issues,” Herz agreed. “One of my concerns is that content-wise we’re going to fall behind in the United States in terms of a reporting system. We have a great reporting system in terms of reliability and the auditing, but we may be having a lot of enforcement and litigation over things that don’t really matter that much. I think certainly not a 21st century reporting system. And some might argue that the 20th century reporting system is just an expansion of what we had in the 19th century.”

Working with Auditors

Strauss asked the panelists to describe the characteristics that lead to a smooth audit. “I’m not quite sure if they should be smooth, given what the auditor’s responsibility is,” Laux responded. “It should be a little tough, asking tough questions. … I think it can be planned much better, but that goes for both sides. Preparers complain about auditors, but I think we could both communicate better.”

“The only thing I would add is that, from a management perspective, the company should take responsibility for the issues that come up; at NBCUniversal, we put together a memo on every single issue and we actually deliver that memo to the auditors,” Cohen said. “I think it’s about being proactive and making sure you’re communicating on a constant basis with your auditors.”

Bielstein agreed with these comments from an auditor’s perspective: “An audit is not necessarily supposed to be fun, and it is a challenging process when issues arise. Working together and making sure there’s communication between management and the auditor is obviously key.”

PCAOB Inspections and Changes to the Audit Report

Strauss next asked whether PCAOB inspections have increased the workload for auditors. “That’s the way it works,” said Laux. “The PCAOB inspection is very thorough, but some of the things that come out of it … seem like minor issues to me, but we have to document the heck out of them.”

Strauss asked the panelists what they thought about the PCAOB’s proposals to expand the audit report and name the audit partner. LaMonte replied, “Let me start with the audit partner being named issue. Quite honestly, I don’t know that it’s going to directly drive decision making. We’re not going to downgrade a company because one partner got named versus another. We don’t even do that because one firm is doing the audit versus another. … However, to the extent it focuses auditors more and improves audit quality, it certainly is beneficial. We rely on these numbers. They’re our main raw material, so anything that helps improve the quality of the underlying auditing of those
numbers is helpful.” With respect to an expanded audit report, he continued, "If it turns out to be just more boilerplate—if it isn’t content that really helps point the investor to areas of risk or disclosure that they need to look at more closely—then it isn’t helpful.”

From a preparer’s point of view, Laux said that he is a supporter of expanding the audit report, although perhaps not exactly according to the PCAOB’s proposal. He added, “I’m going to be blunt: this naming of the actual partner and signing their name is silly, in my opinion. … We have bigger and better things to do.”

“On the international front, the audit partners’ names are actually listed now,” Cohen said. “I do think people take things seriously more when their name is on something. I don’t know if it’s going to have any material change, though. People do take the audit pretty seriously right now. … In Europe, it’s happening, and it doesn’t look like it’s impacting anything either way.”

“I personally would take the view that auditors should be reporting on information provided by management,” Bielstein said. “I do think there is room for improvement in the overall reporting model and providing the auditor reporting on more information than just the basic financial statements that we have today.”

“It’s important to understand that the PCAOB proposal, right now, is trying to focus on critical audit matters from the auditor’s perspective, in terms of conducting the audit; therefore, I don’t think management is the appropriate party to comment on that,” Herz commented. “Sometimes auditors might comment on things that management is not required to disclose. One that always comes up is a significant internal control deficiency, rather than a material weakness. Right now, you don’t have to disclose individual significant deficiencies, yet there might be a significant deficiency that led to expanded audit procedures.”

Cohen replied, “But if we just continue to add another layer of information that’s not useful—if we have critical accounting policies in the MD&A [management’s discussion & analysis] section, the auditor’s report will just list those and discuss them a little bit, and then you have those same exact critical accounting policies in the footnotes—you’re not adding to the discussion.”

Audit Committees and Disclosure

The conversation turned to audit committees and their relationship with preparers. “We do have a significant role in discussing issues with the audit committee,” Cohen said. “At every audit committee meeting, the chairman turns to us and says, ‘Were there any close calls? Were there any judgments that you should discuss with us?’ … We have discussions about our financial statements, things that we’re including and not including. So I think having an active audit committee is very important.”

“My belief is that the utmost responsibility of the audit committee is to ensure transparent financial reporting to the shareholders. But I’m pretty disappointed. I don’t know if I see that discussion actually going on,” Laux said. “They are getting a ‘D’ in my book, if I had to grade them.”

Strauss asked whether there is an inherent weakness in the expectations about an audit committee, given the limited time it has and the complexity of the accounting transactions it must deal with.

“Something is wrong with the structure,” Laux agreed. “The audit committee members are inundated with detail and requirements and what’s expected of them. … And they’re not just audit committee members, they’re board members, and most of them probably are on another committee, like compensation or nomination.”

“I don’t know if I agree,” Cohen responded. “I don’t think the audit committee members have to look at the detailed subledgers to fulfill their obligations. We review financial statements with the audit committee at every single audit committee meeting, but we also review other topics. … When we’re going over the financial information, we just don’t send a 100-page set of financial statements; we actually have a memo that goes through what has changed since the last financial statement and the big judgments in those financial statements. And then we actually discuss and highlight the important issues that we focused on.”

“Some of the kind of information that Allan talked about is the kind of information we also...
get, which is very contextual and explanatory,” Herz said. “We also bring in people from the various businesses—not just the CFO of that business, but also the CEO, the one who’s running the business—to talk to us about the key business drivers and how that translates into the financial statements, and how they monitor controls or what systems they’re working on, and then we ask for the auditors’ commentary on that. … You have to make sure that the agendas are structured and the materials provided are going to enable a good understanding and discussion. … It’s hard work. The audit committee of the olden days, where you just appeared and flipped pages, doesn’t work anymore.”

The audit committee’s report, however, is just “another example of boilerplate,” LaMonte said. “One thing that isn’t necessarily being done effectively at an audit committee level is to focus strategically on disclosure. One of the big problems with disclosure is that a lot of companies take the path of least resistance. It’s easy just to throw everything in there to ensure that you’ve complied with the rules, rather than making hard choices about what’s important and how to present your disclosure in the most meaningful way in order to bring out those important issues. An audit committee could add a lot of value in helping management make some of those strategic choices around disclosure and determining what’s important—really driving management to do the hard thing.”

“What’s unusual is that we have principles-based standards, but we have rules-based disclosures,” Cohen said. “We have to figure out how to get to principles-based disclosures so that people understand what’s being disclosed in a very concise manner.”

Working with Users of Financial Statements

Strauss next asked about the relationship between audit committees and users. Cohen said that they tend to get questions through a company’s investor relations group; they put out trending information outside of the financial statements to help users understand the company.

“Users all have different views on the world; it’s hard to get a consistent answer from the financial statement user community,” LaMonte said. “But I think the boards are doing a pretty good job, particularly FASB. … The appropriate feedback is being sought from the user community. How that gets distilled is challenging.”

Strauss asked whether putting leases on the balance sheet is a good thing for FASB to be doing. “Most financial statement users are already putting leases on the balance sheet today,” LaMonte replied. “It’s debatable whether we need FASB and the IASB to do that for us. The path they’re going down may make our lives more difficult, because different users have different approaches to what they want on the balance sheet for leases, and we’re probably going to adjust on top of what FASB and the IASB put on the balance sheet.”

“Maybe what’s been proposed to put on the balance sheet is not an accurate representation,” Laux said, “but the argument of using disclosure to figure out what the financial obligation is is a very blunt-force instrument. … I don’t quibble with the way FASB or the IASB is going about it … [but] I struggle with the concept that people can use this disclosure to come up with the number.”

“We spent years developing a very complex model to do this,” LaMonte replied. “It’s a fairly common convention to take rent expense and multiply it by something; it’s blunt, but it serves our purpose. The models are calibrated to that and it works.”

Strauss noted that there’s a longstanding perception that users always want more information and management would
always rather disclose less. LaMonte agreed that it is a problem: “We do always want more, more, more, but at the same time, we want less, less, less. We want more of the right stuff and less of the noise. The problem is we’ve been getting more of the noise, and it’s making it harder to find the right things. There needs to be a balance where you don’t need everything for every company; you need those things that are important to a particular company or industry. Do I need a 10-page pension disclosure in Citibank’s financial statements? No. Do I need a very detailed financial disclosure in that set of financial statements? Absolutely. For General Motors, I probably need that 10-page pension disclosure because it really drives what happens with that company. It isn’t a one-size-fits-all model out there, but unfortunately a lot of the disclosure requirements are.”

“I do find that when you ask users do they want certain information, they’ll always say, yes,” Cohen said. “I do think it’s up to us to help explain what the implications are of what they’re getting and make sure that we are communicating the right message when we put something in financial statements.”

“One thing I wanted to add from the preparer side,” Laux commented, “is that you have to keep in mind that there’s an agency issue: management doesn’t own the company; the shareholders own the company. … The academic literature would tell you over and over again that the more transparent you are, the lower your cost of capital is in the long term. The academic literature is weighted to one side, but businesses don’t believe that, and I’m not sure why. My major point is: can we get above this discussion? It’s the same discussion we’ve had for 30 years.”

“It gets back to complexity—are there some things we could actually do?,” Cohen said. “Let’s say, taking out the ratio of earnings to fixed charges. I don’t know how many people actually look at that and use it for any valuable information. Recently, there have been close to 80 letters that have gone to FASB to try to reduce complexity, and there are some quick hits that FASB and the SEC could probably do to reduce complexity. As you reduce complexity, hopefully you’ll make financial statements a little bit clearer.”

“There are other sources of complexity,” Bielstein added, “where the principles and the concepts of the standards aren’t clear, and as a result, you really can’t answer a question on an accounting matter unless it’s specifically written in a rule somewhere. I think we find those kinds of questions around what’s debt and what’s equity. That’s probably one of the biggest areas that I see a need for principles to be developed. … For financial instruments, we don’t want fair value apparently, so we have all kinds of classification and measurement rules. … I think we’ll see the same thing around the lease accounting, with different models for different types of leases. Some of that complexity results from things that FASB’s constituents have asked for, so we need to recognize that some of this is our own doing.”

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Levels of Assurance under the SSAEs

A Quick Reference Guide

By Joyce C. Lambert

CPAs perform many services beyond the audit of financial statements under a general-purpose framework (such as GAAP or IFRS) or the audit of financial statements under special-purpose frameworks (such as cash, tax, regulatory, or contractual bases). This discussion will review the services and summarize the levels of assurance for services under the Statements of Standards for Attest Engagements (SSAE).

Attestation Engagements

Guidance issued by the Auditing Standards Board (ASB) covers a broad range of attestation services. An attest engagement is defined as occurring when a CPA is engaged to issue an examination, review, or agreed-upon procedures report on any subject matter (or an assertion about the subject matter) that is the responsibility of another party. Attest engagements include prospective financial statements, performance measurements, break-even analyses, human resources practices, compliance with laws or regulations, internal control processes, physical characteristics (such as square footage), and historical events (such as prices of items on a certain date). Services not included under the SSAEs include those covered by Statements on Auditing Standards (SAS), Statements on Standards for Accounting and Review Services.
Attestation Standards

Attestation standards are similar to auditing standards; they contain general, fieldwork, and reporting standards. General standards cover training and proficiency, adequate knowledge of the subject matter, objective criteria available to users, independence, and due professional care. Independence is required for all attestation services. The ED requires independence for attest engagements, except when the law or regulations require a CPA to accept an engagement and report on the subject matter or assertion (para. 1.24). In these situations, a CPA should disclaim an opinion and state the lack of independence. Although disclosure of the reasons for a lack of independence is not mandatory, all reasons must be given if a CPA does choose to disclose. CPAs must follow the ethics rules on independence when performing attestation engagements. The ethics rules prohibiting commissions and contingent fees for attest clients must also be followed.

Only two fieldwork standards exist. The first requires that the engagement be properly planned and assistants be supervised. The second requires that sufficient evidence be collected to provide a reasonable basis for the conclusion given in the attestation report.

Four reporting standards are required when a report is issued. A CPA must identify the assertion and describe the character of the work performed, conclude whether the assertion conforms to the criteria, and state all significant reservations.

Finally, the report is considered limited if the service is agreed-upon procedures, if the written assertion from the responsible party is not provided, or if the criteria are available to or appropriate for only a limited number of parties.

Written Assertion

A CPA may report on a written assertion or directly on the subject matter itself. A CPA should not be the responsible party. If there is no written assertion, a CPA may report on the subject matter directly, as long as this report is restricted. The ED requires a written assertion when performing an examination or a review (para. 2.8). It does not allow restricting the report on an examination or a review to compensate for the lack of a written assertion (p. 5).

When the client is the responsible party and a written assertion cannot be obtained, the CPA should modify the report as a scope limitation. The CPA should withdraw if the service is a review and the client who is the responsible party will not provide a written assertion, or if the CPA is unable to perform inquiry and analytical procedures.

Written Representation Letter

For attest services, a CPA should obtain a written representation letter from the responsible party. If the client refuses, then the CPA should consider whether to perform the service. If the CPA decides that the representation letter is necessary, then the absence of this letter is a scope limitation. The CPA should withdraw if the service is an examination and no representation letter is obtained, then the CPA should disclaim an opinion or withdraw from the engagement. But a qualified opinion is possible. If service is a review and no representation letter is obtained, then the CPA should withdraw.

The ED requires a written representation letter for an examination or a review. If the client is the responsible party and such representation is not provided for an examination, and the CPA has sufficient doubt about the client’s competence or integrity, this scope limitation prevents the CPA from providing a clean opinion. This situation may cause the CPA to withdraw from the engagement (paras. 2.45 and 2.A63). Similar considerations exist when the service is a review.

