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Navigating Financial Reporting: Views from Regulators and the Profession

On May 2, 2013, Baruch College’s Robert Zicklin Center for Corporate Integrity held its 12th Annual Financial Reporting Conference, where regulators, financial statement preparers and users, auditors, and members of the private sector discussed financial reporting. Featured speakers were outgoing FASB Chair Leslie F. Seidman, SEC Chief Accountant Paul A. Beswick, and PCAOB member Jay D. Hanson. Four panel discussions examined the following: the convergence projects for revenue recognition, leases, and financial instruments; current enforcement issues at the SEC; standards-setting developments in the private sector; and the development of GAAP for private companies.
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This string of accounting scandals has, in turn, sparked deep concerns about the quality of Chinese audits. Audit firms have recently resigned at many China-based companies, citing fake bank statements, made-up invoices, and—perhaps most disturbing—intimidation of staff during the audit. As of 2012, 67 China-based issuers have had their auditor resign and 126 companies have either been delisted or have stopped filing regular reports with the SEC, according to a PCAOB report (http://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx).

Concerns over Chinese audit quality are not limited to smaller U.S. audit firms that lack a proper quality review program and do not have staff who speak Chinese; they also apply to the Big Four audit firms. These concerns are highlighted by a recent lawsuit brought by the SEC against the Chinese affiliates of global accounting firms for failing to hand over documents from their Chinese audit clients who are under SEC investigation for potential fraud.

The Big Four Audit Model in China

Auditing Chinese firms that are preparing to go public on overseas exchanges is a lucrative business. The Chinese arms of the Big Four—Deloitte & Touche, Ernst & Young, KPMG, and Pricewaterhouse-Coopers—dominate China’s accounting industry. In 2010, the combined revenue of their audit practices (excluding consulting business) was more than $1.75 billion, according to the Chinese Institute of CPAs (CICPA; http://www.cicpa.org.cn), and they employed approximately 40,000 people (including consulting services).

Because the Chinese government does not permit foreign ownership of private firms, all of the large accounting firms use a joint venture model to do business in China. The Chinese arms of the Big Four are affiliated with the Big Four global audit networks, but they are essentially Chinese audit firms and fall under Chinese local jurisdiction. For example, Ernst & Young in China is a local joint venture, with the global brand superimposed on the local firm Hua Ming. Pricewaterhouse-Coopers pays a significant “rental” fee for the license of a local joint venture partner, and the firm operates as PwC Zhong Tian in China. In short, the Chinese members of the Big Four global network do not belong to the same partnership structure that U.S. investors are familiar with.

Because the firm issuing the respective audit opinion is responsible for the quality of each audit, auditors of U.S.-traded companies must follow PCAOB rules in overseeing the quality of the audit. Although the joint venture model has worked well in other countries, in China it presents a challenge for reasons including China’s
For the second year in a row, New York State Attorney General Eric T. Schneiderman has taken on the grossly out-of-date laws that govern not-for-profit organizations with his proposed legislation, the Nonprofit Revitalization Act.

Although last year’s attempt stalled in the legislative process before it could reach the floor, Schneiderman made great strides in the 2013 session and introduced comprehensive legislation (S.5845-13/A.8072-13) that was sponsored on both sides of the aisle in both state legislative houses, and was passed at the end of the legislative session.

The Society’s membership had a very big stake in this process. Many members count not-for-profit organizations as part of their client base or work directly for such entities as CFOs, among other positions. In addition, not-for-profit organizations often call upon CPAs in their community to serve as members of their respective boards of directors in order to utilize their financial expertise. The NYSSCPA Not-for-Profit Organizations Committee reflects the size and scope of CPAs’ involvement: it is one of the Society’s most active committees, and its annual conferences in New York City and Rochester attract more than 600 attendees.

The Proposal Process

This legislation is a welcome first step for all of the state’s nonprofits. For years, CPAs involved with not-for-profit organizations have had to navigate a system governed by archaic rules and regulations that drained resources from mission-critical programs, especially those providing important social services to New Yorkers. The need for these services has only grown in recent years, as New York has faced a variety of challenges, from the 2007–2009 recession to Hurricane Sandy.

In brief, the legislation recommends a number of commonsense modernization rule changes for tasks such as meeting notification guidelines. In addition, it contains vital new audit guidance to provide a clearer road map for CPAs tasked with checking not-for-profit organizations’ books. The bill also proposes an increase in the audit threshold in order to provide relief for smaller organizations unduly burdened with unrealistic audit requirements. The new audit guidelines, along with improved conflict-of-interest and whistleblower policies, would improve transparency and increase nonprofits’ accountability to the public.

Since Schneiderman first broached the idea of nonprofit reform last year, the Society has offered assistance on the matter and has been communicating with the State Attorney General’s office. Recognizing our expertise in this area and our increased presence in Albany on other legislative issues, the bill’s sponsors—State Senator Michael Ranzenhofer (R-61) and Assemblyman James Brennan (D-44)—invited the NYSSCPA to take part in the public hearing process. Following the invitation, members of the Society’s Not-for-Profit Organizations Committee and Legislative Task Force put together a basic response to the proposed bill and crafted those comments into testimony that Society members Kevin McCoy and Ethan Kahn delivered in May 2013 before the New York State Senate and Assembly Committees on Corporations, Authorities, and Commissions.

The Society supported the overall concept of the legislation; the members who reviewed it said that it provided a refresh for the 21st century. Their technical recommendations centered on the desire to see increased unification and consistency in the language of audit standards and related guidance. Following the testimony, one of the bill sponsors and the State Attorney General’s office asked the Society to submit further technical comments and to present its overall impression of the bill; this signifies a great stride both for the Society and the accounting profession in increasing our involvement in the legislative process.

Getting Involved in Government

The Society’s involvement in the early stages of this bill is a direct result of our improved, proactive, and member-responsive approach to government relations. Through member support, we are able to establish connections and influence with lawmakers and officials in Albany, so that when the call goes out for relevant subject matter experts, we are on the list.

The NYSSCPA is playing a greater role in the legislative process. Presenting public testimony during the initial rollout of related legislation is now another tool that the Society can use to spread the word about the level of expertise that CPAs possess in many legislative topic areas. For far too long, lawmakers in Albany have undervalued the voice of CPAs, even when subjects directly related to the profession are discussed and codified into law. Our efforts on a variety of bills this past legislative session—one of the most active for the Society—illustrate the valuable progress we are making in establishing ourselves as a trusted resource for lawmakers.

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(Continued from page 6)

political structure; the complex Chinese corporate structure; and the significant language barrier or unique local customs, such as paying kickbacks. These issues will only become more complicated, given that most of the joint ventures will expire in a few years when the Big Four Chinese firms have to convert to local partnerships.

PCAOB Oversight

In China, the Ministry of Finance (MOF) and the China Securities Regulatory Commission (CSRC) jointly oversee the activities of the accounting and auditing profession. The MOF licenses all accountants in China and oversees accounting firms that audit private companies. The CSRC, created in 1992, has jurisdiction over accounting firms (including local Big Four audit firms) that audit the public companies with securities listed on the Chinese domestic market. It governs all securities exchanges and futures markets activity within China; similar to the SEC in the United States, the CSRC is the regulatory body that enforces securities laws and regulations in China.

The Sarbanes-Oxley Act of 2002 (SOX) requires periodic inspections of public accounting firms that audit companies whose securities trade in the United States. As long as they audit companies listed on U.S. exchanges, Chinese audit firms are required to register with the PCAOB. In theory, they must go through the same level of scrutiny as their U.S. counterparts; in practice, however, the PCAOB has not inspected any of the Chinese audit firms, including those affiliated with the major international audit networks. So far, Chinese authorities have refused to grant the PCAOB permission to inspect China-based auditors, citing concerns of sovereignty and national security. This lack of PCAOB oversight imposes significant financial risks on U.S. investors.

Many of the recent accounting frauds that occurred in publicly traded Chinese firms were facilitated through use of “reverse mergers.” In a reverse merger, a private company—for example, one based in China—buys a public shell company that no longer operates but is listed on a U.S. exchange; the private company then sells its shares on the exchange through the approvals granted to the previously listed company (“Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region,” PCAOB, Mar. 31, 2010). This technique allows companies to start trading without going through a formal underwriting process or having prospectuses reviewed by the SEC. Arguably, the lack of scrutiny involved in the process makes reverse mergers much more susceptible to fraud.

Although the PCAOB and the SEC have sought to investigate some of the audit firms involved with these companies, they have been stymied by Chinese authorities. Those

Concerns about the audit quality of Chinese companies are further fueled by a recent localization rule for foreign auditors.

agreement permits the observers to watch Chinese officials’ examination of audit firms’ quality controls, but it does not allow detailed reviews of specific audits. Although this indicates progress, the agreement is far from the PCAOB’s goal of achieving the same level of rigor in a PCAOB review for accounting firms that audit the Chinese companies listed in the United States as in a review of any other auditor of U.S.-listed firms.

Localization and Independence

Concerns about the audit quality of Chinese companies are further fueled by a recent localization rule for foreign auditors in China. In May 2011, the MOF announced a new regulation to assert more control over Chinese affiliates of major accounting firms. The new rule limits the percentage of foreign-qualified partners at the Big Four auditing firms in China at 40%, as of August 2013, and at 20% by 2017. The new rule also calls the Big Four to localize their management ranks, starting in 2013, and to appoint Chinese citizens to head their mainland operations within five years. Lastly, the MOF stipulated that foreign partners should become Chinese CPAs after a three-year grace period in order to qualify to be chief partners.

Although the Big Four firms have hired thousands of Chinese accountants in recent years, the China operations of these firms rely heavily on foreign expertise. Many of their senior staffers and partners in charge are expatriates who have come from outside China. Because the CPA exams in China are very hard to pass and are not given as often as CPA exams in the United States, only about 30% of the Big Four’s partners in China have been certified in China (http://articles.latimes.com/2012/may/10/business/la-fi-china-auditing-rules-20120511). Although many CPAs in China are educated and trained in the United States and there is no shortage of qualified Chinese CPAs in China, China’s rapid economic growth has created a huge demand for experienced auditors. The biggest challenge facing the Big Four is to find qualified Chinese accountants to carry out the audit and train local employees to be senior partners.

By localizing the affiliates of Big Four firms, China is bringing them in line with
norms seen in other countries—for example, accounting firms in Singapore must be owned by locally qualified accountants. But it is not clear whether China and its auditors are ready for such a shift. There are considerable concerns that the localization rule might increase the influence of Chinese authorities over the auditing profession in China and impair the independence of Chinese auditors. Many observers question whether local partners will be as independent as foreign partners with respect to large state-owned enterprises, and they fear that local partners are more susceptible to political pressures than foreign partners because of their close ties to government (e.g., see Paul Gillis, China Accounting Blog, www.chinaaccountingblog.com).

Historically, the majority of Chinese CPA firms were established by the government and sponsored by the state. At the national level, the Chinese auditing profession is not self-regulated, but government-regulated. The association between the Chinese government and audit firms suggests that the audit firm, in essence, is a government entity. Similarly, the controlling shareholders of many listed or unlisted companies are also government entities. The government ownership of both clients and their auditing firms makes it difficult for auditors to distance themselves from the client and thus be truly independent. Even though many businesses have gone through a disaffiliation program and are no longer owned by the government, that association still exists informally. This political and economic interdependence of the audit firms, clients, and government can compromise auditor independence.

Implications

The quality of Chinese audits is a function of many key factors, such as the development and implementation of a comprehensive quality control program, auditor rotation, and periodic inspection by regulators. Nevertheless, the quality of Chinese audits will also be affected by the success of the localization process and the ability of the PCAOB to oversee Chinese auditors. In the long run, the PCAOB must find ways to collaborate with Chinese authorities to inspect China-based audit firms in order to ensure the quality of financial statements and protect U.S. investors.

Ning Du, PhD, is an associate professor, and Kevin Stevens, DBA, CPA, is the KPMG Alumni Distinguished Professor of Accountancy and the director of the school of accountancy and management information systems at DePaul University, Chicago, Ill.

CEO Compensation: Chasing the ‘Welch Rabbit’

CPA Journal Editor-in-Chief Mary-Jo Kranacher wrote an excellent column on a difficult subject in her May 2013 editorial, “CEO Compensation Controversy: A Corporate Governance Failure.” Having served as director of a Big Four firm’s review service for Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation, I assisted GE with valuation calculations with regard to Jack Welch’s retirement package. I agree in general with Kranacher’s assertions about excessive executive compensation, but the $417 million figure that she referenced is, in my opinion, overvalued by approximately 100%, due to the flawed valuation protocol of SFAS 123 (now Accounting Standards Codification (ASC) Topic 718, “Accounting for Stock Compensation”)—and perhaps also due to the exuberance of the former Mrs. Welch’s (Jane Beasley) divorce counsel.

What Kranacher has touched upon is the role that Welch’s retirement package played in compensation circles after his retirement. That package became a “marker”—that is, an upper limit now in play by consultants and corporate boards in setting stock-based compensation amounts granted to key executives. Welch’s retirement package became the “rabbit” that other executives chase; although it was generally reachable by virtually no one, it was still in the public arena and available as a reference point.

In my opinion, great CEOs are worth any amount that they are paid—now more than ever. Our excessive executive compensation issue is twofold: 1) we have far too many mediocre executives who benefit from the compulsion by consultants and compensation committees to ante up for top talent, and 2) we have far too few great executives whose executive compensation, excessive or not, would be happily agreed to and accepted by all parties involved. The solution: we need more rabbits.

Timothy R. Wing
CME Stock/Option Consulting Services Inc.
Warrenville, Ill.
2012 Max Block Awards Presented

The winners of the 2012 Max Block Distinguished Article Awards were honored during The CPA Journal Editorial Board meeting on June 3, 2013. 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 Mary-Jo Kranacher presented the awards to three authors—Vincent J. Love, Richard H. Kravitz, and Arron Scott Fleming—at the meeting. Although author Nicholas C. Lynch could not attend in person, he did send a letter of thanks that was read aloud at the meeting. The 2012 winners are as follows:

**Technical Analysis.** “A New Perspective on an Old Problem,” by Jack W. Dorminey, Arron Scott Fleming, Mary-Jo Kranacher, and Richard A. Riley Jr., June 2012, won in the Technical Analysis category. This article looked closely at fraud and presented a meta-model to serve as a framework for considering possible fraud acts, as well as for more effective and efficient fraud prevention and detection. The authors also focused on the factors that stand between a potential perpetrator and a financially motivated crime, such as internal controls and corporate governance.

Jack W. Dorminey, PhD, is an assistant professor of accounting in the college of business and economics at West Virginia University, Morgantown, W.Va. Arron Scott Fleming, PhD, CPA, CMA, is an associate professor of accounting, also at West Virginia University. Mary-Jo Kranacher, MBA, CPA/CFF, CFE is The CPA Journal Editor-in-Chief and the ACFE Endowed Professor of Fraud Examination at York College, City University of New York. Richard J. Riley Jr., PhD, CPA/CFF, CFE, is a member of The CPA Journal Editorial Board and the Louis F. Tanner Distinguished Professor of Public Accounting, also at West Virginia University.


These articles examined ethics and morality in the profession, with respect to whether an auditor should be held responsible for fraudulent financial statements. They addressed whether the profession has abandoned its mission to protect the public trust and whether the current system for addressing auditing issues and making reasoned changes is satisfactory.

Richard H. Kravitz, MBA, CPA, is the founding director of the nonprofit Center for Socially Responsible Accounting, as well as a fellow of the American College of Forensic Examiners and a member of the NYSSCPA’s, the AICPA, and the American Society of Pension Professionals and Actuaries. He is also managing director of R H Kravitz & Company, Island Park, N.Y. Vincent J. Love, CPA/CFF, CFE, is a member of The CPA Journal Editorial Board and the managing director of VJL Consulting LLC, New York, N.Y.

**Policy Analysis.** “The Controversy over Private Company Reporting Standards: Recommendations of the Blue Ribbon Panel and the Financial Accounting Foundation’s Response Spark New Debate,” by Nicholas C. Lynch, July 2012, won the Max Block Award for Policy Analysis. In the article, the author explored the debate over the creation of GAAP for private companies and provided a comprehensive overview of the standards-setting developments in this area.

Nicholas C. Lynch, PhD, is starting a new position in the fall as an associate professor of accountancy at California State University, Long Beach, Calif.

Determining the Winners

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

About Max Block

Max Block (1902–1988) was a founding partner of Anchin, Block & Anchin LLP, and he 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.”
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In the author’s opinion, the student loan industry will be the next area of failure that will cost taxpayers significantly.

A Debate on Debt

In the author’s opinion, the student loan industry will be the next area of failure that will cost taxpayers significantly. I recently spoke with a couple that was seeking general financial advice. Both individuals are between 20 and 30 years old and live in New York City; the husband has an annual income of $55,000, and his spouse earns $35,000 annually, with a child on the way. They are trying to accumulate funds to purchase a house in northern New Jersey with a 30% down payment, but they are struggling; between them, they have $385,000 in student loans outstanding from private education. Unfortunately, this has become a very common case.

According to a New York Times editorial, student loan debt is nearly $1 trillion (“Student Debt Debacles,” Oct. 24, 2012). Moreover, college tuition is increasing at an average rate of 8% per year, while the Society of Human Resources Management states that salaries are increasing at an average rate of approximately 3%, consistent with the current rate of inflation. These statistics indicate an issue that requires attention. Who is going to “bail out” the institutions that granted or purchased these loans as they eventually fail when borrowers have no means to repay them?

Responsibility for these loans will rest with the taxpayers, in the form of yet another government bailout. Should one be allowed to borrow $300,000 to fund an education that has a limited chance of producing an income or employment great enough to sustain future repayments and standards of living? Should there be lifetime loan limits to individuals, based upon anticipated average salary within a profession, or based upon university job placement statistics within a specific academic program? Should the rules be significantly tightened up for academic progress and loans stopped sooner than they are presently for students who show little promise of graduation or ability to earn sufficient income to pay off the debt?

These are tough questions, and I cannot provide answers in this article. These questions have the potential to seriously divide society and lead to significant debate over equality, opportunity, and the right to a college education for all individuals. Faculty and administrators from universities and programs that historically have low job placement and minimal starting salaries or from high-tuition private universities might also have a lot to say in an effort to justify why certain majors and programs should exist, or even why some schools should be entitled to any federal student loan funding.

A Call for Change

One can only delay pain for so long; the bailout of banks after the last financial crisis was no more than a stopgap to delay the significant failure of other bubbles, such as the student loan industry. Without significant social responsibility, to educate lawmakers on the implications of their policies, as well as to educate the next generation on basic financial literacy, so its members make the right decisions for their future. The time for CPAs to act is now.

Mitchell Franklin, PhD, CPA, is a professor in the Joseph I. Lubin School of Accounting at Syracuse University, Syracuse, N.Y.
Regulators, financial statement preparers and users, auditors, and members of the private sector discussed developments in financial reporting at Baruch College’s 12th Annual Financial Reporting Conference, hosted by the Robert Zicklin Center for Corporate Integrity, in New York, N.Y., on May 2, 2013. The featured speakers were Leslie F. Seidman, outgoing FASB chair; Paul A. Beswick, SEC chief accountant; and Jay D. Hanson, a member of the PCAOB.
Four panel sessions throughout the conference examined several timely topics. The first panel looked at progress made by FASB and the IASB on the “big three” convergence projects—revenue recognition, leases, and financial instruments. The next panel provided updates from the SEC’s corporate finance and enforcement divisions. An afternoon panel examined standards-setting developments in the private sector, with a focus on recent projects from FASB, its Emerging Issues Task Force, and the AICPA Financial Reporting Executive Committee. The final panel debated the development of GAAP specific to private companies, as well as the role of the Private Company Council.

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.
Leslie F. Seidman presided as FASB chair from December 2010 to June 2013 and served two terms as a FASB board member since July 2003. Prior to her appointment as chair, Seidman first served as a FASB industry fellow, later as a project manager, and then as assistant director of research and technical activities. Before joining FASB, she set accounting policies for J. P. Morgan & Co. (now JPMorgan Chase) and worked as a member of Ernst & Young’s audit staff.

Paul A. Beswick is the SEC’s chief accountant. The Office of the Chief Accountant (OCA) is responsible for establishing accounting and auditing policy at the SEC. Beswick oversees the SEC’s work with private-sector accounting organizations, such as FASB; he also serves as an observer to FASB’s Emerging Issues Task Force (EITF). Prior to joining the SEC, Beswick was a partner at Ernst & Young.

On May 2, 2013, Seidman and Beswick presented the opening remarks at Baruch College’s 12th Annual Financial Reporting Conference, discussing recent developments at FASB and the SEC, respectively. The following is an edited transcript of their remarks delivered at the conference.
This spring, FASB is celebrating its 40th anniversary, and we are here to stay. FASB was created in response to calls for greater independence and accountability in the development of accounting standards. We’ve had six chairmen over those 40 years, and although each of us has clearly introduced new ideas about processes and priorities, two things have remained constant: 1) our commitment to developing standards that benefit investors by providing a clear window into the financial condition and performance of the companies in which they are invested or they seek to invest in, and 2) our commitment to a transparent, collaborative process that involves all of our stakeholders and produces standards that meet users’ informational needs at a reasonable cost. My 10-year term ends on June 30, and my successor and fellow board member Russell Golden will become the seventh chairman of FASB.

I’d like to start by giving you an update on how FASB is working to promote convergence of global accounting standards. I then want to highlight some developments on the due process front here at home, including how we’re considering costs and benefits, and then I want to mention plans related to FASB’s future technical agenda.

**FASB remains committed to our longstanding and long-term objective of improving U.S. GAAP.**

**Working with the IASB**

The past four decades have seen remarkable development in the improvement and convergence of financial reporting internationally, driven by the demands of our increasingly global capital markets. Since signing the Norwalk Agreement in 2002, FASB and the IASB have completed work on a number of major joint projects, including our impending standard on revenue recognition. Our work together has both improved financial reporting and brought global reporting standards much closer together, delivering significant benefits to investors and other users of financial statements around the world.

Our methods of working together have evolved over those years. Most recently, as you know, FASB and the IASB have been working intensely as partners on the revenue recognition, leasing, financial instruments, and insurance projects. The completion of these remaining four joint projects over the course of the next year or so will end our formal bilateral relationship with the IASB. It will not, however, end our participation in the development of improved and converged global standards.

The establishment of the ASAF [Accounting Standards Advisory Forum] ushers in a new, multilateral approach to pursuing the objective of global convergence. FASB, along with representatives of 12 other national or regional accounting standards setters, will meet periodically to advise the IASB as it develops IFRS. FASB’s participation on the ASAF is an important opportunity to represent U.S. perspectives in the IASB’s standards-setting process and to learn from the experiences of other jurisdictions. We plan to support the process by providing research and analysis, staff support, and timely comments on the IASB’s discussions. One of the key projects that this group will discuss with the IASB is the conceptual framework project, including measurement, derecognition, and other comprehensive income. The IASB is planning to issue a discussion paper sometime this summer, and FASB will help solicit input from U.S. stakeholders.

FASB will retain control over its own technical agenda. Whether we’re considering the conceptual framework or any other project, any proposed changes to U.S. GAAP will go through FASB’s deliberative and public due process procedures. On topics of mutual interest, our goal will be to contribute to and leverage the work of the IASB in order to maximize the changes for a converged outcome.

At least for now, FASB will continue to decide what changes are made to U.S. GAAP following our normal due process procedures. In the absence of any decision from the SEC, I want to emphasize that FASB remains committed to our longstanding and long-term objective of improving U.S. GAAP and promoting greater convergence in financial accounting standards. Ideally, the world’s standards setters can work together, so that eventually the differences in standards across nations will become so insignificant that the standards have, in effect, become a single set of accounting standards.
In Focus

FASB’s Standards-Setting Process

Accounting standards are essential to the efficient functioning of the economy because decisions of how resources are allocated depend upon credible, concise, and understandable financial information. A body of academic research demonstrates the link between the decision-usefulness of financial information and the cost and availability of capital—that is, higher quality financial reporting reduces investor uncertainty, which has a beneficial effect on the cost of capital, bid-ask spreads, market liquidity, and so forth. For that reason, our starting point in developing an accounting standard is understanding and evaluating the investor’s perspective. How can we make financial reports more decision-useful for them?

Doing a better job at gathering information from investors—the benefit side of the equation—is one of the most significant improvements to the process that we’ve made in recent years. But financial information comes at a cost—the cost of preparing and using that information. So when FASB says it won’t issue a standard unless the benefits justify the cost, it means that we aim to issue standards only if the expected improvements in the quality of reporting will justify the cost of preparing and using the information. Until investors have experienced using that information, our understanding of the benefits is based upon what they tell us they need, and how they plan to use it. Likewise, until a company has adopted a new standard, our understanding of the cost is based upon their imprecise estimates, even in a well-constructed and broad-based field test.

The process that I’ve just described to identify the most faithful way to produce the information includes an implicit statement: we do not try to control how others will interpret or act on the information. We also do not attempt to quantify a specific economic effect on a particular company or a particular industry. For example, if we were to issue a standard that changes a measure of leverage, the cost of capital for entities with higher leverage could rise, whereas the cost of capital for other entities with less leverage could decline. We don’t try to influence the outcome of that reallocation or repricing of capital.

Our goal is to provide neutral information; however, it is observable that when market participants perceive an improvement in the credibility of the information they’re receiving, the efficiency of the market improves, and investors are better able to price stocks and other capital investments.

Expanded Outreach Efforts

The entire FASB standards-setting process is a means of gathering information and carefully analyzing the expected benefits and costs of proposed changes. We regularly review and modify our procedures to enhance the quality of that analysis. For example, we’ve expanded and will continue to expand our outreach efforts to financial statement users, particularly in the early, preagenda evaluation of whether to add a project to make sure that we’ve properly identified the problem or the potential improvement in reporting. We’ve also been using our XBRL [Extensible Business Reporting Language] team to conduct research on our projects and to identify current reporting processes, as well as part of our postimplementation review process.

We’ve also expanded our outreach to the preparer community by hosting industry workshops and other forums at which preparers provide focused input on the cost and workability of our proposals. Our extensive work on the revenue recognition proposal, which also included investors, is an example of this proactive approach. In addition, we’re developing a transition resource group on the revenue recognition project and on any other major changes in accounting in order to provide a transparent way for questions about implementation to surface and be resolved.

In recent years, the Financial Accounting Foundation [FAF] has also implemented a postimplementation review process that takes an independent look at the effectiveness of the standards after they’ve been in effect for several years. These postimplementation reviews provide us with useful information about the benefits and costs of financial reporting in light of actual experience in both preparing the information and in using it.

Our staff is now analyzing how we might address these findings. The evaluation of whether a proposed accounting change produces more useful information to investors at a reasonable cost is necessarily subjective; however, we are committed to using methods that proactively and broadly engage users, preparers, auditors, and regulators so that board members can make informed decisions, and in responding to that feedback, board members can identify areas for further improvement and change. The process should work as a continuous feedback loop, so that we are improving reporting on a timely and efficient basis.

FASB’s Upcoming Agenda

The last topic that I’d like to mention is FASB’s future agenda. Several of our major projects will conclude over the next year or so. We asked our Financial Accounting Standards Advisory Council (FASAC) to gather information from stakeholders about potential agenda items for FASB in the near future. We’re going to be asking about the importance and relative priority of projects that we have put on the backburner in order to make room for higher priorities, such as distinguishing between liabilities and equity and improving financial statement presentation; items that have been in the news recently, including accounting for pensions and accounting for income taxes; convergence items; and any other topics that stakeholders would like to raise.
Current Priorities
Overview of OCA and Its SEC Chief Accountant
PAUL A. BESWICK
Paul A. Beswick is the Chief Accountant at the SEC, overseeing the PCAOB and the IASB, and overseeing the OCA. The office is set up such that there is a chief accountant who is, by title, listed as the principal advisor on all accounting, auditing, and independence matters. There are three groups within the OCA: an accounting group; a profession-al practice group, which is responsible for overseeing the audit and independence functions; and an international group. The importance of the international group is that the SEC plays a very active and involved role in the International Organization of Securities Commissions (IOSCO). We also have a chief legal counsel.

Consultations
Are we improving the decision-usefulness of information to investors? Can the standards be implemented?

Another aspect is rulemaking. Although we don’t take the lead on many rulemak-ings, we are very active in a number of them. It always seems that no matter what the SEC picks up, there’s some inter-action with either accounting and auditing independence. So we work very closely with our other offices and divisions.

In terms of our priorities, we’re spending a lot of time working on the conver-gence projects. FASB and its staff are pro-ducing several exposure drafts right now, and we’re spending a lot of time reviewing them and providing our comments. We have a group of about 12 people who work on overseeing the PCAOB; they also have a very active agenda in terms of standards set-ting. We’re also focusing on IFRS outreach.

In terms of the nature of the consultations, they haven’t been changing much year over year, but if you look at the top four, you have revenue recognition (which is primarily principal-agent consideration and multiple-element arrangements). You’ve got financial instruments, troubled debt restruc-turings, allowance for loan losses.

Getting a little more granular in terms of the process: when a consultation comes in, we assign a team to it, usually three to four people who have expertise in the area. We then focus on understanding the transac-tion and obtaining the relevant facts. We try to understand the basis for the company’s accounting. But ultimately, what we’re trying to do is make a determination about whether we object to a company’s accounting.

Overview of OCA and Its Current Priorities

The past six months at the commission have seen a lot of change. The former chief accountant has left; we now have a new chairman—Mary Jo White—and she’s very quickly prioritizing her issues and get-ting stuff done. But in the past six to nine months in the OCA, we’ve really been sticking to our core competencies, like consulti-tations, overseeing the standards setters (FASB and the IASB), and overseeing the PCAOB. The office is set up such that there is a chief accountant who is, by title, listed as the principal advisor on all accounting, auditing, and independence matters. There are three groups within the
accounting literature, discuss the difficult judgments with the registrant, and ultimately conclude whether we object. That’s generally the process we try to follow.

We honestly don’t try to substitute our judgment for the judgment of the company and its auditors. We’re really trying to determine whether the accounting is outside the bounds of what is acceptable. Unfortunately, in those situations where we do object, people have tended to say that we substituted our own judgment, but that’s not really the goal. We don’t try to push preferred views; if there are multiple views that are acceptable under the literature, we really try to support that. We use this whole process of consultations as input into FASB’s standards setting; as input for our own efforts; and, in some cases, as input for the enforcement division.

**Standards Setting and Convergence**

I often get asked what our role is in relation to FASB’s standards setting. The approach that I take, and I know some of my predecessors have taken this approach, is that we really don’t try to substitute our judgment for what FASB is doing or what the IASB might be doing. We look at our role in terms of answering some key questions: Are we improving the decision-usefulness of information to investors? Can the standards be implemented? Are the objectives sufficiently clear? We look to FASB as the experts and accounting standards setter; its staff has done a lot of work and a lot of outreach. We really try to just focus on making sure that the standard is improving financial reporting. I think FASB should get a lot of credit because they’ve really increased both the quality and the quantity of outreach to investors over the past couple of years.

I would be remiss if I didn’t talk about IFRS. We frequently get asked what the next steps are. As I said, we’ve got a new chair and she’s working through her priorities. I wouldn’t read into anything, in terms of whether IFRS isn’t or is a priority. I think there are just some things that need to get addressed first—money market fund reform, cross-border filing, those sorts of things.

In 2010, the commission issued a statement in support of convergence in global accounting standards and directed the staff to develop and execute on a work plan. The staff finished that work plan on July 13, 2012. As we looked around the global market, we learned that almost every jurisdiction has some sort of mechanism to ensure suitability, and I don’t think that should be lost on anybody. At times people came in and said, are you trying to get rid of FASB? In my view, FASB is integral to any decision that the commission makes. And one of the things we heard from people is that FASB does a wonderful job and that we need to keep it heavily involved. That’s not to say that there wouldn’t be benefits from taking the next step, and the question is: what is the next step, and how big a step are we going to take? That’s something that the staff is continuing to study; we’re continuing to do outreach to preparers and auditors to continue to explore these issues.

Why does this matter? Why does moving to a single set of global accounting standards matter? When I look back to my experience at the commission, as compared to when I started there four-and-a-half years ago, things are getting more global. It’s not just accounting. The commission is working on over-the-counter derivatives, and they’re working hard to try to resolve the issue on a global basis. That’s not to say that we’re going to give up our sovereignty and regulate over-the-counter derivatives, and rely on somebody else to do that regulation. But one of the things that the financial crisis taught us is that there is interconnectedness, probably a lot more than we might have realized.

The other reason why IFRS matters and why a single set of standards matters is that IFRS is already in the U.S. capital markets. IFRS in the U.S. capital markets is probably a lot bigger than people realize. Since the commission lifted the reconciliation for foreign private issuers, we’re now up to more than 450 foreign private issuers who are using IFRS without reconciliation. The market cap is in the trillions of dollars for those foreign private issuers, which is bigger than a lot of jurisdictions that claim to be on IFRS. There are U.S. investors who are trading and making investment decisions using IFRS-based standards. From my perspective, it’s important that we stay involved. I think Leslie’s given you some wonderful examples of what FASB’s doing through its participation in the ASAF. We were very supportive, and we think their participation can improve that product. Once again, I don’t think their participation lessens their role in the U.S. capital markets. I think FASB’s role in the U.S. capital markets will always be important.

There are other things we’re doing as well. The chair of the SEC is on the monitoring board, which provides the governance oversight to the IASB. The IASB is including the United States in many more working groups. For example, it has a working group that’s trying to do what they call “effect analysis.” They’re trying to determine how they should think about costs and benefits, and I’ll be participating in that, along with some representatives from FASB. Things are becoming more interconnected, and that’s why this matters. People are making investment decisions based upon IFRS, so it’s important that we focus on IFRS and try to make it the best-quality product that we can.

**Questions from the Audience**

**Audience Member:** At each conference, the SEC representative says...
that they’re studying the issues. Conceptually, this works, but you’ve got to take a stand.

Beswick: One of the things that we’ve learned is that, right now, there is a lot of change fatigue in the system. FASB is setting standards on some of the most fundamental projects that exist in financial reporting. A typical refrain we hear from preparers is that all they can handle right now is what FASB’s already putting out. So to layer on top of that another series of changes could be somewhat problematic.

What I’m trying to do is think about the ways that we can have a softer transition over time. In some ways, that will frustrate preparers because they’ll feel like they’re facing perpetual change, and that’s one of the challenges we face. But I think there is real risk to the system if you use a “big bang” approach.

We’re also seeing that in other jurisdictions, like Japan and India, which are having the same realizations in terms of change management. That’s one of the reasons why we’re studying it. We are eight years ahead of where we were five years ago, in terms of the level of information that we have on this. It might have slowed down the process, but it’s going to make any decision that’s made a better decision. We’re a lot better informed today, and by using that information, we can make better decisions.

Audience Member: My question relates to the revenue recognition, as it relates to IFRS adoption. One of the larger debating points when we were talking about IFRS adoption was the importance of the regulation system around revenue recognition in terms of SEC enforcement. But now that we’re evidently going to have a joint project on revenue recognition, and we’re going to have some experience in the application of that guidance, do you see that particular impediment lessening as an objection to IFRS?

Beswick: I don’t want to say we’re experimenting with the capital markets—but this is going to be an interesting test from a regulatory perspective. It’s good that FASB and the IASB can get to a converged standard, and I think they deserve a lot of credit for getting to that. We then have to look not only to FASB and the IASB, but to the securities regulators and the accounting firms to make sure that application and enforcement is relatively consistent. You’re never going to have perfect consistency; you don’t even have that in U.S. GAAP. But the range of consistency, at least what we’ve seen in U.S. GAAP, is fairly narrow, and I think people are interested in making sure that remains the case on a global basis.

One of the things we’re doing is increasing our interactions with our counterparts across the globe. There’s an organization called ESMA—the European Securities Market Authority. They oversee securities regulators throughout the European Union. We’re increasing our interactions with them. We’re having greater dialogue with people in Asia. Really, it’s to share views and highlight places where the divergence might become too great. To the extent that we see that, we then need to go inform the standards setters. We’re already seeing that, in standards that have converged. Things are getting sent to the International Financial Reporting Interpretations Committee [IFRIC], for instance, on issues where there was convergence and we identified some different practices.

To your point, that’s a really good test case to make sure that these standards can stay converged. That’s one of the things that preparers and investors want to see. I think FASB coming up with this resource implementation group is a wonderful step; it demonstrates great leadership by FASB and the United States on a global basis.

Seidman: I was going to mention the plan to develop this implementation group, and our view is that the IASB should be participating with us on it. One of the suggestions is that we might include somebody from IOSCO, an international securities regulatory group, which will provide a natural mechanism for diversity in interpretation to surface early in the process, so that we can resolve those matters before widespread application. We’re taking the steps we think are necessary to have a transparent, thorough discussion of the standard.

As you know, we’ve allowed for a significant amount of lead time to adopt the revenue recognition standard, but we really want to make this transition as smooth as possible for everybody on not only the preparer side—because we know for some industries it’s going to be a costly effort to systematize this—but also, importantly, on the investor side. We want to try to avoid having a hiccup in the transition to revenue recognition if at all possible.

Audience Member: In your personal opinions, did the rule that allowed foreign-based corporations to issue financial statements here without reconciliation to GAAP further your core mission of financial statements being more readily understandable by the investment public?

Beswick: In 2008, when the commission took action, it was to remove the reconciliation. Companies always could have used IFRS, so I don’t know if the information loss was in the reconciliation. On a global basis, it sent a good message about not having carve-outs and trying to promote high-quality financial reporting. We’ve learned a lot through that process. We issue comment letters on FDIs [foreign direct investments] that are filing under IFRS. The marketplace is learning from our experiences, in terms of our understanding of IFRS.

When I look back to four-and-a-half years ago, our understanding of IFRS has increased significantly. What would be interesting would be to do some sort of postimplementation review or to go back and look at investors and how they’ve reacted to the loss of incremental information that is the reconciliation. That’s something we haven’t done, but that might be an interesting exercise.

Seidman: The exercise would probably give you a different result today than it would back then, because we’ve continued to narrow the differences between U.S. GAAP and IFRS. I do think it has furthered our core mission, with regard to our commitment to converge these standards. The fact that there are more than 400 foreign private issuers filing in the U.S. capital markets with a different set of accounting standards provides the impetus for us to continue to narrow the differences.
The Big Three
Convergence Projects

Revenue Recognition, Leases, and Financial Instruments

Panelists Leslie F. Seidman, Paul A. Beswick, Katherine Gill-Charest, Mark LaMonte, and John Bishop
Revenue Recognition, Leases, and Financial Instruments

The first morning panel at Baruch College’s 12th Annual Financial Reporting Conference on May 2, 2013, focused on three standards-setting projects integral to the convergence of U.S. GAAP with IFRS: revenue recognition, leases, and financial instruments. The panelists discussing these issues represented preparers, regulators, users, and auditors. Norman Strauss, the Ernst & Young Professor-in-Residence at Baruch College, moderated the panel.

Accounting for Leases

FASB Chair Leslie F. Seidman commenced the discussion on the accounting for leases project, which was driven by the SEC’s recognition that off-balance sheet financing needed to be addressed. The current guidance—what Seidman called “a poster child for rules-based accounting”—is not only too complex for people to understand and apply, but it also provides the opportunity for structuring transactions in order to end up with completely different representations of transactions on the financial statements, despite only minor changes in contractual terms.

John Bishop, a partner at PricewaterhouseCoopers, summarized the proposal’s effect on lessees: “The cornerstone goal was to put all leasing arrangements for lessees on the balance sheet.” Lessors, on the other hand, will follow “a two-model system, not unlike what we have today”: the receivable and residual approach and the operating lease approach.

Representing preparers, Katherine Gill-Charest, senior vice president and controller of Viacom Inc., said she believes that the profession will see a completed standard: “The hybrid method that has emerged after the initial exposure draft goes a long way to address many communities’ issues with the potential change in P&L [profit and loss] recognition that could have happened.”

Mark LaMonte, managing director and chief credit officer of Moody’s Investors Service, noted that “ultimately, what’s going to end up back on the balance sheet as a result of applying the standard isn’t going to satisfy too many users of financial statements.” He added, “What we’re going to have to do is adjust on top of what’s going on the balance sheet. And quite honestly, it’s easier to start from zero and adjust than it is to start from halfway there, unwind what was done, and then adjust.”

In the two-model system for reporting, “a lot of the concepts about inclusion of renewal options are very similar” to what exists today, Bishop said. “It won’t surprise me if things don’t start to behave the same way. Contingent rents are included in the same way that we have today. The changes are not as acute, and so therefore it will make the costs of implementation a much more sensitive issue. … The question is: could these issues have been fixed with a targeted remediation, as opposed to a broad brush?”

SEC Chief Accountant Paul A. Beswick later responded to this point: “I’m not sure if targeted changes ever could have worked. Having a rethink of the model makes a lot of sense.”

Seidman followed up by saying that FASB had conducted outreach on this question with investors, who had diverse perspectives but tended to agree that “putting these obligations on the balance sheet is an improvement. … And there’s also a generally common belief that they would like one method for doing so—but they don’t agree on the method.”

Lease Terms and Renewal Options

Strauss next detailed certain changes in the second exposure draft, including the approach that leases with a term of 12 months or less do not need to go on the balance sheet. LaMonte considered whether analysts would accept this approach: “The change regarding the renewal options of lease terms is one of the things that moved me away from my support for this proposal.” He gave an example of two airlines—one that buys all of its airplanes and one that leases them—that analysts would want to compare in terms of leverage. But “when you narrow the definition of lease terms to more of a base term and make
Presentation

The most controversial area in lease accounting is the effect on the balance sheet, Strauss said. “When leases are recorded on the balance sheet, you put the asset up at the present value of the lease payments and the liability up at the same amount,” Seidman explained. “The asset is amortized over time as amortization expense and then interest expense is recognized on a declining balance of a liability as the payments are made; so it does create a natural front-loaded pattern. The theory behind it was to try and have comparability between purchases of assets with financing and leases of assets with financing; however, I think what we learned was that there are diverse views about whether all leases are purchases and financings, to the extent of the contractual terms.”

“The issue after you get over the balance sheet treatment,” Seidman continued, “is: what’s the appropriate [P&L] pattern to be reflecting the expense in the income statement, as well as the classification of it?”

Bishop explained the differences between the two proposed models: “The straight-line approach is very simple, and it’s what we’re familiar with. … The interest and amortization model is simply a financed-acquisition model, where the financing is amortized on a mortgage basis and the asset is amortized on a straight-line basis.” Under this model, the amounts at the outset would be greater than the straight-line amount at the outset, and less than it at the conclusion.

Gill-Charest next explained the complexities introduced to the bookkeeping. “If you’re in the straight-line model under this hybrid proposal, you still do your liability accounting in the same way to come up with what I’ll call the ‘interest component of the rent expense,’ although in the straight-line model, the classification goes back to a single line: rent expense,” she said. “Then, you simply plug back to the amount that would be necessary to adjust your asset, because you know your straight-line expense, you know your liability. But at the end of the day, you’re plugging that asset side of the entry. Perhaps the hybrid methodology managed to appease factions of stakeholders and achieve some of the objectives. … But when I think of it academically and conceptually, I’m somewhat troubled by the fact that we had started trying to develop a conceptually sound principle, and we got halfway there, and then we plugged.”

Bishop explained that the basic principle for determining which method to use is whether a lease entitles the lessee to use more than an insignificant amount of an asset. If it does not, companies will use the straight-line model; if it does, they will use the interest and amortization approach. Exceptions exist for property (i.e., land and buildings) and equipment. The assumption is that lessees will no use more than an insignificant amount of land or buildings, whereas they will use more than an insignificant amount of equipment.

“The principle of how to reclassify the leases will be based on the extent to which the lease conveys more than an insignificant amount of the utility of the underlying asset,” Seidman clarified. “It’s not the same as SFAS [Statement of Financial Accounting Standards] 13 [Accounting for Leases] because, under SFAS 13, for you to get a capital lease or the amortization and interest expense pattern, you have to have transferred a significant amount. This flips it—if you’ve transferred more than an insignificant amount, you’re getting that pattern. Compared with today, it has the effect of sweeping in a significant number of leases to the interest and amortization pattern. … These are not intended to be exceptions or bright lines, but rather a principle.”

Transition

One of the transition options will be full retrospective, Bishop said. But “there’s also going to be an option called ‘modified retrospective,’ which tries to eliminate the need to go back in time and make historical judgments of the facts that were available at the time.” Instead, companies would “capitalize leases as of the earliest period being presented, based upon the facts available at the time, with the ability to use hindsight.” Under the straight-line model, companies will use the present value of the rents that exist, and the related asset will be measured at the same amount. Under the interest and amortization approach, “there’s going to be an attempt to capture the notion that the assets and liability will be accounted for independently, and that the carrying values will not be the same,” Bishop stated.

Financial Instruments

“This is an area where we do not have the same standards under U.S.
GAAP and IFRS, and we acknowledge that this can cause confusion in the marketplace,” Seidman said. “The standards that we currently have in place on financial instruments are quite form-driven, meaning that over the years, the accounting has been determined based on the nature of the instrument in question. We’ve got separate accounting for loans, separate accounting for securities, trade receivables, and equity instruments. Those differences may not make sense from an economic standpoint.”

FASB is also responding to concerns that, during the financial crisis, losses that could have been reasonably expected were not timely recognized. “With regard to classification and measurement, we want to take a fresh look at those cases where cost accounting continues to be appropriate,” Seidman continued. “I would say that the question that came out of the crisis was whether certain types of assets should have been carried at cost. Some of those differences between U.S. GAAP and IFRS—especially related to when transfers between the portfolios are appropriate—really brought that issue into sharp focus.”

Strauss asked Seidman to explain why SFAS 5, Accounting for Contingencies, no longer worked under the new model. “SFAS 5 basically applies to trade receivables or pools of smaller balanced loans before credit deterioration has been observed,” she replied. “The key question under current GAAP is: when do you move from SFAS 5 to SFAS 114 [Accounting by Creditors for Impairment of a Loan], where you are taking a full lifetime estimate of the losses?” She asked: “What is an incurred loss? What is a loss event? … What we’re trying to do is address what are perceived to be aspects of the current standards that defer timely recognition of the losses. SFAS 5 already includes an element of incurred, but not reported, losses. We call today’s GAAP incurred loss reporting, but even SFAS 5 has an element of expected loss. … The key thing is to get any barriers to timely recognition of expected and estimable losses out of accounting.”

“There’s a separate issue about whether regulators need to do something,” Beswick noted. “We should not be using accounting standards to start building accounting buffers for bad times; we have to focus on providing transparent information to investors.”

Bishop commented on the proposal itself: “One of the great improvements that is going to come out of this proposal is a standardization of impairment for all financial assets, and that will include whether they are debt securities in form, loans, loan commitments, trade receivables.”

LaMonte warned that, from an international perspective, narrowing the choices might never be effective, “because reserving practices will be highly influenced by what regulators want reserving practices to be. We can improve the standards, but I would say there’s not much of a chance of getting truly comparable reserving practices on a global basis.”

Strauss asked whether the expected model means that companies have to look into the future and predict whether they will ever have a problem with, for example, a long-term mortgage. The simple answer, Seidman said, is no. “There’s been a fair amount of confusion about the use of the term ‘lifetime losses.’ … You should be looking at all of your experience with similar types of assets, and that should be your starting point in developing an estimate,” she explained. “But then you would be expected to consider all available reasonable and supportable information to ask yourself whether history is a good reflection of your current estimate of the losses you expect to realize. The key point is that the lifetime aspect of this estimate is built into your historical data.”

Gill-Charest cautioned that this method “will have a direct P&L impact” and will create a greater burden for companies to monitor the fair value of securities. When asked whether this would be auditable, Bishop said that it would depend upon the type of company; although he did not expect problems with respect to financial institutions, companies without experience extending and evaluating credit could present challenges.

*The IASB’s model.* Although FASB and the IASB had agreed on a basic three-bucket approach, outreach revealed concerns among U.S. stakeholders. “Under the IASB’s approach, that group of loans—the good loans, I’ll call them—that have not yet exhibited any signs of deterioration, the vast majority of loans held by any bank, would have only had a 12-month forward look, in terms of identifying any expectations of default,” Seidman said. “Most asset classes have loss-emergence periods; in other words, the losses tend to realize themselves over a two- to three-year period on many long-term asset classes and are usually estimable.” In addition, stakeholders warned “that limiting your forward look to only 12 months was going to be an inadequate representation of the losses that you can expect and estimate,” according to Seidman.

“The additional concerns that we heard had more to do with [operativeness],” she continued, “because the proposal said that while the loans [that] are ‘good’ use this 12-month estimate, … then, when there’s evidence of significant deterioration, you move into a full lifetime loss estimate.” These concerns, regarding what it means to have evidence of significant deterioration and whether that reintroduces the incurred-loss trigger concept under current GAAP, contributed to FASB’s decision to go back to the drawing board.
Recognition and Measurement

The panelists next discussed the second major financial instrument proposal, which FASB took on in an effort to converge U.S. GAAP with IFRS 9, Financial Instruments. “The big question here is what should qualify for cost accounting,” Seidman said. “As you know, we have SFAS 115 [Accounting for Certain Investments in Debt and Equity Securities] as well as some accounting for loans standards that address when something can be carried at cost. The thinking under the new proposal, generally speaking, is: how do you expect to realize cash flows on the assets that are held? That’s really the overall threshold question that would drive whether fair value is the most relevant measure, or whether cost might be an appropriate measure.”

The current proposal is similar to SFAS 115, but has the benefit of being applicable to all types of debt investments, regardless of whether they’re receivables, loans, or securities, Seidman said. “I think one of the great positives here,” Bishop added, “is that we’ll be migrating from a model that today is very much based on the form of the instrument to a model that’s focused on … the intent for holding the instrument, its economic benefits, and the terms and conditions of the instrument themselves. All financial assets, whether they are debt securities or loans, will all fall under this single model.”

LaMonte said that users are ready for a new model, noting that “eliminating the distinction between debt securities and originated loans is very helpful. … I’m also supportive of the idea of handling mostly all equity securities in a fair value through a net income-type of approach.” Beswick agreed that the model addressed the concerns directed to FASB during its outreach.

Seidman reviewed the proposed model’s basic approach: “The first thing you would do is look at the cash flow characteristics of the instrument and ask yourself whether they represent solely principal and interest. If the answer to that question is no, then you automatically go to fair value through net income. … Because of the variability of the principal and the interest, according to the terms of the instrument, we think fair value is the most relevant. An effect of this is that all equity securities, unless they’re accounted for by the equity method, would be carried at fair value through net income, which is a pretty major change for some companies.”

“If you pass the test that says that it’s principal and interest—i.e., a debt instrument of some kind—then you move into the business model evaluation,” Seidman said. Under this model, a company would assess whether its business strategy is holding the debt instrument for the collection of cash flows; if so, it qualifies for amortized cost accounting.

“Then you can evaluate a category where your business model might be either to hold for the collection of cash flows or to sell opportunistically under the right circumstances,” Seidman continued. “For a bank or an insurance company, this would typically include interest rate risk management activities or liquidity management activities. Those would typically be classified as fair value through other comprehensive income. … And then, even if you have plain-vanilla cash flow characteristics, if your business model is to trade the assets or otherwise use them economically as a hedge, those would be classified as fair value through net income. So what we’re trying to describe is an entity’s evaluation of its typical business activities—then you would classify the instruments in accordance with the way you expect to realize the cash flows, either by holding or by selling.”

This classification will occur at inception, Bishop explained, and reclassification is expected to be rare. With respect to equity investments, the concept of significant influence for those items that do not qualify for the equity method of accounting is not being changed by this proposal; those equity investments will, for the most part, be measured at fair value through net income. Strauss clarified that the available-for-sale through other comprehensive income option would no longer exist for equities.

Bishop delved into liabilities: “For the lion’s share of liabilities, amortized cost will be the measurement approach. In the unusual circumstance where there’s observed activity of off-
laying those liabilities to third parties, then fair value would be the model. … Short-sale transactions would also attract fair value.”

**Convergence and transition.** Although FASB and the IASB have made progress, the standards are not yet fully converged. “The IASB only opened IFRS 9 for selected issues,” Seidman said, “and on those we have broadly reached converged solutions.” On the topic of convergence, Beswick later said, “What I am encouraged about is the commitment … and the willingness to sit down and try to deal with some of the differences.”