If the client is the responsible party and will not provide such representation, the CPA should take the appropriate action (para. 3.36), presumably withdrawal.

If the client is not the responsible party, the CPA should request such representation from the responsible party. If the written representations are not provided in writing, but the CPA is able to obtain satisfactory oral evidence to form an opinion, an alert paragraph should be added that restricts the use of the examination or review report to the client who engaged the CPA (para. ED 2.46). If the CPA cannot obtain written or oral representation from the responsible party, this situation is a scope limitation. The CPA should consider the implications on the report (para. 2.46). Similar considerations exist when the service is a review. If the client is not the responsible party and will not provide such written or oral representations, then this situation constitutes a scope limitation and the CPA should withdraw (para. 3.37).
Services and Levels of Assurance

The services allowed under the attestation standards are examination, reviews, and agreed-upon procedures. The levels of assurance are shown in Exhibit 1.

Examinations. An examination is the most comprehensive service that a CPA can perform. In an examination, the CPA provides an opinion on whether the subject matter is in conformity with the criteria or if the assertion is fairly stated with the criteria in all material respects.

Reviews. A review is substantially more limited in scope than an examination. In a review, the CPA gives a moderate level of assurance based upon the inquiries and analytical procedures applied to the data. In a review, the conclusion is negatively worded, such as “nothing came to our attention that caused us to believe that the subject matter is not presented, in all material respects, in conformity with the criteria.” In a review, however, material modifications will be described in the report.

Agreed-upon procedures. Agreed-upon procedures are the lowest level of attestation services. The CPA is not performing enough procedures in order to give an opinion on the service as an examination. As such, the level of assurance for agreed-upon procedures is a disclaimer of opinion. The CPA may obtain a representation letter from the responsible party. Agreement is reached on how many items are to be selected. The report names the agreed-upon parties, lists the procedures done, gives the findings that agree (or do not agree) with the attributes performed, and gives a disclaimer on the item. Examples of agreed-upon procedures are the inspection of documents for certain attributes; sampling items; confirmation of information with third parties; comparison of documents or analyses; mathematical computations; and performance of procedures on work done by others, such as internal auditors.

Other Considerations: Financial Forecasts and Projections

Prospective financial statements are forward-looking statements. Projections are various “what if” scenarios under different assumptions. A projection is the most likely combination of projected events. Because prospective financial statements are forward-looking, the assumptions are critical for the user to understand the results. If the assumptions are not attached, a CPA is not permitted to report on forecasts or projections. In addition, a CPA cannot vouch for the achievability of the forecast or projection. The report contains language to the effect that actual outcomes are likely to vary from forecasted or projected amounts and that the CPA has no responsibility to update for changes after the date of the report.

Users of prospective financial statements may be limited third parties or general third parties. Limited third parties are parties that can negotiate with the client. Limited third parties can ask questions of the client and obtain answers to their questions, such as banks or regulatory agencies. General third parties are the general public, whereas limited third parties can receive either forecasts or projections. General third parties cannot receive projections only, because the public might not understand why there are so many variations of the entity’s financial statements; however, general third parties can receive projections if a forecast is included.

The services allowed for forecasts and projections are examinations, agreed-upon procedures, and compilations. Compilations are not technically one of the attestation services; however, the original standard on prospective financial statements that permitted compilations predated the establishment of the attestation standards, and the standard was brought under the attestation standards umbrella.

Pro Forma Financial Information

CPAs may perform an examination or review of pro forma financial information; these financial statements should be labeled “pro forma.” Common examples of pro forma information are business combinations, changes in capitalization, sales of a significant portion of the business, changes in the form of a business entity, and proposed sales of securities and use of the proceeds. CPAs should obtain a written representation from management.

Examination of an Entity’s Internal Control Over Financial Reporting with a Financial Statement Audit

This service is the parallel of the PCAOB’s audit of internal controls of an SEC registrant under section 404 of the Sarbanes-Oxley Act of 2002. A CPA may perform an examination of an entity’s internal control over financial reporting with a financial statement audit if management accepts responsibility for the effectiveness of internal control, evaluates internal control, shows support for its assertion of effectiveness, and provides an assertion about the effectiveness of internal control. If management refuses to provide this written assertion on effectiveness, the CPA should withdraw from the engagement. If withdrawal is not permitted by law or regulation, then the CPA should disclaim an opinion.

When performing an examination, the CPA is looking for indications of material weaknesses, such as fraud or a material misstatement in the financial statements that was not initially identified by the client’s internal control and that would not have been detected during its review process. A material weakness results in an adverse opinion.

Compliance Attestation

A CPA may perform an examination or agreed-upon procedures as a compliance attestation. Examples of compliance attestations are an entity’s compliance with specific requirements of laws, regulations, rules, contracts, or grants, as well as an entity’s internal control compliance with specific requirements, such as compliance with procedures (not compliance with internal control over financial reporting). Compliance attestation is not compliance with respect to a financial statement dollar amount, such as sales or accounts receivable, which is covered under the auditing standards (AU-C 805, “Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement”).

EXHIBIT 1
Levels of Assurance

<table>
<thead>
<tr>
<th>Attestation Service</th>
<th>Highest Level of Assurance</th>
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</thead>
<tbody>
<tr>
<td>Examination</td>
<td>Opinion</td>
</tr>
<tr>
<td>Review</td>
<td>Negative Assurance</td>
</tr>
<tr>
<td>Agreed-Upon Procedures</td>
<td>Disclaimer</td>
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JULY 2014 / THE CPA JOURNAL
The responsible party identifies compliance requirements; establishes and maintains internal control; evaluates and monitors compliance; and specifies that the entity satisfies the legal, regulatory, or contractual requirements. The responsible party provides a written assertion on the entity’s compliance. If the responsible party refuses to provide this written assertion, then the CPA should withdraw from the engagement. If withdrawal is not allowed by law or regulation, the CPA should disclaim an opinion, unless the CPA has evidence that an adverse opinion is appropriate. When performing agreed-upon procedures, if the responsible party is not the client, the CPA is not required to withdraw. But the CPA should consider the refusal by the responsible party to provide a written assertion when deciding whether to accept the engagement or to provide a report on the engagement.

When performing an examination, the CPA considers attestation risk. Attestation risk is the product of inherent risk, control risk, and detection risk. If no material instances of noncompliance are present, the CPA expresses a positive opinion on compliance. If material instances of noncompliance are found, the CPA expresses a qualified or adverse opinion. When performing agreed-upon procedures, the CPA disclaims an opinion, because unlike in an examination, he has not performed enough procedures in order to express an opinion.

Management’s Discussion and Analysis
Public companies are required to prepare a management’s discussion and analysis (MD&A). A nonpublic company may prepare an MD&A using the SEC’s rules. A CPA may perform an examination or a review of the MD&A, provided that the CPA has audited the financial statements for the latest period to which the MD&A relates and the CPA or a predecessor auditor has audited the prior years. If a nonpublic company’s management provides a written assertion that the MD&A is prepared using the SEC’s rules, then the CPA may perform an examination or a review of the MD&A. A written representation letter from management should be obtained. The distribution of a review report is limited to specified parties.

Reporting on Controls at a Service Organization
A business may outsource the processing of their transactions to a third party. When a CPA audits such an entity’s financial statements, the CPA needs to obtain an opinion on the internal control over financial reporting at that service organization. If the controls are effective, the service organization may receive a positive opinion when its CPA performs an examination of the internal control over financial reporting. A written assertion from management on its controls is required. If management refuses to provide the written representation, then the CPA should consider its effect on the integrity of management and on the reliability of any representation by management, and should consider disclaiming an opinion or withdrawing from the engagement.

A Quick Reference
Exhibit 2 summarizes the various attest engagements and their corresponding highest levels of assurance, presenting an overview of the SSAE guidance. As with any summary, CPAs should refer to the standards directly for all ramifications of the various situations that may occur. The profession has many standards, such as SASs, SSARSs, SSAEs, and PCAOB standards. This chart provides a tool for CPAs to understand the place of SSAEs within the framework of applicable professional standards.

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Cost Recovery Issues Involving the Acquisition of Open-Air and Prefabricated Structures

By Mark A. Segal and Bruce M. Bird

Over time, some taxpayers might encounter cost recovery issues involving the acquisition of certain types of structures. In most situations, the acquisition of open-air or prefabricated structures occurs pursuant to the acquisition of nonresidential real property. When acquiring a depreciable structure, a taxpayer’s goal is typically to “shorten” the time period during which cost recovery will occur for some or all of the total acquisition cost involved. The difference in depreciation expense in each of the early years of such a structure’s useful life can, in many situations, provide a taxpayer with a significant deferral of tax liability.

Depreciation of Nonresidential Real Property

Nonresidential real property is defined as Internal Revenue Code (IRC) section 1250 property, other than 1) residential rental property, or 2) property with a class life less than 27.5 years [IRC section 168(e)(2)(B)]. Class lives are contained in Revenue Procedure 87-56. Under the modified accelerated cost recovery system (MACRS), depreciable nonresidential real property placed into service after May 12, 1993, is generally subject to a 39-year cost recovery period, using the straight-line method and midmonth convention [IRC section 168(c)].

Real Property under IRC Section 1250

Treasury Regulations section 1.1250-1(e)(3) defines “real property” by a process of exclusion. Real property is any property that is not personal property under Treasury Regulations section 1.1245-3(b). This regulation then refers to the definition of property qualifying for the investment tax credit under the old investment tax credit rules. Basically, personal property is tangible property other than land and improvements thereto.

Accordingly, buildings and other so-called “inherently permanent” structures, along with their related structural components, will typically be treated as IRC section 1250 property. In addition, an inherently permanent structure or its components qualifying as a land improvement will typically be treated as IRC section 1250 property. In a few situations, however, real property can qualify as “IRC section 1245 real property.”

For example, certain single-purpose agricultural or horticultural structures are treated as section 1245 real property.

Depreciating Structures and Buildings

Typically, if a structure is a nonresidential building, it will be depreciated over 39 years. (Under MACRS, a residential building will typically be depreciated over 27.5 years using the straight-line method and midmonth convention.) Sometimes, tax professionals might question when a structure is a building. In general, it will be classified as a building for depreciation purposes if it meets both the inherently permanent and appearance and function tests (discussed later).

If the structure is not a building, then it will usually be either a land improvement or IRC section 1245 personal property. When a taxpayer acquires in a “basket purchase” a building and a structure that is not a building, the services of an appraiser should be procured in order to determine the fair market value of each depreciable asset acquired. The total acquisition cost will then be allocated, using the relative fair market value method, between the building and structure that is not a building.

If an asset is considered to be a land improvement not specifically included in another asset class and is otherwise depreciable, it will typically be depreciable over 15 years. (See Revenue Procedure 87-56; such land improvements are categorized as Asset Class 00.3.) Under MACRS, the depreciation of a land improvement is generally taken pursuant to the 150% declining-balance method. Examples of land improvements under Revenue Procedure 87-56 include “sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in class 51), wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers”; however, examples of such assets do not include “land improvements that are...
explicitly included in any other class, and buildings and structural components as defined in section 1.48-1(e) of the regulations." In a few situations, Revenue Procedure 87-56 will assign the land improvement to a different asset class requiring a shorter recovery period; thus, the business activity in which the taxpayer is engaged may have an effect upon the depreciable life of the improvement for the purposes of applying Revenue Procedure 87-56.

Where an asset is classified as a land improvement rather than as depreciable real property, the difference in depreciation expense in each of the early years of such asset’s life can be significant. For example, consider a taxpayer who bought an existing property consisting of a real estate lot (nondepreciable property), a commercial office building (nonresidential real property), and a parking lot (land improvement) for a total of $1.36 million. A qualified appraiser, using the relative fair market value method to allocate cost, determined the cost of the land to be $200,000; office building, $1.1 million; and parking lot, $60,000.

The taxpayer placed the office building in service on April 29, 2013. The taxpayer placed no other depreciable assets in service during 2013. The depreciation for 2013 (Year 1) would be as follows:

- Land Improvement: $3,000 (Land improvement will be treated as 15-year property using MACRS table depreciation with half-year convention. Depreciation: $60,000 × 5% = $3,000.)
- Commercial Office: $19,979 (Commercial real estate will be treated as 39-year property using MACRS, straight-line method, and midmonth convention. Depreciation: ($1,100,000 ÷ 39) × (8.5 ÷ 12) = $19,979.)

The depreciation for 2014 (Year 2) would be as follows:

- Land Improvement: $5,700 (Depreciation: $60,000 × 9.5% = $5,700)
- Commercial Office: $28,205 (Depreciation: $1,100,000 ÷ 39 ÷ 2 = $28,205).

The above example illustrates the notion that, in the early years of an asset’s life, a land improvement is depreciated at a faster rate than the nonresidential real property. In Year 1, taking into account the half-year convention, 5% of the land improvement cost will be recovered; the recovery percentage for the nonresidential depreciable real property will be approximately 1.8162%. In Year 2, 9.5% of the land improvement cost will be recovered; the recovery percentage for the nonresidential depreciable real property will be approximately 2.564%. The increase in tax expense by depreciating the cost of a land improvement over a shorter life than the cost of real estate will work to decrease the taxpayer’s taxable income in the early years of the land improvement’s depreciable life. It will also defer the taxpayer’s tax liability until a later year (or years) and, using the principles of time value of money, may ultimately result in significant tax savings.

Against this backdrop, a basket purchase of nonresidential real property that contains open-air or prefabricated structures can pose a number of thorny cost recovery issues. In many situations, the issue involves the question of whether the structure is a building.

Open-Air Structures

Open-air structures are used in a variety of trades and businesses. The steel industry, for example, features structures that house interior, overhead magnetic cranes for purposes of moving slabs of steel. Typically, the structure itself is large, rectangular, and “covered with metal or other relatively cheap siding, but having large doors, roof ventilators, and other openings” [Field Service Advice (FSA) Memo 0536, IRS, Aug. 6, 1992]. Typically, the cranes “consist of two steel rails mounted atop steel columns along the sides of the structure and running the length of the structure. A steel bridge spanning the width of the structure is attached to steel wheels that sit on the rails so that the bridge can move up and down the length of the structure” (IRS 1992).

In Lukens Inc. v. Comm’r (TC Memo 1987-464) and Barrenechea v. Comm’r (TC Memo 1990-471), the Tax Court held that the structures that housed the cranes at issue constituted personal property qualifying for the investment tax credit under prior law. In these two decisions, the Tax Court classified the open-air structures as personal property and not as buildings. In addition, the IRS announced in FSA Memo 0536 that it would not litigate this issue again in the context of structures that house overhead traveling cranes.

Another type of open-air structure that has attracted IRS scrutiny is the stand-alone parking garage. In a 2009 Coordinated Issue Paper (CIP), the IRS adopted the position that a stand-alone open-air parking structure constitutes depreciable real property (see LMSB4-0709-029). Unlike land improvements, which are associated with the ground but nothing more (e.g., fences, sidewalks, roads, landscaping), buildings or structures meet distinct function and appearance tests. According to the CIP, the appearance test under Treasury Regulations section 1.48-1(e)(1) requires that the property be a “structure or edifice enclosing a space within its walls, and usually covered by a roof”—in other words, the property must look like a building. Moreover, the function test requires the property “to provide shelter or housing, or to provide working office, parking, display or sales space.”

The CIP refutes two arguments often made by taxpayers when asserting that an open-air structure is a land improvement: 1) open-air structures do not provide workspace or shelter and, as a result, do not pass the function test, and 2) in any event, open-air structures do not pass the appearance test. With regard to the latter, taxpayers contend that stand-alone open-air parking structures do not contain walls or a roof for the specific purpose of sheltering people or vehicles, remain open to the elements, and do not have many of the structural components of a building (or do not share structural supporting elements with a building).

Citing Treasury Regulations section 1.48-1(e), the IRS asserted that “working, office, parking, display or sales space” is sufficient to meet the function test and that the provision of parking space meets such standard. With respect to the appearance test, the CIP noted the following:

- Each parking level (other than the top level) acts as both a ceiling and floor. By this, it is meant that each parking level is a ceiling for the floor beneath it and a floor for the level above it. The top level functions as a roof.
- There are walls for each parking level.
- The presence of walls and floors means that each level is not totally vulnerable to the elements. It is not critical for a structure to have a mechanical means of heating and cooling.
- The structure has elevators, fire extinguishers, and sprinkler systems, along with wiring and lighting fixtures. Each of these items is associated with a structure.
The longevity of such a parking structure is comparable to those of other structures or buildings—that is, in the range of 25–40 years.

“For depreciation purposes, the term building is given its commonly accepted meaning,” according to Treasury Regulations section 1.48-1(e)(1). “The term includes, for example, structures such as apartment houses, factories and office buildings, warehouses, barns, garages, railway or bus stations, and stores.” In the IRS’s opinion, no reasonable argument can be made for the proposition that a garage is not a building. Taxpayers asserting such an argument may be subject to a negligence penalty pursuant to IRC section 6662. The CIP indicates that the mere fact the taxpayer may have consulted a tax professional for advice, and such professional supported the alleged position taken by the taxpayer, is not, by itself, sufficient to show reasonable cause and good faith to defend against a negligence penalty.

Prefabricated Structures

The phrase “prefabricated structure” can mean many things. To some, it means “made in a factory.” A mobile home used as a temporary office building is an example of a prefabricated structure. Some factories produce airplane hangars, storage facilities, and other structures. Often, prefabricated structures take days or even weeks of on-site assembly prior to being placed in service; some of these are moveable, whereas others are not. To further complicate matters, some moveable structures are either never moved or cannot be moved without incurring substantial additional costs.

If the prefabricated structure is moveable, then it is probably not inherently permanent in nature. Such property typically will be treated as IRC section 1245 property. In Fox Photo Inc. v. Comm’r (TC Memo 1990-348), the taxpayer attached prefabricated one-hour photo labs to concrete pads on commercial lots. If necessary, the prefabricated structures could be removed and relocated by using a flatbed truck over the course of two to three days. The taxpayer did move some of the prefabricated structures from their existing locations and relocated them to new sites; it cost the taxpayer less money to remove and relocate these existing structures than to buy new ones. Given these facts, the Tax Court held the prefabricated structures to be IRC section 1245 property.

Filmm N’Photos Inc. v. Comm’r (TC Memo 1978-162) involved a movable, prefabricated photo-processing hut and the concrete base to which it was attached. The property at issue in Filmm N’Photos was smaller than the property at issue in Fox Photo. The process of loading the photo-processing hut and attached concrete base onto a trailer could occur in less than one hour and did not require the unit’s disassembly. Accordingly, the Tax Court classified the entire unit as personal property.

The fact that a prefabricated structure can be moved does not necessarily preclude it from being inherently permanent for purposes of satisfying the tests for being classified as a building. In L.L. Bean Inc. v. Comm’r (TC Memo 1997-175, aff’d 145 F.3d 53 (1st Cir., 1998)), the taxpayer built a storage warehouse measuring, 500’ by 190’ by 57’. L.L. Bean presented evidence at trial that another taxpayer in the book-printing industry had, in fact, moved a similar structure.

The court noted that L.L. Bean had specially designed its storage warehouse to be an addition to its existing distribution center, and, given “improbability and expense” of the storage structure’s relocation, found it to be inherently permanent in nature and subject to being depreciated as nonresidential real property.

J. McManus v. Comm’r involved a prefabricated airplane hangar that the taxpayer claimed could be disassembled and reassembled by four workers in less than two weeks [863 F.2d 491 (CA7). JFM Inc., TC Memo 1994-239 (1994)]. The court found the structure to be inherently permanent. The court also held that the structure had both the appearance and function of a building. Although most courts require the structure involved to satisfy both the inherently permanent test and the appearance and function test to be classified as a building, the court in J. McManus apparently did not find this necessary.

Sometimes the structure involved is not a building, but the depreciable life of the structure itself is in dispute. This might occur because the cost recovery rules contained in the various sources of the tax law are many and varied. At times, they do not appear to work well together. By way of example, although an improvement is typically depreciated over 15 years, if a prefabricated structure is in the nature of IRC section 1245 property, then it will typically be treated as IRC section 1245 property; however, Revenue Procedure 87-56 also contains rules that list how certain items are to be treated in situations involving taxpayers engaged in certain activities.

In PDV America v. Comm’r (TC Memo 2004-118), the taxpayer placed steel petroleum storage tanks in service. The taxpayer categorized the storage tanks under Asset Class 57.0 as IRC section 1245 property used to market petroleum and petroleum products. The IRS took the position that the storage containers should have been categorized under Asset Class 57.1 as land improvements. This category specifically includes land improvements used in marketing petroleum and petroleum products. The Tax Court held that the storage tanks, although large and heavy, were not inherently permanent, precluding IRC section 1245 status. Accordingly, the Tax Court ruled in favor of the taxpayer.

Practical Advice

Tax professionals sometimes find it difficult to classify certain assets for purposes of calculating depreciation. Whenever a structure is acquired in connection with the acquisition of nonresidential real property, an analysis of the facts and circumstances of the acquisition, along with the relevant sources of the tax law, is highly advisable.

To the uninitiated, it might seem a bit odd that a parking lot owned and placed in service by a taxpayer will typically be depreciated over a 15-year period, whereas an open-air, multilevel parking garage owned and placed in service by that same taxpayer will typically be depreciated over a 39-year period. Accordingly, when it comes to open-air or prefabricated structures, a taxpayer is well advised to obtain a favorable ruling from the IRS before proceeding to depreciate such property.

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On June 26, 2013, the U.S. Supreme Court struck down section 3 of the Defense of Marriage Act (DOMA), finding that it violated the equal protection clause of the Fifth Amendment of the U.S. Constitution, as applied to same-sex couples who were legally married in states that permitted such marriages [United States v. Windsor, 133 S. Ct. 2675 (2013)]. The ruling is significant for same-sex married couples, who were denied federal tax benefits previously only available to couples in opposite-sex marriages, per Revenue Ruling 2013-17. (The Windsor ruling does not apply to registered domestic partnerships, civil unions, or similar formal relationships recognized under state law.)

Such benefits include, but are not limited to, income tax benefits, estate and gift tax benefits, and employee tax benefits. For example, as more fully explained below, prior to Windsor, same-sex married couples were not permitted to file a joint tax return; rather, individual same-sex spouses could only file either as single or, if they had children, as head of household. Furthermore, if the partners had a qualifying child, only one of the taxpayers could claim the child as a dependent and receive
the benefit of the dependency exemption. In addition, tax benefits that flowed from jointly owned property (e.g., real estate taxes and the home mortgage interest deduction) had to be allocated between spouses in same-sex marriages and claimed on separate tax returns.

Same-sex couples must now also confront certain negative tax ramifications of the Windsor decision. The benefits of filing a joint return might not always be greater than filing as single or as head of household. Couples with similar incomes often pay a “marriage penalty,” with their tax liability as a couple being higher than it would be if filing as single or head of household. Couples previously denied joint return status must determine the effect of filing joint returns both for future tax years and for previously filed tax years that are still open within the statute of limitations on refund claims. Because spouses in same-sex marriages are not obligated to file amended joint returns, same-sex couples and their tax advisors must consider how a change in filing status will affect previously filed returns.

The purpose of this article is to identify and examine the changes in the federal tax laws following the Windsor decision that will affect same-sex couples in complying with and planning under federal tax laws. Other available federal benefits, including those under Social Security, immigration, the Family and Medical Leave Act, and qualified retirement plans, are outside the scope of this article.

Place of Celebration Approach

In response to the Windsor ruling, the IRS issued Revenue Ruling 2013-17 (2013-38 IRB 201), which explains that the IRS will use a “place of celebration” approach, rather than a “place of domicile” approach, in determining whether same-sex couples are married for federal income tax purposes. [See Revenue Ruling 58-66 (1958-1 C.B. 60); the IRS previously used a “place of celebration” approach it had applied for common law marriages.]

The place of celebration approach looks to whether same-sex couples were married in a state that recognizes same-sex marriages. If a couple was married in a state that recognizes same-sex marriages, the couple will be treated as married for federal tax purposes, even if the state where they are domiciled does not recognize same-sex marriages. With regard to the place of celebration approach, Revenue Ruling 2013-17 states the following:

For federal tax purposes, the Service has a general rule recognizing a marriage of same-sex individuals that was validly entered into in a domestic or foreign jurisdiction whose laws authorize the marriage of two individuals of the same sex even if the married couple resides in a domestic or foreign jurisdiction that does not recognize the validity of same-sex marriages. (See also “FAQ for Individuals of the Same Sex Who Are Married under State Law,” Q3, IRS, Sep. 19, 2013.)

States Recognizing Same-Sex Marriage

Exhibit 1 lists the states that currently recognize same-sex marriage, as of this writing. Since the Windsor decision, seven states have legalized same-sex marriage (two by state legislative action, five as a result of court decisions). Same-sex marriages became legal in the following states at the end of 2013: New Jersey, Hawaii, and New Mexico. In 2014, courts ruled in Oregon, Pennsylvania, and Wisconsin that same-sex marriages were legal (the Wisconsin ruling on the effective date of marriages is still pending). On June 1, 2014, same-sex marriages became legal in the State of Illinois. Same-sex marriage cases are pending in courts throughout the country, or awaiting appeals, in the following states: Arkansas, Idaho, Kentucky, Michigan, Oklahoma, Tennessee, Texas, Utah, and Virginia. As of this writing, recognition of same-sex marriage is a very fluid issue that is changing in states across the country.

Per Revenue Ruling 2013-17, beginning on September 16, 2013, and for all tax years thereafter, same-sex couples are required to file their original federal income tax returns as either married filing jointly or as married filing separately. This includes spouses in same-sex marriages on extension who have not filed their federal 2012 returns. Such taxpayers are required to file using a married status on or after September 16, 2013. The Internal Revenue Code [IRC section 7703(a)(1)] considers a person’s marital status as of December 31; if a person is married on December 31 of a particular tax year, they are considered married for the entire tax year.

As for previously filed tax years, same-sex couples who were considered legally married in 2010, 2011, or 2012 may elect to amend their previously filed income tax returns to claim a refund for taxes previously paid. (If protective refund claims were previously filed for these, or prior, tax years, taxpayers should discuss this with their advisors. Protective refund claims are discussed below.) A refund claim must be filed before the expiration of the statutory refund claim period, which is the later of three years from the time the return was filed or two years from the time the tax was paid. If the refund claim is filed within three years after the date the return was filed, the credit or refund may not exceed the part of the tax paid within those three years, plus any filing extensions, before the claim is filed. If the taxpayer did not file a return, a refund claim must be filed within two years after the tax was paid [IRC section 6511(a)]. A separate refund claim must be filed for each tax year and each type of tax for which a taxpayer seeks a refund. As discussed above, Revenue Ruling 2013-17 does not require same-sex married couples to amend their tax returns; it only provides the availability to file a refund claim if the couple was married in any of the three years prior to 2013. Exhibit 2 summarizes how legally married same-sex couples can handle prospectively and previously filed tax returns.
The Option of Amending Previously Filed Tax Returns

Same-sex married couples should consider amending a previously filed federal tax return, provided that they were legally married during a tax year that is still open under the statute of limitations (generally, 2010, 2011, and 2012) and if they will realize a tax refund by so amending. Per Revenue Ruling 2013-17, taxpayers are not required to amend previously filed returns to change their filing status; thus, they should only do so if the change would provide a tax benefit.