FASB has not yet decided upon an effective date for either proposal, Seidman said. “The transition for both proposals is a cumulative effect treatment, rather than retrospective. … We’re prohibiting early cumulative effect treatment, rather than fair value.”

The transition approach, she said, was one of the proposal’s most controversial elements. Although investors wanted full retrospective treatment, preparers raised serious concerns about the cost.

After conducting roundtable forums and outreach, FASB decided to require companies to “record the cumulative effect in the first year of application, and then provide disclosures in that first year that show the accounting under the old method,” Seidman explained. “You will need to capture both sets of information for a year. But the savings here is that entities will not have to go back and restate contracts in prior periods. … I realize that not everybody is going to be happy with this solution, but it was what we thought was the best way to give some comparability of the methods for trending over time, while also trying to balance out the extreme cost associated with this change.”

To get ready for the new standard, Gill-Charest advised preparers to “go back to your principal revenue streams … get into those contracts and really understand the contractual obligations.”

In terms of companies’ disclosures on the impact of a newly adopted pronouncement, Beswick said that the SEC had published its views in SAB 74. “Revenue is material to everybody, so we’ll start looking for an understanding of where people are in the process,” he said. “I think FASB is doing a good thing by having this implementation group to deal with this. … I’m already getting the sense that there are organizations out there that are trying to be first to press in terms of shaping the views.”

“We’ve tried to include a lot of the folks who are responsible for that type of guidance on our group,” Seidman added. “The AICPA, of course, is going to want to update those audit guides as quickly as possible, as well as the accounting firms. We’re not trying to interfere with that process at all, but rather make it go as smoothly as possible.”
The Latest from the SEC

Corporation Finance and Enforcement Divisions

Reporting Issues and Enforcement Actions

Panelists Craig Olinger and Howard Scheck
he second panel at Baruch College’s 12th Annual Financial Reporting Conference on May 2, 2013, featured two speakers from the SEC representing the Division of Corporation Finance (DCF) and the Division of Enforcement (DOE). The panelists discussed current reporting and filing issues, enforcement strategies, and ongoing investigations.

The Role of the DCF
Craig Olinger, acting chief accountant of the DCF, began by reacquainting attendees with the role and responsibilities of the DCF-OCA (Office of the Chief Accountant). His office provides support to the accountants in the DCF who actually review filings. The DCF participates in the OCA’s consultation process, in which registrants can write in on a prefilling basis to deal with GAAP issues. “Our office is essentially the primary arbiter of Regulation SX reporting matters and form and content requirements in filings,” Olinger said.

He noted that the DCF frequently receives questions about Rule 305 and Rule 309 and handles waiver requests: “We do recognize that, in those particular areas—305 and 309 for example—they have significant thresholds to determine when you’re in or out of the rule, and how many periods you need. Certain cases will arise where the application of the test may produce a result that doesn’t entirely make sense. In those cases, we encourage people to write in if they think they’ve got a case where the rule would say, ‘Yes, you need financials,’ but they believe the circumstances indicate otherwise.” Olinger went on to advise anyone making such a request to provide DCF-OCA with as much background information about the company and the transaction as possible.

The JOBS Act
Olinger recalled the progress the SEC has made in implementing the requirements of the Jumpstart Our Business Startups (JOBS) Act: “Over the course of the year, there have been a couple of hundred IPOs [initial public offering] identifying themselves as EGCs [emerging growth company].” With regard to the JOBS Act’s provision that EGCs need only report two years of audits rather than three in their initial common equity IPO, Olinger said, “We found that, in many cases, companies were doing three [years] anyway ... and apparently that’s because, in some way, the market demands it.” He added that rulemaking is in progress for other portions of the act, such as the crowd-funding provisions.

Domestic and Foreign Registrants
Olinger continued by noting that there are “roughly 8,000 domestic and about 950 foreign registrants at this point ... Domestic registrants have to use U.S. GAAP, and foreign private issuers do not necessarily,” he said. “Canada has gone to IFRS now ... Europe, of course, is IFRS. Asia and Oceania are a mixture.”

“Of the 950 total foreign registrants, they break down roughly equally between U.S. GAAP and IFRS,” Olinger noted. “Some companies are still home-country GAAP with U.S. GAAP reconciliation, but it’s now down to just dozens.” The profile of IFRS companies has changed as well: “It used to be mostly large European companies, but now the majority are Canadian companies, and they are more diverse in terms of size and in terms of industry. ... We have a lot more smaller companies on IFRS, with Canada coming over.”

Foreign private issuers. The DCF website now features a new separate document on foreign private issuers. Olinger described it as a “primer for a company that wants to come into our system as a foreign private issuer, or people who advise such companies; it gives an overview of everything that should be considered.”

Frequent Comment Areas
The DCF reviews approximately 4,000 companies a year. “The most frequent comment area overall is actually MD&A [management’s discussion and analysis] comments,” said Olinger. Most of the comments revolve around basic changes on the financial statements during the year, he said. The most frequent MD&A comment the DCF issues is a request that a company “explain what happened—what were the causes of those changes?”

Deferred tax asset recoverability has also been a common issue in recent years; the comments have focused on why there isn’t a valuation allowance for a deferred tax asset. “We look for a pretty rigorous and thoughtful
approach to how companies apply the literature in that area," Olinger said. "We are now starting, with things getting a little better in the economy, to see the question of when is it appropriate to reverse the allowance for a deferred tax asset, assuming you had one in the first place."

Revenue recognition is another frequent comment area, with cases running the gamut. In some cases, comments are sent to request more clarity around policy disclosures and how particular circumstances relate to particular policies. Other cases, such as multiple-element arrangements, can be more complicated, even under existing requirements.

**Frequent Comment Areas under IFRS**

The DCF reviews approximately 450 companies filing in IFRS, making it the second largest GAAP used in U.S. markets. Like all other registrants, IFRS companies get reviewed at least once every three years by the relevant industry group.

The most frequent comment areas in IFRS are similar to those in U.S. GAAP: financial instruments, financial statement presentation, provisions and contingent liabilities, impairment of assets, consolidation and equity method, revenue recognition, operating segments, income taxes, and business combinations. "I think that suggests that it tends to be the company’s particular circumstances—the kind of transactions and arrangements they have—that probably tend to drive comment frequency," Olinger said.

With many Canadian companies filing with the SEC, the DCF has been dealing with reporting issues having to do with Form 20-F and first-time implementation.

Olinger also noted that the influx of smaller companies reporting in IFRS has led to an increase in going concern issues: "The audits of foreign private issuers have to comply with PCAOB standards, and part of that is the standard audit report wording. ... Companies from other places may be more accustomed to different going concern formulations."

Due to technical issues, the SEC has not yet approved the IFRS taxonomy for Extensible Business Reporting Language (XBRL). Olinger recommended that companies not try to jam IFRS statements into the U.S. GAAP taxonomy.

**Current Reporting Topics**

Olinger discussed current reporting issues regarding domestic registrants with substantially all operations outside the United States: "The risks of the local operating environment are very different than the U.S. operating environment. The risks of VIE [variable interest entity] structures may be in place. We have also started seeing some revenue recognition issues. ... We’ve seen some pretty strange, possibly alarming, relationships there, and so we will raise questions if receivables seem to be building rapidly and not being collected. ... In some cases, it may be an indication that there are no fixed and determinable terms."

Following up on an issue raised last year, Olinger said that “over the course of the year, we’ve noted more and different types of non-GAAP measures involving adjustment of pension expense.” He noted, “If a non-GAAP measure is misleading, pension adjustments or otherwise, then you really can’t use it anywhere.”

Olinger discussed Rule 3-10 on guarantor reporting: “Let’s say you have a change in the composition of guarantors, or you have a disposition of a subsidiary, or you have transfers of assets among subsidiaries. ... When you’re in the Securities Exchange Act of 1933, and you’re doing a debt offering for the first time, you’re looking at what your structure is at the date of filing and then at the date of effectiveness. Then you construct your condensed consolidating information retrospectively, based on the status of who’s a guarantor and who’s a nonguarantor.”

“I think it’s more interesting when you’re in the Securities Exchange Act of 1934,” Olinger continued. “You’ve been reporting under Rule 3-10 a certain way, and then you have some of these types of changes—how do you deal with those? First, you try and make the condensed consolidating columns as ‘GAAP-like’ as possible. ... Second, you try to make the presentation of the guarantor and non-guarantor columns as comparable over time as possible. There are certain transactions where it’s hard to do both of those at the same time.” In such situations, Olinger suggested consulting with the DCF.

**Division of Enforcement**

Howard A. Scheck, chief accountant for the DOE, began with a brief overview of his group’s responsibilities. His team collectively provides auditing and accounting expertise on all investigations and works on litigation and settlement support. ... We also facilitate conversations with the other divisions—mostly the DCF and OCA—to make sure they are on board with our recommendations. ... We also coordinate with the PCAOB enforcement folks regularly.”

**Auditor Cases**

Scheck discussed the DOE’s procedures: “The standard operating procedure looks at the auditor’s conduct role in connection with financial reporting misstatement issues.” Depending upon the type of case, the DOE may also look at auditors with respect to stand-alone PCAOB auditing violations.

The DOE team looks not only at whether the auditors complied with federal securities laws, but also whether there was improper professional conduct. “Rule 102(e) of the commission’s rules of practice allows us to bar accountants from practicing before the commission,” said Scheck. To determine if an auditor violated federal securities laws, they check to see "whether they aided
and abetted the client, conspired with the client in some way ... most of the cases that we do relate to improper professional conduct, [but] we do have cases where the auditors are being charged with fraud as well.” The DOE carefully considers cases against auditors. “Section 10(a) [of the Securities Exchange Act] requires auditors to have policies and procedures in place in order to detect a potential illegal act, and they require the auditor to report to the SEC if certain remedial measures aren’t taken by the client,” Scheck said.

The whistleblower adopting release that came out last year specifically indicates that auditors can whistleblower on their own firms regarding Section 10(a) violations. “This is not only in connection with the audit itself, but it’s also in connection with non-audit services,” Scheck said. “It could relate to insider trading, or independence, or quality control.”

**Analyzing violations.** Scheck listed various audit firms against which the DOE has brought Section 10(a) violations: “They are very complicated, highly complex facts-and-circumstance things that we have to consider. There is a lot of judgment involved.” Scheck added that it comes down to professional skepticism—how much do auditors care about what was done in connection with things they learned during the audit. Auditors’ conduct is compared with what the PCAOB auditing standards would have required.

The DOE still continues to see situations where auditors have not demonstrated a critical mindset and appear to be trying to corroborate management expectations, Scheck said: “We’re seeing situations where contrary evidence was not adequately dealt with; situations where qualitative materiality may not have been adequately evaluated; and also a lot of after-the-fact arguments.”

**Recent Cases**

The most recent case that the DOE filed involved the TierOne Bank audit, which revolves around a loan loss reserve. “The allegations,” Scheck explained, “are that the impairment measurements were not correct—the company was using stale appraisals and were not using information related to the value of the collateral.” He stated that the DOE not only charged TierOne Bank, but it also has a Section 102(c) proceeding in connection with the senior manager and partner.

Scheck briefly spoke about the Vaszquez & Co. audit of the Soyo Group Inc.: “In that particular case, millions of dollars were booked for fictitious transactions and the company was, despite having booked all these fictitious transactions, constantly having liquidity problems and cash flow problems. Nonetheless, the auditors didn’t do a sufficient job related to going concern.”

The Gruber case involved a mining company with Russian operations; Scheck stated that the individuals who were preparing the financial statements “couldn’t get access to enough information to prepare the financial statements. … The company’s financial statements were literally all estimates because they didn’t really have the numbers. The auditor knew this, and we charged the auditor with fraud and a [Rule] 10(a) violation.”

**Cross-Border Enforcement**

Scheck summarized the cross-border cases that the DOE has brought against issuers through a risk-based initiative that looked into China-based audits done by small firms. He noted that section 106 of the Sarbanes-Oxley Act of 2002 (SOX), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, enables the SEC and PCAOB to get documents related to foreign audit workpapers.

Scheck touched upon the China audit cases that have been in the press: “With respect to the Big Four and BDO, we filed administrative proceedings against those firms in order to protect the commission’s processes, because we’re not getting [section 106] documents.” He said that a recent Administrative Law Judge opinion favored the SEC’s position. He also noted that the SEC had a subpoena enforcement action against Deloitte & Touche in the Longtop Financial Technologies fraud case, another case involving a Chinese company from which the SEC is trying to obtain documents.

These cases shared some common themes. “A lot of them are in the energy industry,” Scheck said. “A lot of these cases relate to undisclosed related-party transactions or phony transactions or overstating assets.” The recent case of Keyuan Petrochemicals involved related-party transactions as well as “an off-the-books cash account that the company was using to fund gifts to Chinese government officials.” The SEC also charged a U.S. CFO with failing to address many details that had occurred with his knowledge.

Scheck provided details on other similar cases. Northeast Petroleum, he said, “diverted millions to insiders, and this was mostly carried out by after-the-fact adjustments made before they filed their financial statements. Worldwide Energy … transferred most of the ownership in the subsidiary to individuals and that was undisclosed. And there was another one—China Sky One—where 25% of the revenue was essentially fake.”

**Other Issues**

Scheck mentioned a recent bank case: “We filed a Capital One case last week … We charged not only the bank; we charged the chief credit risk officer and the divisional credit officer. They didn’t have any real basis or justification for not recording incurred losses and using the estimates from their own models, indicating that the loan loss reserves should have been more.”

With respect to revenue and expense recognition cases, Scheck spoke about Volt Information Sciences Inc. and TheStreet Inc. Volt is a revenue recognition case—“the type of accounting case that the DOE used to see before the financial crisis.” TheStreet involved two separate charges: the CFO recorded revenue prematurely, and the vice presidents of the divisions were essentially fabricating revenue.

Scheck concluded with two cases regarding improper expense recognition—Huron Consulting Group Inc. and KCAP Financial. Huron was charged based on failure to properly record sales proceeds redistributed to employees as a compensation expense. KCAP involved the improper valuation of debt securities and collateralized loan obligations.
Jay D. Hanson has been a member of the PCAOB since January 2011. Prior to joining the board, he spent nearly 32 years at McGladrey & Pullen, LLP, where he was the national director of accounting and leader of the firm’s accounting standards group. He served as a member of FASB’s Emerging Issues Task Force (EITF) from 2006 to 2011. He also was a member of the AICPA’s Financial Reporting Executive Committee (FinREC) from 2005 to 2011, serving as chairman from 2008 to 2011. Hanson is a CPA licensed to practice in his home state of Minnesota.

The following is an edited version of the keynote speech Hanson gave at Baruch College’s 12th Annual Financial Reporting Conference on May 2, 2013.
Remembering Sarbanes-Oxley

My theme today will be a little bit of the past, a little bit of the present, and a little bit of the future. I will talk about what brought us to have something called the Public Company Accounting Oversight Board and will discuss some of the things we’ve been doing at the PCAOB, as well as some of the things I see as really important for the future.

In thinking about the past, I like to talk to students. What’s really interesting is that when you talk to seniors or master’s students about things like WorldCom and Enron and the companies that caused the PCAOB to come into existence—today’s students were 12 years old then—they don’t know what we’re talking about. We know the sad story that a lot of fraudulent financial reporting was not detected or condoned by the major accounting firms; after the crisis of confidence in 2002, Congress needed to do something to restore some confidence in the financial markets, and they passed the Sarbanes-Oxley Act of 2002 (SOX), which created the PCAOB as an independent regulator.

Last summer there was a lot of celebrating in some quarters around the anniversary of SOX. The act’s namesakes were asked, “Was SOX perfect?” And by their own admission, they would say no. The PCAOB, although now 10 years old, is really kind of like a start-up organization; it is still having some growing pains. The work of those founding board members was the four core things that the act requires us to do: register audit firms; set standards for firms; inspect firms; and, when we see egregious behavior, pursue bad auditor conduct through our enforcement division. Today, we have nearly 800 staff and roughly 15 locations all around the country. The bulk of us are in Washington, D.C., but we are all over the country. Inspectors—the folks that actually go out and look at the work of the auditors—make up the biggest chunk of our people.

Our registration records show that we’ve got more than 2,350 firms regis-
tered from 85 different countries. We inspect the work of the auditors wherever they are. Some countries have been a little reluctant to let us in and look at the work. We’re making good progress though, and we’re in most major countries. The biggest challenge that we face—and I think our staff is encouraged by the progress we’re making—is in China. That’s proving to be the most challenging country for us to get in and actually inspect the work that the auditors do there.

One of these was based on observations from the 2010 inspection cycle (inspecting 2009 audits), in the area of internal controls over financial reporting. This was the first major report we put out after the dust settled around AS [Auditing Standard] 2 [An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements] and AS 5 [An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements]; the report actually looked at the performance of auditors against the requirements of AS 5. This general-purpose report covered eight firms that are all inspected annually, and the report showed a number of troubling things. In a quiet moment, some of the firm leaders will actually admit to me that, frankly, firms took their eye off the ball in terms of internal control reporting.

We get a lot of criticism over what our inspectors are doing, and the criticism often runs to, “It sounds like your inspectors are bringing back that bottom-up approach on testing controls,” which we did away with when we got rid of the original AS 2 and replaced it with the top-down approach of AS 5. But if you look at this general-purpose report, or any one of the major firm reports about this, the findings are all about not adequately testing the controls from a top-down perspective. One of the things that many firms are struggling with is that it is important to understand what that top-down control actually does. It’s really about if you see a signature where somebody says “I approved it,” how do you know that wasn’t a “sign here” sticker, versus somebody actually looking at what’s behind what they’re approving and knowing whether what they are doing will actually detect an material misstatement? That’s the biggest challenge we’re having—all of the firms are figuring this out. Just looking at a signature is not enough without knowing what they did and whether it was really effective.

Another general-purpose report we put out in February might be of interest to many. It’s on smaller, non-annually inspected firms—that is, firms that do less than 100 issue audits per year—covering the 2007 to 2010 cycle. What’s interesting is, just as Craig [Oling] was talking about the findings and Division of Corporation Finance reviews that are the most challenging, these are the same things that we look at and find problems in. Revenue recognition is something we look at in virtually every inspection, and we see lots of challenges there. Share-based payments are unsurprisingly a problem for smaller companies. Convertible debt instruments—has anybody here actually tried to apply the accounting standards on convertible dead instruments? It is exceedingly difficult to do. Fair value measurements run through virtually all of these complex areas. Business com-
binations were also mentioned by Craig Olinger. Accounting estimates in general are also challenging. Related-party transactions—Howard Scheck mentioned some of those issues, with respect to enforcement. The use of analytical procedures as a substantive audit test is also an issue. You know, most days I would like to say, “Let’s ban the phrase ‘appears reasonable’ from all auditors’ speech,” because that doesn’t cut it when you’re actually trying to test if a balance is right. It has to be far more granular and far more fact-based than “what does the auditor expect?” ‘Appears reasonable’ just doesn’t cut it. And then, an overarching problem is the auditor responding to the risk material misstatement due to fraud. Sometimes we see the challenge of an auditor properly identifying a fraud risk in a particular area, and then doing exactly the same thing they do in every other audit. It’s a challenge to all of you, as auditors: if you identify a fraud risk, what are you going to do differently? If you do the same thing, you didn’t get it. Doing something different, if there is an elevated risk of fraud, is a challenge.

When we put out these reports, we try to ask audit committee chairs to do a better job of publicizing them. Part of it is so that if you’re an audit committee chair you read it and you know what to talk to your auditor about. For the academics in the room, you might even assign this as a homework assignment, to ask your students, what the heck does this mean?

**Standards Setting**

To focus on standards setting: since our existence, we’ve published 16 separate auditing standards. The most recent one we issued was on increasing the rigor around communications between the auditor and the audit committee. We have a couple of really significant projects on our agenda. One of them, which we exposed a year ago, relates to a topic that we talked about earlier: relat ed-party transactions. We are modernizing that standard, which has not really changed significantly since 1975, on what the auditor does around related parties, essentially making many of the “consider” statements in the current standard be things that the auditor “must” do in virtually all situations, and adding a little more rigor around what they do related to the usual transactions and related-party transactions. We’re going to actually repropose that standard as a result of the comments that we’ve heard.

Another important standard is the auditor reporting model. It’s one of our lightening-rod projects because there are passionate camps on either end of the spectrum on this. Part of the reason for taking on this project is the wide range of input we’ve heard from investors about why, during the financial crisis, the auditor’s reports didn’t tell you anything about what was going to happen in some of the large financial institutions. Investors are also quite cranky about how the going concern standard is working out for auditors, so that’s a project too. On the auditor reporting model, we put out a concept release in June 2011, and we’ve had many discussions and a roundtable about it. We’re hoping to get a proposal off by the end of September.

It’s a challenge to balance what investors want—which I heard it described to me as similar to a transaction support-type engagement, where you help a client do due diligence on an acquisition, a detailed, in-depth type of service. Frankly, what we’re hearing from some investors is that that’s what they want the auditor’s report to look like. That’s what they say: “We’re the customer, that’s what we want.” And then the rubber meets road on, practically, how do you do that for general-purpose consumption? It’s one thing to write a report and sit down with the buyer, with a client that’s actually going to make a decision on whether to make an investment, and explain what you found; it’s another thing to put that out so everybody on Earth can understand exactly what it is that you did and said.

This concept release didn’t propose anything, but rather put out several ideas—ranging from just tinkering with the boilerplate in the report, which we know will satisfy no one, to the other end of the spectrum, with the auditor writing what’s been coined as an “auditor’s discussion and analysis,” similar in scope to management’s discussion and analysis, with a broad range of the auditor’s views on the financial statements and things like that. It’s not likely that we’re not going to end up there, but rather somewhere in the middle. The most talked-about thing in our building is expanding the use of matters of emphasis paragraphs. They are rarely used today—and when they are used, it’s essentially putting asterisks on the index to the financial statements, which won’t satisfy anybody either, so they have to be more rigorous than just pointing to a footnote.

The companion project that the International Auditing Assurance Standards Board (IAASB), has focused on the matters most significant to the auditor in their audit and what was most difficult for them in completing their audit. That’s what a lot of the discussion in our building is: should we put out something similar to that, which is really focused on the auditor’s skill set and what they found, which would get at a lot of the same issues that investors want and which is one of the most difficult things to get your arms around in the financial statements? That’s coming out in the relatively near term, and we will likely have another roundtable on it with the actual proposal. We got a lot of comment letters on our concept release, more than 150, and I’m guessing we will get a lot with this project as well.

**Enforcement**

I want to talk a little bit about our enforcement operations. Howard Scheck talked about the SEC enforcement earlier; it has the broad authority to essentially tackle both management and auditors when pursuing enforcement actions. Our authority is limited to what the auditors did. We actually have some cases where there wasn’t a financial reporting problem, so the SEC didn’t pursue it, but we can see that the auditors did something that didn’t comply with our standards and rules, so we have pursued those separately.

We do have a lot of coordination that goes on with the SEC, because we want to avoid duplication of effort. There is a discussion about who makes sense to take the lead on a case against auditors. Howard Scheck mentioned this case with PwC India, the Satyam case, which was known in some circles as the Enron of India.
That was a joint enforcement effort by both the PCAOB and the SEC, and it resulted in some fairly severe sanctions to the affiliates of PricewaterhouseCoopers in India. A recent one that also involved a firm in India, which we just got out the door this past week, is a case where it was a smaller firm that had a single U.S. public client. In the early years of their work they were engaged to do the 2006 and 2007 audit, and they performed no work. They got smarter as they went along: they were doing more and more work, but they were just absolutely clueless as to what it takes to do an audit in accordance with the U.S. standards or the PCAOB auditing standards. The firm has been barred; the lead partner, whose name was on the front door, has been barred for life, and some of the others involved got barred for a number of years. So our enforcement efforts span across the globe, just like the SEC’s enforcement efforts do.

Identifying Priorities

A little bit about the future—I call this challenging business as usual. We’ve celebrated our 10-year anniversary at the PCAOB, and we’re kind of moving past the start-up phase. Those of you with clients that were start-ups maybe found that when they got to a certain point, they needed a little jolt to say, “Something needs to change, because what you did originally was good, but is it the right thing for the future?” Similarly, I have been asking myself some questions: Has the board always achieved its objectives? Have there been unintended consequences? Some people in my building say, no, there have been no unintended consequences, and others would say that there have been lots of unintended consequences.

The board has identified some near-term priorities; some of them are internally focused, some of them are externally focused, and some are kind of a combination. These include improving the timeliness, content, and readability of our inspection reports. The primary thing that the world sees is what we write about a firm, and I’m personally very motivated and committed to take a step back and say, “What’s the full range of what we can say about a firm?” when we do an inspection.

I’ll give you an example: Let’s say big firm A audited a big client—let’s say it was a big bank—and then we went in to inspect the firm. And let’s say we had 10 people for two weeks looking at the most difficult areas in that bank audit, including the allowance and loan losses, all the investment issues, and the income tax challenges that many banks have. In the end, we find that the auditor didn’t do a good enough job in testing some of the IT general controls. In our world, that could be reported as an auditor failure. But a lot of people would say, “Gee, if you looked at all the most difficult areas and had that many people on the ground for weeks, wouldn’t somebody want to know that context when they were understanding the situation? Maybe there was a failure to test the IT general controls, and this resulted in a failure of the audit, but look at all the things that you looked at and there wasn’t a problem with.” I don’t know if we’ll ever accomplish my goal of putting that context around, but that should give it some insight into what I think should be on the table for us to talk about.

Another priority is related to our remediation process, so there’s part of the report on every firm that is non-public and stays non-public as long as the firm remediates the quality control deficiencies. We have a long way to go to get our systems up to par so we can get these done in a quicker fashion, and we’ve learned a lot over the years. For those of you in a smaller firm, maybe you’ve received an inspection report that says, “Your practice aid for your independence letter to the audit committee has an outdated phrase in it.” Well, that’s a real easy one to fix—you change the phrase. But for a large firm that’s had problems with fair value estimates for many years running—where training hasn’t helped, a new checklist hasn’t helped, a new policy hasn’t helped—there has to be something different done in that situation, and we need to do a better job on our end to communicate what are all the things that worked. That’s one of my goals.