Taxpayers affected by Windsor may also want to consider filing a protective refund claim for taxes previously paid, pending further guidance from the IRS. For example, Revenue Ruling 2013-17 only briefly discusses the estate and gift tax ramifications from the Windsor decision, leaving uncertainty as to its application to same-sex married couples. If a taxpayer believes that she would be entitled to a refund for gift taxes paid, or her deceased spouse would be entitled to a refund for estate taxes paid, she might want to file a protective claim to preserve her right to amend a previously filed estate/gift tax return.

A protective refund claim is filed for a taxpayer when there is current litigation that will not be resolved, or expected changes in the tax law that will not occur, until the statute of limitations for filing an accurate amended return has expired. A protective claim can be submitted as either a formal written claim or as an amended return for credit or refund [IRS Publication 556, “Examination of Returns, Appeal Rights, and Claims for Refund,” p. 14 (2008)]. In situations where the statute of limitations is about to expire for a particular tax return, a married same-sex couple should consider filing a protective claim for a refund with the IRS in order to preserve the ability to obtain such a refund. In determining whether to file a protective refund claim, taxpayers should keep in mind that once the statute of limitations has expired, they will be prevented from ever seeking a refund claim for those tax years.

Revenue Ruling 2013-17 provides that if same-sex spouses amend their returns, “all items required to be reported on the return or claim that are affected by the marital status of the taxpayer must be adjusted to be consistent with the marital status reported on the return or claim.” Therefore, before deciding to file a protective claim, the same-sex married couple and their tax preparer must ensure that filing a joint return will be truly beneficial.

The following addresses both the advantages and disadvantages that same-sex couples should consider prior to filing amended returns.

Marriage penalty possibilities. When same-sex married couples consider amending their previously filed returns, they should be aware that there are situations where filing separately as “single” taxpayers might result in less tax due. The marriage penalty refers to the imposition of higher taxes on certain married couples that file jointly as compared with two otherwise identical taxpayers filing singly and reporting the same combined income. Tax advisors must determine if it is more advantageous for the same-sex married couple to leave the previously “single” return alone, or amend the return and file jointly.

As mentioned previously, a greater disparity of income between the spouses generally leads to a greater benefit from filing jointly. For example, in 2012, an unmarried couple where each individual had a taxable income of $80,000 was subject to a maximum tax rate of 25%; however, if the same couple were married filing jointly or married filing separately, the combined taxable income of $160,000 would be subject to a maximum tax rate of 28%.

Employer-provided health insurance coverage. Married couples are eligible for many tax breaks and benefits. For example, a taxpayer can include his spouse on their coverage if the spouse receives medical coverage through the employer; such monthly premiums are not considered taxable income. Such monthly premiums are taxable for unmarried domestic partners.

Prior to Revenue Ruling 2013-17, companies that provided health insurance plans which allowed employees to include their same-sex spouse in their health plan had to impute income to the employee for federal income tax purposes equal to the fair market value of the health coverage provided to the same-sex spouse. In addition, employers who provided healthcare coverage to employees and their opposite-sex spouses on a pre-tax basis were required to treat the same coverage to a same-sex couple’s spouse on an after-tax basis. Revenue Ruling 2013-17 provides that any employee who purchased healthcare coverage on an after-tax basis for their same-sex spouse during a period in which the statute of limitations is open may file a claim for a refund of income taxes paid on the premiums for the coverage (FAQ, Q11). This would not apply to unmarried domestic partners for periods when same-sex couples were not married.

Cafeteria plans. The IRS issued guidance on cafeteria plans (IRC section 125 health

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EXHIBIT 1

States Recognizing Same-Sex Marriage

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Effective Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Massachusetts</td>
<td>May 17, 2004</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Nov. 12, 2008</td>
</tr>
<tr>
<td>Iowa</td>
<td>Apr. 27, 2009</td>
</tr>
<tr>
<td>Vermont</td>
<td>Sep. 1, 2009</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>Jan. 1, 2010</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>Mar. 9, 2010</td>
</tr>
<tr>
<td>New York</td>
<td>Jul. 24, 2011</td>
</tr>
<tr>
<td>Washington</td>
<td>Dec. 6, 2012</td>
</tr>
<tr>
<td>Maine</td>
<td>Dec. 29, 2012</td>
</tr>
<tr>
<td>Maryland</td>
<td>Jan. 1, 2013</td>
</tr>
<tr>
<td>California</td>
<td>Jun. 26, 2013</td>
</tr>
<tr>
<td>Delaware</td>
<td>Jul. 1, 2013</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Aug. 1, 2013</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Aug. 1, 2013</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Oct. 21, 2013</td>
</tr>
<tr>
<td>Hawaii</td>
<td>Dec. 2, 2013</td>
</tr>
<tr>
<td>New Mexico</td>
<td>Dec. 19, 2013</td>
</tr>
<tr>
<td>Oregon</td>
<td>May 19, 2014</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>May 20, 2014</td>
</tr>
<tr>
<td>Illinois</td>
<td>Jun. 1, 2014</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Pending order of judge</td>
</tr>
</tbody>
</table>

† In 2013, the New Jersey Supreme Court upheld a lower court ruling allowing same-sex marriage, which has not been appealed by Gov. Chris Christie.
and dependent care flexible spending arrangements, and IRC section 223 health savings accounts) in Notice 2014-1 [referring to Treasury Regulations section 1.125-4(c)] on December 16, 2013, whereby a cafeteria plan may treat an individual who was married to a same-sex spouse as of June 26, 2013, as if the participant experienced a change in legal status. Such participant may revoke an existing election, making a new election indicating a change in legal marital status. A cafeteria plan participant who enters into a same-sex marriage after June 26, 2013, is allowed to make a midyear election change due to the change in marital status. Once the election is made, it takes effect as of the date that any other change in coverage becomes effective for a qualifying benefit that is offered through a cafeteria plan. Notice 2014-1 (FAQ section) provides extensive guidance on the various cafeteria plan employee benefits, amplifying previous guidance provided in Revenue Ruling 2013-17.

**Offsetting gains and losses.** Married same-sex taxpayers might examine prior open years to see if one taxpayer had capital losses that could have been offset against the spouse’s capital gains.

**Estate and gift taxes.** As detailed below, married same-sex taxpayers will now receive certain estate and gift tax benefits previously only provided to those in opposite-sex marriages. The ability of same-sex married couples to amend previously filed estate and gift tax returns to retroactively take advantage of these benefits remains an unresolved issue. For example, the IRS has yet to issue guidance on how same-sex married couples can report and track previously reported gifts that are now eligible for the marital exclusion or the gift-splitting election. Amending these previously filed tax returns would allow taxpayers to restore applicable unified credit amounts for previously made gifts. The ability to amend previously filed gift tax returns has an even greater collateral effect for estates of the first deceased spouse in same-sex married couples that exhaust their unified credit during their lifetime. Given the considerable amount of variables and uncertainty that surround these issues with regard to estate and gift taxes, it is generally advisable to err on the side of caution and file an amended return.

**Information required by preparers.** Tax professionals should make sure that when they mail tax return checklists to clients for the next tax year, they incorporate language that informs all clients in a same-sex marriage to update their filing status if they are changing their filing status from single or head of household (if there is a qualifying child) to married filing jointly or separately. Moreover, a checklist should require taxpayers to update dependency information if the couple has any qualifying dependents. If a same-sex married couple is filing jointly, both spouses need to submit tax information to the preparer, as well as sign the affidavit on the checklist that the information reported is accurate and complete.

**Innocent Spouse Rules**

Revenue Ruling 2013-17 requires that on September 16, 2013, and for all income tax returns due thereafter, couples in same-sex marriages must file return as either married filing jointly or married filing separately. If a couple files jointly, both spouses must sign the federal tax return. Moreover, both spouses will be jointly and severally responsible for the income tax determined on the return as well as interest or penalties that may result. While both married taxpayers should be aware of items reported on the federal tax return, innocent spouse rules under IRC section 6015 are available for any taxpayer impacted by fraudulent information as well as unreported income attributable solely to the other spouse.

**Income Limitations Impacting Married Tax Filers**

In general, married taxpayers will be subject to adjusted gross income (AGI) threshold limitations based on whether same-sex married couples file jointly or separately. Exhibit 3 highlights some of the main tax provisions impacted by AGI limitations for 2014 joint tax filers:

**Marriage penalty.** As previously discussed above, same-sex couples must now consider the effect of the marriage penalty, not only on previously filed returns, but also for future tax years.

Consideration should be given to the following: changes to federal tax rates on ordinary income, changes to federal tax rates on capital gains and losses, and changes to miscellaneous itemized deductions.

**EXHIBIT 2**

**Tax Returns Filed Prior to 2013**

If a same-sex married couple was considered married in the following year(s):

<table>
<thead>
<tr>
<th>Year</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013–present</td>
<td>Must file as either married filing jointly or married filing separately.</td>
</tr>
<tr>
<td>2012</td>
<td>Returns filed prior to Sep. 16, 2013: May choose to amend 2012 federal tax return and file as married filing jointly or separately.*</td>
</tr>
<tr>
<td>2011</td>
<td>Same-sex married couples may (but are not required to) file amended tax returns changing their filing status to married filing jointly or married filing separately; this amended return to claim a refund must be filed no later than three years from the date the return was originally filed or two years from the date the tax was paid, whichever is later.*</td>
</tr>
<tr>
<td>2010</td>
<td>Same-sex married couples may (but are not required to) file amended tax returns changing their filing status to married filing jointly or married filing separately; this amended return to claim a refund must be filed no later than three years from the date the return was originally filed or two years from the date the tax was paid, whichever is later.*</td>
</tr>
</tbody>
</table>

* For more information, see Tax Topic 308, Amended Returns (http://www.irs.gov/taxtopics/tc308.html).
imposed two additional taxes of note: to 20% for taxpayers in the 39.6% tax term capital gains and qualified dividends. ATRA also raised the top tax rate for long-term taxable income in excess of $228,800. When a married couple has taxable income in excess of $457,600; for those married filing separately, the 39.6% bracket takes effect for taxable income in excess of $228,800.

Capital gains and dividends. The ATRA also raised the top tax rate for long-term capital gains and qualified dividends to 20% for taxpayers in the 39.6% tax bracket only.

ACA. Starting in 2013, the ACA imposed two additional taxes of note:

- An additional 0.9% Medicare tax on wages and self-employment income in excess of the applicable threshold
- An additional 3.8% tax on net investment income when adjusted gross income exceeds certain thresholds.

The applicable threshold amounts are modified adjusted gross income of $200,000 for taxpayers filing singly, but only $250,000 for joint filers.

To illustrate the negative implication of these taxes for joint filers, consider the following example: In 2014, Tom and Bill, a legally married same-sex couple residing in Massachusetts, each earn $300,000 of ordinary income and $50,000 of dividend income. Had Tom and Bill remained single, they each would have paid ordinary income tax at a maximum rate of 33%, and all of their dividend income would be taxed at 15%. If, however, Tom and Bill decide to file a joint return, it will reflect $600,000 of ordinary income and $100,000 of dividend income. As a result, $150,000 ($600,000 – $450,000) of their ordinary income will now be taxed at a maximum of 39.6%, and the entire $100,000 of dividend income will be taxed at 20% rather than 15%. In addition, Tom and Bill must also pay the additional 0.9% Medicare tax on $350,000 of wages ($600,000 – $250,000) and an extra 3.8% on net investment income of $100,000.

### Estate and Gift Tax Considerations

Although the application of the unlimited estate tax marital deduction to same-sex married couples was at dispute in Windsor, the Supreme Court focused its decision on the constitutionality of section 3 of DOMA. As such, the application of the unlimited estate tax marital deduction, and other related provisions, was left to the discretion of the IRS. Revenue Ruling 2013-17 only briefly addresses the estate and gift tax implications of Windsor, stating that taxpayers who wish to file a refund for gift and estate taxes should file Form 843, Claim for Refund and Request for Abatement.

Further guidance in the estate and gift tax area, including, but not limited to, the marital deduction, gift splitting, and portability, is anticipated from the IRS. The value of the property transferred would reduce the transferor’s applicable unified estate [Internal Revenue Code (IRC) section 2010] and gift tax [IRC section 2505(a)] exclusion amount (i.e., the lifetime exclusion amount), currently $5.25 million, adjusted annually for inflation. The top marginal transfer tax rate of 40% would be imposed on any transfers in excess of the lifetime exclusion amount [IRC section 2001(c)].

Following Windsor, married same-sex couples can now utilize the unlimited marital deduction from federal estate (IRC section 2056) and gift taxes [IRC section 2523(a)]. The marital deduction provides an unlimited deduction for transfers between spouses (IRC section 2056). This means that individuals can now transfer, during life or at death, property in any amount to a same-sex spouse, free of federal estate or gift tax.

Gift splitting. Same-sex married couples will now also benefit from gift splitting. In general, individual taxpayers are allowed to exclude the first $14,000 of gifts made to each donee (i.e., the annual exclusion amount) during the calendar year. With gift splitting, the annual exclusion amount is doubled, with each gift considered as made one-half by each spouse. If a split-gift election is made, spouses can each use their

### EXHIBIT 3

AGI Thresholds for Married Taxpayers for Tax Provisions for 2014

<table>
<thead>
<tr>
<th>AGI Threshold Issues with Deductions, Credits, and Exclusions:</th>
<th>MAGI Phase-outs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Itemized deduction limitation</td>
<td>Deduction phases out for MFJ with AGI starting at $305,050.</td>
</tr>
<tr>
<td>IRA deduction (only if taxpayer also participates in qualified retirement plan)</td>
<td>Deduction phases out for MFJ with AGI starting at $96,000.</td>
</tr>
<tr>
<td>Roth IRA</td>
<td>Ability to fund for MFJ phases out with AGI starting at $181,000.</td>
</tr>
<tr>
<td>Student loan interest deduction</td>
<td>Deduction phases out for MFJ with AGI starting at $130,000.</td>
</tr>
<tr>
<td>American Opportunity Tax Credit</td>
<td>Credit phases out for MFJ with AGI starting at $180,000.</td>
</tr>
<tr>
<td>Lifetime Learning Tax Credit</td>
<td>Credit phases out for MFJ with AGI starting at $108,000.</td>
</tr>
<tr>
<td>Child Tax Credit</td>
<td>Credit phases out for MFJ with AGI starting at $110,000.</td>
</tr>
</tbody>
</table>

Note: AGI = adjusted gross income; MAGI = modified AGI; MFJ = married filing jointly
annual exclusion amount to reduce the potential gift tax liability. (The election is made on Form 709.) By acting together, married couples can gift up to $10,000 to any one donee per year without using any portion of either spouse’s lifetime exclusion amount. Once the annual gift tax exclusion amount for a given year is exhausted, the couple can still make combined gifts or bequests of up to $10.5 million over their lifetimes without incurring federal estate or gift tax.

Portability. Finally, same-sex married couples now receive the benefit of the portability election [See IRC section 2010(c)(2) and (4), as amended by P.L. 112-240; Temporary Regulations sections 20.2010-2T, 3T.] The portability election must be made on a timely filed estate tax return, including extensions actually granted; it transfers a deceased spouse’s unused lifetime exclusion amount to the surviving spouse. The surviving same-sex spouse will now be able to use this extra amount to make additional tax-free gifts or reduce the tax liability of their own estate.

One issue concerns the portability election for the estate of the first deceased spouse in a same-sex marriage. In order for a decedent’s estate to take advantage of the portability election, the executor of the predeceased spouse’s estate must have timely filed an estate tax return on which the election is made (IRS Notice 2011-82, 2011-42 IRB 516). The due date of the estate return is nine months after the date of death, plus an additional extension of six months [IRC section 6075(a)]. Thus, it is likely that the time for making a portability election has already expired for some previously filed estate tax returns of first deceased spouses in same-sex marriages. In addition, if an estate fell below the threshold for filing, or was not otherwise required to file, it is possible that no return was ever filed.

In general, because estates were considered ineligible to make the portability election on a late-filed return, taxpayers in same-sex marriages that did not previously file a protective refund claim lost their opportunity to file an amended estate return and make the portability election. [Executors who failed to timely file Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, but still wanted to make the portability election were required to seek relief under the cumbersome Private Letter Ruling procedures provided for under Treasury Regulations section 301.9100-3.] Of course, estates that timely filed an estate tax return should amend such returns and make the portability election.

In response to this inherent unfairness, the IRS recently issued Revenue Procedure 2014-18, which provides a simplified method for eligible estates to obtain an extension of time to make the portability election on a deceased spouse’s estate tax return. Under Revenue Procedure 2014-18, the estate of a decedent who died in 2011, 2012, or 2013, and was survived by a spouse, and who did not timely file an estate tax return, will now have until December 31, 2014, to retroactively make the portability election on Form 706. Revenue Procedure 2014-18 provides a simplified method for eligible estates to obtain an extension of time file the estate tax return, allowing such estates to avoid the rather cumbersome private letter ruling process.

An estate is eligible for relief under Revenue Procedure 2014-18 if the following conditions are satisfied:

- The decedent died after December 31, 2010, and on or before December 31, 2013.

- The decedent was a U.S. citizen or resident.

- The decedent was survived by a spouse who was a U.S. citizen or resident.

- The estate was not required to file an estate tax return because it lacked sufficient assets.

- The estate did not timely file an estate tax return.

If the estate meets these requirements, the executor must file a complete and properly prepared Form 706 for the estate on or before December 31, 2014, and must write “Filed pursuant to Revenue Procedure 2014-18 to elect portability under section 2010(c)(5)(A)” at the top of the return.

Many Questions Remain

The Windsor ruling overturned federal law and allowed married same-sex couples to be considered legally married for tax and other purposes in those states that recognize such marriages. Revenue Ruling 2013-17 formally adopts the spirit and holding of Windsor, and it is the first form of written tax guidance by the IRS that has affirmatively stated that same-sex married couples will be treated as married for federal income tax purposes, regardless of whether the state the couple resides in recognizes such marriages. This article summarizes and highlights some of the major federal tax implications that will impact married same-sex couples following Windsor and provides guidance to tax advisors who are attempting to tackle the many unanswered questions that still remain. As of this writing, same-sex marriages are recognized in 20 states and the District of Columbia, with several states challenging existing bans. The tax implications of same-sex marriage have become more complex as marriage recognition has become more available to taxpayers nationwide.
Social Security Benefit Strategies for Baby Boomers

By Howard Davidoff

In 2014, the youngest members of the baby boom generation (defined as those born during 1947 and 1964) will be turning 50, and its oldest members will close in on 70. As baby boomers reach retirement age, they find themselves confronting the labyrinth of rules and regulations contained within the Social Security system. This article will discuss some strategies for enhancing the payout of Social Security for those approaching the age of benefit eligibility.

The Basics

The age at which one can receive full retirement benefits is currently 66 years old [Social Security Act of 1935 (SSA) section 216(l)(1)(A)]. This is the age at which one is entitled to the primary insurance amount [SSA section 215(a)(1)(A)]. This age will increase by two months for those born after 1954 until 1960, at which point the normal retirement age will be frozen at 67 [SSA section 216(l)(1)(D), (E)]. For example, someone born in 1957 will qualify for full benefits at 66 years and 6 months.

Individuals can qualify for early retirement benefits as early as their 62nd birthday [SSA section 216 (l)(2)]. However, one’s benefit will be permanently reduced by this complex formula: five-ninths of 1% per month for each month before normal retirement age, up to 36 months [SSA section 202(q)(1)(A)]. For example, an individual who applied on her 63rd birthday in 2013 would see her benefit permanently reduced by $1,000 per month (5/9 × 36 months). Although one can qualify as early as age 62, the penalty for applying more than 36 months prior to normal retirement age is only five-twelfths of 1% per month [SSA section 202(q)(9)(A)]. If one starts receiving benefits at age 62, then the benefit reduction would only increase another 5% (5/12 × 12 months). In short, there is a 25% penalty for those who start receiving their benefits as early as possible. It is also worth noting that if one’s earned income (wages and self-employment income) exceeds a certain amount ($15,480 in 2014), benefits would be temporarily reduced further by $1 for every $2 of earned income that exceeds the threshold amount [SSA sections 203(b)(1), (a)(3), (f)(8)]. This additional loss of benefit will be actuarially restored when one reaches normal retirement age.

In contrast, those who wait until after reaching normal retirement age to receive benefits will be rewarded [SSA section 202(w)(1)]. This enhancement is two-thirds of 1% for each month beyond normal retirement age, up to a maximum of age 70 [SSA section 202(w)(6)(D)]. This represents a maximum increase of 32%, or 8% per year. Using the example of someone receiving a $1,000 monthly normal benefit, if she starts to collect her benefit at age 62, it would only be $750 per month; however, if she opted to delay until age 70, her benefit would increase to $1,320 per month—76% greater than the early benefit option. In these times of comparatively low inflation and minimal interest rates on savings, it is hard to argue with the wisdom of a delayed payout unless one really needs the cash.

Retroactive Enhancement

Is there anything a taxpayer that has already filed for early benefits can do to recover this enhancement benefit? The following are two options:

■ One can file a withdrawal request of the application for benefits within 12 months and reapply later. Any benefits received must be remitted back to the Social Security Administration.

■ Once one reaches the normal retirement date, the collection of benefits can be suspended, thereby enhancing the benefit by two-thirds of 1% for each month until age 70 [SSA section 202(j)(3)]. The loss of current benefits must be weighed against the amount of the future enhanced benefit—the longer one lives, the more attractive this option will be.
**Strategies for Married Couples**

Although there are benefits to delaying the receipt of Social Security benefits, there are times when an individual whose earnings were significantly less than their spouse’s might want to start collecting as early as possible. The percentage decrease won’t mean as much when collecting the early benefit, and one can switch to a “spousal benefit” when a higher-earning spouse reaches full retirement age. The spousal benefit is equal to—

- one-half of the higher-earning spouse’s full retirement benefit, less the lower-earning spouse’s full retirement benefit, plus
- the lower-earning spouse’s benefit [SSA Program Operations Manual System (POMS), RS section 00615.020].

If the 25% reduction is insignificant, then the lower earning spouse can get a four-year “head start” on Social Security benefits. This must be weighed against the fact that, as outlined in the spousal benefit formula above, the lower-earning spouse’s benefits will permanently increase the longer the couple waits to receive benefits.

**Example.** Jerry and Stella are both 62 years old. Jerry’s normal retirement benefit is calculated at $2,000 per month, whereas Stella’s is $500 per month. If Stella opts to take her benefit immediately, she can collect her reduced benefit of $375 per month ($500 less 25%) for four years, or a total of $18,000 over four years. Should Jerry apply and collect at age 66, Stella could then switch to a spousal benefit of $875 per month (one-half Jerry’s full benefit of $2,000, less Stella’s full benefit of $500 plus her current benefit of $375).

If Stella waited until she turned 66, her spousal benefit would be $1,000 per month (one-half of Jerry’s benefit). The analysis comes down to whether the increase of $125 per month for the duration of Stella’s life is worth forgoing the $18,000 she can collect during age 62–66. In this scenario, the author would say that waiting is not worth it, considering that the break-even point for Stella would not come until she reaches age 78. When factoring in the time value of money, the break-even point would come even later, presuming she does not die prior to the break-even point.

One way of further enhancing this strategy would be to have the higher-earning spouse file at normal retirement age and elect to suspend payments until age 70. This is commonly referred to as the “file and suspend” strategy (POMS GN section 02409.100). Not only would Stella enjoy the same benefits as outlined above; Jerry’s benefit would increase by 32%, to $2,640 per month, once he starts to collect at age 70. In either case, it is essential that the higher earning spouse does not apply for benefits before reaching normal retirement age, lest the lower earning spouse’s spousal benefit be permanently reduced.

For couples who will be receiving comparable benefits, the following strategy, known as filing as restricted application (POMS GN section 00204.020), should be considered:

- Have one spouse file at normal retirement age and suspend collection of benefits until age 70.
- Have the other spouse file and collect the spousal benefit while deferring collection of their own retirement benefit until age 70.

This will have the effect of maximizing both spouses’ retirement benefits while allowing one spouse to receive the spousal benefit for up to four years. But both spouses need to wait until normal retirement age to employ this strategy.

**A Strategy for Divorced Couples**

Divorced individuals married for at least 10 years may collect a spousal benefit based on an ex-spouse’s earnings record as long as the ex-spouse claiming the benefit is unmarried (POMS RS section 00202.005). It does not matter whether the other ex-spouse is remarried. If both ex-spouses remain unmarried, an interesting opportunity exists. Unlike married individuals, who may not both simultaneously apply for the spousal benefit, a divorced couple can each collect spousal benefits on the other’s work record if they are at the normal retirement age (POMS RS section 00202.020). In the meantime both ex-spouses could defer collection of their own benefit until age 70, thereby increasing their own benefit by 32% for the rest of their lives.

**Children**

Many baby boomers are getting married (or remarried) and starting families later in life. As a result, those reaching retirement may still have young children. Children age 17 or younger (or up to 19 if they have not yet graduated from high school) have the right to collect Social Security benefits when a parent starts collecting (POMS RS section 00206.005). This also extends to a younger spouse or ex-spouse who would be eligible to collect a father’s or mother’s benefit until a child’s 16th birthday (POMS RS section 00208.005). These benefits continue even after the death of the Social Security recipient.

**Tax Implications**

Social Security benefits may be subject to federal income tax should the recipient (or the recipient’s spouse, if married filing jointly) have other significant income subject to federal income tax [Internal Revenue Code (IRC) section 86]. The formula in IRC section 86(a)(2) phases in the amount of benefits subject to taxation. The maximum amount of taxable Social Security benefits is equal to 85% of benefits received during the year. It would be prudent for individuals that might be affected to sit down with a tax planner to try to minimize the tax burden.

One possible strategy may be to time the receipt of other retirement assets [e.g., individual retirement accounts (IRA), 401(k) plans, pension assets] so that they would not have the “double negative” effect of increasing taxable income by both their receipt and the increase in taxable social security benefits. Taxpayers might consider converting some of these assets to Roth IRAs in a year other than one in which Social Security benefits are received. While the conversion itself would be a taxable event, all subsequent distributions would be tax exempt [IRC section 408A(d)(3)(C)]. This would not cause any negative impact on the taxation of Social Security benefits in years after the Roth conversion. One could also consider selling capital assets with unrealized gains in a year when Social Security benefits are not received, so that the gains would not increase their taxability.