Audit quality measures something that a number of groups, including the IAASB and the Center for Audit Quality, have projects on. A lot of people have studied this in the past, and I personally look at this particular initiative as a crucial one in order for us at the PCAOB to have a credible story. The only thing we put out publicly is bad news. If you just measure our effectiveness based on solely the number of findings of audit failures in firms, you’d quickly conclude that audit quality has dropped dramatically over the last 10 years. But most of you, I think, would agree that the audit profession today is night-and-day different compared to what it was 10 years ago. But we have to have something to quantify that. Some have said, “You’re crazy, you’ll never be able to measure audit quality,” but we have to at least start the discussion and think of indicators that would be good to make public.

We see a lot of things when we go in to inspect a firm. I kind of learned in my early days at the PCAOB when I brought up a term that got shot down by the lawyers, which is best practices. I would like to actually have something, maybe not styled as best practices, but at least as an observation. Let’s say we go into a firm and we see engagement A. We didn’t really have a lot of problems there, and when we poured engagement B into the same industry, the team did a good job. And my question is, what’s the difference between the team that gets it right and the team that gets it
wrong? This is probably not going to be in the work papers, it’s probably going to be something else when you’ve got the same tone at the top, same tools, same guidance, same training, same methodology. What is that characteristic that defines that audit team that really nailed it? I think we should be able to describe that quality and tell the world about it—this is a long-term goal of mine.

Our standards-settings process has evolved over the years, and we’re making good improvements there. But as a newer board member, I’m challenging a lot of assumptions. How do we go about even putting something on our standards-settings agenda, and how do we go about prioritizing it? I know that FASB has gone back and forth on that challenging question for years. You have to resist putting things on the agenda that you can’t reasonably get done, but you also have to have a way to prioritize them. If something’s really important, it has to trumps even projects that have been going on for a while. What’s the methodology for prioritizing?

A lot of these issues tie together with improving our outreach to audit committees. One of the things we heard from our 2012 roundtables on mandatory firm rotation and auditor independence was that some audit committees are doing a good job, and some are doing a suspect job. We can’t regulate audit committees or tell an audit committee what to do, but we can sure give them a lot better information to help them do their job. We’ve met with some audit committee chairs of some of the largest companies in America, and I’m very impressed with what they’re doing. But yet we also hear from a lot of people that it’s a joke and some companies are really not doing their job at all. We need to improve our outreach for both things that we put out in writing, as well as when we actually meet face to face with audit committees. I would love it if I could stand in front of a room of audit committee members, in a group like this, and actually have a real discussion. I want it to be a two-way dialogue, not just a one-way conversation.

One of the other challenges that we have is related to whether we are doing enough robust economic analysis for everything that we do. We’ve always had that in mind—the cost and benefit of the standards and the rules that we issue, but it’s clear that we need to make our process more rigorous and more transparent. We have to do a better job of talking about what it is that we’re doing, how we consider the costs of what we’re doing, and how we measure that against the benefits. We know that it’s not possible to precisely measure it, but we know we need to work harder on that.

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One of the things that Craig [Olinger] mentioned earlier, the JOBS [Jumpstart Our Business Startups] Act that was passed in 2012 has a specific provision related to the PCAOB for emerging growth companies. When we put out a new rule, the SEC needs to make a determination if that rule is in the public interest for these emerging growth companies after considering the efficiency of competition for capital formation; that’s code for cost-benefit. There might be some standards that we backed up by messaging; but more importantly, the messaging has to be backed by things that matter, which is holding people accountable. Does the training support the tone? Does the reward system support the tone? Does the promotion system support the tone? If there is a disconnect on the ground, if the culture really does not support with what the leader is saying, then you have to ask: is it really a genuine message if you’re not doing anything to back it up?

We can’t regulate audit committees or tell an audit committee what to do, but we can sure give them a lot better information to help them do their job.

That’s something that we observe in every inspection. We are very mindful of what we see on the ground in the offices. What do we see in the proposals, in the letters to clients, in the messaging from the top of the organization? If we see disconnects, we call out the leaders on that, and sometimes they don’t even know what was going on the ground, so they appreciate hearing from us. In my two years in the board, I’ve seen some positive improvements from some of the firms, especially when we say, “You might not think about this, but what you’re doing with your messaging is inconsistent with what you’re telling us. You have to do something different.” I’m encouraged by that. One of the things that Paul [Bewick] mentioned earlier is the expansion of consulting practices, especially in the major firms. The consulting practices are growing, and audit practices are flat, so the audit is becoming a smaller and smaller part of the major firms. I know some are really troubled by that, and some of the European proposals call for having audit-only firms. Personally, I don’t think that’s the right path, and I think, in theory, a solid, growing consulting practice can exist side by side with an audit practice, but you have to have the leaders in place that understand what an audit’s all about, what protecting investors is all about, and make the investments in the audit practice that are necessary to sustain that.

I have just a couple of last words on objectivity and skepticism. We’ve gotten a lot of feedback on this concept release we issued in 2011 on independence objectivity and professional skepticism, with a mind towards is mandatory audit firm rotation the right path to go? We’ve gotten a lot of feedback on this question, very wide-ranging views on it. There are those that think it’s the solution to every problem, and there are those that it would solve no problems—and what we’re really talking about is the ability of an auditor to be challenging and tough with management on the most difficult areas of an audit.

I ask myself a lot of questions. What’s the real reason behind any one of you not being tough enough with your client on any given issue? Is it tenure, or is it one of the following: Is it possible for every auditor to know that to do in every situation? Is it a technical competence issue that it’s behind almost every failure that we see? I question that, and I suspect that that’s part of it. Is it that that area is so difficult that even if you know everything about it, it’s still a really difficult area to make a judgment call on? So maybe you back down when you don’t have that confidence to go toe-to-toe with your client—is it the time pressures involved?
The clock and the calendar still run the business world, and filing dates aren’t getting any longer, they’re getting shorter, and the hours in the day are not there. Were there pressures to reduce the hours and fees to meet an audit committee’s demand that the fees be reduced? I have talked to students about this. Most of the students in accounting are generally not the folks that have that in-your-face temperament; they really like the logic and the numbers. And I have to confess that I was that way for a lot of my career.

One last thing I’ll close with is the sheer number of hours that the profession demands on your people, and especially your younger people. I try to tell students that, during the busy season, it’s 55 hours a week, and you don’t have much control over your life. I think most professionals learn to accept that; they don’t like it, but they learn to accept it. But when it starts to be 16 hours a day ... I question how anybody can rationally make the tough calls and be the skeptical, objective auditor when they’re put under that kind of pressure. It ranges from staff all the way to partner. I don’t have solid facts on this, but I sure have anecdotal evidence of people telling me that the problem is probably worse today than it’s ever been.

If I were an audit committee chair, I would want to know, what’s the work plan? If you tell me that it’s 55 hours, I accept that, but I want to know if that number starts to creep up to a much higher level, because I’m concerned about the quality of work that’s going on. If it’s creeping up, I want to ask the audit partner: Did you not sculpt the audit right? Can’t you get the resources? Did management fall down and not deliver what they should have? What’s the reason? And what’s the solution? Because working people 18 hours a day is not the answer to improving audit quality. That’s the antithesis of audit quality. I’m asking firm leaders, up close and personal, what are you doing to ensure that you don’t have a disaster unfolding before your eyes? If I’m an audit committee chair, I might put the following on the table with our partner in engagement: I want to set a maximum number of hours. People working more than 12 hours a day, five days a week—not on my watch. That will not promote audit quality; in fact, it will drive it down.

**Questions from the Audience**

**Audience Member:** You said that the difference in audit quality over the last 10 years has been night and day. Can you give some background on what you’re basing that on?

**Hanson:** Well, I look at the fact that we haven’t had the disasters of the nature of Enron or WorldCom. Even though there have been challenges—I think about some of the transactions that got off-balance sheet treatment, especially in the repo area—I haven’t heard from anyone that the accounting was wrong, even when you might question the motivation behind the transactions. Before coming to the PCAOB, I saw a difference in attitude and quality in terms of what was being done. I think the PCAOB—frankly, being the cop on the beat—has made a big difference. The types of findings we’re seeing are very different than they were 10 years ago, when we first started them. We’re drilling much deeper into the more complex areas, and even there we’re seeing a substantial improvement in the depth of what the auditors are doing. Good questions—that’s why I want to try to get some metrics to show it.

**Audit Member:** Bill McDonough, the first chair of the PCAOB, said in some of his speeches that one of the ways of measuring the success of the PCAOB over
In Focus

Current Developments in the Private Sector

Digging Deeper into Complex Topics

Recent FASB Projects

FASB Technical Director Susan Cosper updated attendees on FASB’s ongoing projects dealing with going concern and discontinued operations.

Going concern. “All we really wanted to do was lift what was in the auditing literature and put it into the GAAP codification,” Cosper said. The first phase of the project—when and how to apply the liquidation basis of accounting—has been completed. The second phase is whether and how to assess an entity’s ability to continue as a going concern.

After deliberations based on public feedback, FASB plans to release the second exposure draft for comment soon. Cosper said that the board’s objective is just to “standardize the disclosures. What we’ve learned from all of the voluminous outreach that we’ve done is that there are inconsistencies in the timing of when disclosures are made. … The other thing that we’re going to do is provide management guidance on when and how to disclose goodwill uncertainties.” The proposed model would, at each reporting period, have management assess an entity’s ability to continue as a going concern, as well as the need for disclosures.

This assessment would occur over a “reasonable period” of time, defined as 12 months from the date of the financial statements, or up to 24 months if there are probable events. “If it’s more likely than not [i.e., more than 50%] when considering ordinary activities or management’s ordinary plans in the normal course of business that the entity will not continue as a going concern, you start disclosures,” Cosper said. “There are disclosures along the way that start at ‘more likely than not’ and go to ‘probable,’ where you have substantial doubt.” Some companies claim that, “if you start to make disclosures, it’s the nail in the coffin. … Our business is going to close.” But Cosper noted that “substantial doubt” has a higher threshold under the proposal than what exists today. “Is this disclosure continuum helpful?” she asked. “Does it help stakeholders make decisions?”

Concerns were also raised about management’s assessment of an entity’s ability to continue as a going concern. Cosper explained that because private companies—unlike public entities—are not currently subject to the notion of substantial doubt, it raises questions: “If there’s no assessment by private companies, then it falls back on the shoulders of the auditor. … What kinds of behavior will that drive?”

Discontinued operations. Cosper explained the project’s rationale: “What we’ve heard is that there are too many asset disposals that qualify as a discontinued operation; it was diminishing the information that users were getting.” Although the previous exposure draft had raised discontinued operations to the level of an operating segment, the upcoming proposal brings it back down to the level of a component, defined as “being a major line of business or major geographical area of operations,” Cosper said. “There’s also expansive disclosures associated with this proposal.”

“I think you need to be careful,” commented Robert Laux, senior director of financial accounting and reporting at Microsoft. “You hear that we won’t have as many discontinued operations, but there are additional disclosures.” These disclosures are not just on discontinued operations, he said, but also on individually material items. He asked FASB to “take a very close look … [the proposal] could actually mean more disclosures.”

FASB’s Current Agenda

Cosper next discussed projects currently on FASB’s agenda, such as repurchase agreements, the disclosure framework, and not-for-profit financial statements.

Repurchase agreements. This project continues an initiative that FASB started in 2012 that addresses transparency concerns posed by users and aims to ameliorate some application issues, such as establishing effective control and determining when a transferred security is substantially the same. It also addresses a concern about the quality of the securities that are being used today to effect those transfers, Cosper said.

“One of the most significant impacts of this standard is to require repurchase agreements to maturity to be recognized as a secured borrowing,” she continued. The repurchase agreement would be recognized as a secured bor-
Disclosures with broad relevance. FASB received comments related to financial statement footnotes, management’s discussion and analysis (MD&A), and materiality and relevance. Cosper said. Most comment letters revealed a preference for alternatives that required a minimum set of disclosures but offered flexibility depending upon facts and circumstances. FASB’s next step will be to develop a new chapter for the conceptual framework.

Disclosure framework. This is “not necessarily a project just to reduce the volume of disclosures,” Cosper explained. “If you improve their effectiveness, then naturally reducing the volume of disclosures may be a byproduct.”

The project has several components, Cosper said: “One is a decision process for the board to think about when they’re actually setting disclosures for projects. The second is a decision process for reporting entities on the type of disclosures that should be made. The other component is the organization and formatting of the notes to the financial statements.” The board’s decision process was designed to help FASB identify disclosures with broad relevance.

FASB provided an update on the postimplementation review team’s work. The group positively reviewed FASB Interpretation 48, “Accounting for Uncertainty in Income Taxes.” The group also performed a review of SFAS 131, Disclosures about Segments of an Enterprise and Related Information, Cosper said: “The postimplementation review indicated that there was enhanced relevance of segment disclosures and more information provided under this standard than what was provided previously; investors had a better understanding of the entity’s activities and there was better alignment with management’s internal activities.”

Recent EITF Projects
Jackson Day, a partner at Ernst & Young and EITF member, spoke about several items on the EITF’s agenda, such as joint and several liabilities, currency translation adjustment, and pushdown accounting.

Joint and several liability arrangements. Using the example of an individual who needed to borrow money from a friend, Day refreshed attendees on this topic: “I have three choices: I can 1) pay a very high interest rate; 2) get my friend Norm to guarantee that I will pay the money; or 3) I can get him to sign the note with me, and then we’ll cut a deal between us as to who is going to pay. Let’s pretend we do this joint and several liability situation, and we borrow $1,000 together.”

After deliberations, the EITF decided that the borrower should put on his books the amount he agreed to pay, plus the amount he expects to pay on behalf of the lender. Day explained fur-
“Norm agreed to pay $0, so then I have $1,000, plus $0, on my books. Norm has $0, plus $200 because he thinks I’m going to come up short. … We end up with $1,200 total on the books, even though there’s only $1,000 owed; that’s a lot better than the $2,000 that was on the books before.” These arrangements are sometimes seen in the healthcare industry and the real estate industry, but most often in family-owned businesses.

**Currency translation.** This “is the old SFAS 52 [Foreign Currency Translation], which says you don’t ever release currency translation until you substantially liquidate,” Day said. He gave an example of an escalating translation rate in London and an investment that increased proportionately in value: “What the financial statement accounting would say is that you would record that difference each year and the credit in this case would go to other comprehensive income in a column called ‘currency translation adjustment’ [CTA], It’s only once you sell and liquidate that investment that you would record that transaction gain or loss.” Newer standards that emphasize fair value, however, created some confusion as to whether a partial liquidation would release the currency translation.

The EITF’s decision to set the threshold at “substantial liquidation” is based on a loss of control, Day explained. Furthermore, it applies step acquisitions in order to make it compatible with the new accounting on step acquisitions in the business combination guidance; it also says that groups of assets should be treated in the same way. One exception that relates to equity-method investment is the release of a pro rata portion of CTA; the EITF decided to leave that treatment alone.

**Other issues.** Day concluded by briefly discussing the other agenda items, such as pushdown accounting, service concessions, the risk-free rate for federal funds, and affordable housing credits.

**FinREC Update**

Rich Paul rounded out the panel by talking about FinREC’s industry accounting guides. First, he updated attendees on three audit and accounting guides published by the AICPA on not-for-profit accounting, employee benefits, and insurance. Paul provided further details on the guides for testing goodwill for impairment; in process research and development (IPR&D); and valuing privately held company equity securities issued as compensation, which he called the “cheap stock” guide.

**Goodwill.** “It’s basically a soup-to-nuts articulation of what you would need to do in a goodwill impairment,” Paul said. “It does do a nice job of laying out all the different things that you’d need to do if you were doing a goodwill impairment test. … We think it’s a one-stop shop if someone’s struggling with goodwill impairments.” The guide also includes the ASU 2011-9 qualitative test for impairment (i.e., whether it’s more likely than not that the fair value of the reporting unit is less than its carrying value), and it provides a model for performing the test.

**IPR&D.** This guide relates the updated treatment of IPR&D acquired in a business combination. Paul said, “You’ll see some refinements to this guide as it relates to fair value concepts, and you’ll see a whole new chapter on subsequent measurement that goes through some of the things you’ll want to think about: How do I test IPR&D for impairment? When I actually put it in service, how do I go about amortizing it?”

The IPR&D guide also addresses the concept of core technology, Paul said:

“When you think about what the guidance is now, versus what it was then, core technology is not always necessarily be something that would be legally defined by a contract as separable. So the task force … decided that’s an antiquated concept that we should pull out.”

**Cheap stock.** “This is specifically for companies that are considering going public,” Paul explained. It articulates some questions and issues that can arise in companies that have not yet gone public and thus have equity securities that are difficult to value and measure; it also includes guidance on necessary disclosures and examples to aid users.

**Agenda items.** Currently, FinREC is working on a business combinations guide and a guide on determining the fair value of portfolio investments of venture capital, private equity firms, and other investment companies. Another potential guide will focus on determining whether an instrument is a liability or equity.

“We’ve gotten a lot of questions on liabilities and equity, particularly how to navigate the guidance in the codification because it’s spread out over multiple sections,” Cosper added. “One of the efforts that we have under way is trying to rewrite that section of the codification and to make it easier to navigate.”
In Focus

GAAP
For Private Companies

Debating Alternatives for Small and Medium-Sized Entities

Panelists Susan Cosper, Thomas Groskopf, Daniel Noll, and Mark Bielstein
Creation of the PCC

“We have been involved in private company issues for some time and probably have gotten more involved in the past five years or so, following some of the Blue Ribbon Panel recommendations that the FAF [Financial Accounting Foundation] had organized,” said FASB Technical Director Susan Cosper. FASB’s efforts included a private company financial reporting advisory group and the creation of staff positions devoted to monitoring private company issues and performing private company outreach. “We have some initiatives on educating private companies, which would include talking to the CPE providers, doing webcasts, and things like that,” Cosper continued.

Daniel Noll, a director of accounting standards at the AICPA, noted that the organization had been performing outreach on this topic since the mid-1970s, but that these issues had now reached “the tipping point.”

KPMG partner Mark Bielstein, a member of the EITF, agreed that concerns about complexity in the standards were significant for private companies, as well as for public companies and nonprofits. “Hopefully this focus on private companies will potentially reduce complexity across the board,” he said. “Complexity needs to be considered in a broader context than just making accounting standards easier for private companies.”

PCC member Thomas Groskopf said that one factor influencing the PCC’s creation was the use of different standards in various parts of the world, such as IFRS for small and medium-sized entities (SME). “There was a lot of attention to what we do with these non-listed entities globally and here in the United States,” Groskopf said. “I think the [FAF] trustees, when they went on their listening tour, heard a lot of those concerns, and that gave rise to the PCC.”

Cosper described the PCC’s duties in greater detail: “The council actually has two roles. One of them is what most people are probably familiar with: look-back projects. Are there existing standards in place that would benefit from some improvement for private companies because of user relevance, cost, complexity, or other factors? The other role, which is very important to FASB, is the ongoing advisory role. We have a lot of significant projects on our agenda, and we need that advisory group to help us understand what some of these private company issues are, with respect to the standards.” Bielstein noted that FASB retains the authority to set standards for both public and private companies.

Groskopf discussed the decision-making framework that FASB and the PCC would rely on: “The Blue Ribbon Panel and others looked at it and said that there needed to be some common framework or some common understanding upon which differences or alternatives should be based when decisions are going to be made for unique private company alternatives, whether it’s recognition and measurement, financial statement presentation, disclosure, transition, or effective date. Without that common understanding, each standards setter … would be creating standards based on their own individual framework.”

“The discussions in the public sessions with FASB and the PCC around the decision-making framework were pretty robust,” Cosper added. “The board has been very committed to the framework, even in discussions about active projects.”

“I don’t think the decision-making framework is needed for the board and the PCC to decide what might be reasonable differences for GAAP,” Noll responded. “Having said that, if that framework is viewed as helping PCC and FASB board members make decisions, I say go for it.”

Although Bielstein agreed that the framework might not be helpful in evaluating whether differences should or should not exist in standards for private and public companies, he did think it could be important in identifying which specific differences would benefit financial statement users.

Private and Public Differences

Bielstein next discussed some distinguishing characteristics of private and
In Focus

public companies. For example, private companies may have more control over whom they give their financial statements to; thus, they may have fewer users. In addition, those users may be limited to a select number of owners or lenders in certain situations. As compared to public companies, users of private company financial statements might have more access to additional information from management. Bielstein suggested that other differences might include investment strategies and accounting resources.

“What’s difficult is to translate that into actual different information needs,” Bielstein said. “One of those that I have a particular concern about is access to management. As far as setting accounting standards for general-purpose financial statements, I question whether the ability to pick up the phone and call management is an appropriate distinguishing characteristic. … I think that it does not, in and of itself, address whether the information is actually useful to the user of the financial statements. Also, that presumption of access doesn’t ensure that the users could get the information if they wanted it.”

Groskopf delved further into the issue: “I think you do have to have some user in mind when you design any accounting framework, and if all of your decisions are based on one particular set of users—say, a public company analyst—then you see things in the footnotes to the financial statements, such as roll forwards, that are not all that relevant for private companies. In my view, that is part of the reason why this framework is important to have: so that we make those distinctions.”

A final concern was whether industry-specific guidance was presumed to apply to both private and public companies. “The initial document did have a rebuttable presumption in there, and there was a lot of commentary from certain sectors of the economy about that,” Bielstein explained. “The exposure draft, after consideration of those views, has recognized that, on some noncore items, there might be a need for a difference, but they will be addressed on a case-by-case basis, without any type of rebuttable presumption.”

Groskopf said that FASB hopes to get feedback on industry-specific guidance during the comment period. She also stressed the importance of the framework to the legacy of the project that FASB and the PCC have initiated: “It helps for people who come later … to understand how this inaugural panel made some of its decisions.

During the PCC decision-making process, Groskopf noted, the council focused on user relevance and asked basic questions about setting standards on recognition, measurement, disclosure, effective dates, transitions, and financial statement presentation. For example, according to Groskopf, some recognition and measurement questions might include the following: “Does it affect cash? Is it a core item? Does it affect collateral? If it’s a fair value issue, is it something that reverses quickly? And if so, does the timeliness or lack of timeliness in the issuance of a private company statement render that not very useful? How much does it cost? Does it require outside specialists? Is it difficult to audit?”

“The Blue Ribbon Panel actually found it very appealing to have the idea that when FASB sets GAAP, it does it on almost a baseline-type mentality, which means GAAP that makes sense for all,” Noll added. “The reality is that there’s going to be times when we’re going to have to go into more of an exception-and-modification mode to see if an answer should be different, not just for private companies but also nonprofit organizations or employee benefit plans.”

Next, Strauss asked panelists whether there should be any differences in the requirements of FASB standards, depending upon whether a company is public or nonpublic. The big question, he said, is whether income could be different just because one company is public and the other is private.

“It just depends, based on how one thinks about user relevance and the cost of complexity, whether differences could result,” Cosper said. “We’re already seeing that on our active projects. Leasing is a particularly good example, where we have recognition and measurement differences. We have had disclosure differences and effective-date differences for some time. Those don’t necessarily seem to be as troublesome as folks believe the recognition and measurement differences might be.” She added, “While the PCC will be focusing on some of these issues—for example, VIEs [variable interest entities] and business combinations—FASB will also be looking at these same issues as they relate to public companies and as they relate to employee benefit plans and nonprofits.”

With respect to whether there could be differences in recognition and measurement, and thus income, attributable to whether a company was public or private, Bielstein said, “If those differences are based on different needs of the financial statement users and there are reasons to have the requirements different for public company users, as compared to private company users, I’m very open to hearing about that.”

“You hear, from time to time, these dogmatic statements that income should be the same or … private companies and public companies should account for the same transaction the same way,” Groskopf countered. “There are already differences today in recognition and measurement, share-based compensation, liabilities and equity, push-down accounting. … If we look at what’s going on right now, it’s not happening.”

“To some extent, we usually focus on complexity by thinking about the difficulties in applying a particular standard,” Bielstein added. “It’s also important to think about complexity from the overall financial reporting system and what those kinds of differences mean, particularly if they become per-
asive across standards.” He provided an example of the complexity that could result: “How do we disclose differences between public and private companies, and let the users of financial statements actually know which standards they’re applying, particularly if there’s widespread differences and a company has the ability to pick and choose whether to apply public or private standards in particular situations?” Although Bielstein expects that differences will not become such a dire concern, “once you start moving toward widespread differences, it creates complexity for the overall financial reporting system, even though it might make an individual standard easier to apply.”

The PCC’s Agenda

Some projects the PCC had agreed to consider included VIEs, plain-vanilla interest rate swaps, and identifiable intangible assets. “These topics are right on the money,” Noll said. Groskopf agreed that concerns on these topics had been heard during private company roundtables and the Blue Ribbon Panel’s recommendations. He also commented on the issue of interest rate swaps: “It really comes down to a disconnect in the current mixed-attribute model. If I have a straight fixed-rate piece of debt, I account for something one way. And if I have a synthetic fixed-rate piece of debt using a swap and variable underlying note, I account for it differently—at fair value, basically. … Is there a way within the context of the PCC to try to provide some relief and perhaps an alternative?”

Coser then provided an example of an intangible asset that a nonpublic company might not have to record, but that a public company would: “You could have customer relationship intangibles or customer lists, or similar things that could potentially be excluded from having to be separately identifiable. Some of these issues are not just issues for private companies. If you look at identifiable intangible assets, the first issue is identifiable intangibles: should they be separated in business combinations? The second issue is goodwill: should it be amortizable? Should it be a direct write-off? Those are things that we heard when we did what I call the ‘step zero’ goodwill impairment project. We heard it from both public and private companies.”

Defining a Private Company

If differences exist for private and public companies, it is important to decide who would be eligible to use those differences, Strauss said.

“We do have a separate project on our agenda to identify the definition of a non-public entity,” Cosper said. “The other objective is to ask, ‘Whom should we be thinking about when we get to a private company decision-making framework? Whom should the PCC be making decisions for?’ … We’re trying to make sure we have a fulsome definition of a public company in order to understand what is not a public company.” Although it might be easy to assume that a public company is an entity that furnishes or files financial statements with a regulatory agency, shades of gray do exist. “You have, on one end of the spectrum, a very clear idea of what a public company is, and on the other end of the spectrum, you probably have a very clear understanding of what a private company is,” Cosper noted. “It’s that stuff in the middle that we’re trying to make sure we’ve got sorted out.”

In the scope of the private company decision-making framework, nonpublic financial institutions would be considered private. “If a decision were made on something that was core to a financial institution,” Cosper said, citing the example of loans, “there would have to be a decision made as to whether financial institutions should be scoped in or scoped out.”

The AICPA’s Proposed Framework

Strauss next brought up the AICPA’s controversial proposed financial reporting framework for small and medium-sized entities (SME) that relies upon an other comprehensive basis of accounting (OCBOA), rather than on U.S. GAAP. Noll provided an update: “In early June, we are issuing another form of OCBOA … that term is being replaced with the notion of a special-purpose framework. … There appear to be many out there who would say that there’s something missing with the current OCBOAs and with GAAP, even with the differences that the PCC and FASB might put into GAAP, and that there needs to be another basis to help private companies. … So we’re building the Financial Reporting Framework for SMEs.”

The proposal contains a full model and accounting rules on different topics, Strauss explained; however, he noted that some have expressed concerns that companies following this new OCBOA will have to learn an entirely new set of rules. Noll said that the new framework is optional, and that it will probably be smaller companies, guided by their auditor, that choose to rely on it.

Bielstein expressed his support of the project: “Companies now have choices. They can use GAAP. They can use IFRS. They can use IFRS for SMEs, tax basis, cash basis. If there are some companies that find that those standards are not particularly useful, and there’s a different OCBOA that would be useful for the company and its users, I don’t see any harm.”

Despite his overall agreement with the idea, he raised two issues: 1) that the framework, disclosures, and financial statements must clearly reflect that the new OCBOA is not GAAP, in order to avoid confusing users, and 2) that the framework must be based on the user’s needs. “I think there are some inconsistencies in the framework as proposed,” he added, “and there are probably a few too many elections that are too broad-based.”
One important use of the audit deficiencies identified by the PCAOB’s settled disciplinary orders (SDO) is improving education related to audit quality. The audit deficiencies identified in SDOs and other PCAOB releases can be used by CPA firms, continuing education providers, and college audit professors in order to improve training and educational programs, with the goal of avoiding similar violations in the future. This, in turn, can help enhance audit quality.

PCAOB inspections of smaller public accounting firms have been explored in earlier research (e.g., Dana R. Hermanson and Richard W. Houston, “Quality Control Defects Revealed in Smaller Firms’ PCAOB Inspection Reports,” The CPA Journal, December 2008, pp. 36–38; Dana R. Hermanson and Richard W. Houston, “Evidence from the PCAOB Second Inspections of Small Firms,” The CPA Journal, February 2009, pp. 58–60; James F. Boyle, Douglas M. Boyle, Dana R. Hermanson, and Richard W. Houston, “Quality Control Defects in Smaller Firms’ PCAOB Inspection Reports: An Updated Analysis,” The CPA Journal, June 2013, pp. 34–39). Although the inspection reports may describe apparent noncompliance with auditing and ethical standards, they might not include all of the PCAOB’s criticisms regarding audit quality; for example, the PCAOB’s criticisms of potential defects in the quality control system of a firm under inspection are not made public if the firm addresses those criticisms or defects to the satisfaction of the PCAOB within 12 months of the inspection report’s date (PCAOB Release 104-200-077, “The Process for Board Determinations Regarding Firms’ Efforts to Address Quality Control Criticisms in Inspections,” Mar. 21, 2006).

In addition, inspection reports do not constitute conclusive findings of facts or violations; however, SDOs that detail violations of regulations established through the PCAOB’s disciplinary process—providing an opportunity for the firm to defend itself—are conclusive (PCAOB Release 104-2004-001, “Statement Concerning the Issuance of Inspection Reports,” Aug. 26, 2004). Thus, this discussion focuses on violations addressed in SDOs, which represent settled disciplinary actions against registered firms or associated persons for their noncompliance with the PCAOB’s professional standards and rules. The findings of the PCAOB inspectors reported in these SDOs offer valuable information that, if utilized appropriately, can significantly improve the quality of future audits and related accounting information.

The PCAOB’s Oversight Role

The Sarbanes-Oxley Act of 2002 (SOX) established the PCAOB to oversee the audits of public companies in order to protect the interests of investors and further the public interest through the preparation of informative, accurate, and independent audit reports. To accomplish this, the PCAOB registers public accountants and authorizes them to audit public companies and issue audit reports; promulgates auditing standards; inspects registered public accountants to ensure their compliance with SOX; disciplines registered public accountants for noncompliance; and, where appropriate, imposes sanctions on registered public accountants.

The PCAOB annually inspects firms that issue more than 100 audit reports; in 2012, the board inspected nine such large public accounting firms, according to its website. The PCAOB triennially inspects all other smaller firms, per PCAOB Rule 4000–4012 and Rule 4020(T). But the PCAOB does not inspect audit documentation of accounting firms located in some foreign countries, due to the laws of those countries (http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx).
The results of the periodic inspections are summarized and posted on the PCAOB’s website (http://pcaobus.org/Inspections/Pages/PublicReports.aspx). As previously mentioned, criticisms relating to quality control matters remain nonpublic if the firm addresses them to the board’s satisfaction within 12 months of the report date; if the firm fails, these criticisms are made public.

In connection with the SDOs, the PCAOB can sanction a firm by suspending individual registered members from auditing public companies, revoking a firm’s registration, or imposing monetary penalties. Furthermore, the board may also direct a registered public accounting firm to make improvements in its quality control system or training of staff, among other matters, in order to enhance the registered firm’s compliance with PCAOB regulations.

Overview of SDOs

As indicated above, SDOs represent the settlements the PCAOB has reached with registered firms or their associated persons, arising out of disciplinary proceedings for violations of PCAOB standards and rules. These proceedings are kept confidential until a final decision about imposing sanctions is made; if sanctions are imposed, the PCAOB issues an SDO. From the issuance of the first SDO in 2005 to February 2012, the PCAOB issued approximately 40 SDOs, a relatively small proportion compared with the number of audits it inspected.

The PCAOB annually inspects eight large registered accounting firms: BDO, Crowe Chizek and Company, Deloitte & Touche, Ernst & Young, Grant Thornton, KPMG, McGladrey, and PricewaterhouseCoopers. The remaining registered public accounting firms, which audit fewer than 100 public companies annually, are inspected triennially. The board has inspected 1,662 audits (from 2004 to 2007) conducted by annually inspected firms and 497 audits (from 2004 to 2006) conducted by triennial firms. The PCAOB’s inspections of these 2,159 audits revealed some audits free of any audit deficiencies, leaving the remaining audits with varying degrees of concerns about potential quality control issues and audit performance-related matters; however, the PCAOB has cautioned against using its inspection releases to draw broad conclusions about the quality of audits performed by any of these firms. The PCAOB also observed that the number of audits inspected constitutes a relatively small proportion of the total audits performed by CPAs and that the inspected firms are not representative of the total audits that the CPA firms performed. The PCAOB’s cautionary advice likewise applies to the relatively small number of SDOs (less than 2% of inspections, constituting approximately 40 SDOs out of 2,159 total inspections).

Categories of Significant Violations

Violations by registered public accounting firms can be grouped into three broad categories: general standards, fieldwork standards, and reporting standards (AU section 150, “Generally Accepted Auditing Standards”). Key elements of general standards include exhibiting technical proficiency in audits, maintaining an attitude of independence (in fact and in appearance), and exercising due professional care. Implicit in exercising due professional care is maintaining an attitude of professional skepticism and exercising professional judgment when complying with the other standards relating to fieldwork and audit reporting. In other words, as shown in Exhibit 1, the general standards impact the other standards; therefore, adherence to the general standards should effectively contribute toward compliance with the others.

The three fieldwork standards are directed toward obtaining and evaluating sufficient and appropriate audit evidence; this, in turn, will help ensure a high (reasonable) degree of assurance that reported account balances (based upon an entity’s transactions for the period) and disclosures in the entity’s financial statements are presented in accordance

EXHIBIT 1
Categories of Significant Violations

<table>
<thead>
<tr>
<th>GENERAL STANDARDS</th>
<th>FIELDWORK STANDARDS</th>
<th>REPORTING STANDARDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independence</td>
<td>Adequate planning of audit and proper supervision of assistants</td>
<td>Auditor’s Report</td>
</tr>
<tr>
<td>Technical Proficiency</td>
<td>Obtain sufficient appropriate audit evidence through audit procedures in order to afford a basis for the audit opinion</td>
<td></td>
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<tr>
<td>Due Care and Professional Skepticism</td>
<td>Obtain understanding of internal control (to assess risk of material misstatement) to determine responsive audit procedures</td>
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</tr>
<tr>
<td>PCAOB Standard *</td>
<td>Example</td>
<td></td>
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<tr>
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<tr>
<td>AU section 150, “Generally Accepted Auditing Standards”</td>
<td>These pervasively affect all phases of an audit; for example, if an auditor does not exercise due professional care, it might result in a lack of appropriate audit evidence supporting an unqualified audit opinion.</td>
<td></td>
</tr>
<tr>
<td>AU section 220, “Independence”</td>
<td>Auditor owning shares of an audit client’s stock.</td>
<td></td>
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<tr>
<td>AU section 230, “Due Professional Care in the Performance of Work”</td>
<td>Not maintaining an attitude of professional skepticism; for example, not developing and applying responsive audit procedures to address assessed risk level. Failure to take necessary steps to minimize the effect of incompetent professionals assigned to an audit.</td>
<td></td>
</tr>
<tr>
<td>AU section 310, “Appointment of the Independent Auditor”</td>
<td>Failure to establish and document an understanding with a client regarding the services to be performed for each engagement.</td>
<td></td>
</tr>
<tr>
<td>AU section 311, “Planning and Supervision”</td>
<td>Failure to plan the audit or prepare audit programs; review and supervise the work of audit assistants.</td>
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</tr>
<tr>
<td>AU section 312, “Audit Risk and Materiality in Conducting an Audit”</td>
<td>Increasing the planned materiality level to make overstated earnings/assets immaterial. Failure to evaluate financial statements sufficiently to determine whether they are fairly stated.</td>
<td></td>
</tr>
<tr>
<td>AU section 315, “Communications between Predecessor and Successor Auditors”</td>
<td>Failure to make inquiries for determining whether to accept an audit by the successor.</td>
<td></td>
</tr>
<tr>
<td>AU section 316, “Consideration of Fraud in a Financial Statement Audit”</td>
<td>Failure to consider risk of material misstatement that could arise due to fraud, or not appropriately designing audit procedures when situations appear unusual. Preparing audit work papers to justify a misstatement as immaterial when it is not.</td>
<td></td>
</tr>
<tr>
<td>AU section 317, “Illegal Acts by Clients”</td>
<td>Failure to take necessary steps after becoming aware that a client has committed an illegal act.</td>
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<tr>
<td>AU section 326, “Audit Evidence”</td>
<td>Failure to obtain sufficient appropriate audit evidence in support of audit opinion.</td>
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<tr>
<td>AU section 328, “Auditing Fair Value Measurements and Disclosures”</td>
<td>Failure to audit or test impairment in value of intangibles (despite deteriorating business conditions).</td>
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<tr>
<td>AU section 329, “Analytical Procedures”</td>
<td>Failure to develop expectations in connection with performing analytical review.</td>
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</tr>
<tr>
<td>AU section 330, “The Confirmation Process”</td>
<td>Failure to confirm accounts receivable (approximately 10% of assets) or other accounts receivable–related procedures were performed. No determination of a sufficient basis to conclude that the confirmation provided meaningful and competent evidence.</td>
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</tr>
<tr>
<td>AU section 332, “Auditing Derivatives, Hedging Activities, and Investments in Securities”</td>
<td>Failure to evaluate valuation of investment in marketable securities.</td>
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<tr>
<td>AU section 333, “Management Representations”</td>
<td>Accepted management representation (as sufficient appropriate evidence) without meeting audit procedure requirements. Did not obtain management representation.</td>
<td></td>
</tr>
<tr>
<td>AU section 334, “Related Parties”</td>
<td>Accepting management representation without performing audit of a significant related party transaction. Failure to obtain sufficient appropriate evidential matter concerning property acquisitions from a controlling shareholder.</td>
<td></td>
</tr>
<tr>
<td>AU section 336, “Using the Work of a Specialist”</td>
<td>Failure to perform procedures to ascertain the qualifications of the specialists, their relationships to the client, or the methods or assumptions used by the specialists.</td>
<td></td>
</tr>
<tr>
<td>AU section 339, “Audit Documentation”</td>
<td>Failure to prepare documentation. Stating in the working papers, without performing, any of the following: “Reviewed all working papers,” “reviewed completed audit programs,” “reviewed the financial statements and [was] satisfied that they had been prepared in conformity with [GAAP],” “reviewed the auditor’s report and [was] satisfied it properly expressed audit opinion in accordance with auditing standards.”</td>
<td></td>
</tr>
<tr>
<td>AU section 341, “The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern”</td>
<td>Wording (language) included in the explanatory paragraph was not according to the prescribed format.</td>
<td></td>
</tr>
</tbody>
</table>
with GAAP and are free of material (qualitative and quantitative) misstatements due to error, fraud, or illegal acts.

The authors grouped the specific SDO violations examined into three categories: violations of general standards, violations of fieldwork standards, and violations of reporting standards (AU section 150, “Generally Accepted Auditing Standards”). The sections below review the types of violations that appeared in each category. Exhibit 2 lists the PCAOB standards with which registered public accounting firms failed to comply and provides examples of the violations.

Violations of general standards. The PCAOB has reported several situations involving auditor violations of general standards. For example, one situation involved a registered public accounting firm with only one engagement partner responsible for 300 engagements over a three-year period. In addition, these audit engagements were staffed by individuals who had little or no accounting or auditing experience (PCAOB Release 105-2009-006, “Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions,” Aug. 27, 2009). This situation—involving a large number of clients, a lack of proficient staff, and only one engagement partner—clearly violates the concepts of independence (in fact and in appearance) and due professional care in planning and executing audit engagements.

In another situation, a public accounting firm partner assigned to an engagement was found to be incompetent.

Other situations involving an independence violation include providing prohibited services (e.g., bookkeeping), acquiring a financial interest (e.g., purchase of common stock), and having a close relative with a financial interest in an audit client. In other cases, auditors did not have adequate knowledge of PCAOB standards and rules, which include quality control and ethics standards.

Although auditors have an obligation to maintain an attitude of professional skepticism, the PCAOB has reported many situations where auditors did not maintain this attitude. For example, a firm did not take adequate steps to compensate for the effects of nonperformance of sufficient appropriate audit procedures managed by an incompetent engagement partner (http://pcaobus.org/Enforcement/Decisions/Documents/12-10_Deloitte.pdf). Other examples include a partner failing to exercise due care while reviewing the work of an engagement partner, and auditors failing to perform responsive audit procedures to gather sufficient appropriate audit evidence based on the assessed risk level.

General standards have a pervasive effect on fieldwork and reporting standards. As described previously, auditors’ technical proficiency and independence could influence the effectiveness with which they exercise due professional care and maintain professional skepticism, which is implicit in exercising due care. Improper professional care, outright disregard, or gross auditor negligence could result in an auditor not developing and applying responsive audit procedures to obtain compelling evidence in support of an audit opinion.

Violations of fieldwork standards. The violations of fieldwork standards reported by the PCAOB included improper documentation of audit work and not performing necessary audit procedures, such as frequent violation of Auditing Standard (AS) 3, Audit Documentation, where auditors have added (or changed the date on) working papers after the completion of an audit, or where working papers were not reviewed but dated as though they had been reviewed. Moreover, auditors did not perform necessary audit procedures, including the following violations:

- Ineffectively auditing reported revenue from products for which a right of return existed (e.g., allowing client to adjust sales returns at replacement cost instead of gross sales price, thereby misstating sales revenue, and failing to properly audit return estimates)
- Failure to determine the reasonableness of a new estimating technique used, which resulted in a substantial (from 47% to 32%) reduction of the allowance for doubtful accounts, thereby increasing assets and revenue
- Failure to detect an overstatement of cash by $1 billion and accepting confirmation requests sent to (and received from) banks by management
- Failure to verify valuations (e.g., two assets which collectively accounted for 90% of total assets; research and development costs, existence and valuation of marketable securities, goodwill and intangibles accounting 97% of total assets; right to $500 million bonds and related interests; and approximately $300 million in notes)
- Failure to perform sufficient procedures to verify related party transactions (e.g., regarding disclosure, not obtaining evidence for the valuation of properties acquired in a related party transaction)
- Failure to follow up when information about a client’s illegal activity surfaced.

Many situations involved auditors not performing adequate procedures to determine the fairness of revenue related items and valuation of assets. Such lax audit procedures can encourage management to manage earnings.

Violations with respect to audit reports. As part of completing an audit, auditors should determine that the financial statements are free of material misstatement and are presented in accordance with GAAP. In its inspections, the PCAOB identified violations that included the following:

![Image](https://via.placeholder.com/537x404)

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Allowing material misstatement in the financial statements—for example, accepting a 50% increase of the materiality threshold, knowing that it would result in material ($19.7 million) misstatement of overstated assets, revenues, and earnings

■ Not reporting correction of a prior period error, and misclassification of certain other items
■ Failure to subject audit documentation to an independent review by a quality control section or department within the firm, or by a professional other than the engagement partner
■ Several situations involving noncompliance with quality control standards, which should include procedures relating to 1) acceptance of new clients or continuance of existing clients in repeat audits, 2) review of audit workpapers to determine that audits are planned and performed in compliance with standards/regulations, 3) management of personnel, and 4) procedures to monitor that the firm’s quality control procedures have been effectively followed; despite the quality control standards, the PCAOB identified situations where firms had either no quality control system or an inadequate system
■ Situations where auditors issued unqualified audit reports without performing an audit or only a limited audit without obtaining sufficient supporting evidence.

Internal control deficiencies. In a recent PCAOB inspection report relating to 2010 inspections on audits of internal control over financial reporting (PCAOB Release 2012-006, “Observations from Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control over Financial Reporting,” Dec. 10, 2012), the PCAOB staff found that in approximately 15% of audits of internal control, the auditors did not obtain sufficient appropriate audit evidence to support the audit opinion on the effectiveness of internal control over financial reporting. The PCAOB indicated that firms should be proactive in considering how to prevent similar deficiencies, through strong firm quality control systems, robust training and guidance, and strategies to better anticipate and address risks that might arise in specific audits.

**Actions to Address PCAOB Criticism**

To ensure that audit deficiencies identified by a PCAOB inspection remain nonpublic, a registered accounting firm must address the deficiencies within 12 months. If the firm fails to address the deficiencies, then the PCAOB may conduct a disciplinary proceeding to establish whether the deficiencies constitute violations of any laws, rules, or professional standards for which sanctions should be imposed. In contrast, if a firm addresses the deficiencies, and the PCAOB’s determination regarding the actions taken by the firm is favorable, then the criticisms are not made public; however, the PCAOB observed that favorable determination should not be construed to mean that the firm has completely and permanently cured the audit quality control–related deficiency, but instead that the firm has demonstrated substantial progress to address the audit quality issue.

### EXHIBIT 2 (CONTINUED)
Examples of Violations Identified in PCAOB Settled Disciplinary Orders

| AU section 342, “Auditing Accounting Estimates” | Failure to obtain an understanding as to how the client developed its estimate concerning the fair value of goodwill, either by reviewing and testing the process used by management to develop the estimate or by developing an independent expectation of the estimate to corroborate the reasonableness of management’s estimate. |
| AU section 431, “Adequacy of Disclosure of Financial Statements” | Failure to adequately disclose related party transaction. Failure to adequately disclose accounting policy (e.g., relating to sales returns), which should include appropriateness of those principles when situations appear unusual. |
| AU section 508, “Reports on Audited Financial Statements” | Failure to obtain sufficient appropriate evidence in support of audit report. |
| AU section 543, “Part of Audit Performed by Other Independent Auditors” | Principal auditor’s failure to properly coordinate audit with other audit firm, and failure to follow up on indications that another audit firm’s work used by the firm may not have been performed in accordance with PCAOB standards and may not have provided sufficient competent evidential matter that the financial statements were in accordance with GAAP. Failure to obtain and review 1) a list of significant fraud risk factors and how other auditors addressed those risks, 2) information relating to significant findings or issues inconsistent with the auditor’s final conclusions, 3) a schedule of audit adjustments, 4) all significant deficiencies and material weaknesses in internal control over financial reporting, 5) letters of representation from management, and 6) all matters to be communicated to the audit committee. |
| AU section 561, “Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report” | Failure to use the information (about significant amount of sales returns subsequent to year end) and effects on the financial statements as of year-end. |

* The PCAOB issued Auditing Standard (AS) 8 through 15 in 2010, relating to the auditor’s assessment of and response to risk of material misstatement in an audit. These eight standards replaced interim standards AU sections 311, 312, 313, 319, 326, and 431. AS 3 replaced interim standard AU 339.
Most registered public accounting firms inspected by the PCAOB have taken steps to address the deficiencies identified and described in their inspection reports within the 12-month remediation time frame. Matters relating to quality control, which have a pervasive impact on audit quality, were most frequently cited among the remedial actions taken by firms.

Actions taken by annually inspected firms include the following:

- Separated audit quality function and audit business operations to ensure that audit quality is not compromised
- Strengthened internal inspection programs (e.g., adding additional full-time personnel)
- Implemented specific continuing education for non-U.S. professionals who work on the audits of U.S. issuers’ foreign locations
- Conducted independence reviews of foreign affiliates by a group dedicated to that purpose in order to ensure that prohibited services are not provided by foreign affiliates.

Actions taken by triennially inspected firms included the following:

- Implemented annual technical training for audit personnel to enable them maintain a high level of technical competence (e.g., achieve familiarity with SEC rules and regulations, PCAOB auditing standards, accounting standards, independence requirements, and specialized industry guidance)
- Improved audit methodologies, including audit programs and practice aids
- Strengthened the firm’s own internal monitoring of audit performance.

Enhancing Audit Quality through Training and Education

In order to make audits more effective, CPA continuing education providers and audit educators should not just develop training and educational materials; they should also consider the concerns expressed in PCAOB inspection reports and in SDOs, which include significant violations of auditing standards that the CPA firms failed to address. Audit training and educational materials should highlight these violations and provide approaches to prevent such violations. For example, educators and continuing education providers should encourage supervision of audit assistants to ensure that they have exercised due care and maintained professional skepticism. Supervisors should document that due care has been exercised, particularly when risk of material misstatement is assessed at a relatively higher level.

In addition, educators and continuing education providers should stress the importance of a quality control review of each audit engagement and of monitoring the firm’s quality control system. The quality control system should ensure that—

- quality control staff have the needed skills and authority to discharge their responsibilities effectively;
- staff assigned to audits are trained and possess adequate proficiency in audits, maintain professional skepticism, and effectively exercise due care and professional judgment;
- there is effective review and supervision of audit at various levels (e.g., supervisor, manager, partner);
- there are effective review and supervision of audit at various levels (e.g., staff, supervisor, manager, partner);
- there is periodic evaluation (monitoring) of quality control systems.

A Dynamic Process

Although PCAOB inspection reports, unlike SDOs, may not reveal disciplinary proceedings if there are any pending, the fact that PCAOB makes its inspection reports and SDOs available to the public increases the effectiveness of the process. Auditors are now aware that their work will be periodically inspected, with audit deficiencies identified and reported. Noncompliance with PCAOB regulations might result in sanctions against audit firms (or individuals), might expose audit firms (and auditors) to litigation, and might result in adverse publicity. Furthermore, the public now knows that it can report abuses to the PCAOB (via the PCAOB’s “tip and referral” center, http://pcaobus.org/Enforcement/Tips/Pages/default.aspx). All of the above are likely to strengthen audit quality.

The issues brought out in the SDOs can be a rich resource for CPA firms, professional education providers, and academics, perhaps providing the bases for case studies focused on areas of concern in actual incidents. Enhancing audit quality is a continuous and dynamic improvement process, and SDOs and inspection reports can be used to further accomplish that goal.

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Cross-border business and investment activities give rise to a host of reporting and filing obligations under both the Internal Revenue Code (IRC) and various other statutes, such as the Bank Secrecy Act of 1970 (BSA). Once CPAs are aware of an individual’s cross-border activities, they must ensure compliance with all reporting obligations. Failure to properly report such activities can result in draconian consequences, far more severe than the penalties that are ordinarily assessed for unfiled or late tax returns.

For example, the opportunity to make an IRC section 871(d) election—to treat real estate activities in the United States as effectively connected with a trade or business in the country and, therefore, taxable on a net rather than gross basis—is jeopardized if an accurate (IRC sections 874[a] and 882[c][2]) and timely (Treasury Regulations sections 1.874-1[b][1] and 1.882-4[a][3][i]) return is not filed. (The Tax Court held that the timeliness requirement of the Treasury Regulations is invalid because it is inconsistent with the plain meaning of the statute,
which requires only that the return be filed in the “manner” required by the statute; however, this decision was overturned on appeal [Swallows Holding Ltd. v. Comm’r, 515 F.3d 162 (3d Cir. 2008), rev’d 126 T.C. 96 (2006)].

A willful failure to file a Foreign Bank Account Report (FBAR), required under the BSA, can result in penalties as high as 50% of the highest balance in the foreign account for each year (31 USC section 5321[a][5][C] and [D]). In addition, a willful failure to file can result in criminal prosecution for both taxpayer and advisor (31 USC section 5322[a]). Given the breadth and diversity possible in cross-border transactions, some might require the filing of forms not specifically discussed in this article. As such, this article provides guidance for the most critical forms that CPAs should be aware of in order to ensure compliance with the reporting requirements. It is also important to understand that any relevant, applicable treaty provisions between the United States and a foreign person’s residence may supersede the default provisions of U.S. law related to reporting requirements.

Foreign Taxpayers’ Filing Obligations

Foreign persons are subject to tax filing and payment responsibilities in the United States if they are engaged in a trade or business in the country (IRC section 871[b]) or if they receive specific types of income from a U.S. source (IRC sections 871[a] and 881[a]). For example, the receipt of fixed, determinable, annual, or periodical (FDAP) income from a U.S. source by a foreign person subjects that individual to U.S. tax filing obligations.