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Internal Revenue Code (IRC) section 1402(a) generally provides that a partner’s share of partnership trade or business income is subject to self-employment (SE) tax, but two exceptions may apply:

- If the partner is a “limited partner,” SE tax applies only to guaranteed payments for services rendered to the partnership [IRC section 1402(a)(13)].
- If the payments are made pursuant to a written plan providing for payments on account of retirement, all such payments may be exempt from SE tax, provided that certain requirements are satisfied [IRC section 1402(a)(10)].

For any tax years in which a partner is active in a service partnership, it is difficult to qualify any portion of the trade or business income for any SE tax exemption. But when payments are made to a retiring partner, it is often assumed that he will not be subject to SE tax because he is no longer actively involved in the firm; however, in order to qualify for the IRC section 1402(a)(10) exclusion, the partner must receive retirement payments for life and be fully paid his capital by the end of the tax year of the payment, among other requirements.

It is not unusual for service partner retirement payments to end after a specified period, rather than continuing for the partner’s life. In addition, many small or midsized partnerships cannot fund full payment of the partner’s capital before any retirement payments are made. Finally, small or midsized partnerships often rely upon the expertise of retired partners for specific engagements; if the partner continues to perform services on behalf of the partnership, it will prevent use of the exclusion. Any one of these issues will make the IRC section 1402(a)(10) retirement pay exclusion inapplicable.

If the partnership is unable to structure retirement payments to qualify for the retirement exclusion, it is unclear whether the IRC section 1402(a)(13) limited partner exclusion may be available. Partners in professional service partnerships have historically been general partners; even after the advent of LLC and LLP entity forms, they are generally treated the same as general partners for SE purposes. It is not clear how the SE tax applies to members of LLCs. Proposed regulations issued in 1997 sought to mitigate this uncertainty by proposing a uniform definition of a “limited partner” for purposes of IRC section 1402; however, these regulations are not authoritative and generally do not favor taxpayers who are active members of a service partnership. Despite this, the definition of a limited partner found in the proposed regulations might be helpful to a partner who is no longer active and who seeks to exclude retirement payments from SE tax. Yet, the ability to use the proposed regulations for this purpose is further confused by the classification of retirement payments as income or property payments under IRC section 736.

This discussion will examine how the SE tax provisions apply to payments made to partners who have retired from active participation in a service partnership. An analysis will demonstrate the ability to use either or both IRC sections 1402(a)(10) and (a)(13) to support exclusion from SE tax.

**IRC Section 1402(a)(10)**

IRC section 1402(a)(10) provides the basic requirements for exclusion of partner retirement payments from SE tax, including the following:

- Retirement payments must be made on a periodic basis, pursuant to a written plan of the partnership.
■ Payments must continue at least until the partner’s death.
■ The retired partner must not render any services in connection with the partnership’s trade or business for the partnership tax year ending with or within the year in which a payment is received.
■ The partnership must not have any obligation to the partner other than the retirement payment for the year of such payment.
■ The partner must have received full payment of partner capital by the close of the partnership tax year in which payment is made.

The written plan of the partnership must also comply with any regulations prescribed by the Treasury Department. Treasury Regulations section 1.1402(a)-17 requires that eligibility for retirement be based on factors such as age and years of service, with payments based on factors such as years of service and compensation received. This is typically not difficult for a service partnership to satisfy.

Treasury Regulations section 1.1402(a)-(17) requires that payments are classified as IRC section 736(a) or 736(b) payments. This confirmed that the application of the IRC section 1402(a)(10) exception does not depend upon whether payments are “income” or “property” payments under subchapter K.

In Private Letter Ruling (PLR) 9630012 on July 26, 1996, the IRS held that an active partner in a professional service entity organized as an LLP is to be treated as a general partner for purposes of application of the SE tax. This ruling was issued at a time when many professional service firms organized as general partnerships were converting to LLPs. The IRS concluded that the conversion would not affect the partners’ obligations for SE tax. Although this ruling is not authoritative, it is logical, based on the intent of the SE tax rules; however, the conclusion need not apply to a partner who is no longer active in the firm. The IRC section 1402(a)(10) exclusion applies without regard to the classification of a partner as a general or a limited partner and should not be affected by the entity form.

In PLR 200142004 on October 22, 2001, a law firm organized as an LLP had a mandatory retirement age of 65 and provided that, upon retirement, a partner would be paid his capital in full by the close of the year preceding the date of retirement. The retiring partner would receive all benefits payable under the firm’s benefit plans and would be paid monthly retirement payments for a period ranging from 60 to 120 months. At the expiration of this base period, the firm would continue to make payments of $100 per month for the remainder of the retired partner’s life. The letter ruling concluded that 1) all payments made pursuant to the plan would be exempt from SE tax, provided that the terms of the plan were adhered to, and 2) the holding of the ruling applied only to SE tax, and had no bearing on the determination of payments under any other provision of the tax laws [e.g., whether payments were classified as IRC section 736(a) or 736(b) payments]. This confirmed that the application of the IRC section 1402(a)(10) exception does not depend upon whether payments are “income” or “property” payments under subchapter K.

The IRC section 1402(a)(10) exception, enacted in 1967, was intended as a relief measure for partners who would otherwise be subject to the (then existing) general rule that any distributive share income of a partnership engaged in a trade or business would be subject to SE tax, without regard to whether the partner was active in the business of the partnership. The exception would apply when the partner had terminated her association with the trade or business by severing any financial ties other than the retirement payments (hence the requirement that all capital be paid) and by no longer performing any services on behalf of the partnership. It is clear that all of the requirements of IRC section 1402(a)(10) must be satisfied to qualify for the retirement exception—it is an all-or-nothing proposition.

Because many service partnerships are not able to fully pay the retiring partner’s capital before making any retirement payments, the exclusion will often fail to apply to all payments made to a retired partner; however, if it is possible to specify that payments will first be applied to repayment of partner capital, the SE tax exclusion could then apply to those payments made in the year that capital is fully repaid and all subsequent years. It would also be necessary to provide for a continuation of payments until the partner’s death, although that would appear to be satisfied by use of some nominal payment, such as the $100 per month called for in PLR 200142004. Finally, in no event could the exception apply to any years in which the partner continues to provide services to the partnership or otherwise continues to enjoy financial benefits from the partnership.

IRC section 1402(a)(10) may then present two general problems for service partnerships seeking to assist partners in avoiding or minimizing SE tax for retirement payments. The first problem is posed by any provisions affecting the partnership retirement plan that fail to qualify for the exclusion, such as the term of the payout and whether retired partners’ capital may be paid before retirement payments are made. Second, individual partners may continue to perform services on behalf of the partnership. Postretirement consulting arrangements would be by individual agreement between the firm and the partner, but partners who continue to provide services would fail the IRC section 1402(a)(10) exclusion for any years that services are provided.

If one assumes that changes cannot be made to the agreement to permit retirement payments to meet the IRC section 1402(a)(10) exception or that one or more partners continue to provide services to the partnership, it is then necessary to consider to what extent the IRC section 1402(a)(13) limited partner exception could apply. Treating a partner in a service partnership as a limited partner seems anomalous, but it may be justified under the proposed section 1402 regulations.

IRC Section 1402(a)(13)

For a service partner who is no longer active in the firm, the IRC section 1402(a)(13) limited partner exception might be relevant in avoiding SE tax in postretirement years. It remains unclear whether a partner who receives retirement payments while arguably classified as a “limited partner” may be exempt from SE tax based on IRC section 1402(a)(13), or whether IRC section 1402(a)(10) is the exclusive means of avoiding SE tax for
payments made pursuant to a retirement plan from a service partnership.

There is no authority supporting the contention that a service partner gets “two bites of the apple” in efforts to avoid SE tax on partner retirement payments, but there is also no authority that treats IRC section 1402(a)(10) as the sole exemption for retirement payments. If the retired partner could satisfy the definition of a “limited partner” under IRC section 1402(a)(13), there would be statutory authority for exempting qualifying payments from SE tax. While a service partner in a professional firm would not be a limited partner under state law, it is possible that a retired partner would meet the definition proposed by the Treasury Department.

The IRC section 1402(a)(13) exception was enacted in 1977 as an antiabuse measure to prevent passive limited partners from accruing Social Security credits. At that time, the SE tax burden was not considered onerous and the ability to participate in the Social Security system could justify the intentional inclusion of distributive share income as subject to SE tax. The purpose of the limited partner exclusion was different than IRC section 1402(a)(10), and no effort was made to tie the 1977 amendments to the retirement exception that had been adopted 10 years earlier; thus, it is not clear whether the two provisions may both be available to a partner receiving retirement payments.

When IRC section 1402(a)(13) was enacted in 1977, there were no state LLC or LLP statutes. (Wyoming enacted the first LLC statute in 1978 and Texas enacted the first LLP statute in 1991.) The original use of “limited partner” would have been based on the common meaning of that term; however, the advent and growth of LLC and LLP entities has created confusion about the meaning of the limited partner exception with respect to post-1977 entity types that are organized as state law LLCs or LLPs and are taxed as partnerships.

The IRS issued proposed regulations in 1997 that attempted to define a limited partner for purposes of SE tax in light of the member rights and responsibilities found in the expanded types of entities taxed as partnerships for income tax purposes. Proposed regulations may not generally be relied upon; however, in 2003, the IRS informally stated that it would not challenge taxpayers who relied on the proposed section 1402 regulations for determining applicability of SE tax. But these regulations are now 17 years old and are unlikely to be issued in temporary or final form.

Proposed Treasury Regulations section 1.1402(a)-2(g) states that a limited partner’s share of trade or business income of a partnership will not be subject to SE tax, with the exception of guaranteed payments for services. Whereas this is simply a restatement of the statutory exception of IRC section 1402(a)(13), Proposed Treasury Regulations section 1.1402-2(h) provides a definition of limited partner that is more expansive than is commonly used or could have been intended by the 1977 legislation. The proposed regulation begins by treating all partners as limited partners, and then identifies exceptions to that general rule.

A partner classified as a “service partner” cannot be treated as a limited partner under the proposed regulations. For this purpose, a service partner is one who provides services on behalf of a service partnership’s trade or business. If no services are provided, or only a de minimis amount of services is provided, the partner is not a service partner for the year at issue [Proposed Treasury Regulations section 1.1402(a)-2(h)(6)(ii)]. A service partnership is one in which substantially all of the activities are in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting [Proposed Treasury Regulations section 1.1402(a)-2(h)(6)(iii)].

The purpose of Proposed Treasury Regulations section 1.1402(a)-2(h)(6) is to treat all active partners in professional service firms as general partners for SE tax purposes. This position is both logical and consistent with that adopted in PLRs issued to professional service firms, without regard to the entity form selected; however, the provision appears to exempt any partner who does not provide any services (or only a de minimis amount of services) during the year in question.

If retired partners can rely on Proposed Treasury Regulations section 1.1402(a)-2(h)(6)(ii), any partner who provides no more than a de minimis amount of services during a calendar year may be exempt from SE tax under the limited partner exception of IRC section 1402(a)(13); however, even the limited partner exception does not provide relief to the extent that the payment is an IRC section 707(c) guaranteed payment, if it is established that the payment is in exchange for any (de minimis) services rendered.

Payments made to a retiring partner are classified as either IRC section 736(a) “income” payments or IRC section 736(b) “property” payments. IRC section 736(a) further classifies payments as either distributive share payments, if determined by reference to the income of the partnership, or as IRC section 707(c) guaranteed payments. Therefore, even if the definition of a limited partner found in the proposed section 1402 regulations can be relied upon when determining the SE treatment of retirement payments, SE tax will still apply if IRC section 736 classifies any payment as a guaranteed payment for services. [Note that the IRC section 1402(a)(10) retirement exception applies without regard to the classification of payments under IRC section 736.] IRC section 736(a)(2) classifies non–section 736(b) payments that are determined without regard to the income of the partnership as IRC section 707(c) guaranteed payments. Treasury Regulations section 1.1402(a)-1(b) treats all guaranteed payments, whether for services or for capital, as trade or business income subject to SE tax. But the exclusions available to qualifying retirement payments or the income of a limited partner would be available to limit SE taxation. IRC section 736(a)(2) guaranteed payments may still qualify for the limited partner SE tax exclusion if properly classified as a guaranteed payment for capital, rather than a payment for services rendered to or on behalf of the partnership.

Service partnerships often pay a retiring partner the amount of his capital and an additional payment intended to reflect the value of the partner’s equity interest. Both would generally constitute payments for partnership property; however, IRC section 736(b)(2) provides that property payments may not include any payments for a partner’s share of IRC section 751(c) unrealized receivables or goodwill that is not specifically called for in the partnership agreement. This provision applies only
to payments made to a general partner in a partnership in which capital is not a material income-producing factor [IRC section 1402(b)(3)].

The House Committee Report to the enacting legislation states that capital is not a material income-producing factor if substantially all of the gross income of the partnership is from fees, commissions, or other compensation for personal services. The report also states that the professional service activity of a partner engaged in the professional fields of health, law, engineering, architecture, accounting, actuarial science, or consulting would not qualify as a business in which capital is a material income-producing factor, even if there is a substantial investment in equipment or other tangible property. Thus, retirement payments made to a general partner in a service partnership will be guaranteed payments if not determined by reference to partnership income.