Foreign persons must file a U.S. tax return on Form 1040NR, U.S. Nonresident Alien Income Tax Return, if they are—

■ nonresident aliens who engaged in the conduct of a U.S. trade or business at any time during the taxable year, even if they had no U.S. source income and all income was exempt from tax;
■ nonresident aliens who were not engaged in a U.S. trade or business during the year and had U.S. source income subject to tax, and not all of the tax owed was withheld from that income;
■ the executors or personal representatives of a deceased nonresident alien who would have been required to file; or
■ representing an estate or trust that is required to file Form 1040NR. (See the instructions for Form 1040NR, p. 3.)

Foreign persons who rely upon an income tax treaty to reduce or modify their U.S. tax obligations must file a separate treaty-based return position disclosure form for each position taken (IRC section 6114[a]); the disclosure is made on Form 8833, Treaty-Based Return Position Disclosure under Section 6114 or 7701(b). (For a discussion of when and how to file Form 8833, see the IRS article, “Claiming Benefits,” http://www.irs.gov/Individuals/International-Taxpayers/Claiming-Tax-Treaty-Benefits.)

U.S. Taxpayers’ Filing Obligations

The following sections describe the filing obligations for U.S. taxpayers with foreign bank accounts, securities accounts, or other financial accounts or financial interests.

FBAR Requirements

The BSA requires a U.S. person to file a Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, if the individual has any financial interest in (31 CFR section 1010.350[c]) or signature or other authority over (31 CFR section 1010.350[f]) a bank account, securities account, or “other financial account” in a foreign country, with an aggregate value of more than $10,000 at any time during the calendar year. It is important to note that the FBAR regulations under 31 CFR section 1010.350(b) mirror the definition of “U.S. person” found in IRC section 7701[a][30]. In addition, “bank account” refers to a savings deposit, demand deposit, checking, or any other account maintained with a person engaged in the business of banking (31 CFR section 1010.350[c][1]); “securities account” means an account with a person engaged in the business of buying, selling, holding, or trading stock or other securities (31 CFR section 1010.350[c][2]). A “foreign financial account” includes an insurance or annuity policy with a cash value, as well as an account with a mutual fund or similar pooled fund (31 CFR section 1010.350[c][3]).

U.S. persons can be required to produce foreign bank records under the BSA, even when the act of production is clearly incriminatory (In Re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, no. 11-3799, CA-7, Aug. 27, 2012, reversing an unreported DC Ill. decision). Under these circumstances, the Fifth Amendment privilege against self-incrimination is trumped by the “required records” doctrine and offers no protection against the filing and recordkeeping requirement established by the BSA. In Shapiro v. U.S. (335 U.S. 1, 33 [1948]; quoting Davis v. U.S., 328 U.S. 582, 589-90 [1946]), the court stated:

[Under the required records doctrine] the privilege which exists as to private papers cannot be maintained in relation to records required by law to be kept in order that there may be suitable information of transactions which are the appropriate subjects of governmental regulation, and the enforcement of restrictions validly established.

Moreover, when “the requirements of the Required Records Doctrine are met, a witness cannot resist a subpoena by invoking the Fifth Amendment privilege against compelled, testimonial self-incrimination” (In Re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011). The appeals court in In Re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011 referred to Marchetti and Grosso v. U.S. (390 U.S. 62 [1968]), which interpreted the required records doctrine as having the following three requirements:

■ The purposes of the government inquiry must be essentially regulatory.
■ Information is to be obtained by requiring the preservation of records of a kind that the regulated party has not customarily kept.
■ The records must have assumed public aspects that render them at least analogous to a public document.

In invoking the doctrine, the court emphasized the voluntary submission—in essence, a waiver of Fifth Amendment protection—by choosing to engage in a regulated activity. The court stated:

The voluntary choice to engage in an activity that imposes record-keeping requirements under a valid civil regulatory scheme carries consequences, perhaps the most significant of which, is the possibility that those records might have to be turned over upon demand, notwithstanding any Fifth Amendment privilege. That is true whether the privilege arises by virtue of the contents of the documents or by...
the act of producing them. (In Re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011)

The FBAR must be received by the Department of the Treasury, not merely filed, on or before June 30 of the year following that in which the account holder meets the $10,000 threshold (31 CFR section 1010.306[c]), regardless of any extensions granted. U.S. persons who are required to file FBARs must also keep records available for inspection that relate to the foreign financial accounts that triggered such filing obligations for five years following the FBAR filing (31 CFR section 1010.420). For each foreign financial account, the filer must keep records showing the name in which the account was held, the type of account, the account number or designator, the name and address of the foreign bank or other persons with whom the account was maintained, and the maximum value of the account during the reporting period (31 CFR section 1010.420).

Financial interest. For FBAR purposes, a financial interest is defined by ownership of record or legal title, regardless of whether the account in question is maintained for the benefit of others, even if they are non-U.S. persons (31 CFR section 1010.350[e][1]). The regulations apply a look-through analysis in order to determine whether a U.S. person has a financial interest in an account held in trust. Such a person is considered to have a financial interest in a trust account if it is treated as the individual’s account under the IRC grantor trust rules (31 CFR section 1010.350[e][2][iii]). Furthermore, a U.S. person who has a “present beneficial interest” in more than 50% of the assets of a trust or receives more than 50% of a trust’s current income is deemed to have a financial interest in the financial accounts of that trust (31 CFR section 1010.350[e][2][iv]); however, a present beneficial interest does not include a remainder interest or the interest of a beneficiary with purely discretionary benefits (Federal Register, vol. 76, no. 37, I. section 103.24[e], Feb. 24, 2011).

A U.S. person does not need to be the legal owner of record or the holder of legal title in order to have a financial interest in the account. Such a financial interest includes accounts owned by an agent, nominee, or an attorney. In addition, for FBAR purposes, ownership of more than a 50% interest in a corporation, partnership, or trust is treated as the equivalent of direct ownership of any accounts owned by the entities themselves (31 CFR section 1010.350[e][2]).

Signature or other authority. Mere signature or other authority over a foreign financial account—that is, the authority “to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained” (31 CFR section 1010.350[f][1])—is sufficient to require filing of an FBAR (31 CFR section 1010.350[a]).

FBAR penalties. Failure to make a required FBAR disclosure can result in both civil and criminal penalties. Criminal penalties include fines and imprisonment, and they are subject to a five-year statute of limitations beginning on the due date of the FBAR (18 USC section 3282). Criminal liability requires proof that a taxpayer knew of the reporting requirement but did not file (U.S. v. $359,500 in U.S. Currency, 828 F.2d 930 [2d Cir. N.Y. 1987]).

The civil penalty for failing to file an FBAR is the greater of $100,000 or 50% of the balance in the account at the time of willful violation (31 USC section 5321[a][5][C][D]). A nonwillful failure to file subjects an individual to a civil penalty of up to $10,000 per failure, unless the failure is abated as a result of the reasonable cause exception (31 USC section 5321[a][5][B][ii][I]–[II]); however, this requires that “the amount of the transaction or the balance in the account at the time of the transaction was properly reported” by the taxpayer (31 USC section 5321[a][5][B][ii][II]).

FATCA Requirements

The Foreign Account Tax Compliance Act (FATCA), under section 511 of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, requires a U.S. person holding an interest in a specified foreign financial asset to attach Form 8938, Statement of Specified Foreign Assets, to each current income tax return for any year in which the aggregate value of all such specified foreign financial assets exceeds $50,000 (IRC section 6038[D][a]). Although the required information is similar to that disclosed in an FBAR, reporting under FATCA is a separate and distinct obligation; FBAR and FATCA reports must be filed when the statutory prerequisites are met. Form 8938 is filed with the applicable “annual return”—including Form 1040, U.S. Individual Income Tax Return; Form 1120, U.S. Corporation Income Tax Return; Form 1065, U.S. Return of Partnership Income; Form 1041, U.S. Income Tax Return for Estates and Trusts; Form 1120-S, U.S. Income Tax Return for an S Corporation; and Form 1040NR, U.S. Nonresident Alien Income Tax Return—at its due date.

Specified foreign financial assets. These are typically any depository or custodial accounts at a foreign financial institution (IRC section 6038D[b][1]). Specified foreign financial assets can also be stocks or securities issued by foreign persons, any other financial instrument or contract held for investment that is not issued by a U.S. person or has a counterparty that is not a U.S. person, and any interest in a foreign entity (IRC section 6038D[b][2][A]–[C]).

Filing Form 8938. In general, FATCA reporting is required only if the value of a U.S. person’s specified foreign financial assets exceeds $50,000 at any point during the year (IRC section 6038D[a]). The assets are presumed to be worth more than $50,000 if 1) the IRS determines that an individual has an interest in one or more specified foreign financial assets, and 2) the individual does not provide sufficient information to demonstrate the aggregate value of the assets (IRC section 6038D[e][1]–[2]).

This reporting threshold varies, depending upon whether the individual lives in the United States or files a joint income tax return with a spouse. If the taxpayer is single or married filing separately and is not living abroad, the reporting threshold is satisfied only if the total value of the taxpayer’s foreign financial assets is more than $50,000 on the last day of the tax year, or more than $75,000 at any time during the tax year. If the taxpayer is married filing jointly and not living abroad, the reporting threshold is satisfied if the total value of foreign financial assets is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year (Instructions to Form 8938).
If a U.S. citizen is a bona fide resident of a foreign country or countries for the entire tax year, or at least is present in a foreign country for 330 full days as of the last day of the tax year being reported, then the reporting threshold increases to more than $200,000 on the last day of the tax year, or more than $300,000 at any time during the tax year. If such a taxpayer is married filing jointly, the reporting threshold increases to $400,000 on the last day of the tax year and $600,000 at any time during the tax year (Instructions to Form 8938).

**FATCA penalties.** Failure to file Form 8938 subjects the holder of the foreign asset to a $10,000 civil penalty under IRC section 6038D(d)(1); this penalty increases by $10,000 for each 30-day period (or fraction thereof) during which the form remains unfiled after 90 days from the date that the IRS mails a notice of the failure (IRC section 6038D[d][2]). A failure under IRC section 6038D might result in a separate underpayment penalty under IRC section 6662(b)(7) and (j); the maximum penalty for each taxable year is $50,000. Any underpayments of tax attributable to undisclosed foreign financial assets are subject to a substantial additional understatement penalty of 40% under IRC section 6662(j)(3), unless the taxpayer can demonstrate reasonable cause for the failure (IRC section 6038D[g]). Taxpayers and their advisors should keep in mind that prohibitions against disclosure of the required information under foreign law cannot be relied upon to establish reasonable cause.

**Additional foreign account filing requirements.** Taxpayers with signature authority over a foreign financial account must report its existence on Schedule B, Part III of their federal income tax returns (Form 1040), regardless of the account’s value. Taxpayers are required to report this information, regardless of whether an FBAR is filed; failure to report the existence of such accounts might keep the statute of limitations open as an incomplete return.

**Information Returns for Foreign Business Entities**

The following sections describe the information returns required for foreign business entities.

**Interests in Foreign Corporations**

Four categories of U.S. persons with specific interests in or connections to foreign corporations must file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. (Although five categories are referenced in the Instructions to Form 5471, the first category of filer is no longer required to file, following the repeal of IRC section 6035 in 2004.) Depending upon the specific filer and circumstances, the report may include the corporation’s business structure, transactions, and undistributed earnings (IRC sections 6038(a) and 6046A; Treasury
A U.S. person who is treated as a U.S. shareholder of a controlled foreign corporation under Subpart F (IRC section 6038(a)[4]; Instructions to Form 5471, category 5 filer).

The transfer of tangible or intangible property to a foreign corporation, or the transfer of cash in excess of $100,000 by a 10% or greater stockholder, triggers an obligation to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. The form is due with the income tax return for the year of the transfer.

Reporting of passive foreign investment company interest. U.S. shareholders of a foreign corporation that is a passive foreign investment company (PFIC) must file Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund (IRC section 1298(f)). For reporting purposes, a PFIC is a foreign corporation that has at least 75% passive income, or in which at least 50% of its assets either actually produce or are held to produce passive income (IRC section 1297(a)[1]–[2]).

In general, a U.S. shareholder will pay additional tax and interest on a distribution or disposition with respect to PFIC stock (i.e., “interest charge regime”; IRC section 1291[c]); however, a U.S. shareholder of a PFIC may elect to treat the corporation as a qualified electing fund (QEF) and, thus, avoid paying additional tax and interest on deferred PFIC income. The QEF election allows U.S. shareholders to include their pro rata shares of the PFIC’s earnings and profits as ordinary income and classify the PFIC’s net capital gain as long-term capital gain, for each year the PFIC stock is held (IRC section 1293[a][1][A]). This election is valid only if the PFIC complies with the IRS information disclosure requirements that enable the IRS to determine the PFIC’s ordinary earnings and capital gains. The U.S. shareholder must timely file Form 8621 by the due date (including extensions) of the federal return for the first year to which the election will be applied (IRC sections 1295[a] and 1295[b][2]). Once made, the QEF election is effective for the current tax year and all subsequent tax years; it is revocable only with IRS consent (IRC section 1295[b][1]).

As an alternative to the QEF election, if PFIC stock is marketable—that is, if it is regularly traded (i.e., other than in de minimis quantities, on at least 15 days of the calendar quarter) on a national securities exchange that is registered with the SEC, the Nasdaq, or any exchange designated to have rules adequate to carry out the PFIC provisions—U.S. persons owning the PFIC stock can instead make a mark-to-market election under IRC section 1296 in order to avoid the interest charge regime (IRC section 1291; Treasury Regulations section 1.1291-1[c]).

Under the mark-to-market election, the shareholder annually includes in income an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the tax year over the shareholder’s adjusted basis in the stock (mark-to-market gain; IRC section 1296[a][1]; Treasury Regulations section 1.1296-1[c][1]). When stock in a PFIC that has made a mark-to-market election is sold, any gain is treated as ordinary income (IRC section 1296[c][1][A]; Treasury Regulations sections 1.1296-1[c][2] and [c][7], Ex. 2). If the foreign corporation is not a PFIC at the time of the sale, the gain can be long-term capital.

The mark-to-market election is made on Form 8621, which should be attached to the shareholder’s U.S. income tax return on or before the due date (including extensions) of the year for which the election is to be effective (Treasury Regulations section 1.1296-1[h][1][i]). The election continues to be in effect unless the foreign corporation ceases to be a PFIC or the IRS consents to a revocation. An election or obligation to mark-to-market the stock under another IRS provision also terminates the PFIC mark-to-market election (IRC section 1296[k]; Treasury Regulations section 1.1296-1[h][2]).

Prior to the passage of the HIRE Act, only taxpayers who directly or indirectly owned PFIC stock were required to file Form 8621 upon a disposition of PFIC stock or with respect to a QEF (IRS Notice 2010-34, Internal Revenue Bulletin (IRB) 2010-17; IRS Notice 2011-55, IRB 2011-29). The HIRE Act, however, added IRC section 1298(f), which now requires all U.S. shareholders to file Form 8621 if they owned PFIC stock throughout the year (see IRS Notices 2010-34 and 2011-55). The HIRE Act also extended the statute of limitations on assessment to six years if a taxpayer omitted reporting gross income in excess of $5,000 attributable to a foreign

Regulations section 1.6038-3 details the information reporting requirements.

For each foreign corporation, a filer must attach a separate Form 5471 to a timely filed income tax return (Treasury Regulations sections 1.6038-2[a][2] and 1.6046-1[e][2]; Instructions to Form 5471).

If two or more individuals are required to furnish information with respect to the same foreign corporation for the same period, they can make one joint return instead of separate returns (IRC section 6038[d]; Treasury Regulations sections 1.6038-2[j][1] and 1.6046-1[e][1]). There are significant penalties for failing to file Form 5471, depending upon the taxpayer’s status, such as monetary penalties, extensions of the statute of limitations, and the loss of foreign tax credits (IRC section 6038).

The following U.S. persons with specific interests in or connections to foreign corporations are required to file Form 5471:

- A U.S. person who is an officer or director of a foreign corporation in which another U.S. person owns or acquires either 10% or more of the voting or value of the foreign corporation’s stock (IRC section 6046[a][1][A]; Instructions to Form 5471, category 2 filer)
- A U.S. person who acquires or disposes of 10% or more of the voting or value of the foreign corporation’s stock or becomes a U.S. person who owns 10% or more of the voting or value of the foreign corporation stock (IRC section 6046[a][1][B]; Instructions to Form 5471, category 3 filer)
- A U.S. person who “controls” the foreign corporation for 30 or more continuous days during the foreign corporation’s taxable year that ends with or within the U.S. person’s tax year (IRC section 6038[a][1]–[2]; Treasury Regulations section 1.6038-2[a]); for purposes of this filing requirement, a person controls a foreign corporation by owning stocks that provide more than 50% of the total combined voting power of all classes of stock entitled to vote or that provide more than 50% of the total value of shares of all classes of stock of the foreign corporation (IRC section 6038[e][1]). Constructive ownership of stock in the foreign entity is considered, with certain modifications, in determining whether the control requirement is satisfied (Treasury Regulations section 1.6038-2[c]; Instructions to Form 5471, category 4 filer)
financial asset, including PFIC stock. In addition, the statute of limitations period for assessment is suspended if the taxpayer fails to timely file Form 8621.

On June 21, 2011, the IRS issued Notice 2011-55, which limited the application of the new filing rules until a new Form 8621 is released. PFIC shareholders who would have been required to file Form 8621 before March 18, 2010, must still file Form 8621 upon a disposition of stock of a PFIC or with respect to a QEF (see IRC section 1298[f]; IRS Notice 2010-34 and Notice 2011-55); however, other PFIC shareholders are not required to file prior to the release of a new Form 8621. Subsequent to the release of the revised form, PFIC shareholders will be required to attach Form 8621 to the return for each year during which the requirement was suspended (see IRC section 1298[f]; IRS Notice 2010-34 and Notice 2011-55). In essence, the standards of the prior law remain in effect until the new form is issued.

The IRS recently released a draft version of Form 8621; thus, it is likely that a final version will be released in the near future, which will trigger the new filing requirements.

Penalties. Failure to make a timely filing of the required foreign corporation or PFIC information returns can result in penalties and a reduced foreign tax credit (IRC section 6038[b]–[c]). A penalty of $10,000 applies to any person who does not timely file a foreign corporation or PFIC information return (IRC sections 6038[b][1] and 6679, which imposes the penalty for failing to file under IRC section 6046 or 6046[A]). The penalty increases by $10,000 for each 30-day period (or fraction thereof), up to a maximum $50,000 for each taxable period during which the return remains unfiled past 90 days after the IRS mails a notice of the failure to file (IRC sections 6038[b][2] and 6679[a][2]); however, if the failure is due to reasonable cause, the penalty will be waived (IRC section 6038[c][4]).

In addition to the above penalties, the taxpayer’s foreign tax credit may be reduced by 10%; an additional 5% reduction is made, starting 90 days or more after notification of the failure to file by the IRS, for each three-month nonfiling period (IRC section 6038[c]). The maximum reduction is the greater of $10,000 or the income of the foreign corporation during the annual accounting period in which the failure occurred (IRC section 6038[c][2]).

Interests in Foreign Partnerships
Any U.S. persons who 1) acquire an interest in a foreign partnership, 2) dispose of an interest in a foreign partnership, or 3) have an interest in a foreign partnership that changes substantially may be required to file Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, with their timely filed (including extensions) income tax return for the year in which the reportable event occurred (IRC section 6046[a][1]–[3];
Regulations section 1.6038-2). Such individuals will also be required to file Form 8865 if their direct proportional interest in a foreign partnership has increased or decreased by the equivalent of a 10% interest (IRC section 6046A[a], [d]). The instructions to Form 8865 refer to the following four distinct categories of U.S. persons who are required to complete Form 8865:

- A category 1 filer is defined as a U.S. person who owns more than a 50% interest in a foreign partnership under Treasury Regulations 1.6038-3(a) at any time during the taxable year.

- A category 2 filer is considered any U.S. person who was a “controlling 10% partner” in a foreign partnership during the taxable year (Treasury Regulations section 1.6038-3[b]). A person is a controlling 10% partner if, at any point during a foreign partnership’s tax year, the individual owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons owning 10% or greater interests (Treasury Regulations section 1.6038-3[a][2]). The individual is not a controlling 10% partner for the tax year if, at any point during that year, the partnership had a controlling 50% partner (Treasury Regulations section 1.6038-1[a][2]).

- A category 3 filer is any U.S. person who contributes property to a foreign partnership in IRC section 721 transactions if the total value of the property contributed for the year exceeds $100,000 or if the U.S. person directly or constructively owns 10% of the foreign partnership after the contribution (IRC section 6038B[a][1][B]; Treasury Regulations section 1.6038B-2[a][1][i]-[ii]; see also instructions to Form 8865). This includes indirect contributions by a U.S. person through a domestic partnership (Treasury Regulations section 1.6038B-2[a][2][i]); the regulations do not require reporting of indirect contributions through a trust.

- If U.S. persons experience an IRC section 6046A reportable event during the tax year, they are considered category 4 filers; such reportable events under IRC section 6046A are acquisitions, dispositions, or changes in proportional interests, discussed in the sections below.

**Acquisitions.** A U.S. person who acquires a foreign partnership interest has a reportable event if his interest in the partnership was less than 10% prior to an acquisition and 10% or more thereafter. Similarly, if a U.S. person who had a reportable event acquires an additional interest in a subsequent tax year that increases his existing interest by at least another 10%, he must file once again.

**Dispositions.** A U.S. person who disposes of a foreign partnership interest has a reportable event if she had a 10% or greater interest prior to a disposition and less than 10% thereafter. Similarly, if a U.S. person who had a prior reportable event makes a disposition in a subsequent tax year, which decreases her existing interest by at least 10%, she must file once again.

**Changes in proportional interests.** A reportable event also occurs if a U.S. person’s direct proportional interest has increased or decreased by at least the equivalent of a 10% interest in the partnership from the time of the last reportable event.

### Foreign Disregarded Entities

A foreign disregarded entity (FDE) is an entity that is created or organized in a foreign jurisdiction and is disregarded as separate from its owner for U.S. income tax purposes (Treasury Regulations section 301.7701-3). All U.S. persons with direct ownership in an FDE must file an information return on Form 8858, Information Return of U.S. Person with Respect to Foreign Disregarded Entities. In addition, certain U.S. persons who indirectly own at least 10% of an FDE through a controlled foreign corporation (CFC) or a controlled foreign partnership (CFP) are required to file Form 8858 for each FDE, according to the instructions for Form 8858. Direct owners of an FDE should attach the Form 8858 to their federal income tax returns; indirect owners of an FDE should attach the form to any other required form pertaining to the foreign entity that owns the FDE (e.g., Form 5471, if the FDE is owned by a CFC).

In addition, category 4 and category 5 filers of Form 5471 must also file Form 8858; the associated schedules depend upon their specific status relative to the FDE (see instructions to Form 8858).

### Information Returns for Gifts and Trusts

The following sections describe the information returns required with respect to gifts from foreign individuals and estates and foreign trusts.

**Requirement to File a Foreign Gift Return**

A U.S. person receiving foreign gifts valued at more than $100,000 (not adjusted for inflation) from a nonresident alien individual or a foreign estate, or gifts valued at more than $10,000 (adjusted annually for inflation, set at $14,723 for 2012; see Revenue Procedure 2011-52, section 3.35) from foreign corporations or foreign partnerships, is required to file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, and report each such foreign gift (IRC section 6039F[a]). Once the $100,000 threshold has been met, Form 3520 requires a donee to separately identify each gift in excess of $5,000, but does not require the identification of the donor (see Notice 97-34, section V(B)(1), 1997-1 C.B. 422). Form 3520 requires a donee to separately identify all gifts from a foreign corporation or foreign partnership, including the identity of the donor entity. A foreign gift is “any amount received from a non-U.S. person which the recipient treats as a gift or bequest” (IRC section 6039F[b]). Form 3520 must be filed by the U.S. donee on the due date, including extensions, of that U.S. person’s income tax return following the year the gift was made.

**Penalties.** If the U.S. donee fails to report any foreign gifts, the donee will be subject to a penalty of 5% of the value of the aggregate unreported foreign gifts for each month in which the foreign gifts were not reported, up to a maximum of 25% of the value of the foreign gifts (IRC section 6039F[c][1][B]). Penalties can be abated, if the failure to report is due to reasonable cause and not to willful neglect (IRC section 6039F).

### Foreign Trust Reporting

A U.S. person who creates, transfers, or receives a distribution from a foreign trust is required to file Form 3520, as well as Form 3520-A, or on or before the income tax return’s due date, including extensions (IRC section 6048[a], [c]; IRS Notice 97-34; Instructions to Form 3520). Form 3520 must also be filed following the death of a U.S. person who is...
treated as the owner of any portion of a foreign trust, or if any portion of such trust was included in the decedent’s gross estate (IRC section 6048[a][3][A][iii][I]-[II]). A U.S. person who is the owner of a foreign trust under the grantor trust rules is also responsible for the filing of an annual return by the trust on Form 3520-A, which is due by the 15th day of the third month following the close of the trust’s taxable year (IRS Notice 97-35; Instructions to Form 3520-A).

**Penalties.** The typical deficiency procedures relating to income, estate, and gift taxes do not apply to the assessment or collection of the penalties with respect to foreign trusts (IRC section 6677[a]). The IRS holds that the IRC section 6677 penalty is not a “divisible tax,” meaning that a taxpayer who seeks to challenge the entire assessment must pay the entire penalty before bringing a refund suit; however, because the penalty may be imposed for a variety of failures, the IRS’s position is that a taxpayer who contests only a portion of the penalty relating to one or more particular failures may pay that portion and sue for a review (see Chief Counsel Advice [CCA] 201150029).

Failure to timely or accurately file any notice or return required by the foreign trust reporting rules can result in a penalty equal to the greater of $10,000 or 35% of the gross reportable amount (IRC section 6677[a], as amended by the HIRE Act). For these purposes, the gross reportable amount is defined as the gross value of the property transferred or received, as of the date of the transfer or receipt (IRC section 6677[c]). In the case of a failure to file an annual return by a U.S. person treated as the owner of any portion of a foreign trust under the grantor trust rules, the penalty is 5%, rather than 35%, of the gross reportable amount (IRC section 6677[b]). The penalty increases by $10,000 for each 30-day period (or fraction thereof) during which such failure continues beyond 90 days after the IRS mails a notice of the failure (IRC section 6677[a]).

A U.S. person’s failure to report activities with a foreign trust can expose the individual to both the penalty for failing to report a foreign gift and the penalty for failing to comply with foreign trust reporting requirements. If both penalties apply, the trust reporting penalty is assessed first and reduces any penalty for failing to report a large foreign gift (IRS Notice 97-34). An additional 40% accuracy-related penalty will also apply to any understatement attributable to any transaction involving a foreign trust with respect to which an information return is required (IRC section 6662[b][7]).

An estate is liable for the initial penalty for a decedent’s failure to file Form 3520-A; the estate assumes the decedent’s liabilities, including a liability for failing to file the required return (CCA 2012208028). The estate may be liable for additional penalties if the failure to file continues after notification from the IRS (CCA 2012208028).

**Offshore Voluntary Disclosure Program**

Taxpayers who have failed to properly report the existence of, or income from, foreign financial accounts may now be able to achieve compliance without placing themselves in jeopardy by taking advantage of the IRS’s offshore voluntary disclosure program (OVDP). The most recent iteration of this program’s requirements is presented in an updated set of frequently asked questions (FAQ) issued on June 26, 2012, in IR-2012-64 and IR-2012-65. (The initial terms of the 2012 OVDP were set forth in IR-2012-5, released on January 9, 2012.)

The OVDP is a counterpart to the long-standing IRS Criminal Investigation voluntary disclosure practice. When a qualifying taxpayer truthfully, timely, and completely complies with all provisions, the IRS will not recommend criminal prosecution to the Department of Justice. The OVDP addresses the civil side of a taxpayer’s voluntary disclosure of foreign accounts and assets by defining the number of tax years covered and setting the civil penalties that will be applied (FAQ 3).

The OVDP is available to individuals and entities (i.e., corporations, partnerships, and trusts, according to FAQ 13) that have undisclosed offshore accounts or assets and are not currently under examination by the IRS, including those that made disclosures after the deadline for the earlier offshore voluntary disclosure initiative (OVDI) in 2011 (FAQ 12).

One significant difference between the current OVDP and its predecessors is the lack of a specified application deadline. The IRS has, however, reserved the right to change—or even eliminate—this program at any time (FAQ 12).

The OVDP applies a single penalty in lieu of the numerous penalties that could otherwise be imposed, such as the FBAR and fraud penalties (FAQ 5). The current OVDP imposes an “in lieu of” penalty equal to 27.5% of the highest aggregate balance in foreign bank accounts or entities, or the value of foreign assets at any time during the eight tax years prior to the disclosure (FAQ 7). In the 2011 OVDI, the penalty rate was 25%. As in that program, some taxpayers in the current OVDP may qualify for reduced 5% or 12.5% penalties; however, the standard accuracy-related or delinquency penalties continue to apply, in addition to the in lieu of OVDP penalty (FAQ 7).

**Practical Considerations**

Nowhere is the axiom “forewarned is forearmed” more appropriate than when dealing with the myriad reporting responsibilities that arise from cross-border business activities. CPAs and their advisors must remain abreast of this complex arena, from various foreign reporting requirements (i.e., FBAR, FATCA, PFIC, CFC) to the responsibility to file reports related to interests in foreign partnerships, corporations, trusts, and even foreign gifts. Moreover, they must enhance their understanding of related conditions and penalties in order to successfully navigate these obligations.
Considering Roth IRA Conversions

Is Recharacterization a Viable Option for Taxpayers?

By Magda B. Szabo

In light of continued volatility in the markets and the recent expansion of the scope of Roth individual retirement account (IRA) conversions under the American Taxpayer Relief Act of 2012 (ATRA), some taxpayers might be reconsidering the decision to complete a Roth conversion during 2013 and pay taxes owed. In order to best advise these taxpayers, tax professionals should remain aware of both the costs and benefits of converting to a Roth account, as well as the possibilities and limitations of reconsidering, or “recharacterizing,” Roth conversions. Recharacterization might represent a practical option for taxpayers reconsidering a prior Roth IRA conversion, especially those who are adversely impacted by market conditions that have materially decreased the value of the converted account.

Roth IRAs Versus Traditional IRAs

Roth IRAs were established in 1997 as an alternative tax-deferred investment vehicle to traditional IRAs and pension plans. In contrast to the back-loaded tax liability of such traditional investment options, Roth IRAs have a front-loaded tax liability—that is, instead of contributing pretax dollars to a fund where growth is tax free and distributions are fully taxed, Roth IRAs involve contributions of earned income net of tax with tax-free growth and tax-free distributions.

Many estate and financial planners favor Roth IRAs over traditional IRAs for numerous reasons, including the following:

- Assuming even a modest amount of investment growth, the overall tax liability is appreciably lower.
- Traditional IRAs are subject to required minimum distributions (RMD) in the year that the taxpayer reaches age 70½, whereas Roth IRAs are not.

- Roth and traditional IRAs are generally valued equally for estate tax purposes, despite the fact that traditional IRA distributions are treated as taxable income to recipients, whereas Roth IRA distributions are tax free.

Although Roth and traditional IRAs are subject to the same annual contribution limitations ($5,500 for single taxpayers in 2013 or $6,500 for taxpayers who are older than age 50 in 2013), Roth IRAs are restricted to annual earned income levels of $112,000 (phasing out at $127,000) for single taxpayers and $178,000 (phasing out at $188,000) for married taxpayers filing jointly.

In 2006, the “Roth concept” was expanded to employee elective deferrals under 401(k) cash or deferred arrangements (CODA)—that is, “an arrangement under which an eligible employee may make cash or deferred election with respect to accruals or other benefits,” according to the IRS (http://www.irs.gov/irm/part4/irm_04-072-002.html#d0e240). Where such 401(k) plans have been amended to allow for elective Roth contributions, the annual deferral limitations are much higher—$17,500 (or $23,000 for those age 50 or older).

Expanding the Scope of Roth IRAs

In 2010, the Hiring Incentives to Restore Employment (HIRE) Act materially expanded the scope of Roth IRA deferrals; this allowed conversion from traditional IRAs and certain pension plans to Roth IRAs without limitations on income level or filing status. Furthermore, taxable income created by a conversion in 2010 could be recognized across a delayed two-year period (2011–2012); thus, conversions were taxable largely in the year following a rollover (with the return).

Conversions from traditional IRAs, simplified employee pension (SEP) plans, or Savings Incentive Match Plan for Employees (Simple) IRAs (if held for at least two years) can be achieved through one of the following three methods: 1) a distribution from a traditional IRA that is rolled over into a Roth account within 60 days of distribution; 2) a trustee-to-trustee transfer from a traditional to Roth IRA; or 3) a transfer of accounts (traditional to Roth), where the same trustee maintains both accounts. In addition, 401(k) plan distributions—such as in the year of termination, retirement, or upon reaching age 59½—can also be converted.

With the enactment of the ATRA, the 401(k) rollover option was further expanded to allow plan participants to make in-plan rollovers, even when they are not eligible for a plan distribution as in prior years. Employers that offer 401(k) plans that have traditional features and Roth features may now allow employees to transfer amounts in their traditional accounts to their Roth account at any time, even if they are not eligible for a rollover. In order to offer this option to plan participants, however, the plans will need to be modified.

Given market volatility risks, taxpayers who have elected to convert eligible funds to a Roth IRA might experience a decrease in value of the underlying investments. These potential decreases can occur after electing conversion, but before the date when tax payments associated with the conversion are due. For such taxpayers, limited relief is available in the form of a recharacterization of the original conversion to an eligible rollover.

Requirements for Recharacterization

The decision to recharacterize should only be made after careful consideration by taxpayers and their advisors. Failing to strictly adhere to the rules of this process can result in a deemed taxable distribution of the funds involved, triggering not...
only income taxes on the distribution, but also 10% excise (penalty) taxes and interest on unpaid taxes.

Several requirements are necessary for recharacterization. A trustee-to-trustee transfer of funds that the taxpayer no longer wishes to convert must be completed no later than the due date of the tax return, including the six-month extension period. If the recharacterization is effectuated after the return has already been filed, taxpayers must file an amended return. Furthermore, a statement explaining the reversal must be attached to the return (or to the amended return).

Eligible transfers include those involving the same trustee, as well as custodial and account transfers. The amount of the transfer must be adjusted for any income or loss allocable to the funds that are not being converted (recharacterized). The following requirements must also be met in order to qualify for recharacterization:

- No deduction or adjustment could have been involved in the original conversion.
- The funds cannot be traceable to a Roth IRA.
- The trustees of the IRAs involved must be informed.

The recharacterization will require several filings, including Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts; Form 5498, IRA Contribution Information (detailing the amounts and earnings); and Form 8606, Nondeductible IRAs.

The following two examples are useful in illustrating recharacterizations.

**Example 1.** Assume that taxpayer Jacob Smith made a qualified rollover contribution, converting his traditional IRA to a Roth IRA of $100,000 in 2012. Assume that the earnings on this $100,000 are $20,000 from the time of the conversion to the time of recharacterization. Due to declines in the market, Smith does not have enough money to cover the entire associated tax bill, so he decides to undo half of this conversion. In order to do this, he must take 50% of the converted amount ($50,000), plus half of the earnings ($10,000), and transfer this entire sum ($60,000) from the Roth IRA back into a traditional IRA by engaging in a trustee-to-trustee transfer during 2013.

Once a Roth recharacterization is completed, the funds are treated as though they never left the traditional IRA; if the funds came from a company pension plan, they are treated as though they were directly rolled over to a traditional IRA. If a client is more than 70 1/2 years old, the total from which the RMDs must be calculated will also increase. This calculation is critical because failing to distribute the appropriate required minimum amount from a pension plan or traditional IRA can result in the imposition of a 50% excise tax penalty on the undistributed amount.

**Example 2.** Due to the state of the economy in 2009, the provisions mandating RMDs from traditional IRAs and pension plans were suspended; it is important to keep this in mind when considering the following example involving minimum required distributions and a recharacterization. Assume that taxpayer Anna Jones is 80 years old and has a traditional IRA with a balance of $1 million. After taking an RMD in 2012, she converts 50% of her IRA to a Roth account. Due to market losses in 2013, she realizes that she might need to withdraw funds from the converted Roth IRA over the next five years for personal living expenses; thus, she decides to recharacterize this conversion. Assuming that the earnings on the converted amount are $30,000 at year-end—thereby increasing the value of the balance by that amount—and that the remaining unconverted portion did not increase in value or suffer any losses, the RMD for 2013 must be calculated by taking all of these amounts into account: the original and reconstituted IRA total of $1 million, plus the $30,000 increase in value by the year-end (i.e., a total of $1.03 million).

**Avoiding Income Tax Liability**

As noted earlier, one of the most valuable applications of the recharacterization rules occurs when the underlying IRA has dropped in value, due to market losses subsequent to conversion. Although this results in an income tax liability owed by the taxpayer on higher values that have since disappeared, individuals in such situations can rescind the conversion entirely through recharacterization; thus, the taxpayer can avoid paying taxes on income imputed from asset values that no longer exist.

Once a conversion is undone, or recharacterized, a taxpayer cannot choose to reconvert until the later of the beginning of the tax year following the original Roth conversion, or the end of a 30-day period that commences on the day the Roth conversion was recharacterized.

For example, assume that, in 2012, taxpayer Matt Johnson elected to convert 50% of his $200,000 traditional IRA to a Roth account. On April 15, 2013, Johnson extended the filing of his 2010 return. Due to market conditions as of June 30, however, Johnson’s converted IRA balance of $100,000 dropped in value to $85,000. To avoid paying income taxes on the full value of the IRA (i.e., $100,000), he can recharacterize and rescind the June 30 conversion by making a trustee-to-trustee transfer (including profit/loss amounts netting to $85,000) and filing the appropriate information with his tax return. Doing so causes the original $100,000 to be treated as though it never occurred. Thirty days later, on July 30, Johnson can again elect to convert this lower amount of $85,000 to a Roth IRA, thus completing a Roth IRA conversion at a tax liability that is adjusted for the drop in value of the IRA. Once this is done, Johnson cannot recharacterize again until the following year (2014). This example demonstrates that when the market drop is substantial enough, a recharacterization makes sense.

**Practical Benefits**

Recharacterization mitigates a significant amount of the risk associated with conversion to a Roth IRA, especially if adverse conditions arise, such as market drops or cash flow limitations. Taxpayers and their advisors should familiarize themselves with this option, as well as with all of the requirements for achieving a tax-deferred rollover, prior to finalizing their Roth IRA conversions.

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Timely information on operations and the competitive environment are essential for the successful implementation of a business strategy. Dashboards have become a popular tool for giving users better access to crucial information in a way that doesn’t overwhelm them. One trend is to implement dashboards to improve an entity’s performance reporting system at the strategic and operational levels. Users are considering a wide range of dashboard development tools and techniques; for example, dashboard tools can use basic Microsoft Excel features or more specialized software to process company data into actionable information.

What Are Dashboards?

Many different types of dashboards exist. Essentially, a dashboard focuses on a goal or objective, and it displays the most relevant information on a digital screen. An effective dashboard utilizes visualization techniques and cues to engage a user in the information processing experience. The visual techniques may include the use of colors, dials, buttons, graphs, and the positioning of information on the screen. (A good example of a simple financial analysis dashboard, which can be used to examine complex data for periodic planning, can be found at http://resources.businessobjects.com/support/cx/samples/download_45/financial_analysis_calculator/financial_...
Defining a Dashboard Project

For practice management, as well as with
vices firms can use strategic dashboards
lead to better decisions. Professional ser-
adopters who believe that dashboards can
boards in practice provides support for
believe that the increasing use of dash-
will result in a payoff. The authors
monitoring performance. Such individuals
ing and reporting metrics, as well as
leadership roles in the process of select-
ing planning.

A dashboard should enhance a manag-
er’s ability to process information and take
action. For example, a CEO’s responsibil-
ity is the successful implementation of a
business strategy; thus, the CEO’s dash-
board should include performance mea-
sures (key performance metrics) associated
with strategic goals. Traffic light icons, for
example, can be used on the dashboard to
provide cues to signal variations from
performance measure target values. A red
light attracts the greatest attention for a sig-
nificant undesirable deviation from target;
the red cue will remain on the dashboard
until the company is back on course. A
yellow light indicates caution for smaller
deviations, or a trend toward a significant
deviation, from a target. The potential ben-
efits of dashboards include improving the
entity’s ability to quickly monitor progress
in achieving goals, enhancing efficiency in
responding to business events, and improv-
ing planning.

In many organizations, accounting pro-
essionals in the finance function assume
leadership roles in the process of select-
and reporting metrics, as well as
monitoring performance. Such individuals
will question whether using dashboards
will result in a payoff. The authors
believe that the increasing use of dash-
boards in practice provides support for
adopters who believe that dashboards can
lead to better decisions. Professional ser-
vice firms can use strategic dashboards for practice management, as well as within in their consulting services offerings.

Defining a Dashboard Project

The starting point for a dashboard project is to clearly define the project’s goal. Because a dashboard’s focus is on a goal or task, the design must be goal- and user-oriented. The dashboard display of information should facilitate management’s insight into the business’s performance, with respect to achieving its goals. Thus, a basic question at the start of a dash-
board project is whether a dashboard has the potential to improve insight. In addition, some other important questions should be asked before moving forward: Are man-
gers dissatisfied with the current report-
ing system? Is information overload a prob-
lem? Is the current reporting system too
complex? Do reports appear to be bor-
ing? Have there been unexpected failures
to meet performance targets? Have some
failures to meet performance targets result-
ed from inaction, even in the face of
unfavorable trends? Have executives been
late in identifying opportunities because
they do not use the information available?
The answers to these questions should indi-
cate whether a dashboard project would
have a potential impact.

A dashboard user’s needs and charac-
teristics are very important factors. Some
users might have a lot of experience with
this technology, whereas others might be
relative novices. Certain types of problems
may also lend themselves to certain kinds
of visual displays. User issues vary, with
respect to the three basic types of dash-
boards (i.e., strategic, analytical, opera-
tional), but all users have a need for access
to insightful information that is relevant
and timely enough to support decisions.

A strategic dashboard is used for mon-
itoring strategy implementation at the enti-
ty level. It has high-level measures and
mostly simplified displays of static (non-
interactive) information. The Exhibit
shows a partner sales dashboard prepared
with Microsoft Excel that focuses on the
goal of monitoring sales activity. Because
top management’s responsibility is suc-
cessful strategy implementation, the dash-
board includes performance measures (met-
rices) associated with strategic goals. In this
case, graphs are good for displaying trends.
For example, the dashboard uses a line
graph to present the sales percentage
change from the prior year on the partner
sales dashboard.

A dashboard has the potential to enhance
top management’s ability to monitor key
performance metrics by focusing on mea-
sures that matter. Interactive capabilities
may provide top management with the sup-
port staff to explore specific problems and
opportunities, which may include links
to other strategic dashboards for strategic
business units.

The analytical dashboard is used by ana-
lysts with a qualified skill set for complex
data analysis; such analysts provide sup-
port for executives, including the develop-
ment of different “what-if” scenarios.
Although the analytical dashboard illus-
trates a simple financial analysis planning
model, a more complex model with addi-
tional input variables and a more complex
set of formulas can be created. Analysts
typically use these models to make sense
of the data; data integration, drill-down
capability, and real-time data are important
to them. Analysts may also use statistical
tools to develop predictive models.

An operational dashboard is used for mon-
itoring strategy implementation at an oper-
ational responsibility center. It can also
be used to support alerts for critical events and
interaction with detailed real-time data. An
operational dashboard user in a highly auto-
mated manufacturing plant will have different
characteristics from those of an audit
manager, for example. (A good example of
an operational dashboard that focuses on
monitoring the operations of the various state
governments in the United States can be
found at http://resources.businessobjects.
com/support/examples/download_45/
performance_benchmarking/performance_
benchmarking.swf.) Each state is graded
based upon the health of its finances, work-
force, information, and infrastructure. Users
can easily change the base view by using a
drop-down list to quickly see grades for each
key area, as well as overall grades. Each
measure is color-coded for a quick way of
sorting through a vast amount of data.

Dashboard Technology Issues

Dashboards can use static or real-time
data. Thus, the dashboard should be able
to access a company’s database in a timely
fashion. The static data could come from
periodic reports (daily, weekly, monthly)
or Microsoft Excel spreadsheet models.
Spreadsheets increasingly have better
pre-built-in connectivity to corporate
databases. Examples of some common
connectors contained within Microsoft
Excel include XML data connections,
query as a web service, Microsoft’s struc-
tured query language (SQL) server, and
other web service connections.

A wide range of dashboard development
tools are available. Dashboard capabiliti-
have increasingly appeared in product
offerings from major vendors, such as
SAP’s BusinessObjects/Crystal Dashboard.
Design (formerly called Xcelsius) software and Oracle’s Business Intelligence Suite. These integrated vendor programs provide tools for designing dashboards that can access and display information from the company’s data warehouse. Some tools, such as Crystal Dashboard Design, became popular because they made it easier for end users to develop their own dashboards if they were already integrated with Microsoft Excel. They are also powerful because they can be expanded to support the development of enterprise-wide dashboard initiatives. The programs available from major vendors have higher costs that must be justified by improved ease of use, data integration, and quality of the visualization features. Another issue is the availability of IT department support and policies.

Microsoft Excel is an increasingly attractive tool for developing dashboards. It is a very cost-effective solution for many companies because their personnel may already have Excel skills. Many university business schools teach dashboard Excel skills in an introductory course. Excel also provides more flexibility than other dashboard tools; a dashboard administrator can make changes quickly in order to adapt to new situations. In larger businesses, it provides the flexibility to develop, implement, and maintain a dashboard without heavy reliance on support from the IT department. One possible strategy for gaining experience is to use Excel with a limited number of dashboards before expanding dashboard usage. Some companies even use Excel to prototype dashboards before moving to more sophisticated platforms.

Excel’s graphics capabilities provide a wide range of display options, including tables, graphs, and pictures. If there is a need, the dashboard layout can be done in the data-intensive style of leading business magazines, such as Forbes and Bloomberg Businessweek. Dashboard design templates can also be purchased separately at a low price.

Excel has a range of data import options. Some dashboard data can be stored in Excel itself, or a menu on the data tab can be used to get data stored outside Excel (e.g., Microsoft Access databases, an SQL server, a web server, or an XML source). The connection with the data source refreshes the dashboard data so that the most recent data are displayed in Excel. A dashboard designer, however, is likely to need the cooperation of the database administrator for user permissions or connection information.

Data integrity is another important dashboard issue. An attractive dashboard with erroneous information is not useful. Excel has error-testing and error-finding capabilities. For example, users can search for missing values or unreasonable high or low values in Excel database files.

Excel also has the capability to support the business analytics trend that is changing the competitive landscape. The evidence-based management movement advocates basing decisions on data analysis rather than on limited experience or past practices. It has the analytical power to process data, and it can run analytical statistical models. Moreover, add-ins such as Solver can increase the program’s analytical capabilities.

There are various ways to approach an Excel dashboard project. For those who
want to start from the very beginning, there are many dashboard “how-to” books on the market. Another approach is to purchase dashboard templates that can be modified for a company’s purposes. A third option is to hire consultants, at a reasonable cost, to design a dashboard. Be aware that one downside to using Excel for dashboard projects is that a business may have to custom program some of the common design elements, such as spinners, maps, or other selectors that come prepackaged in more specialized dashboard developer tools.

The Dashboard Development Process
Creating a dashboard involves the following activities:
- Define the dashboard objective.
- Define the dashboard metrics.
- Seek user input.
- Build the initial dashboard and test.
- Publish the dashboard and monitor its use.

The top management strategic dashboard objective is to focus attention on key performance measures that indicate whether the company is on course to achieve its strategic goals. Thus, an important question is which metrics are most important. The traditional approach is to pay the most attention to financial measures, such as profit growth, profit margins, and return on investment. In the past 20 years, there has been a shift toward using a mix of financial and nonfinancial performance measures. For example, the popular balanced scorecard model uses four perspectives—financial, customer, internal process, and learning and growth. For some companies, a financial measure dashboard may be best, but for most firms, a mix works best.

In defining the dashboard strategic performance management framework, there may be the opportunity to take a fresh look at key performance metrics and existing models. The authors recommend that a strategic dashboard have four to eight key performance metrics in order to provide focus. Research studies have shown that too many performance measures result in information overload and difficulties in processing the information. People have a limited attention span and a limited working memory for diagnostic activity. A drill-down capability can provide access to supporting dashboards, additional metrics, or the data behind the metrics.

For example, a company’s balanced scorecard model might have 30 performance measures. The CEO’s leader dashboard could have one or two key performance metrics from each perspective, with a link to a separate dashboard for each of the four perspectives, which would allow for drill-down or what-if scenarios.

Seeking user input is essential to a successful dashboard project. Executives may be reluctant to use a dashboard with fewer key performance metrics than the report they have used before. It is important to realize that key performance metrics include correlated measures. For example, a retailer’s customer performance measures might include mystery-shopper program ratings, repeat

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sales, customer returns as a percentage of sales, customer satisfaction ratings, and average yearly sales per rewards program customer. One should expect that customer satisfaction ratings over a period of 36 months would be correlated with the other customer measures. A statistical study could be used to produce a correlation matrix showing correlation coefficients of varying sizes and identifying candidates to be excluded from a more sophisticated type of executive dashboard.

Building the dashboard visualization involves a considerable amount of design activity. A dashboard will be used regularly over time, and there is an opportunity for creativity. The dashboard graphics should enhance ease of use and provide for instant recognition of important changes in key performance metrics. A dashboard that is not used is of no value, regardless of its content. It is important to consider user preferences in the design process. Users’ personality characteristics can influence dashboard design, and their mental processes vary, depending upon cognitive style or experience. For example, relative novices tend to prefer graphical data visualization, whereas more expert users often gravitate toward tabular display formats. Thus, seeking user viewpoints to test the dashboard visualization can help avoid unintended consequences.

A dashboard should only be published after testing and evaluating feedback. If a static dashboard is replacing a periodic black-and-white report, it can be exported to a Microsoft Word or an Adobe PDF document as before. Deploying a static or interactive dashboard on a company’s web server allows authorized users access on demand. If a dashboard is dynamically updated, care must be taken to bind the dashboard data to the firm’s database so that it will be updated over time. For some dashboards, users will want the data refreshed in near real-time. For other data, it won’t make sense to refresh them more than once a day. Users should be made aware of any such data latency issues so that they know what to expect.

In today’s environment, developing a mobile dashboard for a smartphone or tablet appears to be very attractive; however, the technology for nonstatic dashboards is expensive, so users should consider some important cost-benefit issues. Mobile devices present a whole new set of design issues and opportunities. In most cases, it is not a good practice to simply export a dashboard from a desktop platform to a mobile device, and it is important to know what the target device will be when creating a dashboard.

Companies can periodically improve a dashboard by monitoring its use and getting feedback from users. As users become familiar with how the dashboard works, they should be interviewed about every six months to find out which measures are most important to their work or which measures they would like to see included. Sometimes, performance measures that are developed become so valuable that they turn into closely guarded proprietary secrets that can provide a significant competitive advantage. This is one of the often overlooked benefits of the dashboard development process.

Judgmental bias is a pitfall of strategic performance measurement. Research has shown that managers often apply their own assumptions to the importance of key performance metrics, resulting in biased decisions and performance assessments of subordinates. Studies have revealed that managers tend to focus on financial performance metrics, such as net income or revenue growth, and they discount or ignore nonfinancial metrics. This bias might result from their training and skill set. Research has also indicated that common measurement bias is a performance evaluation issue. If two or more profit center managers are being evaluated, there is a judgmental bias toward focusing on the performance metrics (financial and nonfinancial) that are common to all managers and discounting or ignoring the performance measures that are unique to a particular profit center.

For example, a manager of a retail store group has performance measures unique to the store experience, such as the mystery-shopper rating. Another manager who is responsible for online shopping has performance measures unique to online shopping, such as the conversion ratio. But because both managers have common performance measures, such as percentage of sales from repeat customers and gross profit percentage, there exists a potential judgmental bias to favor these common measures over the unique measures. Dashboard visual design is potentially useful for mitigating such bias.

**Dashboard Visual Design**

Dashboard visual design makes a difference. Design consultants are one source of expertise. Most professionals will also have some experience designing Microsoft PowerPoint slides in order to achieve a desired communication objective. The following is an overview of dashboard visual design guidelines:

- Use design and visual perception principles.
- Use data emphasis techniques.
- Use charts that effectively communicate.
- Use alerts and markers to highlight problems and opportunities.
- Use interactivity to engage the user.
- Use art and backgrounds to enhance the user experience.