Any effort to avoid SE tax using IRC section 1402(a)(13), based upon the definition of a limited partner found in the proposed regulations, may be stymied by payments that are attributable to partnership unrealized receivables or unspecified goodwill if the retiring partner is treated as a general partner for purposes of IRC section 736. Retiring partners may be properly classified as general partners under IRC section 736 based on their role during their preretirement years. The limited partner status is based on the definition found in the proposed section 1402 regulations, a definition that does not apply to IRC section 736. The partner will likely still be a general partner for purposes of IRC section 736.

Amounts paid to a retiring partner classified as IRC section 736(a)(2) guaranteed payments create a benefit to continuing partners because they are deductible by the partnership; however, the payments would then fail to qualify for the IRC section 1402(a)(13) SE tax exemption for the retiring partner unless the guaranteed payment was for capital rather than services. Under the proposed regulations, a limited partner may provide de minimis services to the partnership. The provision of any services would make it more difficult to qualify for a full exclusion from SE tax. It would be necessary to demonstrate what amount, if any, represented a payment for services rendered to or on behalf of the partnership. Amounts that are classified as IRC section 736(b) property payments would not be deductible by the partnership but may qualify as exempt from SE tax to the retiring partner who can satisfy the limited partner definition. The continuing partners may have a different incentive than the retiring service partner, because guaranteed payments are deductible by the partnership. The competing incentives may be amicably resolved if the retiring partner provides no continuing services and all parties rely on the limited partner definition found in the proposed regulations. Any guaranteed payments would then be for capital and be deductible by the partnership and exempt from SE tax for the retiring partner. If any payments represent IRC section 736(a)(1) distributive share income, the continuing partners’ share of such income will be reduced and the income may still be SE tax exempt if the retiring partner can satisfy the limited partner definition in the year of the income allocation. IRC section 736(a)(1) distributive share payments may then meet the needs of both the retiring and continuing partners.

### Practical Considerations

A partner seeking to avoid SE tax on retirement payments is most likely to rely on IRC section 1402(a)(10), a provision enacted for the purpose of allowing general partners who are no longer active in the business to avoid SE tax. This SE tax exclusion is available without regard to how retirement payments are classified under IRC section 736.

Many partnerships, however, will not be willing or able to structure payments to satisfy the provisions of IRC section 1402(a)(10)—including the requirement that payments continue for the partner’s life and that all of the retired partner’s capital be paid by the end of the year—that the exclusion is intended to apply to. Many small or mid-sized service partnerships will also need to rely upon the expertise of retired partners for specific postretirement engagements, and the IRC section 1402(a)(10) exclusion will not be available for any of those.

An alternate path to excluding retirement payments from SE tax is the limited partner exception. It is difficult to argue that an active partner in a service partnership could be classified as a limited partner for purposes of IRC section 1402(a)(13); however, the 1997 proposed section 1402 regulations could permit a retired partner in a service partnership to be treated as a limited partner for purposes of the SE tax exclusion. A partner who provides no services (or even de minimis services) for a tax year could satisfy the limited partner definition found in the proposed regulations. While not authoritative, the IRS is not likely to challenge a taxpayer who relies on the proposed section 1402 regulations. But even if a retired service partner could be classified as a limited partner, the SE tax will still apply to any payments classified as IRC section 707(c) guaranteed payments for services.

The retired service partner is likely still a general partner for purposes of IRC section 736, which classifies retirement payments as income or property payments. Any payments for partnership unrealized receivables or goodwill not specified in the partnership agreement would be classified as guaranteed payments if the recipient is a general partner in a service partnership. The partnership generally has an incentive to classify retirement payments as income payments so that the continuing partners may either deduct the item or allocate distributive share income to the retiring partner. Characterization as an IRC section 736(a)(2) payment, however, would cause the retired partner to lose the protection of the IRC section 1402(a)(13) SE tax exclusion if the resulting guaranteed payment were considered to be in exchange for services rather than capital. This is more likely when the retired partner continues to provide de minimis level of services, a threshold permitted by the limited partner definition of the section 1402 proposed regulations. But there does appear to be some latitude to allow the retiring partner to avoid SE tax, based upon the limited partner definition found in the proposed section 1402 regulations, while also providing continuing partners with a deduction or a reduction in distributive share income under IRC sections 736(a)(1) and (a)(2).

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As a teenager, John D. was wild. At age 19, he was caught in a car with drugs and convicted of criminal possession of a controlled substance. Instead of being issued a long prison sentence, he was given an opportunity to change his life—he was sentenced to complete a residential drug treatment program and a term of probation. This allowed John to get the help he needed. After he fulfilled his court mandate, he graduated from college with a bachelor’s of science degree in accounting. Now, years after his misstep, he has started to seek employment as a junior accountant; however, his past continues to haunt him. Every application to a large firm (and some small ones) contains the dreaded words, “Have you ever been convicted of a crime?” John worries that he’ll never be able to rise to the top level in his profession because of a mistake he made in his youth.

Does an encounter with the law for a nonviolent offense have to put a stain on one’s record, particularly when that individual seeks to enter a licensed profession?

The answer is a resounding no to those who are familiar with the protections provided by New York’s Criminal Procedure law, which permits sealing conviction records for some defendants who participate in certain treatment programs.

Background

John could have taken advantage of this record-sealing protection at the time of his arrest, he might be eligible for record sealing later if he voluntarily participated in a qualifying program following his arrest and has subsequently lived a law-abiding life.

In People v. Brocki, 2013 WL 6360628, 2013 N.Y. Slip Op. 23409 (2d App. Term 2013), the appellate term reversed the criminal court’s decision of ineligibility because the movant entered treatment voluntarily without a judicial order and the program was not judicially sanctioned. The appellate court ordered a hearing to determine whether the defendant’s program was “similar in terms of duration and intensity” to judicial diversion programs, which “would make him eligible to have the records in question sealed.”

New York Criminal Procedure Law (CPL) section 60.58 permits a court to seal all official records and papers relating to an individual’s arrest, prosecution, and conviction that led to their participation in a judicially sanctioned drug treatment program. Sealing the record also enables the court to seal up to three prior eligible misdemeanors [see CPL section 160.58(2)].

In the example above, John’s criminal conviction could be sealed because he participated in a judicially sanctioned or similar drug treatment program; however, the sealing is conditional. If John is again convicted of any misdemeanor or felony, the sealed conviction becomes unsealed permanently under CPL section 160.58(8). [It appears that unsealing will occur by operation of law if a person is arrested for any misdemeanor or felony; however, a misdemeanor or felony arrest that results in a noncriminal conviction (disorderly conduct or a traffic infraction) will trigger the rescaling by operation of law.]

Short of executive clemency, CPL section 160.58 is the exclusive remedy for having a record “expunged” in New York State. If John is already a licensed CPA, he might be required under the state licensing laws to report the conviction. Once a sealing order is obtained, it would be relevant to militate against the fact of the conviction in connection with a determination of whether John has engaged in unprofessional conduct. For example, the Rules of the Board of Regents [section 29.10, subdivision 14(e)] of the New York State Education Department define conviction of a felony or misdemeanor as “reportable events,” and provide that failure to report within 45 days is “unprofessional conduct.”

If John’s conviction is sealed, he would be protected by New York Executive Law section 296(16); the sealed conviction could not be used as a basis for an adverse employment decision, nor could an employ-
er inquire about such a sealed conviction. [See New York Executive Law section 296(19); see also Clemons v. Wellpoint Companies Inc., 2013 WL 1092101 (N.D.N.Y 2013), 11.] Furthermore, no applicant is required to divulge information relating to a CPL section 160.58 sealing. This puts a conditionally sealed offense on the same level as an acquittal after trial or a plea to a noncriminal offense, such as disorderly conduct. (See also CPL sections 160.55, 160.50.) People in a similar situation as John, who have truly shown a commitment to successful rehabilitation, stand to benefit greatly from this sealing relief.

The Statute: CPL Section 160.58

On April 7, 2009, then-Governor David Paterson signed into law the Drug Law Reform Act of 2009, which included the provision for conditional sealing pursuant to CPL section 160.58. This retroactive sealing provision went into effect on June 6, 2009, and is the first conditional sealing statute enacted in New York.

At the time of this article’s publication, the conditional sealing statute is only available for certain convictions, namely any article 220 (controlled substance) or article 221 (marijuana) misdemeanor or felony offenses, including both sale and possession [see CPL section 160.58(1)]. In addition, conditional sealing is available to a person who has been convicted of those offenses listed in CPL section 410.90(3), commonly known as “Willard” offenses. [“Willard is a Drug Treatment Campus (DTC) operated by the NYS Department of Correctional Services (DOCS) in collaboration with the Division of Parole and the state Office of Alcohol and Substance Abuse Services (OASAS). … The Willard program was created as an intermediate sanction—with teeth—to deal with the problem of relapse,” http://www.oasas.ny.gov/cj/programs/Willard.cfm.] These include non-violent felonies for crimes such as grand larceny, possession of stolen property, and other related substance abuse motivated crimes. Interestingly, a literal reading of CPL sections 160.58 and 410.90(3) would seem to allow the conditional sealing of a felony grand larceny conviction but not provide the same sealing for the conviction of misdemeanor petit larceny.

If the individual was convicted of one of those offenses or is facing prosecution for one of these offenses, the defendant might wish to take advantage of the ability to participate in a judicially sanctioned drug treatment program, successful completion of which is a precondition to obtaining the benefit of sealing. CPL section 160.58 requires that the defendant participate in a drug treatment program prescribed by statute, which includes a judicial diversion program pursuant to CPL article 216; a drug treatment alternative to prison (DTAP); or a judicially sanctioned drug treatment program of similar duration, requirements, and level of supervision [CPL section 160.58(1)]. Finally, the defendant has to complete the program and all other aspects of the sentence in order to obtain the sealing benefit [CPL section 160.58(2)(c)]. This typically requires either the favorable termination of probation or the passing of the period of conditional discharge, which is either one year from the date of sentencing for a misdemeanor or three years for a felony [see New York Penal Law section 65.05(3)]. Other than this minimum “waiting period,” there is no requirement that the motion be filed within a certain time period.

No Discrimination if Record Is Sealed

Upon the granting of an application for conditional sealing pursuant to CPL section 160.58, the court will order that “all official records and papers relating to the arrests, prosecutions, and convictions, including all duplicates and copies thereof, file with the division of criminal justice services or any court shall be sealed and not made available to any person or public or private agency,” except—

- the defendant or defendant’s agent;
- any qualified agencies defined in N.Y. Executive Law section 835(9) (e.g., Office of Court Administration, Department of Probation, district attorneys’ offices), but only when acting within the scope of their law enforcement duties;
- any law enforcement agency or agency responsible for issuing gun licenses with respect to an application for such license; and
- any employer of police or peace officers with respect to an application for employment [CPL section 160.58(6)].

As such, conditional sealing truly masks a blemish on a person’s record, unless the applicant subsequently becomes the subject of a criminal investigation, applies for a pistol license, or seeks employment in law enforcement.

New York law specifically protects an applicant or employee from any repercussions as a result of a sealed conviction. The New York Human Rights Law provides that it is an unlawful discriminatory practice to inquire about or act adversely to an individual whose records have been sealed pursuant to CPL section 160.58 [see N.Y. Executive Law section 296(16)]. Similarly, this protective law does not require an individual to divulge information pertaining to a sealed record. Consequently, applicants can be safely advised they do not need to check the box on the job application that causes so many convicted persons to be declined employment.

Practical Benefits

New York has recognized in several ways that being convicted of a crime can have a lasting effect on an individual seeking employment or licensure. New York’s public policy is to protect a convicted offender from adverse consequences, unless there is a direct relationship between the job and the conviction or the conviction indicates a danger to persons, the public, or property (see N.Y. Corrections Law section 752). Even then, employers must review a variety of factors, such as the age of the offense, the age of the offender when the crime was committed, the seriousness of the offense, and whether there was a certificate of relief from civil disabilities, among other matters (see N.Y. Corrections Law section 752).

The legislature has provided the judiciary with a means of rewarding those who have changed their lives by protecting them from a major barrier to successful employment—an unsealed criminal conviction. Licensed professionals who fear that they will not be hired if the conviction is revealed should consider taking advantage of the benefit offered by CPL section 160.58.

Sharon P. Stiller, JD, directs the employment law practice at Abrams, Fensterman, Fensterman, Eisman, Formato, Ferrara & Wolf, LLP, and Joseph L. Indusi, JD, is a trial attorney at Brooklyn Defender Service.
Website of the Month:
Standard & Poor’s Rating Services

By Susan B. Anders

Standard & Poor’s Financial Services (S&P) is one of the “Big Three” nationally recognized statistical rating organizations (NRSRO). S&P’s web presence consists of three sites: S&P’s Rating Services (http://www.spratings.com), S&P Dow Jones Indices (http://www.spindices.com), and S&P Capital IQ (http://www.capitaliq.com); alternatively, all of these websites can be accessed via http://www.standardandpoors.com. S&P provides internationally focused credit risk research and benchmarks to aid investors, businesses, and markets. It also publishes credit ratings on corporations, financial service providers, and government entities.

This month’s column focuses on S&P’s Rating Services, which makes its ratings freely available to the general public, along with articles, reports, webcasts, videos, and interactive infographics and tools. The homepage and main pages are organized by resource type, as well as by industry and geographic sectors, with current news and videos displayed in the center of the page. Users can indicate their specific interests when they create a free online account, which will generate a homepage tailored to their preferences.

Research and Analysis

The research and analysis section of the website combines articles and webcasts on specific topics. As the number of resources for a given subject grows, a subsidiary webpage is established. Articles are generally provided in webpage format, with a link to a print view, whereas longer reports are available as downloadable PDFs. Premium subscribers can also download many related charts and tables.