Design and visual perception principles can improve dashboard design. Some design principles, such as “unity,” might be viewed as instinctive. Unity refers to how the elements on a screen belong together. It’s
the principle that causes a viewer to first see the whole and then the parts. Without some degree of unity, there is an unsettling feeling of disorganization. Unity provides the dashboard user with “a logic of confidence.” The term “gestalt” comes from a German word meaning “essence or shape of an entity’s complete form.” This definition, rooted in German theories of human visual perception, may be one of the most important rules of design.

Webpage and dashboard designers who rely on gestalt principles focus on the overall look, rather than on the details. The following are important gestalt and design principles:

- **Similarity.** Similar things (e.g., color, size, shape) are perceived to be more related than dissimilar things.
- **Proximity.** Things that are close to each other are perceived to be more related than things spaced farther apart.
- **Closure.** When looking at an arrangement of individual elements, people tend to see a recognizable pattern (i.e., incomplete shapes are perceived in a complete manner).
- **Continuity.** Objects arranged on a line or on a curve are perceived to be related.
- **Past experience.** People tend to group together elements in a way that reflects past experience, either as individuals or as a group.
- **Focal point.** A point of interest or emphasis will capture and will tend to hold the viewer’s attention.

The space between design elements is called white space, or negative space. There might be a temptation to completely fill the dashboard screen with data and charts, which is the positive space, but this usually overloads the user. White space is used to organize elements and improve the visual experience. It can also help achieve professionalism and sophistication in a dashboard design; this can be thought of as providing an attractive “frame” for the dashboard design elements that will draw the user’s attention to the content.

Dashboard data emphasis techniques can make a difference on user perception. All performance measures may not be equal. The management team may decide that one or two metrics are of greatest importance. If so, data emphasis techniques can be used to communicate the greater weights. (This differs from judgmental bias, which is unintended.) One technique is positioning. Because the upper left and center areas on the dashboard are subject to the greatest visual focus by users, this is the place for the most important performance measurement information. The lower right area generally attracts the least attention, but visual techniques, such as color intensity and line width, can be used to counteract this.

Charts on a dashboard communicate trends and facilitate comparisons, which can provide perspective on trends and relationships. A line graph can be used to show a pattern over a period of time, such as for monthly sales. A vertical-column chart provides another way of showing the pattern of monthly sales. A horizontal-bar chart is a good choice for visualizing rankings. Pie charts are best used to show relative shares compared to a total, such as relative share of revenue by service category (e.g., audit, accounting, tax, consulting). In selecting charts, the third dimension of depth on charts should be avoided. Gridlines in bar graphs are a distraction, unless the user is expected to read values directly from a graph. Variations in chart color that do not encode a meaning can be another source of distraction or distortion.

Dashboard alerts and markers are used to highlight problems and opportunities. In the tradition of financial control systems, accountants are trained to calculate favorable and unfavorable variances from budgets or standards, but these markers can become dated. Dashboards can use an alert to attract a manager’s attention to a specific measurement that has reached or exceeded a predefined limit. Alerts can be defined for budget targets, key performance metrics targets, and other benchmarks. They can be associated with single-value components, such as a variance from target or a chart. Different alert levels and colors can also be used. The common traffic-light red, yellow, and green alerts are often used. Values can even be highlighted in red if they are at a dangerous level. (The appropriate range of values should be determined in the user interview process and refined through later testing.) Alerts also provide the opportunity for interactivity. If a yellow signal for a variance from target signals caution, an interactive feature can engage the user to think about the issue. For example, if gross fee margin percentages are below target for a certain month and a dashboard graph shows a declining trend, the user may want more insight. The dashboard can then present an option to click on a button to examine a horizontal bar chart showing gross fee margin percentages by product group or by geographic region.

Predictive analytics represent an interactivity option designed to engage users and facilitate action. For example, a dashboard can incorporate a statistical model that is applied to gross fee margin percentages and other variables in the firm’s data warehouse for the past month and the previous 30 months to forecast the coming months. A what-if feature could allow a user to enter a gross fee margin percentage and calculate a forecasted net profit. These, of course, are generally more sophisticated dashboards and require more development time and modeling efforts.

Artwork and backgrounds can also enhance the user experience. Dark colors on a bright background or light colors on a dark background can help important information stand out. Background maps or shapes can send a message or can be used to give a dashboard a unique feel. A new background can signal a major modification to a dashboard.

**Enhancing Information Processing**

The use of dashboards to monitor strategy implementation at various organizational levels is an accelerating trend. Use of the Internet for business, e-mail, social media, and other activities has changed visual expectations. Dashboard graphics can enhance ease of use and provide for instant recognition of important changes in key performance metrics. Professional services firms should consider strategic dashboards for practice management as well as consulting services offerings.

A strategic dashboard project can start out with a small investment using Microsoft Excel. If the expected benefits of enhanced information processing, alerts, interactivity, and action are realized, the use of dashboards can be expanded to improve a business’s alignment with strategic goals.

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Economy-Driven Changes in Recruiting Practices

Essential Recommendations for Accounting Firms

By Lisa A. Owens-Jackson, Gwendolyn Highsmith-Quick, and Diana R. Robinson

In mid-2008, accounting ranked as one of the top five most recession-proof professions in a Jobfox report (“Top 20 Most Recession-Proof Professions,” http://www.reuters.com/article/2008/07/14/idUS102886+14-Jul-2008+PRN20080714). But between June 2008 and June 2009, the number of accounting jobs fell by more than 2%, according to the Bureau of Labor Statistics (http://www.bls.gov/oes/2009/may/oes132011.htm). The authors’ own interviews with national recruiters revealed that, on many college campuses, accounting firms cut recruiting numbers by as much as 50% over that period. Many large public accounting firms dropped permanent and intern recruiting by 10% to 15%. One firm reported having to rescind offers that had already been extended to and accepted by candidates.

As the economic climate improved in 2010, hiring numbers improved. In 2011, accounting firms placed among the top 10 entry-level employers: PricewaterhouseCoopers ranked fifth, KPMG placed sixth, and Ernst & Young ranked eighth (http://www.collegegrad.com/topemployers/2011_entry_level.php). In 2013, accounting firms and businesses plan to hire additional entry-level accounting, information systems, computer science, and business administration professionals.

During the economic downturn, the recruiting and hiring process was characterized by multiple qualified candidates vying for every open position. These recruiting challenges led large and small CPA firms to change their hiring practices; many firms have continued to rely on these modified practices because they improved hiring and firmwide productivity.

This article’s authors discussed hiring practices with three national recruiting managers at three Big Four accounting firms, six Big Four regional recruiters, recruiting directors at two large national firms and three regional firms in the United States (two in the Southeast and one in the Northeast), and recruiters from several Fortune 500 companies (e.g., Abbott Laboratories, Caterpillar, GE, John Deere). Their insights can provide public accounting firms, corporations, and governmental agencies with advice on how to improve the recruiting process. Each of the following four recommendations was supported by at least 25% of the individuals interviewed.

Use Assessment Measures to Direct Recruiting Efforts

Employers have adopted new measures to assess recruiting success and to strategically direct future recruiting efforts. They have long evaluated campuses and directed efforts based upon the number of
recruits that accept offers; however, they have changed their focus from short-term returns to long-term returns by establishing databases and monitoring the medium- to long-term performance of recruits. In addition, employers are concentrating more on long-term retention rates, rather than on hiring rates; they are examining their recruits’ certification timetables, readiness for promotions, ability to adjust to change, and willingness to move to key markets. Furthermore, they are evaluating both universities and recruiting efforts based upon economic measures, such as costs per hire or costs per contact (which is calculated by dividing the total cost of a campus event by the number of attendees or resumes collected).

If colleges and universities are unable to generate a large pool of qualified accounting candidates, firms remove those universities from their recruiting lists. The definition of a qualified accounting candidate has also changed: firms are looking beyond initial technical qualifications and want candidates who can obtain certification quickly, who are willing to move to key markets rather than major cities, or who yield long-term return on hiring and training dollars. One regional firm indicated that it has stopped recruiting at two universities included in top 125 accounting programs because the hiring and retention rates dropped over multiple years.

Another regional firm, Dixon Hughes Goodman, expects two to five qualified candidates from a lead school each recruiting season. This firm has chosen lead schools primarily based upon location footprints—that is, the students have traditionally been willing to move to key office locations. All of the firms interviewed by the authors indicated that the demographics of an accounting program and a university’s student population are of significant importance, because firms seek programs and universities that have expansive, diverse student bodies. The firms analyze the performance of college recruiting each year; their target school lists are constantly subject to change or reevaluation.

Use Internship Programs to Feed Permanent Hires

Another resounding theme among all firms is an effort to get serious as early in the recruiting process as possible. Career fairs—once considered unimportant—now represent a useful recruitment tool. Firms are paying attention to students’ appearance and soft skills (e.g., initiating and maintaining a conversation) during such career fairs or other social events. Opportunities to see students in a more relaxed situation are invaluable because such preliminary observations enable firms to narrow their list of on-campus interviews, to limit the number of office visits, and to focus on internship and permanent recruiting efforts.

Internships have been considered fertile ground for hiring in the past. Many firms use interns to fill in key staffing holes. The large international firms surveyed indicated that they outsource repetitive tasks to overseas labor markets. This allows them to create more challenging internships and provocative initial assignments for new hires. Need and desire have caused regional firms to develop and provide rich internship experiences and responsibility-filled initial assignments. Decreased staffing resources prohibit them from indulging entry-level employees; all firms want their employees to hit the ground running and exhibit leadership and initiative.

The applicant-to-job ratio continues to represent one key problem for many employers. To address this, some have narrowed their hiring primarily to the intern pool. Considering the necessary qualifications, businesses identify viable candidates as early as the end of the students’ freshman year. In addition, companies are directing students into case competitions, as well as encouraging them to take leadership or volunteer positions in various organizations. Companies reward students with financial incentives, ranging from a few hundred dollars for textbooks to thousands of dollars in scholarship funding.

Although businesses used such tools in the past, they are now specifically directing these efforts and funds to preselected candidates; this helps create a good reputation among these students at lower cost. After nurturing this smaller pool of candidates, companies hire students during their sophomore year for administrative internships and during their junior year for technical and service assignments. The human resources departments of the medium-sized firms surveyed indicated that 80% to 90% of interns return as better permanent employees. Recruiters from three...
large firms revealed that more than 60% of the hiring is from intern pools and that 90% of interns will return with greater short-term productivity.

**Build Long-Term Relationships with Universities**

One of the resounding themes that arose in interviews with recruiters and human resources personnel was the need to recruit on key campuses that offer opportunities for recruiting success; however, each employer has its own definition of recruiting success. Every firm has a talent pipeline that needs to be continually filled for the business to remain strategically and financially successful. Some firms nurture campus relationships by attending career fairs and volunteering to attend and support university events, even when they cannot afford to hire students. For example, Katie Tibbits of Johnson Lambert LLP indicated that staying visible on campus is key:

“We have been more strategic and we are doing more planning earlier. We are talking to professors and asking the organizations to plan events around career fairs and scheduled on-campus visits. This limits travel cost, which is one of our biggest expenses. We send alumni to make presentations at events sponsored by Beta Alpha Psi, Accounting Societies, and the National Association of Black Accountants.

Other firms assign partners to key schools and make recruiting performance a part of the partner’s performance evaluation. Firms depend upon faculty to make endorsements in the classroom and to give recruiting advice behind the scenes. They nurture relationships with faculty through periodic contact and resource assistance. For example, Deloitte builds faculty relationships in part by developing its “Trueblood” case series for faculty use and sponsoring conferences to update faculty on current regulations and events. KPMG sponsors faculty internships and fellowships in order to give faculty hands-on experience with current technology and modern auditing and tax procedures.

KPMG also gives faculty member access to their online continuing professional education (CPE) training. On a smaller scale, Dixon Hughes, a regional firm, invites faculty to firm-sponsored CPE sessions and appreciation events. Kim Bullard of Dixon Hughes Goodman stated, “We try to maintain our relationships in order to convince faculty and university placement officials—the front line for recruiting—to recommend and endorse us to top-tier students.”

All firms interviewed agreed that a key to maintaining faculty and administrative relationships is providing honest appraisals of the firm’s situation and future plans.

A key to maintaining faculty and administrative relationships is providing honest appraisals of the firm’s situation and future plans.

Firms also pay attention to faculty involvement on campus. One recruiter said, “At the banquets and meetings, faculty attendance and involvement is obvious. If the faculty members are not there to see our commitment, they cannot trumpet it to the students. This affects the campuses we recruit on.”

**Increase Minimum Interview Standards and Apply Consistently**

Finally, companies and firms have distinguished their starting candidate pool by increasing the minimum interview standards. For several years, positions in commercial banking and investment banking had all but dried up; finance, marketing, economics, and other business majors started taking accounting courses and applying for accounting positions. One corporate recruiter stated—

In large markets, we have an excess number of accounting applicants and also finance and economics applicants that could not find positions in once booming commercial and investment banking markets. The students in these other fields have taken or are willing to take additional accounting courses as electives to qualify for our positions.

This was a common theme heard among all the Big Four firms and several regional firms, with offices in Atlanta, Charlotte, Chicago, and New York. This signifies the increased competition within the profession.

According to national recruiters, many firms have raised the minimum GPA to 3.3 (from 3.0), and even to 3.5 (from 3.3) in competitive urban markets. In addition, firms are requesting transcripts prior to on-campus interviews and are examining students’ performance in accounting and business courses to discover any grade replacements or multiple attempts. Work experience, even if not professional experience, is a requirement.

For example, Ernst & Young indicated that 98% of its interns and permanent hires had work experience. Volunteer and non-professional experiences that provide many leadership opportunities and develop workplace skills are considered valuable. Candidates must exhibit true leadership; one of the primary indicators of leadership is holding a position as an officer in student organizations, rather than simply being a member.

Furthermore, many firms are looking for indicators of good ethics, such as membership in honors fraternities like Beta Alpha Psi and Beta Gamma Sigma. Some firms are checking applicants’ background, credit, and
even driving records. They are paying attention to and verifying claims made on resumes. For example, one recruiter said, “If a student indicates an expertise with Microsoft Word and Microsoft Excel, then we examine the formatting of the resume for the use of tabs and other Microsoft Word tools.” Firms are starting early and doing up-front work in order to minimize failed hiring and improve the return on their recruiting dollars.

**Achieving Strategic Success**

As organizations continue to do more with less, pressure to hire and retain the best and the brightest in an efficient and cost-effective manner grows. In many accounting firms and companies, hiring practices have been revised or changed completely to improve the long-term strategic success of recruiting. Employers are seeing improvements in recruitment, while simultaneously reducing cost. Based on the authors’ interviews with national and regional recruiters and with human resources managers, accounting firms and other organizations should consider implementing the four best practices detailed above in order to improve recruiting.

These changes in recruiting practices might lead faculty and university administrators to change their strategies for student placement. Employers want students to recognize the significant financial commitments necessary to support internships and hiring programs. Employers want to build sustainable relationships with universities that reflect a long-term exchange of economic resources for intellectual resources. If the employer-university relationship becomes one-sided, however, employers are committed to immediate and potentially permanent change. Universities and students need to anticipate and accommodate recruitment changes driven by the economy.

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The U.S. GAAP Convergence and IFRS website is one of several special-focus sites maintained by PricewaterhouseCoopers (PwC) to provide expertise-based resources to the general public. This specialty website, www.pwc.com/us/en/issues/ifrs-reporting/index.jhtml, addresses issues related to U.S. GAAP and IFRS and offers comparisons of the two sets of accounting standards in the form of articles, booklets, reports, surveys, videos, and webcasts. Most of the content is available without subscription, but some videos and webcasts require free registration if they include continuing professional education (CPE) credit.

The homepage promotes some of the website’s featured resources, whereas the main topic pages provide more detailed navigation indexes. The site’s major focus is the convergence process, as well as similarities and differences between U.S. GAAP and IFRS.

Publications

The site offers a variety of publications and articles, which also link to related resources under other specializations. “The Importance of Being Financially Bilingual” provides a short perspective on U.S. GAAP versus IFRS by addressing the usefulness of identifying financial reporting differences and of understanding how financial reporting and regulatory requirements interact in cross-border transactions. This 12-page booklet discusses some of the basic differences between U.S. GAAP and IFRS from a market-valuation standpoint; it also provides a comparison of income reconciliation under the standards.

More in-depth coverage can be found in “IFRS and U.S. GAAP: Similarities and Differences,” a 232-page report published annually that can be downloaded in full. It discusses the impact of IFRS on changes to U.S. GAAP and why knowledge of IFRS is important, despite slowed progress toward convergence. It also contains summaries of the standards’ major differences and other accounting and reporting topics.

“U.S. GAAP Convergence and IFRS: What You Need to Know about the IASB and FASB’s Joint Projects” is a customizable collection of PwC’s current convergence publications. Users can download an overview of the most recent FASB/IASB joint activities, as well as project-specific documents covering 11 areas (e.g., financial instruments, revenue recognition, fair value measurement, consolidation). Industry supplements are also available in certain areas.

The 280-page “IFRS Adoption Status by Country” reviews the rules for listed and statutory filings, IFRS convergence plans, and tax regimes for approximately 130 countries, grouped geographically.

The IFRS: Current Situation and Next Steps webpage summarizes a July 2012 SEC
The staff report concludes that most participants in the U.S. capital markets do not support adopting IFRS in the United States; however, the SEC staff believes that there is sufficient support for exploring other methods of incorporating IFRS (e.g., endorsement). The staff report doesn’t include a final policy recommendation. This webpage includes links to an IFRS adoption map and PwC’s U.S. IFRS outlook survey.

Surveys
This website offers summary reports on two PwC international accounting-related surveys. “The 2011 U.S. IFRS Outlook Survey: Companies’ Thoughts on the Best Timing and Methods for Incorporating IFRS in the U.S. Financial Reporting System” examines the responses of more than 2,700 business executives from a variety of companies and industries. Approximately 63% (down from 80% in an earlier survey) believed that the SEC would eventually require mandatory IFRS reporting in the United States. Endorsement, defined as incorporating IFRS into U.S. GAAP, was viewed as a viable alternative by 75% of respondents, although only 35% thought it was the most appropriate action for U.S. markets. Some participants thought that keeping U.S. GAAP while moving closer to IFRS presented a better option. Although two-thirds of participants stated that voluntary adoption should be allowed, only 21% said that their companies would consider it.

“The 2011 U.S. GAAP Convergence and IFRS Survey: How Companies Are Preparing for Convergence between U.S. GAAP and IFRS” addresses the views of 1,400 executives and professionals on the convergence process. Although 43% of respondents thought the pace of convergence was too fast, 15% thought it was too slow. With respect to the top three convergence projects, executives rated leasing as having the greatest effect; revenue recognition and financial instruments placed second and third, respectively. Respondents indicated similar expectations for how long each would take to implement. Whereas 30% expected significant improvement in the quality of U.S. GAAP and IFRS to result from the convergence projects, 37% thought the cost of implementation exceeded the perceived benefit.

Videos and Webcasts
The IFRS video learning center features 16 technical sessions and four industry-sector sessions that address the differences between U.S. GAAP and IFRS. These videos run for approximately 30 minutes and require users to fill out a brief registration form in order to view them for free.

The industry sector presentations focus on energy and utilities. The technical sessions include topics such as revenue recognition; property, plant, and equipment; consolidations; and classification. For example, the first-time adoption session covers key terms, required reconciliations, and disclosures. The income tax video discusses the major provisions of International Accounting Standard (IAS) 12, Income Taxes, as well as similarities and differences with U.S. GAAP.

The IFRS video perspective series currently offers six free four- to eight-minute discussions featuring three PwC partners. Topics include consistency of IFRS application, the concept of endorsement, the speed of potential change, and next steps for U.S. companies. U.S. GAAP Convergence and IFRS webcasts are offered periodically and enable viewers to obtain CPE credit at the time of the live broadcast. (Archived webcasts are accessible without CPE credit.) Users can also access webcasts—generally 60 to 90 minutes—on revenue recognition, classification and measurement of financial instruments, and leasing.

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ECONOMIC & MARKET DATA
monthly update

Forté Capital’s Selected Statistics

U.S. Equity Indexes 5/31/13 YTD Return
S&P 500 1,631 14.30%
Dow Jones Industrials 15,116 15.30%
Nasdaq Composite 3,456 14.50%
NYSE Composite 9,302 10.20%
Dow Jones Total Stock Market 17,015 14.70%
Dow Jones Transports 6,290 18.50%
Dow Jones Utilities 482 6.40%

Selected Interest Rates 5/31/13 4/30/13
Fed Funds Rate 0.09% 0.14%
3-Month Libor 0.28% 0.27%
Prime Rate 3.25% 3.25%
15-Year Mortgage 4.07% 3.59%
1-Year ARM 2.54% 2.62%
3-Month Treasury Bill 0.04% 0.06%
5-Year Treasury Note 1.07% 0.30%
10-Year Treasury Bond 2.18% 1.67%
10-Year Inflation Indexed Treas. −0.05% −0.64%

Forté Capital’s Proprietary Market Risk Barometer
Bullish Neutral Bearish
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Market Valuation
Monetary Environment
Investor Psychology
Internal Market Technicals
Overall Short-Term Outlook 5.71 As of 5/31/13
Overall Long-Term Outlook 4.74

Equity Market Statistics 5/31/13 4/30/13
Dow Jones Industrials
Dividend Yield 2.54% 2.49%
Price-to-Earnings Ratio (12-Mth Trailing) 15.29 15.09
Price-to-Book Value 2.94 2.89
S&P 500 Index
Earnings Yield 6.03% 6.17%
Dividend Yield 2.16% 2.12%
Price/Earnings (12-Mth Trailing as Rpt) 14.89 14.54
Price/Earnings (Estimated 2012 EPS) 14.89 14.54

Key Economic Statistics

National
Producer Price Index (monthly chg) 0.50% −0.70%
Consumer Price Index (monthly chg) 0.10% −0.40%
Unemployment Rate 7.60% 7.50%
ISM Manufacturing Index 49.00 50.70
ISM Services Index 53.70 53.10
Change in Non-Farm Payroll Emp. 175,000 165,000

New York State
Consumer Price Index - NY, NJ, CT (monthly) 0.10% −0.20%
Unemployment Rate 7.60% 7.80%
NYS Index of Coincident Indicators (annual) 4.61% 6.20%

Commentary on Significant Economic Data This Month

Although the labor market has continued to add jobs at a modest pace, this pace has slowed since the beginning of the year. In May 2013, payroll employment increased by a net of 175,000 new jobs, which was slightly above consensus estimates. The three-month moving average of net job gains was 155,000, as compared to average net job gains of 207,000 during the first quarter of the year. This addition of new jobs was driven by the private sector, which added 178,000 jobs, whereas the government sector shed 3,000 jobs. The unemployment rate increased from 7.5% to 7.6%, as the growth in the labor force participation rate increased from 63.3% to 63.4%. Weak global demand has caused the manufacturing sector to reduce payrolls for the past three months, but the strengthening housing market is supporting construction payroll and building-related manufacturing.

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Environmental sustainability has taken center stage as the responsible and successful way to operate a business in the 21st century. According to the U.S. Environmental Protection Agency, “Sustainability creates and maintains the conditions under which humans and nature can exist in productive harmony” (http://www.epa.gov/sustainability/basicinfo.htm). It is essential to ensuring the continued availability of water, materials, and other natural resources needed to safeguard human health, while also balancing the environmental, social equity, and economic demands of present and future generations.

Large corporations, such as Walmart and the Ford Motor Company, have already followed the impetus to “go green.” Some achievements cited in Walmart’s 2013 Global Responsibility Report include the installation of doors on refrigerated supermarket cases in Brazil and Mexico, as well as a change to higher efficiency motors for walk-in coolers and freezers in the United States and Puerto Rico. Ford reduced the carbon dioxide emissions from its vehicles by 37% from 2000 to 2010, and the company is planning an additional 30% decrease by 2025. Ford also substantially reduced the amount of waste it sent to landfills by sending paint solids from its factories to utility plants for use as a fuel source. Ford’s CFO, Robert L. Shanks, has made it clear that the company’s sustainability decision is part of a larger strategy to enhance its financial stability and profitability.

The CPA’s Role

Sustainability efforts are increasingly becoming the responsibility of those in control of an organization’s purse strings, and most financial experts relate to the bottom line—a business can’t be sustainable if it isn’t profitable. But are sustainability and profitability mutually exclusive? The following ideas (inspired by the Sustainability Initiative) represent some strategies that a business can use to enhance its sustainability efforts while improving its profitability:

- **Use automation to control costs.** Automation can help businesses work more efficiently, reduce labor costs, and control energy usage.
- **Reduce chemical use.** This can save money and can represent an appealing marketing aspect for consumers.
- **Use energy efficiently.** This can control costs while reducing one’s carbon footprint. According to the U.S. Department of Energy, “Quality LED products can last 25 times longer than an incandescent bulb and use 75% less energy” (http://www.energy.gov/energysaver/articles/led-lighting).
- **Consider alternative resources.** Advancements in technology have made renewable energy sources, such as wind and solar, viable options for business. Durable and fast-growing wood, such as bamboo, helps to ensure a plentiful supply of materials to satisfy customer demand.
- **Conserve water.** Rainwater recapture systems used by greenhouse businesses have helped to add to the bottom line while saving a precious resource.
- **Consider logistics.** Better product tracking from shipping point to destination can improve the efficiency of the shipping process and enhance customer relations.

Whenever businesses—especially small businesses—consider going green, one primary concern has been the cost-benefit relationship. In reality, businesses that are serious about sustainability are focused on the efficient use of limited resources. The examples above challenge the common misconception that going green will cost more. Sustainability and profitability are not actually at odds with one another; rather, they are complementary.

**Looking to the Future**

We’ve already begun to see the effects of energy-related carbon dioxide emissions and the resulting rise in temperatures: droughts, heat waves, changing rainfall patterns, rising sea levels, and floods. This is just the tip of the iceberg.

So, CPAs, here’s your chance to be a superhero. Whether you’re a trusted advisor within your company or to your firm’s clients, you can help save the earth by making sustainability-conscious decisions.

As always, I welcome your comments.

Mary-Jo Kranacher, MBA, CPA/CFF, CFE
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