The global accounting and governance insights webpage (https://www.spratings.com/accounting-and-governance/Accounting.html) addresses the impact of accounting, financial reporting, and corporate governance standards and practices on financial performance analysis. One article, “Farewell Discontinued Operations: U.S. Financial Statement Analysis Just Got Harder,” and a related video cover Accounting Standards Update (ASU) 2014-08, which increases the threshold for what qualifies as a discontinued operation. S&P’s view is that, with fewer dispositions qualifying as discontinued operations, the historical information required will be less relevant and potentially distort trends. S&P encourages management to disclose more information.

Another article, “The Statement of Cash Flows: Comparing the Incomparable,” presents S&P’s recommendations for improving the transparency and comparability of cash flow statements. Specific suggestions cover the purchase of assets to be leased, cash paid for interest, hedging activities, and noncash transactions. The report includes examples of actual cash flow statements where different com-
Credit Ratings

S&P makes its credit ratings publicly available through its website. Users can find a specific organization by entering its identifying ticker or CUSIP number, or they can browse ratings by category (i.e., corporates, financial institutions, funds, insurance, governments, or structured finance). For each entity, S&P provides the rating type, the actual rating, its date, the credit watch/outlook, and its date. Premium subscribers can also access credit-related news and research.

Several resources are available to aid users with the “find a rating” and “understanding ratings” sections of the website. Articles and videos are grouped under “about credit ratings,” “performance,” and “criteria.” One key document found on the understanding ratings webpage is “Standard & Poor’s Ratings Definitions,” which runs about 30 pages and defines the long- and short-term credit rating categories (“AAA,” “AA+,” etc.), local and foreign currency ratings, a variety of specialized and special purpose ratings, and identifier symbols that provide additional information.

A complementary document, “Understanding Standard & Poor’s Rating Definitions,” explains the key attributes of S&P’s credit ratings, which include creditworthiness; likelihood of default; and secondary factors, such as payment priority, projected recovery, and credit stability. Appendices include historical default rates by category and an interesting list of historical stress scenarios, beginning with the Panic of 1797.

S&P also produces several guides (less than 20 pages in length) that are downloadable as PDFs after users complete a free registration. “Guide to Credit Ratings Criteria,” published in 2010, explains what credit ratings criteria are, how they are applied in the rating process, and how they are developed and refined over time (http://img.en25.com/Web/StandardandPoors/GuideToCreditRatingsCriteria.pdf). “Guide to Ratings Performance,” published in 2011, discusses what ratings performance is, how S&P measures it, and why it is important (http://img.en25.com/Web/StandardandPoors/SP_GuideToRatingsPerformance.pdf). This booklet includes several tables and charts, such as global corporate default rates by rating category. The 2013 “Guide to Credit Rating Essentials” explains what credit ratings are, who uses them, and how they may be useful to the capital markets (https://media.ratings.standardandpoors.com/documents/A+Guide+To+Credit+Rating+Essentials.pdf). The guide presents several useful visual aids, such as the division between investment grade and speculative grade, and the identification of business risk factors versus financial risk factors.

Interactive Tools

A global aging tool allows users to view the impact of aging on total age-related spending and the old-age dependency ratio. The tool includes data from S&P’s 2013 study, “Global Aging 2013: Rising to the Challenge,” which covers 50 countries, representing two-thirds of the world’s population and three-fourths of the world’s gross domestic product (GDP).

Sovereign risk indicators can be manipulated by rating category, geographic region, and country group. Graphical comparisons can be made between individual countries on savings, investment, unemployment, consumer price index, and other factors. Available related reports include “Sovereign Ratings and Country T&C [Transfer and Convertibility] Assessments,” and “Sovereign Risk Indicators,” which provides tabular presentations of the interactive data.

Some of the most practical tools on the S&P website are the credit scenario builders, which can be created online and downloadable as a PDF, or can be prepared in a downloadable Excel format. Each scenario allows for the estimation of several risk and economic factors. For example, the bank credit scenario includes business position, capital and earnings, and liquidity, among others. The corporate credit scenario addresses business risk and financial risk factors, as well as modifiers such as diversification and capital structure. The local government scenario builder covers seven factors, including economy, management, and institutional framework.

Susan B. Anders, PhD, CPA, is a professor of accounting at St. Bonaventure University, St. Bonaventure, N.Y.
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<thead>
<tr>
<th>AD INDEX</th>
<th>Page#</th>
<th>INTERNET ADDRESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avalara</td>
<td>C2</td>
<td><a href="http://www.avalara.com/aasp">www.avalara.com/aasp</a></td>
</tr>
<tr>
<td>Pearl Insurance</td>
<td>01</td>
<td><a href="http://www.nysscpainsurance.com/journal">www.nysscpainsurance.com/journal</a></td>
</tr>
<tr>
<td>Christopher Persson</td>
<td>07</td>
<td><a href="http://www.DeferCapitalGainesTaxes.com">www.DeferCapitalGainesTaxes.com</a></td>
</tr>
<tr>
<td>Accounting Practice Sales</td>
<td>51</td>
<td><a href="http://www.accountingpracticesales.com">www.accountingpracticesales.com</a></td>
</tr>
<tr>
<td>Intuit Full Service Payroll</td>
<td>57</td>
<td><a href="http://www.GetIntuitPayroll.com">www.GetIntuitPayroll.com</a></td>
</tr>
<tr>
<td>Adjusters Internationa</td>
<td>63</td>
<td><a href="http://www.aiblc.com">www.aiblc.com</a></td>
</tr>
<tr>
<td>Transition Advisors LLC</td>
<td>74</td>
<td>www-transitionaladvisors.com</td>
</tr>
<tr>
<td>RF Resources LLC</td>
<td>75</td>
<td><a href="http://www.rf-resources.com">www.rf-resources.com</a></td>
</tr>
<tr>
<td>Lilling &amp; Company</td>
<td>78</td>
<td><a href="http://www.lillingcpa.com">www.lillingcpa.com</a></td>
</tr>
<tr>
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<td>C4</td>
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### U.S. Equity Indexes 5/31/14 YTD Return
- S&P 500 1,924 4.10%
- Dow Jones Industrials 16,717 0.80%
- NASDAQ Composite 4,243 1.60%
- NYSE Composite 10,756 3.40%
- Dow Jones Total Stock Market 20,093 3.50%
- Dow Jones Transports 8,105 9.50%
- Dow Jones Utilities 545 11.10%

### Selected Interest Rates 5/31/14 4/30/14
- Fed Funds Rate 0.08% 0.09%
- 3-Month Libor 0.23% 0.22%
- Prime Rate 3.25% 3.25%
- 15-Year Mortgage 3.28% 3.50%
- 30-Year Mortgage 4.19% 4.41%
- 1-Year ARM 2.41% 2.44%
- 3-Month Treasury Bill 0.04% 0.03%
- 3-Year Treasury Note 0.78% 0.86%
- 10-Year Treasury Bond 2.50% 2.66%
- 10-Year Inflation Indexed Treas. 0.26% 0.49%

### Equity Market Statistics 5/31/14 4/30/14
- Dow Jones Industrials
  - Dividend Yield 2.30% 2.30%
  - Price-to-Earnings Ratio (12-Mth Trailing) 16.05 15.85
  - Price-to-Book Value 2.93 2.92
- S&P 500 Index
  - Earnings Yield 5.66% 5.78%
  - Dividend Yield 2.03% 2.08%
  - Price/Earnings (12-Mth Trailing as Rpt) 17.87 17.30
  - Price/Earnings (Estimated 2014 EPS) 16.08 15.74

### Key Economic Statistics

<table>
<thead>
<tr>
<th>National</th>
<th>Most Recent</th>
<th>Prior Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Producer Price Index (monthly chg)</td>
<td>– 0.20%</td>
<td>0.60%</td>
</tr>
<tr>
<td>Consumer Price Index (monthly chg)</td>
<td>0.40%</td>
<td>0.30%</td>
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<tr>
<td>Unemployment Rate</td>
<td>6.30%</td>
<td>6.30%</td>
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<tr>
<td>ISM Manufacturing Index</td>
<td>55.40</td>
<td>54.90</td>
</tr>
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<td>ISM Services Index</td>
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<td>55.20</td>
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<tr>
<td>Change in Non-Farm Payroll Emp.</td>
<td>217,000</td>
<td>288,000</td>
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<tr>
<th>New York State</th>
<th>Most Recent</th>
<th>Prior Month</th>
</tr>
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<tbody>
<tr>
<td>Consumer Price Index - NY, NJ, CT (monthly)</td>
<td>0.50%</td>
<td>0.40%</td>
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<tr>
<td>Unemployment Rate</td>
<td>6.70%</td>
<td>6.70%</td>
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<tr>
<td>NYS Index of Coincident Indicators (annual)</td>
<td>– 0.10%</td>
<td>2.40%</td>
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### Commentary on Significant Economic Data This Month

U.S. vehicle sales increased to 16.8 million units on a seasonally adjusted annual rate in May 2014—the best pace since February 2007. This represents an increase from 16 million in April 2014 and is above the average of 15.8 million units so far this year. Steady gains in vehicle sales had been expected because the average age of U.S. vehicles is at a record high of 11.4 years, and consumers are trading in their older vehicles for newer ones. Ample incentives, especially during the Memorial Day weekend, and good weather also brought out shoppers.

Most manufacturers (except for Volkswagen) benefited from strong sales during the month. For General Motors, there was little evidence that the company was hurt by recent highly publicized recalls; in fact, sales increased from 2.9 million in April 2014 to 3.0 million in May 2014.

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A Dialogue about Financial Reporting

The challenge of effective financial reporting is a topic near and dear to my heart. I am writing about it again because at Baruch College’s recent Financial Reporting Conference—the focus of this issue of The CPA Journal—I especially enjoyed the interplay between the panelists discussing “Financial Reporting Issues for Preparers” (see page 44). The conference planners chose a group of knowledgeable speakers who represented the various sides of the debate about how to prepare (and audit) financial reports that are useful and compliant. The speakers discussed some of the key issues: complexity of standards, disclosure simplification projects, the responsibilities of auditors, the effectiveness of audit committees, the relevance and usefulness of financial statements, and the regulatory framework around financial reporting.

Improving Financial Reporting

My favorite quote regarding the relevance of financial statements came from Bob Herz, who indicated that we need to stop thinking about a “paper-based paradigm,” and instead focus on making information more useful and having less enforcement and regulatory scrutiny in areas that are not really important. This pertains not just to financial statements, where the requirements are somewhat structured by FASB and SEC standards, but also to corporate reporting packages, investor-relations materials, and other forms of reporting (including sustainability and corporate responsibility reporting).

This same panel mentioned that the most effective audit committee communications (and financial reporting) are those that involve others outside of accounting and finance who truly understand what is going on in a company’s operations and which metrics drive results. This same theme was echoed by Mark Bielstein, who called for “an overall reconsideration” of financial information.

As Herz noted, it is not only the content, but also the delivery, of financial information that is lacking. He pointed out that our reporting system is not what it should be, given available technology. Although much has been said about XBRL as a way to share data in real time, rather than periodically, and to facilitate comparison across companies, would preparers and auditors say that XBRL has actually helped so far? Or has it just added complexity for those trying to tag and report data based on regulatory requirements? Would analysts say that they are benefitting from the use of XBRL data? Or would preparers say that they still have to provide separate reports and answer multiple questions from analysts and rating agencies in addition to their required financial reporting?

The Audit Process and Audit Committees

On the subject of the audit process, I enjoyed the panel discussion around what makes for a “smooth audit” and Robert Laux’s comment that “an audit is not necessarily supposed to be fun.” Both auditors and their clients would surely agree with that statement. I also agree with Laux’s and Allan Cohen’s comments that auditors need to ask tough questions, but management has the responsibility to understand its own issues and help the auditors be more effective through consistent documentation and communications. Writing memos takes time, but it is a key part of internal controls and makes management’s job (along with the auditors’ job) easier, because it memorializes the decisions that were made and the thought processes that accompanied them.

With respect to the discussion about audit committees and their relationship with preparers, I was most interested in the panelists’ differing views on the role and effectiveness of the audit committee in the area of financial statement disclosures. Different companies have different approaches to audit committee involvement; at times, the approach depends upon the company’s size and management’s experience. Over the years, I have worked with audit committees that possessed varying degrees of expertise and interest, and I agree with the panelists’ overall support for and optimism about the role of effective audit committees in improving financial reporting and disclosures.

Cohen shared that his audit committee played an active role in this area by asking at every meeting about sensitive accounting issues and significant areas of judgment related to the financial statements. He suggested that management support the audit committee by providing them with analysis not just on the financial statements but also on other issues important to the company. Laux, on the other hand, expressed his disappointment that audit committees are not structured in a way that allows them to succeed in this area; he noted that too much is expected of them in the limited time they have. Herz, as an audit committee member, supported Cohen’s view that it is important for audit committees to understand key business issues in order for them to ensure that financial statement disclosures and controls are appropriate. Mark LaMonte noted the importance of audit committees in helping management make “strategic choices around disclosure.”

Moving Forward

As the panelists noted, these issues are not new ones, and we have had these discussions at annual conferences for a very long time. FASB and the SEC are working on “new” projects that involve the current disclosure systems, and they are promoting “simplification” once again.

Let’s keep chipping away at these issues. As Laux noted, “Things are complicated, but we’re smart people. We get paid well. We can figure them out.”

Maria L. Murphy, CPA
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